

Misconduct and Fraud in Unregistered Offerings: An Empirical Analysis of Select SEC Enforcement Actions¹

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ABSTRACT:

While more than \$2 trillion of capital is raised annually through unregistered offerings of securities that relied on an exemption from registration, very little research exists about the extent and type of misconduct, including fraud, in this space. This study analyzes a distinct, hand-collected set of SEC district court enforcement actions related to offerings involving unregistered securities to provide insights into the characteristics of the offerings that result in these enforcement actions as well as those of issuers, investors, and intermediaries who participate in them. Of the more than 73,000 offerings initiated during 2014-2015 that relied on an exemption from registration, I identify 210 unique SEC district court enforcement actions, including 130 cases where the Complaint was first filed in civil court during the 2-year period. Analyzing the 210 cases, I find that a vast majority of these offerings may not have complied with exemptions from registration, and may have been conducted in disregard of securities laws. The most frequent types of issuers in these offerings are pooled investment funds, financial firms, oil and gas companies, pharmaceutical companies and technology firms. A significant number of these offerings involved solicitation of unsophisticated investors. I also find that most intermediaries in the analyzed enforcement cases are unregistered and are defendants in the case, that recidivist participation in these cases is greater in the financial services and private fund sectors, and that internet-based solicitations are the most commonly used solicitation modes in these offerings.

¹ *The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission. The author prepared this white paper as a part of the Division of Economic and Risk Analysis (DERA) White Paper series. Jeannette Crawford, Mareisa Ho, Alexandra Kokinchak, Enrique Lopez, and Sze Wing Wong provided research assistance.*

1. INTRODUCTION

The market for raising capital through unregistered offerings of securities that rely on available exemptions (exempt offerings),² attracts a large number of issuers and investors and has become a significant method for capital formation in the U.S. economy. As shown in Section 2 below, there were almost 15 times as many new exempt offerings than in registered debt and equity markets during 2014-2017. In terms of capital formation, more than \$2.7 trillion was reported to be raised in new exempt offerings during 2017, while approximately \$1.8 trillion was raised through registered offerings of securities. In the past few years, regulatory changes have better enabled firms, especially small firms, to utilize existing and new exemptions to raise capital.³ The numbers presented above for exempt offerings capture only a subset of all unregistered offerings as data on offerings conducted in accordance with certain exemptions, for example Section 4(a)(2) offerings, is not easily available. These numbers also do not reflect offerings that are conducted in violation of the federal securities laws as a result of a failure to register when an exemption is not available (i.e. illegal offerings).

Yet, despite the large size of the unregistered offerings market, very little is known about the prevalence and type of misconduct that exists with respect to these offerings. The steady increase in issuers across industries and size utilizing private placements in the past 10 years, and the growth of investor interest could in itself suggest that fraudulent behavior may not be widely prevalent in these offerings. Particularly, since the adoption of the 2012 JOBS Act provisions that permitted advertising in private offerings for the first time and created new exemptions for private offerings to solicit from less sophisticated investors, there has not been a noticeable spike in cases alleging violations of provisions of securities laws.⁴ But understanding fraudulent actions in this market informs SEC's mission to maintain fair and efficient securities markets, and to protect investors while facilitating capital formation. As yet, due to insufficient or inaccessible data, it has been difficult to assess the extent and type of possible misconduct in private offerings that fail to qualify for an exemption from registration. While data is available with respect to offerings conducted in reliance on federal exemptions such as Regulations D, A and Crowdfunding or resales of unregistered securities under Rule 144, very little data is available with respect to the incidence of fraud in securities offerings

² Under the federal securities laws, a company may not offer or sell securities unless the offering has been registered with the SEC or an exemption from registration is available. Unregistered offerings are sometimes referred to as private offerings or exempt offerings. See, https://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html.

³ See, e.g., regulatory changes adopted pursuant to Titles II, III, and IV of the Jumpstart Our Business Startups Act of 2012 (JOBS Act).

⁴ See, for example, <https://www.investmentnews.com/article/20151028/FREE/151029905/secs-white-says-private-placement-fundraising-booming-but-fraud-is>

conducted pursuant to a valid exemption from registration or for offerings that are illegal. Additionally, a significant number of unregistered offerings are conducted by early-stage firms, start-ups and small firms⁵. Survival rates for such firms tends to be low⁶ and often, it may be difficult to distinguish between business factors and fraudulent motivations that may have led to the failure, making data collection in this space challenging. As a result of all these factors, there are few insights – academic, industry, or regulatory into possible violative conduct in the offering space.

In this study, I provide some insights into the scope of possible fraud and misconduct in the unregistered offerings market by analyzing SEC district court enforcement actions and Form D filings. Publicly-available information from litigation releases and related documents concerning SEC enforcement actions (for example, complaints filed by SEC in district courts) is used to identify characteristics of issuers, investors, and intermediaries who participated in the offerings that were the subject of the enforcement actions. Due to the limited amount of information available in cases under administrative proceedings, my sample of 210 cases is derived entirely from cases that were being litigated by the Commission in civil courts.

I find that a majority of offerings in the sample were outright fraudulent offerings that failed to register and did not qualify for an exemption from registration. More than \$7.1 billion was solicited from investors in the sample of offerings. While approximately half the cases involved an alleged violation under Sections 5(a) and 5(c) of the Securities Act of 1933 (Securities Act),⁷ almost 95% of the cases involved alleged violations under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act)⁸ and about a quarter of the cases included charges under the Investment Advisers Act of 1940 (Advisers Act). The most frequent types of issuers in these offerings are pooled investment funds, financial firms, oil and gas companies, pharmaceutical companies and technology firms. The issuer or its control person was a defendant in 82% of the cases, whereas intermediary misconduct was alleged to be present in approximately 55% of the cases. More than a quarter of the identified unregistered offerings in

⁵ For example, 88% and 76% of issuers voluntarily reporting in Form D filings for conducting a Regulation D offering report that they are less than 5 years and 2 years old when they conduct the capital offering.

⁶ Per Bureau of Labor Statistics., approximately 30% of small businesses fail within the first three years and 50% fail within the first five years since inception. See, <https://www.bls.gov/bdm/entrepreneurship/entrepreneurship.htm>

⁷ Under the federal securities laws, a violation of Section 5 of the Securities Act may be determined upon a showing that: (1) no registration statement was filed or in effect as to the offer and sale of the securities; (2) a person, directly or indirectly, sold or offered to sell the securities; and (3) the sale or offer to sell was made through the use of interstate facilities (including the mail). Once a *prima facie* violation of Section 5 is established, the burden shifts to the person claiming an exemption from registration to establish the availability of the claimed exemption. See, <https://www.sec.gov/divisions/marketreg/faq-broker-dealer-duty-section4.htm>.

⁸ Section 10(b) is an anti-fraud provision of the Exchange Act, and Rule 10b-5 is the rule the SEC promulgated thereunder. Rule 10b-5 prohibits the use of any "device, scheme, or artifice to defraud.

https://www.law.cornell.edu/wex/securities_exchange_act_of_1934.

the analyzed enforcement cases involved a recidivist.⁹ Recidivists were more frequently present in offerings conducted by issuers in the financial and private fund industries, compared to non-financial industries *viz.* operating firms. Almost 40% of the cases in the sample involved the solicitation of unsophisticated and vulnerable individuals and entities (for example, the elderly, unemployed, and affinity-based). This proportion increases to over 50% when investors solicited in pump and dump schemes are included. Based on solicitation methods described in the case documents, internet-based solicitation methods (website, chatrooms, ads, email, videos, social media) are the most commonly used methods for attracting investors. Most offerings lure investors by promising high returns at low or no risk. A number of offerings used celebrity endorsements and outright misrepresentations to persuade investors.

Based on the data available from the sample of SEC litigated cases, one of the various types of regulatory enforcement actions, the findings indicate that offerings involving an unregistered intermediary or a recidivist, or those that solicit from unsophisticated investors are more likely to involve fraudulent behavior. This suggests that for example, coordination across various regulators, at state and federal levels, for tracking persons or entities found in previous violation of securities laws, may assist compliance and enforcement efforts in this space. Additionally, these findings, along with the frequency of sample cases in certain types of industries indicates that investor education for some types of investors and enforcement measures focused on issuers and intermediaries in certain sectors may affect the extent of misconduct in the exempt offerings market and more importantly identify red flags in offerings that are conducted in disregard of securities laws.

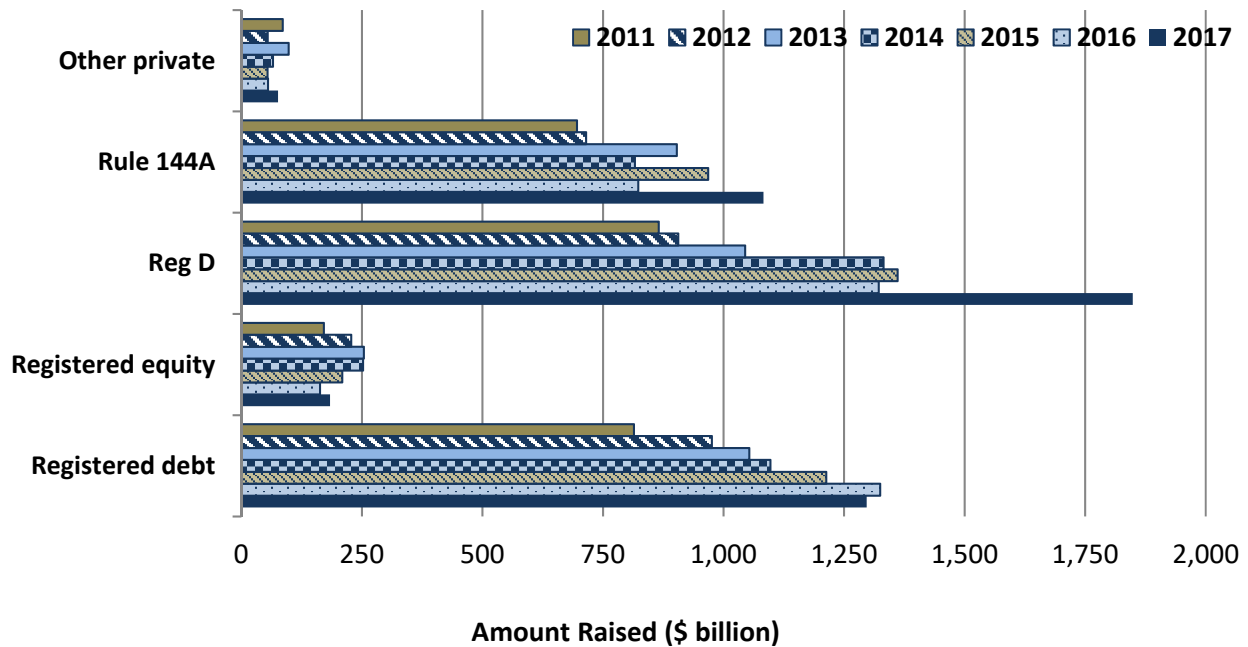
In the next section, I provide a description of recent trends in capital formation activity in exempt offerings markets relative to registered offerings. I also provide regulatory context to underscore the significant role of the exempt offerings market in the U.S. financial markets and consequently the importance of understanding the extent and type of misconduct in this space. Section 3 provides an overview of prior studies in securities offering fraud. Section 4 describes the data and the source of data. Sections 5 and 6 provide the results of my analysis.

⁹ Recidivists refer to persons previously charged or persons previously enjoined or found to have violated the laws including state securities laws and criminal laws. From the information available, none were ‘bad actors’ under the ‘bad actor’ disqualification provisions under Regulation Ds, A or Crowdfunding.

2. THE EXEMPT OFFERINGS MARKET

Regulatory compliance for issuers to conduct an offering registered with the SEC requires an extensive initial information production and subsequent annual and periodic reporting. A vast majority of U.S. businesses choose not to register their securities offerings.¹⁰ Figure 1 below shows the amount of capital reported to be raised through registered offerings of debt and equity and through exempt offerings (Regulation D, Rule 144A and other offering exemptions - Regulations A, S and Crowdfunding) during the years 2011-2017. As the figure shows, substantially larger amounts were raised in private capital markets, including more than \$2.7 trillion in 2017, compared to registered offerings markets which raised \$1.5 trillion.

Figure 1: Amounts Raised in Registered and Exempt Offerings of Securities¹¹

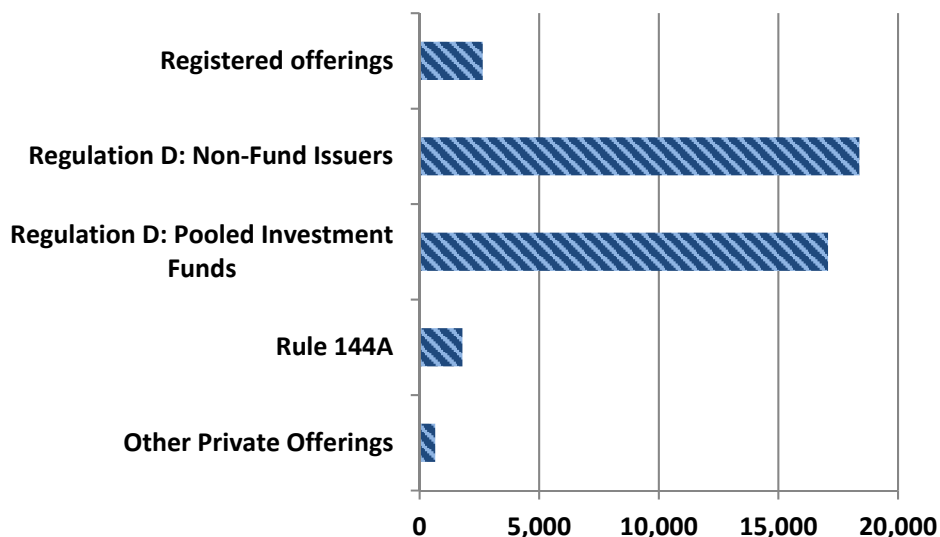


¹⁰ A substantial number of firms choose to stay private and not become a public company. See e.g., Brau J. and S. Fawcett, "Initial Public Offerings: An Analysis of Theory and Practice," *Journal of Finance* 2006, 61, 399-436. A number of public companies also opt to raise capital through private offerings. See, e.g., Gomes, Armando and Gordon Phillips, "Why do public firms issue private and public securities?," *Journal of Financial Intermediation* 2012, 21, 619-658.

¹¹ Data for Regulation D offerings from EDGAR Form D filings; for registered debt and equity offerings, and other private offerings from Thomson Financial - SDC Platinum; for Rule 144A offerings from SDC Platinum and Dealogic databases. See, Bauguess, Scott, Rachita Gullapalli and Vladimir Ivanov, "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Offerings, 2009-2017", August 2018 ('Unregistered offerings Study') for details regarding methodology used in analyzing data for amounts reported to be sold in each of these offering types. While on average, the kind of issuers that participate in these markets can be quite different, some issuers access

A similar picture emerges when I consider the number of unique issuers or number of offerings initiated in these markets. Information available from EDGAR filings shows that during 2017 more than 40,000 offerings raised capital in the exempt offerings markets, while approximately 2,822 offerings were conducted in registered securities markets.¹² Figure 2 shows that the average number of unique exempt offerings during 2014-2017 also far exceeded the average number of registered offerings of securities.

Figure 2: Average (Annual) Number of Exempt Offerings of Securities during 2014-2017



The number of firms that are willing and able to access public markets is very small relative to the total number of firms in the US. According to the U.S. Census, there were approximately 7.6 million employer-based U.S. establishments in 2014.¹³ Including non-employer businesses, the number of establishments increases to almost 23 million establishments.¹⁴ In comparison, there

multiple markets to raise capital. For example, registered debt and equity markets comprise of mature, relatively larger firms, but also microcap firms, and firms quoted on over-the-counter markets. Rule 144A is relied on by large corporate entities who primarily raise corporate debt, and foreign firms that raise equity and debt. Regulation D issuers tend to be young and small firms but may also include certain large and publicly listed firms. A large proportion of capital is raised by private funds, also known as pooled investment funds.

¹² *Id.* 2009-2017, the average number of exempt offerings conducted each year was approximately 35,000, while the average number of registered equity/debt offerings was 2,600. Almost 93-95% of the exempt offerings relied on Regulation D.

¹³ U.S. Census, <https://www.census.gov/data/tables/2014/econ/susb/2014-susb-annual.html>. An establishment is defined as a single physical location where business is conducted or where services or industrial operations are performed.

¹⁴ Data for 2014 from Small Business Administration website. See, https://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016_WEB.pdf. A non-employer business is defined as

were only approximately 4,400 U.S. exchange-listed companies during 2014-2017.¹⁵ The number of exchange-listed companies has declined steadily since 2011¹⁶ due to firms delisting or deregistering with the Commission and because fewer new firms are going public. Various reasons have been attributed in academic studies for the shift,¹⁷ including firms' preference to be acquired rather than go public (economies of scope), declining market conditions, increased costs of SEC disclosure requirements, and the expanded scope of regulatory exemptions that may make private placements more attractive and allow firms to grow without having access to a larger pool of investors. This recent decline in the number of listed companies coupled with the significantly larger pool of US firms that choose not to access or do not find it feasible to access registered offering markets, highlights the increasing role of private capital markets in financing the investment needs of U.S. firms, especially for small businesses.

While the US has active exempt capital markets, there is by design, less oversight and regulation of these markets than registered capital markets. A vast majority of firms that conduct exempt offerings tend to be private firms that are not reporting to the SEC.¹⁸ This can result in lower levels of disclosure and transparency, which could lead to increased levels of information asymmetry between firms that are seeking to raise capital and their investors. While sophisticated investors in the private equity markets may be able to conduct extensive diligence and oversight, unsophisticated and retail investors may not possess the ability or

one that has no paid employees, has annual business receipts of \$1,000 or more (\$1 or more in the construction industries), and is subject to federal income taxes.

¹⁵ There were 4,369 and 4,336 listed domestic companies in 2014 and 2017, respectively. See, World Federation of Exchanges Database, World Bank. <http://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US>. Including non-exchange listed companies (for example OTC companies), the number of companies reporting to SEC and filing Form 10-K in 2016 was 7,395. This excludes foreign private issuers opting to file Series F forms. See Final Rule "Amendments to Smaller Reporting Company Definition", available at: <https://www.federalregister.gov/documents/2018/07/10/2018-14306/smaller-reporting-company-definition>.

¹⁶ *Id.* World Federation of Exchanges database shows that the number of listed domestic firms was 4,279 in 2010, compared to 6,177 in 2001, and 8,090 in 1996.

¹⁷ See, e.g., Marosi, Andras and Nadia Massoud, "Why do Firms Go Dark", *Journal of Financial and Quantitative Analysis* 2007, 42(2), 421-442; Gao, Xiaohui, Jay R. Ritter, and Zhongyan Zhu, "Where Have All the IPOs Gone?", *Journal of Financial and Quantitative Analysis* 2013, 48(6), 1663-1692; Doidge, Craig, G. Andrew Karolyi, and René M. Stulz, "The U.S. left behind? Financial globalization and the rise of IPOs outside the U.S.", *Journal of Financial Economics* 2013, 110(3), 546-573; Doidge, Craig, G. Andrew Karolyi, and René M. Stulz, "The U.S. listing gap", *Journal of Financial Economics* 2017, 123(3), 464-487. The number and volume of IPOs have picked up during 2019 with the second quarter showing a 5-year high in IPO activity. See DERA's Economic and Risk Outlook, November 2019 available at https://www.sec.gov/files/DERA_Quarterly%20Economic%20and%20Financial%20Outlook%20Nov%202019.pdf

¹⁸ For example, DERA staff analysis of Form D filings from 2009-2017 shows that approximately 8% of Regulation D offerings are conducted by firms that are listed or subsequently listed on a national exchange, or quoted on OTC markets. See, Unregistered Offerings Study.

resources to evaluate the potential risk-reward tradeoffs of investment in the securities of an issuer through an unregistered offering.

Illiquidity in the securities of an unregistered offering can also adversely impact unsophisticated investors to a greater extent. Securities purchased in unregistered offerings are often restricted from being sold for a period that can extend up to one year.¹⁹ Even after the restricted period has expired, it may be difficult for investors to liquidate securities of private firms that are not traded on a public exchange or quoted over-the-counter.

Most exemptions and safe harbors that allow exempt offerings have some form of restrictions for participation by unsophisticated investors. For example, Rule 506(c) of Regulation D allows for general solicitation, but sales are limited to “accredited investors,” which the Commission currently defines based on income and net worth standards. While there is academic literature showing correlation between wealth and financial sophistication, concerns have been expressed that the pool of accredited investors may include individuals that are wealthy but financially unsophisticated;²⁰ and that not all such investors may adequately understand the risk-reward tradeoffs of investing in unregistered securities offerings that do not undergo both the Commission and a market review process.

In this context where investors in unregistered offerings possibly face greater constraints with respect to information, liquidity and regulatory supervision, misconduct and fraud in the conduct of such offerings could adversely impact the supply of capital from investors. This may impede capital formation, especially for small businesses that are unlikely to have options beyond private capital markets. Thus, to ensure well-functioning private capital markets that facilitate capital formation, protecting investors from possible fraud and misconduct remains an important concern in the unregistered offerings space. Understanding the extent and type of possible misconduct in this space could help federal and state regulators undertake precautionary measures (e.g., investor education) and corrective measures (e.g., enforcement actions) that are focused on reducing possible fraudulent activity in this space.

¹⁹ See, <https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html>.

²⁰ See, Section IV(B) of “Report on the Review of the Definition of “Accredited Investor,” December 18, 2015, available at <https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf>. Some commenters have also suggested that the standard is under-inclusive as certain financially sophisticated individuals that do not meet the income/net worth tests may not qualify.

3. PRIOR ACADEMIC AND OTHER STUDIES

Empirical analysis of fraud and misconduct is challenging because only detected instances of possible fraud and misconduct are available for analysis. These challenges are exacerbated in private offerings because they are not registered with the Commission, and as a result, much lower level of information is available for review and analysis by regulators and certain market participants, including gatekeepers like underwriters and specialized investors.²¹ There appear to be no academic studies that examine fraudulent offerings in private capital markets, and there are very few that study fraud in registered offerings. For example, Wang *et al.* (2010)²² study the frequency of detected fraudulent activity in firms that conducted an initial public offering (IPO) between 1995 and 2005. They find that of 3,297 IPO issuers, 382 were sued for accounting-related financial fraud between 1996 and 2007 by the Commission or in private litigation.²³ Of these, 110 fraudulent actions (of which 30 had an SEC enforcement action) were alleged to have occurred before or during the IPO year, which the authors verified were committed in order for the issuers to go and label them as IPO frauds. The remaining instances of corporate fraud occurred after the IPO year. The study finds that the identification of IPO fraud, relative to optimistic times, decreased substantially during periods when investors were pessimistic about market conditions (e.g., after the tech boom in 2000). They show that underwriters and specialized investors who are likely to have more skills, resources and incentives to monitor firms, act as an important check on fraud, and are likely to be more vigilant during bad times. The authors also find industry concentration in the observed fraud, with fraud detected most often in the business services, computer software, electronic equipment, pharmaceutical and communications industries.²⁴

In contrast to research on offering fraud in primary capital markets, there is a large body of research on other types of corporate fraud, including accounting fraud and secondary market fraud involving registered securities, such as insider trading, microcap fraud and market manipulation. While these studies do not directly apply to unregistered offering fraud, they may provide some insights that could be extended to private offerings that solicit retail

²¹ Specialized investors can be those with a greater degree of expertise or resources to assess the risk-reward tradeoffs of investing. For example, venture capital firms, private equity firms, large financial institutional investors.

²² Wang, Tracy, Andrew Winton and Xiaoyun Yu, "Corporate Fraud and Business Conditions: Evidence from IPOs", *Journal of Finance* 2010, 65(6), 2255-2292. The study uses SEC's Accounting and Auditing Enforcement releases and private securities class action lawsuits to identify detected fraud.

²³ *Id.* p.2268. The 382 frauds were obtained from the merger of IPO sample (3,297) and litigation sample of firms involved in accounting irregularities and subject to SEC actions (423) and private class action lawsuits (1085, of which 212 were subject to SEC enforcement as well).

²⁴ These are also industries that have the highest numbers of IPOs during the study period. Based on analysis of IPOs in SDC Platinum database.

investors, particularly some of the findings of research related to investment and fraud in securities that are traded or quoted on over-the-counter (OTC) markets. OTC issuers often are small or microcap companies²⁵ with a significant presence of retail investors. A large number of OTC firms do not file with or report to the Commission, and because of lower disclosure obligations and higher information asymmetry, stocks of microcap and small issuers are relatively illiquid and may be often susceptible to manipulative market schemes.²⁶ The capital raising and subsequent secondary market environment for unregistered offering issuers, especially those that solicit from retail investors, is also marked by higher information asymmetry, illiquidity and lower regulatory oversight of relatively small and young issuers. Fraud and misconduct in unregistered offerings can also be impacted by firm-level factors and macroeconomic conditions. A few academic studies related to corporate fraud risk factors suggest that fraud is related to general business conditions as well as financial conditions within the firm, and that fraud is more likely to occur when there are fewer outside gatekeepers like underwriters, analysts and regulators.²⁷

²⁵ These are companies that have market capitalization less than \$50 million, and between \$50 million and \$300 million, respectively.

²⁶ These schemes often involve stock promoters who tout the securities through persuasive sales tactics that promise high yields by investing at low prices. Their tactics are meant to increase demand and liquidity for the stock in order to conduct transactions at inflated prices. See, for example, Nelson, K., Price, R., Rountree, B., "Are individual investors influenced by the optimism and credibility of stock spam recommendations?" *Journal of Business Finance and Accounting* 2013, 40, 1155–1183.

A recent study finds that investments by elderly and other vulnerable individual investors (i.e. less educated, lower income and net worth, less residential stability) in promoted microcaps tend, on average, to perform worse than investments of other investors in microcap stocks (White, Joshua T., "Outcomes of Investing in OTC Stocks", White Paper, U.S. Securities and Exchange Commission 2016; https://www.sec.gov/dera/staff-papers/white-papers/16dec16_white_outcomes-of-investing-in-otc-stocks.html). Some academic studies have posited that investors may be attracted to OTC stocks because of the perception of "lottery like payments", where a small change in price can generate a large investment return, in terms of percentages (See for example, Brüggemann, U., Kaul, A., Leuz, C., Werner, I., "The twilight zone: OTC regulatory regimes and market quality", Working Paper, National Bureau of Economic Research 2016). Other studies find that even sophisticated investors with high level of resources experience negative returns, which could suggest that informational asymmetries and manipulative tactics (rather than naiveté) may play a larger role in explaining investor behavior in these markets (See for example, Nofsinger, J., Varma, A., "Pound wise and penny foolish? OTC stock investor behavior", *Review of Behavioral Finance* 2014, 6, 2–25).

²⁷ See for example, Povel, Paul, Rajdeep Singh, and Andrew Winton, "Booms, busts, and fraud", *Review of Financial Studies* 2007, 20, 1219–1254. finds that fraud levels peak when investors believe financial and business factors are good;

Some studies examine the effect of growth, leverage, and external financing needs on corporate fraud. They find that corporate fraud and financial fraud are more likely to occur when there are fewer outside gatekeepers, often during deteriorating financial conditions, with the objective of covering up the slowdown in order to maintain high stock market valuation. See, Crutchley, CE, Jensen M, Marshall BB., "Climate for Scandal: Corporate Environments that Contribute to Accounting Fraud", *Financial Review* 2007, 42, 53-73; or Dechow, Patricia, Ge W, Larson CR, Sloan Richard, "Predicting Material Accounting Misstatements", *Contemporary Accounting Research* 2011, 28, 17-82.

Besides corporate issuers, exempt offerings are often used by private investment funds to raise capital. These fund issuers include venture capital funds, hedge funds, and private equity funds. There is some academic research that relates to misconduct in the private fund space. For example, Atanasov et al. (2012)²⁸ show that older, more reputed venture capital (VC) funds are less likely to be sued for fraudulent activity. They posit that reputational mechanisms proxied by number of deals that a VC invests in prevent widespread fraud, and that litigation can enhance enforcement mechanisms related to reputation with entrepreneurs, by informing counterparties of fund misbehavior. While most academic studies on private funds do not directly study offering fraud in raising capital from investors, there is some research related to managerial manipulation and misstatement of fund performance.²⁹

In addition to academic studies, regulatory studies also provide insights into offering fraud. State securities regulators play an important role in monitoring the private offering space. The North American Securities Administrators Association (NASAA) issues enforcement reports every year that summarize enforcement actions filed by state regulators. Recent Enforcement Reports from NASAA show that during 2015,³⁰ the most reported products and schemes, in order of frequency of investigations reported by states, were Ponzi schemes, real estate fraud, oil and gas fraud, internet fraud and affinity fraud,³¹ while for calendar year 2014,³² the most frequently reported products and schemes were Ponzi schemes, Regulation D- Rule 506 offerings, real estate fraud, internet fraud, and oil and gas fraud. NASAA's 2015 report further states that "of the 746 reported cases of fraud, 484 involved unregistered securities, and 675 actions involved unregistered firms or individuals." The report also notes that more than half of all reported enforcement actions that involved a senior victim also involved an unregistered

²⁸ Atanasov, Vladimir, Vladimir Ivanov and Kate Litvak, "Does Reputation Limit Opportunistic Behavior in the VC Industry? Evidence from Litigation against VCs", *Journal of Finance* 2012, LXVII(6), 2215-2246.

²⁹ See, for example, Aragon, George and Vikram Nanda, "Strategic Delays and Clustering in Hedge Fund", *Journal of Financial and Quantitative Analysis* 2017, 52, 1-35. The authors find hedge fund managers tend to be strategic about report performance and often delay reporting bad performance; Similarly, Agarwal, Vikas, Naveen Daniel and Narayan Naik, "Do Hedge Funds Manage Their Reported Returns?", *Review of Financial Studies* 2011, 24 (10): 3281-3320 find that hedge funds inflate returns at the end of fiscal year to earn higher fees.

³⁰ See, NASAA 2016 Enforcement Report – Based on 2015 Data. http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2016/09/2016-Enforcement-Report-Based-on-2015-Data_online.pdf. The report is based on survey information provided by 50 states and 2 territories.

³¹ Investment fraud committed by luring members of identifiable groups, for example based on religious or ethnic communities, professional groups, etc.

³² See, NASAA Enforcement Report- 2015 report Based on 2014 Data, http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/08/2015-Enforcement-Report-on-2014-Data_FINAL.pdf. The report is based on survey information provided by 49 states.

security.³³ The report indicates that affinity fraud and unregistered securities scams disproportionately affect seniors.³⁴

4. DATA

I use data from litigation releases published by the SEC,³⁵ as a measure of detected fraud. Using textual analysis tools, filed actions that contain information related to unregistered offerings are identified. I consider unregistered offerings, for the purposes of the study, as offerings of securities that are not registered with the Commission. This includes both offerings that were not registered because they were exempt from registration and offerings that were in violation of securities laws because they were neither registered nor exempt.

I focus on litigation releases issued during the years 2014 and 2015. The SEC's filed complaints and related documents contain allegations and, at times, other information, including details about the issuer whose securities are involved in the offering, investors, intermediaries, and additional offering characteristics. This information was hand collected for the analysis presented below.

Throughout this study, I use the term "case" to represent an unregistered offering (or set of offerings) conducted in possible violation of federal securities laws, as alleged in a complaint filed by the SEC in federal court. A case, therefore, can include multiple and separate enforcement actions being filed in different jurisdictions against one or multiple offering participants; but it involves the same issuer (or set of issuers) and unregistered offering (or set of offerings). Based on this, I identify 210 unique cases that relate to enforcement actions in unregistered securities offerings.

Of the 210 unique cases that had a published litigation release during 2014-2015, 54 cases involved a complaint filed by SEC Enforcement staff during 2014 and 76 cases had a complaint filed in 2015.³⁶ The remaining 80 cases had a litigation release issued in 2014-2015, but the initial complaint was filed prior to 2014. Table 1 below presents the types of federal securities law violations charged in the cases. While 53% of the 210 cases involved an alleged violation under Sections 5(a) and 5(c) of the Securities Act, almost 95% of cases alleged violations of

³³ *Id.*

³⁴ *Id.*

³⁵ <https://www.sec.gov/litigation/litreleases.shtml>. In each published litigation release that is used in this analysis, the SEC's Enforcement staff had filed a complaint with a U.S. District Court containing allegations of possible securities fraud or misconduct that may result in a permitted remedy.

³⁶ The remaining cases had complaints filed during years prior to 2014, primarily during the period 2011-2013.

Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.³⁷ Approximately a quarter of the cases alleged violations of the Advisers Act, for example Section 206(1), 206(2) and 206(4). Other alleged violations include, among others, violations of Sections 15(a), 13(b), 16(a), and 20(a) of the Exchange Act.

Table 1: Types of Federal Securities Law Violations Identified in SEC Enforcement Cases

Statute(s) and Rule Violations	Number of Cases
Securities Act Sections 5(a) and 5(c)	111
Exchange Act Section 10(b) and Rule 10b-5 thereunder	202
Securities Act Section 17(a)	194
Advisers Act Section 206, among others	48
Other (e.g., Exchange Act Sections 20(a), 15(a))	57

94% of the 111 cases involving a Section 5 violation also involved a Section 17(a) and Exchange Act Section 10(b)/Rule 10b-5 violations. Only 18 of the 111 cases involving a Section 5 violation also involved a violation under Advisers Act.

Two primary caveats should be underscored when interpreting the data analysis below. The first is selection bias – SEC Enforcement actions provide only a partial window into the extent of all fraudulent activity. The prevalence of securities fraud can therefore be quite different from the incidence of ‘revealed’ fraud. Similarly, certain characteristics that indicate a higher propensity for fraud may actually imply a higher propensity for detection of fraud. For example, a particular type of fraud may be more likely to be detected and result in an enforcement action if an intermediary is used and/or is participating in the fraud, or if a recidivist participates in the offering. Additionally, alleged misconduct in securities offerings may be the subject of enforcement action by other regulators at the federal and state levels, as well as private litigation initiated by victims of the fraud.

The second issue is what can be considered survivorship bias. SEC initiates a number of enforcement actions against alleged securities law violators in this space. This study is based on a subset of all such enforcement actions brought by the SEC. The study’s data does not include Commission allegations of securities law violations in administrative proceedings, unless the offering also included litigation in the district court.³⁸ In light of the large amount of resources

³⁷ Section 17(a) of the Securities Act prohibits fraud and misrepresentations in the offer or sale of securities. Charges under this provision are often brought in conjunction with Exchange Act Section 10(b) and Rule 10b-5 thereunder.

³⁸ Administrative remedies include, among others, censures, cease-and-desist orders, officer and director bars, and penny stock bars. See, <https://www.sec.gov/enforce/how-investigations-work.html>. The enforcement staff obtains data leading to possible violations of the securities laws from many sources, including market surveillance

involved in bringing such cases before a civil court, it may be possible that litigated cases involve more egregious violations or sufficient evidence to withstand a defendant's motion to dismiss. Some cases where there was insufficient evidence to withstand a defendant's motion to dismiss may have been abandoned. Additionally, some cases may be settled before any action is filed in the district court, and as a result they are not part of my sample.

Nevertheless, in light of the lack of academic research into the type and extent of fraud in this space, the analysis presented in this study provides useful insights that can inform market participants and could be useful to better target investigative efforts that could potentially facilitate a better allocation of scarce resources. The findings may enable regulators, through better-informed investor education (to warn them of possible risks and red flags) and enhanced enforcement mechanisms (for example, tools that can identify and track recidivists) to scrutinize future offerings that could potentially cause greater harm to unsuspecting investors, especially unsophisticated, individual investors.

5. RESULTS OF DATA ANALYSIS

Data collected through litigation documents filed in 2014 and 2015 shows that Ponzi schemes³⁹ were the most common type of offering violation among the SEC's federal court actions. Other types of fraud included private fund fraud,⁴⁰ pump and dump schemes for selling unregistered or restricted securities,⁴¹ oil and gas fraud, and pyramid schemes.⁴² The categorization of type of fraud was determined based on the description in the filed complaint. In instances where the

activities, investor tips and complaints, other Divisions and Offices of the SEC, the self-regulatory organizations, other securities industry sources, and media reports. Following an investigation, the Commission may authorize the Enforcement staff to file an action in federal court or in an administrative court. In many cases, the Commission and the defendant(s) may also settle a matter.

³⁹ A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. See, <https://www.sec.gov/fast-answers/answersponzihtm.html>.

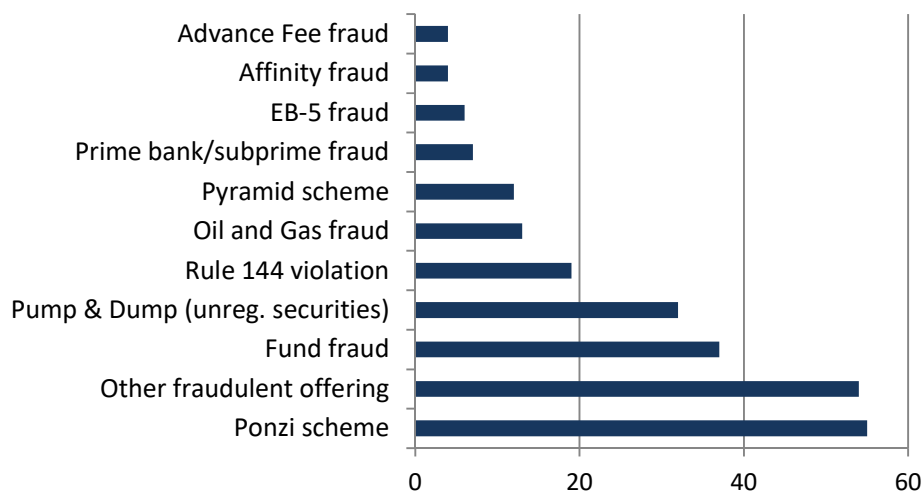
⁴⁰ Unlike operating issuers, private funds often raise capital continuously (i.e. there is no end date when the offering closes). In some instances, the information states that fraud was occurring at the fund and fund performance was being manipulated. Marketing of fund performance is often used in soliciting new investment. Nevertheless, I include only those cases where there is clear information that new capital was being raised during the fraud period.

⁴¹ Restricted securities" are securities that were issued in certain exempt transactions. Security holders can only resell restricted securities into the market by registering the resale transaction or relying on a valid exemption from registration for the resale.

⁴² "Pump-and-dump" schemes involve the touting of a company's stock (typically small, so-called "microcap" companies) through false and misleading statements to the marketplace. See, <https://www.sec.gov/fast-answers/answerspumpdumphtm.html>. A pyramid scheme involves participants attempting to make money solely by recruiting new participants into the program. See, <https://www.sec.gov/fast-answers/answerspyramidhtm.html>.

description does not clearly state the type of fraud, I categorized the type as ‘Other fraudulent offering’. A few cases could be categorized as more than one type of fraud. For example, the description in 6 cases stated Ponzi scheme as well as pyramid scheme, and two cases involved affinity-based fraud involving EB-5 visas. Figure 3 below records such overlapping categories in both types of fraud.

Figure 3: Fraud Types



Information in the complaints show that the median period over which the fraudulent activity occurred was four years prior to the filing of a complaint. Some of the longest-running violations that occurred prior to detection were Ponzi schemes.

ISSUER CHARACTERISTICS

An issuer or its control person was the defendant in 82% of the cases. Not surprisingly, control persons were less likely to be involved in pump and dump cases or cases that involved sales of restricted securities (Rule 144 violation) as they involve secondary sales of issuer securities. Individuals were charged as defendants in 204 of the 210 cases, while both individuals and entities were charged as defendants in 156 cases. Additionally, data collected shows that the median number of individual defendants was two. Thirty cases involved five or more individual defendants, including 2 cases where 15 individuals each were charged as defendants.

Figure 4 presents the distribution of cases by industry. Approximately a quarter of the cases involved issuers that are private investment funds (fund issuers). Among non-fund issuers in the sample, the largest numbers were from the technology, other services, financial firms and oil

and gas industries. The industry break-up is consistent with what I find analyzing private offerings that rely on Regulation D – fund offerings (37%) and offerings by issuers in the technology industry (15%) constituted almost half of all new offerings during 2009-2016.⁴³

Figure 4: Number of Cases and Total Offering Amount by Issuer Industry

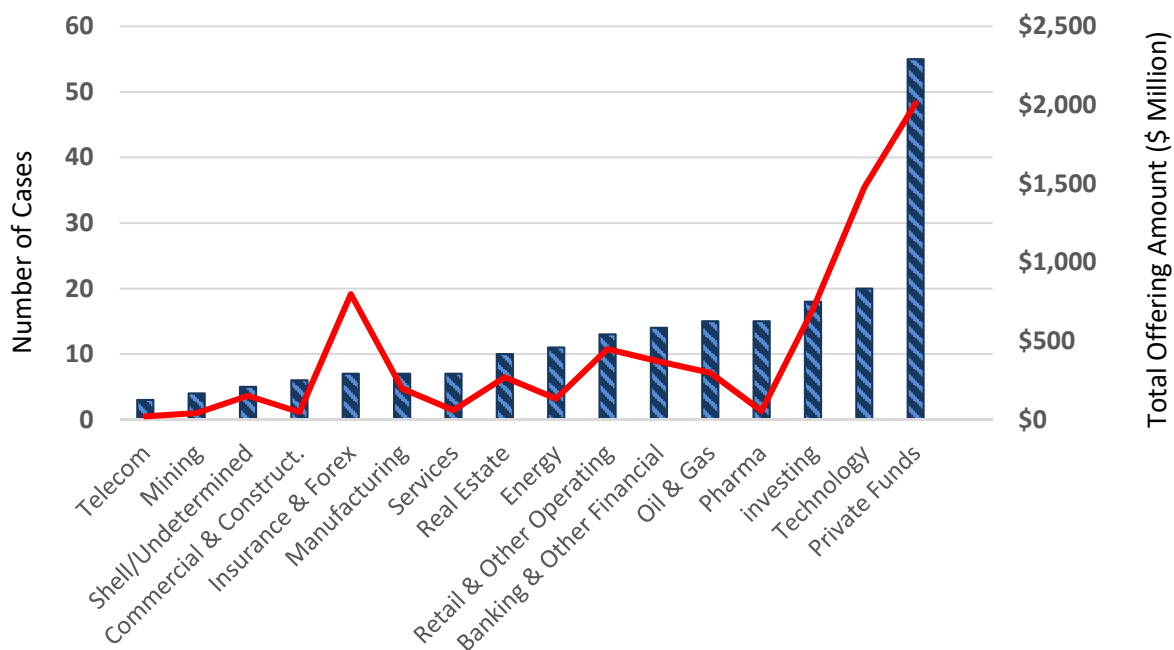


Table 2 below shows the incidence of case types by industry. For example, Ponzi schemes were largely concentrated in the financial services/investing and private fund sectors, and pump and dump schemes using unregistered/restricted securities were more frequent in the pharmaceutical industry.⁴⁴

Table 2: Issuer Industry by Case Type

CASE TYPE	INDUSTRY WITH HIGHEST INCIDENCE
Ponzi schemes	Investing, Private Funds
Pyramid schemes	Technology
Oil and Gas fraud	Oil and Gas
Other fraudulent offerings	Technology, Real Estate, Pharmaceutical
Pump and Dump/Rule 144 violation for unregistered securities	Pharmaceutical
Advance fee, prime bank schemes	Financial services and Investing

⁴³ Based on analysis of EDGAR Form D filings.

⁴⁴ Analysis of Form D filings for 2009-2016 shows private investment funds, technology, pharmaceuticals and health care, and real estate as the industries with highest numbers of new offerings.

Figure 5 presents the distribution of issuer location as determined by the state where its headquarters is located. The largest number of issuers was located in Florida (30) and California (26). 16 cases involved issuer/issuers that were located in a foreign country. Other major states of issuers' headquarters include New York (15), Massachusetts (14), and Texas (13). The largest number of complaints filed in a federal court was in New York (32). In many cases, the lawsuit may be filed in the state where a significant number of victims reside, where the issuer or its control persons may be located, or where the majority of planning and implementation of the scheme occurs.⁴⁵ Indeed, in 184 of the 196 cases where information was available in the complaint, the case was filed in the particular district court because '*certain acts, practices and courses of business alleged herein occurred within this judicial district*'. For the other 12 cases, the issuer (11) or intermediary (1) was located in the state where the case was filed.

⁴⁵ There are federal guidelines that determine SEC's choice of jurisdiction in filing a federal court enforcement action. In most instances, it is required to be filed in the district where the violation occurred. *See*, for example: "Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found", Section 27 of the Exchange Act.

"Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found", Section 22(a) of the Securities Act.

Figure 5: Issuer Location and State where District Court Action Filed

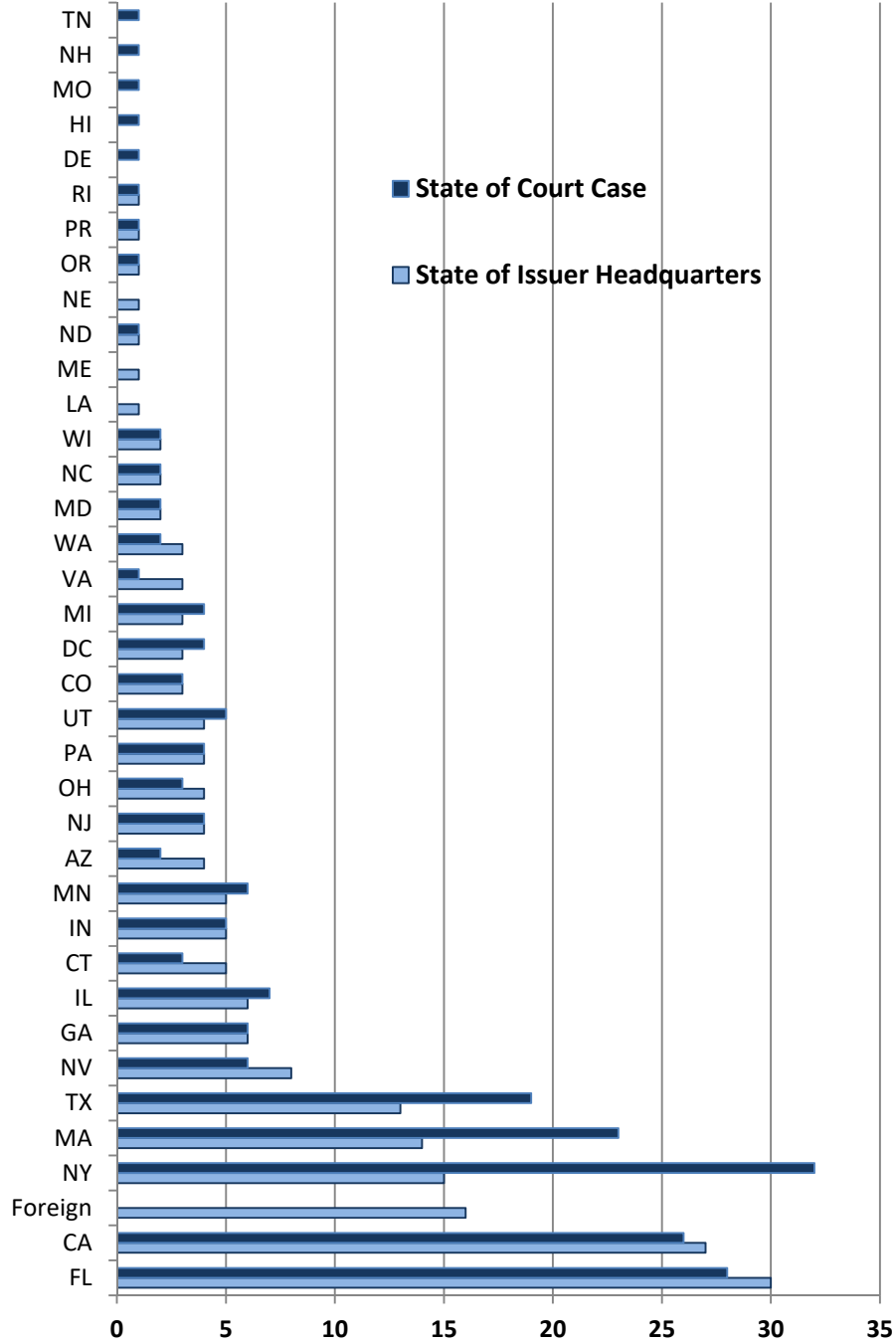
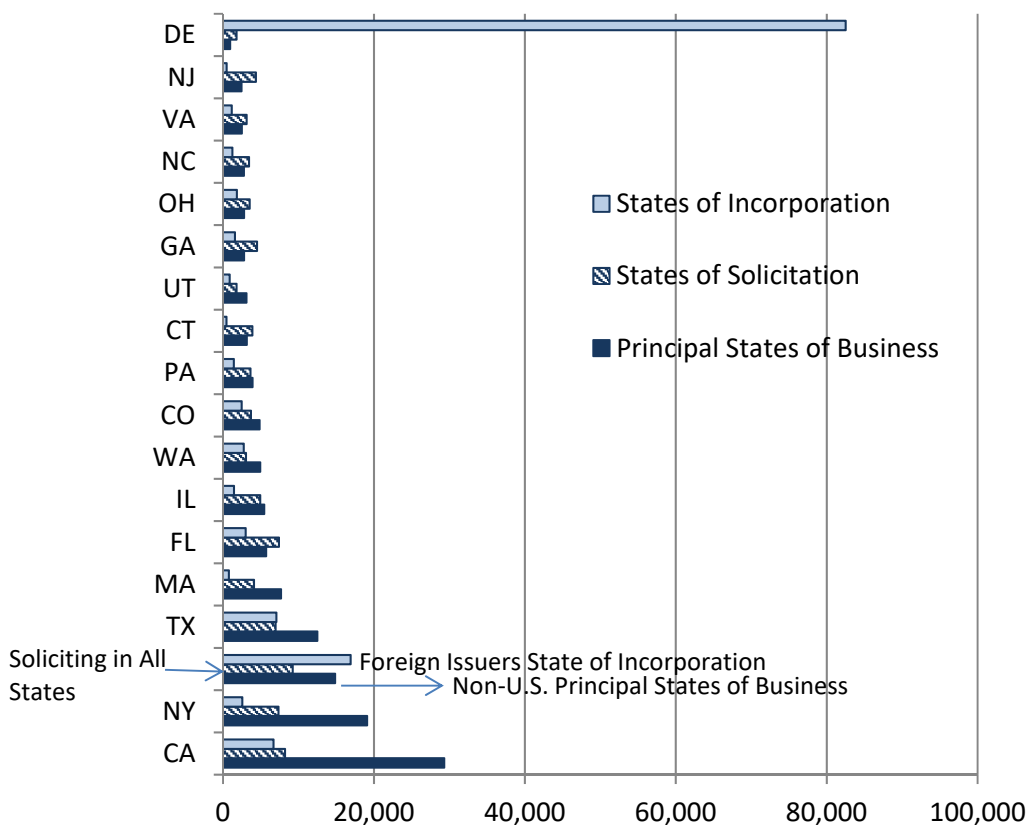


Figure 5 shows that the top 6 states where issuers in the sample are located (California, Florida, New York, Texas, Massachusetts, Foreign) is identical to the top 6 states where Regulation D issuers that undertake unregistered offerings are located (Figure 6).⁴⁶ It is to be noted that

⁴⁶ These states, with the exception of Massachusetts, are also the four most populous states in the U.S. See, <https://www.census.gov/data/tables/2016/demo/popest/state-total.html>.

Florida, a state that has the sixth largest number of Regulation D issuers has the largest number of issuers in the sample. Florida has the highest proportion of seniors in its population and accounts for the second largest number of seniors amongst all states.⁴⁷ With more than half of financial assets in the US estimated to be owned by seniors,⁴⁸ elderly investors are considered to be the most targeted and vulnerable to financial exploitation.⁴⁹

Figure 6: Primary States of Location for Regulation D Issuers (2009-2016) ⁵⁰



Almost three-quarters of the issuers in the sample were non-public issuers. Among public issuers, in 8 cases the issuers were listed on a national exchange, 10 were quoted on the OTC-Bulletin Board, 27 on the OTC Pink Sheets, and issuers in 7 cases had information that issuers were public issuers but did not mention where they were listed, traded, or quoted. Most cases

⁴⁷ See, "65+ in the United States", June 2014, United States Census Bureau, available at: <https://www.census.gov/content/dam/Census/library/publications/2014/demo/p23-212.pdf>

⁴⁸ US Census data, <https://www.census.gov/data/tables/2013/demo/wealth/wealth-asset-ownership.html>

⁴⁹ See for e.g., Lusardi, Annamaria, Olivia S Mitchell and Vilsa Curto, "Financial Literacy and Financial Sophistication in the Older Population", Journal of Pension Economics and Finance, April 2014, pp. 1-20. Also see, <https://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf>

⁵⁰ See, Unregistered Offerings Study.

for listed/quoted firms relate to market manipulation involving unregistered or restricted securities. Information on year of incorporation is available in 148 of the 210 cases. Of these, 70% involved issuers that were below 2 years of age relative to the incorporation date, at the time the underlying offering was initiated. Table 3 shows the distribution of firm age for the 148 issuers where such information is available.

Table 3: Issuer Age at the Start Year of Offering Violation

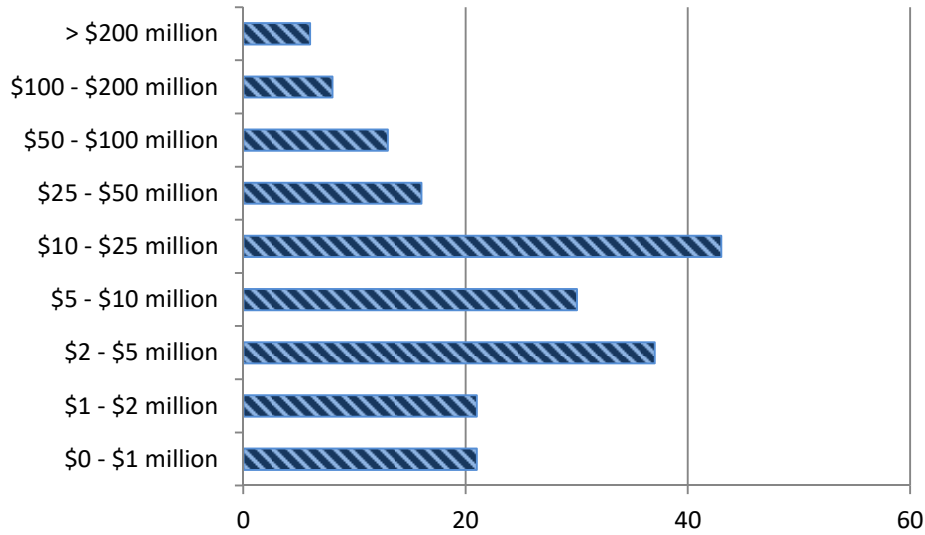
Age	Number of Issuers	Proportion
0-2 years	102	69%
3-4 years	10	7%
5-7 years	16	11%
8-10 years	10	7%
10-20 years	7	5%
>20 years	3	2%
	148	

OFFERING CHARACTERISTICS

The unregistered offerings identified in these cases raised between \$90,000 and \$850 million in capital in each case.⁵¹ In aggregate, approximately \$7.1 billion (less than 0.5% of capital reported to be raised during 2014-2015 in exempt offerings) was raised in 195 of the offerings in the sample. Figure 7 shows the distribution of capital raised in these cases. The median offering amount reported is \$7.3 million. There were 6 offerings, primarily involving pyramid schemes, which raised at least \$200 million.

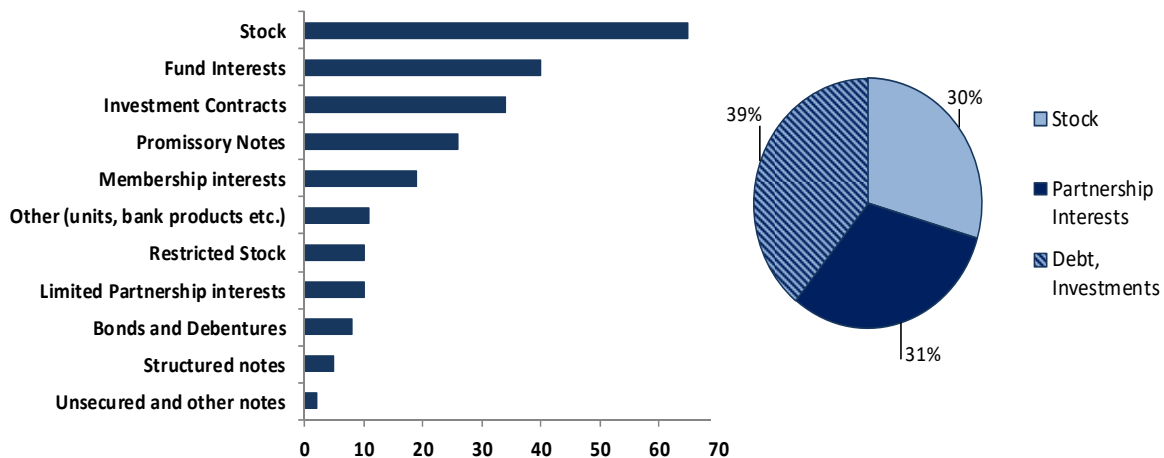
⁵¹ Of the 210 total observations, 195 cases reported the amount of capital raised in the unregistered offering. Market manipulation cases in this sample (pump and dump schemes) usually do not have certain information on dollar amount raised from unwitting investors in the scheme.

Figure 7: Offering Amount



Approximately 40% of offerings in the sample involved debt instruments – mostly ‘investment contracts’ and promissory notes, but also bonds and structured notes (Figure 8). Partnership interests – pooled fund interests, membership interests, and limited partnership interests – were the next largest category (31%) of securities. Some cases involved multiple types of securities.

Figure 8: Securities Offered in Unregistered Offerings Facing Enforcement Action



Analysis of the sample data shows that 194 offerings in the sample involved issuers who did not file a form indicating an intent to rely on an exemption from registration (for example, a Form

D, Form 1-A or Form C). As a result, the Commission and other regulators often rely on information sources beyond filings (for certain exempt offerings where a filing is required) for tracking misconduct and fraud in this space. Data in Table 4 shows that less than 8% of all cases (i.e., 16 cases) referenced offerings where issuers filed a form indicating an intent to rely on an exemption from registration. Of these 16 cases, 12 relied on exemptions under Regulation D. While all 16 cases involved Exchange Act violations under Section 17(a) and Rule 10b-5, 11 of the 16 cases involved a Section 5 violation and one case involved violation under Advisers Act.

Table 4: Enforcement Cases with Reference to Offerings Relying on an Exemption from Registration⁵²

Exemption	Number of cases
Rule 504	3
Rule 506	2
Rule 506(c)	2
Regulation D	5
Rule 144	2
Other – Regulation S	2

Presence of Recidivists: The data compiled from the litigation documents in the 210 sample cases shows that 27% of all cases (57 cases) involved individuals who had an enforcement action (for example, being barred or sentenced) brought against them in prior proceedings for violative acts. (Table 5).⁵³ Incidence of recidivist participation is higher among offerings that purported to rely on an exemption from registration - in 9 of these 16 cases (56%), defendants included a recidivist.⁵⁴ The previous bad acts resulted in sanctions by the Commission, other regulatory agencies, or state regulators.⁵⁵ I find that in 16 of the 57 cases, individuals had a

⁵² The data in this table is compiled from information in the complaints filed by the SEC in federal court. Rule 506 exemption refers to Rule 506 safe harbor that was available prior to the creation of new Rule 506(c). In some cases, the complaint states that the issuer relied on Regulation D for an exemption from registration but does not provide information regarding which Rule of Regulation D was relied on.

⁵³ As suggested before, there may be selection bias here.

⁵⁴ In the past few years, a number of exemptions from registration (for example under Regulation D, Regulation A and Regulation Crowdfunding) have adopted provisions related to “bad actor” disqualification. It is to be noted that disqualification arises only for disqualifying events that occurred after the effective date of the rule provisions. For more information, see, <https://www.sec.gov/smallbusiness/exemptofferings/faq>.

⁵⁵ Examples include: *Securities and Exchange Commission v. James A. Torchia et al.*, Civil Action No. 1:15-cv-03904-WSD (N.D. Ga., filed November 10, 2015): defendant in case had cease and desist orders in 2006 and earlier instituted by securities regulators in states of Florida, Alabama, Georgia, and Tennessee for selling unregistered securities in violation of securities laws.

Securities and Exchange Commission v. Paul R. Downey, et al., Civil Action No. 1:14-CV-00185-C (N.D. Tex. Abilene Division): Broker-dealer in the offering had a previous suspension for 2 years instituted by FINRA.

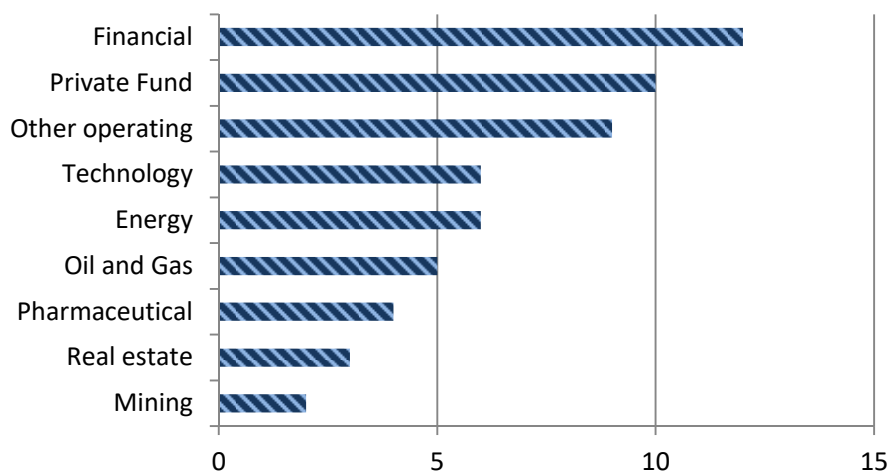
record of prior criminal convictions for prior securities violations or other non-securities related actions.⁵⁶

Aggregating data collected for the subset of 210 cases that involved recidivist participation, I find that more than \$1.4 billion was raised from over 15,000 investors. Recidivists appear to be more common in financial and private fund sectors (Figure 9).

Table 5: Presence of Recidivists by Fraud Type

	Cases involving Recidivists	Total Enforcement Cases	Proportion
Other Fraudulent offering	21	54	39%
Ponzi scheme	12	55	22%
Private fund fraud	10	37	27%
Market manipulation (P&D)	7	32	22%
Rule 144 violation	3	19	16%
Pyramid scheme	4	12	33%
Oil and Gas fraud	5	13	38%
Prime bank/subprime/advance fee	1	11	9%
Affinity/EB-5 fraud	0	10	0%
	57	210	27%

Figure 9: Presence of Recidivists by Industry



⁵⁶ Examples include: *Securities and Exchange Commission v. Lawrence P. Schmidt et al*, Civil Action No. 1:14-cv-01002 (filed June 13, 2014): Schmidt had lengthy criminal record from 1980s and 1990s (6 convictions including check fraud) and a cease and desist order instituted by the Pennsylvania state regulator in 2003, and the Tennessee state regulator in 2004 for raising capital through unregistered offerings in violation of securities laws.

INTERMEDIARIES

An intermediary was reported to be used in 154 of the 210 cases (73%). This is much higher than in the total population of Regulation D offerings where, based on Form D filings, we find that fewer than 20% of issuers, on average,⁵⁷ reported using an intermediary.⁵⁸ As Table 6 shows, broker-dealers and investment advisers were the most commonly used intermediaries in the sample of 210 cases. Other types of intermediaries include promoters, sales agents, and attorneys. In 40% of the offerings that use an intermediary, more than one type of intermediary was involved.

Table 6: Intermediary Types

Intermediary type used	Number of cases	Proportion of offerings using intermediary
Broker-Dealer	61	40%
Investment Adviser	60	39%
Promoter/Finder	37	24%
Sales agents	26	17%
Attorney	20	13%
Auditor/other intermediary	9	6%
Consulting firm/Consultant/ Marketing firm	8	5%
Transfer agent	4	3%

Generally, individuals or firms that are engaged in the business of providing advice on securities for compensation are required to register with the Commission or with state securities authorities under state law.⁵⁹ Individuals, including placement agents, that actively solicit investors in securities offerings that are exempt from registration, or receive remuneration for such participation, may be required to register as a broker-dealer.⁶⁰ In 115 (71%) of the 154 cases using intermediaries (55% of 210 cases), intermediaries were listed as defendants in the litigation action initiated by the Commission. In 110 cases, the intermediary was not registered or licensed with the proper authority. Registering as an intermediary subjects the individual or entity to regulation and disclosure in filings to the Commission and/or other securities regulators. A higher degree of involvement of unregistered or unlicensed intermediaries in

⁵⁷ See, the Unregistered Offerings Study.

⁵⁸ Note that Form D is a voluntary filing and issuers may be underreporting intermediary usage. Data for 2009-2015.

⁵⁹ See, 'Regulation of Investment Advisers by the U.S. Securities and Exchange Commission', March 2013. https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf

⁶⁰ <https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html#II>

offerings involving possible fraud or misconduct suggests that investors should be wary of unregistered and unlicensed intermediaries.

Solicitation Type: Almost 90% of the offerings under study involved solicitation by the issuer or its intermediaries to investors. General solicitation for investment in an exempt offering is permitted under limited circumstances (for example, if the issuer is conducting a Rule 506(c) offering and sells only accredited investors). Figure 10 shows a distribution of the various types of solicitations reported to be used in these offerings. Internet-based media (websites, internet videos, online chatrooms, social media and email) were the most commonly used methods for soliciting investor interest. With the increasing use of online platforms to raise capital, especially through crowd-funded offerings, internet-based solicitation methods also are likely to become more popular. Market manipulation schemes also used cold calling and the internet to attract customers. Ponzi schemes and fund frauds appear to have relied extensively on written material along with in-person meetings or a website to attract investors. Most offerings used multiple solicitation methods to offer their securities to investors.

Figure 10: Types of Solicitation

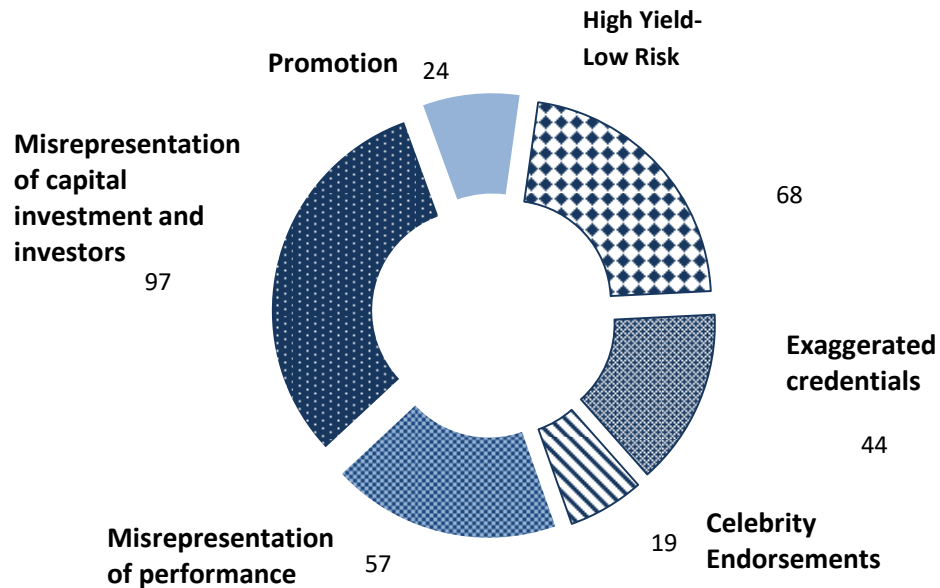


Solicitation Hooks Used to Attract Investors: A wide variety of solicitation schemes were used in the 210 sample cases to attract investors. These ranged from the familiar (like cold calling, using false press releases, or misleading investors about developing a new product or new medicine in order to boost investor interest) to creative and often implausible strategies (for example, one case involved an issuer touting a proprietary investment strategy using 3-dimensional matrices that could not be stated on paper, while another issuer provided misleading information about high historical returns on a strategy aligned with astrological movements). A number of offerings were conducted on the false lure of an imminent IPO of the

issuer, whereas a number of issuers touted celebrity endorsements or acquisition plans. Some schemes targeted unemployed individuals to invest money in exchange for huge returns and employment.

In general, almost 50% of the offerings involved misrepresentations about the use of funds raised, ownership of certain assets, or having attracted significant investor interest (Figure 11). Sixty-eight offerings promised exceedingly high returns with little or no downside risk for investment. One-third of the offerings misrepresented their historical performance, while approximately 30% of the offerings provided exaggerated credentials or celebrity endorsements. A number of offerings used multiple hooks to attract investors.

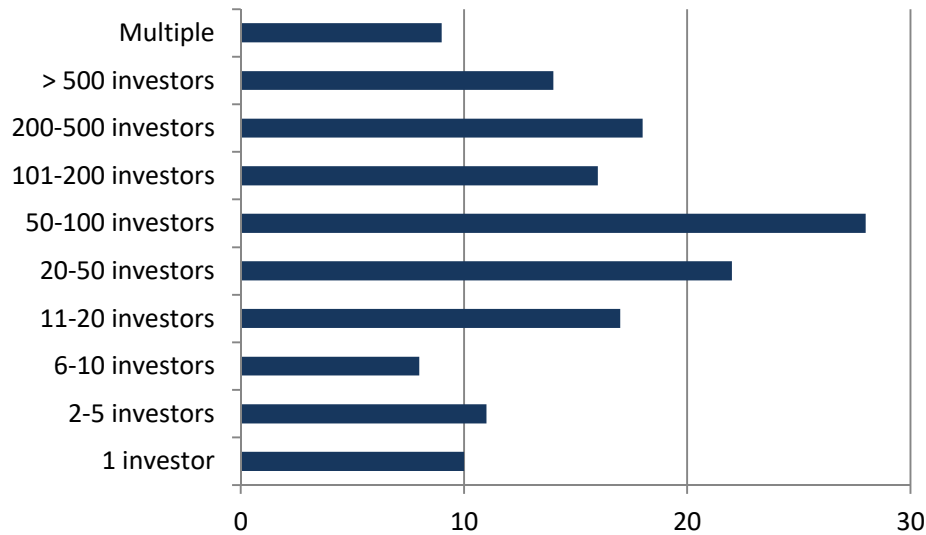
Figure 11: Major Hooks Used to Lure Investors



INVESTORS

Information on the number of investors was available in 153 of the 210 cases. Among these, the median number of investors was 54. The number of investors ranged from one to several thousands. In aggregate, more than 118,000 investors were involved. Offerings that relied on pyramid schemes or Ponzi schemes tended to have large number of investors (Figure 12).

Figure 12: Number of Investors



Presence of Vulnerable and Unsophisticated Investors: In 92 of the 210 cases, information was provided on characteristics of investors (Table 7). The information in the complaints shows that 67 of the offerings (32%) involved sales to investors that were either unaccredited, financially unsophisticated, unemployed, or seniors who were encouraged to use funds from their retirement accounts or pensions to invest in these offerings. Approximately 25 cases involved investors who were solicited based on their affinities to certain communities, such as military or ethnic communities, church membership, or were acquainted to the defendants as family, friends, or colleagues. At least five cases mentioned solicitation to small businesses. The total number of cases where offerings were targeted towards vulnerable investors (i.e. unsophisticated investors or individuals/entities that were susceptible to certain types of affinity-based schemes) was 81 (38% of all 210 cases).

Most pump and dump cases in my data sample do not provide information on investor type. A recent study, however, suggests that the defendants target unsophisticated investors.⁶¹ If I assume all cases involving pump and dump tactics in the sample target unsophisticated investors, the number of cases involving vulnerable investors could increase to 51% (column 3 of Table 7).

⁶¹ A recent study of microcap fraud finds that, investors lured by such pump and dump tactics tend to be older, lower income investors who lack financial sophistication. See e.g., White, Joshua T., "Outcomes of Investing in OTC Stocks", White Paper, U.S. Securities and Exchange Commission 2016. https://www.sec.gov/dera/staff-papers/white-papers/16dec16_white_outcomes-of-investing-in-otc-stocks.html

Table 7: Enforcement Cases with Information on Investor Type

	Specific information in litigation documents	Including market manipulation cases
Total cases	210	210
Information available regarding investor type	92	115
High net-worth clients/entities	14	
Financially unsophisticated and susceptible individual investors targeted	67	93
Affinity based investors targeted	25	
Small business entities targeted	5	
Total – Vulnerable investors targeted	81 (38% of all cases)	107 (51% of all cases)

6. MATCHED SAMPLE ANALYSIS

While the above discussion provides information on the characteristics of unregistered offerings identified in my sample, it is not evident whether these characteristics are similar to what I observe in the universe of all unregistered offerings. In order to determine if fraudulent offerings can be identified through certain characteristics, I compare characteristics of unregistered offerings linked to SEC enforcement actions by creating matched control groups within a proxy group (Regulation D offerings) for the universe of unregistered offerings. I use data from Form D filings to identify characteristics of offerings relying on exemptions and the safe harbor under Regulation D to create comparison groups.⁶² The following characteristics of offerings linked to enforcement cases were used as criteria for creating the comparison group:

- Time period - Offerings initiated during 2010, based on the year when most offerings in the sample were conducted⁶³
- Issuer sector and industry
- Maximum offering amount - based on the offering amounts reported in the vast majority (80-90%) of offerings linked to enforcement actions
- Issuer location - state where headquarters of the majority of issuers in enforcement cases are located

⁶² It should be noted that Regulation D offerings may not be entirely representative of the population of unregistered offerings. Additionally, information in Form D filings may not be complete and is subject to reporting error.

⁶³ I used offering data for one year to reduce the discrepancy between the size of the control group and treatment group samples. As alternatives, I repeated the analysis after pooling Regulation D offerings over 2009-2012 and 2011-2015 time periods. Results were similar.

Based on these criteria, I create comparison groups for the three sectors— operating companies, financial companies, and pooled investment funds, as well as for the major industries of issuers in the sample. Table 8 below presents the criteria used, and the resulting number of observations for each sub-group.

Table 8: Matched Sample Groups and Criteria

Sector	Maximum Offering Amount (\$)	Major States of Issuer Location	Treatment Group (Enforcement Cases)	Control group (Regulation D Offerings)
Operating	150,000,000	CA, NY, FL, TX, MA, NV, IL	105	5,563
Financial	150,000,000	CA, NY, WA, IN	35	269
Private Fund	70,000,000	NJ, NY, CA, FL, CT	46	1,128
Industries in Operating Sector (Top 3 by number of cases)				
Oil and Gas	45,000,000	TX, CA	15	379
Technology	75,000,000	CA, NY, FL, NJ	18	1,830
Pharma	15,000,000	MA, FL, CA	12	346

Tables 9 and 10 present the results from the matched group analysis that uses univariate comparison of means and medians for different characteristics. It is to be noted that these may not be comprehensive matches given the inadequacy of variables available for matching. It is to be also noted that while the results presented indicate a strong correlation between certain offering/participant characteristics and incidence of misconduct, they do not necessarily imply a causal relationship. Some of the results may also be affected by the difference in size of the control and treatment groups. With a larger sample size and more characteristic information for each offering, a multivariate analysis may present a causal relationship that can be used for monitoring and risk assessment purposes.⁶⁴ Nevertheless, the results below provide useful insights into offerings that are linked to alleged securities violations, relative to the larger population of private offerings.

Offerings in the sample by non-fund issuers, on average, appear to raise larger amounts of capital from a greater number of investors and unsophisticated investors.⁶⁵ Non-fund issuers in

⁶⁴ Another statistical option could be to create a matched control sample using propensity score matching techniques, where a Regulation D offering (control group) is assigned a propensity score based on how ‘close’ it is to an offering involving violations. As the variables that I use for matching are primarily categorical variables (industry, state), it is not feasible in this analysis (for example, it is not possible to compute ‘distance’ between pharmaceutical and construction industries).

⁶⁵ Information in litigation documents does not state clearly in all cases if unsophisticated investors are actually unaccredited investors (accredited investors per Securities Act has a net-worth/ income standard that needs to be met).

the sample also tend to be somewhat older than non-fund issuers relying on Regulation D offerings. The results are not consistent across all types of operating issuers. For example, it appears that in technology and pharma industries, Regulation D issuers tend to be of similar age and offer similar amounts (Table 10) as issuers in the sample.

The unregistered offerings in the sample were more likely to use intermediaries and involve issuers with securities listed on an exchange or quoted on OTC, relative to the average unregistered offering. Unsophisticated investors also targeted to a greater extent by offerings in the sample. The exception among these identified industries is the oil and gas industry (Table 10), where unregistered offerings claiming Regulation D exemption have a much higher presence of intermediaries (58%), unsophisticated investors (27%), and public firms (11%) than the average unregistered offering across all industries. As a result, I see few differences in these three characteristics among offerings in the sample and Regulation D offerings in the oil and gas industry.

Table 9: Matched Sample Group Analysis of Offering and Issuer Characteristics in Operating, Financial and Private Fund Sectors

Offering/Issuer Characteristic	Treatment Group (Enforcement Cases)	Control group (Regulation D Offerings)	Significance [@]
Operating Companies			
Number of offerings	105	5,563	
Issuer age since incorporation (years)	4	2	3.75***
Offering amount (\$ mn)	\$17.8 mn	\$7.3 mn	2.89***
Number of investors	274	13	3.07***
Intermediary usage	70%	20%	10.95***
Presence of unsophisticated investors	26%	10%	3.58***
Public firms	40%	13%	5.59***
Median offering amount	\$6.5 mn	\$2.2 mn	8.79***
Median number of investors	100	6	83.35***
Financial Companies			
Number of offerings	35	269	
Issuer age since incorporation (years)	5	1	1.90*
Offering amount (\$ mn)	\$23.4 mn	\$11.8 mn	1.83*
Number of investors	105	15	2.53**
Intermediary usage	69%	28%	4.88***
Presence of unsophisticated investors	46%	6%	4.64***
Public firms	11%	9%	0.50
Median offering amount	\$7 mn	\$4 mn	1.66*
Median number of investors	40	5	9.59***
Private Funds (Pooled Investment Funds)			
Number of offerings	46	1,128	
Issuer age since incorporation (years)	1	1	1.12
Offering amount (\$ mn)	\$13.8	\$14.6 mn	-0.36
Number of investors	108	25	4.21***
Intermediary usage	80%	21%	9.78***
Presence of unsophisticated investors	30%	8%	3.19***
Median offering amount	\$7.5 mn	\$8.5 mn	-0.31
Median number of investors	60	14	9.06***

@: ***, **, * denote that the difference of the univariate means (or medians) of the two groups is statistically different from zero with confidence level of 99%, 95% and 90%, respectively.

Unsophisticated Investors: Form D- Issuer identification if they have sold or intend to sell to a non-accredited investor; Enforcement data- If the litigation documents identify involvement of investors that are either of the following – unaccredited, unsophisticated, naïve, senior, using money from retirement accounts, unemployed, or small businesses.

Table 10: Matched Sample Group Analysis of Offering and Issuer Characteristics in Major Industries within Operating Sector

Offering/Issuer Characteristic	Offerings in Enforcement Cases	Regulation D Offerings	Significance [@]
Oil and Gas			
Number of offerings	15	379	
Issuer age since incorporation (years)	4	1	1.99**
Offering amount (\$ mn)	\$12.1 mn	\$3.8 mn	2.49**
Number of investors	126	11	2.62**
Intermediary usage	71%	58%	1.09
Presence of unsophisticated e investors	21%	27%	-0.52
Public firms	7%	11%	-0.57
Median offering amount	\$6.5 mn	\$1.3 mn	6.81***
Median number of investors	60	2	21.06***
Technology			
Number of offerings	18	1,830	
Issuer age since incorporation (years)	2	2	-0.14
Offering amount (\$ mn)	\$11 mn	\$5.9 mn	1.41
Number of investors	11	5.9	1.41
Intermediary usage	107	9	3.60***
Presence of unsophisticated investors	61%	11%	4.21***
Public firms	39%	5%	2.90***
Median offering amount	\$5.7 mn	\$2.8 mn	2.25**
Median number of investors	100	6	34.27**
Pharmaceutical			
Number of offerings	12	346	
Issuer age since incorporation (years)	7	2	1.10
Offering amount (\$ mn)	\$4.5 mn	\$3.6 mn	0.67
Number of investors	19	13	0.69
Intermediary usage	83%	17%	5.86***
Presence of unsophisticated investors [#]	33%	7%	1.83*
Public firms	67%	18%	3.35***
Median offering amount	\$3.1 mn	\$2.5 mn	0.39
Median number of investors	18	6	2.93**

@: ***, **, * denote that the difference of the univariate means (or medians) of the two groups are statistically different from zero with confidence level of 99%, 95% and 90%, respectively.

Unsophisticated Investors: Form D- Issuer identification if they have sold or intend to sell to a non-accredited investor; Enforcement data- If the litigation documents identify involvement of investors that are either of the following – unaccredited, unsophisticated, naïve, senior, using money from retirement accounts, unemployed, or small businesses.

#: As a number of fraudulent offerings in the pharmaceutical sectors were pump and dump schemes, investors were assumed to be vulnerable investors, even if it was not specifically stated in the enforcement documents.

7. CONCLUSION

The exempt offerings market has grown substantially in the past few decades and now rivals the market for public securities offerings in size.⁶⁶ Understanding the incidence and type of misconduct in this space is essential for investor protection as well as for capital formation, especially small business capital formation. The data available from SEC's enforcement actions in federal courts is limited in scope, but the analysis provides some initial insights into fraudulent private offerings. The offerings identified in the sample constitute a small proportion of the number of offerings initiated every year. Analysis of the sample data suggests that offerings linked to SEC enforcement actions more likely involved an unregistered intermediary or a recidivist, or solicited from unsophisticated investors. These findings along with the frequency of enforcement cases in certain types of industries suggests that coordination across regulators, investor education and enforcement measures focused on certain types of participants may affect the extent of misconduct in the private offerings market.

A broader understanding of fraud and misconduct in this space could be gained by analyzing data over a longer time frame, and from a more comprehensive set of information sources, including state enforcement and other regulatory enforcement data, as well as information from non-regulatory sources (for example, private litigation and class-action litigation data) that relates to misbehavior in the conduct of unregistered offerings.

⁶⁶ See Section 2 above.