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STATEMENT OF
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BEFORE THE

SUBCOMMITTEE ON SECURITIES OF
THE SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

ON

PREVENTING INVESTORS FROM BEING DEFRAUDED WHEN BUYING SECURITIES SOLD IN TRANSACTIONS CLAIMED TO BE PRIVATE SALES

Mr. Chairman, we are here at your request to discuss our report on the private placement exemption--section 4(2)--a provision of the Securities Act of 1933 which enables companies, under certain conditions, to offer and sell new securities without registering them with the Securities and Exchange Commission (FGMSD-80-55).

Although the private placement exemption has been used to raise billions of dollars of business capital legitimately,

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it has also been misused. Investors are being defrauded out of hundreds of millions of dollars--sometimes their life's savings--by buying securities which business promoters falsely claim are being sold as private transactions exempt from registration with the Commission. Many of the defrauded persons are novice investors who are not experienced in securities investing and who are not knowledgeable about the industries in which the financed businesses operate. By the time they realize that the promoters have sold them securities in fraudulent schemes, it is generally too late to recover their money.

The Securities Act of 1933 insures full and fair disclosure in securities sales, and requires issues to be registered with the Securities and Exchange Commission unless the issues are exempt from registration. One such exemption--section 4(2)--is for issues sold to investors in private transactions and is called the private placement exemption.

MISUSE OF THE PRIVATE PLACEMENT EXEMPTION

During the 3 years ending September 30, 1978, the Securities and Exchange Commission investigated 142 cases involving misuse of the private placement exemption. The investigations showed that many promoters misused the exemption to avoid registering securities with the Commission. The promoters violated the act's provisions by not providing the investors with information needed to make informed investment decisions and by deceiving them through use of false and misleading sales presentations.

In 1953, the Supreme Court determined that investors who buy private placement securities should have access to the same kind of information that registration would provide. The Commission investigations showed that the investors frequently failed to receive adequate information in areas such as financial status of the company and promoters, risks of the business undertaking, and how the investors' money was to be used. This type of information would have been available to the investors if the securities had been registered.

The Commission investigations also show that the promoters violated the act's antifraud provisions which prohibit the sale of securities based on untrue statements or omissions of material fact.

The defrauded investors represent a broad cross section of the investing public, including persons of wealth, as well as those of limited means, and persons who were sophisticated investors as well as those who were not. The single most common characteristic among the diverse investors who lost their money is that they acted on the basis of incomplete and inaccurate information.

The following examples from Commission files on its 142 investigations of exemption misuse show where investors were provided inaccurate and incomplete information.

--Promoters raised $10.3 million selling securities in businesses to construct apartment buildings. They overstated their experience, their financial strength, and the profitability of their previous real estate businesses. They did not disclose that the businesses were in serious financial difficulty when the investors bought their interests, that a prominent businessman who was held out to be an investor was in fact one of the promoters, and that funds were diverted to pay off unrelated debts. By the time the scheme collapsed, investors had been defrauded out of $9 million.

--Promoters raised $700,000 from investors by selling oil and gas interests. The promoters falsely claimed extensive experience in the oil and gas industries. They claimed the investment carried little risk because they were drilling "inside" developed fields, but this was not true. They also claimed that they had no royalty interest in the wells, but they did. The investors' entire $700,000 was lost.

The Supreme Court also held in 1953 that to comply with requirements of the exemption, issuers should offer privately placed securities only to persons who are shown to be able to fend for themselves and who have requisite knowledge and experience in business matters--commonly called sophisticated investors. However, the Commission's investigative files showed that many persons who purchased fraudulent private placement securities lacked the sophistication needed to make informed investment decisions. This is especially serious when you consider that they invested in highly specialized businesses such as oil and gas drilling and real estate development.

In contrast to the problems encountered by individual investors, the Commission's 142 investigations did not indicate that the purchase of fraudulent securities was a problem for institutional investors, such as insurance companies. One reason could be that many institutional investors develop in-house capability for evaluating investment opportunities which enables them to request and use the type of information which would be provided for securities registered with the Commission.

The following examples from Commission files on the 142 fraudulent schemes illustrate the investors' lack of investment sophistication.

--Promoters raised $45 million selling securities in real estate businesses which were represented as tax shelters. Investors who did not have sufficient income to benefit from tax shelter investments were nevertheless sold such investments. One investor was a widow, with five children, who had no taxable income and whose main support was veterans and social security benefits. Another tax shelter investor was a 71-year old retiree living on social security and a low paying part-time job. Investors such as these lost at least $5 million.

--A promoter raised more than $5 million from investors to drill oil and gas wells. Many of the investors were retired or were persons of moderate means. In general, the investors had never before purchased limited partnership interests and were unfamiliar with gas and oil financing. Their investment experience was confined solely to mutual funds. The entire $5 million was lost.

INVESTORS SUFFERED SERIOUS LOSSES

In 95 of the 142 investigations conducted by the Commission, roughly 30,000 investors were defrauded of over $255 million. Loss estimates were not available for the other 47 investigations. Some investors, because of their advanced age, limited earning power, or ill health, were not in a position to recover from the losses incurred. In some cases, the losses wiped out family savings.

The following examples from the Commission files on the 142 fraudulent schemes illustrate the serious harm to investors.

--A man invested over $30,000 to ensure an income to help care for his brain-damaged child. He raised the money by selling his home and was promised a 30- to 40-percent annual return on his investment by the promoter. After finding he had been defrauded of his entire investment, the man committed suicide.

--An investor who worked for 30 years and whose recent annual salary was about $12,500 loss his entire life savings of more than $45,000. He needed money because he was in ill health and could not work.

--A man, 84 years old and senile, was induced to invest $37,400 in a business purported to be a recreational resort and an oil and gas venture. The promoter used the $37,400 to pay his personal expenses.

We do not know the full extent of investor losses but the losses disclosed by the Commission's investigations may only be the tip of the iceberg. In reply to a questionnaire we designed to obtain State views on the Federal private placement exemption, 28 commissioners estimated that their investigations of fraudulent private placement transactions in 1978 alone involved investor losses of between $330 and $350 million. Forty-three State commissioners said that fraud appeared to be present in 462 of the 528 investigations which they conducted in 1978 involving the private placement exemption.

COMMISSION CANNOT EFFECTIVELY ENFORCE PRIVATE PLACEMENT PROVISIONS

Misuse of the private placement exemption is difficult to control under any circumstance, but the Commission is hampered in its enforcement efforts for two major reasons. First, the act does not provide the criteria or identify the conditions under which the exemption may be used. Promoters of fraudulent business schemes use the vagueness of the act to their advantage in claiming the exemption. Second, the Commission cannot act in a timely manner because issuers are not required to give notice when they sell securities under the section 4(2) exemption. The Commission frequently does not know that a promoter is selling privately placed securities until a defrauded investor complains. Further, the Commission does not have timely access to promotional literature and other information which could indicate misuse of the exemption.

Let me discuss these points in more detail.

Continued uncertainty about use of the exemption

Because the act does not provide adequate guidance, there has been much uncertainty over the past 45 years as to what section 4(2) means in exempting from registration "transactions by an issuer not involving any public offering." Lack of clear-cut objective conditions governing use of the exemption limits the Commission's enforcement capability.

As mentioned earlier, in 1953 the Supreme Court established two requirements for satisfying the conditions of the exemption: first, the investors should be sophisticated enough to fend for themselves and, second, they should be given access to the kind of information which registration would disclose. The Court, however, did not define these requirements. In the two decades following the Supreme Court's decision, other courts as well as the Commission applied various interpretations to the exemption. An American Bar Association committee concluded, in 1975, that it was difficult if not impossible to determine the proper use of the private placement exemption.

The Commission attempted to reduce issuers' uncertainty in using the exemption by adopting Rule 146. The rule, which incorporates the Supreme Court's investor sophistication and access to information requirements, details additional requirements which issuers must meet to qualify for the private placement exemption. If these are met, the Commission considers that the issuer has qualified for the section 4(2) exemption. However, because substantial questions exist as to the extent of its authority to issue rules limiting or conditioning the use of the section 4(2) exemption, compliance with Rule 146 is optional. Simply put, a promoter wishing to defraud investors merely ignores the rule and claims the exemption under the act. Promoters have taken advantage of this escape hatch and the ambiguity of the act in selling fraudulent securities.

<u>Commission cannot act in a timely manner</u>

The Commission is also hampered because it does not have the capability to initiate timely investigations of exemption misuse. For the most part, the Commission can only react upon receiving a complaint or other indication that securities law violations are occurring. By that time, the investors' money is usually lost. To provide earlier enforcement capability, the Commission would need the authority to

--require that it be notified when the exemption is to be used, and

--obtain prompt access to promotional literature and other information on private placement offerings.

The Commission does not have notification of exemption use

Because section 4(2) of the act does not specify the conditions governing use of the exemption, issuers are not required to give notice when they use the exemption. As a result, enforcement is reactive because the Commission is usually unaware of use of the exemption in cases where there were fraudulent transactions until it receives a complaint or other indication that abuses are occurring.

Notification need not be burdensome. Issuers would not need to furnish the detailed information required by registration, but would merely advise the Commission that they are selling exempt securities and provide certain information such as the name of the company, its promoters, and the nature of the securities being offered. The one-time filing of a single sheet form, which is a short, simple, and inexpensive reporting process, would be sufficient.

The Commission does not have prompt access to information on private placement offerings

The Commission is also hampered because it does not have the authority to readily obtain issuers' promotional literature and other information which could indicate misuse of the section 4(2) exemption. This enables promoters to continue to sell fraudulent securities and to further divert investors' money.

As mentioned previously, even though private placements are exempt from registration, investors must be given access to the same kind of information that registration would provide. Commission experts can identify inconsistencies, misstatements, and inadequate disclosure by reviewing promotional literature and other information.

Under its existing authority, however, the Commission cannot easily obtain promotional literature and other information from the issuer unless it is furnished voluntarily. If the issuer refuses to provide the information, the Commission is forced to use subpoenas. The Commission is careful in using subpoena power and requires its staff to show that a likely violation of the act's provisions has occurred before approving use of subpoenas. Without access to the promotional literature and other information, this evidence is difficult to obtain.

<u>The Commission needs to establish earlier communications with investors</u>

The Commission could further improve its capability to detect misuse of the private placement exemption by making it easier for the public to contact the Commission through use of a publicized toll-free telephone line.

We noted that the Commodity Futures Trading Commission uses seven toll-free telephone lines to exchange information with the public. This communications system not only aids the investor, but also provides the enforcement group with much useful information on specific ongoing frauds and on the overall pattern of violations. Using a toll-free telephone service, in tandem with notification and access to information provisions, should enable the Commission to obtain similar results and get involved earlier in private placement frauds.

In summary, it is important to note that vast sums of money have been legitimately raised through the sale of privately placed securities and the ability to raise such capital must be preserved. At the same time, we believe a loophole in existing legislation is permitting thousands of unsophisticated investors to be seriously harmed by unscrupulous promoters.

In our report we recommended that Congress amend the Securities Act of 1933 to better protect investors and still enable legitimate promoters to raise capital through use of the private placement exemption. As part of this recommendation, we offered three options.

--Provide guidance and criteria under which the private placement exemption can be used.

--Provide the Commission with authority to establish mandatory rules conditioning use of the exemption.

--Provide the Commission with pertinent information on the use of the exemption.

In considering the options we offer and other options that might be developed, the Congress may wish to solicit the views of the Commission, the Small Business Administration, and other interested agencies and organizations, to deal with the problem of misuse of the private placement exemption.

We also recommended that the Commission establish a publicized toll-free telephone service to enable earlier contact with investors to help strengthen enforcement capabilities.

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This concludes our statement. We will be happy to respond to any questions you or other Members of the Subcommittee may have.