Questions for the Record for Stephen L. Cohen of the Securities and Exchange Commission Senator Dianne Feinstein

Senate Judiciary Committee

Hearing on EB-5 Regional Center Program

February 2, 2016

1. Securities Fraud

Your written testimony states the following:

> **"As regional centers pool multiple investors' funds into commercial enterprises, this change allowed regional centers, and their related entities, to offer EB-5 investments that can qualify as securities. These investments are often limited partnership interests or limited liability company units and are also typically offered under one or more exemptions from the registration requirements of the federal securities laws. As a consequence, just like the thousands of other unregistered private offerings in the U.S. every year, the SEC has limited visibility into this market as compared to registered offerings in the public market. Despite any potential exemption from registration, however, these investments are still subject to the statutes and rules governing the offer and sale of securities, including the antifraud provisions of the federal securities laws.**
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> **....**
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> **Additionally, as EB-5 investments are sold to non-U.S. persons, there is limited regulatory transparency with these offshore offers and sales of securities."**

A. **Question: Because so much of the marketing and promotional activity for EB-5 investments occurs overseas, does the SEC have increased difficulty being alerted to, and investigating, fraud and other unlawful activity in connection with such investments?**

Answer: In general, there are a variety of sources from which we receive tips, complaints and referrals containing potentially actionable intelligence, and we receive such information from domestic and international sources. This is also true in the area of EB-5 investments. Although only a small percentage of the approximately 15,000 tips, complaints and referrals that the SEC receives annually relate to EB-5 investments, the SEC has brought numerous enforcement actions based on this very intelligence. We have worked with our domestic and international law enforcement partners, including the USCIS, to appropriately investigate allegations through our information-sharing relationships. As with all private offering investigations, we sometimes face challenges finding or tracing the money and otherwise obtaining evidence of who is responsible for the fraud. Obtaining evidence from foreign countries for SEC investigations involves working with diverse foreign legal systems and foreign counterparts with different capabilities. Depending on the foreign jurisdiction, the SEC's Office of International Affairs may use various information sharing arrangements, including, treaties and other multilateral and bilateral agreements to obtain bank, brokerage and beneficial ownership records. One area that can present particular obstacles is obtaining testimonial evidence from witnesses located overseas. Another is local laws that inhibit the production of certain materials and information to the SEC. As we often do not have direct visibility into the offshore aspects of fraudulent schemes and transactions, it is therefore necessary to leverage the cooperation and resources of our foreign counterparts

B. **Your written testimony also states: "Because the Commission does not administer the EB-5 Program, it generally does not receive or review materials related to applications under this program."**

Question: Would it help the SEC if, as a matter of course, EB-5 business plans and I-924A applications were provided to the SEC by USCIS?

Answer: The Division of Enforcement typically investigates offerings when presented with allegations or other intelligence indicating a potential violation of the federal securities laws. However, as further described in the written and oral testimony, we also have certain information sharing protocols in place with the USCIS. Through those existing information sharing channels, where appropriate law enforcement interests exist, the SEC would already have access to such documents collected by the USCIS and be able to utilize them effectively to investigate allegations and bring cases, as we have in the past.

C. **Question: What are the main barriers you see to uncovering fraudulent misstatements by regional centers and unlawful diversion of EB-5 funding for personal use?**

Answer: As noted in response to the question above, obtaining evidence from foreign countries for SEC investigations can present challenges. By working with our Office of International Affairs to make use of various information sharing arrangements, treaties and other multilateral and bilateral agreements, in many cases, depending on what country we are working with, SEC staff can obtain bank, brokerage and beneficial ownership records. One area that can present particular obstacles is obtaining testimonial evidence from witnesses located overseas.

D. **Question: What recommendations do you have for how to address such barriers?**

Answer: The Commission has not taken a position on particular reforms specific to any aspect of investigating EB-5 offerings. The staff will continue to stand ready to provide technical assistance to Congress when asked for such assistance.

E. **Question: It seems to me that USCIS and SEC should have access to all promotional materials, investment prospectuses, marketing documents, and promotional events related to EB-5 investments. Do you agree, and are there any other materials you would want to ensure SEC and USCIS have access to?**

Answer: Being mindful of harmonizing any reforms with the SEC's existing statutory and regulatory framework for private offerings, I can envision the materials referenced above assisting our investigations.

2. <u>Lawful Sourcing of Funds</u>

The EB-5 program involves huge pools of money invested by foreign nationals. A key question is how to ensure such funds are not from unlawful or nefarious sources – in other words, how to enable U.S. government authorities to trace the funds that are invested back to their source.

At the hearing, you mentioned that SEC has had occasion to trace funds in the course of its own investigations.

A. **Question: Has SEC had any difficulty tracing funds internationally in the course of an investigation connected to the EB-5 program?**

Answer: It is not generally within the SEC's purview to trace investor funds to their original source in order to determine their lawfulness. Typically, the Division of Enforcement traces funds for the purpose of: identifying the disposition of funds received from investors; investigating the use of funds in order to identify securities law violations; and recovering assets for the benefit of investors. While there are numerous complexities involved with tracing funds abroad, with the assistance of those foreign counterparts with whom we participate in information sharing agreements, we often can obtain relevant records sufficient to trace funds, depending on where those funds are located.

B. **Question: Are such issues linked to a particular country or countries? If so, which ones?**

Answer: As described above, to the extent we receive information from foreign regulatory authorities for law enforcement purposes, such assistance from foreign governments is based on existing information sharing agreements. Obtaining timely enforcement assistance from some jurisdictions, however, is more difficult than others. As you are aware, the vast majority of EB-5 investments come from China. Despite some challenges, the SEC has made progress with China, and we would like to see this progress continue. In fact, in an EB-5 case we charged last year, we obtained critical assistance from the Chinese CSRC and the HKSFC in our investigation.

3. **<u>SEC Regulations – Accredited Investor</u>**

As I understand it, EB-5 investment offerings are governed by U.S. securities laws, but are typically exempt from registration with the SEC. In particular, Rule 506 of Regulation D provides an often-used exemption from registration.

Under Rule 506(c), according to the SEC's website, the securities issuer "can broadly solicit and generally advertise the offering" – which otherwise would not be permitted – as long as the investors in the offering are *all* accredited investors. Presumably this is because accredited investors are more sophisticated financial actors.[1]

As I am sure you know, accredited investors are defined to include a natural person who earned $200,000 per year in the two prior years, with a reasonable expectation of continuing to earn that income; or a natural person whose net worth is over $1 million, not counting their primary residence.

The Rule requires that the securities issuer "take reasonable steps to verify that purchasers of securities sold in any offering . . . are accredited investors." The issuer can satisfy this requirement "if the issuer uses, at its option, *<u>one</u>* of the following non-exclusive and non- mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor." The options then mentioned include:

- **reviewing IRS forms and a written statement from the individual;**
- **reviewing bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties, as well as consumer credit reports; and**
- **obtaining written confirmation that a registered broker-dealer, investment advisor, attorney, or CPA has verified that that the person is an accredited investor.**

I would like to know more about how these verification mechanisms work in the context of EB- 5, and whether they can be improved.

A. **Question: Are the verification methods listed above being used to verify accredited investor status in the context of EB-5? What other methods are used to verify accredited investor status? Please identify as many as possible.**

Answer: In order to rely on Rule 506(c) for the offer and sale of securities, an issuer

[1] The SEC has stated that the definition of "accredited investor" is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary." (Dec. 2015 SEC Report)

must take reasonable steps to verify the accredited investor status of purchasers, and it is the issuer's responsibility to ensure compliance with the conditions of the rule. The rule sets forth non-exclusive methods of verifying accredited investor status and there may be other methods used by issuers. The SEC does not specifically have information regarding the methods used by issuers to verify accredited investor status when Rule 506(c) is used in the EB-5 context. It is my understanding, however, that I-526 applications submitted to the USCIS are required to include information concerning an EB-5 investor's net worth and source of funds. In the context of an investigation where SEC staff is examining the availability of exemptions from the registration requirements, the issuer would need to demonstrate its ability to rely on Rule 506(c), including how the issuer verified accredited investor status.

B. **I understand that, often, the EB-5 investor invests in a newly-formed corporate entity like a Limited Liability Partnership formed specifically for the purpose of being an EB-5 investment vehicle. That entity then loans or otherwise uses the money to help finance a project.**

Question: How does the SEC ensure that such newly-formed entities, as the issuers of these securities, actually verify accredited investor status?

Answer: In order to rely upon Rule 506(c), the burden is on the issuer to demonstrate it met its obligations under the rule, including the verification of accredited investor status. As a general matter, when the SEC's Enforcement Division investigates whether an offering qualifies for an exemption from registration, the staff would use its subpoena authority to obtain documents substantiating any due diligence undertaken by the issuer to verify accredited investor status.

Question: Does USCIS regularly provide the SEC with regional centers' I-924A forms, which should list these commercial enterprises and could assist the SEC in ensuring that issuers are verifying that investors are accredited?

Answer: The USCIS routinely provides the SEC with documents, including I-924A forms, in the context of specific investigations as part of the agencies' ongoing information sharing arrangement

C. **It seems to me that stronger "accredited investor" verification requirements for EB-5 would not only help protect against securities fraud, but also could significantly improve USCIS's ability to police the unlawful sourcing of funds.**

Such enhanced requirements could include requiring the regional center and/or issuer to:

- **use *all* applicable verification methods listed in Rule 506(c) (as opposed to just one);**

- **obtain a narrative statement of how the individual generated his or her net** worth, along with employment history and references;

- **use other substitute verification methods that may apply to investment marketed and promoted abroad to foreign nationals; and**

- **keep detailed documentation of all evidence they obtain indicating that an investor is an accredited investor, and to require that this information be submitted to the SEC and shared with USCIS (or vice versa);**

Question: Does the SEC have any plans along these lines, or any other plans, to bolster accredited investor verification requirements for EB-5 offerings?

Answer: I am not aware of any such plans by the SEC to promulgate rules specific to EB-5 offerings. Such offerings fall within the same regulatory scheme as other unregistered private offerings to foreign investors and have historically been treated as such.

Question: Is the SEC exploring how to use its regulatory power to minimize fraud and unlawful sourcing of funds in the EB-5 program?

Answer: As noted in the written and oral testimony, the SEC is committed to investigating fraud in the EB-5 area and has been doing so. We will continue to use the tools already available to us and work with our law enforcement partners to enforce the federal securities laws as they apply to EB-5 offerings and to the individuals and entities that offer, sell and market those offerings.

Question: Does anything in current law inhibit the SEC from taking the steps that are outlined above and that would be in the SEC's jurisdiction?

Answer: There is currently no legal impediment to the SEC investigating and bringing cases involving the EB-5 program, as demonstrated by the proceedings brought thus far. I am not aware of any statutory prohibition on regulations involving this area. As noted, these offerings are similar in most regards to other private offerings under the federal securities laws that fall within the SEC's existing statutory and regulatory framework for private offerings.