

# Direct Public Offerings on the Internet: A Viable Means of Obtaining Capital?

by  
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## I. INTRODUCTION

The Internet — a global web of computers — is a powerful force in everyday life.<sup>1</sup> Terms such as “website,” “browser,” “chat line,” and “server,” which were once reserved for computer professionals, are now part of our ordinary vernacular. Yet the Internet is a relatively recent phenomenon.

Designed strictly for military purposes, the Internet was conceived by the United States Department of Defense in the wake of the Soviet launch of Sputnik. It was originally called “ARPAnet,” which combines a short form of “network” with an acronym for the Advanced Research Projects Agency, the governmental agency that first worked on the project.<sup>2</sup>

In developing ARPAnet, the agency’s primary goal was to create a decentralized network of independent computers that could share valuable military information. This network of computers reduced the risk of losing information if a single computer was destroyed.<sup>3</sup> The U.S. government scientists who originally designed the Internet did not foresee its commercial evolution.<sup>4</sup> What began as a government defense project continues to evolve into a global, commercially viable media space.<sup>5</sup>

The Internet’s creation was “one of the twentieth century’s most productive accidents.”<sup>6</sup> Before 1997, typical business use of the Internet was as

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1. PHILIP E. MARGOLIS, RANDOM HOUSE PERSONAL COMPUTER DICTIONARY 259, 523 (2d ed. 1996).
2. STEPHEN SEGALLER, NERDS 2.01: A BRIEF HISTORY OF THE INTERNET 29 (1998) (detailing creation of the Internet through the eyes of those responsible for its design and structure).
3. *Id.*
4. *Id.*
5. *Id.*
6. *Id.*

an extension of traditional advertising campaigns — similar to television and print advertising. Companies began to flash their web addresses everywhere as a way of showing the public how “hip” they were. But the original commercial websites were far from “hip” or interactive. Instead, they were simply passive advertisements that usually contained basic, and sometimes outdated, corporate information.<sup>7</sup> These original sites were not intended to substitute for, or extend, traditional methods of doing business. For example, until the late 1990s, both K-Mart Corporation and the Borders Group sponsored purely passive websites. Today, of course, both sites are interactive, allowing online purchases.<sup>8</sup>

But commercial growth of the Internet has expanded even beyond such uses. Businesses like Amazon.com, Yahoo!, America Online, and eBay have been formed and have operated solely on the Internet. This evolutionary business model was facilitated by advances in technology, including: (1) faster Internet connections; (2) cheaper, more powerful computing devices, and (3) new interactive programming languages.

At first, some Internet businesses were perceived as having more market capitalization than their traditional “brick and mortar” counterparts.<sup>9</sup> Although “e-commerce”<sup>10</sup> is still in its infancy, it has already presented serious challenges to traditional business concepts.

Despite this rapid evolution of e-commerce, most businesses still rely on traditional methods of raising capital, including private placement, venture capital, and initial public offerings (IPOs). The price for such capital is often steep, and the competition is fierce. Issuing costs — as a percentage of the gross proceeds of a public offering — average about 6.5%, and tend to be even higher for smaller issues. Stock issues of \$1 million or less can run as high as 15% of the gross proceeds.<sup>11</sup>

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7. *Id.*

8. See <http://www.kmart.com>. Compare <http://www.bordersgroup.com> with <http://www.borders.com>.

9. See <http://www.finance.yahoo.com> (reflecting that in July 2000, the market capitalization of Amazon.com was about \$10.6 billion, compared with only about \$1.32 billion for Barnes and Noble, Inc. and \$1.03 billion for the Borders Group).

10. See DAVID JOHNSTON ET AL., CYBERLAW: WHAT YOU NEED TO KNOW ABOUT DOING BUSINESS ONLINE 37 (1997) (defining “e-commerce” — a term coined by Lawrence Livermore in 1989 — as “the consolidation of technology, material, people, and processes on an electronic network for commercial transactions”).

11. DONALD R. CHAMBERS & NELSON J. LACEY, MODERN CORPORATE FINANCE: THEORY AND PRACTICE 322 (1994).

Small-to-medium-sized businesses have even fewer financing options, and are often at the mercy of venture capitalists, who frequently require a large stake in a corporation before making an investment. For example, the founders of Apple Computer — Steve Jobs and Steve Wozniak — gave up a significant portion of their interest in Apple to Silicon Valley investor A.C. “Mike” Makkula. Because outside brokerage houses are similarly expensive, only a few companies seek outside financing. In 1999, a record year, public offerings for Internet-related technology companies raised \$24.66 billion dollars for only 289 companies.<sup>12</sup>

The high cost of capital has stymied many businesses in their attempts to survive and prosper. But the emergence of the Internet and the explosive growth of e-commerce have created new opportunities for some businesses to explore different sources of additional capital. Many small-to-medium-sized companies have not yet fully appreciated the potential of this rapidly growing global network.

In 1998, 33% of American households were online — a percentage that by 2003, should increase to 51%.<sup>13</sup> More important, the Securities and Exchange Commission (SEC) estimated that, at the end of 1999, as many as ten million investors had bypassed brokers to take advantage of Internet stock trading. This figure represented about 25% of all retail brokerage transactions in 1999.<sup>14</sup>

The Internet is no longer solely a mechanism for product information and sales. It is now a viable, potentially untapped method for raising business capital. This article focuses specifically on use of the Internet by small-to-medium-sized companies as an alternative to use of traditional public stock offerings.

Part II of this article discusses how this practice began and how it is developing. It also explains how federal securities laws have evolved to make this method of corporate finance possible. Part III examines the legal concerns of Internet direct public offerings (DPOs), analyzing actual DPOs, discussing the SEC’s reaction, and examining the resulting law. Part IV discusses the future of the Internet DPO and the reasons for its slow market acceptance.

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12. [http://www.haledorr.com/publications/ipo/1999/1999\\_iPO\\_rev.html](http://www.haledorr.com/publications/ipo/1999/1999_iPO_rev.html) (noting that in 1998, public offerings raised \$1.96 billion for 42 technology firms, while venture capitalists invested \$13.7 billion in about 2,000 of these firms).

13. *See id.*

14. *See* Technika, at <http://www.technika.org/ec/news/020699.htm>.

## II. BACKGROUND, DEVELOPMENT, AND THE LAW

### A. Electronic Stock Trading

For many years, electronic stock trading has occurred through established markets like NASDAQ and the NYSE. Before trading stocks electronically, companies must be accepted by one of the organized and registered securities exchanges in the U.S.<sup>15</sup> To achieve such acceptance, companies must employ brokers, underwriters, traders, and other securities industry professionals, often at a significant cost.<sup>16</sup>

Electronic trading is now more accessible to individuals at the retail level. Many brokerage houses maintain websites that allow its customers to make trades at substantially reduced commission rates.<sup>17</sup> Anyone with a computer and a few dollars to invest in equities can trade on the market. As a result, the number of new investors entering the market has reached an all-time-high. An important part of this growth is a new breed of novice "day traders" — those who buy and sell stock on personal computers at home.<sup>18</sup> But the majority of this trading is limited to stocks listed on a traditional exchange. Where does that leave the other businesses that have been turned down by large brokerage houses or venture capitalists? What are their options for raising capital? Is it possible for these businesses to bypass the traditional methods of raising capital and take their cause directly to the public by offering stock online?

The Internet gives small businesses the opportunity to offer shares of stock directly to the public through a DPO, without any listing requirements, investment bankers, or brokers. In such a DPO, issuers create their own "cyberspace" markets that bypass traditional stock exchanges and over-the-counter markets. This method enables a business to raise capital without the high costs of underwriting.<sup>19</sup> With the number of Internet users estimated at 80

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15. JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 234 (Barron's Educ. Series 3d ed. 1991) (noting that a stock accepted and registered on one of these exchanges is a "listed security").

16. CHAMBERS & LACEY, *supra* note 11, at 71-72.

17. For examples of reduced prices for Internet trading, see Charles Schwab, at <http://www.schwab.com> (advertising trades for as low as \$14.95 per trade); Waterhouse Securities, at <http://www.waterhouse.com> (advertising trades for as low as \$9.99 per trade); Datek Online, at <http://www.datek.com> (advertising fees of \$9.99 for all types of orders); Ameritrade, at <http://www.ameritrade.com> (advertising trades for as low as \$8.00 per trade).

18. *See* Technika, *supra* note 14.

19. CHAMBERS & LACEY, *supra* note 11, at 71-72.

million and growing,<sup>20</sup> there are enough potential investors to raise a significant amount of capital and enough information to create an orderly and efficient Internet stock market.<sup>21</sup>

Improved technology is not the only factor facilitating Internet DPOs. In 1992, many provisions of the federal securities laws<sup>22</sup> were liberally revised.<sup>23</sup> The 1992 changes gave small businesses greater flexibility in raising capital.<sup>24</sup> Before 1992, issuers were often limited by restrictive provisions of exempted transactions, which required investors to be "sophisticated" or "accredited."<sup>25</sup> Also, once investors purchased shares under the old provisions, they were often subject to restrictions on transferability. But the changes in Regulation A relaxed the restrictions and opened the door for Internet DPOs.

### **B. Regulation A: The Starting Point for an Internet Offering**

Regulation A, the "Conditional Small Issues Exemption," consists of Rules 251-264 of the Securities Act.<sup>26</sup> This exemption recognized by section 3(b) of the Securities Act,<sup>27</sup> which authorizes the SEC to exempt certain securities from registration when it finds that the dollar amount of the offering is so small,

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20. See Forrester Research, at <http://www.forrester.com/ER/WelcomeGuest/1,1402,0,FF.html>.

21. James E. Grand & Gary Lloyd, *Internet IPO's: A Potential Oasis for Small Companies*, Upside Publishing, at <http://www.upside.com/texis/mvm/story?id=34712c14c> (July 1996).

22. See Securities Act of 1933 (codified as amended at 15 U.S.C. § 77a et seq. (1994)) [hereinafter "Securities Act"]; see also Securities Exchange Act of 1934 (codified as amended at 15 U.S.C. § 78a et seq. (1994)) [hereinafter "Exchange Act"].

23. JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS 72-78* (Little, Brown & Co. Supp. 1996).

24. *Id.*

25. Regulation D, Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.501-230.508 (defining "accredited investors" as those deemed to have access to registration information and possessing investment sophistication and those whose net worth exceeds \$1 million at the time of purchase).

26. See *id.* §§ 230.251-230.264.

27. Regulation A, Conditional Small Issues Exemption, 17 C.F.R. § 230.

or that the offering would be so limited, that a full public offering under section 5 of the Securities Act would be unwarranted.<sup>28</sup>

The Commission has authority to exempt securities under Regulation A only if an issue's aggregate offering price does not exceed \$5 million.<sup>29</sup> Before the 1992 changes, Regulation A was seldom used because it limited offerings to a maximum of \$1.5 million for any 12-month period. With the increased maximum, Regulation A has become popular among small businesses, which like its flexibility and adaptability.<sup>30</sup> Issuers of existing and proposed stock offerings commonly use Regulation A.<sup>31</sup>

Regulation A offerings begin when an "offering statement" is filed with an SEC regional office.<sup>32</sup> Such regional filing makes the process more convenient, and thus less burdensome, for small businesses. The requirements for an offering statement are similar to those for a registration, but simpler.<sup>33</sup>

One of the most appealing provisions of Regulation A is that it allows companies to "test the waters"<sup>34</sup> by soliciting indications of interest before filing

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28. Securities Act § 3(b) (codified as amended at 15 U.S.C. § 77c(b)); see LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 137 (3d ed. 1997) (noting that a Regulation A offering has been called a "mini-registration" or "mini-public-offering").

29. See SEC Rule 251(b), 17 C.F.R. § 230.251(b) (discussing requirements for aggregate offering price).

30. See Small Business Initiatives, Exchange Act Release No. 33-6949, 51 SEC Docket No. 20 (CCH) ¶ 2154, at 2156 (July 30, 1992) (discussing liberalization of Regulation A); see also COX ET AL., *supra* note 23, at 75.

31. See Constance E. Bagley & Robert J. Tomkinson, *Internet Is Seeing Its Share of Securities Offerings: Rise in Web-Based Services for Small Issuers Helps Make Online Route a More Viable Alternative*, NAT'L L. J., Feb. 2, 1998, at C3 (explaining that the Internet may also be used to conduct registered public stock offerings and that such an offering operates like a traditional registered IPO except that it occurs on the Internet).

32. See SEC Rule 252, 17 C.F.R. § 230.252.

33. See COX ET AL., *supra* note 23, at 76 (stating that for a Regulation A offering, the circular and the financial statements need not be audited unless the issuer has prepared them for some other purpose).

34. See *id.*

an actual offering statement.<sup>35</sup> Under the federal securities laws, materials used to “test the waters” are not deemed a “prospectus” so long as they comply with Regulation A guidelines.<sup>36</sup>

Another benefit of Regulation A is its lack of restrictions on the resale of issued securities.<sup>37</sup> This provision makes Regulation A superior to other exemptions, which impose significant resale restrictions.<sup>38</sup> Regulation A also allows issuers to make secondary offerings up to \$1.5 million.

Regulation A offerings will not be integrated with other exempt and registered offerings, provided there is an appropriate waiting period before stocks are offered.<sup>39</sup> Despite the overall liberal posture of Regulation A, the SEC reserves the right to suspend the exemption’s use for noncompliance with specific provisions of the rule.<sup>40</sup>

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35. See SEC Rule 254(a), 17 C.F.R. § 230.254(a) (allowing an issuer to “publish or deliver to prospective purchasers a written document or make scripted radio or television broadcasts to determine whether there is any interest in a contemplated securities offering,” but requiring the document or script to be submitted to the Commission and making it subject to the anti-fraud provisions of the securities laws); see also <http://www.direct-stock-market.com> (providing an example of “testing the waters” for a Regulation A Internet offering).
  36. SEC Rule 254(e), 17 C.F.R. § 230.254(e); see Securities Act § 2(10), 15 U.S.C. § 77b(10) (defining “prospectus”).
  37. See Small Business Initiatives, Exchange Act Release No. 33-6949, *supra* note 30 (discussing restrictions on resale in commonly exempted transactions); SEC Rule 502(d), 17 C.F.R. § 230.502(d) (stating that “securities acquired under Regulation D shall have the status of securities acquired in a transaction under section 4(2) of the Act and *cannot be sold without registration* under the Act or an exemption therefrom” (emphasis added)).
  38. See *supra* note 37; see also Exemption for Local Offerings from Registration, Exchange Act Release No. 33-4434, 1 Fed. Sec. L. Rep. (CCH) ¶ 2270, at 2275 (Dec. 6, 1961).
  39. SEC Rule 251(c), 17 C.F.R. § 230.251(c) (stating that offers and sales made in reliance on Regulation A will not be integrated with certain other offerings that are specifically enumerated or that occur over six months after the completion of the Regulation A offering); SEC Rule 254(d), 17 C.F.R. § 230.254(d) (stating that an issuer with a “bona fide change of intention” who decides to register the offering instead of proceeding with the Regulation A offering may do so without fear of integration if: (1) the offering statement has not yet been filed; (2) at least 30 calendar days have elapsed between the last solicitation of interest and the filing of the registration statement with the SEC; and (3) all solicitation-of-interest documents have been submitted to the SEC).
  40. See SEC Rule 258, 17 C.F.R. § 230.258.

Although Regulation A is often used for Internet offerings, it does not specifically discuss the effect of electronic media on an offering. Yet the effect of electronic media has been addressed under other provisions of the federal securities laws. Therefore, for an Internet DPO, the SEC's position on electronic media must be considered in conjunction with Regulation A.

## C. Electronic Media Under the Federal Securities Laws

### 1. Electronic Data Gathering, Analysis, and Retrieval System

In 1984, the SEC began using its Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) to collect corporate filings.<sup>41</sup> EDGAR is an electronic medium that makes receiving and processing documents filed with the Commission more efficient. Thus, companies no longer have to endure the tedious and costly process of filing large paper documents.

Once EDGAR was implemented, over 70% of all domestic public companies filed documents electronically. Indeed, the system was so successful that in May 1996, the SEC began requiring all domestic companies registered with the SEC to file their documents electronically.

### 2. Relevant Securities and Exchange Commission Releases

In 1995, the SEC issued three releases — 33-7233, 43-36345, and IC-21399<sup>42</sup> — that discuss the use of electronic media for document delivery under the federal securities laws.<sup>43</sup> In these releases, the SEC observed that electronic document delivery is promising because it enhances the investors' ability to access, research, and analyze the pertinent information.<sup>44</sup> As the SEC noted, electronic distribution has many benefits and "should not be disfavored."<sup>45</sup>

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41. See EDGAR, at <http://www.sec.gov>; Kenneth B. Noble, *SEC Inaugurates Computer Filing System*, N.Y. TIMES, Sept. 25, 1984 at D1, col. 1.

42. Use of Electronic Media for Delivery Purposes, Exchange Act Release Nos. 33-7233 and 34-36345 & IC-21399, 60 Fed. Reg. ¶ 53,458 (Oct. 6, 1995) (codified at 17 C.F.R. pts. 231, 241, and 271), available at 1995 WL 588462 (S.E.C.).

43. *Id.* §§ 53,458–53,467 (discussing use of electronic media under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940).

44. *Id.* § 53,458 n.7 (predicting that electronic filings through EDGAR will "encourage rapid dissemination of additional information considered valuable by many members of the investment community").

45. *Id.* § 53,459.



Furthermore, in these releases, the SEC explained that using electronic media increases market efficiency by allowing dissemination of market information in a more "cost efficient, widespread, and equitable manner than traditional paper based methods."<sup>46</sup>

Overall, then, the SEC has viewed electronic media favorably, although somewhat cautiously. Because Internet stock offerings are completely paperless offerings that exist entirely online, the SEC's continued approval of electronic media is vital to the ongoing viability of Internet DPOs.

### III. LEGAL ISSUES OF INTERNET DIRECT PUBLIC OFFERINGS

#### A. The SEC's Response to Internet DPOs

In March 1996, Spring Street Brewing, Inc. revolutionized the way stock is offered by conducting the first public stock offering over the Internet.<sup>47</sup> A small New York City microbrewery, Spring Street was looking for a novel way to raise a small amount of additional capital. Andrew Klein, the company chairman and a former securities lawyer, believed that a traditional public offering would be far too costly.<sup>48</sup> After considering Regulation A and the recent developments in securities laws, he devised a method to offer Spring Street stock directly to investors over the Internet.

In connection with the proposed offering, Klein created a computer bulletin board called "Wit-Trade."<sup>49</sup> The site was designed to match prospective buyers of Spring Street shares with sellers, thereby creating a marketplace for the company's stock. Wit-Trade gave investors in Spring Street's unregistered shares a means to contact other investors about potential trades. The trading mechanism was simple — two online bulletin boards and a form contract that parties could use to execute binding agreements to trade shares.

In a March 22, 1996 no-action letter to Klein, the SEC detailed its concerns about this new method of stock offering and bulletin-board trading.<sup>50</sup> First, the SEC expressed a general concern that investors relying on Internet

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46. *Id.* § 53,461.

47. Associated Press, *SEC Clears Trades of Spring Street Stock on Internet*, N.Y. TIMES, Mar. 26, 1996, at D4.

48. See ANDREW D. KLEIN, WALLSTREET.COM: FAT CAT INVESTING AT THE CLICK OF A MOUSE 88 (1998).

49. See Wit Capital Corporation: Introduction to the Company, at <http://www.witcapital.com> (stating that the offering successfully raised \$1.6 million).

50. Spring Street Brewing Co., SEC No-Action Letter, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,001, at 77,201 (Apr. 17, 1996).

stock trading would not be adequately protected from risks. Next, it listed five specific concerns to be addressed by Spring Street:

- (1) investor understanding of the risks of illiquid stocks,
- (2) proper handling of investors' funds,
- (3) proper handling of securities,
- (4) frequency of security price updates, and
- (5) methods of disclosure for company information.<sup>51</sup>

Although the SEC did not prohibit this new Internet-based trading practice, it was plainly cautious in granting its full endorsement.<sup>52</sup> In response to the SEC's concerns, Spring Street voluntarily halted trading after raising about \$1.6 million in the Internet offering.

Since the Spring Street offering, other companies have followed a similar path, using Regulation A to offer securities directly to the public over the Internet.<sup>53</sup> Companies such as Perfect Data Corporation, Real Goods Trading Information, the Flamemaster Corporation, and the Angel Capital Network have all sought to provide a website where shareholders and potential investors could meet to arrange trades.<sup>54</sup>

In response to these proposals, the SEC took the position that the issuer of the shares should have no proprietary, financial, or other interest in the operation of the website.<sup>55</sup> Instead, the website should function simply as a place where investors could meet. In this respect, the website serves almost the same function as corporate headquarters.<sup>56</sup>

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51. *Id.*

52. *Id.* (noting that innovation and creativity "are the hallmark of our nation's securities markets, contributing enormously to the most efficient capital formation system in the world" but adding that "it is our job, first and foremost, to insure protections for public investors").

53. Bagley & Tomkinson, *supra* note 31.

54. Real Goods Trading Corp., SEC No-Action Letter [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,226, at 77,131 (June 24, 1996); Flamemaster Corp., SEC No-Action Letter, 1996 WL 762990 (Oct. 29, 1996); Angel Capital Elec. Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996).

55. Joseph J. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millenium*, 52 BUS. LAW. 815, 829 (1997) (citing Real Goods Trading Corp., SEC No-Action Letter [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,226, at 77,134 (June 24, 1996)).

56. *Id.*

The no-action letters granted to these later Internet offerings, tempered by the legal issues raised in the SEC's letter to Spring Street, serve as the basis for this developing body of law.<sup>57</sup>

## B. Specific Concerns About Internet DPOs

### 1. Investor Understanding of Risk

Internet stock offerings pose high risks. Although some safeguards exist, investors are essentially investing in shares that are the equivalent of nontransferable venture-capital interests, which are nontransferable unless the company has a public offering. Since there is still no public market or standardized method to transfer exempt securities, the Internet investment is almost impossible to buy or sell. Although prospectuses posted online must clearly describe these risks, such postings alone may not be enough.<sup>58</sup>

The Internet reaches many people who have little investment experience and who may be misled by the seemingly low prices of DPO shares. For them, an Internet DPO may be extremely risky. For example, in 1996, Pyromid Corporation, a manufacturer of outdoor cooking equipment, planned an Internet DPO. The proposed offering price was seemingly inexpensive at \$5 per share. But at the time, Pyromid was under Chapter 11 bankruptcy protection, had never made a profit, and had little prospect of emerging from bankruptcy. While an experienced investor might have known these facts, an inexperienced one might not have. Without a legitimate market to dictate price, the average investor has no way of knowing whether \$5 per share is a bargain or is overpriced.

The federal securities laws and the SEC seek to protect unsophisticated investors.<sup>59</sup> But for an Internet DPO, this goal is hard to achieve. Although the anti-fraud provisions of the Securities Exchange Act of 1934 apply, the Internet's size and decentralization present difficult enforcement problems for the SEC. For example, "virtual corporations" that exist entirely on the Internet are often transient. And when an offending company's sole address is in cyberspace, the offender may be hard to track down.

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57. See Use of Internet Websites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore, Exchange Act Release Nos. 33-7516, 34-39779, IA-1710, and IC-23071, 1998 SEC LEXIS 488 (Mar. 23, 1998) (taking particular note of the global reach of the Internet and the new issues that have arisen as a result).

58. For an example of an online prospectus, see <http://www.direct-stock-market.com>.

59. SEC Mission Statement, at <http://www.sec.gov>.

## 2. Proper Handling of Funds and Securities

The SEC has expressed particular concern over the way investor funds and securities are handled by companies using the Internet for DPOs.<sup>60</sup> In the Spring Street offering, investors mailed checks directly to Spring Street without any fund-handling by an escrow agent or intermediary. In its no-action letter on this offering, the SEC stated that the use of a third party would prevent potential commingling of funds and protect both the corporation and the investor.<sup>61</sup>

Later, the SEC required companies offering and trading securities over the Internet to provide investors with the same protection that they would have in trading on a traditional exchange.<sup>62</sup> Therefore, corporations contemplating Internet DPOs must now use a third-party escrow agent. This practice prevents the potential conflict of interest that arises when one party both receives funds and issues stock, thus standing on both sides of the same transaction.<sup>63</sup>

Unless a third-party escrow agent is involved, an issuer may be subject to "broker-dealer" regulations under securities laws.<sup>64</sup> Under those regulations, a broker-dealer may be held liable for violating section 5 registration requirements by making a material misrepresentation or omission in a prospectus. An issuer of Internet stock that is not registered as a broker-dealer may avoid accountability for its actions, thus leaving investors with less protection.

Notably, Spring Street registered itself as a broker-dealer for its newly formed investment banking subsidiary, Wit Trade. For its offering, Spring Street issued stock directly from its treasury without using a transfer agent.<sup>65</sup>

As a practical matter, many small-to-medium-sized corporations do not have the resources to handle securities directly. Some have scarcely enough personnel to run their core businesses, much less to accurately record names on certificates, to keep issuance records up-to-date, and to keep track of treasury stock. Although using a third-party transfer agent increases the costs of a DPO, it also frees the issuer from the administrative burden of handling securities, thus enabling it to focus its attention on its core business.<sup>66</sup>

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60. Spring Street Brewing Co., SEC No-Action Letter, *supra* note 50; *see also* Klein, *supra* note 48, at 101-06.

61. Spring Street Brewing Co., SEC No-Action Letter, *supra* note 50.

62. Cella & Stark, *supra* note 55, at 828-29.

63. *See* Greg Desmond, *Internet Stock Offerings*, at <http://www.law.miami.edu/~froomkin/seminar/papers/desmond.htm>.

64. Securities Act of 1933 § 12 (codified as amended at 15 U.S.C. § 771).

65. Spring Street Brewing Co., SEC No-Action Letter, *supra* note 50; *see also* Klein, *supra* note 48, at 101-06.

66. *See, e.g.*, Spring Street Brewing Co., at <http://plaza.interport.net/witbeer/withome.htm>.

### 3. Frequency of Price Updates

Wit-Trade, which was created and developed by Spring Street Brewing, was the first trading mechanism designed to provide investors with a method of trading their shares over the Internet. The original system was nothing more than a bulletin board that enabled buyers and sellers of shares to negotiate trades.<sup>67</sup> This system was best described as a facilitator, rather than as an exchange.<sup>68</sup> As a result, it was not subject to the rules that govern exchanges under federal securities laws.<sup>69</sup>

Since the creation of Wit-Trade, other websites, including IPOnet<sup>70</sup> and Direct,<sup>71</sup> have specialized in issuing and trading Regulation A and D offerings. Unlike Wit-Trade, however, these two websites are affiliated with registered broker-dealers, a relationship that increases credibility.<sup>72</sup> Other examples, like the Angel Capital Network and IPO.com, operate much like Wit-Trade by seeking to facilitate information flow and to coordinate orders between buyers and sellers. These companies do not create markets, match buy and sell orders, or negotiate transactions.<sup>73</sup> Instead, they provide an inexpensive, efficient alternative to traditional financial-service providers without forcing offerors to handle everything on their own.<sup>74</sup>

Wit-Trade was deemed insufficient because it had no mechanism that could update the market, display the last trade, or give accurate quotes. The systems that followed Wit-Trade have not solved this problem. But an SEC ruling has expanded the definition of "exchanges" and has approved the use of alternative trading systems.<sup>75</sup>

On December 8, 1998, the SEC adopted new Rule 3b-16, which contains a new regulatory framework scheme for "Alternative Trading Systems" (ATS). The new rule requires an ATS to either: (1) register with the SEC as a national

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67. *Id.*

68. Grand & Lloyd, *supra* note 21.

69. Securities Exchange Act of 1934 § 3(a)(1) (codified as amended at 15 U.S.C. § 78c (defining "exchange")).

70. IPOnet, at <http://www.e-iponet.com> (noting that IPOnet is affiliated with W.J. Gallagher & Co., Inc., a registered broker-dealer).

71. Direct IPO, at <http://www.directipo.com>.

72. Bagley & Tomkinson, *supra* note 31.

73. *Id.*

74. *Id.*

75. 17 C.F.R. §§ 240.3b-16, 242.300–242.303.

securities exchange in accordance with the Securities Exchange Act of 1934; or (2) register as a broker-dealer and comply with the new requirements of the ATS rule. It is unclear, however, how the new rule will affect the status of unregistered, nonaffiliated trading systems.

#### 4. Liquidity

Liquidity is another SEC concern for stocks offered through an Internet DPO. While these stocks are offered publicly, there is no recognized public market for selling them. While the trading mechanisms discussed above help facilitate buying and selling, there is not yet a critical mass of traders, which is needed to create a liquid market.<sup>76</sup> Of course, ever-increasing Internet use — both domestically and internationally — could help to achieve such a critical mass. But when U.S. securities are traded abroad, new securities-law issues inevitably arise.<sup>77</sup>

The best means of improving liquidity would be to create a bona fide registered Internet stock market. With the passage of the ATS rules, this solution may become more feasible. But in the absence of such a market, disclosure is the best means of addressing the liquidity problems of Internet DPOs.<sup>78</sup>

To comply with exempt-offering requirements, prospectuses for Internet DPOs must disclose the risk of illiquidity. But such disclosure alone is probably insufficient. The SEC has suggested that offerors should provide more detailed disclosures about the risks of purchasing illiquid securities.<sup>79</sup>

Specifically, investors should be warned that they may be unable to sell their shares at the purchase price — or at any other price. And given the availability of Internet offerings to unsophisticated investors, offerors should provide plain English disclosures of the risks of illiquid securities. Indeed, the SEC has required such disclosures in other areas of securities law.<sup>80</sup>

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76. Bagley & Tomkinson, *supra* note 31.

77. See Use of Internet Websites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore, *supra* note 57 (taking particular note of the global reach of the Internet and the new issues that have arisen as a result); see also Cella & Stark, *supra* note 55, at 834-35.

78. Spring Street Brewing Co., SEC No-Action Letter, *supra* note 50.

79. *Id.*

80. For examples of disclosure documents, see HOWARD M. FRIEDMAN, SECURITIES REGULATION IN CYBERSPACE 2-9, 2-20 (1997); see also <http://www.direct-stock-market.com>.

## 5. Compliance with State Blue Sky Laws

Understanding and complying with state securities laws is a tedious and costly process for issuers using Internet DPOs. These laws, also called "Blue Sky Laws,"<sup>81</sup> require issuers to register their offerings in each state in which the securities will be sold. To do so, an issuer must prepare financial disclosure documents and pay a filing fee in each state of intended sales.<sup>82</sup>

Most state Blue Sky Laws differ from federal securities laws by requiring more than "disclosure only."<sup>83</sup> Indeed, for most states, securities administrators evaluate a proposed offering on its merits and allow the sale only if the offering is deemed desirable.<sup>84</sup>

Currently, an issuer of Internet stock cannot legally bypass Blue Sky Laws. By contrast, the New York Stock Exchange has automatic exemptions from those laws for securities listed on the exchange. With the passage of the Capital Markets Efficiency Act of 1996,<sup>85</sup> the Blue Sky exemption will extend to all "exchanges," as defined under the Securities Exchange Act of 1934.<sup>86</sup> The recently expanded definition of "exchange" could encompass some of the new alternative trading systems.<sup>87</sup>

## 6. Security of Information

Another major concern of the SEC is the security of information, particularly financial information, sent over the Internet. But advancements in encryption technology and secure Internet servers have drastically reduced concerns in this area.

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81. See *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917) (noting that the expression "Blue Sky Laws" reflects the states' initial purpose for enacting such laws — to stop the sale of interests in companies with no more substance than "so many feet of blue sky").

82. DOWNES & GOODMAN, *supra* note 15, at 241.

83. Desmond, *supra* note 63.

84. *Id.*

85. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 102, 110 Stat. 3416, 2419 (1996); Capital Markets Efficiency Act of 1996, Pub. L. No. 104-290, § 101, 110 Stat. 3417 (1996) (exempting all enunciated securities from Blue Sky Registration under the Act).

86. 15 U.S.C. § 78c(a)(1) (1994) (defining "exchange").

87. Regulation ATS, 17 C.F.R. § 240.3b-16 (2000).

#### IV. SLOW ACCEPTANCE OF DPOS

Since the first offering in 1996, DPOs have yet to receive widespread market acceptance. In fact, their overall impact on the market has been small.<sup>88</sup> Three key factors have played a significant role in this slow acceptance.

##### A. Unfamiliarity of DPOs

Any new trading facility, whether Internet-based or traditional, may be subject to a rocky, uncharted beginning.<sup>89</sup> For example, the SEC issued a widely publicized release restricting companies like travelzoo.com and ecompare.com from issuing shares free of charge.<sup>90</sup> The SEC's concern about these shares was their lack of registration and their potential use as a fraudulent "come on."<sup>91</sup> In 1998, the SEC filed nearly 40 cases involving online stock scams, alleging that investors had lost hundreds of millions of dollars.<sup>92</sup>

Potential investors unfamiliar with DPOs commonly hear about the dangers of DPOs, including fraud, market manipulation, and so-called "pump and dump" schemes.<sup>93</sup> But they often do not learn about successful offerings by companies such as Spring Street Brewing that have legitimately used DPOs to raise capital that might otherwise be unattainable.

##### B. Affordable Internet Stock Trading

Large brokerage houses, financial institutions, and pension funds have shown little interest in DPOs. Thus, if DPOs are to be successful, they must attract and retain public interest through other channels.

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88. Bagley & Tomkinson, *supra* note 31.

89. Cella & Stark, *supra* note 55, at 830.

90. Sarah Hewitt & Gerard R. Boyce, *Web Offerings and the SEC*, 221 N.Y.L.J. 5 (1999) (discussing a no-action letter issued by the SEC stating its position on stock giveaways).

91. *Id.*

92. Alex Lash, *10 to Watch in 1999*, THE INDUSTRY STANDARD, January 11-18, 1999, at 36, 38, available at <http://www.thestandard.com/article/display/0,1151,2993,00.html> (discussing ten people worth watching in the area of electronic commerce, including John Reed Stark, the SEC's director of Internet Securities Fraud Enforcement).

93. *Id.*



Recently, online brokerage commissions have fallen to as low as \$8.00 per trade,<sup>94</sup> making brokerage accounts affordable for people who have never before had such accounts. Many of these people have concluded that since they can purchase listed, registered, and liquid securities at low commission rates, there is no reason to invest in DPOs. And since in recent years, the market has provided double-digit and sometimes triple-digit returns, investors are less likely to seek alternative investment vehicles. DPOs often cannot compete with stocks that gain many points over a short period and that may be purchased for only \$8.00 in commission.

### C. Lack of Reliable, Liquid Market for DPO Securities

While the new ATS laws make it easier to establish reliable alternative trading systems, such a system has not yet been created for unregistered DPO stocks.<sup>95</sup> Existing websites do not have a sufficient market to transform the character of unregistered DPO securities from "illiquid" to "liquid."

Efforts are underway, however, to resolve this problem. For example, William Hambrecht, a well-known investment banker, is trying to change public perception of the Internet DPO. His newly devised system may eventually legitimize the Internet DPO.<sup>96</sup>

Hambrecht's company has created an Internet-based auction system that will deliver IPOs to individual and small institutional investors more equitably. Hambrecht's firm provides research and after-market support for the companies it helps to underwrite.<sup>97</sup> These are small-to-medium-sized companies that might otherwise conduct DPOs themselves because they would lack the necessary capital for a public stock offering and would be unable to attract scarce venture-capital funding.<sup>98</sup> For these companies, Hambrecht's fees are significantly lower than those charged in a traditional underwriting.

The most revolutionary part of Hambrecht's system is the actual method of distributing and offering the shares. The system, called OpenIPO, is designed to avoid favoritism in selecting those who receive shares of an IPO.<sup>99</sup> Based on

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94. See, e.g. Ameritrade.com, at <http://www.ameritrade.com> (advertising an online commission rate of \$8.00 per trade).

95. Regulation ATS, *supra* note 87; see, e.g., IPOnet, at <http://www.e-iponet.com>; Direct IPO, at <http://www.directipo.com>.

96. See Jeffrey Davis, *The Underwriting Underdog*, BUSINESS 2.0, May 1999, at 110-11 (profiling William Hambrecht, his investment firm, and his new method of underwriting and offering securities).

97. *Id.*

98. *Id.*

99. *Id.*

the "Dutch Auction Model," OpenIPO uses a bidding process to find an optimal price for the stock — ideally the lowest price at which the issuer can sell all its shares.<sup>100</sup> This approach prevents large institutional investors from engaging in "flipping,"<sup>101</sup> a practice that is rampant in most traditionally underwritten IPOs.

On April 9, 1999, Hambrecht completed his first managed underwriting — a \$12 million IPO auction for Ravenswood Vineyards, a California Winery.<sup>102</sup> Since then, he has completed several others.

## V. CONCLUSION

For small-to-medium-sized companies, the Internet DPO offers the promise of crucial capital unattainable to them through other methods. Yet this form of trading, which is still in its infancy, has yet to overcome many of the problems it has faced since its inception. Securities fraud, illiquidity, and investor disinterest still plague the Internet DPO and prevent its widespread acceptance.

Nevertheless, the Internet's continued growth may help to create a larger potential base of DPO investors. And creative developments such as the OpenIPO system may eventually overcome the legal and practical concerns about this new form of trading.

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100. *Id.*

101. *Id.* (explaining that "flipping" occurs when a newly issued stock surges on the open market and institutional investors, who bought shares at great discounts, sell the stock to make hefty short-term profits).

102. *Id.*