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Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation

By John C. Coffee, Jr.*

Miranda: ... O brave new world
That has such people in't!
Prospero: 'Tis new to thee.¹

It is now a trite commonplace that the advent of the Internet will in time revolutionize securities regulation. Merely the facts that the Internet has somewhere between thirty and sixty million users worldwide today (with an estimated ten to thirty million in the United States)² and that some 800,000 U.S. investors already have online brokerage accounts³ establish that there is a potential global market that can be accessed at very low cost. But the magnitude of the market says little about what will be the character and effect of this approaching revolution.

Technological change is not a new phenomenon for securities markets, and, in the past, such transitions have not necessarily been benign for investors. The introduction of the telegraph and the telephone profoundly changed the character of the securities markets, increasing the speed with which information could reach the market and the accessibility of investors to issuer communications. But an indirect result was to increase the informational advantages possessed by the professional trader over the average investor. More recently, the appearance of the computer revolutionized securities markets by facilitating the application of modern financial economics to actual trading decisions and making feasible the use of complex

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1. WILLIAM SHAKESPEARE, THE TEMPEST, act 5, sc. 1.
3. See Allio & Lloyd, supra note 2; see also Greg Miller & Tom Petruno, For Investors, the Internet Has Promises, Paris, L.A. TIMES, June 3, 1996, at A1, available in 1996 WL 10574186 (estimating that 1.3 million such accounts will be opened by 1998).
portfolio trading strategies. Again, the individual investor seems to have been largely a bystander to this transition. Thus, that improvements in information technology can reduce costs, increase speed, and expand the audience accessible to an issuer or other provider of financial information is not a new story, but in the past this has not implied the advent of a kinder, gentler world for investors.

This prefatory comment is not intended to imply that pessimism is justified about the implications of the Internet, but only to suggest that significant transitions typically have both upsides and downsides. Indeed, the introduction of the Internet may have unique positive implications that distinguish it from prior technological advances. Among these possible implications, the following stand out.

**INVESTOR EMPOWERMENT**

Earlier improvements in information technology primarily seem to have increased the ability of informed traders to reap arbitrage profits. Paradoxically, even as market efficiency was enhanced, technological innovations exacerbated informational asymmetries with the result that informed traders profited handsomely at the expense of the uninformed. In contrast, the Internet raises at least the prospect that informational asymmetries will be reduced, not aggravated.


5. The impact of the telegraph on the securities markets provides a fascinating example of how the gains from technological innovations can be appropriated by a limited number of traders. Prior to the telegraph's invention, news reached the securities markets primarily by mail, but reached traders in the market at more or less the same time. The invention of the telegraph introduced significant informational asymmetries, in part because use of the telegraph was costly in comparison to the mail. Those who could afford to use the telegraph got news ahead of those that could not—and traded ahead of them. The easiest way for the informed trader to profit was by arbitraging the price differences between securities traded in two different markets. As a result, the differences between the prices of securities traded in both London and Glasgow narrowed significantly between 1846 and 1860 as telegraph technology was introduced and made reliable. See R.C. Michie, *The London and New York Stock Exchanges, 1850-1914*, 7-10 (1981). A similar narrowing of price differentials occurred between stock prices in New York and London once the trans-Atlantic cable was laid in 1866. *Id.* at 47-48.

In contrast, the Internet (in part because of its broad accessibility and low cost) offers the prospect of a market that comes closer to approaching the ideal of a market of homogeneously informed traders. For a fuller treatment of these issues and a more skeptical view that such a homogeneously informed market is unlikely, see Paul Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 73 WASH. U. L. REV. (forthcoming in symposium issue in 1997).

6. This is not to suggest that all informational advantages will be eliminated by the In-
Earlier technological innovations (such as the telephone) seem to have assisted the issuer more than the investor, allowing the former to target the latter. In contrast, while the Internet may assist the prospective issuer to access the market, it does even more to enable the investor to obtain significantly more information without filtration by brokers or other securities professionals who may have a self-interest in promoting transactions. Indeed, on the Internet, it is closer to the truth to say that the audience finds the issuer, rather than the issuer finding the audience. Not only can investors immediately access the EDGAR database, but they can also engage in new non-linear browsing strategies through hyperlink features that connect related materials.

The benefits are even clearer in the context of the Securities Exchange Act of 1934 (1934 Act). Rival proxy solicitations can now reach the beneficial owners almost at once through World Wide Web (Web) sites; the proxy itself may give way to electronic voting by the individual shareholder; e-mail permits better informed interaction between broker and customer; and new "chat rooms," while vulnerable to fraud, permit far more sophisticated and current intra-investor communications than did their only real precursor, the investment club. On the near-term horizon, there is the prospect of alternative trading systems on the Internet that will permit shareholders to trade with each other without the costly intervention of financial intermediaries. On the longer-term horizon, there is even the visionary possibility that the Internet can be used to pass through voting rights in securities held by pension and mutual funds to the fund's own owners or beneficiaries—a possibility that carries with it profoundly destabilizing implications for institutional investors.

The information in the Securities and Exchange Commission's EDGAR database is often stale, and access to it will not equalize informational advantages. But the Internet does much more than simply make the information filed pursuant to the SEC's mandatory disclosure system available to investors. Other sources of information, particularly those reaching online services, are very current, although not always reliable. To the extent that market prices are moved by rumors and possibilities of future contingent events, online services provide the individual investor with substantially greater access to such "noisy" information. This is both a virtue and a vice, as discussed later.


9. I do not mean to imply that the pass through of voting rights would be a sensible change from a public policy standpoint. If large institutions holding portfolios with several thousand stocks are today often overloaded, individual pensioners would be both swamped and rationally indifferent to the outcome of most proxy contests (given their small stakes). Still, a continuum of possibilities exists: beneficial owners could opt out and cast their own votes, or could engage in referenda that would inform, or even formally instruct, the fiduciaries holding the actual voting power.
MARKET EFFICIENCY

The cost of acquiring and processing information has long been recognized as one of the constraints that determine the boundaries of the efficient market.\(^\text{10}\) In other words, whether the stock price of a corporate issuer fully reflects all available information about the issuer (the usual definition of "semi-strong" market efficiency) depends in turn on the cost of acquiring information about that issuer. Reduce those costs, and the boundaries of the efficient market expand. Thus, one implication of the Internet's advent is that the boundaries of the efficient market may extend outward to include less actively traded securities on regional exchanges or the lower tiers of NASDAQ that are not today closely followed by securities analysts. This has both legal consequences\(^\text{11}\) and deregulatory policy consequences for proposals such as "company registration," which would essentially abandon (or at least relax) the transactional focus of the Securities Act of 1933 (1933 Act).\(^\text{12}\)

STATUTORY OBSOLESCENCE

By the same token, the advent of the Internet also seems likely to hasten the obsolescence of legal concepts upon which federal securities regulation has pivoted for the last sixty-odd years, but which were clearly premised on a paper-based information technology. Concepts such as "solicitation," "gun jumping," and "free writing," which are all central to the 1933 Act, presuppose a specific transactional structure for primary market securities offerings—i.e., the large, discrete offering separated in time and space from other offerings and effected by professional intermediaries (called underwriters)—that may change dramatically in a world of electronic communications. Similarly, in the context of secondary markets, the statutory structure of the federal securities laws has long assumed that the distinction between an "exchange" and a "dealer" was virtually self-evident.\(^\text{13}\) Yet, as the Securities and Exchange Commission (the Commission or SEC) has appropriately recognized in a recent concept release, the line


13. Of course, it has long been clear, if it was not in 1934, that some very close questions could arise on the boundary. See, e.g., Board of Trade v. SEC, 923 F.2d 1270 (7th Cir. 1991).
between these two legal categories has blurred.\textsuperscript{14} New information technology has given birth to functional substitutes (dubbed "alternative trading systems" in this release)\textsuperscript{15} that are rapidly becoming serious competitors to both the auction market and the dealer market. While competition is socially desirable, the understandable concern of regulators is that these new entrants may escape the oversight and accountability that the traditional exchanges have long accepted.

Statutory obsolescence is inevitable not simply because the nature of transactions will change or new competitors will appear. Rather, the Internet simply does not fit within the concepts known to the federal securities laws.\textsuperscript{16} For example, the 1933 Act draws a basic distinction between "oral" and "written" communications, tolerating the former during periods in which the latter are basically forbidden.\textsuperscript{17} Yet, as one federal court has already found, the Internet is a "unique and wholly new medium of worldwide human communication,"\textsuperscript{18} which therefore does not fit within this "oral" versus "written" schematization.

This does not mean that radical deregulation is therefore required. Fraud remains fraud, whether the medium of communication is oral, written, or electronic. Indeed, new justifications for increased regulation also surface. In a slower, paper-based world, quarterly reporting frames were deemed adequate for purposes of the 1934 Act's continuous disclosure system (and even aspirational in comparison with the rest of the world). But in an era of electronic communications, it is possible to advocate a much more rapid reporting obligation—and possibly even an obligation to report all material information on a timely, current basis.\textsuperscript{19} Similarly, while the delivery obligation imposed by the 1933 Act with regard to the

\textsuperscript{14} See \textit{Regulation of Exchanges}, Exchange Act Release No. 34-38672, 64 S.E.C. Docket (CCH) 1631 (May 23, 1997) [hereinafter \textit{Regulation of Exchanges}].

\textsuperscript{15} \textit{Id.} at 1635.

\textsuperscript{16} For reasons both of space economy and the author's limited knowledge, this Article does not undertake to describe the internal structure, organization, or operation of the Internet. But for a very accessible description in an important judicial opinion, see \textit{ACLU v. Reno}, 929 F. Supp. 824, 830-44 (E.D. Pa. 1996), aff'd, 117 S. Ct. 2329 (1997).

\textsuperscript{17} 15 U.S.C. § 77b(10) (1994). The "oral" versus "written" distinction is basically made by section 2(10) of the 1933 Act which defines the term prospectus to mean "any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale." Thus, oral statements do not amount to a prospectus and hence can be communicated during the "waiting period" prior to effectiveness without violating section 5(b) of the 1933 Act. \textit{Id.} § 77e(b). But is an interactive Internet communication shown on a computer monitor oral or written or something else? \textit{See infra} text accompanying notes 43-47.

\textsuperscript{18} \textit{See ACLU v. Reno}, 929 F. Supp. at 844.

\textsuperscript{19} The difficulty in any such proposal is not technological but legal. Today, silence is not actionable, absent a duty to disclose. \textit{See Basic, Inc. v. Levinson}, 485 U.S. 224, 231 (1988). Such an obligation can arise because of a reporting requirement under the 1934 Act. Thus, a consequence of a constant obligation to report material developments on a timely basis is vastly to increase the risk of liability.
final prospectus was greatly relaxed by recent amendments to Rule 434 in light of the advent of T+3 settlement, immediate electronic delivery of the final prospectus is feasible, and arguably should be required.

INSTITUTIONAL STRUCTURE

Clearly, new competitors are appearing (such as the above-mentioned "alternative trading systems"), and normally this should reduce the cost of services to consumers. But, as new entrants appear, their arrival may also expose the arbitrary and outdated character of the existing regulatory structure, which leaves some new entrants arguably underregulated and thereby results in an unlevel playing field. Also, to the extent that new competitors (such as electronic communication networks) begin to compete with, and partially supplant, existing financial intermediaries (such as underwriters), some of the traditional functions performed by the older intermediary (such as the gatekeeper role of underwriters) may be lost or abandoned, arguably with consequent social injury.

DISINTERMEDIATION?

The outer limits of the changes in institutional structure that the Internet may cause are hazy, but already the most enthusiastic prophets of the Internet predict an approaching revolution in which issuers will directly access investors over the Internet (without the need for the costly services of underwriters) and in which shareholders will directly trade with other shareholders (without the need for brokers or dealers). The common denominator in these scenarios is the relative disappearance, or at least downsizing, of traditional financial intermediaries—a possible development this Article calls "disintermediation."

How likely is the prospect of disintermediation? This Article argues that modest movement in this direction is likely, but major shifts are improbable. Advances in information technology do not render obsolete the key services that financial intermediaries in the securities markets actually provide, namely: (i) acting as reputational intermediaries in primary market


21. Among academics, the leading prophet of the "virtual exchange" without intermediaries is probably Professor Junius Peake, a finance professor at the University of Northern Colorado and a former vice chairman of the National Association of Securities Dealers (NASD). See also Melissa Bane, The Virtual Exchange: Who Needs Wall Street?, COMPUTER-WORLD, June 17, 1996, at 125A, available in 1996 WL 2372613. See Michael Meyer, Deep-Sixing Doubloons, NEWSWEEK, June 16, 1997, at 72. Professor Donald Langevoort probably published the first prophecy that new information technology would lead to the partial replacement of underwriters by electronic substitutes that would permit direct sale of equity by issuers. See Langevoort, supra note 4, at 765-78. That prophecy now appears to have been at least thirteen years premature (although it could still prove accurate and perceptive).
transactions, and (ii) supplying liquidity and immediacy to secondary markets. Thus, the more likely prospect is for that which can be called "partial disintermediation." Direct transactions between issuers and investors in primary offerings and between investors in secondary market transactions will become more likely, even if they account over the near term for only a token minority of such transactions. Nonetheless, as intermediary-less transactions become more common, regulatory problems will surface, which, if they cannot yet be solved, can at least be identified.

**FRAUD AND EXTRATERRITORIAL EVASION**

The downside to the Internet's appearance is the increased potential for fraud. A rogue issuer or broker (or simply a non-licensed person offering "guaranteed safe" investments) can reach an audience via the Internet that is larger by orders of magnitude than the same person could have reached working a telephone in the traditional boiler room. More importantly, not only may individual investors be overreached, but the market in a security may be intentionally manipulated through anonymous or misattributed tips or rumors placed on "chat rooms" and other online bulletin boards. Although Internet fraud is far from undetectable (and indeed is probably more easily observed than fraud from the classic boiler room), special problems arise when the issuer (or other provider of information) is based offshore. The SEC's practical ability to obtain effective enforcement over the offshore rogue is at best doubtful. In addition, the Internet creates the possibility of offshore exchanges and trading systems that may be entirely beyond the SEC's effective reach.

In light of these multiple trends, two very different scenarios now compete for dominance. On one hand, the optimistic scenario sees the potential for enormous reductions in the distribution costs for issuers and the trading costs for investors, and the potential to introduce new competitors into the system to replace unnecessary and costly financial intermediaries. On the other hand, the pessimistic scenario focuses less on increased efficiencies than on the political and legal anarchy that the Internet portends. Because the Internet network (as in reality, a collection of interconnected nodes at which computers store information, service information requests, and establish communication links with other systems in the network) is beyond the jurisdictional reach of any centralized political or legal authority, the world of the Internet arguably resembles the Hobbesian state of nature or the American Wild West of the nineteenth century. From this

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pessimistic perspective, cyberspace may be beyond the effective reach of traditional legal rules.

Given the magnitude of these potential changes, it would take a level of confidence bordering on hubris to announce the likely outcome or the optimal regulatory solution. This Article pursues only a more modest goal: to survey recent developments in several distinct contexts and examine the short- to intermediate-term regulatory issues that these developments pose. A special focus is on the likely impacts of the Internet on the gatekeepers and intermediaries who have, to date, largely operated and monitored our securities markets. Specifically, the contexts examined are: (i) the primary market (with a specific focus on the initial public offering), (ii) the secondary market context (in light of the new SEC focus on alternative trading systems), (iii) private markets, (iv) the new character of Internet fraud (and what can be done about it), and (v) the extraterritorial context.

THE PRIMARY MARKET CONTEXT

The first anniversary of the initial online public offering has already passed without any serious effort yet being made to assess its implications. In March 1996, a small New York microbrewer of European-style beers, Spring Street Brewing Co., completed the first online public offering, raising a relatively modest $1.6 million without the assistance of investment bankers. Founded in 1992, Spring Street had previously raised capital through private placements, but it was too small and unproven to attract the attention or interest of investment banking firms. Needing to find its own financing without the aid of investment bankers, it simply created a Web page from which investors could download its offering documents. Some 3500 investors purchased 844,581 shares at $1.85 per share (for a total offering of slightly less than $1.6 million).

So what are the implications of this first online offering? In overview, the Spring Street offering provides a predictable example of what happens when a new issuer without an established reputation seeks to market its

24. The term "gatekeeper" has a special meaning within the field of law and economics: namely, a third party typically having reputational capital whom a firm enlists to gain legitimacy, expertise, or satisfy a legal requirement (for example, an accountant). See Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53 (1986).


26. See Kollar, supra note 25.
securities on its own without an underwriter or other financial intermediary. Given that 3500 investors invested nearly $1.6 million, the numbers work out to an average investment per investor of approximately $474 (or, on a per share basis, approximately 241 shares per investor). In short, the average investor gambled only a very small amount (even by the standards of penny stocks) on an investment that was not associated with any well-known investment banking or brokerage firm.

This should not be surprising. At least within the academic world, a standard view of investment banking firms is that they serve (particularly in the initial public offering context) as "reputational intermediaries," implicitly pledging their own reputations for their often little-known clients. In this view, it is not the underwriters' distributive capacity or their financial risk-bearing capability that is critical; rather, it is their ability to pledge their reputational capital for the issuer, in effect implicitly certifying the accuracy of its disclosures. An offering, such as the Spring Street offering, in which the issuer does not employ such reputational intermediaries and (possibly as a result) obtains only a very modest investment from each investor, seems to confirm this view of the underwriter's central function.

The Spring Street offering was also accomplished through a special exemption from registration (known as Regulation A), which permits the issuer to use a short-form substitute for the much longer registration statement that the SEC would ordinarily require. Although the Spring Street offering attracted a great deal of media attention in the United States as the first successful online offering, its value as a guidepost for the future is limited by its reliance on Regulation A. That exemption applies only to certain non-reporting issuers and permits such an issuer only to raise up to $5 million in the aggregate during any twelve-month period—a ceiling well below the capital needs of most start-up companies.

Nonetheless, that anyone invested in the Spring Street offering may have been the consequence of a unique feature of Regulation A which permits the issuer to "test the waters" by contacting investors before it files its offering documents. In contrast, an issuer seeking to register an initial public offering (IPO) may not condition the market in any way prior to filing its registration statement with the SEC. For an issuer, like Spring Street, that wants to raise capital without the assistance of investment bankers, the ability to engage in informal contacts and solicitation before it delivers the formal offering documents may facilitate the offering (although the regulations also require the issuer to stay below the $5 million

27. See Gilson & Kraakman, supra note 10, at 613-21.
29. See id. § 230.251(a)(2).
30. See id. § 230.251(b).
31. Rule 254 permits the use of a "solicitation of interest" document prior to filing an offering statement. See id. § 230.254.
A number of companies appear to be following Spring Street's lead, and some may also be relying on Regulation A.

If the Spring Street offering thus suggests that a direct issuer offering without any financial intermediary is more a novelty than a trend (or is, in fact, a desperate gamble by an issuer with no other alternatives), other contexts can be postulated in which the Internet may make such a direct equity offering more plausible. For example, a mature company with an existing shareholder base might well wish to conduct a subscription offering using its Web page as the principal means of contact with prospective investors. The obvious attraction of this approach is that it eliminates the underwriter's discount without necessitating the traditional lengthy delay that subscription offerings required in the past.

Already, large companies have begun to use their Web pages as a means to disseminate their prospectuses. In such a registered public offering, however, stricter limitations apply than in a Regulation A offering. Not only may the issuer not in any way seek to "condition the market" before it files its registration statement with the SEC, but, during the often lengthy waiting period while the SEC reviews the registration statement (and negotiates changes with the issuer), "free writing" is not permitted. This means that only those written documents expressly permitted by SEC rules can be used during this period when the offering is, in fact, being marketed to investors. Currently, Rule 134 states the applicable limitations on written statements (other than pursuant to a prospectus) after a registration statement has been filed. When it was promulgated, it was narrowly framed with the traditional "tombstone ad" in mind. Hence, at present, only limited, factual statements seem permissible on a Web page prior to the "effectiveness" of the registration statement (if the issuer is registering the securities and not relying on Regulation A).

32. See Internet Offerings: On-Line Capitalism, ECONOMIST, Nov. 23, 1996, at 92, available in LEXIS, News Library, Econ File (estimating that 30 companies were then embarked on similar initial offerings patterned after Spring Street). It is not clear that all these issuers are relying on Regulation A; some may be attempting fully registered IPOs.

33. Of course, underwriters might (or might not) be used on a standby basis and receive a commitment fee for this service. Although subscription offerings have not been popular in the United States, they are the dominant distribution technique in Great Britain. One reason for their unpopularity in the United States is the delay associated with their use. Typically, investors are given a 30-day period to exercise the subscription warrants that were earlier distributed to them as a dividend. This time period might easily be telescoped in a world of electronic communications.


36. See 17 C.F.R. § 230.134. The traditional "tombstone ads," which appear in financial newspapers, such as the Wall Street Journal, and list the participating underwriters, are expressly permitted by Rule 134. Id. § 230.134(a)(7).
For the mature corporation that qualifies for Form S-3, these pre-filing restrictions are less important because their registration statements are likely to be in a state of constant effectiveness. Yet, even though restrictions applicable to the pre-filing or waiting periods do not apply to them, they also cannot distribute or use written materials (other than the prospectus or material exempted by a specific rule, such as Rule 134) until a copy of the final prospectus is sent or given to the investor. In 1996, several issuers used Web pages to download their prospectus. But their ability to do more (for example, to include a short summary of the offering or to engage in interactive communications with investors) is substantially constrained today by the 1933 Act’s prohibitions.

Against this backdrop, several legal issues of significance surface: (i) Should the “testing the waters” loophole under Regulation A be generalized to permit electronic communications prior to filing or disseminating the formal disclosure document (whether a preliminary prospectus or a Regulation A disclosure statement)?; (ii) How (if at all) should the prohibition on “free writing” be revised to tolerate Web pages and other electronic communications during the waiting period?; and (iii) Should underwriter-less direct equity offerings by issuers be encouraged or discouraged? And, if the former, how?

**Testing the Waters**

The first issue is particularly timely in light of the SEC proposal for a new Rule 135(d), which would permit non-reporting issuers and their underwriters similarly to “test the waters” in registered offerings by employing oral and written soliciting materials prior to filing a registration statement. Proposed Rule 135(d) would permit “testing the waters” solicitations of potential investors only in the case of “non-reporting” companies, and, in so doing, seemingly follows the model of Regulation A (which is similarly available only to companies not subject to the continuous disclosure requirements in the 1934 Act).

The initial problem with the “testing the waters” proposal is that it subverts the design of the 1933 Act, which intentionally structured a “quiet
period” into the processing of the registration statement in order to ensure that the statutory prospectus (and, later in the 1933 Act’s history, the preliminary prospectus) is the first document that the investor sees. The premise (still sound in the context of IPOs) is that, if investors could see other offering materials first, the prospectus would become simply an after-the-fact insurance policy that lawyers would draft to protect the issuer but that would be unreadable and unread by investors. In effect, to make the prospectus into a viable marketing document, it had to be given a monopoly. The 1933 Act did this by both establishing a “quiet period” before the filing of a registration statement during which the issuer (and its agents) may not solicit or condition the market and by prohibiting the use of other written offering materials (so called “free writing”) prior to the sending of the statutory prospectus.

For issuers subject to the 1934 Act’s continuous disclosure system, the 1933 Act’s premise that the prospectus should stand in lonely isolation is no longer valid because, for such “reporting” companies, a constant stream of mandatory disclosures will reach the market (which the Internet makes instantly accessible to all investors). The statutory goal of a quiet period is thus irretrievably lost. But this is not the case for non-reporting companies. In this context (which is the only context that proposed Rule 135d addresses), legitimizing a “testing the waters” solicitation seems likely to trivialize the preliminary prospectus. If the issuer can “front-run” its own preliminary prospectus with an earlier solicitation document, then the typical investor will have already made at least a tentative investment decision based on the earlier distributed disclosure document and will have little incentive to read the prospectus (particularly to the extent that it is written in the inevitably cautious, padded, and generally turgid language that lawyers insist upon for documents subject to the liability provisions of sections 11 and 12(2) of the 1933 Act). In short, once a written offering document is authorized that precedes the preliminary prospectus, the odds are high that the latter document will become merely an unread “memento of the transaction,” suitable for framing in Lucite™ plastic cubes, but drafted with an almost exclusive focus on liability prevention.

This is true even without the advent of new information technology. But now add the incremental impact of the Internet, and these problems are aggravated substantially. To the extent that the Internet may make possible intermediary-less IPOs (as in the Spring Street Brewery case), there is less reason to anticipate that the disclosures made in a “testing the waters” solicitation document will be adequately verified or even examined at all by an experienced securities professional. Issuers who do not use a broker-dealer firm as a financial intermediary are likely to be disproportionately composed of fraudulent or recklessly optimistic issuers who, in most cases, could not attract a reputable underwriter.39 Even if

39. One justification that has been raised for Rule 135d is that few problems have been
this is not the case, an issuer acting on its own behalf (rather than through a broker-dealer) is not subject to many of the regulatory strictures that bind the broker-dealer. For example, a corporate issuer is not itself subject to any suitability obligation to refrain from recommending high-risk securities to persons unable to bear such a level of risk.

Finally, the deregulatory benefits of proposed Rule 135(d) seem modest. In theory, the proposed rule saves issuers the costs of undertaking an offering that proves to be infeasible. But the issuer must incur significant costs to find this out for itself (and often it will find that the offering will not fly only after incurring substantial costs during a failed marketing effort). More importantly, this is precisely the kind of estimation at which underwriters have had long experience (including contemporaneous experience with other ongoing marketing efforts). In this light, proposed Rule 135d seems a solution to a non-problem.

**Free Writing and the Reporting Issuer**

If radical deregulation of the 1933 Act seems, then, to make little sense in the case of non-reporting companies, does this same analysis carry over in the context of reporting companies? The answer seems clearly no. First of all, the 1933 Act’s goal of a quiet period was long ago substantially subordinated to the 1934 Act’s goal of keeping the much larger number of investors in the secondary market adequately informed. The advent of the Internet ensures that the ordinary investor will have easy access to the information, either directly through EDGAR or indirectly through a variety of online services that filter this information into their analyses and recommendations. More importantly, in the case of mature Form S-3 issuers, the idea of the prospectus as a critical marketing document also seems largely out of date. Integrated disclosure long ago consigned the prospectus to a twilight role, under which most material information about the issuer is simply incorporated by reference into the prospectus. While the investor may still read the summary description of risk factors in the preliminary prospectus, Rule 434 now delays full delivery of the final prospectus until well after the investment decision has been made and indeed until after the securities have been paid for. Thus, there may be little to be lost, and something to be gained, by relaxing the prohibition on the use of alternative written offering materials to facilitate Web page communications within this context.

experienced with Rule 254 under Regulation A, which permits a “testing the waters” solicitation document. Two short answers to this justification should suffice: (i) given the $5 million ceiling on Regulation A, there has been relatively little interest in exploiting its permissiveness; and (ii) Regulation A offerings were not intermediary-less until the Spring Street Brewery offering in 1996. Thus, the experience under Regulation A for both these reasons is not likely to provide a realistic proxy for what might happen in the case of registered IPOs.

In this light, the most obvious candidate for relaxation is the prohibition on free writing. For a mature company that may be in a state of constant registration (with an “evergreen” Form S-3 effective at all times), gun-jumping issues are less relevant. Such an issuer, however, remains subject to the requirement that it not distribute any written document amounting legally to a prospectus until it has first sent or given the investor a copy of the final prospectus. Yet, this issuer would undoubtedly like to use its Web site to communicate information to investors, going well beyond the seeming boundaries of current Rule 134. Of course, it can put its prospectus (or preliminary prospectus) on its Web page for investors to examine and/or download. But should it be limited to this option? For example, the issuer might well want to provide an additional one- or two-page short-form summary of its preliminary prospectus on its Web page.

A strong argument can be made that any information previously or contemporaneously disclosed under the reporting requirements of the 1934 Act should be disclosable on a Web site without constituting impermissible free writing, even if the presentation or format of the information is changed. In addition, the issuer might sensibly be permitted to make some relatively brief statement (for example, not to exceed 200 words) on its Web page that would introduce, integrate, and summarize these other statements. As a safeguard, this exemption could be conditioned upon the linkage of such a Web page through a hyperlink feature to the same disclosures in the EDGAR system. Indeed, one justification for limiting this exemption to Web pages and similar Internet communications is the ease with which such information can be hyperlinked to the actual 1934 Act disclosures, thus enhancing the total disclosures easily accessible to the investor. This result would do no more than “company registration” intends. The role of the formal prospectus in such a system largely would be to attach liability to misstatements or omissions (and force the secondary parties liable under section 11 to verify this information), but the marketing role of the prospectus would be eclipsed.

For reporting companies not eligible for Form S-3, it is more debatable

41. This follows section 2(10) of the 1933 Act, which defines “prospectus” to include any notice, circular, advertisement, letter, or communication . . . which offers any security for sale . . . except that (a) a communication sent or given after the effective date of the registration statement . . . shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 77j of this title at the time of such communication was sent or given to the person to whom the communication was made . . .


42. Precisely this proposal that an up-to-200 word electronic statement be exempted from the definition of free writing has been made by another commentator. See Joseph McLaughlin, ‘Booting’ the Federal Securities Laws into the 21st Century, INSIGHTS, July 1997, at 21, 22.
whether the same wide latitude should be given. These companies still face a true (if still relatively brief) waiting period during which time free writing would be forbidden. The complete suspension of the free writing prohibition for these companies may be undesirable because it would eliminate any need for a broad circulation of the preliminary prospectus in order to market the stock. Still, if one believes that the boundaries of the efficient market will expand with improvements in information technology, Form S-2 is apt to apply to a shrinking category of issuers and the eligibility standards of the Form S-3 seem likely to be lowered. In the future, the Form S-2 category may be largely limited to companies that have only recently entered the "reporting company" category (say within the last twelve to eighteen months).

A last category of free writing that clearly needs reexamination is e-mail communications between a broker and a client during the waiting period. Today, a client may call a broker and engage in uncensored discussions that are subject only to the antifraud rules. But if the same client prefers to communicate by e-mail, different rules may apply. If e-mail is considered a written communication, it falls within the statutory definition of a prospectus under section 2(10) of the 1933 Act. Today, written communications to the client must be approved by the firm before the broker may send them. All this seems arbitrary given that the use of e-mail is usually for convenience (enabling the client both to send communications and queries at any hour and avoid lengthy sales efforts by the broker), and that the risk of error or miscommunication falls when e-mail is substituted for an oral message (often left on a voicemail system). Already, the SEC has shown some flexibility with regard to electronic communications during this period. In a no-action letter, it has approved video transmissions of road shows to a limited audience. Also, both the NYSE and the NASD

43. During 1994 and 1995, the average waiting time at the SEC for registration materials of Form S-2 registrants was 15.6 days. See Report of the Advisory Committee, supra note 12, at appendix A, table 2.
45. Both the New York Stock Exchange (NYSE) and the NASD have submitted rule change proposals to the SEC that would end the current requirement of prior approval by the firm of all written correspondence with the client. In lieu thereof, sampling techniques would be used, involving random spot checks and e-mail logs. See Notice of Filing of Proposed Rule Change by the NASD, Inc. Relating to Supervision and Record Retention Rules, Exchange Act Release No. 34-38548, 64 S.E.C. Docket (CCH) 1159 (Apr. 25, 1997) (discussing the earlier NYSE proposal as well).
46. See Private Financial Network, SEC No-Action Letter, 1997 WL 107175 (Mar. 12, 1997). The no-action letter was premised on the concern that the video transmission could be deemed a prospectus given the express reference in section 2(10) of the 1933 Act to
have submitted proposed rule changes to the SEC that will end the re-
requirement of prior supervisory review of written communications by a
registered representative with a client based on the justification that such
a rule interferes too intrusively with electronic communications.47

But a broader concept needs to be recognized: e-mail does not have to
be invariably classified as written communication.48 Inherently, it is inter-
active, much like oral communication. Of course, this does not mean that
an existing written document, having an independent existence apart from
e-mail, should lose its character as a “prospectus” simply because it is
transmitted by e-mail. But exemptive rules can easily deal with these prob-
lems—if the SEC can be prodded to be more Internet-friendly.

**Direct Issuer Offerings**

On an abstract level, the case for facilitating direct issuer equity offerings
seems clear. By eliminating a costly intermediary, one seemingly removes
the underwriters’ discount from the corporation’s cost of equity capital.49
Moreover, at least in the case of IPOs, there is abundant evidence that
such offerings are usually underpriced, meaning that the cost of capital is
inefficiently high from the corporation’s perspective.50 But eliminating the
underwriter would also seemingly eliminate the principal gatekeeper from
the disclosure process in primary market transactions and thus increase
the risk of fraud and the uncertainty for investors. Hence, two distinct
issues tend to become inextricably combined: (i) Are direct equity offerings
by issuers feasible?; and (ii) Are they socially desirable?

The puzzling persistence of underwriters has long intrigued theorists.
While the underwriter’s reputational capital is certainly an explanation for
survival in an economic world that normally seeks to reduce transaction
costs, it seems possible in theory to obtain reputational capital in other
ways. Mature companies also may have their own reputational capital.
Some commentators have thus offered the hypothesis that the fear of li-
ability (particularly under section 11 of the 1933 Act) explains the unwill-
ingness of other parties to play the necessary role of reputational inter-
communication by television. The staff agreed, however, that video transmission to a limited
audience does not amount to “television” as that term is used in section 2(10). See 15 U.S.C.
§ 77b(10).

47. See supra note 45.

48. For example, obvious distinction can be drawn between one-to-one e-mail and “list-
serv” communication to a broad audience.

49. This point is not as definitional as it sounds. If on the announcement of a direct issuer
offering by a mature company its stock price fell, and by an amount greater than the un-
derwriter’s typical discount, the actual cost of capital to the issuer would be greater in such
a direct offering.

50. One study has found that the average operating company’s IPO return is 10-15% on
its first day of trading—strong evidence of underpricing. See Roger G. Ibbotson et al., *The
Market’s Problems with the Pricing of Initial Public Offerings*, J. APPLIED CORP. FIN., Spring 1994,
at 66.
mediary. In contrast, the underwriter, as a repeat player, can bear this legal risk, in part by charging a hefty insurance premium in its underwriting discount for this risk-bearing service. Hence, the argument runs, because no one else seems likely to take its place, the underwriter cannot safely be discarded even if its services are not essential to marketing the offering.

The contemporary problem with posing the issue of the underwriter's position in these terms is that it is not clear that the underwriter today still performs the classic gatekeeping function. This issue has been debated since the adoption of shelf registration more than a decade ago, and most doubt that underwriters attempt anything approaching the same due diligence efforts at verification in the case of a shelf offering as they do in the case of an IPO. Many argue that serious due diligence efforts are simply not feasible within the time constraints of shelf registration. Given these constraints, they claim that the solution lies in downsizing the threat under section 11. But this is not happening. The Private Securities Litigation Reform Act of 1995 (PSLRA) has had little impact on the 1933 Act, and recent cases have, if anything, increased the threat of section 11 liability.

In short, underwriters seem to accept the risk of section 11 liability as a cost of the business and factor it into their price, but do not appear to conduct significant due diligence activities outside the IPO context. If so, there seems less reason to discourage direct equity offerings by issuers. Today, however, the issuer who contemplates such a direct offering faces some special legal barriers. For example, Rule 415, which governs shelf registration, permits an “at the market offering” of equity securities only if the securities are “sold through an underwriter or underwriters, acting as principal(s) or as agent(s) for the registrant.”

This may be a small point because a subscription offering would seemingly not qualify as an “at the market offering” in any event, but Rule 415 effectively also precludes the direct sale of shelf-registered equity securities by an issuer to a group of institutional purchasers in a “bought deal.”

51. See Langevoort, supra note 4, at 777 (arguing that other “specialists” who assisted in “securities marketing” would likely be deemed “underwriters” under the broad definition in section 2(11) of the 1933 Act).

52. PSLRA substantially heightened the requirements for pleading fraud under the 1934 Act, but not the 1933 Act. New section 21D(b)(2) of the 1934 Act requires a plaintiff who seeks to plead a cause of action under that Act (including Rule 10b-5) to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” The parallel provision of the 1933 Act (new section 27(b)), however, contains no corresponding pleading requirement (although it does provide for a similar stay of discovery pending a motion to dismiss). Thus, except with regard to the special area of “forward-looking statements” (see section 27A of the 1933 Act), the PSLRA does relatively little of significance to change the balance of advantage between plaintiff and defendant under the 1933 Act.

53. Indeed, recent cases may have increased the underwriters' exposure under section 11. See Shaw v. Digital Equipment Corp., 82 F.3d 1194 (1st Cir. 1996).

From a policy perspective, the prospect of direct equity offerings by issuers raises two distinct issues: (i) Should some effort be made to structure a gatekeeper into the process to test and verify the issuer's disclosures before the current barriers to direct issuer offerings are relaxed?; and (ii) Is it realistic to expect issuers to attempt such direct public offerings in view of the threat of section 11 liability when the obvious alternative is a private placement that is outside the reach of section 11?

Most commentators have recognized that the threat of section 11 liability gives the issuer a strong incentive to rely on a private placement (or other exemption) as an alternative to a registered offering. But privately placed securities trade at a discount, thus increasing the cost of corporate capital. In response, commentators have proposed quite different answers. Some have simply urged that section 11 be relaxed for mature companies. Others have proposed modernizing section 11 (in order to preserve the incentive to engage in due diligence verification of the issuer's disclosures) by extending section 11 to cover the issuer's Form 10-K with the proviso that liability could arise only at specified intervals. As a practical matter, however, both proposals to eliminate section 11 for reporting companies or expand it to cover the Form 10-K seem politically unrealistic.

In truth, it is not clear that there is a problem here that needs answering. The discount on privately placed securities makes private placement a costly choice for the already public company. But, even if the private placement exemption is used to outflank section 11, it is not evident that this is socially undesirable given the greater possibility of carefully drawn contractual protections in the private placement context. More importantly, the public issuer contemplating a direct equity issuance does have an alternative that minimizes the practical risk of section 11 liability. Considerable evidence suggests that securities class actions focus on large distributions of securities and ignore smaller distributions. Presumably, this


56. Professor James Cox proposes the novel ideal that periodically (he suggests every three years) the issuer's Form 10-K would be subject to section 11 liability. See James Cox, The Fundamentals of an Electronically-Based Federal Securities Act (forthcoming). His goal is to escape section 11's current transactional focus, but the resulting liability risk seems enormous. Moreover, it is not clear who would have standing to assert this proposed remedy. If all persons who acquire the equity securities in the open market over the year following the Form 10-K's release could sue (a significantly larger population than under section 11 today), the result would often be that a majority of the shareholders would be suing the issuer (and indirectly the remaining minority).

57. See James Bohn & Stephen Choi, Fraud in the New Issues Market: Empirical Evidence on Securities Class Actions, 144 U. Pa. L. Rev. 903, 936 (1996) (Table 2.5 shows that offerings below $6.71 million accounted for only 14 out of 122 liability suits in the sample, or roughly 11%); see also Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497, 513 (1991) (Table 3 shows that, of the 12 worst-performing computer-related IPOs in 1983, the six companies with the smaller offerings were not sued, while those with the larger were).
is because the entrepreneurial plaintiffs’ lawyer sees little prospect of profit from attacking the smaller distribution given that the expected fee will in fact be around one-third of the recovery (discounted by the likelihood of a defendant’s victory); moreover, the plaintiff’s attorneys’ own costs do not rise or fall in proportion to the size of the offering. Given this incentive to focus on larger offerings, this in turn suggests an attractive distribution technique made feasible by the Internet that largely outflanks the in terrorem risk of section 11: namely, small periodic equity “dribbles” into the market (possibly pursuant to some form of shelf-registration statement). In terms of feasibility, such small periodic issuances are probably the maximum that feasibly can be sold without the assistance of an underwriter; yet, they are small enough that they seem relatively unlikely to attract a securities class action.58 As a result, at least in the case of an established issuer with its own reputational capital, such an offering does not require an underwriter. Even if an underwriter is used (possibly in an advisory capacity), the issuer should be able to negotiate a smaller insurance premium for the underwriter’s services, given the underwriter’s lesser legal vulnerability.

But if such “dribbled” offerings are feasible, there remains the policy question of whether they need participation by a gatekeeper to assure verification of information. Of course, the issuer’s board of directors would still have section 11 liability, but it is not the optimal gatekeeper. The practical answer may be that self-distributed equity offerings will be so rare, at least at first, that they will receive special scrutiny by the SEC staff.59 Every agency has its priorities and, if such offerings do materialize, direct issuer equity offerings should receive the highest level of SEC staff attention. In short, the most logical gatekeeper is the SEC staff, whose role would be otherwise downsized with regard to mature companies. This suggests, in turn, that Rule 415 should not be simply extended to permit direct issuer offerings, but that a compromise needs to be worked out that permits greater staff scrutiny—without the long waiting period that attends the typical IPO.

THE SECONDARY MARKET CONTEXT

The substitution of technology for intermediation has advanced farthest in the area of secondary trading markets. Here, the daily press is filled with predictions of electronic stock exchanges and “Wall Street Without

58. The assumption here is that the offerings will be sufficiently separated in time that they cannot be combined into a single class. Generally, the definition of the class in a federal securities class action includes those who purchased or sold over a relatively brief time period.

59. Commentators differ as to whether they regard the SEC as a valuable gatekeeper. This author does. For a similar view, see Abba David Poliakoff, SEC Review: Comfort or Illusion?, 17 U. BALT. L. REV. 40 (1987).
Walls.” A recent SEC release shows that the growth of alternative trading systems now accounts for a substantial share of the NASDAQ market.60

**Recent Development**

During 1996, new categories of trading systems appeared, but, once again, the most publicized story involved the Spring Street Brewing Company.

Spring Street’s post-offering problem was predictable and flowed from the absence of any underwriter in its primary offering. Given a broad retail distribution to 3500 investors, the desire of investors for a secondary trading market was foreseeable. Yet, the absence of an underwriter during the primary offering also implied that no market maker would likely make a secondary market at the conclusion of the initial Spring Street offering. In addition, because the offering was not registered and Spring Street was not a “reporting company,” current information was lacking about the company. SEC rules restrict the ability of broker-dealers to quote bid/asked prices or to make a market in such a stock.61

To remedy this problem, Spring Street Brewing again sought to rely on the Internet, this time as a substitute for a market maker. Without prior SEC approval, Spring Street announced at the conclusion of its primary offering that it had set up an electronic bulletin board on its Web page where shareholders could trade their shares without the intervention of any broker or dealer. Specifically, Spring Street created Wit-Trade, which it described as a “bulletin board based stock market” for trading in Spring Street’s stock. The main menu of the Wit-Trade bulletin board permitted an investor to “click” on the following separate functions: (i) an explanation of the stock trading mechanism; (ii) a file to register to use Wit-Trade; (iii) a file of recent financial reports on Spring Street; (iv) a summary of recent trading activity in the stock; (v) a buyer’s bulletin board; (vi) an entry procedure to list, change, or remove an entry on the buyer’s bulletin board; (vii) a seller’s bulletin board; (viii) an entry procedure to list, change, or remove an entry on the seller’s bulletin board; (ix) a procedure for receiving a standardized “offer and acceptance” form by e-mail; and (x) a procedure for printing and sending an “offer and acceptance” form by e-mail.62 Users would place buy orders on the buyer’s bulletin board and sell orders on the seller’s bulletin board. Offers and acceptances were handled by e-mail without the need for oral contact.

60. According to the SEC, alternative trading systems now account for almost 20% of over-the-counter stock volume and nearly 4% of the NYSE’s volume. See Regulation of Exchanges, supra note 14, at 1635.
61. SEC Rule 15c2-11 precludes a broker-dealer from entering bid or asked quotations in a security (i.e., making a market) unless it has specified information in its possession. 17 C.F.R. § 240.15c2-11 (1997).
62. For a fuller description, see Boyce, supra note 25.
This procedure had not, however, been cleared with the SEC, which, on Wit-Trade's public announcement, quickly requested that trading on the Wit-Trade system be halted. Arguably, the SEC could have viewed Wit-Trade as a broker-dealer, or potentially even viewed the entire system as a stock exchange. In either case, this would have subjected Wit-Trade to elaborate regulation of its capital structure and governance. The SEC did not, however, seek to shut down Wit-Trade. Taking a decidedly Internet-friendly approach, it sent Spring Street an informal letter describing the conditions on which the SEC would insist before permitting bulletin-board trading to resume over the Internet. Of chief concern to the SEC was the fact that Spring Street would itself hold the proceeds of every secondary market trade while the transaction cleared. In the SEC's understandable view, an independent transfer agent was necessary to lessen the potential for fraud or embezzlement.

Although the ambitious Wit-Trade bulletin board was never fully implemented, the principals behind Spring Street have announced plans to develop a broker-dealer firm that will assist in both online public offerings and bulletin-board trading. The SEC, however, formalized the conditions for online bulletin boards in a no-action letter issued to Real Goods Trading Company (RGTC) in June 1996. This no-action letter has been widely viewed "as a preliminary green light for Internet trading."

Unlike Spring Street, RGTC was a listed company traded on the Pacific Coast Stock Exchange. Like Spring Street, however, RGTC had never registered a public offering; instead, it relied on Regulation A for private placements. Under RGTC's system, participants would be able to list on RGTC's bulletin board their names and contact information, the number of shares of RGTC common stock desired to be sold or purchased, the price at which the participant was willing to buy or sell, and the date of such information. No transactions would be conducted over the RGTC system. RGTC would also play no role in effecting transactions, nor would it use the system itself to buy or sell its own securities. Participants would execute their transactions independently of the RGTC system, presumably by phone contact, and RGTC would receive no compensation for maintaining the system and would not give advice on the merits of any transaction.

Based on these represented facts, the SEC Division of Corporation Fi-

nance agreed that the RGTC system was exempt from registration as a securities exchange, as a broker-dealer, and as an investment adviser. Similar no-action letters have now been issued to other corporations, again on the terms that the corporation (i) not buy or sell securities on its system, (ii) not give advice with respect to transactions, and (iii) not receive compensation in any form for maintaining the system. The SEC staff has warned, however, that persons who enter two-sided quotations on such bulletin boards effectively may be performing the function of market makers and will have to register as broker-dealers. In effect, these conditions have legitimized the possibility of bulletin board trading over the Internet through issuer-run systems and have permitted the operators of such systems to escape any obligation (for the present) to register as broker-dealers.

Do these fairly primitive bulletin board trading systems represent an important evolutionary advance in market structure? In all likelihood, these systems, at least as implemented by the individual issuer, will not grow much beyond their current scale. For the most part, they offer a matching service for issuers whose level of trading is insufficient to attract a market maker. In the case of listed companies (such as RGTC), they seem more a useful component in a sophisticated shareholder relations program than an attempt to compete against existing market intermediaries. Although an issuer-run bulletin board can economize on brokerage costs for odd-lot and other small transactions, the great deficiency is the lack of assured liquidity. For the small investor whose trading decision is typically liquidity-driven (i.e., the investor needs the money for some other purpose), brokerage costs are less of a consideration than quick execution and price continuity. Use of a bulletin board in this thinly traded context may easily entail a several day wait for a buyer followed by a period of uncertainty as to whether the trade will actually settle. This counterparty risk cannot easily be eliminated because issuers are not likely to guarantee performance by either party. Experience with such systems may convince investors that market makers are cheap at the price. Similarly, issuers, who receive no compensation for establishing such bulletin boards, may find them an expensive investment in shareholder relations.

Alternative Trading Systems

If complete disintermediation (i.e., the elimination of the dealer as an intermediary) seems unlikely, partial disintermediation may be more feasible. Partial disintermediation is represented by broker-dealer firms that establish either a passive matching system or an auction system, in either

case permitting market participants to trade directly without the intervention of a dealer as intermediary. A number of such systems have been placed in operation by discount brokerage firms, but they seem to have had no better than modest success to this point. For example, one of the best known such systems, InterConnect, established by Jack White & Co., a West Coast discount broker, covers thirty of the most actively traded stocks on NASDAQ (Intel, Microsoft, etc.). Its system allows investors to enter their own buy and sell orders anonymously in an open order book, and automatically executes trades some eight times a day at the midpoint of the best bid and asked spread. Attractive as this sounds, however, InterConnect has this year matched only an estimated ten to fifteen trades per week. Risky as generalizations are, the supply of electronic trading systems at this point appears to be outstripping the demand.

But will investor indifference to online crossing systems continue? Put differently, why would investors ignore the opportunity to trade between the spread? For the future, two answers suggest a limited role for such systems: First, retail investors want immediacy and will resist waiting even an hour for an automated execution so long as prices could move adversely to them over that period. Second, the desire to trade between the bid/asked spread increases as spreads widen and subsides as spreads narrow. Here, recent developments, such as the SEC's new order handling rules and the advent of decimalization, imply reduced spreads and hence reduced demand for electronic crossing systems. Indeed, the SEC's new order handling rules permit investors to place themselves between the bid/asked spread on NASDAQ by entering limit orders, chiefly through the medium of "electronic communications networks" (ECNs). Some new ECNs seem to have been created principally for the purpose of facilitating

69. In a recent Concept Release, the SEC estimates that broker-dealer firms have placed over 140 alternative trading systems in operation (although some are only for internal use by traders within a single firm). See Regulation of Exchanges, supra note 14, at 1639 n.14.

70. See Kimberly Weisul, Leveling the Trading Field; Unlike Institutions, Retail Investors Have Largely Been Unable to Cross Their Trades... Until Now, INVESTMENT DEALERS' DIG., Aug. 26, 1996, at 14.


72. Even in the case of Instinet, the largest and best known trading system, match rates usually fall below 30%, meaning that the customer's trade is usually not executed. See Leslie Eaton, Wall Street Without Walls—A Special Report; Slow Transition for Investing; Stock Market Meets Internet, N.Y. TIMES, Nov. 11, 1996, at A1. This is a less serious problem for the institutional trader, which is regularly executing portfolio trading strategies and has a lesser need for immediacy. In this light, to attract retail customers, execution must either be guaranteed (which is unlikely) or crossing systems must provide for an automated fallback referral to the market if a match cannot quickly be found.

such competition. Although these developments are promoting both competition and partial disintermediation, they do not require the use of online alternative trading systems or the Internet to attain their goals.

Whatever the level of investor interest in online alternative trading systems, their advent also raises serious public policy issues. In a recent Concept Release, the SEC recognized that one incentive for the rapid growth of alternative trading systems has been the shield they provide to some market participants from the norm of transparency that governs trading activity on the exchanges and NASDAQ. The SEC's leading concern in this regard is that "[a]lternative trading systems are not fully integrated into the national market system. As a result, activity on alternative trading systems is not fully disclosed to, or accessible by, public investors. The trading activity on these systems may not be adequately surveilled for market manipulation and fraud."  

Essentially, the SEC is concerned that the activity of participants on alternative trading systems who are not market makers or specialists is not disclosed to the public market. As a result, it concluded: "Because a majority of trading interest on alternative trading systems is not integrated into the national market system, price transparency is impaired and dissemination of quotation information is incomplete." As an example, the Concept Release points to the SEC's recent investigation of NASDAQ trading, which specifically analyzed "trading in the two most significant trading systems for NASDAQ securities (Instinet and SelectNet)" and found "that the majority of bids and offers displayed by market makers in these systems were better than those posted publicly on NASDAQ." Although the Concept Release discusses several regulatory options, its clear preference appears to be to expand the definition of exchange to include both active trading systems (such as Instinet) and low-volume and passive systems, presumably including even issuer bulletin boards. This is a virtual about-face from the SEC's position in 1989 when, in a proposed rule (now withdrawn), it noted that an expansive definition of the exchange registration requirement would impose substantial burdens on existing proprietary trading systems, such as Internet and POSIT. That was then, however, and this is now. Alternative trading systems are out of the nursery, and the SEC no longer feels the need to coddle the larger of them. It

74. The Island System is operated by Datek Securities Corp., a registered broker-dealer and long a "SOES activist." Island System has accepted the designation of an ECN. See Regulation of Exchanges, supra note 14, at 1646 n.59. Not all ECNs display to the public the best prices of all orders entered into their systems, but at least two ECNs now do. Id. at 1645 n.58. Doing so clearly shows that the ECN is attempting to facilitate competition to narrow the bid/asked spread.
75. See id. at 1635.
76. Id. at 1646.
77. Id. at 1645.
does, however, intend to apply a different and much lighter level of regulation to low-volume and passive trading systems.\textsuperscript{79} Justified as this approach may be, it suggests that the prospect of increased regulation and the loss of immunity from the transparency rules that govern financial intermediaries is likely to slow the growth of alternative trading systems. Technological substitutes for market makers and specialists thus face at least a somewhat uncertain, and possibly forbidding, regulatory future.

**PRIVATE MARKETS**

Perhaps the least noted area where the SEC recently has taken action that could result in significant disintermediation has been the private placement context.\textsuperscript{80} In three important no-action letters, the SEC staff has recognized a limited role for the Internet in private placements. The key doctrinal problem addressed by these no-action letters is the breadth of the 1933 Act's concept of "general solicitation." Under traditional dogma, a private placement fails if there is a general solicitation, even if all the purchasers in the offering are highly sophisticated investors who do not need the protection of the 1933 Act.\textsuperscript{81} If no registration statement has been filed, the traditional doctrine is that section 5(c) of the 1933 Act is violated by a general solicitation, even if no sales are made.\textsuperscript{82}

From this starting point, the SEC had been initially skeptical of any role for the Internet in private offerings. In a 1995 release on electronic communications, it provided a clear warning that use of an Internet Web site would typically amount to a "general solicitation" that destroyed a private placement.\textsuperscript{83} Specifically, this release deliberately framed an example in which private placement offering materials were placed on a Web page and concluded that this action amounted to a general solicitation in violation of Rule 502(c).\textsuperscript{84}

Since 1996, however, the SEC has shown an increased friendliness toward the Internet. First, in the IPOnet no-action letter,\textsuperscript{85} the Division of Corporation Finance approved a procedure whereby a broker-dealer published an accreditation questionnaire on its Web page in order to screen

\textsuperscript{79} See Regulation of Exchanges, supra note 14, at 1657-58.
\textsuperscript{81} See 17 C.F.R. § 230.502(c) (1997).
\textsuperscript{82} Section 5(c) says that "[i]t shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy... any security, unless a registration statement has been filed." 15 U.S.C. § 77e(c).
\textsuperscript{84} Id.
potential investors for participation in private placements. Once a sophisticated investor was found to be qualified, the investor would receive a password permitting access private placement offerings. The investor could, however, only access to offering materials for private placements whose offering began after the investor had been so qualified.\footnote{86}

Three months later, the Division of Market Regulation issued a corresponding no-action letter to the Angel Capital Electronic Network (Angel Network), which permitted it not to register as a broker-dealer under similar circumstances.\footnote{87} The Angel Network was organized and operated by several universities and non-profit entities under the general sponsorship of the U.S. Small Business Administration, which funded its development as part of pilot project to increase the access of venture capital companies to accredited investors.\footnote{88} Again, once qualified, accredited investors would be provided a password that would enable them to view a list of small corporate offerings maintained by the Angel Network and to download the offering circulars. The contemplated offerings were conducted pursuant to Regulation A or Rule 504 of Regulation D. No person or entity would provide investment advice, receive compensation (other than a flat, nominal fee to cover administrative costs), handle customer funds or securities, participate in negotiations between the issuer and a potential investor, or otherwise directly assist the issuer or the investors with the completion of any transaction. Finally, the operators of the Angel Network would not “hold themselves out as providing any securities-related services other than a listing or matching service.”\footnote{89}

While the non-profit nature and university and governmental sponsorship of the Angel Network may have influenced the SEC staff, the staff has subsequently accepted private sponsorship of another network in a more recent 1997 no-action letter. In the Lamp Technologies Inc. no-action letter,\footnote{90} a private software company specializing in the creation and maintenance of Web sites proposed to establish a Web site that would

\footnote{86} The SEC no-action letter noted that in reaching its conclusion, the SEC relied on the fact that “a potential investor could purchase securities only in transactions that are posted on the password-protected page of IPONet after that investor’s qualification with IPONet.”\footnote{Id. at *2. The staff appears to have been concerned that, if the investor could participate in already commenced offerings, the qualification procedure might become simply a pretext with the real focus on identifying offerees for the current offering.}


\footnote{89} Angel Capital Electronic Network, SEC No Action Letter, 1996 SEC No-Act. LEXIS 812, at *2 (emphasis added). This exception suggests that the Angel Network could establish a matching system among accredited investors for resale of privately placed securities. This would be a significantly more difficult doctrinal barrier for the SEC to relax (except possibly pursuant to Rule 144A, or sales pursuant to Rule 144, after the requisite waiting period).

contain information (including offering memoranda) about "private funds" that were exempt from regulation under the Investment Company Act of 194091 and that would be privately offered to investors under Regulation D. Potential investors would again complete a questionnaire designed to allow Lamp Technologies to form a reasonable basis for determining that each such investor was an "accredited investor" who had at least a $2 million investment portfolio. Upon qualification, the investor again would receive a password permitting the investor to access Lamp Technology's Web site.

The Lamp Technology no-action letter is particularly important because it goes beyond the narrow conditions placed by the staff on the IPOnet and Angel Network letters in two respects: (i) it permits each investor to pay a $500 per month subscription charge ($6000 per year); and (ii) it permits investors to invest in funds previously posted on Lamp's Web site, provided that the investor not invest in such a previously listed fund for thirty days following the subscriber's qualification. This latter provision sensibly drops the cumbersome prophylactic requirement in the IPOnet no-action letter that investors could only be given access to offerings that commenced after the time of their qualification and substitutes a thirty-day cooling-off period.92

Taken together, these three no-action letters both establish the concept that a password-protected Web site does not amount to a "general solicitation" or "general advertising" in violation of Rule 502 (and hence of section 5(c) of the 1933 Act) and the potential to permit a new class of competitor—the Web site operator—to compete with broker-dealers and investment advisers. Such a rival would not be a true financial intermediary because it could not offer advice on the merits of the investment or negotiate with the issuer on behalf of the investors, but, under the Angel Network letter, the network operator could provide a matching service. Although the three no-action letters avoid the question, logic suggests that such a matching service might also seek to facilitate secondary transactions (i.e., private resales) among accredited investors.93

91. The private funds claimed to be exempt from regulation as investment companies pursuant to section 3(c)(1) or (7) of the Investment Company Act of 1940, which, respectively, exempt funds held by not more than 100 persons or held by "qualified purchasers." 15 U.S.C.A. § 80a-3(c)(1), (c)(7) (1994 & West Supp. 1997).

92. The SEC staff noted, however, a special characteristic of private investment funds in accepting this substitution: the private funds involved were only available to take subscriptions on a quarterly or annual basis (and thus would not be in a state of constant solicitation). Lamp Technologies, Inc., SEC No Action Letter, 1997 SEC No-Act. LEXIS 638, at *5. Based on this factor, the staff was satisfied that investors would not be subscribing to the service "to invest in any particular fund." Id.

93. The SEC's staff has granted an important no-action letter to Niphix Investments Inc., a registered broker-dealer, for an alternative trading system that would specialize in trading exempt securities issued under Regulation A and securities of businesses that qualified as "small business issuers" under Rule 405. See Niphix Investments, Inc., SEC No-Action Letter,
Indeed, if one can assume that the Lamp Technologies no-action letter will apply beyond the context of private funds and will be generally available to networks listing venture capital companies, it probably represents the leading example to date in which a communications network has matured to the point that it can compete with a financial intermediary. Of course, the mere appearance of a new competitor on the scene does not imply that it will survive or triumph in the resulting competition. Broker-dealer firms can presumably also market private placements through password-protected Web sites, can charge transaction-based fees for doing so, can give investment advice and make recommendations (subject to their usual suitability obligations), and can sponsor alternative trading systems for their resale. These differences give the broker-dealer the advantages of vertical integration in that it can both market the securities in a password-protected system and possibly sponsor a matching system for their resale. In such a competition, the traditional financial intermediary still appears to have the upper hand over a communications network that is not a broker-dealer.

Looking to the distant future, one can imagine information technology creating a vastly more expansive role for private markets. If password-protected systems are sufficient to permit Internet offerings at the primary market stage, then they arguably should also be sufficient to permit trading among accredited investors of privately placed securities—in effect, extending the PORTAL-type secondary market from the “qualified institutional buyer” level down to the “accredited investor” level. If this happens, new liquidity might enter the market for private securities and the volume of privately placed transactions would soar. Any such reallocation of volume between public and private markets raises policy issues beyond the scope of this Article.

INTERNET FRAUD

If the impact of new trading systems and new electronic distribution techniques made possible by the Internet remains uncertain, the certainty

1997 SEC No-Act. LEXIS 566 (Apr. 18, 1997). All trading participants were to be accredited investors. The interesting question this no-action letter raises is whether the SEC may eventually approve a similar system for private resales that were exempt from registration under the 1933 Act pursuant to Rule 144, or pursuant to the so-called “section 4(1 1/2) exemption” (for transactions between accredited investors), or, in some cases, pursuant to Rule 144A.

of the Internet's impact on the potential for fraud is more evident. Clearly, the Internet makes possible a vastly wider dissemination of a fraudulent statement and by a wider class of persons, including those who have no connection with the issuer and who would not, in its absence, credibly be able to reach many investors. Whereas the traditional "boiler room" promoter might reach several hundred customers (at most) through fraudulent phone calls and/or mailings, the fraudulent promoter on the Internet might reach tens of thousands—and at virtually no cost.

Again, however, this is only half the story. Although fraudulent statements can be disseminated more broadly via the Internet, they are also more visible. Whereas the SEC can hope to catch the classic "boiler room" promoter only when an injured victim complains (typically after the fact) or when, by mistake, the promoter solicits an enforcement official, the Internet is today subject to ongoing monitoring by SEC enforcement officials.95

There are, however, two distinctive problems with Internet fraud. First, a fraudulent promoter can hide his or her identity on the Internet and make statements on an anonymous or misattributed basis.96 Second, the fraudulent statement can originate offshore, beyond the SEC's seeming reach.

Anonymous Statements

The distinctive new contribution of the Internet to the age-old problem of fraud is the "chat room." Chat rooms, electronic bulletin boards, newsgroups, or other news forums are sponsored by both the major online services (e.g., America Online, CompuServe, and Prodigy) and by independent entrepreneurs who simply establish a Web page.97 Typically, conversations in these chat rooms focus on individual stocks or groups of stocks that are too small to receive much attention from securities analysts. Individuals can post statements on a bulletin board about the individual stocks covered by that chat room. These statements range from opinions to wild predictions (which make no claim to objectivity), and rumors (and claims that rumors have been confirmed by the company) to deliberately fabricated lies. A recurrent modus operandi is for several messages to be posted in rapid succession, all repeating a particular rumor or prediction. Such concerted action may have been pre-arranged or may have been sent by the same person using different aliases. The key point is that state-

95. See Cella & Stark, supra note 22, at 835-37.


97. For present purposes, it is not necessary to distinguish here between "private" chat rooms (for which a subscription fee may be charged) and public newsgroups.
ments on the Internet can effectively be made anonymously or, worse, persons may claim the identity of a well-known Internet commentator to make a false statement.

The best known illustration of this new phenomenon was the sudden run up in the price and trading volume of Comparator Systems Corporation (Comparator), a small, probably insolvent company that was suddenly rumored in May 1996 to have developed a fingerprint recognition system that could be incorporated into a major credit card. One rumor, widely circulated on the well-known Motley Fool chat room on America Online, suggested that MasterCard would soon adopt the Comparator technology into its credit card system. Almost overnight, the stock rose from $.03 per share to over $1.75 per share, representing an increase in aggregate market capitalization from $36 million to over $1 billion. On a single day in May 1996, more than 178 million shares of Comparator traded on NASDAQ, breaking the single-day record for both NASDAQ and the New York Stock Exchange. Over three days, in May 1996, 449 million shares traded—until trading was halted by NASD. Ultimately, it was learned that Comparator's technology was stolen from British researchers and that no basis existed for the rumors that MasterCard had any contract or understanding with Comparator. The stock price quickly fell back to a few cents per share, and the company entered bankruptcy later that year.

More importantly, in the wake of the Comparator scandal, the NASD conducted an informal study of several others stocks that had experienced dramatic increases in both trading price and volume and found "a close correlation between [those increases] and Internet postings." Although Comparator's management may have culpably misstated key facts, the real beneficiaries of the manipulation of its stock seem to have been brokerage firms that placed their clients into the stock just before the anonymous tips about the alleged new technology first appeared on the Internet. Small cap stocks, trading in a less than fully efficient market, seem then uniquely vulnerable to rumors and price manipulation.

But what can be done about this? Neither the SEC nor the NASD has regulatory authority over ordinary investors who wish to post anonymous comments in Internet chat rooms, nor can either agency easily detect if broker-dealers are behind the rumors that it does see posted.

The problem is not only that anonymous commentary is part of the Internet's cherished anarchic tradition, but that the First Amendment sometimes protects the right to engage in anonymous speech. Still, as

98. For representative stories, see Miller & Petruno, supra note 3 (detailing actual rumors entered into newsgroups about Comparator); Therese Poletti, Internet Stock Tips Pose Free Speech Dilemma, REUTERS BUS. REP., June 11, 1996, available in LEXIS, News Library, Reubus File.
99. See Poletti, supra note 98 (quoting Marc Beauchamp of the NASD).
the U.S. Supreme Court’s most recent decision on anonymous speech makes clear, the protective cases that shelter anonymous speech rest on facts that involved political elections where “core political speech” was at issue, and hence “exacting scrutiny” was the legal standard that had to be satisfied. Where, however, commercial speech is at issue (as here) and the clear intent of the legislation is to prevent fraud and manipulation, the courts have recognized that a far more permissive legal standard would apply.

Nonetheless, it is important to specify the regulatory goal narrowly. Anonymity itself is not the evil to be suppressed; indeed, anonymity has been the characteristic style of much Internet communication, where pseudonymous commentators often “flame” in language they would probably not use if their identities were disclosed. But an important distinction can be drawn between “anonymity” and “traceability.” Securities regulators need the ability to trace the identity on an after-the-fact basis of anonymous communications sent by e-mail or postings on the Usenet to chat rooms or newsgroups. They do not need blanket authority to learn the identity of all “information content providers” (in the Internet parlance) to a chat room.

A major obstacle to traceability is the rise of anonymous “remailers” that conceal the identity and even location of the sender. Such attempts to hide the identity of the sender typically require a cooperating agent who remails the communication to the chat room or newsgroup. Potentially, such a person could be seen as an aider and abetter of a securities law violation. With the passage of the PSLRA, the SEC has regained the ability to enjoin knowing aiders and abettors. The problem with this approach is that the agent who remails the communication for the original sender, thereby rendering it anonymous, may not know that the statement was false or fraudulent. Read closely, however, new section 20(f) of the 1934 Act requires only that the defendant “knowingly provides substantial assistance to another person.” If the SEC were to adopt a release indicating a view that remailing communications, in a manner to render

102. Id. at 343-44, 348-51.
104. Techniques vary from simple remailing that deletes the message heading to more sophisticated forms of encryption. See Froomkin, supra note 103, para. 20-25; Tien, supra note 103, at 120 n.5.
105. New section 20(f) of the 1934 Act provides that “any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter . . . shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.” See 15 U.S.C. § 78t(f) (Supp. I 1995).
106. Id.
them anonymous, to a chat room or newsgroup known to be conducting discussions about securities prices and values could make one an aider and abetter of the original party's primary violation, the extent of this practice should decline.

Of course, the simpler, more direct path might be to focus on the operator of the chat room itself. Most, but not all, chat rooms have private sponsors who limit access to subscribers. Today, most major online services exercise some supervision to delete obscene comments or sexual references, and presumably they can also take reasonable steps to delete those comments that come from anonymous remailers. This would involve, however, a monitoring burden that they may not wish to shoulder. Nor is it clear that they are legally obligated to do so. As a result of the Communications Decency Act of 1996, section 230(c)(1) of title 47 now provides: "No provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider." Although these words literally say nothing about liability as an aider and abetter, the congressional intent seems to have been to give broad protection to online services from common law suits based on a failure to monitor information content providers. Attempts to impose such a duty seem beyond the authority of the SEC, particularly when it has jurisdiction to enjoin only "knowing" aiders and abetters.

The one remaining candidate over whom the SEC does have clear authority and much leverage is the broker-dealer industry. No doubt exists about the authority of regulators to require broker-dealers and other securities professionals to disclose their own identity, but closer questions surround their vicarious responsibility for the communications of others. The SEC staff has long indicated that "a broker-dealer conducting business over the Internet should consider the extent to which it may be responsible for content provided by a third party."

107. Cyber Patrol, first introduced in 1995, now serves both direct Internet access providers (e.g., Netcom, Uunet, etc.), and commercial online service providers (e.g., America Online, CompuServe, Prodigy, etc.), is compatible with all Web browsers (e.g., Netscape, Netcruiser, Mosaic, etc.), and seeks to detect and delete inappropriate materials. See ACLU v. Reno, 929 F. Supp. 824, 840 (E.D. Pa. 1996), aff'd, 117 S. Ct. 2329 (1997). Technologically, it or similar software could seemingly also detect non-traceable sources and deny them access, delete their comments, or at least specially label their comments.


110. See supra note 105.

indicated that a broker-dealer must not link to a Web site that the member knows contains misleading information about the member’s products or services.\footnote{112} This rule could easily be extended to bar linking to a Web site in which anonymous and non-traceable communications were known to be prevalent. In turn, by furnishing the names of Web sites to broker-dealers that were so dominated, regulators could discourage broker-dealer linkages to such Web sites and possibly in turn motivate their sponsors to monitor for non-traceable communications.\footnote{113}

The pessimistic bottom line for the present is that one cannot identify a convenient gatekeeper that easily can be pressured or persuaded to monitor the content or traceability of messages posted in chat rooms or on similar bulletin boards. Although the SEC may be able to jawbone the major online services into some limited monitoring, the anarchic orientation of the Internet culture, which tends fervently to persist in the mistaken belief that cyberspace is beyond the reach of the law, implies that other, smaller sponsors are likely to be intransigent. Among the various secondary participants, only the anonymous remailers look like deserving candidates for enforcement actions, and even in these instances prior warnings might wisely be given.

For the future, however, traceability should be as important a goal for regulators as is transparency. At a time when the SEC is concerned that alternative trading systems allow market participants to hide their identities, it would be ironically inconsistent to permit far more misleading messages to be openly posted on the Internet by anonymous, non-traceable persons.

\textit{EXTRATERRITORIALITY PROBLEM}

\textbf{Foreign Markets}

The SEC’s problems in dealing with anonymous messages in chat rooms pale in comparison with the enforcement problems it encounters with foreign broker-dealers and foreign exchanges. The problem is not that the SEC’s jurisdictional reach is limited. In fact, the 1934 Act applies to foreign broker-dealers as well as to domestic ones and prohibits the use of any jurisdictional means to induce or to attempt to induce the purchase or sale of any security, unless the broker-dealer is registered with the SEC.\footnote{114} The SEC rules also expressly regulate the activities of foreign broker-dealers,\footnote{115} and SEC releases have suggested that broker-dealer registration with the SEC is required even in the case of a foreign broker-
dealer with no presence in the United States, but who uses U.S. phone lines to trade securities with or for U.S. persons located in the United States. Indeed, the SEC has even suggested that a foreign broker-dealer who simply executes unsolicited orders from U.S. customers may have to register. In general, U.S. courts have supported the SEC’s views and broadly found subject matter jurisdiction to exist in securities cases.

But now, test the SEC’s powers against the following practical case. An entrepreneur in Central Europe or Southeast Asia begins making a market in certain heavily traded foreign stocks (and possibly some well-known U.S. stocks) and publishes price quotations on a real-time basis on a Web page. This new market maker is located in a host country with strong free-market views (e.g., the Czech Republic or Singapore) and a distaste for governmental intervention in the marketplace. Most importantly, this entrepreneur has no assets or operations in the United States. Technically, this market maker does not mail or wire information into the United States; rather, the interconnected character of the Internet’s network of networks does that by itself. In any event, some U.S. customers do access this


117. Id. at 2086 & n.52. Suffice it to say that this is a more controversial assertion of SEC jurisdiction, which no court has yet upheld.


119. The Internet is a “giant network which interconnects innumerable smaller groups of linked computer networks.” ACLU v. Reno, 929 F. Supp. 824, 830 (E.D. Pa. 1996), aff’d, 117 S. Ct. 2329 (1997). This point may have considerable jurisdictional significance because the information content provider does not voluntarily penetrate the space of a jurisdiction in the same way that it does by mailing a letter or sending a wire. Rather, the audience finds the content provider by using browsing strategies and search engines. This distinction may prove important under the standard “minimum contacts” test used by federal courts to determine the outer constitutional boundaries on personal jurisdiction. See Helicopteros Nacionales de Columbia v. Hall, 466 U.S. 408, 414 (1984) (a foreign defendant must have minimum level of contact with jurisdiction that allows exercise of jurisdiction to be reasonable); International Shoe Co. v. Washington, 326 U.S. 310 (1945). The case law on when an Internet user can be sued in a foreign jurisdiction is scarce. For an important decision in which a service provider (CompuServe, Inc.) was able to establish personal jurisdiction over a foreign defendant, see CompuServe, Inc. v. Patterson, 89 F.3d 1257 (6th Cir. 1996). See also Zippo Mfg. Co. v. Zippo Dot Com, Inc., 952 F. Supp. 1119 (W.D. Pa. 1997). Still, the minimum contacts between the defendants in these cases and the forum state seem substantially greater than those of the market maker with the United States in the hypothetical in the text. For a decision finding insufficient minimum contacts based on use of the Internet to establish personal jurisdiction, see Pres-Kap, Inc. v. System One, Direct Access, Inc., 636 So. 2d 1351 (Fla. Dist. Ct. App. 1994). Obviously, different interests, and a different statute, apply in the SEC’s case, but even in the most expansive decisions upholding personal jurisdiction in cases brought by the SEC against a foreign defendant, the defendant had typically engaged in a securities transaction in a U.S. securities market or had opened a U.S. brokerage account. See, e.g., SEC v. Knowles, 87 F.3d 413 (10th Cir. 1996); SEC v. Unifund SAL, 910 F.2d 1028 (2d Cir. 1990).
new "Internet Stock Market" because of its extended hours of operation, low transaction costs, and electronic execution capability.

What can the SEC do? Of course, it can seek an injunction from a U.S. court. The enforceability of that injunction (or any other decree or order) abroad, however, seems doubtful. Other jurisdictions may well feel that the host country’s own laws should govern because the market maker did not truly enter the United States in any traditional sense. Indeed, a clever entrepreneur might even add a conspicuous provision on its Web page that persons placing orders with it thereby accept a forum selection provision that makes the courts of the host country the exclusive forum in which a private action may be maintained against it.120

As a practical matter, the SEC’s ability to prevent this entrepreneur from interacting with U.S. investors without registration will depend on its ability either (i) to identify some necessary connecting link between the foreign entrepreneur and U.S. investors (i.e., a gatekeeper) and bring sufficient pressure to bear on this gatekeeper to enable the SEC substantially to achieve its regulatory purposes; or (ii) to secure an international agreement with which the host country is a party that governs the dissemination of securities data and offering materials over the Internet. This year, in its "Regulation of Exchanges" Concept Release, the SEC has explored the former approach.121

Essentially, the Concept Release first examines the possibility of relying on the host country's own regulatory system and, second, the possibility of forcing foreign exchanges to register with the SEC. Then, after noting problems with both approaches, it discovers (much like Goldilocks) a third approach, which the release implies is neither too hot nor too cold. This approach, it terms, "regulating access providers to foreign markets."122 Who are "access providers”? They "fall into two basic categories."123 First, the release suggests that "entities that distribute or publish information regarding transactions on a foreign market, and provide a direct electronic link on behalf of the U.S. members of that foreign market" could be regulated as "securities information processors" (SIPs).124 Second, according to the release, broker-dealers (both foreign and domestic) who "provide U.S. persons who are not members of a foreign market with the techno-

120. This would not affect the SEC's suit, but might preclude private litigation depending on a legal standard that currently differs from circuit to circuit. See, e.g., Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974); The Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 15 (1972); Bonny v. Society of Lloyd's, 3 F.3d 156 (7th Cir. 1993); Roby v. Corporation of Lloyd's, 996 F.2d 1353 (2d Cir. 1993).
121. See Regulation of Exchanges, supra note 14, at 1695-1704.
122. See id. at 1695.
123. Id.
Is anyone left out by these definitions? Online communication firms that simply provide data and have no "direct electronic link" to an exchange member appear to escape the first category and clearly are not broker-dealers. Therefore, they also escape the second definition. Even if a network operator provides a direct electronic link, the Concept Release does not deem it a SIP unless the link is provided "on behalf of the U.S. members of that foreign market."126 This seemingly means that e-mail and the major commercial online services are not covered. Thus, U.S. citizens could still transact with our hypothetical foreign market maker (either by e-mail or an online service firm) as long as no U.S. broker is involved. To be sure, the foreign market maker may well be covered, but it may be effectively unreachable.

Of course, SEC thinking is still at an early stage, and it may yet tighten its definitions. But the basic approach primarily reaches broker-dealers and their agents. Remaining unregulated is the variety of communication networks that would be given a strong incentive to grow and fill in the interstices left unregulated by this proposal. Even in the case of those entities that are regulated by this approach, it is not clear that SEC authority to regulate SIPs is a sufficient regulatory hook upon which the SEC can hang all its regulatory aspirations. For example, can such a SIP be held responsible for the fact that the London Stock Exchange has a very different attitude towards transparency than does the SEC? The most that seems appropriate is some form of disclosure (which will swiftly become boilerplate) about the differences in market structure and operation between the United States and London.

An alternative approach is to seek international agreements, possibly styled as memoranda of understanding,127 and possibly negotiated on a global level through the International Organization of Securities Commissions. Unquestionably, this approach would be slower. Inevitably, many nations would not be signatories, and others would, in any event, not abide by its conventions. The advantage, however, is that with cooperation comes effective reciprocal enforcement. But this approach will clearly never end regulatory disparities (that is, the London Stock Exchange may unfortunately continue to view price transparency as a fetish of American regulators).

**Toward Accommodation**

If international agreements are pursued, it is predictable that the U.S. regulatory position will quickly become untenable that an offer made on

125. Regulation of Exchanges, supra note 14, at 1695.
126. Id. (emphasis added).
127. Memoranda of understanding are deemed not to be treaties and thus not to require Senate ratification. At least, that is the theory.
the Internet subjects the offeror to the jurisdiction of courts in every jurisdiction to which the offer is transmitted (i.e., the whole world). Unlike mailing an offer into the United States (which is the underlying fact pattern in many U.S. cases that have found subject matter jurisdiction), publishing an offer on the Internet is qualitatively different; in effect, the audience finds the offeror, rather than the reverse. Because more evidence thus will be necessary to establish jurisdiction, the SEC’s enforcement efforts will be complicated. Regrettably, complicated enforcement is likely to be the necessary price of international comity.

What should be the standard? Regulation S already offers a well-established standard: Have there been “directed selling efforts” in the United States? But this leads in a circle back to the basic question: Should the posting of offering material on the Internet (presumably in downloadable form) amount to “directed selling efforts” in the United States? That is, suppose a British or Hong Kong firm places a prospectus on the Internet for an offering that is principally targeted at citizens in its own country. This seems basically innocuous, even if some U.S. citizens see it and somehow buy the offering.

A practical answer here could emerge from following the practice already adopted by state “blue sky” regulators. Although state blue sky regulators have consistently taken the position that electronic offerings are not exempt from their statutes, they have largely agreed on a compromise first developed by Pennsylvania. Recognizing the inherent tendency for overregulation in the doctrinal position that an Internet offer is an offer in all fifty states, Pennsylvania developed a procedure for exempting Internet communications if (i) the offering documents indicate that the securities are not being offered to persons in Pennsylvania; (ii) the securities are, in fact, not offered to Pennsylvania residents by any other means; and (iii) no sales of the securities are made in Pennsylvania as a result of the offering. If these conditions are not satisfied, Pennsylvania takes the position that an offer made on the Internet constitutes a mass mailing, public media advertisement, and general solicitation subject to its statute.

The basic framework of the Pennsylvania order has been adopted by a number of other states, and in January 1996, the North American Se-

130. See Bertraum, supra note 129, at 26.
131. Some 20 NASDAA jurisdictions have apparently provided transactional relief for Internet offerings, either by order, regulation, or no-action position. Other states face statutory problems, however, that make it impossible for them to grant exemptive relief without new legislation. Id. at 27-28.
The Securities Administrators Association (NASAA) also endorsed it. The resolution adopted by NASAA recommends to its member jurisdictions that offers on the Internet be exempted from the registration provisions of state securities laws when “[t]he Internet offer indicates, directly or indirectly, that the securities are not being offered to the residents of a particular jurisdiction; and [a]n offer is not otherwise specifically directed to any person in a jurisdiction by or on behalf of the issuer of the securities.”

This same approach can be replicated on the international level. Today, nothing in Regulation S assures an issuer that an Internet communication intended for one audience (say, Europeans) will not be deemed to constitute “directed selling efforts” in the United States. Should the issuer later wish to sell to sophisticated U.S. institutional investors, either in a private placement or by means of extraterritorial sales outside the United States, such an Internet communication could be fatal to the exemption (whether the exemption claimed is Regulation S for extraterritorial offers or Regulation D for private placements).

**CONCLUSION**

The recurrent themes in this Article have involved gatekeepers and intermediaries. The gatekeeper has played a critical role in the history of securities regulation. To the extent that the 1933 Act worked, it did so by enlisting (under duress) underwriters, accountants, and directors to undertake the task of verifying issuer statements. A similar strategy is now evident in the new SEC Concept Release on exchange regulation: the SEC is attempting to enlist those having the technological ability to connect U.S. investors with foreign markets by characterizing them as SIPs. Similarly, this Article has suggested that to interdict Internet fraud, the cooperation of another class of gatekeepers must be secured: namely, those who sponsor and can monitor chat rooms and newsgroups that are focused on securities valuation topics.

But the realistic capacity of gatekeepers to undertake such monitoring obligations is not unlimited. In a slower-paced era, the 1933 Act’s strategy worked well, but outside the IPO context, it is highly questionable that it is working as effectively today. Correspondingly, the duties that SIPs can be expected to assume seem modest. If greater obligations are imposed, the result largely will be to throw sand in the gears that connect global markets—to no one’s long term benefit.

Put more generally, while underwriters, accountants, lawyers, and directors are classic gatekeepers, securities information processors and chat
room sponsors are not. They are not "incorruptible outsiders" that the primary actor employs "to gain legitimacy or expertise or to meet a legal requirement,"\textsuperscript{135} but merely participants in a private commercial relationship that can easily be overburdened. Nor do they necessarily possess the reputational capital to motivate them to interdict offenses to protect their own reputations. This does not mean that they should not be conscripted, but rather that the duties imposed should be limited and specific.

With respect to financial intermediaries, this Article is skeptical of predictions that the Internet implies their extinction. Their persistence has puzzled economists for years—and will continue to do so. But partial disintermediation is a real prospect. This structure, under which traditional intermediaries face competition from new unregulated entrants performing functionally equivalent tasks, has now vividly appeared on the scene with the emergence of alternative trading systems. It will predictably reappear in other contexts as well as technological innovation introduces new competitors. In each instance, issues will predictably surface about whether the playing field is level between the traditional intermediary and the new entrant.

Nonetheless, these are not the most important issues for the future. If this Article is correct in its judgment that financial intermediaries are not likely to wither away in the face of technological change, the advent of the Internet does not imply a crisis for the future of the securities laws, but only the need for some relatively modest updating and streamlining. To the extent it is wrong, however, (and this possibility is non-trivial), then a reduced role for financial intermediaries implies a system without meaningful gatekeepers or a coherent strategy for testing the accuracy of issuer disclosures. In that event, the most basic assumptions of the federal securities laws may need to be reconsidered.

\textsuperscript{135} For the standard definition of "gatekeeper" in a strategy of third-party liability as requiring such a relationship, see Reinier H. Kraakman, \textit{Corporate Liability Strategies and the Cost of Legal Controls}, 93 \textit{Yale L.J.} 857, 891 (1984). \textit{See also} Kraakman, \textit{supra} note 24.