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## IPOs on the Internet: The Need for the Next Step

Daniel M. Weisenfeld

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# IPOs on the Internet: The Need for the Next Step

by  
DANIEL M. WEISENFELD\*

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## Introduction

In the new millennium computers are being used for nearly everything. With the tremendous increase in computer use has come the growth of the Internet. The Internet currently has approximately four hundred million users.<sup>1</sup> It is estimated that over one hundred and forty million of those users are in the United States.<sup>2</sup> By 1996, it was estimated that nearly 800,000 U.S. investors had an online brokerage account,<sup>3</sup> and that by 1998, 1.3 million investors would have Internet accounts.<sup>4</sup> In 1999, Charles Schwab alone, which accounts for almost half of on-line brokerage accounts<sup>5</sup>, had nearly six million accounts, all of which can be accessed through the Internet.<sup>6</sup> In total, Schwab executes nearly 150,000 Internet trades daily.<sup>7</sup> With the onset of “day traders”<sup>8</sup> the number of Internet brokerage accounts was expected to reach 10.5 million in 1999.<sup>9</sup>

Along with the rise of on-line technology as a tool for brokerage houses has come the possibility of using the Internet for initial public offerings (“IPO”). In March 1996, Spring Street Brewing Company (“Spring Street”) undertook an initial public offering.<sup>10</sup> This IPO was unique because rather than spending the money to go through a brokerage house, Spring Street decided to sell its stock over the World Wide Web.<sup>11</sup> The offering earned Spring Street \$1.6 million at an offer price of \$1.85, with 3500 investors buying 900,000 shares.<sup>12</sup>

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1. See *Global Internet Statistics* (viewed Feb. 11, 2000) <<http://www.glreach.com/globstats/index.php3>>.

2. See *id.*

3. See Greg Miller & Tom Petrino, *For Investors, the Internet Has Promise, Perils*, L.A. TIMES, June 3, 1996, at A1.

4. See *id.*

5. See Ian Wylie, *Going for Broker: New World Orders*, THE GUARDIAN, Feb. 20, 1999, at 101.

6. See *id.*

7. See *id.*

8. See David Lidsky, *Fire Your Broker*, PC MAGAZINE, Mar. 1999, at 16 (explaining that a day trader is a stock trader who spends his or her day on-line making stock trades for the trader's own benefit. The practice is a rapidly growing trend with the rise of on-line brokering cites).

9. See Lynnley Browning, *Fidelity Will Add Specialty Services to On-Line Trading*, THE BOSTON GLOBE, Feb. 16, 1999, at E1.

10. See Jim Gallagher, *Cyber Stocks: Small Firms Turning to the Internet to Raise Capital*, ST. LOUIS POST DISPATCH, Aug. 11, 1996, at E1; Robert A. Robertson, *Personal Investing in Cyberspace and the Federal Securities Laws*, 23 SEC. REG. L.J. 347, 385 (1996); Gary Weiss, *Online Investing*, BUS.WK., June 5, 1995, at 64, 74.

11. See Gallagher, *supra* note 10 at E1.

12. See Kerry Hannon, *Going Public to the Public; Small Businesses Can Bypass*

This strategy of Spring Street to bypass an underwriter and go directly to the public via the Internet was quite innovative. However, that innovation opened the door to problems of misuse. At the same time, this opened the door for small businesses to raise capital through a means that was not financially feasible prior to Internet IPOs. This note examines the SEC's reaction to IPOs on the Internet, the resulting benefits and concerns with these Internet IPOs, and suggests in ways in which the SEC should respond to such Internet IPOs.

## I

### Federal Regulation of IPOs

#### A. Registration Under The Securities Act of 1933<sup>13</sup>

Sales of securities are different from other types of transactions in three ways. First, unlike the purchase of a good exhibiting an immediate tangible use, such as a book, securities represent a subjective valuation of a company.<sup>14</sup> Securities are also different than purchases of goods in that they aren't used, but rather are traded as a sort of currency.<sup>15</sup> Thirdly, security markets are uniquely susceptible to manipulative and deceptive practices due to their reliance on the valuation of securities.<sup>16</sup> Due to these factors, securities trading has developed into a unique industry where people sell and purchase securities for investors and traders.<sup>17</sup> These three factors were relied upon in the passing of the Securities Act of 1933 ("1933 Act").<sup>18</sup>

The 1933 Act was passed as a reaction to the failure of blue sky laws<sup>19</sup> to control securities fraud, the 1929 stock market crash and Franklin Roosevelt's 1932 presidential campaign.<sup>20</sup> The 1933 Act is

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*Underwriters and Save Big Money*, U.S. NEWS & WORLD REPORT, June 17, 1996, at 74.

13. 15 U.S.C. § 77a-77bbbb (1994).

14. See David L. Ratner, *SECURITIES REGULATION 1* (6th ed., 1998).

15. See *id.* at 2.

16. See *id.*

17. See *id.*

18. Securities Act of 1933, 15 U.S.C. § 77a-77bbbb (1994).

19. See James S. Mofsky, *BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 9-11* (1971) (explaining that a "blue sky law" is a state regulation governing securities. When the first blue sky law was enacted in 1911 in Kansas, it focused on regulating fraudulently valued securities).

20. See Robert W. Hamilton, *CORPORATIONS INCLUDING PARTNERSHIPS & LIMITED PARTNERSHIPS 368* (5th ed. 1994); See also Larry D. Soderquist, *UNDERSTANDING THE SECURITIES LAWS 1* (1987).

mainly a disclosure statute.<sup>21</sup> It does not give the SEC power to decide which securities can be offered, but insists that the issuer make a full disclosure of all material facts.<sup>22</sup> This theory comes from the belief that if the investor receives accurate information in a timely manner, the 1933 Act's goal of investor protection is accomplished.<sup>23</sup>

The section of the 1933 Act that has the most impact is section 5.<sup>24</sup> Section 5 requires that securities be registered or exempt in order to be offered.<sup>25</sup> This registration requires that the offering company complete a registration statement,<sup>26</sup> which consists of a prospectus<sup>27</sup> and any additional information that is publicly available but is not in the prospectus.<sup>28</sup> Because this document must be precise, an issuer must go through the process of hiring numerous attorneys, accountants and a publisher to write and produce the prospectus.<sup>29</sup> In addition to these costs, an IPO normally requires the hiring of a securities underwriter and securities firms to distribute the shares.<sup>30</sup>

## **B. Exceptions from the 1933 Act & Regulation A**

Section 5 of the 1933 Act requires registration for the sale of any security unless it is specifically exempted from the registration provisions.<sup>31</sup> Section 3(b) allows the SEC to expand the types of

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21. See Ratner, *supra* note 14, at 32.

22. See *id.*

23. See generally SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) ("The design of the [Securities Act] is to protect investors by promoting full disclosure of information thought to make informed investment decisions."); Gregg Knute, *Regulation A Initial Public Offerings on the Internet: A New Opportunity for Small Business?*, 1 J. SMALL & EMERGING BUS. L. 417, 422 (1997) ("The Securities Act reflects the philosophy that so long as investors have enough accurate and timely information at their disposal to make investment decisions, the goal of investor protection has been established.").

24. 15 U.S.C. § 77e(a).

25. *Id.*

26. See Hamilton, *supra* note 20, at 370.

27. "A printed document that describes the main features of an enterprise (especially a corporation's business) and that is distributed to prospective buyers or investors." See BLACK'S LAW DICTIONARY 510 (Pocket Edition 1996).

28. See Hamilton, *supra* note 20, at 370.

29. See generally Carl W. Schneider et. al., *Going Public: Practice Procedure and Consequences*, 25 CORP. PRAC. COMMENTATOR 89, 96-121 (1983-1984) (discussion of the many parties involved in an IPO).

30. See Hamilton, *supra* note 20, at 370 (stating that an underwriter is typically an investment bank or securities firm which "acquires shares for resale or who arranges the direct sale of shares by the issuer.").

31. See Ratner, *supra* note 14, at 53.

securities which are to be exempt from the registration process.<sup>32</sup> The Act states:

The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$5,000,000.<sup>33</sup>

Under the authority of section 3(b), the SEC adopted Regulation A in 1936.<sup>34</sup> Regulation A is a general exemption for IPOs of ordinary securities.<sup>35</sup> Regulation A allows an issuer to raise up to five million dollars with unobstructed access to investment markets.<sup>36</sup> In addition to the quantity limitations, certain "good guy" qualifications listed in Rule 252 must be met.<sup>37</sup> These qualifications prevent those who have been convicted of securities offenses, who have been subject to SEC disciplinary proceedings, or who have been involved in certain other types of proceedings from being eligible for participation in an IPO offered under Regulation A.<sup>38</sup>

While it is called an exemption, Regulation A actually serves as a simplified form of registration.<sup>39</sup> Some commentators even refer to it as a "mini-registration" because it imposes two significant registration requirements.<sup>40</sup> Regulation A requires that an offering statement, which contains both notification of the IPO and an offering circular, be filed with the SEC at least ten days before going public.<sup>41</sup> The offering circular must be provided to each potential investor of the issuer.<sup>42</sup> It must contain information similar to what is required by section 5 of the 1933 Act, but with less detailed financial statements, which need not be audited.<sup>43</sup>

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32. See 15 U.S.C. § 77c(b) (1994).

33. *Id.*

34. See Securities Act Release nos. 627-32 (Jan. 21, 1936).

35. See Ratner, *supra* note 14, at 65.

36. See 17 C.F.R. § 230.251 (1997).

37. 17 C.F.R. § 230.252 (1997).

38. See *id.*

39. See Ratner, *supra* note 14, at 65.

40. C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L. J. 591, 612 (1996).

41. See Ratner, *supra* note 14, at 66.

42. See C.F.R. § 230.251 (d)(1).

43. See Ratner, *supra* note 14, at 66.

## II

### The Rise of Initial Offerings on the Internet

#### A. Spring Street Brewing Company and the Rise of Wit Capital Corp.

In the world of Wall Street, an IPO which raises \$1.6 million is of little significance.<sup>44</sup> However, Spring Street Brewery's IPO in March, 1996, which sold nearly 870,000 shares and raised 1.6 million dollars was significant, because it was the first company to conduct its IPO exclusively through the Internet.<sup>45</sup> To satisfy Regulation A requirements, Spring Street linked its circular to its Web site. The circular could then be downloaded and a potential investor would have all the documents required by the SEC, along with a subscription agreement.<sup>46</sup> Andrew Klein, the mastermind behind Spring Street Brewery, explained how the first IPO worked:

Instead of asking potential investors to phone an 800-number, this section offered a button - a hyperlink to another site where the prospectus was replicated as a wordprocessing document. That meant that all the would-be investor had to do was to click on the button to view the prospectus, download it, and print it. The printed version included a subscription agreement; anyone who wanted to buy . . . stock could fill it out and send it to us - with a check.<sup>47</sup>

The most important factor in this IPO is that Spring Street made all of the proceeds with a cost of only \$200 a month.<sup>48</sup> Spring Street was able to keep its costs low because they avoided paying any "commissions to investment bankers, underwriters, or securities lawyers."<sup>49</sup>

After the success of Spring Street's on-line IPO, Klein created Wit Capital Corporation, the first investment bank dedicated solely to Internet IPOs.<sup>50</sup> While Wit Capital does employ the same staff that a traditional investment bank would employ, shares offered through Wit Capital are not sold in a traditional manner.<sup>51</sup> In contrast to a

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44. See Andrew Osterland, *IPOs in Cyberspace*, 165 FIN. WORLD, Apr. 22, 1996, at 24.

45. See *id.*

46. See *id.*

47. Andrew Klein, *WallStreet.Com: How the Beer Company that Created the First Internet IPO Is Shaking Up the Stock Market* (visited Mar. 4, 1999) <[http://www.wired.com/wired/archive/6.02/wallstreet\\_pr.html](http://www.wired.com/wired/archive/6.02/wallstreet_pr.html)>.

48. See *id.*

49. *Id.*

50. See *id.*

51. See Wit Capital, *Wit SoundView: About Us* (visited January 11, 2001) <<http://www.witcapital.com/about/about.jsp>> (explaining the purpose of Wit Capital, the

non-online IPO, in which an underwriter sells shares to institutional customers, who in turn distribute them to the public,<sup>52</sup> public offerings through Wit Capital are sold directly to the public through the Internet.<sup>53</sup> On Wit Capital's Web site, companies wishing to go forward with an IPO can post their prospectus along with promotional material designed to inform potential investors about the company.<sup>54</sup> Wit Capital offers the opportunity for smaller issuers to gain some capital without having to pay the normally high costs that an IPO would require.<sup>55</sup>

Along with providing issuers a cheaper way to raise capital, Wit Capital also makes it easier for the general public to invest. Wit Capital attempts to offer the general public a chance to invest on the same level as institutional investors.<sup>56</sup> It does this by offering IPOs at reasonable prices.<sup>57</sup> These prices are even more reasonable because an investor does not have to pay broker fees or commissions since the investors are investing independently.<sup>58</sup> As the company puts it, by "routing orders to trade through its digital market, the Company . . . offer[s] retail investors trading prices that are better than the national best bid/ask prices."<sup>59</sup> In the long run, this will save its larger customers thousands of dollars per trade.<sup>60</sup>

## B. The Rise of Other Internet IPO Sources

As of January 1997, just ten months after the first Internet IPO,<sup>61</sup> at least thirty-five additional Internet IPOs were completed.<sup>62</sup> Many companies have entered the industry of providing small companies the opportunity to execute their IPOs online.

One such company, ImSpectus, delivers prospectuses over the

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method in which it sells its stock, and services that the company hopes to add in the future). Note that since the writing of this Note, Wit Capital has merged many of its operations with E\*TRADE.

52. *See id.*

53. *See id.*

54. *See id.*

55. *See id.*

56. *See* Wit Capital, *supra* note 51.

57. *See id.*

58. *See id.*

59. *Id.*

60. *See id.*

61. *See supra* note 44 and accompanying text.

62. *See* Timothy C. Barmann, *Netting Shareholders: 2 R.I. Firms Are Offering Their Stock for Public Sale Directly Over the Internet*, PROVIDENCE BULL., Jan. 8, 1997.

Internet for companies who are planning an Internet IPO.<sup>63</sup> ImSpectus gathers the SEC-required documents and makes them available to possible investors of companies offering their IPO over the Internet.<sup>64</sup> The company “loads a prospectus or any other SEC-related or public issue documents on the Internet [within] an hour after being cleared for printing.”<sup>65</sup> ImSpectus meets the SEC guidelines for the prospectus because an ImSpectus prospectus is similar to a printed prospectus that other offering companies make available to their investors.<sup>66</sup> The difference is that this information is on-line and much easier to navigate than a prospectus printed on paper. This is also a better means of gaining information about a possible investment because it can be updated constantly.<sup>67</sup> This is useful if a company has changes to make to its information. As such, it is a good way to keep possible investors well informed.

### III

#### The SEC’s Reaction to Internet IPOs

The SEC approached the Spring Street IPO with caution. The SEC had dealt with changes in the world of IPOs before, but the Internet posed a new problem. It created an entirely new way to conduct IPOs which took seasoned professionals out of the picture. Prior to the first Internet IPO, the SEC dealt with the use of electronic devices to deliver a prospectus.<sup>68</sup>

##### A. The Brown & Wood No-Action Letter & the Use of Electronic Devices in the Delivery of a Prospectus

Because of technological advances, companies wanted to know whether they could use devices such as the Internet, CD-ROMs, and fax machines to deliver a prospectus.<sup>69</sup> In response to the inquiry, the SEC issued a no-action letter,<sup>70</sup> which provided guidance for use of

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63. See *ImSpectus, Pioneer On-Line Prospectus Provider, Powers Successful Optical IPO*, BUS. WIRE, June 18, 1996.

64. See *id.*

65. *Id.*

66. See *id.*

67. See *id.*

68. See *e.g.*, Brown & Wood, SEC No-Action Letter, Fed. Sec. L. Rep (CCH) ¶ 77,000, at 78,841 (Feb. 17, 1995) (asking whether electronic delivery of prospectus meets delivery requirements).

69. See *id.*

70. “. . . [T]he staff has . . . been willing to respond to individual private inquiries as to whether a certain transaction could be carried out in a specified manner. These responses are known as ‘no-action’ letters, because they customarily state that ‘the staff will

electronic devices in delivering a prospectus.<sup>71</sup>

On February 17, 1995 the SEC issued the Brown & Wood No-Action letter.<sup>72</sup> The letter was written in response to an inquiry from Joseph McGlaughlin, an attorney at the law firm of Brown & Wood, asking for advice in the use of electronic devices in the delivery of a prospectus.<sup>73</sup> He was concerned that the use of these devices would not meet the delivery requirement of the 1933 Act.<sup>74</sup> The response came from the Division of Corporate Finance:

Based on the facts presented, it is the Division's view that the term "prospectus" as defined in Section 2(10) . . . and used in Sections 5 and 10 of the Securities Act includes a prospectus encoded in an electronic format. In addition, if transmitted electronically as described in your letter, for purposes of Section 2(10)(a), such prospectus would be sent or given "prior to" the communications described in your letter that, but for Section 2(10)(a), would constitute a "prospectus" as defined in Section 2(10). Further, if transmitted electronically as described in your letter such prospectus would "precede" the security for purposes of Section 5 (b)(2).<sup>75</sup>

Thus, Brown & Wood had what it needed to move forward with a prospectus that would be delivered solely over electronic media devices.

## B. The SEC's Reaction to the First Internet IPO

Spring Street began their IPO on March 1, 1996.<sup>76</sup> On March 4, around 11 a.m., Spring Street and Klein received a call from the SEC.<sup>77</sup> In his conversation with the SEC, Klein spoke with SEC Commissioner Steve Wallman.<sup>78</sup> Affirming that the SEC supported the use of new technology to conduct IPOs, Klein described Wallman as saying that he was very interested in the use of technology for such things.<sup>79</sup> In fact, Wallman stated that "he didn't wish to discourage financial innovations on the Internet."<sup>80</sup> On March 18, as a result of

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recommend no action to the Commission if the transaction is done in the specified manner." Ratner, *supra* note 14, at 16.

71. See Brown & Wood, *supra* note 68, at 78,841.

72. See *id.*

73. See *id.*

74. See *id.*

75. *Id.* at 78, 845.

76. See *supra* note 10 and accompanying text.

77. See Klein, *supra* note 47.

78. See James E. Grand & Gary Lloyd, *Internet IPOs: A Potential Oasis for Small Companies*, UPSIDE, July 1996, at 92.

79. See *id.*

80. *Id.*

this call, Spring Street voluntarily ended their Internet trading so that the SEC could examine the practice.<sup>81</sup>

On March 22, 1996, the SEC issued a no-action letter to Spring Street which allowed the company to resume its on-line trading.<sup>82</sup> For Spring Street to resume trading, the SEC required that Spring Street revise their trading mechanism in order to meet the SEC's five recommendations.<sup>83</sup> The SEC stated, "In particular, we are concerned that investors' funds and securities be handled appropriately, that investors understand the risks involved in purchasing illiquid and speculative securities, that buyers are aware of last sales prices and that investors are provided with ongoing disclosure about the Company."<sup>84</sup>

First, because Spring Street was not a registered broker-dealer, it must use an independent agent to receive the funds from its investors.<sup>85</sup> Second, the SEC next recommended that Spring Street disclose to its investors that it was not being traded on a registered securities exchange.<sup>86</sup> That disclosure would protect investors from the unique risk of buying a security from a non-registered company.<sup>87</sup> Third, the SEC was concerned that Spring Street's users appear to be "dealers" if they were to post quotas on Wit's<sup>88</sup> bulletin boards.<sup>89</sup> Being a dealer requires one to follow certain regulations. Wit had to inform its users of the risk of this misrepresentation.<sup>90</sup> Fourth, the SEC recommended that the SEC keep accurate records of both the quotations posted on Wit's bulletin board and all of the securities transactions which took place through the use of the system.<sup>91</sup> Finally,

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81. See *Staff Clears Way for N.Y. Concern to Resume Stock Trading on the Internet*, 28 SEC. REG. & L. REP. (BNA) No. 13, at 437 (Mar. 29, 1996) [hereinafter *Resume Stock Tradings*].

82. See *id.*

83. See *id.*

84. Spring Street Brewery Co., SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,201, at 77,001. [hereinafter *Spring Street No-Action Letter*].

85. See *id.*

86. See *id.*

87. See *id.* The SEC reasoned that because Spring Street was a small company seeking minimal investments, an investment in such a company would be riskier than a bigger company being traded on a registered exchange. See Rose Marie Burke, *Bouncing Back: High Failure Rates Plague Entrepreneurs, But Most of Them Refuse to Give Up*, WALL ST. J., Oct. 16, 1992, at A1.

88. Spring Street used Wit's bulletin board for selling its stocks. See Klein, *supra* note 47.

89. See *Spring Street No-Action Letter*, *supra* note 84, at 77,001.

90. See *id.*

91. See *id.*

the SEC recommended that Spring Street use Regulation A as the exemption from the 1933 Act and to stay in accordance with that regulation, they should update their offering circular.<sup>92</sup>

### C. The SEC Release on the Use of Electronic Media Devices for Delivery

To help clear up the problem on the use of electronic media devices for delivery, the SEC issued more detailed instructions on October 6, 1995.<sup>93</sup> As part of the release, Commissioner Wallman not only stated that the use of electronic media was acceptable, but that they should actually promote it in the future.<sup>94</sup> “Given the advantages afforded by electronic media, we determined that our goal should be to encourage electronic delivery of information, even to the point of preferring it over paper in the long run.”<sup>95</sup> Keeping in mind its fundamental goal of informing investors so as to remove some risk, the release states that electronic delivery will satisfy “the federal securities laws if such distribution results in the delivery to the intended recipients of substantially equivalent information as these recipients would have had if the information were delivered to them in paper form.”<sup>96</sup>

All three of these early reactions by the SEC to the use of the Internet and other electronic devices show that the SEC was prepared to move forward with the rest of the world and let technology grow. The SEC is concerned with keeping investors informed of the risks that are involved with investing, whether that be on the Internet or not. As Commissioner Wallman points out, “The challenge is to maintain a regulatory regime flexible enough to allow for the continued development of such systems, consistent with allowing us to meet our regulatory objectives without imposing unnecessary or constraining costs.”<sup>97</sup> So far, the SEC has refrained from strict regulation of Internet IPOs.

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92. *See id.*

93. *See* Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, Exchange Act Release No. 36,345, Fed. Sec. L. Rep. (CCH) ¶ 3200, at 3128 to 3131-12 (Oct. 6, 1995) (hereinafter SEC Release).

94. *See id.*

95. *Id.*

96. *Id.*

97. Commissioner Steven M.H. Wallman, *Regulating in a World of Technological and Global Change*, Address Before the Institute of International Bankers 3 (Mar. 4, 1996).

## IV

### Benefits of IPOs on the Internet

As computers play a larger role in the lives of Americans, Internet IPOs are taking a greater role in the financial world. One question, however, is how fast online investing is expected to grow? Forrester Research predicts that by the year 2001 there will be 9.3 million Internet accounts comprising eight and one half percent of the market.<sup>98</sup> Because the movement towards online investing, it seems logical that IPOs would follow suit. To understand why the movement to Internet IPOs is happening, it is crucial to evaluate the benefits of conducting an IPO this way.

#### A. The Investor

One reason that IPOs on the Internet are becoming greater in number may be that investors enjoy using the Internet. The Internet is good for investors because it gives them the opportunity to invest on equal grounds with brokerage firms and institutional investors.<sup>99</sup> This is one of the factors that drove Wit Capital Corporation to start its on-line investment company.<sup>100</sup> This is bad for casual investors because by the time they get a chance to purchase the stock, the price has become so inflated that it leaves the investor with securities that do not reflect their real value. Investing directly in the company through the Internet removes this disparity and gives a customer securities actually worth their value.

Investors also have more access to information through the Internet than they would through normal investing. As Gary Weiss put it:

Sources of information online are rich, some startlingly so. And perhaps the greatest resources are the investors themselves. For the first time, small investors have a way of rapidly exchanging information — and it's often the kind of nitty-gritty details that are prized by the pros. The message boards of large commercial services and the message-exchange powerhouse known as Usenet, with it's 30 million potential users, can easily outclass the one-sided and often unreliable output of the Street's analyst-report machine.<sup>101</sup>

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98. See Kimberly Weisul, *Report: New 'Mid-Tier' Brokers to Get 60% of On-Line Trades*, INVESTMENT DEALER'S DIG., Sep. 30, 1996 at 11.

99. See Joseph J. Cella, III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium. A Program for the Eagle and the Internet*, 52 BUS. LAW. 815, 816 (1997).

100. See *supra* note 51 and accompanying text.

101. Weiss, *supra* note 10.

Thus, the Internet gives a small investor, who lacks the resources to spend on brokerage fees and information finding, a chance to invest on even ground with richer investors.

### **B. Smaller Companies as Issuers**

Most IPOs on the Internet are Regulation A IPOs. A Regulation A IPO on the Internet is one of the best ways to issue stock for small companies. First and foremost, a small issuer will save a substantial amount of money by issuing stock via the Internet.<sup>102</sup> This savings occurs because normally with a Regulation A IPO an issuer would have to print and distribute its offering circular to potential investors while continuously updating it.<sup>103</sup> From the time of the original offering circular to the actual IPO, revisions become necessary.<sup>104</sup> This can cause an even greater expense in the use of paper.

This is where electronic delivery of the offering circular becomes helpful. Rather than printing revisions, an Internet issuer would simply update the web page. This would allow potential investors to download all the information that they would need to have in deciding whether to invest. As Klein noted, this would cost an Internet issuer around \$200 a month,<sup>105</sup> rather than the estimated twenty to fifty thousand dollars spent on offering circulars on non-Internet IPOs.<sup>106</sup> Thus, an Internet IPO would save a tremendous amount of money in printing costs alone.

Another cost advantage that Internet IPOs have is that an issuer would not have to use a traditional underwriter.<sup>107</sup> In a typical issuance of stock, an issuer hires an underwriter to locate a market for the stock being issued.<sup>108</sup> As compensation for this search, an underwriter would contract with the issuer the ability to purchase all or a portion of the issuer's stock at a discounted rate.<sup>109</sup> The underwriter would then sell the stock purchased at the discounted

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102. See Cella, *supra* note 99 at 816.

103. See Lee F. Benton et. al., *Practical Aspects of Preparing the Issuer for Its Public Offering Formation*, PRIVATE AND PUBLIC FINANCINGS, at 309.

104. See *id.* at 312-13.

105. See Klein, *supra* note 47.

106. See Daniel Bates, *Engineering an IPO*, SM. BUS. NEWS-PITTSBURGH, Sept.1, 1996, at 8.

107. See Schneider, *supra* note 29, at 120.

108. See Richard Raysman & Peter Brown, *Securities Offerings Over the Internet*, N.Y. L.J., June 10, 1997, at B1 (noting that companies almost never go public without the assistance of an underwriter).

109. See Samuel L. Allen, *A Lawyer's Guide to the Operation of Underwriting Syndicates*, 26 NEW ENG. L. REV. 319, 320-21 (1991).

rate to investors at full price.<sup>110</sup> The amount of the discount that is given to an underwriter depends both on the risk of the offering and the reputation of the underwriter.<sup>111</sup> Thus, for small businesses that are more risky investments, the discount given to an underwriter is high. This will lead to a company making much less in its IPO than it would if it did not have to use an underwriter.

An IPO on the Internet cuts out the expense of using an underwriter.<sup>112</sup> An issuer would not need to hire an underwriter to find the market for the stock, because the Internet itself function as the market. Companies wishing to execute an IPO on the Internet would be able to advertise their offering on their own Web pages as well as other Web sites.<sup>113</sup> This new ability to advertise IPOs on the Internet would greatly reduce costs necessitated by an underwriter, while giving a potential stock issuer the ability to see if there is a market for the issuance of their stock.

### C. The Four Win-Wins

One company that provides the service of Internet IPOs is DirectIPO. It takes a small company through the entire process of planning an IPO, with the eventual goal of having the company go public, usually on the NASDAQ.<sup>114</sup> The company has described Internet IPOs as being a win-win situation.<sup>115</sup>

There are four reasons why the Internet provides a win-win situation for companies wishing to go public. First, is the effect of small investors.<sup>116</sup> In the case of Internet IPOs, they would act as mini venture capitalists, buying up to 25% of the company, rather than the standard 50% that a traditional venture capitalist would demand.<sup>117</sup> Next, by holding onto their stock for a few years, the small investors will reap venture capital-like returns when secondary stock is sold on the NASDAQ.<sup>118</sup> DirectIPO requires that its users plan to sell on the NASDAQ in two to four years, which provides liquidity for small

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110. *See id.*

111. *See id.*

112. *See* Wit Capital Corporation, *supra* note 51.

113. *See* 17 C.F.R. § 230.251 (d)(ii)(c) (1998).

114. *See* *Direct IPO: Creating Venture Funds Via the Internet* (visited Mar. 4, 1999) <<http://www.directipo.com/serv/fullsr.html>>.

115. *See id.*

116. *See id.*

117. *See id.*

118. *See id.*

investors.<sup>119</sup> Finally, although the initial strategy is to raise funds for small, start-up companies, the larger goal is to make enough money for the company so that they can make a regular offering, not a Regulation A offering.<sup>120</sup> Thus, DirectIPO stresses that both the investors and the issuers would win under their scheme.

## V

### Problems With Internet IPOs

While there are many advantages to having an IPO on the Internet, there can also be problems involved with Internet IPOs. These problems include fraud, cybercrime and state interference by regulation.

#### A. Fraud and Cybercrime

A major problem with investing on-line is the possibility of cybercrime. The SEC needs to protect against the possibility that hackers will create false securities transactions.<sup>121</sup>

The Internet has become a priority for the SEC's Enforcement Division in order to prevent fraudulent investments. Commissioner Wallman has stated that the increase in Internet investment has called for the increased need for regulators to deter fraudulent investments.<sup>122</sup> Along with this idea of locating fraudulent investments, the SEC has taken an active role in educating potential investors about the existence of fraud in securities.<sup>123</sup> This increased education by the SEC came from the realization that fraud in cyberspace is becoming more likely and easier to accomplish.<sup>124</sup>

One example of early fraud on the Internet is found in *SEC v. Gene Block*.<sup>125</sup> In this case, Block lured investors into a scheme where they were promised to double their money in four months.<sup>126</sup> He represented that their "initial investments were guaranteed against

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119. *See id.*

120. *See id.*

121. *See* Hal Lux, *An IPO Over the Internet Isn't Good for Wall Street*, INVESTMENT DEALER'S DIG., May 22, 1995, at 34.

122. *See* Wallman, *supra* note 97.

123. *See id.*

124. *See* Osterland, *supra* note 44, at 25-26.

125. *SEC v. Gene Block*, SEC LITIG. REL. No 14,711, 60 SEC DOC. 1894 (Nov. 10, 1995).

126. *See id.*

loss because a 'Prime Bank Guarantee' would secure the transaction."<sup>127</sup> The guarantee was bogus, and Block's assets were frozen by the SEC through a temporary restraining order requiring him to repay everyone who invested in his scheme.<sup>128</sup>

This type of fraudulent claims is one of the problems of securities transactions via the Internet. As Klein points out, there is a problem because, "[t]here were a lot of people at the SEC and in the state offices who couldn't see our Web site or what we were doing because they didn't have computer access."<sup>129</sup> The problem is in the policing. As a result, the Enforcement Division added a place for people to register complaints on the SEC's Web page.<sup>130</sup> This page gives investors tips on investing, explains the process of filing a complaint, and warns investors of recent investment schemes reported to be fraudulent.<sup>131</sup>

## B. State Regulation

The main problem in applying state regulation to Internet IPOs is that each state deals with IPOs differently. The Internet adds an additional problem to this type of regulation because most Internet transactions don't occur in a single state. In a state adopting Section 301 of the Uniform Securities Act, it is illegal to offer securities for sale without either state regulation or an exemption.<sup>132</sup> The question then is, does the sale of securities through the Internet to a buyer in another state violate this rule if the seller has not registered in the buyer's state?

In 1996, the National American Securities Administrators Association (NASAA) met to confront the problem of IPOs on the Internet. They felt that because they are influential in state policy making, their formulation of a unified solution might be implemented. Two major rules were proposed at the meeting.<sup>133</sup> First, an issuer cannot offer stock over the Internet to citizens of states unless they have registered with the target state. Second, the issuer

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127. *Id.*

128. *See id.*

129. Charles A. Jaffe, *Don't Get Roped In: As More Firms Use Internet IPOs, Investors Should be Aware of Dangers*, CHI. TRIB., May 21, 1996, at C1.

130. *See* Complaint Center (visited Mar. 4, 1999) <<http://www.sec.gov/enforce/comctr.html>>.

131. *See id.*

132. Unif. Securities Act § 301, 7b U.L.A. 550.

133. North American Securities Administrators Association, NASAA Internet Resolution (visited Mar. 4, 1999) <<http://www.nasaa.org/bluesky/guidelines/res.html>>.

must note on their web page that the securities are not meant for citizens of states in which the issuer is not registered.<sup>134</sup> As of March 4, 1999, 32 states had adopted the resolution and 15 more have indicated that they would adopt it in the near future.<sup>135</sup>

This resolution fails to address the actual problem that it attempts to fix. Because of the use of the Internet, people outside the registered state can and often do purchase securities that were not meant to be sold to them. These people won't be fully protected against the dangers that the SEC seeks to protect against. The whole point is to have unified legislation to protect investors against fraud and other dangers which add to the chance that an investor is making an uninformed decision.

Because of the discrepancy in the state laws, many law firms have asked that the SEC provide better guidelines for the use and electronic delivery of IPOs.<sup>136</sup> One such law firm, Sullivan & Cromwell, expressed concern that state regulators have entered the fray of regulating Internet IPOs while Federal regulators have yet to become involved.<sup>137</sup> Their position is that, because Internet IPOs clearly cross state lines, state regulation of such issues can lead to major problems.<sup>138</sup> They argue that the SEC should issue regulations that preempt state regulation.<sup>139</sup>

## VI

### What Should the SEC Do?

While it is clear that the SEC must enter the fray of Internet securities transactions, it is not so clear what the SEC should do. Keeping in mind that the goal of many Internet IPOs is to open the door for smaller companies to raise capital,<sup>140</sup> one possible solution is to make *all* Regulation A offerings exempt from state regulation. This would advance three important SEC objectives: the effective policing of Internet IPOs, the dispersal of information to Internet investors, and the raising of capital for small issuers.<sup>141</sup>

One other possibility, though not nearly as likely, is for Congress to amend the 1933 Act or write new legislation to deal solely with the

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134. *See id.*

135. *See id.*

136. *See Lux, supra* note 121.

137. *See id.*

138. *See id.*

139. *See id.*

140. *See* discussion *infra* part II.

141. *See* discussion *infra* parts I, V.A.

Internet and IPOs. The problem with this type of change in the law is that it would take a lot of political pressuring to make it happen. If special regulation of Internet IPOs were to occur, there would be an increase in Internet IPOs by small companies. Thus, it would allow small companies to raise capital at a smaller cost than presently available.

## **VII**

### **Conclusion**

In the upcoming years, Internet stock trading will continue to increase at a rapid pace. Millions of users already utilize the Internet for some sort of investing. Because of this, it seems likely that IPOs on the Internet will continue to grow. The SEC, as the federal agency that regulates securities transactions, should step in and preempt state regulation of Internet IPOs so smaller companies will have the opportunity to raise capital. As it currently stands, Internet IPOs are a way for small companies to raise capital. In the new millenium, it is clear that the SEC needs to take some action to unify the system.