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Regulation of Securities and Security Exchanges in the Age of the Internet

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REGULATORY INITIATIVES AND THE INTERNET: A NEW ERA OF OVERSIGHT FOR THE SECURITIES AND EXCHANGE COMMISSION†

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INTRODUCTION

Though merely a communications medium, the acceptance of the Internet in the business world has led to a technological revolution in the securities market. The trading of securities over the Internet has challenged securities regulators to adjust old legal constructs to fit this new medium. However, these constructs do not neatly fit the medium of the Internet. The global nature of Internet communications can lead to the conclusion that Internet activities occur everywhere, nowhere, or both simultaneously, creating jurisdictional conflicts in laws and courts.[1]

As a result, Internet activity has given rise to the conflicting fears of overregulation and underregulation. Because geography is a meaningless construct in cyberspace, a "single actor might be subject to haphazard, uncoordinated, and even outright inconsistent regulation by states that the actor never intended to reach and possibly was unaware were being accessed."[2] On the other hand, there is a contrary risk that significant harms will result from governments' inability or reluctance to enforce existing legal prohibitions.[3]

Regulators are confronted with a plethora of substantive and jurisdictional issues arising out of Internet securities offerings and trading. This Article will argue that the Securities and Exchange Commission has endeavored to tailor its rules to a cyberspace environ-

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1. *See* Pierre Trudel, *Jurisdiction over the Internet: A Canadian Perspective*, 32 INT'L LAW. 1027, 1027–28 (1998).

2. Am. Libraries Ass'n v. Pataki, 969 F. Supp. 160, 168–69 (S.D.N.Y. 1997).

3. *See* Peter P. Swire, *Of Elephants, Mice, and Privacy: International Choice of Law and the Internet*, 32 INT'L LAW. 991, 993 (1998).

ment without relaxing any of its regulations. However, since the Internet is a free and wide-ranging communications medium, and SEC regulations, in essence, control speech, the Internet has forced the SEC to deregulate in certain areas.[4] Further deregulation seems inevitable, especially where United States law is out of sync with foreign laws.

I do not see how the SEC can continue to stand with its finger in the dike while a flood of information washes over the walls. Further, the Internet and the increasing globalization of capital markets have curtailed the SEC's traditional claim to worldwide jurisdiction over antifraud claims.[5] In response, the SEC has been working on cooperating with both domestic and foreign securities regulators and upgrading securities regulation around the world through the harmonization of standards by the International Organization of Securities Commissions (IOSCO) and other international organizations. Such cooperation is necessary in order to combat serious Internet fraud that does not respect national boundaries.

I
REGULATORY INITIATIVES

A. Primary Public Offerings

Six years ago, the SEC was the first securities commission in the world to approve the use of an Internet communication as a "prospectus" for an offering of securities to investors.[6] Shortly thereafter, the SEC issued an interpretative release on the delivery of electronic prospectuses,[7] and, one year later, the SEC issued another interpretative release on the use of electronic media by financial intermediaries.[8] Furthermore, since these releases and a series of subsequent no-action letters[9] did not address all of the problems that had arisen in connec-

4. *See, e.g.*, 17 C.F.R. § 230.155 (2001) (providing a "safe harbor" from integration of private and registered offerings); Roberta S. Karmel, *Integration of Public and Private Offerings*, N.Y.L.J., Apr. 19, 2001, at 3 (explaining the effects of 17 C.F.R. § 230.155).

5. *See* Daniel L. Goelzer et al., *The Draft Revised Restatement: A Critique from a Securities Regulation Perspective*, 19 INT'L LAW. 431 (1985).

6. Lisa A. Mondschein, Note, *The Solicitation and Marketing of Securities Offerings Through the Internet*, 65 BROOK. L. REV. 185, 203 (1999).

7. Use of Electronic Media for Delivery Purposes, Securities Act Release No. 33-7233, 60 Fed. Reg. 53,458 (Oct. 6, 1995) (to be codified at 17 C.F.R. pt. 231).

8. Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Securities Act Release No. 33-7288, 61 Fed. Reg. 24,644 (May 15, 1996) (to be codified at 17 C.F.R. pt. 231).

9. *See, e.g.*, Wit Capital Corp., SEC No-Action Letter, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,577, at 78,906 (July 14, 1999); Private Financial Network, SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶

tion with Internet prospectuses, the SEC issued another interpretative release on the subject in April of 2000.[10]

In the April 2000 release, the SEC recognized that more issuers and broker-dealers were conducting offerings online. The SEC noted that these developments present both benefits and dangers for investors. On the positive side, online brokers give individual investors more access to initial public offerings. On the negative side, individual investors may not receive sufficient information about the online offering process and may make hasty and uninformed investment decisions.[11]

The SEC has been accommodating Internet prospectuses through its interpretative approach rather than through statutory changes or new rules. The SEC has focused on whether Internet communications constitute speech or writings, and, if writings, whether they are prospectuses or "free writings," and then regulated them accordingly. Because of the difference in how the Securities Act of 1933 (Securities Act) treats written as compared with oral offers, and prospectuses as compared with other written materials, these are important distinctions.

Before filing a registration statement with the SEC for a public securities offering, no written or oral offers of the securities may be made.[12] This is considered "gun jumping."[13] After a registration statement is filed, but before it becomes effective, oral offers may be made. After the registration statement is effective, free writing may be sent to an investor.[14] Finally, before securities in a registered public offering may be sold, a prospectus must be delivered to the buyer.[15] Under the Securities Act, a prospectus is a formal document used to offer securities in a public offering.[16] The issuer, directors, underwriters, and their experts are liable for negligence if the prospec-

77,332, at 77,674 (Mar. 12, 1997); Bloomberg L.P., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1023, (Dec. 1, 1997); ITT Corp., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 895, (Dec. 6, 1996); IPONET, SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,252, at 77,270 (July 26, 1996).

10. Use of Electronic Media, Securities Act Release No. 33-7856, 65 Fed. Reg. 25,843 (May 4, 2000) (to be codified at 17 C.F.R. pt. 231) [hereinafter Electronic Media Release].

11. *Id.* at 25,851.

12. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1994).

13. *See* Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457 (1989).

14. Securities Act of 1933 § 5.

15. *Id.*

16. *See* Gustafson v. Alloyd Co., 513 U.S. 561, 574 (1995) (holding private sale contract is not "prospectus" within meaning of 1933 Act).

tus contains any false or misleading statements.[17] A due diligence defense, however, may be available to all but the issuer.[18] It is unclear whether any other writings used in the offering can generate liability for negligence, but any fraudulent statements made with scienter will give rise to liability under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act).[19]

Accordingly, classifying an Internet communication as a prospectus, a free writing, or an oral communication has important implications for the liability of issuers, directors, underwriters, and their expert advisors. The SEC has tried to maintain the balance, established by the securities laws, between fostering capital formation and protecting investors in dealing with such perplexing issues as issuer Web pages, hyperlinks, graphic and moving images, and updating information posted on the Internet. One reason the SEC has remained unwilling to treat Internet communications like telephone calls is that it does not want to take away investors' ability to sue issuers and intermediaries for negligent misrepresentations in offerings.

As a general matter, the SEC has treated Internet prospectuses as statutory prospectuses, and other Internet material as free writing. The SEC permits hyperlinks in electronic prospectuses to other documents officially filed with the SEC.[20] This enables filers to incorporate documents in a prospectus by reference as they have long been able to do with paper prospectuses. The use of hyperlinks is voluntary, but filers must assume liability for the hyperlinked material if it is part of the filing.[21] Animated graphics continue to be prohibited.[22]

In many respects, traditional SEC prohibitions on gun-jumping activities before a registration statement is filed and on the provision of free-writing materials during the "waiting period" are obsolete, especially as to established reporting companies. This obsolescence is more pronounced in an era of Internet communications.[23] The SEC proposed dealing with some of these problems pertaining to free communications in its "Aircraft Carrier Release,"[24] which would have

17. Securities Act of 1933 § 11 (1994 & Supp. V 2000).
18. *See id.*
19. Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994).
20. Rulemaking for EDGAR System, Securities Act Release No. 33-7855, 65 Fed. Reg. 24,788 (Apr. 27, 2000) (to be codified in scattered sections of 17 C.F.R.).
21. *See* Electronic Media Release, *supra* note 10, at 25,848–49 nn.48–61.
22. *Id.*
23. *See* John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1207 (1997).
24. The Regulation of Securities Offerings, Securities Act Release No. 33-7606A, 63 Fed. Reg. 67,174 (Dec. 4, 1998) (to be codified in scattered sections of 17 C.F.R.).

both permitted issuers to test the waters before filing a registration and liberalized the use of free writing.[25] Unfortunately, the Aircraft Carrier seems to have sunk, and reform is still needed.[26] In my view, the SEC should stop trying to suppress speech prior to or during the registration period unless that speech is fraudulent or part of a market manipulation.[27]

B. Private Placements

Another pressing policy issue for the SEC has been whether to allow placement memoranda in private placements to be communicated over the Internet. On the one hand, permitting an offering to be made on the Internet seems inconsistent with the requirements for a private placement because a private placement may not involve a general solicitation or advertising.[28] On the other hand, as the SEC has recognized in permitting electronic roadshows aimed at "qualified institutional buyers" in Rule 144A transactions,[29] institutional buyers are especially well-equipped to take advantage of Internet communications and appreciate their legal context. In a recent release, the SEC has suggested that although broker-dealers may offer private placements over the Internet to accredited investors, others may not do so.[30] This distinction seems quite arbitrary and institutions may be sufficiently dissatisfied with it to demand further change.

C. Market Structure

Crossing systems operated by a broker-dealer, which allow customer orders to meet without exchange or market-maker intermediation, have been a threat to the national securities exchanges and Nasdaq at least since Instinet Corp. became a broker in the mid-1980s.[31] Since then, the technology unleashed by the Internet has given rise to a wide variety of near-exchange marketplaces. The SEC

This proposal is commonly called the "Aircraft Carrier Release" because of the fundamental changes it would have created in the registration and offering of securities.

25. *See* Mondschein, *supra* note 6, at 191.

26. *See* John C. Coffee, Jr., *The SEC Aircraft Carrier Is Under Attack*, N.Y.L.J., Mar. 18, 1999, at 5.

27. *Accord* Chiappinelli, *supra* note 13; Joseph McLaughlin, *The SEC's Coming Regulatory Retreat*, *in* SECURITIES LAW & THE INTERNET: DOING BUSINESS IN A RAPIDLY CHANGING MARKETPLACE 185, 188 (PLI Corp. Law & Practice Course Handbook Series No. B0-00BS, 1999).

28. Electronic Media Release, *supra* note 10, at n.79.

29. *See, e.g.*, Net Roadshow, Inc., SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,367, at 77,849 (Sept. 8, 1997).

30. *See* Use of Electronic Media, 65 Fed. Reg. at 25,852.

31. *See* Instinet, SEC No-Action Letter, 1986 WL 67657 (Sept. 8, 1986).

has dealt with these marketplaces by changing its definition of the term "exchange" and requiring electronic marketplaces to register either as exchanges or as alternative trading systems (ATSs), pursuant to Regulation ATS.[32] The proliferation of ATSs has, in turn, unleashed a wide variety of market structure issues that the SEC has not been forced to confront for twenty years. Central to these issues is the question of whether or how to integrate trading by ATSs with trading over the exchanges and Nasdaq.

Regulators abroad are grappling with similar problems of how to define and regulate an ATS.[33] The even more difficult challenge, however, will be how regulators from different countries will regulate ATSs that operate in the global markets.[34] SEC proposals regarding foreign exchanges have not gone forward.[35] Thus far, the only foreign exchange the SEC has admitted into the United States is Tradepoint Financial Networks plc, a limited volume United Kingdom exchange, and only for the purpose of trading securities that are registered and reporting issuers under the Exchange Act.[36] It is unlikely that the SEC will be able to continue to exclude foreign exchanges from direct dealings with U.S. investors. It cannot, in fact, do so now if those investors go abroad to trade. But what does "abroad" mean in cyberspace?

II
FRAUD

Although the Internet has forced the SEC to address and deregulate communication in some areas, Internet fraud has forced the SEC to expend significant enforcement resources to deal with new problems. "The same features of the Internet that have made it an expedient vehicle for gathering and disseminating information—broad coverage, speed, low costs"—have made it an easy vehicle for the

32. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844 (Dec. 22, 1998) (to be codified at 17 C.F.R. pts. 202, 240, 242, 249).

33. *See* FORUM OF EUROPEAN SECURITIES COMMISSIONS, PROPOSED STANDARDS FOR ALTERNATIVE TRADING SYSTEMS (2001), http://www.europefesco.org/Documents/Consultative/01-035b.pdf.

34. *See* Coffee, *supra* note 23, at 1227–30.

35. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-39884, (Apr. 29, 1998), 63 Fed. Reg. 23,504 (to be codified at 17 C.F.R. pts. 201, 240, 242, 249).

36. *See* Tradepoint Financial Networks plc; Order Granting Limited Volume Exemption from Registration as an Exchange Under Section 5 of the Securities Exchange Act, Exchange Act Release No. 34-41199, 64 Fed. Reg. 14,953 (Mar. 29, 1999).

perpetration of frauds.[37] In 1998, the SEC created an Office of Internet Enforcement (OIE) to administer a comprehensive program of surveillance, training, investigation, and prosecution.[38] The size of the SEC's cyberspace staff has increased to about 250, and additional funds for the SEC to combat Internet fraud have been forthcoming from Congress.[39] The SEC has brought over 180 Internet fraud enforcement cases, including high visibility "sweeps" involving numerous persons and firms.[40] The cases include unlawful touting, Ponzi and pyramid schemes, and "pump and dump" stock manipulations.[41]

One of the more controversial aspects of the SEC's Internet fraud surveillance is the creation of an automated Internet search engine or "bot" to surf the web for fraud.[42] Although the technology for such a bot exists, and is probably needed to make the SEC's efforts to fight Internet fraud effective, critics have argued that the SEC's system would violate individuals' privacy rights and have a chilling effect on online free speech.[43]

Businesses frequently endeavor to circumvent state jurisdiction in order to avoid the application of laws they find overly restrictive.[44] Thus, the Internet, along with globalization, has the potential to undermine inappropriate or unnecessary regulation under the law. Some have argued that cyberspace activity requires the abandonment, or at least compromise, of sovereign claims, and their replacement by a cyberlaw regime governed by its own legal order.[45] Yet, this extralegal world could resemble "the Hobbesian state of nature or the American Wild West of the nineteenth century."[46] Others believe that the problem of jurisdiction in cyberspace is unexceptional because conceptions of territoriality have accommodated to technological change.[47] The Internet, therefore, should be viewed as a communications medium not requiring any serious reconsideration, but only a

37. David M. Bartholomew & Dena L. Murphy, *The Internet and Securities Regulation: What's Next?*, 25 SEC. REG. L.J. 177, 194 (1997).

38. John F.X. Peloso & Ben A. Indek, *Overview of SEC's Response to the Internet in Securities Markets*, N.Y. L.J., Oct. 19, 2000, at 3.

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. Trudel, *supra* note 1, at 1028.

45. *See* Allan R. Stein, *The Unexceptional Problem of Jurisdiction in Cyberspace*, 32 INT'L LAW. 1167, 1170–71 (1998).

46. Coffee, *supra* note 23, at 1201.

47. *See* Stein, *supra* note 45, at 1170–71.

reapplication of existing securities laws principles. Regulators reluctant to cede jurisdiction have generally adopted this position.[48]

This panel addressed the question of how regulators should react to a virtual marketplace, and this Article has given a two-fold answer with respect to the SEC. The SEC should rethink and, to a large extent, eliminate its restrictions on non-fraudulent speech and instead encourage the development of a real-time, continuous disclosure system in cyberspace. One of the many reasons for my view is that if the SEC remains stuck in the distinctions of a paper world, and out of sync with other jurisdictions, First Amendment and other attacks may undermine the SEC's ability to combat fraud. Nonetheless, Internet fraud is a clear threat to the integrity of the public securities markets, and the SEC needs to continue to police cyberspace vigorously. The SEC has been developing new techniques for this policing and, hopefully, unwarranted concerns about privacy and free speech will not stand in the way of implementing reasonable surveillance to protect investors.

48. *See Securities Activity on the Internet: Report of the Internet Task Force, in* SECURITIES LAW & THE INTERNET: DOING BUSINESS IN A RAPIDLY CHANGING MARKETPLACE 533, 537 (PLI Corp. Law & Practice Course Handbook Series No. B0-00BS, 1999).