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SECURITIES DISCLOSURE REGIME - CHALLENGES POSED BY THE INTERNET AND TECHNOLOGY

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by

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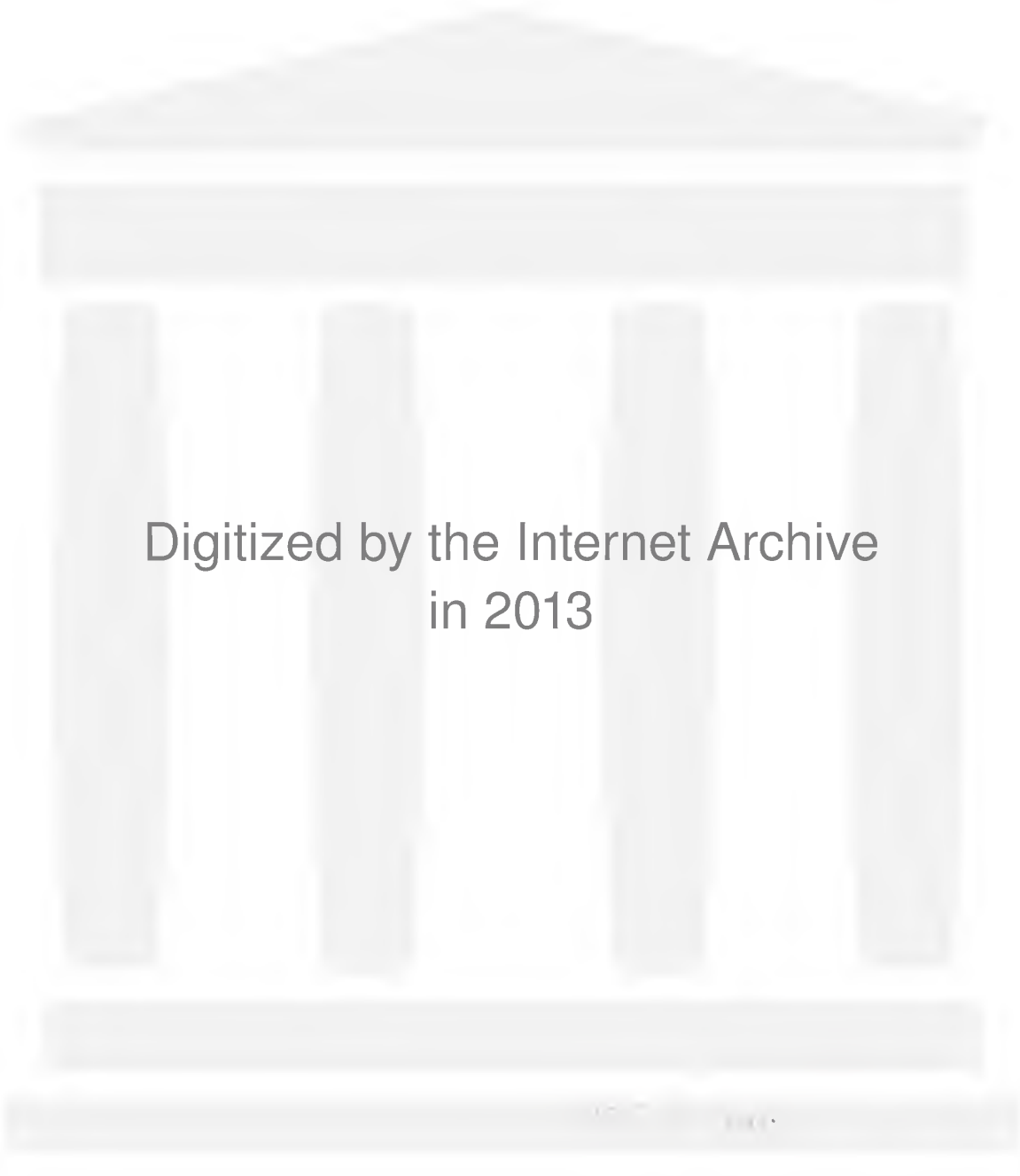

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Chapter I

Introduction

The last decade has witnessed an increasing influence of the Internet and technology on all walks of human life, including the business world. The securities industry, which had resisted major structural change for over past 50 years, is now poised for a technological revolution. This revolution has the potential to alter many of its familiar landscapes beyond recognition. The power of the Internet has already revolutionized securities trading. It has opened the floodgates of information to the investor. By exposing the inherent inefficiencies in the system, it is predicted that the Internet will alter the algorithms of the merchant banking industry and change the way markets function[1]. The established players are facing stiff competition from the new technologically savvy players. While the changes are considered inevitable, it has put a mammoth pressure on the regulatory concepts that have evolved over the period of 50 years. The demands for deregulation are opposed by the growing concerns for market integrity. The regulatory responsibility in this newfangled era is paradoxical - on the one hand to aid new innovation and on the other hand to check any resultant erosion in the integrity of the market.

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[1] *See* the oral Statement of SEC Chairman Arthur Levitt before the Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, Concerning Day Trading, (September 16, 1999) available online at <http://www.sec.gov/news/testmony/tsty2099.htm >visited on February 22, 2000

This thesis is an effort to evaluate the structural changes that has taken place in the securities market of the United States and its impact on securities disclosure regime mandated by the Federal Securities Act. Part 2 of the thesis discusses the securities disclosure regime and its underlying economic theories. This part also traces the challenges posed by technology and takes a quick look at the argument that the traditional norms are incompatible in dealing with those challenges. Part 3 deals primarily with structural developments in the securities market over the past five years by examining some of the innovative models, which have altered the existing structure. Part 4 deals with the regulatory response to these structural changes. Part 5 narrates the shortfalls of the existing system and Part 6 deals with the future possibilities. These parts analyze various arguments for deregulation, taking into consideration the economic cost involved. Part 8 contains author's suggestions for dealing with the problem.

Chapter II

Securities Disclosure Regime - A conceptual analysis

Securities Disclosure regimes across the world are built on the cornerstone of mandated disclosure. Disclosures facilitate dissemination of corporate information to the investing community. Proper disclosure norms play a vital role in the development of an efficient and participative capital market. It creates confidence in transactions and reduces the possibility of market failure. According to a recent document by the International Organization of Securities Commissions (IOSCO), the most effective way to ensure investor protection is through full disclosure of information deemed material to an investors decision[2].

The process of globalization has led to the evolution of a substantial degree of similarity amongst the securities regimes of various countries. The point of convergence is that most of them provide for mandatory ongoing disclosure as a fundamental regulatory standard[3]. The Securities Act of 1933 ("1933 Act")[4] and the Securities Exchange Act of 1934 ("1934 Act")[5] are the two federal statutes that govern the securities market in the United States. These statutes have incorporated mandatory disclosure as a fundamental principle.

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[2] See International Disclosure Standards for Cross-border offerings and initial public listings by foreign issuers – IOSCO publication, September 1998. Available online at <http://www.iosco.org/docs-public/1998-intnl_disclosure_standards.html > visited on February 26, 2000.

[3] See, Mark Gillen & Pittman Potter, *The convergence of Securities Laws and implication for developing securities market*. 24 N.C.J.Int'l Law & Com. Reg. 83 at Page 193 (1998)

[4] 15 U.S.C §§ 77a -77aa (1997)

[5] 15 U.S.C §§ 78a -7811 (1997)

In comparison to other regulatory patterns, the United States has one of the most stringent disclosure regimes. The Federal Securities Act imposes a statutory duty to disclose information through various forms of registration statements, which include annual, quarterly and current reports on forms 10-K, 10-Q and 8-K respectively. These reports disseminate historical financial information, both present and future trends, demands, commitments, events and uncertainties known to management. The dissemination of corporate information also takes effect through varied channels such as business news periodicals, newspapers and investment reports[6]. However, the regulatory structure prescribes the nature and quantum of disclosure at various stages, violation of which would attract penalties under the Securities Act. These regulations are primarily aimed at maintaining investor confidence in the integrity of markets through the vehicle of disclosure[7].

A. Economic theories behind disclosure:

The need for disclosure in a capital market has been well explained by various economic theories. Disclosure assumes economic importance as all public information, from whatever source, gets reflected in the market price of the securities in an efficient capital market. This theory is known as efficient market theory [8]. According to Prof. Eugene F. Fama, a market is efficient when the security prices fully reflect all available information[9].

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[6] Robert Norman Sobol, *The benefit of the Internet: The world wide Web and the Securities Law-Doctrine of truth on the market*, 25 J.Corp.L.85, 86. (1999)

[7] Tamar Frankal, *The Internet, Securities Regulation and the Theory of Law*, 73 Chi-Kent L. Rev. 1319 at page 1334 (1998)

[8] *See* Sobol, *Supra* note 6,at 87

[9] *See* Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FINANCE 1575 (1991).

However, not all information is material enough to attract liability under the Securities Act for non-disclosure. The Supreme Court has set out a test for materiality in Basic Inc. v Levinson[10]. According to this test, a fact is material if there is "substantial likelihood that the disclosure of omitted facts would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[11] Efficient market hypothesis provides a "framework for measuring the value of information" in securities fraud cases.[12] Other distinct features of securities disclosure in the United States are the provisions regarding forward-looking statements.[13] The insistence of disclosure of forward-looking information is based on the premise that the prices of common stock represent the present value of future dividends per share.[14] According to the investor valuation model, it is the future, not the past return that is relevant to valuing securities[15].

The United States has one of the most efficient capital markets. The efficiency factor of the market is attributed to the availability of a tremendous amount of reliable transparent corporate information, mandated through the Federal Securities Act.

B. Emergence of Internet based Securities Transactions:

Recent advances in the information technology, particularly the Internet, are having a profound influence on the United States securities market. The World Wide Web, which is a vast network of information presentation called web sites or web pages,

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[10] 485 U.S 224 (1988)
[11] *Id.* at 231-32
[12] *See* Mark L. Mitchell & Jeffry M. Netter , *The Role of Financial Economics in Securities Fraud Case: Applications at the Securities and Exchange Commission*, 49 Bus.Law.545, 584 (1994)
[13] *See* provisions regarding MD&A , Item 303 of regulation S-K, 17 CFR § 229
[14] LEWELLEN, HALLORAM & LOUSER, 'FINANCIAL MANAGEMENT: AN INRODUCTION TO PRINCIPLES AND PRACTICE, 223 (1998)
[15] *Id.* 225

has provided a friendly, graphic based communications platform for dissemination of information[16]. There are three primary modes of electronic dissemination of information[17]:

1) By accessing the web sites, that are part of the world wide web.

2) Through bulletin board systems- established for users to post written messages or responses.

3) Electronic message or e-mail system, which is similar to regular mail that enables Internet users to send and receive, messages to and from other Internet addresses.

A survey amongst the senior investor relations personnel conducted by National Investor Relations Institute (NIRI) has revealed that 82% of the respondents used websites for corporate communication[18]. A 1997 survey conducted by NASDAQ estimated that 37% of investors use the Internet to obtain corporate information[19]. During the second quarter of 1999, there are about 9.7 million online accounts in the U.S[20]. The significant impact of Internet is that it is moving the securities transaction away from the conventional paper based medium towards a more efficient electronic medium[21]. The use of the Internet to disseminate corporate information provides numerous benefits to companies and other market participants. It makes dissemination faster, less expensive,

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[16] Robert A. Prentice,Vernon J. Richardson & Susan Scholz: *Corporate Web site disclosure and the Rule 10-b (5): An empirical evaluation,* 36 Am. B. L.J 531 (1999)

[17] David M. Cieulusinak., *You cannot fight what you cannot see: Securities Regulation on the Internet,* 22 Fordham Int'l L.J. 612, 615 (1998).

[18] NIRI survey finds significant improvements in corporate disclosure practice among U.S companies: 1998 research measures changes against 1995 benchmark data. PR Newswire, June 08, 1998 available in LEXIS, News Library, Allnws file.

[19] NASDAQ stock market Inc., Peter D. Hart Research Associate shareholder Survey, February 21, 1997 available at <http//www.nasdaq.com/reference/survey.htm>

[20] SEC Report on Online brokerage at Page 1: Available on-line at <www.sec.gov/pdf/cybertrnd.pdf> visited on February 23,2000.

[21] Donald C. Langvoort, *Information Technology and structure of Securities Regulation*, 98 Harv.L.Rev. 747 at Page 758-58. (1985)

and more widespread. It also helps to create a level playing field between large and small companies[22].

The Internet empowers the investor with richer, faster information, which is easier to access. Investors can check stock prices, review analyst's reports, check Securities Exchange Commission ("the Commission") filings and press releases, execute stock transaction and discuss investments over the Internet quickly and at very little cost[23].

C. Incompatibility of traditional norms:

The Securities industry is one of the most regulated industries in the world. The Federal Securities Acts have evolved an offer-based securities disclosure regime, regulating both offers and sales of securities[24]. The structure was devised to preserve market integrity, by mandating dissemination of accurate and material information, to enable investors to make reasoned decisions regarding the purchase/sale of securities. The law also prevents market conditioning, where the issuer attempts to provide incomplete, misleading, or fraudulent information, which would lead to an artificially inflated price[25]. Issuer resorts to market conditioning, in order to stimulate interest in an offering, before the filing of the registration statements[26]. In an offering process, the flow of information is regulated in three district time frames 1) a Pre-filing period, 2) a

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[22] US Securities and Exchange Commission: Report to the Congress-The impact of recent technological , advances and the securities market (Last modified on November 26, 1997), Available online at http://www.sec.gov/news/studies/techrp97.htm visited on February 25, 2000.

[23] *See* David M. Bertholomew & Dave L. Murphy, *The Internet and Securities Regulation: What next?* 25 Sec. Reg. L. J 177(1997)

[24] Holly C. Fontanna, *Securities on the Internet: World Wide opportunity or Web of deceit*, 29 U. Miami Inter Am. L. Rev 297, 300 (1998)

[25] *Id.* at 301

[26] *See Id.*

Waiting period and 3) a Post effective period[27]. It has been argued that the potential of the Internet as a medium for capital raising has not yet been fully utilized, and the current system of regulation has rendered it an ineffective medium for securities transaction[28]. The earlier expectation that the Internet would create a medium that gives business greater access to capital by "creating the stock market of tomorrow" has not yet been realized[29]. Regulation of free flow of information has resulted in certain players such as institutional investors, receiving more information than the retail investors, which has resulted in problems related to information asymmetry. The traditional norms favor intermediation in various stages of capital raising from stock market. It is argued that the costs associated with intermediation renders capital raising more costly and is often out of reach for small companies. The existing disclosure regime presupposes that the average investor is incapable of protecting himself, and shows a paternalistic attitude. These are some of the regulatory ideals that are in direct conflict with the Internet environment.

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[27] Allen J. Berkley & John J. McDonald, *Some background and observation on corporate websites and the federal securities law*, SD 57 ALI-ABA 279, 282 (1999)
[28] *See* M.Louis Turilli & Joseph Kerschenbaum, *Securities on the Internet: Changes in Laws required to increase online offering*: 70-DEC N.Y.St.B.J. 22, 27 (1998)
[29] *Id.* at 22

Chapter III

Changes in Securities Transaction since 1995

A. Impact on Primary Market

1. Online private placement:

Most of the online private placements have taken place under the exempted category. Section 3 (b) of the 1933 Act empowers the Commission to exempt any class of securities when the aggregate amount of issue does not exceed $ 5 Million[30]. Regulation-A provides for conditional exemption to small issues if the aggregate offering price does not exceed $ 5 Million[31]. Regulation D, permits limited offer and sale of securities without registration under the 1933 Act[32]. To qualify for this exemption, strict compliance of conditionalities specified in Rules 501 to 508 of Regulation D is required. The exemptions available under this section can be summarized under the three rules given below:

1) Rule 504: The maximum aggregate offering price under this rule is $ 1 Million. This exemption is not available for the reporting companies or investment companies. There is no limitation on the number of purchases[33].

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[30] 15 U.S.C § 77C
[31] *See* Regulation A., 17 CFR 230, Rule 251(b)- the issuer qualification is specified in rule 251 (a)
[32] *See* Regulation D., 17 CFR 230
[33] *See* COX, HILLMAN & LANGAVROOT, SECURITIES REGULATION: CASES AND MATERIALS, 392 (2d ed. 1997).

2) Rule 505: The exemption extends to the full $ 5 Million permitted under δ 3(b) of the 1933 Act[34]. However, the numbers of buyers is limited to a maximum of 35. This number excludes the 'accredited investors'[35].

3) Rule 506: The conditions stipulated under this rule are similar to Rule 505. The exemption is subject to a maximum of $ 5 Million. Following are the basic differences between Rule 505 and 506[36]:

1. Rule 506 is based on δ 4(2) and not on δ 3(b) of the 1933 Act.

2. The issuer must reasonably believe that each of the non-accredited investors has knowledge and experience of business matters and is capable of evaluating the merits and risks of investment[37].

Section 4(2) of the 1933 Act exempts from registration "transactions by an issuer not involving any public offer[38]". The rationale behind this exception is not to have general solicitation or advertising[39]. This exception is most attractive for an issuer, who plans to make his offering via the Internet[40]. However, care should be taken by the issuer to restrict access to the material on the company's web site. If such precautions are not followed, then it would tantamount to general solicitation or advertising.

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[34] *See Supra* note 30
[35] Accredited Investor is defined in Rule 501 (a), 17 CFR 230
[36] LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION, 315 (3rd ed.1995)
[37] Rule 506 (b) (2) (ii), 17 CFR 230
[38] 15 U.S.C δ 77(d)(2)
[39] Linda C. Quinn & Ottilio L. Jarmel, *Securities regulation and the use of electronic media,* 1150 PLI/Corp 629, 640 (1999)
[40] *See Id.* at 641

Since 1995, many companies have approached the Commission for "no action letters" for a net-based direct public offering. The Commission's position is that posting an offer in the password-protected area of the Company's website, which is accessible only by a accredited/special class of individuals, would not constitute general solicitation[41]. The issuer/underwriter should identify the accredited investor by reviewing a questionnaire, and the password protected web page should be made available only after a determination of qualification by the underwriter[42]. The scope of this category is limited to high-income and high net-worth investors who have substantial financial knowledge and experience[43].

2. Direct Public Offering (DPO) :

After the mercurial success of Spring Street Brewery's Initial Public Issue in March 1996, Internet based IPO's have become part of the US securities market[44]. It is to be noted that the issuers in this new market took advantage of the exemption from statutory registration by qualifying the issue within the exemption provided under the Federal Securities Act. The advantage is the cost saved from the resultant disintermediation. The Spring Street Brewery's IPO was conducted under regulation A. This exemption is allowed for the non-reporting companies that permit a generalized public offer up to $ 5 Million during the twelve-month period[45]. The primary advantage of DPO is that the issuer would get a greater portion of the offering proceeds by

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[41] *See* IPO net., 1996 SEC No-Act . LEXIS 642
[42] *See* Lamp Technologies Inc. 1997 SEC No-Act LEXIS 638
[43] *See TURILLI ET.AL., supra* note 28 at 23
[44] See John Kaufman Winn, *Regulating the use of Internet in Securities regulation* 54 bus.Law.443,448 (1998)
[45] *Id.*

eliminating expensive middleman such as investment bankers[46]. Spring Street Brewery Company raised approximately $ 1.6 Million without the assistance of investment bankers. It created a web page from which investors could download its offering documents. 3,500 investors participated in this online issue where 8,44,581 shares were sold at $ 1.85 per share[47].

After the initial hype in connection with the success of Spring Street Brewery issue in 1995, the Internet based DPO market did not grow as expected. Reasons primarily attributed to this phenomena are the "passive nature" of Internet which calls for novel methods of marketing, and the absence of a secondary market which provides attractive liquidity to the investor[48]. Thus, the prime challenge before an issuer is to get the attention of the person browsing the net. Efforts to create a secondary market for Internet based DPO was made by Spring Street Brewery Company by launching its bulletin board viz. "Wit trade". The Commission took objection to the Spring Street Brewery company collecting checks from the subscribers and advised the company to eliminate its control over the investor funds[49]. However the Commission granted permission to the Real Goods Trading Company (RGTC) in 1996 to operate a bulletin board. Participants in the RGTC system could list their names and contact information, number of shares to buy or sell, and the expected price of the security. No transactions

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[46] For discussion on benefits of DPO over traditional IPO *See* <http://www.directipo.com/trad/empower.html> visited on February 26, 2000

[47] John C. Coffee Jr. *Brave new world ?; The impact of Internet in the modern Securities Regulation* 52 Bus.Law.1195, 1202 (1997)., See also <http://www.witcapital.com/company/mgmt.jsp> visited on February 28, 2000.

[48] Supra note 28 at Page 24

[49] *See* Spring Street Brewery , SEC Reply dated April 17, 1996 SEC No-Act LEXIS 435

were effected by the system. The Commission issued a No-Action letter based on the condition that RGTC will not buy or sell its own shares[50].

The advantage of the DPO is that it fills "the long-standing void between venture capital funding and the underwritten IPOs"[51]. This solution affords entrepreneurs an opportunity to tap the capital market previously accessible only to the high-growth companies[52].

3. Spurt in Micro Cap Securities:

In common parlance microcap securities means those securities offered by a company whose net worth is below $ 10 Million, who has fewer than 500 investors, and whose stocks are not traded in any of the major stock exchanges. Most of these companies do not require registration under the Federal Securities Act . The obvious incentive to invest in these kinds of stocks are that they are competitively priced, and have future growth potential. The risk attached to these stocks are that they are not traded in any of the major stock exchanges and hence do not have access to the secondary markets. Exemption from the stringent disclosure requirements mandated for public companies make their activities less transparent and more prone to incidence of fraud. Most of them are new companies with no proven track record [53].

The Internet and technology had a profound influence on the microcap securities market and aided in the development of a secondary market for these stocks. Microcap securities are traded in the "over-the-counter" (OTC) market and are quoted on OTC

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[50] *See* SEC No Action letter dated June 24, 1996, 1996 SEC No-Act LEXIS 566
[51] < http://www.directipo.com/trad/empower.html > visited on February 26, 2000
[52] For a discussion on advantages of DPO *See Id.*
[53] For a discussion on the subject *See* http://www.sec.gov/consumer/microbro.htm visited on February 22,2000

systems such as the OTC Bulletin Board (OTCBB) or the "Pink Sheets"[54]. Though not fully developed and liquid, OTCBB is significant for the capital formation of small business.

4. Internet based investment bankers:

This new brand of investment banker offers consulting services to non-public issuers who are planning to go public and use their web sites for the hosting prospectus of prospective issuers[55]. An example of such service is Wit Capital, an issuer-driven, Internet-based, investment banking firm that offers a rapidly expanding array of investment banking services including public underwriting, private equity, strategic advisory, and institutional quality research. It claims itself as the first Internet investment-banking firm[56]. Another example of an Internet based investment bank is Direct IPO[57].

B. Impact on the Secondary Market:

The impact of the Internet is more prominent in the Secondary market. There are almost 10 million online accounts currently in the U.S. This signifies growing public participation in the market. One study has revealed that online trading is second only to pornography in popularity amongst web sites in the U.S[58]. While the new technology is hailed for empowering the retail investor with various options and information, it poses new challenges to the Commission. The regulatory system has to accommodate

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[54] *See Id.*
[55] *See TURILLI ET AL. supra* note28 at Page 24
[56] See< http://www.witcapital.com/ibanking/ibank_oview.jsp >visited on February 17, 2000
[57] See< http://www.directipo.com > visited on February 26,2000
[58] *See* Peter C. McMahon, *Securities Law and the Internet : Enforcement Issues*, 1127 PLI/Corp 265,273 (1999)

innovation, ensure investor confidence, and minimize the disruption of existing markets[59].

Traditional secondary markets activity was monitored by the Commission through the regulation of Broker – Dealers and the organized exchanges. The challenge posed by technology is that most of the innovations do not strictly fall under any of the above categories[60]. If a person is facilitating a securities transaction in return for compensation, it might result in categorization as Broker–Dealer. A 1990 release by the Commission better known as the "Delta release" outlined the essential attributes of an exchange[61]. Under the Delta release an important trait of an exchange "is to centralize trading and provide buy and sell quotations on a regular basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations"[62]. Subsequently the Commission felt that the definition of exchange adopted in the Delta release was too narrow in scope, and it excluded many alternative-trading systems from the exchange regulation. In Exchange Act Release No. 38672 (concept release), the scope of the "exchange" was widened to include "any organization that consolidates orders of multiple parties and provides a facility through which or sets material conditions under which, participants entering such orders may agree to the terms of the trade."[63] In the ATS proposal release if an entity was deemed to be an exchange, it could choose to register as a national securities exchange or to register as a broker dealer

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[59] See Brandon Becker, David Westbrook, & Lyle Roberts. *Legal Developments in the Electronic Securities Markets:Online Systems and the use of websites for offshore Internet offers* 1046 PLI/Corp 797 (1998)

[60] Brandon Becker & Soo J. Yim, *Trading Securities Online : Internet and other electronic media* 1127 PLI/corp 295, 297 (1999)

[61] Exchange Act Release No. 27611(Jan.12, 1990), 55 Fed. Reg. 1890

[62] *See Id.* at 1900

[63] *See* Exchange Act Release No. 38672 (June 04,1997), 62 Fed.Reg.30485, 30507

under the regulation [64]. In Exchange Act release no.34-40760, titled as "Regulation of Exchanges and Alternative trading Systems" the Commission has brought out an elaborate regulatory structure for trading systems taking into account the market realities imposed by technological innovation.[65] The release expands the scope of the term Exchange and provides for an innovative three tiered approach for regulation of new generation trading systems[66].

1. Online Trading System by Unregistered entities

Electronic Bulletin Board

A Bulletin Board is an electronic system that allows its customers (potential buyers and sellers) to post their buying or selling interest in the securities. The system primarily provides a meeting point for prospective buyers and sellers. The information required to be posted includes the name, address, telephone number, email address, number of shares, the proposed price and the date of information. The important qualification of a bulletin board is that the transactions are entered or effected outside the system by the interested parties. The parties contact each other directly and finalize the transaction. This characteristic distinguishes it from an exchange and the regulation appended to it in the Federal Securities Act[67]. They do not fall within the category of broker dealers as they neither receive transaction-based compensation nor act as agents[68]. The benefit of a bulletin board is more felt by a Direct Public Offer (DPO) issuer who seeks to create a secondary market for his common stock. The World Wide Web offers

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[64] *See* Exchange Act Release No. 39884 (April 29,1998), 63 Fed.Reg. 23504
[65] *See* Exchange Act Release No.40760 (Dec. 28, 1998), 63 Fed. Reg. 70844
[66] *Id*
[67] *Supra* note 60 at 304
[68] *See Supra* note 60 at 304,

bulletin board trading as an alternative, or in some cases as a supplement to, trading on Nasdaq or in the OTC market. Two major categories of electronic bulletin boards have evolved over the period 1) Issuer Bulletin Board and 2) Third Party Bulletin Board.

1.Issuer Bulletin Boards

The First attempt to have an Issuer bulletin board in place was made by the Spring Street Brewery Company by launching the Wit-Trade, an issuer bulletin board to facilitate trading in the Spring Street Shares. It was intended to create a secondary market for the newly issued and much acclaimed DPO of the Spring Street Brewery Company. The company was not involved in negotiating, crossing, or otherwise facilitating the execution of bids and offers posted on the Wit-Trade. The Commission objected on the following grounds[69]:

1) The company should not handle the investment funds

2) If users of the system post quotations on both the buyer and seller bulletin boards, they would be considered as "Brokers" and would require registration.

3) Transactions are subject to antifraud provisions of the Federal Securities Act.

Real Goods Trading Corporation (RGTC), a California corporation dealing with alternative energy and conservative products, established a bulletin board to trade its common stock which was listed on Pacific Stock Exchange[70]. This system would function as a passive bulletin board, providing information to prospective sellers and buyers. No transaction would be effected by the system and the company would have no role in effecting the transaction. In other words, the parties are supposed to contact each

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[69] Spring Street Brewing Company, SEC No-Action Letter dated March 22, 1996, 1996 SEC No-Act. LEXIS 435

[70] *See*< www.realgoods.com> visited on February 22,2000

other directly and consummate the trade outside the system. The sponsors of the system would neither charge any compensation nor provide any investment advice. The Commission has informed the company that the establishment and operation of the system did not fall within the category of investment adviser, broker dealer and securities exchange, and hence was not required to be registered under Federal Securities Act[71]. RGTC could operate the site on the condition that it would play no role in effecting any transaction, receive no compensation for creating and maintaining the system, not receive, transfer or hold funds or securities in connection with the operation of the system, put disclaimers on the site regarding any registered status, keep records of all quotes entered, and inform users of the applicability of securities laws to offers and sale[72]. Perfect Data Corporation operates a bulletin board, which is similar to that of RGTC[73].

2. Third party Bulletin Board:

In 1997, Internet Capital Corporation established a bulletin board that would enable prospective buyers and sellers to post their bids and offers with respect to the stocks of participating corporations. The facility is available to companies whose common stock is either registered under Section 12 of the '34 Act or who file supplemental periodic information and reports in accordance with Section 15(d) of that Act. The companies are charged for posting information about themselves[74]. The Bulletin Board will provide participants with the following information: (1) the name,

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[71] Real Goods Trading Corporation, SEC No-Action Letter dated June 24, 1996, 1996 SEC No-Act. LEXIS 566

[72] *See Id.*

[73] *See* < www.perfectdata.com > visited on February 22,2000

[74] *Supra note* 60 at 305

address and telephone number (or other contact mechanisms such as electronic mail addresses) of each interested buyer and seller, (2) the number of shares of Common Stock to be involved in the trade; (3) whether the participant is a prospective buyer or seller; (4) the proposed price of the common stock in the trade, and (5) the date on which the information will be removed from the Bulletin Board. No transactions would be effected on the Bulletin Board itself, and the sponsor will have no role in effecting trades between participants. All the trades would be effected only by direct contact between the participants, totally independent of the system. The sponsor will not have transaction records, but will retain records of the quotations listed for not less than three years and will make them available upon request to the staff and any stock exchange or regulated market on which the common stock is listed[75]. Neither the sponsor nor its affiliates would (1) be involved in any purchase or sale negotiations, (2) give any advice on the merit of any trade, (3) use the bulletin board to offer to buy or sell securities, (4) receive, transfer or hold funds or securities as an incident of operating the bulletin board, or (5) directly or indirectly facilitate the clearance or settlement of any securities transactions except to refer participants to a bank[76].

Internet Capital Corporation displayed following disclaimers, notifications and information:

(a) That it is not a registered broker-dealer, securities information processor, broker, dealer, or investment adviser or a securities exchange;

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[75] Internet Capital Corporation, SEC No-Action Letter, 1998 WL 9357 (S.E.C.)
[76] *See Id* at 4

(b) A prohibition against "two-sided quotes," in which a person is not allowed a bid to buy and an offer to sell the same security, at the same time.

(c) A warning that the registration requirements of the federal securities laws apply to all offers and sales through the bulletin board, hence each participants must ascertain the availability of an applicable exemption from registration[77].

The Commission was satisfied with the above arrangement and granted permission to Internet Capital Corporation to operate the system.

2.Online Trading System by Broker Dealers

a. Customer online trading

1. Discount Broker dealers:

Online brokerage has significantly altered the dynamics of the securities market place[78]. The Internet makes it possible for broker–dealers to communicate with large numbers of retail investors in a cost effective manner, thereby creating a new mode of secondary trading for already traded securities[79]. Small discount brokerage firms were the first to offer this service on-line in the year 1995. Since then, the industry has witnessed quantum leaps in the number of online accounts created each year. The term "discount broker" has been traditionally used to distinguish broker dealers who allowed customers to enter unsolicited or non-recommended orders for their accounts from full service brokers, who provide investment advice and, through registered representatives assigned to specific customers, solicit the purchase of specific securities[80]. The well known

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[77] *See Id* at 8

[78] *See* SEC Report on Online brokerage at Page 1: Available on-line at <www.sec.gov/pdf/cybertrnd.pdf > visited on February 23,2000.

[79] *Supra note* 60 at 300

[80] *Supra* note 78 at 18

discount brokers are Charles Schwab & Co. Inc, E* Trade, Ameri-trade and Datek. These firms offer various financial products online. They offer trading in equities, mutual funds, listed options and fixed income securities. The investor also can have access to IPOs, after hours trading and pre-opening trading. The advantage is that the investor can have access to market data, historical charts, securities analysis, mutual fund screeners, interactive calculators and customizable home pages[81]. This information is available to the investor free of cost.

2.Full Service broker Dealers:

The established full service brokerage firms such as Merill Lynch, Paine Webber and American Express have now entered the online market. Full-service brokerage firms have been slower to accept on-line trading. Of the top-five full service broker dealers, only Morgan Stanley Dean Witter & Co. had an early presence in the online brokerage market in 1995[82]. Merrill Lynch commenced online trading in the fall of 1998. Banks have also started offering on line discount brokerage services. Prominent among them are Citigroup, Fleet Financial and Banc One. Most banks entered the market by acquiring existing discount brokerage firms[83].

The present trend in the industry is the convergence of online and full service brokerages. Competition amongst the various players in the market has brought down Commission rates and enhanced the quality of customer service. The next stage of development is personalizing the web site content relevant to each user[84].

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[81] *Supra* note 78 at 16
[82] *See* < www.online.msdw.com/> visited on February 23,2000
[83] Dennis T. Rice, The Internet and the cyber securities market place at Page 6 (July 1998) available on line at http://freeadvice.com/articles/Ricecontent.htm visited on February 21, 2000.
[84] *Supra* note 78 at 20

b. Membership type trading by institutions :

Membership type electronic trading has been in existence amongst institutional investors since 1970. In the initial stage the trading was done through an 'extranet' system. INSTINET pioneered this technology and attracted lot of popularity after the establishment of the NASDAQ, whose broker dealers were looking for a technologically sound system[85]. The Internet adapted this private 'extranet' concept to the worldwide web, whereby large institutional investors used a closed network computer system where they could sell their securities amongst themselves without the intervention of broker dealers[86]. The nature of the transaction is similar to 'extranet' except that trading takes place on web site rather than by telephone or fax[87].

This category of online trading system is now meant to include both broker-dealer trading systems and proprietary trading systems. Exchange Act Rule 17a-23 which defined a broker dealer trading system has been repealed as of April 21,1999[88]. "Proprietary trading Systems" does not have a regulatory definition, but it means an online trading system sponsored by a broker dealer, which does not have to register as an exchange[89]. Due to the fact that various systems operating in the market have a wide mosaic of features, making them difficult to categorize, these different categorizations

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[85] *See* Pioneer Under Pressure, Euromoney November 1999 issue available online http://www.euromoney.com/ visited on February 26, 2000

[86] Rice, *Supra* note 83

[87] Rice, *Supra* note 83

[88] Broker dealer trading system is defined as "any facility that provides a mechanism, automated in full or in part, for : (i) collecting, receiving, or displaying system orders; ad (ii) matching, crossing, or executing system orders, otherwise facilitating agreement to the basis terms of a purchase or sale of a security between system participants, or between a system participant and the system sponsor, through use of the system or the system sponsor.", This Rule 17 a-23 has been repealed by SEC release no. 34-40760 dated December 22, 1998., 63 FR 70844.

[89] *See BECKER ET.AL. supra* note *60* at 302

have now become meaningless. The intra-institutional trades take place for all kinds of securities viz., equity, bonds and treasury bills. These systems are very important as institutional investors play a dominant role in the U.S. capital markets. These systems are now regulated by the Regulation ATS[90].

1. INSTINET

The INSTINET was founded in 1969 and claims to be the world's largest agency brokerage firm. It operates in 40 global markets and is a member of 18 exchanges in North America, Europe, and Asia[91]. INSTINET was used by the institutions to trade large blocks of shares outside the established stock exchanges[92]. It facilitates trade, on an anonymous basis, directly between the buyer and seller agency trading in equities. The parties can communicate, negotiate, and trade electronically either directly with each other using block brokerage service, or they can link to exchanges. Technology enables INSTINET to represent pieces of a single client order simultaneously in multiple markets for a security. The parties, regardless of their location, can trade with fund managers, broker- dealers, market makers and exchange specialists around the world[93]. INSTINET now represents 90% of institutional funds in the market[94].

INSTINET has now invested in Tradepoint, an electronically advanced for profit exchange in the U.K and also in W.R.Hembrecht+Co, a specialist in IPOs which uses a new electronic auction based method of taking companies public on the Internet[95]. Mr.

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[90] *See Exchange Act release No.40760, supra* note 65, The effective date of regulation is April 21,1999.
[91] See<http://www.INSTINET.com/> visited on February 21, 2000
[92] *See Id.*
[93] *See Id.*
[94] *See Id.*
[95] *See* Pioneer Under Pressure, Euromoney November 1999 issue available online <http://www.euromoney.com/>visited on February 26, 2000

Douglas G. Atkin, CEO of INSTINET considers these investments as strategically important for the company. He is of the opinion that the Tradepoint is the future model exchange, where the basis for operations is earning profit [96].

2. POSIT

POSIT is a portfolio system for institutional trading. It uses a crossing system for batches of orders [97]. It uses an electronic equity-matching system, which lets users confidentially find the natural buyer or seller of a stock during the market day. POSIT provides a substantial pool of alternative liquidity, with an annual trade volume of more than 6.4 billion shares.[98] The buy and sell orders, including both individual stocks and portfolios, are entered into the system from many sources. The main POSIT computer processes and compares these orders six times daily, from 10 a.m. to 3 p.m. on hourly basis[99]. Advantages of this system include complete confidentiality, broad based liquidity and easy access[100]. The POSIT system now has presence in the U.S, Australia and the UK. It is planning for a major expansion in Europe during the year 2000[101].

3. Oddlot System

Oddlot is an automated trading system in the fixed income market. It displays live tradable bids and offers for all issues including United States treasury bills, notes, bonds and zero coupons[102]. The system is designed for broker-dealers , regional banks , money managers, institutional investors, financial advisors and trust departments[103].

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[96] *See Id.*
[97] *See*,<http://www.itginc.com/about.htm> visited on February 26, 2000
[98] *Id* .
[99] *Id.*
[100] *Id* .
[101] *See*,<http://www.itgeurope.com/feuropean.html> visited on February 26, 2000
[102] *See*, < http://www.oddlot.com/introduction.html> visited on February 26,2000
[103] *See Id.*

c. Electronic Communication Network (ECN):

ECN is defined under Rule 11 Ac1-1 of the Exchange Act as "any system that widely disseminates to third parties orders entered therein by an exchange market maker or (over–the–counter) market maker, and permits such orders to be executed in whole or in part"[104]. All ECN's are broker dealer systems within the earlier definition under Rule 17 a-3 of the Exchange Act. It performs many functions that are traditionally associated with an exchange. The examples of ECN's are INSTINET, Bloomberg Trade book, Island and REDI[105]. ECN's are engaged in online brokerage services. Most of them offer additional service like after hours trading, complete anonymity and cost effective execution. A vast array of retail brokers, institutional investors, hedge funds, stock specialists, momentum traders, day traders, arbitrage traders, and options specialists participate in most of these system in order to enhance their liquidity[106].

A recent study by Bear, Stearns & Co., Inc. has classified ECN's as radicals and moderates. Radicals are mostly institutions such as INSTINET, Archipelago, and Island who would prefer to see a "new world trading order - or the creation of a central limit order book outside the context of the NYSE or Nasdaq". As part of their rebellious agenda against the current system, both Archipelago and Island are currently in the process of applying for exchange status[107]. They see a need to "uproot the existing

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[104] 17 C.F.R § 240.11Ac1-1(a)(8)

[105] *See*<www.INSTINET.com>.,<http://www.bloomberg.com/products/trade_ts.html>, < http://www.island.com/BookViewer/index.html > and <http://www.redibookecn.com/about.htm> visited on February 23,2000

[106] *See Id.*

[107] 'Electronic Communication Networks: Ripe for Consolidation - An Update'- Bear, Sterns &Co. Inc Equity Research- Report dated January 05, 2000 available online at http://12.3.89.153/news.asp?article=298 visited on February 21, 2000.

infrastructure in order to create efficient markets"[108]. The report considers the approach of REDIBook and BRUT as moderate and predicts that this approach will be more successful in the future. The reasoning attributed to this view is that the radicals would be vulnerable in the event of aggressive competition from the existing exchanges, while the moderates become partners to the existing exchanges and stand to gain from the eventual change of the existing structure. The report claims that the aggressive posture might create vulnerability in the future[109].

ECN's, be they radicals or moderates, are going to change the structure of stock exchange system as we know it. They now trade in 30% of NASDAQ stocks, which is substantial considering that the new system came into being only in the past couple of years.

d. Alternative Trading System (ATS):

The ATS is defined in Rule 300 (a) of Regulation M and ATS[110] as follows: "any organization, association, person, group of persons, or system (1) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of § 240.3b-16 of this chapter; and (2) that does not : (i) Set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system or (ii) Discipline subscribers other than by exclusion from

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[108] *See Id.*
[109] *See Id.*
[110] 17 CFR § 240.300(a)

trading"[111]. This definition now encompasses within its scope the proprietary trading systems, the broker–dealer trading systems and the electronic communication networks.[112]

ATS's are private markets available only to subscribers, and operate similar to a registered exchange and NASDAQ[113]. They now handle almost 20% of the orders listed in NASDAQ and 4% of the securities in other exchange listed securities[114]. In the ATS adoption release, these systems are given an option to be regulated as exchanges or as broker-dealers subject to certain additional restrictions depending on the volume of trade. The Commission has taken a three tiered approach of regulation based on the quantum of trade[115]. The details of the regulatory framework are delineated in Part IV.

3. Online trading system sponsored by self regulatory organizations

a. Initiative by existing exchanges

SUPERDOT system of NYSE

This system is part of automation efforts by the New York Stock Exchange. SUPERDOT (Super Designated Order Turnaround System) allows member firms and institutional investors to route orders to the trading floor through computers[116]. The system handles market and day limit orders, up to specified sizes, in virtually all listed stocks, and transmits them through the common message switch to the proper trading floor workstation.[117]

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[111] *See Id.*
[112] *See* SEC Release No 34-40760, *supra* note 65 at Page70845.
[113] *See Id.*
[114] *See Id.*
[115] See 17 CFR § 240.301(b)(6)(i)
[116] *BECKER ET.AL. supra* note 60 at 304
[117] *See*< http://www.nyse.com >visited on February 22, 2000

Specialists receiving orders through SUPERDOT execute them in the trading crowd at their posts, and return reports to the originating firm's offices via the same electronic circuit that brought them to the floor[118]. SUPERDOT can handle daily volume exceeding 2 billion shares[119].

b. Regional Stock Exchanges

Cincinnati Stock Exchange:

Cincinnati Stock exchange is a fully automated electronic exchange with a "geographically - dispersed trading floor"[120]. Members can effect transactions through national securities trading system while by sitting in their office. The orders entered by the members are then stored, queued and robotically executed by the system[121]. With the substitution of a electronic network for a physical trading floor, all members receive the exact same efficiency and timeliness in quote dissemination, trade execution and trade reporting, regardless of where they are located[122].

c. OptiMark system:

OptiMark Technologies, Inc., a privately held transaction services company, offers an innovative securities matching facility which is designed to increase the efficiency and lower the cost of trading[123]. The system provides order formulation, matching and execution capabilities at very low transaction costs. During specified times throughout the trading day, the system conducts trade optimization calculations against

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[118] *See Id.*
[119] *See Id.*
[120] http://<www.cincinnatistock.com/frame.html >visited on February 22, 2000
[121] *BECKER ET. AL.supra* note 60 at 307
[122] http://www.cincinnatistock.com/frame.html visited on February 22, 2000
[123] *See*< http://www.optimark.com/ >visited on February 22,2000

expressions of interest known as "Profiles" and executes orders [124]. The Commission approved the proposal of Pacific Exchange Inc. to operate an electronic trading facility based on the opti-mark system[125]. The Commission has also approved Nasdaq's request to integrate the OptiMark Trading System into its existing trading network[126].

d. Initiatives by NASDAQ

1. NASDAQ

Nasdaq is the first electronic stock exchange in the world[127]. The system consolidates trading interest of market makers, registered with the National Association of Securities Dealers (NASD) and displays such interest in real time to NASD member subscribers on a computer screen. The system does not provide for automatic execution of orders. Transactions are executed by calling a market maker and arranging the terms over the telephone[128].

2. SELECT NET

SELECT NET is an online trading system operated by NASD . The system allows market makers and other order entry firms to negotiate securities transactions in Nasdaq securities through computer communications rather than relying on telephone[129].

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[124] *BECKER ET. AL supra* note 60 at Page 307
[125] *See* Exchange Act Release No. 39086 (Sept 17, 1997), 62 Fed.Reg.50036
[126] *See* http://www.optimark.com/ press release dated September 30,1999.
[127] *See*< http://www.nasdaq.com/> visited on February 26, 2000
[128] *Id.*
[129] *BECKER ET. AL supra* note 60 at 307

3. Small Order Execution System

This system is for transactions of limited size in active Nasdaq securities. Execution prices of the buy order is set equal to lowest offer price, and sell order to highest bid price.

4. Day Trading

Day trading is a form of stock trading where traders buy and sell the shares in quick succession trying to reap benefit from the volatility of stock market. The activity is mostly speculative in nature and involves a high degree of risk [130]. Day trading is neither illegal nor unethical, and there are many securities firms in the market offering facilities for day trading.[131] A study conducted by the Day Trading project group of North American Securities Administrators Association Inc.,(NASAA), has revealed that there are 68 firms offering this service with a total of 287 branches[132]. The report also cites figures provided by an industry trade group, the Electronic Traders Association, which estimates "4,000-5,000 people trade full-time through day trading brokerages, making 150,000-200,000 trades a day." [133] This represents nearly 15% of daily Nasdaq volume[134].

Day trading firms can be differentiated from the other online brokerage firms. They offer courses in trading strategies, often marketing day trading as a form of strategy or a form of investment.

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[130] For information on day trading and possible risks involved *See* http://www.sec.gov/consumer/daytips.htm visited on February 24,2000.
[131] *See Supra* note 1
[132] NASAA, report of the Day Trading Project Group : Findings and Recommendations (Aug. 9, 1999) Available on line at <http://www.nasaa.org/daytradingreport.htm > visited on February 25,2000
[133] *See Id.*
[134] *See Id.*

Investors register with the day trading firm upon which they get access to the trading activity online. The day trading firms were criticized for abusive practices such as deceptive marketing, violation of suitability requirements, and providing loans to customers, which are against the investors' interest[135]. As part of its investor education program, the Commission has provided extensive information about the day trading industry on its web site[136].

C. Impact on International Securities Market:

Securities markets throughout the world are becoming increasingly integrated. The Internet and other technologies make it possible for U.S. issuers to access investors outside the U.S. Likewise, U.S. investors can invest in international capital markets without the services of various regulated intermediaries in the United States[137]. This phenomenon has raised jurisdictional issues. The offshore offerings pose serious challenges to regulators since they effectively ignore jurisdictional and regulatory boundaries. Extraterritorial application of U.S. Securities law would enable the Commission to claim jurisdiction over any securities activity that has a "substantial, direct and foreseeable effect" on the U.S securities market[138]. In March 1998, the Commission issued an interpretive release on the application of the federal securities laws to Internet offers, offshore securities transactions and investment services[139]. The terms

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[135] *See Id.*

[136] *See* Day Trading : Your dollars at Risk available online at <http://www.sec.gov/consumer/jneton.htm> visited on February 25,2000.

[137] Jane Kaufman Winn, *Regulating the use of Internet in Securities Markets*, 54 Bus.Law. 443,454 (1998)

[138] Denis T.Rice, *The regulatory response to the new world of cybersecurities,*51 Admn.L.Rev. 901,948 (1999).

[139] Statement of the Commission regarding use of Internet web sites to offer securities, solicit securities transactions or advertise investment services offshore, Exchange Act Release No. 33,7516, 63 Fed. Reg. 14806.

of this release indicate that the Commission will not treat an offshore activity as "occurring in U.S. for registration purpose" if it is not "targeted" at the U.S[140].

The spurt in Internet-based on-shore securities transactions led to the evolution of Internet-based offshore securities trading. Island tax heavens provided the ideal setting for the offshore securities industry because of their minimal regulatory requirements. The Internet makes it possible for these tax heavens to attract investors and stocks from remote corners of the world. Investors can open offshore electronic trading accounts and operate them from anywhere in the world through the medium of the Internet[141]. Investors can thus globally diversify their assets and risks[142].

Numerous offshore firms have sprung up in the Bahamas, the Bermuda, the Cayman Islands, the Solomon Islands and others. Most of these jurisdictions boast of having "light but effective regulation"[143]. This regulatory flexibility aids in the introduction of new products and listings. However, these new centers have yet to earn credibility amongst investors. The Bermuda Stock Exchange is a fully electronic offshore securities market and is renowned for the listing of securities and international investment funds[144]. There are more than 300 equities, funds, debt issues and depositary programs listed, with a total market capitalization (excluding investment funds) in excess of US$125 billion[145].

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[140] *Id*, at 14808.
[141] *See* < http://investoffshore.com/traders/>
[142] For a discussion on offshore securities, *See* < http://www.investoffshore.com/> visited on March 3, 2000.
[143] See Bermuda Stock Exchange <http://www.bsx.com/cgi-win/bermuda-inc.exe/bsx-overview >visited on March 2, 2000.
[144] *Id.*
[145] *Id.*

World Investors' Stock Exchange, based in Granada, West Indies is another innovative model, which is in the process of development. This is the only stock exchange that provides its investors with a guarantee that protects against loss of their investment. All stocks sold on the exchange carry Stock Value Bank Guarantees[146].

1.Offers by non-U.S issuers to U.S

The foreign issuers intending to offer shares in the U.S. are subject to reporting requirements of Section 12 of the 1934 Act, if their assets are over $ 10 Million[147] and if the number of equity share holders is 500 or more[148]. There are two exemptions to this general rule. The first is available if the issuer does not make any public offerings in the U.S., or list its securities in any of the national securities exchange or NASDAQ, but the issuer must furnish the Commission with specified information made public during the last fiscal year under the law of the country of the issuers' domicile[149]. Foreign issuers can also rely upon Rule 144 A[150] which exempts from registration, the re-sales of securities that are not fungible with securities trading in public markets and sold to Qualified Institutional Buyers[151].

When a foreign issuer makes an unregistered offshore Internet offering and does not plan to sell the securities in the United States, it should implement adequate measures to prevent U.S persons from participating in the offer[152]. The regulators tend to distinguish

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[146] World Investors Stock Exchange <http://www.wise-exchange.com/Who_We_Are/who_we_are.htm> Visited on March 2,200.
[147] 17 CFR 240. 12g-1.
[148] § 12(g), 15 U.S.C § 78L.
[149] 17 CFR 240. 12g3-2(b). *See* also *supra* note 36 at 158-159.
[150] 17 CFR 230.144 A.
[151] *See* Hall S. Scott & Philip A. Wellons, *"International Finance, Transactions, Policy and Regulation"* 65 (6th ed.1999).
[152] *See supra* note 139 at 14,808-809.

between targeted communication and web site postings[153]. The issuer should consider the following procedures designed to avoid targeting the United States[154].

(1) Disclaimers in the web site to the effect that the offer is directed only to countries other than the U.S. or specify the name of the countries to which the offer is directed.

(2) Implement procedures to guard against sale to U.S. persons.

If a foreign issuer is concurrently making an offshore offer and a private placement to U.S. based institutional investors, it should ensure that its web site postings do not violate the Regulation D requirements[155]. Web site postings during the period of private placements in U.S. would be tantamount to "general solicitation or advertising"[156], and would result in indirect violation of Regulation-D[157].

2. Offer by U.S. issuers outside the U.S.

Regulation-S of 1934 Act provides a safe harbor exemption from registration requirements for offers made by U.S issuers outside the U.S[158]. This exemption is based on the premise that the offerings that take place outside the U.S need not be subject to the registration requirements under the Federal Securities Act. However, the issuer has to ensure that its promotional activities abroad are not targeted to United States, and that such activities are legal and customary in the foreign jurisdiction[159]. Regulation S primarily provides for two safe harbor rules, an issuer safe harbor under Rule 903,[160] and

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[153] *See* Christopher Giancarlo, *International regulation of Internet Securities,* 222 NYLJ 1,2 (1999)
[154] *See supra* note139.
[155] 17 CFR 230 §§501-508.
[156] *Id.* 230 § 502(c).
[157] *See supra* note 139 at 14809.
[158] 17 CFR 230 § 903.
[159] Linda C. Quinn & Ottilie L. Jarmel, *Publicity considerations for corporate issuers: Getting the message across under the federal securities laws " Aircraft carrier" release annotation* 1141 PLI/Corp 533,548 (1999).
[160] 17 CFR 230. 903.

a safe harbor for re-sales under rule 904[161]. To avail themselves of the benefit of these safe harbor rules, issuers should ensure that the offer or sale is made in a "offshore transaction ",[162] and that there are "no directed selling efforts "[163] in the U.S.

The effect of the "directed selling efforts" rule on the web site contents of an issuer availing the exemptions under Regulation-S, was clarified by the Commission in Securities Act Release No.33-7516[164]. The Commission has adopted a stricter approach for the information posted on web sites maintained by issuers from U.S for offshore offerings, because of:[165]

1. Substantial contact of the issuer with the U.S
2. Strong likelihood that the securities sold offshore will subsequently enter the U. S. market.

Therefore, U.S. issuers making offshore offerings are required to ensure that the security is not offered in the U.S. market and design a password protected procedure accessible only by non –U.S. persons[166].

D. Corporate web pages and other communications:

1. Corporate Web sites

Since the advent of the Internet, web sites have become one of the most important vehicles for dissemination of corporate information. Companies create web sites for posting information about their business activity, product, marketing and financial news,

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[161] 17 CFR 230. 904.
[162] For definition of "offshore transaction", *see* Rule 902(h) of Regulation-S, 17 CFR 230. 902(h).
[163] For definition of "directed selling efforts", *see* Rule 902(c) of Regulation-S, 17 CFR 230. 902(c).
[164] *Supra* note 139.
[165] *See supra* note 139 at 14810.
[166] *Id.*

as well as related information and advertisements. Web sites are also used for posting offer documents such as a prospectus and other statutory reports such as annual and quarterly reports[167]. Web sites normally contain hyperlinks to other web sites, which provide additional information such as research reports, stock performance data etc. The widespread use of web sites poses various regulatory issues as they are less amenable to the jurisdictional and regulatory boundaries[168].

The Commission has taken a view that publication of information on a web site is similar to that of a written communication, and that the "liability provisions of the Federal Securities laws apply equally to electronic and paper based media"[169]. The company has a duty to regularly review and update its web site, and would be liable for any erroneous or imprecise representations[170]. Hyperlink connections from a web site have been analogized to mailing different documents in the same "envelope"[171], and any linkage to incorrect information would lead to potential liabilities under the Securities Act. The web site of a company should also conform to the regulatory standards of "conditioning the market" and "Gun Jumping" during the offering process. The web site contents during the offer process attract varying liabilities in the pre-filing period, waiting period, and post-effective periods[172]. The Commission has issued interpretative releases and no-action letters covering the above topics. They are dealt in detail in Part IV of this thesis.

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[167] *See Quinn, supra* note 159 at 575.
[168] *See,Christopher Giancarlo, supra* note *153* at 1.
[169] Securities Act Release No. 7233 (October 06, 1995) 60 Fed. Reg.53458, 1995 SEC LEXIS 2662.
[170] *Quinn supra note 159* at 572.
[171] *See* Securities Act Release No. 7233, *supra* note 169, at 53463.
[172] *See McDONALD ET AL. supra* note 27

2. Electronic and Internet Road shows

Road shows are part of a publicity campaign conducted by the issuer company to develop interest in the offer before the date of public issue. The scope of a road show is limited in the case of a registered offering, as communications in connection with road show often fall within the definition of "prospectus"[173]. The road shows are more frequently used in exempt offerings, under Rule 144 A,[174] as there is no restriction for distribution of offer documents. Under Rule 144 A, the issuer has to ensure that there is no general solicitation or advertising in connection with the offer, and that only sophisticated investors are invited to participate in the offer[175].

The Internet and technology have significantly influenced road show methodology. It is now possible to broadcast electronic road shows directly to a subscriber base[176]. The Commission issued a no-action letter to Private Financial Network (PFN), which envisaged a scheme to broadcast electronic road shows directly to its subscribers. PFN created a private network of "limited audience" subscribers and transmitted video recordings of road show meetings through the network[177]. PFN had a subscriber base of about 100 sophisticated investors. One of the conditions stipulated was that the subscribers agreed not to videotape, copy or distribute the broadcast material, and that the issuer would limit the availability of material to the subscribers[178]. The

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[173] Prospectus is defined as " any notice, advertisement, or communication, written or by radio or television, which offers a security for sale or confirm the sale of a security", Section 2 (a) 10, 17 CFR § 77b
[174] 17 CFR § 77
[175] *Id.*
[176] *JERMEL ET. AL. supra* note 39 at 643
[177] *See* SEC no-action letter to Private Financial Network (March 12,1997)1997 SEC No-Act. LEXIS 406.
[178] *See Id.*

Commission has issued similar no-action letters to Net Road show Inc.,[179] Bloomberg L.P,[180] and Thomson Financial Services, Inc.[181]

[179] SEC no-action letter to Net Road show Inc., (July 30,1997) 1997 SEC No-Act. LEXIS 864.
[180] SEC no-action letter to Bloomberg L.P., (December 1,1997) 1997 SEC No-Act. LEXIS 1023.
[181] SEC no-action letter to Thomson Financial Services,(September 4, 1998) 1998 SEC No-Act. LEXIS 837.

Chapter IV

Response of existing Disclosure regime

A. Private markets

The key regulatory issue associated with online private placement is the prohibition regarding General Solicitation or advertising. The Internet is a high-speed communication medium which can be accessed from anywhere by an investor. Posting of notices of a private offering, let alone other offer documents, in the web site would change the character of offering from that of private to public, and thereby implicate the provisions regarding registration.

The propriety of posting the offer documents of private offerings on web sites was discussed by the Commission in its 1995 release titled "use of electronic media for delivery purpose"[182]. The Commission took the view that the placing of offering material on the Internet would be tantamount to general solicitation, even if the access were subject to prior submission of information[183]. This strict interpretation was relaxed in the subsequent no-action letters.

In the IPONET no-action letter, the Commission opined that the posting of a notice of private offering in a password-protected page of IPONET, accessible only to IPONET members, who have qualified as accredited investors, would not involve any form of "general solicitation" or "general advertising".[184]

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[182] Securities Act Release No. 33-7233 *supra* note 169.
[183] *Id* at 53463.
[184] SEC no-action letter to IPONET (July 26, 1996), 1996 SEC No-Act. LEXIS 642.

Gallagher & Company, Inc., would select members of IPONET through the IPONET web site by soliciting individuals who meet the "accredited investor" or "sophisticated investor" standards of Regulation D[185]. The following additional conditions were stipulated:

> (a) Invitation to complete the questionnaire used to determine whether an investor is accredited or sophisticated and the questionnaire itself will be generic in nature and will not have reference to any specific transactions posted or to be posted on the password-protected page of IPONET; (b) the password-protected page of IPONET will be available to a particular investor only after Gallagher has made the determination that the particular potential investor is accredited or sophisticated; and (c) 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[186].

In 1997, the Commission issued a no-action latter to Lamp Technologies, for operating a private for-profit web site, which would contain information about private offerings accessible to subscribers who were accredited investors[187]. This no action letter is significant because it permits an investor to pay $ 500 per month in subscription charges to receive access to currents investment proposals as well as those previously posted on the web site[188].

B. Primary market

1. Prospectus delivery

The advent of the Internet has made it possible for a company to deliver electronically documents such as a prospectus, annual reports and proxy statements. This

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[185] *Id.*
[186] *Id.*
[187] SEC no-action letter to Lamp technologies (May 29, 1997) 1997 SEC No-Act. LEXIS 638.
[188] *Id.*

assures compliance with Section 5 (b) (2) of the 1934 Act,[189] that requires the issuer to send a final prospectus to the investor before the time of sale so that the investors are provided "with the means to understanding the intricacies of the transaction"[190].

In October 1995, the Commission issued its interpretative release titled the "use of electronic media for delivery purpose"[191]. The release addresses various delivery obligations under the 1933 and 1934 Acts and it reflects the Commission's concern that the new medium of delivery should conform to the Securities Act delivery requirements such as notice, access to information and evidence to show delivery[192]. To determine whether delivery through electronic means has been proper, the Commission uses an analogy to paper-based media, and applies the same standard[193]. However, unlike paper delivery of a prospectus where access to the document can be presumed with delivery, there is no such presumption of access if a company posts its final prospectus on its website[194]. Hence, the posting of a final prospectus on a web site would not satisfy the delivery requirements under the Securities Act, unless accompanied by specific consent from the investor[195]. But it is lawful to place the prospectus on the web site and send mail confirmation to those investors who have consented to receive electronic delivery[196]

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[189] "It shall be unlawful for any person, directly or indirectly to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of Section 10" -§5 (b)(2)., 15 U.S.C § 77e.

[190] *See* Exchange Act release No. 33-7606A, 63 Fed. Reg. 67174, 67222.

[191] Securities Act Release No. 33-7233 *supra* note 169.

[192] *Quinn, supra* note 39, at 636.

[193] Securities Act Release No. 33-7233 *supra* note 169 at 53460.

[194] Example D (1), Securities Act Release No. 33-7233 *supra* note 169 at 53461.

[195] *Id.*

[196] Example D(2); Securities Act Release No. 33-7233 *supra* note 169 at 53461.

Release No.33-7606A, has proposed various reforms in the rules regarding prospectus delivery[197]. One of the proposals concerns the present requirement that delivery of a prospectus can take place at the time of sale. The existing rule has been criticized for not giving enough time to the investor, as the final prospectus arrives after he/she had made an investment decision. The proposed rules would focus on prospectus delivery requirements before investors have made their final decision for purchase[198]. The delivery requirement would depend on the category of issuer, as the proposals envisage a three-tiered registration system[199]. In this release, the Commission has proposed sweeping changes in the areas of registration systems, communication around the time of offering, prospectus delivery requirements, integration of private and public offerings, and periodic reporting under the 1934 Act.

2. Registered Offering:

The prime concern of 1933 Act is the distribution of securities process[200]. The offer and sale of securities in primary markets is highly regulated. The flow of corporate information is controlled in three time periods: *viz.* the pre-filing period, the waiting period and the post-effective period. Dissemination of corporate information through the medium of the Internet has posed various issues for the issuer. Since Internet-based systems of communication fail to conform to the regulatory concepts such as "Gun Jumping" and "Illegal Prospectus".

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[197] *Supra* note 190 at 67223.
[198] *Supra* note 190 at 67224.
[199] Three tiered system envisages three forms. Form A, Form B and Form C. Form A issuers are smaller and unseasoned companies. Form B would be for larger, seasoned and well informed issuers and for those issues made to relatively informed or sophisticated investors. Form C would be for business combinations or exchange offerings. *See Supra* note 190 at 67176.
[200] *SELIGMAN ET.AL. supra* note 36 at 72.

The primary restriction to transmission of information during the pre-filing period arises out of Section 5(c) of the 1933 Act, which reads as follows:

> "It 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 through the use or medium of any prospectus or other wise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under Section 8.[201]"

Issues concerning the apparent conflict involving the dichotomy between the obligation to make a timely disclosure and restriction on publication of information was addressed by the Commission in various releases since 1957.[202] In the eyes of the Commission, restrictions imposed during this period have been aimed at preventing market conditioning by issuers who resort to press interviews, speeches, and reports etc., intended to generate public interest in the proposed offering[203]. However, such restrictions are not designed to hinder the flow of factual information to shareholders and the investing public. This principle was further strengthened by Rule 135[204], which permits the issuer to release certain information about its operations, without being considered prohibitive under Section 5 of the 1933 Act. Rule 135 specifically permits notice of a proposed public offering. However, such notice should state that the offering would be made only by a prospectus, and contain no more than the following information: (1) the name of the issuer, (2) the title, amount and basic terms of the

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[201] 15 U.S.C. § 77e.
[202] See Release No. 3844, [Current Binder] fed. Sec.L.Rep.(CCH) 3,250 at 3147(1957) ., Securities Act Release No. 5009 (1969).
[203] *Supra* note 36 at 82.
[204] 17 CFR 230.135.

proposed offering (3) the nature and class of security intended for offering and (4) manner and purpose of the proposed offering[205]. Similar principles were enshrined in Rule 137 and 139, providing more leverage to the broker dealers during the pre-filing period[206]. The trend towards more relaxation continued in the proposed new rule 135(d), which would allow the issuer to "test the waters", by soliciting indications of interest from potential investors, prior to the filing of registration statement, in order to appraise the feasibility of a public offering [207].

The rules stated above are equally applicable to electronic media. This view was reiterated by the Commission in the Brown & Wood no-action letter,[208] and by the Securities Act release No.7233[209]. These pronouncements of the Commission are significant, as it reiterated the fundamental concept that federal securities statutes do not "prescribe the medium to be used for providing information by or on behalf of the issuers"[210], and that "the liability provisions of the federal securities laws apply equally to electronic and paper-based media"[211]. Since websites are treated on par with other media of communication, the company can continue to advertise products and services, and provide factual information regarding business and financial developments. However, the issuer should insure that those communications prohibited by the Federal Securities Act are not included on a website. Such information includes: issuance of forecasts,

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[205] *Id., See* also *McDonald, supra* note 27 at 283.
[206] 17 CFR 230.137&139.
[207] See Securities Act Release No.7188 [1995-1996 Transfer Binder] Fed.Sec.L.Rep.(CCH) 85,639 at 86,885 (1995).
[208] SEC No-action letter dated February 17,1995, 1995 SEC No-Act. LEXIS 281.
[209] *Supra note* 169.
[210] *Supra note* 169, at 53459.
[211] *Supra note* 169, at 53459, n 11.

projections or predictions related to revenues, and opinions or reports concerning values[212].

The Commission has proposed sweeping changes to the above rules in Securities Act Release No. 33-7606A[213]. The release proposes to remove restrictions on offering communications by large seasoned public companies during the pre-filing period by making an exemption to this effect[214]. In the case of small issuers it proposed to remove pre-filing communication restrictions in the following instances: if the issue is (1) limited to Qualified Institutional Buyers (QIB's), (2) offering of investment grade securities, (3) offering to certain existing shareholders, and (4) offering in connection with market making transactions[215]. The proposal also contains a provision that would exempt any communication made before the 30 day limited communication period from the purview of definition of "offer to sell" or "offer to buy"[216]. This is subject to the condition that the issuer takes reasonable steps to prevent further public dissemination of information during the limited communication period. For all other registrants, the release provides for two safe harbor rules *viz.*, "bright line communication safe harbor" and "communications safe harbor"[217]. Bright line communications safe harbor is applicable only to registered offerings. This proposal envisages a safe harbor for all communications, which takes place during a specified period before the date of filing the registration statement[218]. The communication safe harbor proposes to include within its

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[212] *SELIGMAN ET. AL. supra* note 36, at 83.
[213] *Supra* note 190, at 67210.
[214] See proposed Securities Act Rule 166, 17 C.F.R 230.166,*See* also *supra* note 190, at 67210.
[215] Proposed Securities Act Rule 166(a), 17 CFR 230.166, *see* also *supra* note 190, at 67210.
[216] Proposed Securities Act Rule 167, 17 CFR 230.167.
[217] *Supra* note 190 at 67212-214.
[218] Proposed Securities Act Rule 167, 17CFR 230.167.

scope, factual business communications[219] and regularly released forward-looking information[220].

The period between filing of the registration statement and the effective date is separately treated by the Commission as the "waiting period". Section 5(a) (1) of the 1934 Act, which bans the sale of securities during the waiting period, reads as follows:

> "Unless a registration statement is in effect as to a security, it 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 sell such security through the use or medium of any prospectus or otherwise[221]"

During this period delivery of any prospectus is prohibited[222]. The term prospectus has been defined to include "any prospectus, notice, circular, advertisement, letter or communication written or by radio or television, which offers any security for sale or confirms the sale of any security"[223]. It can be seen from the definition that, all forms of communication including the electronic communication fall within its scope and ambit. However, there are two specific exemptions to the above definition of prospectus. They are better known as "tombstone advertisements"[224], and "preliminary prospectus"[225]. Tombstone advertisements can be in the form of a notice, circular, advertisement, letter, or communication and should state from whom a prospectus meeting the requirement of §10 can be obtained[226]. The contents of such an advertisement have been highly

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[219] Proposed Securities Act Rule 169, 17 CFR 230.169.
[220] Proposed Securities Act Rule 168, 17 CFR 230.168.
[221] 15 U.S.C. § 77e.
[222] See Section 5(b)(1), which states that it shall be unlawful to "carry or transmit any prospectus relating to any security to which a registration statement has been filed under this title, unless such prospectus meets the requirements of Section 10" 15 U.S.C. § 77e.
[223] 15 U.S.C. § 77b.
[224] § 2(10)(b), 15 U.S.C. § 77b & Rule 134 , 17 C.F.R.230. 134.
[225] §10 (b), 15 U.S.C. § 77j & Rule 431, 17 C.F.R.230. 431.
[226] § 2(10)(b), 15 U.S.C. § 77b.

regulated. Such advertisements can identify the security, state the price thereof, state by whom orders will be executed and can include another 13 categories of information specifically permitted by Rule 134[227]. It is not designed for selling literature, and is meant for a limited purpose of communicating the existence of a public offer and the availability of a prospectus for that offer[228]. Nevertheless, oral offers can also be made during the waiting period, even though they are not accompanied or preceded by a prospectus[229].

Other than the tombstone advertisements, the only other information that can be sent during the waiting period by the issuer is a preliminary prospectus meeting the requirements of Section 10(b). The Commission has introduced Rule 431 regarding summary prospectus, *in lieu* of its rule making mandate under Section 10(b)[230]. A summary prospectus is designed to be a condensed or summarized form of a final prospectus and should carry the prominent caveats specified in the Rules[231].

The above principles are equally applicable to electronic media. Issuers should ensure that their websites do not contain information that violates the Federal Securities Laws. One of the areas of concern is that of posting research reports on the web site by way of hyperlinks. The hyperlink connections are treated as analogou to sending two or more documents together in an envelope and hence, restrictive provisions during the waiting period would apply[232].

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[227] Rule 134, 17 C.F.R.230. 134-communications not deemed a prospectus.
[228] *See SELIGMAN ET.AL.supra* note 36, at 89.
[229] *SELIGMAN ET.AL. supra* note 36, at 87.
[230] 17 C.F.R.230. 431.
[231] 17 C.F.R.230. 431(d) & (e).
[232] *Supra* note 169 ,53463, Part D(15).

The changes proposed in the regulation of communication during the waiting period include the use of summary prospectus without being bogged down by the requirements of Rule 431[233]. Proposed Rule 165 would permit post filing free writing if the issuer complies with the preliminary prospectus delivery requirements in proposed Rule 172, and files free writing materials and a final prospectus[234]. The changes are proposed by the Commission to enable the issuers and market participants to take greater advantage of the Internet and other electronic media during the waiting period. Proposed Rule 165 would permit the issuer to (1) conduct electronic road shows to retail and institutional investors without the use of a password, (2) use electronic mail to communicate with the investor during the offering process and (3) conduct chat room discussions or post messages on bulletin boards about the proposed offer[235].

In terms of Section 5(a)(1), the restriction on "sale of a security" ends when the registration statement becomes effective. However, the sale of a security should conform to Section 5(b)(2), which mandates delivery of a prospectus, before or together with the delivery of the security[236]. However, written communications made after the effective date is not "prospectus", and hence the issuer can engage in free writing but these are subject to the anti-fraud liability provisions.

In the Brown and Wood no-action letter, the Commission noted that the term "Prospectus" as used in Section 5 and 10 of the 1933 Act includes those encoded in "an electronic format". If transmitted electronically the prospectus would be treated as "sent"

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[233] Proposed Securities Act Rule 165, 17 CFR 230. 165.
[234] Supra note 190, at 67215.
[235] *Supra* note 233.
[236] 15 U.S.C. § 77e.

or "given" to the customer, meeting the delivery standards of Section 5 of the 1933 Act.[237] The issues regarding electronic delivery of final prospectus and advertisements during the post-effective period has been further clarified by Exchange Act Release No. 7233[238]. The posting of final prospectus in the web site would satisfy the delivery requirement if the issuer obtains proper informed consent from the investor[239]. The issuer should also meet the standards of timely and adequate notice and access[240]. However, the electronic format of the prospectus need not be exact replicas of the paper format, provided the documents comply with the provisions of Federal Securities Act[241]. The standard adopted for delivery requirement is summarized in the following statement of the Commission: "[We] would view the information distributed through electronic means as satisfying the delivery or transmission requirements of the federal securities laws if such transmission results in the delivery to the intended recipients of substantially equivalent information as these recipients would have had if the information had been delivered in paper form"[242].

C. Secondary Market

The secondary market impact of the Internet has been even more profound than in the primary market. The Commission has traditionally regulated the secondary market through registration of "exchanges" and "broker dealers". The new generation trading systems do not strictly fall into any of these regulatory definitions. They exhibit

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[237] SEC No-action letter to Brown & Wood (February 16, 1995) 1995 SEC No-Act. LEXIS 281.
[238] *Supra* note 169.
[239] *Id* at 53461.
[240] *Id* at 53460.
[241] Securities Act Release No. 7289,[1996 Transfer Binder] Fed.Sec.L.Rep.(CCH) 85,806 at 88,013 (May 09,1996).
[242] *Supra note* 169, at 53460.

structures that are alien to the traditional definitions, as technology has increasingly blurred the distinction between an "exchange" and "broker dealer"[243]. The Securities Act Release No. 40760 titled as "Regulation of Exchanges and Alternative Trading Systems" has addressed various regulatory issues posed by the Internet and technology in the secondary market by adopting a novel three-tiered regulatory approach with respect to Alternative trading systems.[244]

1.Regulation of Exchanges

Registration of a trading facility as an exchange is intended to ensure proper reporting procedures, compliance with trading rules, transparency, and integration into the national market system[245]. The term exchange has been defined in Section 3(a)(1) of the 1934 Act as given below:

> "Any organization, association or group of persons, whether incorporated or unincorporated, which constitutes, maintains or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the function commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange."[246]

Issues have been raised in connection with the scope and extent of the all-inclusive definition of Exchanges in Section 3(a)(1). In Board of Trade of the City of Chicago v. Securities and Exchange Commission[247], the petitioners' challenged the no-action letter issued by the Commission, that allowed RMJ Options Trading Corporation, Delta

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[243] *Supra* note 65, at 70846.
[244] *Supra* note 65.
[245] Paul D. Cohen, *Securities Trading via the Internet*, 4 Stan.J.L.Bus.&Fin.1,31(1999)
[246] 15 U.S.C. § 78c
[247] 883 F.2d 525 (7th Cir.1989)

Government Options Corporation, and Security Pacific National Trust Company (SPNTCO), all who trade options on treasury bills, bonds, and notes, to operate a "system" without registration under Section 6 of the 1934 Act. The "system" was a combination of computer hardware and software that matched offers and kept track of the obligations of the longs and shorts until the options expired or the positions were closed by offsetting transactions[248]. RMJ acted as the sole broker of the system. The role of Delta was that of a clearinghouse, administrator and guarantor, which ensured the credit-worthiness of the participants, and SPNTCO acted as clearing bank (facilities manager) for the system [249]. The futures market contended that the "system" was really an "exchange" that required registration under § 6 of the 1934 Act[250]. The court observed that the "system" is one of those "hard to classify entities"[251], which is "neither fish nor fowl"[252], would require proper determination under Section 3 (a) (1) of the 1934, Act and requested the Commission to clarify its definition of exchange in Section 3[253].

In response, the Commission issued an order titled "Delta Government Options Corp. order"[254], which noted that an "expansive reading of exchange is incongruous with the statutory scheme of the 1934 Act"[255]. The wide interpretation to "bringing together of

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[248] *Id* at 528.
[249] *Id* at 527.
[250] *Id* at 526.
[251] *Id.* at 537.
[252] *Id.*
[253] *Id.* at 536-537, *See* also Fairchild J. concurring opinion "Developments in automation and communications are bound to produce more of these hard-to-classify entities. Section 3(a)(1) is a product of the '30s, the System a product of the '80s." at 537.
[254] Exchange Act Release No. 34-27611, 55 Fed. Reg. 1890 (Jan 19,1990).
[255] *Id* at 1898.

purchasers and sellers", language used in Section 3, would result in bringing, entities that are outside the scope of congressional intent within the ambit of regulation [256].

In Securities Act Release No.34-40760, the Commission refined the definition of "exchange" by introducing a new Rule 3b-16, which clarified the key language used in the section 3(a) (1) such as "bringing together purchasers and sellers" and "performing with respect to securities the functions commonly performed by a stock exchange"[257]. This rule 3b-16, defines these terms to mean "any organization, association, or group of persons that (1) brings together the orders of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade"[258]. The import of Rule 3b-16, is to exclude from the ambit of definition of Exchange broker dealer systems that perform only limited functions attached to broker dealer activities.[259] Rule 3b-16(b) also excludes the organization, association or group of persons engaging in one or more of the following activities from the definition of "exchange"[260].

> "(1) Systems that merely routes orders to other facilities for execution; (2) systems operated by a single registered market maker to display its own bids and offers and the limit orders of its customers, and to execute trades against such orders; and (3) systems that allow persons to enter orders for execution against the bids and offers of a single dealer."[261]

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[256] *Id at 1898.*
[257] *Supra* note 65 at 70847
[258] 17 C.F.R. 240. 3b-16
[259] *Supra* note 65 at 70847.
[260] 17 C.F.R. 240. 3b-16(b).
[261] *Supra* note 65 at 70847.

2. Regulation of Alternative Trading Systems

Since the advent of the Internet, the secondary market has witnessed the mushrooming of systems challenging the traditional market structure and regulatory definitions. Simple bulletin boards as well as sophisticated for-profit ATS's, don't easily integrate with existing regulatory definitions. Nevertheless, such new technology applications have benefited market participants by giving them more efficient trading options. It has also raised concerns regarding fragmentation of the markets and misallocation of capital[262]. The Commission's priority is to develop a stable and orderly national market system, where there is centralization of buying and selling interest, so that each investor can get the best possible execution of his order. Their regulatory scheme envisages a market-oriented system that regulates alternative trading systems, but gives them the option to be registered as an exchange, or as a broker-dealer and comply with the additional requirements specifically designed to address the concerns raised by the activities of those systems that choose to register as broker -dealers[263].

If an alternative trading system that handles five percent or more of the trading volume in any national exchange securities or NASDAQ securities, chooses to register as a broker dealer, the regulation stipulates dissemination of the best priced orders, including the institutional orders into the public quote stream[264]. These and other requirements are intended to integrate alternate trading systems into national market mechanisms.

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[262] *See Supra* note 65 at 70858.
[263] *Supra* note 65 at 70847.
[264] *Id.*

The approach taken by the Commission has been lauded as "futuristic', as the regulation takes into account the growing trend amongst Internet-based trading systems to adopt a proprietary structure[265]. The ATS release provides the requisite leverage to the ATS to decide whether to register as an exchange without changing its organizational structure and to the existing exchanges which are membership based to "demutualize" and convert to a for–profit structure[266].

Nevertheless, the ATS release has been criticized as a piecemeal approach, mainly on two grounds: (1) Conflict of interest as the regulatory mandate for those systems with less than five percent trading has been vested with the self-regulatory organizations, who are competitors in the market and (2) Failed to address the regulatory issues involved in the transnational reach of ATS[267].

D. Corporate web pages and e-mail and other forms of electronic communication

The Commission views that the electronic medium is analogous to the paper medium, and hence subject to the same regulatory standards[268]. In order to achieve certainty in the manner of electronic delivery of documents, the Commission has underscored the importance of timely notice, effective access and reasonable assurance of delivery of information as the regulatory standards that determine an effective delivery[269]. Nevertheless, the Commission has proposed far reaching changes in rules relating to publicity that "conditions the market"[270]. The basic regulatory restriction imposed by the

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[265] *See Cohen, supra* note 245 at 36.
[266] *Supra* note 65 at 70848., *See* also SEC modernizes regulation for Alternative Trading Systems, SEC new release SEC-98-127 (December 02,1998) available online at http://www.sec.gov/news/press/98-127.txt.
[267] *Supra* note 245 at 38.
[268] *See supra* note 237.
[269] *Supra* note 182, 53460.
[270] *Supra* note 190.

1933 Act on market conditioning and offers outside the prospectus is under reconsideration to enhance the scope of electronic communication, including the use of electronic mail to answer investors' questions about the public offerings, and the use of chat room discussions or bulletin boards on public offerings to communicate with potential investors[271].

[271] *Id* at 67216, n.326.

Chapter V

Shortfalls of existing Disclosure norms

The existing securities disclosure regime has been criticized as too rigid and not responsive enough to technological innovations. Some of these criticisms are examined below:

A. Impedes the potential of the new medium

The Internet has over the years became a very important medium for the offer and sale of securities and its relevance is bound to increase as more people become "netizens". This new medium has the potential to open floodgates of corporate information relevant to the securities industry as it can transmit them at speeds up to two billion bites per second[272]. Access to information is relatively convenient, economical and expeditious. However, the security industry cannot use the Internet to its fullest potential since the Federal Securities Act mandates a slowing down of information dissemination prior to the release of a prospectus. The system is designed to protect the investing public from the sales literature that is designed to woo the investor and to ensure that the legally mandated material information reaches the investor before finalization of an investment decision. The rules regarding gun jumping and market conditioning have limited the scope of Internet in securities transactions.

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[272] *BECKER ET.AL. supra* note 60 at 301.

Technology has the potential to support in large-scale disintermediation. The present system imposes many functions on market intermediaries such as broker-dealers, and assigns them roles with specific duties and obligations. Intermediaries bring discipline to the market as gatekeepers for the securities regime[273]. Even though the role of intermediaries such as broker-dealers has been significant in maintaining market integrity, they are paid enormous fees and commissions which increases the cost of the transaction, which is ultimately borne by the investor[274]. While total disintermediation is not feasible, technology can help in achieving partial disintermediation for the benefit of the investor. However, the existing securities regime impedes the potential of the Internet and technology to bring in partial disintermediation.

B. Restricts capital formation of Small business

The prohibitive cost involved in the preparation of a registration statement and the attendant expenses related to disclosure, makes the public offering of securities an unviable financing option for small business. Market intermediaries are less interested in the public offer involving small business, as they are better remunerated in an offer involving a sizeable amount. Even the securities price of small issues may not be efficient, as the price of these securities does not reflect publicly available information, thus making the investment more risky for the investor.[275]

The Internet provides many benefits to the small issuers. Easier instantaneous access to information available on the Internet at low expense would attract more

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[273] Stephen J.Choi, *Gatekeepers and the Internet: Rethinking the regulation of small business capital formation*, 2 J. Small & Emerging Bus.L. 27, 47.
[274] Donald C. Langevoort, *Angels on the Internet: The elusive promise of "technological disintermediation" for unregistered offering of securities,* 2 J. Small & Emerging Bus.L.1, 11
[275] *Supra* note 273 at 29.

investors to the small issues. The investor would get a chance to compare the prices between different companies and would demand the same level of information from intermediaries about companies irrespective of their size[276]. A more liberalized regulatory regime would enhance the potential of the small business to raise capital from the market. The cost involved in meeting the terms of the present regulation is disproportionate to the amount of money raised by the small investor[277].

C. Paternalistic Attitude

The prohibition of general solicitation in a securities offering has been designed by the Commission to protect unsophisticated investors[278]. This paternalistic attitude forms the underlying concept of rules relating to securities transactions. The federal securities regime is premised on the protection of a hapless investor against the unscrupulous issuer who could manipulate market information. It assumes the Investor requires the protection of law to get candid information about the Issuer and his business prospects. However, these assumptions lack practical merit as none of the rules can assure a fail-safe transaction, irrespective of the heightened disclosure liability. Moreover, the paternalistic concern is not in touch with reality in the technological era. The Internet has empowered the investor as never before with corporate information. Today's average investor is knowledgeable about the securities market and its idiosyncrasies. The law should assume reasonable prudence on the part of the investor before making his investment decision. In other words, it is the responsibility of the

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[276] *Id.* at 39.
[277] *Id.* at 40.
[278] *Supra* note 274 at 24.

investor to differentiate between the reliable and unreliable information, both of which are extensively available on the Internet.

D. Information Asymmetry

Another important shortfall in the present disclosure regime is that of information asymmetry. The problem arises from the fact that the issuer knows about the quality of securities being offered and the investor has only limited means to verify the quality of the issue. This asymmetry forms the largest cost that stands between the issuer and investor[279]. The information asymmetry leads to other problems such as "adverse selection", and if unresolved can lead the market to a "death spiral" where the honest issuers are driven out of the market thereby affecting the efficient pricing of securities[280]. The Securities Act deals with the problem partly through various reputational intermediaries such as accountants, investment bankers, underwriters, lawyers and venture capitalists and partly through institutions such as regulators[281]. However, the intermediation is costly and adversely affects the price of the issue. The Internet can make the transfer of information from issuer to investor much easier at a reduced cost and can be used effectively to solve the problems relating to information asymmetry.

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[279] Bernard S. Black, *Information Asymmetry, the Internet, and Securities offering,* 2 J.Small & Emerging Bus.L. 91, 92 (1998)

[280] "Adverse selection" represents a phenomena where the high quality issuers leave the market for want of fair price for their securities and low quality issuer make merry at the expense of inefficiency in pricing. *See Id.*

[281] *Id* at `93.

Chapter VI

Future Possibilities

The existing registration system is transaction based and requires a filing every time the company wishes to make an offering. This system is expensive and time consuming especially for big companies, which raises funds from the market in quick succession. Some of the alternatives are discussed in this chapter.

A. Company based registration model

The "company" registration model envisions the filing of registration statement once by the Company and thereafter if it wishes to make public offering, it could do so merely by providing information regarding the specific offering[282]. The registration statement filed becomes effective immediately and the company is required to update disclosures by filing with the Commission around the time of specific offerings[283]. The statutory reports filed by the Company under the 1934 Act are incorporated by reference. The company registration system was intended to eliminate unnecessary regulatory costs and streamline the process of raising capital, to enhance ongoing disclosure to secondary

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[282] *Fontanna, supra* note 24 at 317.
[283] *Id.*

trading and to eliminate the complex distinctions between the public and private, domestic and offshore, and issuer and non-issuer transactions[284].

B. Sale based regulation

The proposal envisages removing the regulatory restrictions on an offer[285]. This would entail total relaxation from the rules relating to Gun Jumping and provide for free writing during the offer process. However, the offer process would continue to be governed by the antifraud provisions of the Securities Act. The sale of securities would continue to be regulated and would be subject to the mandatory disclosure requirements.

C. Arguments for Deregulation

The case for deregulation of the disclosure regime is premised on the argument that the regulator must avoid regulating what the market can regulate better.[286] Supporting this argument is the fact that the regulations are not cost free[287]. Excessive regulation curtails innovation and creates barriers to the introduction of new products. The regulations also fail to ensure the quality of investment. The argument for deregulation assumes more importance in the Internet era as outdated regulations can hinder the potential of the new medium. Deregulation should seek to foster competition, taking into consideration the aggregate benefit of the investor[288].

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[284] *See* Report of the Advisory committee on the capital formation and regulatory process (July 24, 1996) available at <http://www.sec.gov/news/studies/capform.html> visited on May 12, 2000. This approach was first recommended by the task force on disclosure simplification established by the Commission to simplify the disclosure process and to regulate more efficiently the process of capital formation. (Available on line at <http://www.sec.gov/news/studies/smpl.htm>)The study was an effort by the Commission to find out whether registration of offers and sales at the time of sale remain the best method available for accomplishing the disclosure objective.

[285] Linda C.Quinn, former director of SEC Corporate Finance Division, mooted the proposal. *See Linda C.Quinn, supra* note 39.

[286] Stephen M.H. Wallman, *Competition, Innovation, and Regulation in the Securities Market*, 53 Bus. Law. 341, 353 (1998).

[287] *Stephen J.Choi, supra* note 273 at 38

[288] *Stephen M.H. Wallman , supra* note 286 at 354

The present regulatory system embodies an elaborate set of restrictions on corporate disclosure, based on the concept of market conditioning and gun jumping. These rules hinder the use of Internet as a vehicle for dissemination of corporate information. The Internet can help the investor gain access to information on a large scale. However, the Internet can also be used as a tool for market manipulation. These problems can be better resolved under the antifraud provisions and by encouraging competition between various information providers on the Internet. Competition has the potential to check corrupt practices as it creates disincentives based on commercial principles. Such a regime would also expect the investor to assume more responsibility before making an investment decision.

Chapter VII

Conclusion

The Securities disclosure regime, which has existed since 1933, has played a significant role in the development of the securities market in the U.S. However, the regulatory assumptions underlying the mandated disclosure regime have been repeatedly questioned in recent years, prompting Prof. Alan R. Palmiter to comment that "we are in the spring of 1933"[289]. The spirit of deregulation has influenced various proposals in the "Aircraft career" release [290] and if accepted has the potential to alter the disclosure regulatory landscapes beyond recognition. While following the transactional focus of the current system, the aircraft carrier release proposes to change the disclosure requirements in its registration statement forms, prospectus delivery rules, pre-offering communication rules, rules governing integration of public and private offerings and periodic disclosure requirements[291]. However, total dismantlement of the regulatory regime, leaving the regulatory mandate solely to market forces can have a horrendous impact on market integrity. An evenhanded approach, retaining minimum regulatory restriction without impinging innovations, is desirable in the Internet era.

In order to be an effective catalyst in change, the law and regulatory institutions should adapt themselves to the change in environment of the actors who are subject to

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[289] Alan R.. Palmiter, *Toward Disclosure Choice in Securities Offering,* Colum.Bus.L.Rev.1, 135 (1999)
[290] Exchange Act release No. 33-7606A ,*supra* note 190
[291] Exchange Act release No. 33-7606A ,*supra* note 190

regulation. The Aircraft carrier proposal is the first step in this direction. Relaxation in offering process giving more leeway for communication would aid in the effective dissemination of corporate information for the ultimate benefit of the investor.

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