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Electronic Media and the Federal Securities Laws: Perks, Pitfalls and Prudence

INTRODUCTION

Caught up in the almost frightening pace of technological advancement that has characterized the past ten years, issuers today are racing to implement the newest, most effective and innovative ways to communicate with investors and potential investors. The utility and overall accessibility of electronic media, combined with the improved speed at which information can be disseminated to current and potential investors, has provided considerable incentive for companies to use new technology, such as the Internet and email, to enhance communication. The benefits of using electronic media are considerable. A company can create a web site and use it almost instantly as a cost effective means to advertise its products to millions of people. The site can provide information regarding the company's mission, its goals, its products, services and reputation as an employer. Perhaps most importantly, the site can be a highly effective vehicle for the dissemination of a wealth of information of particular interest to investors and analysts.

Certainly the benefits of using electronic media to communicate with current and future investors are too numerous to chronicle. Amid the many benefits electronic media offer to companies and issuers, though, lurk significant regulatory and litigation dangers. The imprudent or thoughtless use of the Internet or email by an issuer in registration, or by one who is attempting to comply with federal disclosure requirements, could potentially leave it vulnerable to a host of securities violations. The main focus of this paper is to identify some of the potentially adverse legal and regulatory consequences of the use of electronic media, most notably the Internet, by an issuer who is either undergoing an initial public offering, or by one who is subject to disclosure obligations as a reporting company.

The legal environment that surrounds these issues is, at best, uncertain. The issuance of securities in the United States is governed by complex federal laws¹ and by the securities laws of the

1. See, e.g., Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994) (hereinafter the "Securities Act"); Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (1994) (hereinafter

individual states.² An exhaustive dissertation of the possible securities infractions that may occur as a result of the use of electronic media is, obviously, beyond the scope of this article. The focus of the article, instead, will be an analysis of the potential legal and regulatory consequences that could result from the inappropriate or thoughtless use of the Internet or email by an issuer of securities, within the framework of the federal securities laws.

Part I of this paper provides a general introduction to the process of registration and rather broadly describes the steps an issuer must undergo when it desires to issue securities to the public. Because these steps are subject to strict statutory requirements and regulation by the Securities and Exchange Commission ("SEC" or "Commission"), this area is fraught with danger to the unwary issuer and uncertainty with respect to electronic communications. It is vitally important for an issuer to monitor and scrutinize all communications with potential investors during this stage, especially those communications made via electronic media. Any communication made outside of the statutorily mandated framework of the Securities Act of 1933 ("Securities Act") and the Securities and Exchange Act of 1934 ("Exchange Act") could potentially subject the issuer to liability.

Different dangers exist once the offering has been made. Part II of this paper will examine the use of electronic media, namely the Internet and email, by issuers who wish to utilize such means to comply with disclosure and delivery obligations. The SEC has been admirably receptive to the use of new means of technology to comply with disclosure requirements. Despite the SEC's enthusiasm, and actual encouragement in this arena, however, issuers must proceed with caution and care in order to ensure that they are meeting their delivery and disclosure obligations.

But what if, despite the best of intentions on the issuer's part, it falls short of meeting its statutory obligations? What kinds of situa-

the "Exchange Act").

2. State statutes that govern the regulation and supervision of securities are generally known as "Blue Sky Laws." See JAMES F. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 10 (1971). In describing the origin of the term, a writer in 1916 wrote:

The State of Kansas, most wonderfully prolific and rich in farming products, has a large proportion of agriculturists not versed in ordinary business methods. The State was a happy hunting ground of promoters of fraudulent enterprises; in fact, their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as the blue sky merchants and the legislation intended to prevent their frauds was called Blue Sky Law.

Id.

tions are likely to leave an issuer most vulnerable to enforcement action by the SEC? Part III of this paper will explore some recent enforcement actions taken by the SEC, and delineate some of the practices that are most likely to arouse the suspicions of the regulatory agencies, both federal and state. Additionally, Part III will examine the efforts the SEC is currently making to improve its policing of the Internet and its ability to detect securities fraud in the complex world of cyberspace.

I. ADVICE TO THE ISSUER IN THE PROCESS OF MAKING AN INITIAL PUBLIC OFFERING — TREAD CAREFULLY

A. *Thinking about going public . . .*

Unless a registration statement has been filed, Section 5 of the Securities Act generally prohibits an issuer from making an offer to sell securities to the public, whether the offer is written or oral.³ The registration process can be divided generally into three distinct periods: pre-filing, waiting, and post-effectiveness.⁴ The pre-filing period basically begins with the decision to make a public offering of securities, or at the very least with the commencement of negotiations with an underwriter to handle a public offering. During the pre-filing period, an issuer is prohibited from making both written and oral offers to sell securities. The term “offer” is defined in the Securities Act as any “attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value,”⁵ and is broadly interpreted by courts. The SEC is primarily concerned with communications during the pre-filing period that could arguably “condition the market” or otherwise arouse public interest in the securities.⁶ The dissemination of certain types of information or marketing materials during the pre-filing period could conceivably be interpreted as an impermissible offer to sell, giving rise to

3. See Securities Act, 15 U.S.C. § 77e(c) (1994), which states in relevant part:

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 otherwise any security, unless a registration statement has been filed as to such security.

Securities Act, 15 U.S.C. § 77e(c) (1994).

4. See A. Jared Silverman, *Cyberspace Offerings Raise Complex Compliance Issues*, 142 N.J. L.J. 1162 (1995).

5. Securities Act, 15 U.S.C. § 77b(3) (1994).

6. See JOHN R. HEWITT & JAMES B. CARLSON, *SECURITIES PRACTICE AND ELECTRONIC TECHNOLOGY* 2-11 (1998).

“gun-jumping” claims and delaying the effectiveness of the registration statement.⁷

It is largely due to gun-jumping and market conditioning concerns that a prospective issuer must be especially cautious during pre-filing about the kinds of communications it posts on its web site. Financial projections, analyst reports and predictions of future earnings or value are becoming common components of many company web sites. While such information may be good for the company's public image, these types of communications are almost invariably considered definite “no-nos” by securities practitioners while a company is in the pre-filing period.⁸ Instead, securities practitioners urge extreme caution during this stage of registration. An issuer contemplating the making of an initial public offering should definitely institute specific procedures whereby the content of its web site is continually reviewed and any potential market conditioning information is purged during the registration process.

That seemingly simple statement gives rise to an important question, though — namely, what kinds of information should be purged? In a recent interpretation release, the SEC warned issuers in registration that they could potentially become liable not just for information posted by the issuers, but also for information on a *third party* web site that is accessible through the issuer's web site.⁹ In particular, the release states that “information on a third party web site to which an issuer has established a hyperlink that meets the definition of an ‘offer to sell’ . . . under Section 2(a)(3) of the Securities Act raises a strong inference that the hyperlinked information is attributable to the issuer for purposes of a Section 5 analysis.”¹⁰ Consequently, during the pre-filing period, and, indeed, throughout the registration process, an issuer must now be vigilant in monitoring not just its own web site, but also any third party web sites to which it may be hyperlinked.¹¹ There are obvious and

7. *See id.*

8. *See* Linda C. Quinn & Otilie L. Jannel, *Securities Regulation and the Use of Electronic Media*, in *SECURITIES LAW AND THE INTERNET* 869, 876 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998).

9. *See* Use of Electronic Media, Securities Act Release No. 33,7856 (May 4, 2000) (hereinafter the “May, 2000 Release”).

10. *See id.*

11. The May, 2000 Release, note 9, *supra*, defines a hyperlink as “an electronic path often displayed in the form of highlighted text, graphics or a button that associates an object on a web page with another web page address. It allows the user to connect to the desired web page . . . immediately by clicking a computer-pointing device on the [hyperlink].” *See* May, 2000 Release, *supra* note 9.

considerable problems, though, with attempting to effectively monitor a third party's web site. The issuer most likely has no control over the content of the third party site, nor any indication of how often it is updated. The prudent course may well be to disable any hyperlink to a third party web site while the issuer is in the process of registration.

What if the issuer has not yet created a web site, but has determined that it would like to go public? Many commentators say that the pre-filing period is not the time to launch a new web site, primarily because of the danger that the creation of the site could be construed as a publicity gathering gimmick aimed at potential investors.¹² For the same reason, an issuer with an established web site should be hesitant about materially expanding the current site during the pre-filing period.

An issuer with an established web site, however, is not paralyzed with respect to its ability to post new items to the site during pre-filing. Provided that the necessary safeguards are in place (i.e., close supervision and regular, consistent review of contents), issuers may continue to use their web sites for ordinary business communications and ordinary product promotion.¹³ In other words, an issuer may generally continue to use the web site in a manner that is consistent with its past use of the site. A word of caution must be heeded, though — hyperlinks to favorable articles, analyst reports, financial projections or favorable forecasts should be avoided at all costs. Heightened scrutiny is required with respect to these materials, as they could arguably be relied upon by potential investors in making a decision to invest in the company. It would be prudent for the issuer in the pre-filing period to eliminate hyperlinks and direct references to these sorts of materials from the web site. It does appear, however, that an issuer can continue to post product promotional materials *if the issuer has historically used its web site for that purpose*, so long as it does not overly "hype" the material or otherwise make excessively optimistic or enthusiastic projections about the product's or the company's performance.¹⁴

12. See Linda C. Quinn & Otilie L. Jarmel, *Securities Regulation and the Use of Electronic Media*, in SECURITIES LAW AND THE INTERNET 869, 876 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998).

13. See JOHN R. HEWITT & JAMES B. CARLSON, SECURITIES PRACTICE AND ELECTRONIC TECHNOLOGY 2-12 (1998). "Use of issuer Web sites [during the pre-filing period] should be consistent with past practices for ordinary course corporate communications and product and service promotion." *Id.*

14. See Linda C. Quinn & Otilie L. Jarmel, *Securities Regulation and the Use of Electronic Media*, in SECURITIES LAW AND THE INTERNET 869, 876 (Brandon Becker, Stephen J.

In addition, Rule 135 of the Securities Act allows an issuer contemplating a public offering to make limited public statements regarding the offer.¹⁵ Rule 135 is highly restrictive with regard to the kind of information the issuer is allowed to disclose, however. Most notably, any advertisement or statement issued in accordance with Rule 135 cannot contain the name of the underwriter(s) or the price of the securities.¹⁶ Assuming that the publication meets the stringent requirements of Rule 135, it should not be a problem if the issuer posts the publication on its web site during the pre-filing period.¹⁷

B. *The wait is on . . .*

Once a registration statement has been filed with the SEC, but before the statement has become effective, the issuer enters the "waiting period." During the waiting period, issuers can make oral offers, and can make written offers pursuant to a preliminary prospectus included in the filed registration statement, but are prohibited from making any sales.¹⁸ Issuers are prohibited from making an offer to sell securities outside of a prospectus that conforms to the requirements of Section 10 of the Securities Act.¹⁹ Section 2(b)(10) of the Securities Act defines a prospectus as any "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 . . ."²⁰ The SEC views communication via the Internet or email as being a written communication;²¹ hence, such communications must conform to the requirements for permitted written offers during the waiting period.²²

Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998).

15. See 17 C.F.R. § 230.135 (2000).

16. See, e.g., 17 C.F.R. §230.135(a)(2)(vi) (2000).

17. See, e.g., Linda C. Quinn & Otilie L. Jarmel, *Securities Regulation and the Use of Electronic Media*, in SECURITIES LAW AND THE INTERNET 869, 876 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998); JOHN R. HEWITT & JAMES B. CARLSON, SECURITIES PRACTICE AND ELECTRONIC TECHNOLOGY 2-13 n.I (1998).

18. See Solicitations of Interest Prior to an Initial Public Offering, Securities Act Release No. 33,7188 (June 27, 1995), 60 Fed. Reg. 35,648 (July 10, 1995).

19. See *id.*

20. Securities Act, 15 U.S.C. § 77b(a)(10) (1994).

21. See Linda C. Quinn & Otilie L. Jarmel, *Securities Regulation and the Use of Electronic Media*, in SECURITIES LAW AND THE INTERNET 869, 876 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998).

22. An extreme example of the dire consequences that could result from a careless or unwitting posting on the Net occurred in October of 1996. Wired Ventures, Inc., terminated its plans for a \$272 million dollar Initial Public Offering after an email written by the president to rally the troops before the IPO was leaked and posted on the Internet. See Deborah

An issuer may post a preliminary prospectus on its web site during the waiting period, but again, it must be cautious in doing so. Any material on the web site that is deemed outside of the prospectus, but which can be construed as an offer to sell securities is impermissible "free writing" and could subject the issuer to liability. In order to minimize the risk that the prospectus will be associated with other parts of the issuer's main web site, some commentators suggest the creation of a separate web page to post the preliminary prospectus. Others suggest that it is acceptable to post the prospectus on the issuer's main web site, but advise the issuer to include a *prominent* disclaimer that effectively negates any supposition that the prospectus is associated with or incorporates the remaining information on the site.

As is the case during the pre-filing period, issuers must be particularly attentive to hyperlinks to third party web sites during the waiting period. Of course, not every hyperlink to a third party site will result in potential liability.²³ The SEC recently addressed the issue of potential liability with respect to hyperlinks to a third party web site.²⁴ The Commission provided some guidance to issuers who are subject to the reporting requirements under the Securities and Exchange Act of 1934.²⁵ The SEC reminded issuers that they are "responsible for the accuracy of their statements that can reasonably be expected to reach investors or the securities markets regardless of the medium through which the statements are made, including the Internet."²⁶ Whether an issuer can also be held responsible for the content of a third party web site accessible through a hyperlink from its own site will depend upon whether the issuer was sufficiently involved with the preparation of the material or has expressly or impliedly adopted or endorsed the material. The SEC has developed two theories of liability with respect to third party information, regardless of the medium by

Lohse and Joan Indiana Rigdon, *Wired Kills IPO Amid Mishap with E-Mail*, WALL ST. J., Oct. 25, 1996, at C1. Although the company officially named market conditions as the reason for terminating the offer, the email had been posted on an on-line service with over 10,000 subscribers. *See id.* Securities lawyers were concerned that the email, although intended as an in-house communication, could be viewed as self-touting by regulators. *See id.*

23. *See* May, 2000 Release stating, "[w]hether third party information [accessible through a hyperlink] is attributable to an issuer depends on whether the issuer has involved itself in the preparation of the information or explicitly or implicitly endorsed or approved the information." *Id.*

24. *See id.*

25. Exchange Act, 15 U.S.C. §§ 78a-78mm (1994).

26. May, 2000 Release § B(1).

which it is communicated. The first is the "entanglement theory," and the second is the "adoption theory."²⁷

The entanglement theory is primarily concerned with how much pre-publication input or responsibility the issuer had for the information disseminated by the third party. The possibility of entanglement occurs most often in the context of analyst reports. The SEC addressed the issue of liability with respect to an analyst report in the 1997 case *In the matter of Presstek, Inc.*²⁸ Although *Presstek* involved a paper copy of an analyst report, the SEC has repeatedly stated that it will examine communications via electronic media by analogy to paper.²⁹

In *Presstek*, the SEC alleged that Robert Howard, *Presstek*'s founder and chairman, reviewed and edited a draft of an analyst report, but failed to correct misleading information contained therein.³⁰ *Presstek* thereafter distributed copies of the misleading report, both to shareholders at the annual meeting and to other members of the public, for a period of approximately six months. During that six month period, the price of *Presstek* stock was extremely volatile, sometimes jumping as much as fifteen percent in one day.³¹

One of the theories upon which the SEC based liability was entanglement.³² Discussing the premise of the entanglement theory, the SEC declared "[a]n issuer is liable for inaccuracies in a research report published by someone else if it 'sufficiently entangled itself' with such information to render [the information] attributable to the issuer."³³ The *Presstek* order further stated, "[w]e have no doubt that a company may so involve itself in the preparation of reports and projections by outsiders as to assume a duty to correct material errors in those projections."³⁴ Because *Presstek*'s president was instrumental in the preparation of the analyst report at issue, the SEC found *Presstek* liable for the misleading representations contained therein.

Presstek was also found liable under the "adoption" theory. While

27. *Id.*

28. In the Matter of *Presstek*, Exchange Act Release No. 34,39472 (Dec. 22, 1997) (hereinafter "*Presstek*").

29. See Use of Electronic Media for Delivery Purposes, Securities Act Release 4 n.II (October 6, 1995) (hereinafter "October, 1995 Release"); See May, 2000 Release §II(A) ¶ 2.

30. See *Presstek*, Exchange Act Release No. 34,39472 at 2.

31. See *id.* at 7.

32. See *id.* at 9.

33. *Id.*

34. *Id.*

the "entanglement" theory is based upon the issuer's level of participation in the pre-publication phase, the "adoption" theory is concerned with whether the issuer explicitly or implicitly adopted or endorsed the material *after* it was published.³⁵ In *Presstek*, the company allegedly distributed the analyst report and several favorable financial projections made by outside sources despite the fact that company insiders knew each contained inaccurate and misleading information.³⁶ The SEC claimed that by doing so, *Presstek* had adopted those projections, which constituted a violation of Section 10(b) of the Exchange Act and Rule 10b-5³⁷ promulgated thereunder.

The holding in *Presstek* alarmed some securities lawyers because they were unsure about the application of the entanglement and adoption theories to the Internet, and especially to hyperlinks to and from an issuer's web site. The SEC provided some measure of guidance with respect to both entanglement and adoption in the Internet context in its May, 2000 Release.³⁸ While refusing to establish a "bright line" mechanical test," the SEC discussed several factors that it will consider when confronted with possible adoption and entanglement issues in the context of a hyperlink to a third party web site.³⁹

First, the Commission will evaluate the context of the hyperlink on the issuer's web site. Factors such as the location of the hyperlink, the surrounding text, and descriptions relating to the link will all be considered by the Commission so that it may determine whether the information on the third party site is attributable to the issuer. The Commission will also examine the presentation of the hyperlink itself. Factors such as its size relative to other links, its color, font and graphic presentation are all relevant, as is whether the link is in-lined or framed. If an issuer situates a hyperlink in a manner so as to make it appear bigger, more attractive or more useful than other links, it may indicate that the issuer has adopted or endorsed the information. In such cases, the issuer risks having the content of the hyperlink attributed to it for liability

35. See *Presstek*, Exchange Act Release No. 34,39472 at 11-12.

36. See *id.*

37. 17 C.F.R. § 240.10b-5 (2000) states in relevant part: It shall be unlawful for any person, directly or indirectly, . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, . . . in connection with the purchase or sale of any security.

38. See May, 2000 Release at § II(B)(1).

39. *Id.*

purposes.

The SEC acknowledges that the presence of a disclaimer can aid it in determining whether the issuer has adopted the material on the third party site. The May, 2000 Release states:

[h]yperlinked information on a third party web site may be less likely to be attributed to an issuer if the issuer makes the information accessible only after a visitor to its web site has been presented with an intermediate screen that clearly and prominently indicates that the visitor is leaving the issuer's web site Similarly, there may be less likelihood of confusion about whether an issuer has adopted hyperlinked information if the issuer ensures that access to the information is preceded or accompanied by a clear and prominent statement from the issuer disclaiming responsibility for, or endorsement of, the information.⁴⁰

Issuers deciding to use a disclaimer to lessen the chances of liability by adoption should remain cautious, however. The SEC has made it clear that the presence of a disclaimer, standing alone, will not prevent a finding of adoption if other relevant circumstances exist⁴¹ which point in that direction.

While such guidance is probably only minimally helpful to the issuer who is trying to determine whether it is complying with the securities laws, it is at least a starting point for counsel when critically examining the content of a web site for possible violations. Prudent lawyering recommends that an issuer in registration minimize available hyperlinks from its web site, at least with respect to required documents. Issuers may want to consider totally disabling questionable hyperlinks, at least during the registration process, in light of the very real risks associated with them. If the issuer decides to include hyperlinks to third party web sites on its own site, it should utilize an intermediate screen that prominently warns viewers that they are leaving the issuer's site. In addition, it should further provide a clear statement disclaiming responsibility for or endorsement of any material on the third party site.

In the midst of the array of general factors it will consider when deciding whether an issuer has adopted third party information, though, the SEC gave issuers and securities lawyers one "bright line" factor. The Commission stated, in reference to documents required to be filed under the federal securities law, "we believe

40. *Id.*

41. *See id.*

that when an issuer embeds a hyperlink to a web site within the [required] document, the issuer should always be deemed to be adopting the hyperlinked information.⁴² With respect to required disclosure, then, the May, 2000 Release made it clear that hyperlinks to a third party web site contained in required documents will always result in adoption.

C. *Sell, sell, sell . . .*

The “post-effective” period begins when the registration statement is declared effective. Limitations on the issuer with respect to offers and sales are lessened considerably in the post-effective period. At that point, the issuer and the underwriters are allowed to consummate sales of securities.⁴³ During the post-effective period, issuers can continue to make offers to sell and can send supplemental material along with offers or confirmations of sales, so long as such materials are preceded by or accompanied by a final prospectus. As mentioned above, an issuer may post the preliminary prospectus on its web page. During the post-effective period, though, the issuer must be careful to ensure that material changes and new pricing information are reflected in the final prospectus, whether the prospectus is electronic or on paper.⁴⁴ In addition, issuers have the obligation to deliver a final prospectus with the confirmation of a sale of securities. How an issuer can satisfy its delivery requirements with respect to the final prospectus, and other mandatory disclosure, is taken up in Part II.

II. THE USE OF ELECTRONIC MEDIA FOR DELIVERY OF REQUIRED DISCLOSURE

The SEC first addressed the issue of delivery via electronic media in an interpretation released in October of 1995.⁴⁵ The SEC encourages the use of technology to facilitate the dissemination of information to investors and the public, and, as a result of that pol-

42. *Id.* In expanding upon its views, the Commission stated, “[w]hen an issuer includes a hyperlink within a document required to be filed or delivered under the federal securities laws, we believe it is appropriate for the issuer to assume responsibility for the hyperlinked information as if it were part of the document.” *Id.* at n.41.

43. See Linda C. Quinn & Otilie L. Jarmel, *Securities Regulation and the Use of Electronic Media*, in *SECURITIES LAW AND THE INTERNET* 869, 876 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998).

44. JOHN R. HEWITT & JAMES B. CARLSON, *SECURITIES PRACTICE AND ELECTRONIC TECHNOLOGY* 2-22 n.41 (1998).

45. See October, 1995 Release, note 28 *supra*.

icy, stated specifically in the October, 1995 release that "issuer or third party information that can be delivered in paper under the federal securities laws may be delivered in electronic format."⁴⁶ The Commission is less concerned with the medium employed for disclosure than with the adequacy of the resulting disclosure. Reminding issuers that one of the purposes of the federal securities laws is to "seek to promote fair and orderly markets by requiring the disclosure of material information that enables investors to make informed investment and voting decisions," the Commission set forth two requirements for adequate delivery of required disclosure.⁴⁷ First, the medium employed must "permit effective communication to investors," and second, it must be "practically available."⁴⁸

The SEC examines whether delivery is adequate by analogizing to traditional paper delivery.⁴⁹ Issuers may use electronic media to satisfy their statutory delivery requirements if "such distribution results in the delivery . . . of substantially equivalent information as [the] recipients would have had if the information were delivered to them in paper form."⁵⁰ Additionally, investors should be given the opportunity to retain a permanent copy of the disclosure, regardless of the medium through which it is delivered.

The three main factors the SEC considers when faced with a question of adequate delivery are notice, access and evidence of delivery.⁵¹ The electronic method chosen for delivery must provide the same degree of notice to the investor as would the delivery of an article through the U.S. Postal Service. Presumably, then, the electronic medium should be sufficient to alert the investor that new information exists and that he or she may have to take action with respect to the information.⁵² The Commission indicated in the October, 1995 Release that delivery of the electronic document itself — "for example, on a computer disk, CD-ROM, audio tape, videotape or email" — will generally satisfy the notice requirement.⁵³ With respect to a posting on the Internet, however, the SEC requires evidence of actual notice. The Commission indicated that

46. *Id.* at 6.

47. *Id.* at 6-7.

48. *Id.*

49. *Id.*

50. *See* October, 1995 Release at 7.

51. *See id.* at 8-10

52. *See id.* at 8.

53. *Id.*

the posting alone will not satisfy the notice requirement absent separate notice to the investor or other evidence of actual notice.⁵⁴

The analogy to postal delivery is again appropriate to questions of access. The investor who receives information via the postal service presumably has direct access to that information. The SEC will examine whether investors have comparable access to information delivered via electronic media.⁵⁵ Issuers are free to use electronic media for delivery of required disclosure, as long as the medium chosen is not so “burdensome that the intended recipients cannot effectively access the information provided,” and the investor is given the opportunity to retain a permanent copy of the information.⁵⁶ In other words, the information must be “practically available” to the intended recipient.

Some industry insiders were disheartened by the requirement that the medium employed not be “burdensome,” worrying that the requirement precluded the use of Portable Document Format, or “PDF.” PDF requires special software in order to view the information. The SEC condoned the use of PDF in the May, 2000 Release, so long as it is not unduly burdensome to access the information.⁵⁷ Issuers who wish to use PDF to deliver required disclosure can ensure that they meet the “unduly burdensome” test by informing investors of the need to download special software and by providing investors with “any necessary software and technical assistance at no cost.”⁵⁸

The SEC again analogized to the postal service when it discussed evidence of delivery. Ordinarily, when a document is sent through the postal service with the appropriate address and postage, delivery can be presumed.⁵⁹ Issuers who wish to use electronic media to comply with delivery requirements must obtain comparable evidence of delivery. The Commission listed some examples of satisfactory evidence in the October, 1995 Release, including obtaining an informed consent from an investor to receive the information through a required electronic medium, obtaining evidence that the investor actually accessed the information, and sending the information via facsimile.⁶⁰

54. *See id.* at 8 and Ex. 1.

55. *See* October, 1995 Release at 8.

56. *Id.*

57. *See* May, 2000 Release at § II A(3).

58. *Id.*

59. *See* October, 1995 Release at 8-10.

60. *See id.* at 10-11.

The issuer can obtain satisfactory evidence of delivery by means of email return receipt or confirmation of access. Also, if an investor uses a form that is accessible only through the electronic medium, the use of the form itself will constitute sufficient evidence of delivery. The easiest method of obtaining evidence of delivery, however, is by obtaining the informed consent of the investor to receive materials electronically.

Investor consent may be obtained via electronic, telephonic or written means.⁶¹ Regardless of the means used to obtain the consent, however, it will be sufficient evidence of delivery only if the consent is informed and specifies the type of electronic media to be used.⁶²

In order to provide informed consent, the investor must consent to the receipt of information via a specified electronic medium or media.⁶³ Additionally, the investor should indicate the period for which the consent is effective and the types of documents he is willing to receive electronically. He should be appraised of his right to revoke the consent and receive disclosure information in traditional paper format. Lastly, the issuer or broker who obtains the consent should retain a record of such consent, comparable to records kept to comply with delivery of paper documents.⁶⁴

The October, 1995 Release indicated that issuers can rely on informed consents supplied by investors to brokers and vice versa.⁶⁵ The release did not address, however, whether investors could give global consent to receive all documents of all types from all issuers represented by a single broker. The May, 2000 Release indicated that global consent to electronic delivery is acceptable and can be relied upon by the broker and the issuers, provided that the consent is informed.⁶⁶ The requirements for informed global consent are identical to those discussed above for individual informed consent. The SEC cautioned brokers, however, that a "global consent to electronic delivery would not be an informed consent if the opening of a brokerage account were conditioned upon providing the consent."⁶⁷ In such a case, the broker (and

61. See May, 2000 Release at § II.

62. See *id.*

63. See October, 1995 Release at 8-9 and attending footnotes; see also May, 2000 Release at § II.

64. See *id.*

65. See October, 1995 Release at n.29.

66. See May, 2000 Release at § II A(2).

67. *Id.*

issuer) would have to obtain evidence of delivery by another means, as the uninformed and mandatory consent would be insufficient to evidence delivery in and of itself.

III. SEC ENFORCEMENT AND AREAS OF IDENTIFIED RISK

How can an issuer subject to the reporting requirements of the federal securities laws ensure that its electronic communications satisfy those requirements? With respect to electronic media, what kinds of activities are likely to arouse the suspicions of the SEC and can potentially lead to issuer liability? These are the questions that confront corporate and securities practitioners daily, and the answers to them are vitally important if an issuer desires to avoid investigation and potential liability.

Unfortunately, the use of electronic media as a vehicle for the widespread, inexpensive dissemination of information to investors, and for capital raising in general, is so relatively new that administrative and legal guidance in this arena is scarce.⁶⁸ The Commission has made it clear that it will analyze transmissions made via electronic media much in the same way as it does those made via traditional paper delivery.⁶⁹ Notably, the SEC has sought no new rules, statutes or enforcement regulations to handle securities violations made via electronic media.⁷⁰ Instead, the Commission is confident that the current regulatory framework adequately encompasses the investigation and prosecution of securities violations made via these media, albeit with some necessary adjustments in application.⁷¹

By enforcing the federal securities laws, the SEC seeks to advance three general statutory goals: "ensuring full and fair disclosure to investors, promoting the public interest, . . . and maintaining fair and orderly markets."⁷² The primary weapons in the SEC's arsenal for furthering these goals and investigating and prosecuting securities violations are the anti-fraud provisions of the Exchange

68. See Harvey L. Pitt & Dixie L. Johnson, *Avoiding Spiders on the Web: Rules of Thumb for Issuers Using Web Sites and E-mail*, in *SECURITIES LAW AND THE INTERNET* 23, 25 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998).

69. See October, 1995 Release at 7.

70. See Joseph F. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, in *SECURITIES LAW AND THE INTERNET* 369, 371 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998).

71. See *id.* at 389.

72. May, 2000 Release at § I.

Act.⁷³ At this point in time, the Commission believes that the antifraud provisions in the Exchange Act are sufficiently broad to encompass fraudulent communications made via electronic media without modification.⁷⁴ Thus, although the means of communication has changed, the regulatory framework within which securities practitioners must work is the same for Internet and email communications as it historically has been for paper, radio or television communications.

The SEC's Division of Enforcement ("Division") is responsible for the surveillance of the Internet and for the detection and investigation of securities fraud in general. To help detect securities fraud over the Internet, the SEC created "Cyberforce," which is a team of over 200 people who are specially trained in detecting possible violations on the Net.⁷⁵ The Cyberforce works in tandem with the SEC's Office of Internet Enforcement to coordinate sweeps of the Internet, conduct surveillance, organize investigations and initiate enforcement actions.⁷⁶

Starting in 1998, the SEC began initiating prosecutions for fraudulent violations as a result of nationwide investigatory sweeps of the Internet. The first sweep, which culminated on October 28, 1998, resulted in the filing of enforcement actions against forty-four individuals and companies.⁷⁷ Accusations in the actions involved mainly violations of the anti-fraud and anti-touting provisions of the federal securities laws.⁷⁸ The kinds of Internet postings that gave rise to these enforcement actions were varied, but can generally be classified as either online newsletters, internet junk mail (called "spams"), chat room or message board postings, or web sites. The SEC accused the authors of these postings of a variety of violations

73. See Joseph F. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, in *SECURITIES LAW AND THE INTERNET* 369, 389 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practicing Law Institute, 1998).

74. See *id.*

75. See *id.* at 390; see also *SEC Steps up Nationwide Crackdown Against Internet Fraud, Charging 26 Companies and Individuals for Bogus Securities Offerings*, Press Release No. 99-49, <http://www.sec.gov/news/press/99-49.txt>.

76. See Joseph F. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, in *SECURITIES LAW AND THE INTERNET* 369, 389 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practicing Law Institute, 1998).

77. See *SEC Conducts First Ever Nationwide Internet Securities Fraud Sweep, Charges 44 Stock Promoters in 23 Enforcement Actions*, Press Release No. 98-117, <http://www.sec.gov/news/press/98-117.txt>.

78. See *id.*

— ranging from lying about the companies involved to selling their stock immediately following fraudulently created spikes in stock prices.⁷⁹

The Commission quickly followed its initial investigatory sweep with two more. In February and May of 1999, the SEC continued its aggressive campaign to stamp out Internet securities fraud by filing an additional eighteen enforcement actions against thirty-nine individuals and companies.⁸⁰ Again, most of the alleged violations involved fraudulent junk emails, web sites and message board postings. The May, 1999, sweep, however, specifically targeted sales of bogus securities via the Internet.⁸¹ In many cases, the SEC, through Cyberforce, uncovered the existence of the fraudulent investment schemes before potential investors lost any money. In speaking of the SEC's commitment to protecting investors from Internet securities fraud, the Director of Enforcement said, "[w]hile the Internet can make it easier for thieves to commit securities fraud, the Internet also puts the fraud in plain view, making it easier for the SEC to catch it."⁸²

So, what were the individuals and companies doing to arouse the interest of the SEC? The Commission alleged that the defendants were involved in a variety of fraudulent investment schemes, ranging from pyramid-type designs to offering "ground floor opportunities" to invest in high tech stocks and software.⁸³ In one case, an accused defendant used his web site to solicit investments while promising an 800% return within ten months — all supposedly risk free.⁸⁴ In another, an Italian entity allegedly engineered a spam pyramid scheme that promised a return of \$116,400.00 on an initial investment of only \$120.00.⁸⁵

79. *See id.*

80. *See SEC Continues Internet Fraud Crackdown*, Press Release No. 99-24, <http://www.sec.gov/news/press/99-24.txt>, and *SEC Steps up Nationwide Crackdown Against Internet Fraud, Charging 26 Companies and Individuals for Bogus Securities Offerings*, Press Release No. 99-49, <http://www.sec.gov/news/press/99-49.txt>.

81. *See SEC Steps up Nationwide Crackdown Against Internet Fraud, Charging 26 Companies and Individuals for Bogus Securities Offerings*, Press Release No. 99-49, <http://www.sec.gov/news/press/99-49.txt>.

82. *See id.*

83. *Id.*

84. *See id.* The SEC alleged that Theodore Pollard used a web site out of Palo Alto, California, to solicit investments in a "prime bank" program. *Id.* The SEC further alleged that Pollard promised investors a return of \$3,000,000.00 on an initial investment of \$35,000.00 in ten months, risk free. *See id.* Pollard refused to comply with judicial subpoenas and was fined for contempt. *See id.* After continued refusal to comply, a judge ordered a bench warrant for Pollard's arrest. *See id.*

85. *See SEC Steps up Nationwide Crackdown Against Internet Fraud, Charging 26*

Not all the violations uncovered by the SEC have been so blatantly and obviously fraudulent, though. For instance, the Commission filed a complaint in March, 1995, alleging that two partners raised more than three million dollars by selling securities relating to a worldwide telephone lottery.⁸⁶ The investors were contacted by telephone and through the Internet and were promised huge profits from the enterprise. The complaint alleged that the partners failed to disclose material obstacles to creating a worldwide lottery. Without admitting or denying the allegations, the partners agreed to repay investors and consented to a permanent injunction on their activities.⁸⁷

The lesson to be learned from the investigatory sweeps and resulting enforcement actions is that the SEC is out there and is aggressively prosecuting *all kinds* of securities violations on the Internet. In a press release announcing the second nationwide sweep and subsequent complaints, Richard Walker, Director of the SEC's Enforcement Division stated, "[i]f you are trying to cheat investors on the Internet, we are watching and we will catch you."⁸⁸ Walker's words also necessarily apply to issuers subject to reporting requirements under the federal securities laws. The issues might not be the same — meaning that few legitimate issuers will attempt to blatantly defraud investors by means of fraudulent investment schemes — but the results may be similar. One of the SEC's specific areas of concern is market manipulation.⁸⁹ An issuer

Companies and Individuals for Bogus Securities Offerings, Press Release No. 99-49, <http://www.sec.gov/news/press/99-49.txt>. "Spanning" is the practice of sending mass junk emails that contain a hard sales pitch that is often misleading or completely untrue. See Joseph F. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, in *SECURITIES LAW AND THE INTERNET* 369, 385-86 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998).

86. See *SEC v. Pleasure Time, Inc.*, Litigation Release No. 1440 (March 15, 1995); see also Joseph F. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, in *SECURITIES LAW AND THE INTERNET* 369, 391 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998).

87. See Joseph F. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, in *SECURITIES LAW AND THE INTERNET* 369, 391 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law Institute, 1998). The condition of repayment was eventually waived because the partners were unable to pay the investors back. See *id.*

88. See *SEC Files Four More Cases Against Purveyors of Fraudulent Spam, Online Newsletters, Message Board Postings and Websites in its Ongoing Effort to Clean Up the Internet*, Press Release No. 99-24, <<http://www.sec.gov/news/press/98-24.txt>> (February 25, 1999).

89. See Joseph F. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, in *SECURITIES LAW AND THE INTERNET* 369, 379-82 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practising Law

who intentionally or carelessly uses the Internet to condition the market during registration is in as much potential jeopardy as is the scammer who uses the Net to further a fraudulent investment scheme.⁹⁰ Both parties risk attracting the attention of the Cyberforce with all of the attending consequences.

In addition to surveillance of the Internet and prosecution of violations stemming from it, the SEC is also encouraging issuers to become active in self-policing.⁹¹ The Commission has recognized that self-policing is a particularly useful tool for patrolling an "increasingly large and complicated marketplace." To facilitate self-policing, the SEC created the "Enforcement Complaint Center," which opened in June, 1996. Internet users who suspect that an investment fraud is being perpetrated or who have complaints regarding disclosure or any other aspect of investing in securities can contact the SEC directly by email and submit an official complaint.⁹² The Enforcement Complaint Center is accessible through the SEC's homepage, and contains information about how to contact the SEC by mail, telephone and fax, and even includes an Internet fraud hotline number.

Additionally, the SEC is working with other administrative offices to increase public awareness and education with respect to Internet investment fraud. The Office of Education and Assistance, with input from the SEC's Division of Enforcement, has published an Investor Alert detailing common types of Internet investment fraud and offering suggestions on how to avoid becoming a victim. The SEC's homepage also contains links to various publications and investment aids.

CONCLUSION

Amid the fast paced world of technology, companies are caught up in a frenzied race to take advantage of the latest innovations in investor communications. The use of electronic media enables issuers to communicate with current and potential investors faster, more economically and more conveniently than ever before.

But, of course, there is a downside. Because of their enthusiasm and eagerness to utilize new communication technology, many

Institute, 1998).

90. *See id.* at 381-82.

91. *See id.* at 389-99. Self-policing has always been an important aspect of the Enforcement Division's program in contexts other than the Internet. *See id.*

92. The SEC's homepage is accessible at <<http://www.sec.gov>> and the Enforcement Division is accessible at <<http://www.sec.gov/enforce/comctr.htm>>.

companies are embarking upon the voyage into cyberspace without fully comprehending the possible pitfalls that could await them. The widespread use of the Internet and email is changing the shape of disclosure and communications today. Because the technology is so new, the legal environment is murky; it is full of uncertainty regarding the permissible parameters of electronic communications.⁹³

Of course, many corporate and securities practitioners are comfortable enough with the familiar rules and regulations contained in the federal securities laws to be able to competently counsel issuers on the subject of permissible electronic communications. Practitioners are not operating in a vacuum — they have the benefit of almost seventy years of jurisprudence and administrative procedures developed in different contexts to guide them. Even so, technological advances in communications will inevitably create novel issues for securities practitioners; and the race to implement the most cost effective and rapid means of communication could subject the unwary to adverse legal or regulatory scrutiny.⁹⁴

It appears that the most prudent course to take is one that combines enthusiasm for the new methods of communication with a healthy dose of caution. Aside from that general course, there are a few “rules of thumb” that practitioners can follow to minimize or eliminate the risks of potential liability.⁹⁵ First, during registration, issuers should be careful to ensure that all communications, electronic or paper, comply with applicable statutory regulations. With respect to a web site, issuers must be aware that any information posted on the site is subject to the same statutory and regulatory requirements as information disseminated through any other medium.⁹⁶ Also, the SEC has warned companies that hyperlinks to a third party web site could create problems of entanglement or adoption if the content of the third party site contains impermissible communications.⁹⁷ The use of intermediate screens and disclaimers may provide some protection for the issuer, as will mini-

93. See Harvey L. Pitt and Dixie L. Johnson, *Avoiding Spiders on the Web: Rules of Thumb for Issuers Using WebSites and E-mail*, in SECURITIES LAW AND THE INTERNET 23, 25 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practicing Law Institute, 1998).

94. See *id.*

95. *Id.*

96. See Linda C. Quinn & Otilie L. Jarnel, *Securities Regulation and the Use of Electronic Media*, in SECURITIES LAW AND THE INTERNET 869, 874-75 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practicing Law Institute, 1998).

97. See Use of Electronic Media, Securities Act Release No. 33,7856 (May 4, 2000).

mizing or eliminating links to analyst reports and favorable press that could potentially condition the market in the pre-filing stage.⁹⁸ The SEC has stated, however, that a hyperlink to a third party web site contained within a required document will always result in the issuer having adopted the content of the site. In such a case, a disclaimer is of no practical use.⁹⁹

A company with an established web site and a history of such use can continue to use the site for ordinary business communications during registration, but must be vigilant about monitoring the content of the site. It is essential that the issuer institute procedures to continuously monitor, update and purge information contained on the site as it becomes necessary in order to avoid statutory violations during registration.¹⁰⁰

Once registration is completed and the issuer is a reporting company, it may be convenient and economical to utilize electronic media to comply with disclosure requirements. The SEC has encouraged the use of electronic media because of the real potential to increase investor education and awareness and to enable investors to make informed decisions in a rapidly changing market.¹⁰¹ In order to comply with statutory disclosure requirements, though, the issuer must make sure that investors have adequate access to and notice of the availability of the disclosure.¹⁰² In addition, the issuer must have some evidence of delivery comparable to that which exists when a document is delivered to the investor via the postal system.¹⁰³ There are a variety of ways to evidence delivery. An issuer could obtain an informed consent to electronic delivery, it could require an electronic return receipt with email or otherwise obtain evidence that a document was accessed or used. The SEC is most concerned that electronic delivery of disclosure provide substantially equivalent information to investors as would paper delivery, that it permit effective communication and that it is practically available.¹⁰⁴

To protect itself, the issuer that desires to use electronic media for required disclosure should implement record keeping proce-

98. See JOHN R. HEWITT & JAMES B. CARLSON, *SECURITIES PRACTICE AND ELECTRONIC TECHNOLOGY* 2-11 (1998).

99. See May, 2000 Release at § II B(1)(a).

100. See JOHN R. HEWITT & JAMES B. CARLSON, *SECURITIES PRACTICE AND ELECTRONIC TECHNOLOGY* 2-11 (1998).

101. See May, 2000 Release at § I.

102. See October, 1995 Release at 8-11; May, 2000 Release at § II A.

103. See *id.*

104. See October, 1995 Release at 7-8.

dures that accurately confirm that the statutory requirements have been met.¹⁰⁵ Additionally, an issuer must still provide paper copies of disclosure to any investor who requests delivery in that form and to an investor that revokes his or her consent to electronic delivery.¹⁰⁶

Lastly, issuers and practitioners alike should be aware that the SEC is aggressively and vigilantly patrolling the Internet looking for fraudulent investment scams and other securities violations perpetrated through web sites, email and through chat rooms or message boards.¹⁰⁷ Most of the violations the SEC has thus far prosecuted have been glaring, but the Cyberforce and the Enforcement Division of the SEC are concerned with *all* kinds of securities violations. Companies should be aware that the day will come when the SEC and the Cyberforce turn their attentions from blatant and glaring fraud to more subtle and unwitting violations. When that day comes, it will be the issuer who has proceeded with the right mixture of caution and confidence into the brave new world of cyberspace that ultimately prevails.

Jennifer L. McDonough

105. *See id.*

106. *See id.*

107. *See* Joseph F. Cella & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, in *SECURITIES LAW AND THE INTERNET* 369 (Brandon Becker, Stephen J. Schulte & Michelle C. Wallach, Co-Chairs, Practicing Law Institute, 1998).