Does this scenario sound familiar? A friend tells you about a company that has a fantastic new product. You discover that this company is looking to expand, needs to raise capital and has decided to go public. Interested in cashing in on this new stock, you decide to call your broker to purchase shares of this company's initial public offering or “IPO.” You discuss your decision to purchase this stock with your broker, and he or she promises to put in an order to buy one-hundred shares as soon as it goes public.

The advent of trading securities over the Internet could change this scenario. On-line trading, which requires only a personal computer and an Internet connection, could spell the demise of the broker-client relationship as we know it. As the parties to an IPO become more comfortable and proficient with the Internet, the way in which Wall Street conducts business could undergo a major revolution.

This Comment discusses recent developments in securities trading on-line, evaluates the United States Securities and Exchange Commission’s (“SEC”) response to these developments, and urges the SEC to act quickly in proposing uniform, federal regulations to preempt state regulations governing on-line trading.

Part I provides an overview of the Securities Act of 1933, the Securities Exchange Act of 1934 (hereinafter “1933 Act” and “1934 Act” respectively), and their relationship to an IPO, in addition to outlining the reasons a company may select an IPO as its vehicle to raise capital. Part II examines current developments in trading and regulating securities transactions on-line. This section also alludes to future developments in cybertrading. Part III explains the SEC’s initial reaction to cybertrading, and argues that despite the SEC’s initial, positive reaction to electronic media, the agency has not addressed many regulatory issues critical to the future of on-line securities trading. This section also suggests a framework within which the SEC could provide regulatory guidance. Finally, Part IV of this Comment concludes that the SEC must act quickly to adopt uniform regulations governing securities trading in cyberspace, or risk losing the ability to effectively regulate securities traded via electronic media due to ever-changing technology and the Internet’s increasing and global audience.

I. RELATIONSHIP BETWEEN THE 1933 AND 1934 ACTS AND AN IPO

A. The Securities Act of 1933

Federal regulation of securities began as a reaction to the inability of blue sky laws6 to control securities fraud; the large number of fraudulently floated securities contributed to the Wall Street crash of 1929.7 As a result, Congress enacted the 1933 Act to prevent and control fraudulent sales of securities on a federal level.8 The scope of the 1933 Act is limited; the Act regulates the distribu-

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1 See generally Vanessa O’Connell & E.S. Browning, Stock Orders On Internet Poised to Soar, WALL ST. J., June 25, 1996, at Cl (explaining that the demand for trading stocks over the Internet may be increasing as a result of all of the stock chat on the Internet). Lycos, an Internet exploration tool, calculated that stock trading is among the top 10 subjects people search for on the Internet, and that the most avid users are “Generation Xers,” or people in their twenties. Id.

2 See ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 368 (5th ed. 1994) (explaining that a “blue sky law” is a state regulation governing securities. When the first blue sky law was enacted in 1911 in Kansas, it focused on regulating fraudulently valued securities).

3 Id.

tions of certain securities and protects purchasers of securities. The 1933 Act requires registration of an IPO with the SEC. The offering company must file a registration statement, consisting of a prospectus and any additional information about the company that is publicly available, but not included in the prospectus. In addition to the expense of complying with these disclosure requirements, an IPO necessitates hiring professional securities underwriters and securities firms for the process of distributing shares.

Despite the costs and complexities associated with an IPO, it remains a significant method of raising capital and affords a company distinct advantages, including creating a market for its shares. For instance, through a public offering, a company can finance research and development and raise capital for expansion.

Not only must the IPO comply with the registration requirements of the 1933 Act, it must also comply with blue sky laws in the states where the securities will be offered for sale to the public. Under the blue sky laws, each state has its own disclosure requirements that a company must satisfy before the shares can be offered for sale to that state’s residents. Hence, a fifty state public offering can be a daunting and expensive task.

B. The 1934 Act

Unlike the 1933 Act, which focuses on the initial issuance of securities, the 1934 Act extends federal regulation to securities that are already issued and traded in the secondary market. Securities trading in the secondary market traditionally occurs on registered exchanges. These secondary markets may take the form of an exchange-based market, which is a physical location where a specialist buys and sells the stock of a particular corporation. The New York Stock Exchange (the “NYSE”), the oldest exchange in the United States, is an example of an exchange-based market, and is the largest exchange with respect to the total capitalization of the shares traded on it. In addition to the NYSE, six other securities exchanges are presently registered with the SEC.

In competition with exchange-based markets are screen-based markets. A screen-based market is essentially a computer system whereby “market makers” quote the prices at which they buy and sell shares. An example of a screen-based market, significant disclosure obligations are required regarding previous transactions that the company may prefer not to make public. Id. 11

See Volarich, supra note 4, at 2236 (delineating the reasons a corporation may seek to raise capital through an IPO). See HAMILTON, supra note 2, at 372 (describing the process of “blue sky”ing an IPO).

13 Id.


15 See Volarich, supra note 4, at 2240 (providing an overview of securities trading in the secondary markets).

16 Id. at 2237 n.53 (stating that “a specialist is a firm that matches the buy and sell orders that come in, almost simultaneously, on an exchange.”)

17 See Volarich, supra note 4, at 2237.

18 Id. at 2240.

19 Id. The 1934 Act requires securities exchanges to register with the SEC, and gives the SEC supervisory powers over the exchanges. See RATNER, supra note 14, at 10.

20 See Volarich, supra note 4, at 2237-38 (contrasting exchange-based markets with screen-based markets).

21 Id.; see also John Downes & Jordan E. Goodman, Dictionary Of Finance And Investment Terms 351 (3d ed. 1991)
II. THE DEVELOPMENT OF ON-LINE SECURITIES TRADING

In recent years, the OTC market has represented the latest technological innovations in securities trading. However, the uncharted waters of Internet trading, absent any form of organized exchange, may now represent the latest technological innovations in the industry, and the biggest challenge facing regulators.

(definition "quotation")

A. Spring Street Brewery and Wit Capital Corporation

Spring Street Brewery ("Spring Street"), a New York City microbrewery whose IPO in February 1996 raised $1.6 million and sold $870,000 shares, does not seem significant in the world of Wall Street IPOs. However, its significance is that it was the world's first Internet public offering. To make the offering, Spring Street linked its official circular to its World Wide Web site, and anyone with a personal computer and a modem could examine the offering. Upon connection to its Web site, a potential investor could download the circular and the attached subscription agreement into his or her home. Once executed, the completed subscription agreement could be e-mailed back to the company. An unprecedented factor in this IPO was that Spring Street raised its $1.6 million without sharing any of the proceeds with Wall Street underwriters. Secondary trading of Spring Street's stock began March 1, 1996 through a Web-based bulletin board mechanism, called Wit Trade, that permitted investors to trade shares without using their brokers or paying commissions.

Along the same lines, Andrew Klein, founder of Spring Street, created Wit Capital Corporation to

23 Id.
24 Id. (discussing the operation of the OTC market).
25 Id.
26 Id. The bid price is the highest price the market maker will pay for a security, while the asked price is the lowest price at which the market maker will sell the security. See Downes, supra note 21, at 351. The spread is the difference between the bid and the asked price, which narrows or widens according to the supply or demand of the security that is offered. Id. at 427-28.
27 Id. (pointing out that although the NYSE is the largest market with respect to the total capitalization of the issues traded on it, the OTC market is the largest segment of the secondary market in terms of the number of issues traded).
28 Id. (offering a discussion of IPOs on the Internet, and stating that IPOs on the Internet have begun to proliferate because Wall Street presents a cost impediment for companies with small capital needs). For example, printing a prospectus can cost around $20,000 on top of other publishing, advertising, mailing, legal expenses and compliance costs associated with SEC and state disclosure requirements. Id. Through the Internet, issuers have a direct link to a vast, global audience, and maintenance of a Web site can cost as little as $185 per month. Id.
30 Id.
31 Id. Subscription agreements are used only to a limited extent today, usually in connection with raising capital of small, closely held companies with few investors. See Hamilton, supra note 2, at 332.
32 See Wit Capital News and Development, supra note 31; Section 2(11) of the 1933 Act, defines an underwriter as "any person who has purchased from an issuer... or offers or sells for an issuer in connection with, the distribution of any security[.]" Securities Act of 1933, 15 U.S.C.A. 77b (1994); see Hamilton, supra note 2, at 375. It is significant that none of the $1.6 million raised by Spring Street Brewery was shared with underwriters because, traditionally, underwriting fees can range from six to nine percent of the total offering. Jennifer Genevieve, U.S. Firms Seek On-Line Solutions to Raise Capital, Reuters News Serv., Feb. 28, 1996.
33 See Id.
become the world’s first investment bank dedicated to offering IPOs over the Internet.\textsuperscript{36} Although Wit Capital has a team of investment bankers and analysts who perform traditional functions such as deal structure and prospectus preparation, shares in an IPO offering arranged by Wit Capital are not distributed in the traditional manner.\textsuperscript{37}

In a traditional IPO, underwriters sell shares to institutional customers, and the institutional customers distribute these shares to public individual investors and small institutions, who must purchase through retail brokerages.\textsuperscript{38} In contrast, shares in public offerings arranged by Wit Capital will be offered and sold directly to the public through the posting of a prospectus and audio and video promotional material on Wit Capital’s Web site.\textsuperscript{39} By eliminating intermediaries and the cost of printing and distributing prospectuses, Wit Capital provides issuers a means to raise capital at a lower cost than through traditional methods.\textsuperscript{40}

Wit Capital also offers the opportunity for public investors to purchase IPO shares at fair prices without having to use traditional brokers or pay commissions.\textsuperscript{41} Wit Capital anticipates that this strategy will attract public investors and that client issuers will pay its fees and commissions.\textsuperscript{42}

Additionally, Wit Capital tries to offer the general public the opportunity to participate in IPOs on a “level playing field” with institutional investors, whereas, in a traditional IPO institutional investors buy the majority of the shares, leaving only a small portion for the retail market.\textsuperscript{43} As a further incentive to investors, the company operates at its Web site a “digital stock market through which investors having accounts with the Company will be able to buy and sell certain highly liquid NASDAQ and listed shares without being subject to the spreads of market-makers and specialists.”\textsuperscript{44}

Finally, by “routing orders to trade through its digital market, the Company . . . offer[s] retail investors trading prices that are better than the national best bid/ask prices” which will save its customers potentially thousands of dollars on each trade.\textsuperscript{45} Recently, Wit Capital Corporation formed Wit Brokerage as a wholly-owned subsidiary and has registered Wit Brokerage to become a broker-dealer.\textsuperscript{46}

B. The SEC’s Regulation of Wit Trade

Wit Trade, Spring Street’s bulletin-board stock trading system, began operations on March 1, 1996.\textsuperscript{47} Shortly thereafter, Spring Street voluntarily ceased trading, following the SEC’s request for time to study Internet trading.\textsuperscript{48} In a letter dated March 22, 1996, the SEC permitted Wit Trade to resume trading after the company agreed to revise its trading mechanism to comply with the SEC’s recommendations.\textsuperscript{49} Andrew Klein, Spring Street’s founder and president praised the SEC for its quick response in allowing Wit Trade to resume operations and for its support of “small business and innovative uses of

\begin{footnotes}
\footnote{Wit Capital Corporation: Introduction to the Company (last visited Feb. 8, 1997) <http://www.witcap.com> (explaining Wit Capital’s purpose, the method by which shares of stock are sold, and services the company hopes to offer in the future).}
\footnote{Id.}
\footnote{Id.}
\footnote{Id.}
\footnote{See Wit Capital Corporation, supra note 36.}
\footnote{Id. In an effort to easily access investor funds for investment in public offerings, Wit Capital intends to provide a brokerage business on-line. Id. In essence, Wit Capital will eventually offer its IPOs only to persons holding active accounts with the company, or with brokers affiliated with the company. Id. To entice investors to open accounts with it, Wit Capital will provide a variety of brokerage services at prices “at or below the most competitive rates in the discount brokerage industry.” Id.}
\footnote{Brewing Company Founder Cites Plans for Internet Investment Bank, Brokerage, BNA SEC. L. DAILY, Apr. 3, 1996, at D3.}
\footnote{See Wit Capital Corporation, supra note 36; see}
\footnote{Id.}
\footnote{See Wit Capital Corporation, supra note 36.}
\footnote{Id.}
\footnote{Id. A broker-dealer is defined as “an individual or firm acting as a principal in a securities transaction.” See Downes, supra note 21, at 99. Principals trade for their own account and, when buying from a broker acting as a dealer, a customer receives securities from the firm’s own inventory. Id. Since brokerage firms tend to operate as both brokers (defined as an intermediary between a buyer and a seller, usually charging commissions) and as principals, the term broker-dealer is typically used. Id. at 99.}
\footnote{Staff Clears Way for N.Y. Concern to Resume Stock Trading on Internet, 28 SEC. REG. & L. REP. (BNA) No. 13, at 437 (Mar. 29, 1996) (outlining the SEC’s reactions to Spring Street Brewery’s bulletin-board stock trading arrangement).}
\end{footnotes}
technology.\textsuperscript{50} The SEC, however, issued several recommendations in an attempt to regulate this novel form of trading. First, the SEC stated that because Spring Street Brewery is not a registered broker-dealer, it must relinquish control over investor funds by hiring an independent agent, such as a bank, to receive funds directly from purchasers.\textsuperscript{51}

Furthermore, reacting to fears that investors may not understand the risks involved in purchasing speculative securities, the SEC requested that Spring Street provide investors with ongoing disclosure about these risks, and make buyers aware of the last prices at which shares were sold.\textsuperscript{52} The SEC further requested that Wit Trade disclose to its investors that Spring Street's shares are not traded on a securities exchange and, as a result, the company's shares may be very illiquid.\textsuperscript{53}

Additionally, the SEC was concerned that Wit Trade's users could falsely appear to be "dealers" if they posted quotes on the buyer and seller bulletin boards simultaneously, thereby requiring compliance with federal and state broker-dealer regulations.\textsuperscript{54} As a result of this potential misrepresentation, the SEC required Spring Street to inform its users of this risk.\textsuperscript{55} The SEC pointed out that Wit Trade needed to develop and provide its investors with a "transaction history" to permit investors to make informed investment decisions.\textsuperscript{56}

Finally, the SEC recommended that Spring Street continue to use the exemption afforded by Regulation A, for compliance with the 1933 Act.\textsuperscript{57}

C. State Regulation of Internet Trading

Federal regulators are not the only party facing the challenge of regulating on-line trading; the fact that the Internet has a global audience also presents new problems for state regulators. Under normal circumstances, corporations going public cannot send prospectuses to residents of states where the offering has not been registered.\textsuperscript{58} In other words, a company is prohibited from distributing offering documents to a state resident unless the company has complied with all state registration requirements or is otherwise exempt from registering the offering in that particular state.\textsuperscript{59}

In light of the fact that an Internet IPO can be accessed by any individual with a computer and modem, many jurisdictional issues concerning regulation have yet to be resolved.\textsuperscript{60} Although these jurisdictional issues are not settled, state regulators maintain that on-line offerings are subject to state regulation.\textsuperscript{61} In the controversy prior to Spring Street's IPO, the Pennsylvania Securities Commission issued regulations that exempt offerings made on the Internet from state registration requirements if certain conditions are met.\textsuperscript{62} The Commission's objective was to create an atmos-

\textsuperscript{50} Id. In its no-action letter, the SEC looked favorably upon Wit Trade's mechanism that provides Spring Street's shareholders with greater liquidity in their investments. \textit{Id.}

\textsuperscript{51} \textit{Id.}

\textsuperscript{52} \textit{Id.}

\textsuperscript{53} \textit{See Spring Street Brewery Co., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) para. 77,201 (Apr. 17, 1996). See Downes, supra note 21, at 192 (defining "illiquid" as an investment not readily convertible into cash. For example, a stock not traded actively would be difficult to sell upon short notice, without taking a large loss).}

\textsuperscript{54} \textit{See Staff Clears Way, supra note 47. The 1934 Act defines "dealer" as "a person engaged in the business of buying and selling for his own account." See Ratner, supra note 14, at 174.}

\textsuperscript{55} \textit{See Staff Clears Way, supra note 47.}

\textsuperscript{56} \textit{Id. By transaction history, the SEC recommended that Wit Trade disclose to potential investors, via its computer system, both the price and number of shares executed in recent transactions. \textit{Id.} Along the same lines, the SEC instructed Wit Trade to keep records of all quotations posted on its bulletin boards and of "all securities transactions effected through use of the system and make them available to the SEC upon its request." \textit{Id.}}

\textsuperscript{57} \textit{See Staff Clears Way, supra note 47. Regulation A is a procedure issued by the SEC over 50 years ago for filing an IPO. See Osterland, supra note 29. Regulation A was designed to simplify the filing requirements for small companies. \textit{Id.} This regulation initially failed in its purpose, due to the conflict between the SEC and state blue sky laws over filing requirements. \textit{Id.} It is possible, however, that with the advent of Internet IPOs, which presently consist of small companies raising small amounts of capital, Regulation A may be resurrected. \textit{Id. See infra note 157.}

\textsuperscript{58} \textit{See Osterland, supra note 29, at 26-27 (discussing the difficulties for state regulators posed by the number of individuals who can access the Internet, irrespective of state boundaries).}


\textsuperscript{60} Osterland, supra note 29; see also Loeb, supra note 59, at 325-26.

\textsuperscript{61} Loeb, supra note 59, at 325. A consequence of state regulators asserting jurisdiction over Internet offerings is that an "issuer [looking to post] a prospectus on the Internet would have to register, or obtain an exemption, in all 50 states," since the Internet crosses state boundaries. \textit{Id.}

\textsuperscript{62} Bruce Rule, \textit{State Regulators Wrestle with Internet Issues, Investment Dealers' Dig.}, Oct. 21, 1996, at 1, 8 (outlining the struggles state securities regulators face, given the Internet's vast audience).
phere which would encourage Internet use in securities offerings, but thwart unintended violations of existing state regulations.63

The Pennsylvania regulations contain three orders that an issuer must adhere to, if it does not want to register and sell shares of its IPO in Pennsylvania.64 The issuer must place language in the Internet material which clearly states that the offering is not intended for Pennsylvania residents; the issuer "cannot have any direct communication with state residents;"65 and "the issuer cannot sell to Pennsylvania residents."66

Taking Pennsylvania's lead, the North American Securities Administrators Association ("NASAA") is advising states to adopt standardized regulations that would permit companies to offer new issues over the Internet, provided that the issuer is clear about where it is registered to sell the offering.67 Under a NASAA proposal issued in January 1996, each state securities commission would have the ability to consider an unregistered company's Internet material as an offering in its state; however, each state securities commission would have the power to exempt the material, as long as the company clearly notes that it is not trying to sell in that state.68 Additionally, NASAA is drafting a proposal to assist brokers and dealers who decide to publicize or disseminate information to potential investors on-line.69 The proposal will contain language permitting brokers and dealers to go on-line, as long as they specify in which jurisdictions they are transacting business.70

NASAA's position has not been regarded favorably by everyone in the securities industry.71 Some commentators argue that, despite NASAA's efforts to create uniform regulations among the states molded after Pennsylvania's guidelines, inconsistencies will nonetheless result among different jurisdictions and between federal and state regulations that will present obstacles to issuers trying to arrange an on-line IPO.72 These commentators strongly suggest that Congress or the SEC should regulate on-line IPOs by developing uniform guidelines to preempt state regulations.73 As expected, NASAA strongly opposes any Congressional or agency action that would preempt the states' regulatory authority concerning on-line offerings, believing the issue to be well within the scope of the states' regulatory powers.74

D. Securities Fraud in Cyberspace

In its October 1995 release regarding the "Use of Electronic Media for Delivery Purposes," the SEC noted that the liability provisions of the federal securities laws which have traditionally applied to paper-based media apply equally to the dissemination of information over electronic media.75 For instance, the antifraud provisions of Delivery Purposes (asking the SEC to adopt rules preempting state securities laws in the area of on-line offerings); see Use of Electronic Media, infra note 75.


63 Id.
64 Id.
65 Id. For example, if a Pennsylvania resident finds the Internet offering material and sends an e-mail to the company, the company must not respond. Id.
66 Id. The Pennsylvania Securities Commission indicated that the basic point of these regulations is to require an issuer of an on-line IPO to show that it is registered in the states in which it intends to conduct business. Id.
67 Rule, supra note 62. The North American Securities Administrators Association ("NASAA") has formed a four person committee to clarify and examine issues relating to Internet securities materials. Id. One of the committee's present goals is to see that all state regulators receive more Internet training. Id.
68 Id. At the time Rule's article was written, all but five states had adopted this language, or were in the process of adopting it. Id.
69 Id.
70 Id.

73 See Weirick, supra note 71.
74 Id. (reviewing a portion of NASAA Comment Letter, supra note 72).
75 Use of Electronic Media For Delivery Purposes, 60 Fed. Reg. 53458 (Oct. 15, 1995) (publishing the SEC's views concerning the use of electronic media as a means of delivering information required under the 1933 Act, the 1934 Act, and the Investment Company Act of 1940). The SEC believes that electronic distribution of information enhances investors' ability to "access, research, and analyze" information, has enabled small investors to communicate quickly with companies, and has enhanced the efficiency of the securities markets by allowing the markets to operate in a more "cost-efficient, widespread, and equitable manner than traditional paper-based methods." Id. See generally Merrill Lynch Comment Letter, File No. S7-31-95, (Dec. 1, 1995) (praising the SEC for encouraging the development and use of electronic media to satisfy disclosure requirements).
the federal securities laws as set forth in Section 10(b) of the 1934 Act and Rule 10b-5 apply to any information delivered electronically, and Section 17(b) of the 1933 Act applies to any report circulated on the Internet ("antifraud provisions").

Accordingly, the Internet has become a priority for the SEC's Enforcement Division in its efforts to prevent fraudulent investments. SEC Commissioner Steven Wallman recently noted that the growth of the Internet and technological advances has required regulators to take a proactive role not only in staking out fraudulent investments on the Internet, but in educating investors to avoid fraudulent investments. Consequently, regulators are beginning to realize that, although it has become cheaper and easier for legitimate companies to offer securities to the public on-line, it is equally easy for perpetrators of fraudulent securities to gain access to willing investors.

For instance, the SEC prosecuted an individual who posted a bond offering through America Online which promised a twenty-percent return for investing in an eel farming business. The individual displayed glowing endorsements from fictitious investment advisors and encouraged investors to send checks. The Complaint, filed August 7, 1995, charged that, through a misleading and false solicitation on the Internet, Daniel Odulo sought investors for a $500,000 offering of $1,000 denomination bonds. The SEC further charged that the solicitation contained "material misrepresentations." For example, Odulo claimed that the bonds were very low risk and failed to disclose that the company was not an established company, but a proposed venture. He also declined to note that he had no prior expertise in the field. As the SEC suspected, Odulo did not possess any eels.

In a separate enforcement action, the SEC charged Donald Spencer, the founder, president and majority shareholder of IVT Systems, Inc., with violating the antifraud provisions of the federal securities laws. More specifically, the SEC charged Spencer with fraudulently promising...
large returns on investments and making other material misrepresentations to investors over the Internet. 87 Spencer used the Internet to solicit investments, representing that the investments would be used to finance the construction of a proposed ethanol plant in the Dominican Republic. 88 Spencer promised a 50% return, but provided no support for this forecast. 89 Moreover, he distributed information to potential investors which contained misrepresentations, including that the company had contracted with various consultants to facilitate representations that would not occur in the on-line market.

As a result of Spencer’s violations, the SEC sought to permanently enjoin him from violating the antifraud provisions and to disgorge from him and IVT all funds that were misappropriated. 91

A final example of the type of fraudulent investments in cyberspace targeted by the SEC’s Enforcement Division is SEC v. Gene Block. 92 Using the Internet, Block promised to double investors’ funds in four months by trading nonexistent “Prime Bank” instruments. 93 Block lured investors by representing that their “initial investments were guaranteed against loss because a ‘Prime Bank Guarantee’ would secure the transaction.” 94 The “Prime Bank” guarantee was nonexistent, and the SEC obtained sanctions against Block in the form of an asset freeze, a temporary restraining order, and an order requiring an accounting and reimbursement of investor funds. 95

In light of these fraudulent schemes in cyber-

space, the SEC’s Enforcement Division has implemented new policing strategies. 96 The Enforcement Division has added a Complaint Center to its Web page, which provides basic tips on investing and explains the process of filing a complaint with the SEC, to aid the Enforcement Division in its task of targeting fraudulent investment schemes on-line. 97 Additionally, the Enforcement Division added an “Investor Alerts” section to its Web page, which warns investors of recently reported fraudulent investment schemes on-line. 98

E. The Future of On-Line Investing

1. The Proliferation of On-Line Trading

How fast is on-line investing expected to grow? Forrester Research states that 120,000 investment accounts exist on the Internet today, but predicts that by 2001, there will be 9.3 million accounts, equivalent to 8 1/2% of the total retail market. 99 Furthermore, Forrester predicts that servicing these accounts will be mid-tier brokers100 who will provide service and advice at an inexpensive price that cannot be matched by the large, full service firms. 101 In addition to the inexpensive prices, mid-tier brokers will employ a new class of investment advisor; an advisor with a series seven license, 102 but with technical skills instead of the sales skills desired by full service brokers. 103 This should enhance the mid-tier brokers’ ability to gain a substantial percentage of the retail mar-

87 Id.
88 Id.
89 Id.
90 Id.
91 See Spencer, supra note 86. The remedies used by the SEC for on-line violations of the antifraud provisions include disgorgement of funds and injunctive relief. Id. These remedies are the standard remedies sought by the SEC for violations of the antifraud provisions, including those which did not occur in the on-line market. See, e.g., Securities and Exchange Commission v. First Jersey Securities, 101 F.3d 1450, 1474-76 (2d Cir. 1996) (discussing appropriate remedies for violations of the antifraud provisions, including disgorgement and injunctive relief).
93 Mathews, supra note 77, at 20-21 (discussing the types of fraudulent investments the SEC's Enforcement Division has prosecuted).
94 Id.
95 Id.
96 Id. at 22.
97 Id.; see Complaint Center (last visited April 27, 1997)
99 See SEC’s Enforcement Division, Investor Alerts (last visited April 27, 1997) <http://www.sec.gov/enforce/inva.htm> (continuing to list the “Prime Bank” scheme discussed above).
100 Kimberly Weisul, Report: New ‘Mid-Tier’ Brokers to get 60% of On-Line Trades, INVESTMENT DEALERS’ DIG., Sept. 30, 1996, at 1, 11 (predicting that “mid-tier brokers,” a soon-to-develop class of brokers between discount brokers and full-service brokers, will have captured 60% of on-line accounts by 2001).
101 See id. (defining a mid-tier broker).
102 Id. (stating that mid-tier brokers will offer trades for a flat rate between $30 and $75, while full service brokers will still charge commissions which average $150 to $300 per trade).
103 See DOWNES, supra note 21, at 361 (defining and listing the qualifications to become a registered representative). Once an employee of a broker-dealer has acquired a background in the securities business and has passed a series of tests, including the series seven examination, the employee may act as an account executive, or as a broker for clients. Id.
104 See Weisul, supra note 99.
In fact, electronic brokerage firms contend that it is only a matter of time before systems for true Internet trading become commonplace, where sellers and buyers meet directly at a Web site, bypassing existing securities exchanges.\(^{104}\) Wit Capital’s Andrew Klein foresee substantial growth for on-line trading; he eventually plans to link mini-exchanges with both on-line brokerage firms and banks that offer deposit accounts on the Internet for the purpose of selling securities on-line.\(^{105}\) Mr. Klein and other on-line trading firms hope to one day charge investors “almost nothing” to trade equities and other securities, producing revenue instead by permitting “insurance companies, lenders and others to advertise on their [Web] sites.”\(^{106}\)

2. The Full Service Firms’ Perspective Regarding the Proliferation of On-Line Trading

In contrast to the on-line brokerages, full service firms argue that most investors will remain with their full service brokers, rather than flock to on-line brokers.\(^{108}\) They claim that the talk of on-line trading forcing the demise of the broker-client relationship is not accurate.\(^{109}\) For instance, the full service firms insist that on-line trading appeals to only a small portion of investors and that the investing community in general is far from comfortable conducting business on-line.\(^{110}\)

Additionally, while conceding that the less expensive price may entice certain investors, the full service firms believe that retail investors as a whole will continue to want advice about their overall financial situations that full service firms provide.\(^{111}\) Consequently, full service providers do not feel threatened; they are analogizing the threat of on-line investing to the advent of “fixed commissions” by the discount brokerages back in 1975, which was supposed to be a “death knell” for the full service brokerages.\(^{112}\) Fixed commissions were by no means the end of the full service firms’ dominance in the retail market; however, over a period of time, it did change the full service brokers’ commission strategy.\(^{113}\)

Smith Barney, a prominent full service firm, has been on the Internet since September 1995, and argues that its clients only want to use the Internet for information, and not for trading.\(^{114}\) A large majority of its clients ask for twenty-four hour access to information about their accounts and for the ability to e-mail their financial consultants; however, Smith Barney claims that very few clients have asked for on-line trading.\(^{115}\)

The bottom line for the full service firms seems to be that, until many clients threaten to leave the firms because they do not provide on-line trading, these firms will delay their entry into the on-line market.\(^{116}\) And so far, only one full service firm, Winston Rodgers & Otalvaro, offers on-line trading in comparison to the discount brokerages, who are moving rapidly into the on-line market.\(^{117}\)

In spite of the full service firms’ view, many in


\(^{105}\) See O’Connell, supra note 1. Presently, over a dozen electronic brokerages are taking orders over the Internet. Id. Some are affiliated with larger discount brokerages, such as Charles Schwab, while others are “electronic trading specialists,” such as E*Trade and K. Aufhauser. Id.


\(^{107}\) Id. Mr. Klein commented that brokerage fees on the Internet are declining and eventually will be near zero because the “cost of each additional transaction [on-line] is so minuscule.” Id.

\(^{108}\) See generally Rule, supra note 104.

\(^{109}\) Id.

\(^{110}\) Id. at 15. Furthermore, Merrill Lynch, a prominent full service firm, claims that it is only young investors who feel comfortable investing on-line and, demographically, older investors have the assets to invest. Id. As a result, the firm believes that the demand for on-line trading will not escalate until the younger generation begins to acquire assets, which is in the distant future. Id. However, despite Merrill Lynch’s arguments, the firm recently indicated that it hoped to have on-line trading mechanisms in place in 1998. Merrill Lynch, Wash. Post, Mar. 4, 1997, at C2.

\(^{111}\) See Rule, supra note 104.

\(^{112}\) Id. at 14-15 (explaining the comparison between the threat of on-line investing to the beginning of fixed commissions).

\(^{113}\) Id. at 15-16.

\(^{114}\) Id. at 17.

\(^{115}\) Id.

\(^{116}\) Rule, supra note 104, at 15.

\(^{117}\) Id. at 16. A leading discount brokerage firm, Charles Schwab, reports that 27% of all of its trades are electronic. Id. Jack White & Co., whose on-line trades total 30% of its business, expects that the percentage of its on-line trades will grow to 40% by the end of 1997’s first quarter (last visited April 27, 1997) <http://pawws.com/jwc/>. Id. Additionally, E*Trade, whose trades are all executed on-line, reports that its number of clients has increased 186% from September
the securities industry foresee the Internet becoming an important part of the way full service brokers conduct business. Since brokers' business involves both taking orders and offering analysis and guidance, on-line trading may allow brokers to concentrate exclusively on analyzing the market and giving better investment advice, since they will not need to take the time to execute trades. Harvard Business School Professor Samuel Hayes believes that the dominance of full service brokers will erode gradually but not overnight. He argues that advocates of on-line services "underestimate the value of the broker's bedside manner, [and therefore] on-line trading will probably only 'nibble at the edges' of the full-service firm's business.

Several full service firms concede that they are aware of the trend toward on-line trading, but that several obstacles need to be overcome prior to offering these services. The first obstacle is the broker-client relationship; full service firms must determine how the on-line execution of trades would fit into their clients' overall portfolio, including the question of how to structure commissions under a new system. The second obstacle is technology. Clearly, the Internet can handle simple transactions such as stock trades; however, large firms like Smith Barney would need to integrate the trades that are executed on-line into a client's overall portfolio, which includes assets aside from equities. To perform these tasks on-line, without fear of exposing their clients to potential invasions of privacy concerning privileged financial information, these brokerage firms need to develop systems with a higher level of security than is currently available on the Internet.

Therefore, it is possible that full service firms are reluctant to enter the on-line arena due to these costly, resource intensive obstacles, and not because they do not foresee clients demanding these services in the near future.

3. Development of a Trade Association

One of the newest developments in the on-line securities industry is the formation of a trade association comprised of Web-based securities underwriters. Under the name, National Internet Securities Association (NISA), this association's goal is to provide a "unified front" for on-line underwriters and consultants trying to secure SEC approval. NISA represents small, start-up companies like Wit Capital and plans to assist these new issuers by establishing a Web site with a roundtable discussion of securities regulation issues and providing a central depository for SEC no-action letters and SEC news. Through this mechanism, NISA hopes to facilitate the means by which new issuers can raise capital on the Internet while fully complying with SEC regulations.

III. FEDERAL REGULATION OF SECURITIES TRADING IN CYBERSPACE

A. Regulation Through the No-Action Letter

With respect to securities trading on-line, the SEC has selected to regulate through no-action letters, instead of providing across the board regulations governing the on-line market. Although this technique assures compliance for the specific entity that requested the no-action letter, this method of regulation falls far short of providing

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118 Id. at 18 (discussing a middle ground position between the views of the small on-line firms, that full service brokers will become obsolete, and the full service firms' view that, even if on-line trading increases, it will not occur for quite some time).
119 Id. On-line supporters predict that full service brokers will eventually focus solely on analysis and guidance because the younger generation, proficient and comfortable with computers, will have no need to pay full service firms much higher prices to execute their trades. Id.
120 Id.
121 Id.
122 Id. (discussing these obstacles).
123 See Rule, supra note 104, at 19.
124 Id.
125 Id.
126 Id.
127 See Weisul, supra note 27.
128 Id. The association states that it does not want to infringe on the SEC's territory, but believes that since Internet-based underwriting and exchanges present many new issues to be resolved, the SEC could use the group's assistance. See id. For instance, NISA states that it could review submissions from issuers looking to raise capital over the Internet and, as a result of reviewing issuer submissions, NISA believes that its approval on Internet IPOs would give credibility to new issuers when dealing with the SEC. See id.
129 See Weisul, supra note 27. NISA intends to help new issuers by listing service providers such as accountants, attorneys, research firms and consultants on its Web site. Id.
130 Id.
uniform, industry-wide standards.\footnote{131} On February 17, 1995, the SEC issued an important pronouncement concerning the delivery of prospectuses for public offerings registered under the 1933 Act.\footnote{132} This pronouncement, considered a landmark decision by the SEC, was a no-action letter in which the SEC approved the use of "electronic prospectuses."\footnote{133} The SEC issued the no-action letter in response to a request by the law firm of Brown & Wood, asking whether the prospectus delivery requirements of the 1933 Act could be satisfied by an underwriter or a dealer "downloading into a computer the complete text of a prospectus and making the prospectus available to customers through" on-line services.\footnote{134}

The request letter indicated that a prospectus encoded in an electronic format constituted a "prospectus" pursuant to Section 2(10) of the 1933 Act, and stated that an electronic prospectus was "written" pursuant to the definition of "written" in Section 2(9), which includes the term "graphic communication."\footnote{135} The SEC staff agreed that Sections 5 and 10 of the 1933 Act include an electronic prospectus; however, the SEC placed several conditions pertaining to content, consent procedure, and terms of access on the delivery of prospectuses to customers electronically.\footnote{136}

What is the impact of prospectuses delivered electronically? Many in the industry believe that the SEC's acknowledgment of electronic delivery could revolutionize the way in which all documents pertaining to a public offering are provided to customers.\footnote{137} First, broker-dealers may be able to achieve substantial time and cost efficiencies, and facilitate the distribution not only of prospectuses, but also of supplementary sales literature, research material, and, in connection with certain types of securities, analytic and computational materials.\footnote{138} Second, issuers will clearly benefit from cost-effective electronic delivery of prospectuses in connection with securities offerings, since printing fees will be reduced.\footnote{139} Finally, the SEC's affirmative response to electronic delivery will stimulate competition among on-line vendors and Internet "gateways" to develop more efficient delivery systems.\footnote{140}

B. SEC Interpretive Release Regarding Electronic Delivery of Information

Following the Brown & Wood no-action letter, the SEC issued an interpretive release ("October Interpretive Release") and related rule proposals concerning the use of electronic methods to deliver or transmit information under the federal se...
curities laws.141 This Release expressed the SEC's views on the electronic delivery of prospectuses and annual reports to shareholders, and directed the Division of Market Regulation to review Rule 10b-10142 to determine when electronic delivery would be feasible.143 In light of the fact that the federal securities laws seek to promote fair markets by prescribing the disclosure of material information which enables investors to make informed decisions, the SEC, in its October Interpretive Release, stated that it would view information distributed via electronic means as satisfying the delivery requirements of the federal securities laws, as long as this method of distribution results in the delivery to the intended recipient of substantially equivalent information as the recipient would have if the information had been delivered in paper form.144 Moreover, the SEC stipulated that broker-dealers and investment advisers145 must closely supervise personnel and implement procedures to prevent and detect misconduct in connection with the delivery of information electronically.146

On the surface, the SEC's acceptance of electronic delivery does not seem to be a dramatic leap forward in the regulation of on-line trading. However, when viewed in combination with its timely response in allowing Wit Trade to resume operations, it appears that the SEC has reacted positively, and has embraced the application of advanced technology to securities trading.

C. Firms Urge the SEC to Promulgate Internet Regulations

Despite this initial, positive response to on-line trading, the SEC has yet to address many issues which would permit investment firms to move into this arena. Instead, the states have taken the lead and issued regulations, without any assurance of whether these state regulations will be compatible with the SEC's future regulation in this area.147 For example, major brokerage and law firms have repeatedly urged the SEC to take a more proactive role in developing federal regulations regarding use of the Internet.148 In particular, industry commentators feel that the SEC should be constantly monitoring the flow of information between issuers, broker-dealers, investment advisers and clients to determine whether electronic communication and distribution of information is "effective, secure and in the public interest."149

The law firm of Sullivan & Cromwell suggested that the SEC's approach in its October Interpretive Release did not sufficiently address potential federal securities law liability and state securities laws issues regarding on-line delivery.150 Addition-

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142 See Rule 10b-10, supra note 138 for a brief description of Rule 10b-10.


144 See Securities Act Rel. No. 7233, 60 Fed. Reg. 53458, 53460 (1995). The SEC explained that as long as the documents are prepared and delivered in a manner in compliance with the federal securities laws, the SEC will not specify the electronic medium that broker-dealers, investment advisers and transfer agents must use. See id.

145 See DOWNES, supra note 21, at 209. Investment advisers or investment advisory services provide investment advice for a fee. Id. Investment advisers must register with the SEC, and follow the rules promulgated in the Investment Advisers Act of 1940. Id. Investment advisers may specialize in a particular type of investment, such as international stocks, mutual funds, etc. Id.; see THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 626-27 (1985) (stating that the

146 See Use of Electronic Media, supra note 143, at 24,645 n.5.

147 In fact, in a keynote address in New York on Oct. 30, 1996, Commissioner Wallman discussed Pennsylvania's regulations of on-line trading which are already in place, and admitted that the SEC needs to begin thinking about the issue and "what to do about it." Electronic Media: Wallman Urges Consideration of Offerings Published Offshore on Internet, SEC L. DAILY (BNA), Nov. 1, 1996, available in Westlaw, BNA-SLD Database.


149 Id. The comment letters to the SEC regarding the October Interpretive Release touch on issues ranging from hosting chat rooms on financial sites to methods of downloading prospectuses, but, across the board, financial firms are encouraging the SEC to expand its rulemaking regarding the Internet beyond its first release on the subject, the October Interpretive Release. Id.

150 Sullivan & Cromwell argues that, without further guidance from the SEC in the area of on-line services, issuers and market participants may be reluctant to use electronic media, thereby frustrating the SEC's intention of welcoming the use of these services. Id.
ally, several firms have urged the SEC to draft "safe harbor" provisions that would give securities firms and issuers guidelines concerning electronic delivery. A few industry commentators predict that firms may not use the electronic delivery capabilities espoused by the SEC in its October Interpretive Release without the safe harbor.

Furthermore, Sullivan & Cromwell is one of many firms worried about the state securities regulators who have jumped ahead of the SEC on the issue of regulating on-line securities. The firm argues that since most states have issued regulations and have asserted state jurisdiction over Internet offerings which clearly cross all state lines, this may deter firms from posting IPOs on-line. Thus, Sullivan & Cromwell and other firms believe that the only solution is for the SEC to issue regulations preempting state laws regarding prospectus dissemination over electronic media and on-line offerings. Even if the SEC agrees and decides to promulgate federal regulations, the question remains, by what means should IPOs and on-line trading be regulated?

D. Possible Means of Federal Regulation

The SEC's most likely route for initial regula-

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151 See Downes, supra note 21, at 386 (defining "safe harbor" as a "provision in a law that excuses liability if the attempt to comply in good faith can be demonstrated. For example, safe harbor provisions may protect management from liability under [SEC] rules for financial projections made in good faith.").

152 See Lux, supra note 148.

153 Id. For instance, suppose an investor reads a prospectus posted on an underwriter's Web site, but instead purchases the offering in the secondary market from a different dealer. Id. That investor could assert a claim against the issuer or underwriter. Id. Accordingly, the SEC has been encouraged to provide a "safe harbor" provision to state that such a posting would not create "publication or delivery to persons other than to those whom the issuer or underwriter has a preexisting delivery obligation." Id.

154 See Lux, supra note 148.

155 Id.

156 Id. NASAA, who has rejected the notion of federal preemption and advocates uniform state regulations modeled after Pennsylvania's law, has not reacted favorably to this suggestion. Id.; see generally Weirick, supra note 71. In fact, state regulators have gone as far as stating that issuers need to observe state registration requirements for an IPO, before they can consider the use of electronic media. Id.

157 Regulation A - Conditional Small Issues Exemption, 17 C.F.R. §§ 230.251-265 (1996); see Weirick, supra note 71 (discussing the use of Regulation A to govern on-line IPOs).

158 See generally Weirick, supra note 71.

159 See Spring Street Brewery Co., supra note 53. In its no-action letter to Spring Street, the SEC noted that the "Regulation A exemption may be used in connection with a service such as Wit-Trade" and stated that Wit-Trade's approach in using Regulation A would continue to be acceptable. Id. at para. 77,002. The SEC instructed Wit Trade to consider its guidance for electronic delivery delineated in its October Interpretive Release. Id.

160 See generally Weirick, supra note 71.

161 See id.

162 See John K. Hoyts, Deciding Whether To Go Public: Certain Basic Considerations, in HOW TO PREPARE AN INITIAL PUBLIC OFFERING, 7, 18-19 (Practising L. Inst. 1996). Prior to the 1992 Small Business Initiative, the ceiling on Regulation A issue was $1.5 million; it was only increased to $5 million in 1992. See Hamilton, supra note 2, at 386. But see Regulation D - Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.501-508 (1996) (stating that this exemption requires "Accredited Investors," defined under § 230.501 to include, inter alia, any bank, saving and loan institution, broker-dealer, insurance company, companies with assets in excess of $5 million or a natural person whose net worth at the time of purchase exceeds $1,000,000). Id. at § 230.501. See Hamilton, supra note 2, at 380-81. See also Hamilton, supra note 2, at 384 (discussing § 230.505 under Regulation D, entitled "[e]xemption for limited offers and sales of securities not exceeding $5,000,000," which requires not only accredited investors, but also demands that there can be no more
tive to small, on-line issuers. Under the 1933 Act, Rule 254, issuers may publish factual information concerning the company and its business and solicit interest in the offering prior to filing the Registration A offering document. Start-up companies like Spring Street Brewery may take advantage of this option because it affords a low-cost, effective means of finding investors prior to the expense of filing the offering statement with the SEC. Once the offering statement is filed, however, the issuer will no longer be able to "test the waters" with solicitation materials and must wait twenty days between using these materials and selling securities. Despite the favorable provisions under Regulation A for small issuers, they should be aware that all solicitations under Regulation A are subject to the "antifraud and civil liability provisions of the federal securities laws."

Another possible method to regulate on-line offerings that the SEC has not explored is Regulation S. Regulation S exempts from the 1933 Act registration requirements offers and sales of securities outside the United States. Although this provision appears as though it may not apply to many offerings, a question emerges: does the global aspect of an offering in cyberspace entirely preclude the possibility of an on-line, Regulation S offering? It is certainly a question that on-line issuers would like to have answered.

Another avenue to regulate on-line offerings is to amend provisions of the 1933 Act, so that the provisions pertain specifically to on-line offerings. The SEC has debated this idea. The former Director of the SEC's Division of Corporate Finance stated that regulatory restrictions on offers, such as those disseminated over the Internet, may be unnecessary, provided that "investors have an opportunity to receive information mandated by the Act before making their investment decision" and assuming that offering materials would not force investors to overlook required disclosures. Regulations of this nature, which decrease the burdens new issuers face, would certainly encourage small issuers to use the Internet as the means to launch their offerings.

The bottom line is that, although the SEC appeared to welcome the application of electronic services to securities offerings in its October Interpretive Release, this single document falls far short of providing those in the securities industry with the guidance necessary to conduct on-line offerings in a fair, cost-effective manner. So far, the states have taken the lead and asserted jurisdiction over global on-line offerings which could present an insurmountable obstacle to many potential issuers who would otherwise turn to electronic media as a source to raise capital.

E. Constraints on the SEC's Ability to Regulate the Electronic Market

While electronic media holds great promise and may represent the future of securities trading, a number of unresolved issues must be addressed. Notwithstanding broad questions re-

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169 Id. "Regulation S is available only for offers and sales of securities outside the United States. Securities acquired overseas, whether or not pursuant to Regulation S, may be resold in the United States only if they are registered under the [1933 Act] or an exemption from registration is available." Id. at 588.

169 See Loeb, supra note 59, at 325 (discussing the possibility of a Regulation S offering on-line).

171 See generally id. (presenting regulatory questions the SEC has not answered concerning the Internet).

172 See Weirick, supra note 71 (addressing the fact that, given the novel issues that have emerged in connection with on-line offerings, in particular, the problems raised by the global nature of on-line offerings, the SEC may need to revise or redraft provisions of the 1933 Act to cover on-line offers).

173 As referenced above, the former Director of the Division of Corporate Finance is Linda Quinn. Id.

174 See generally Lux, supra note 148.

175 Id.

176 Bradley D. Belt, From the Industrial Age to the Information Age: Rethinking the Regulation of Securities Markets, WASH. Q. 19, 115 (Summer 1996) (tracing the development of the securities markets and addressing the issues regulators must
REGULATING SECURITIES TRADING IN CYBERSPACE

Garding the regulation of issuers in cyberspace, the unsettled issues pertain to topics such as security, objective-setting, liability, and jurisdiction. It is clear that on-line offerings and trading merit regulatory oversight. In fact, Wall Street is all but demanding that the SEC act quickly. However, several factors exist which may constrain the SEC's ability to efficiently oversee the developing on-line market.

The first constraint is the increasing power of the global markets. This not only presents jurisdictional issues, such as state versus federal regulation, but begs the question of whether the existing securities regulations have become or are on their way to becoming obsolete. For instance, at the recent Center for Strategic and International Studies Conference ("CSIS") on "The New Frontiers of Finance," a panelist noted, in support of the argument that our existing securities laws are becoming obsolete, that the 1933 Act was a government attempt to restrict "information dissemination." However, in light of the global and electronic marketplace, the SEC cannot restrict information and yet, the 1933 Act remains in force. Hence, should the SEC not permit the use of limited offering exemptions on-line, but instead eliminate the 1933 Act and begin with a clean slate in response to the drastic changes in the market?

A second constraint is federal regulators' willingness to engage in actual regulation of securities trading via electronic media. One panelist at the CSIS conference vehemently stated that the regulatory question should not be put off until the future. Another panelist stated that regulators need to focus on regulation now, for two reasons; first, because it does not make sense to wait until crises occur before regulating and, second, because technology can eventually be fragmenting. Consensus regarding regulation is possible now, but if regulators wait until technology develops further, consensus may never be possible.

In response to these criticisms, SEC Chairman Arthur Levitt claims that in many areas pertaining to technological developments, regulators have "hit a statutory wall" in that they lack the statutory authority to respond to new developments. Whether this is truly the case is the focus of an ongoing debate.

Taking this criticism to heart, however, Congress has passed legislation intended to give the SEC authority to react quickly to changes in the marketplace by providing the SEC with general exemptive authority regarding registration requirements, and the appropriate framework within which to regulate the global and increasingly electronic securities markets).

177 See generally Lux, supra note 148.
178 See Belt, supra note 176, at 118 (discussing the SEC's limitations which will profoundly affect its ability to regulate the electronic market).
179 For example, open systems or publicly accessible systems like the Internet present new questions with respect to the liability of underwriters and issuers. See Loeb, supra note 59, at 324 (discussing potential liability issues that may stem from systems accessible to large audiences, such as the Internet). A liability issue arises when an issuer permits potential investors to access its prospectus on a Web site, and an individual peruses the prospectus but instead buys the security in the secondary market, rather than from the underwriter involved in the offering that the purchaser viewed on the Internet. If the disclosure in the prospectus turns out to be inadequate, the question arises as to whether this purchaser can assert a valid claim against either the underwriter or the issuer. Id.
180 Id. at 122-23.
181 Belt, supra note 176, at 6 (prepared for the Washington, D.C. office of Thacher Proffitt & Wood) (on file with the CommLaw

CONSPECTUS) [hereinafter CSIS Notes].
182 See Belt, supra note 176, at 117-20; see generally CSIS Notes, supra note 182.
183 Ms. Elaine A. LaRoche is Managing Director, Morgan Stanley & Co., and Chairman of the Public Securities Association. See CSIS Notes, supra note 182, at 5.
184 See CSIS Notes, supra note 182, at 5. Ms. LaRoche also stated that technology can be a "very fragmenting instrument" and argued that if regulators do not act quickly to regulate, they will never "catch-up" due to the rate of technological development. Id. at 5-6.
186 Id. at 9. Mr. Solomon insisted that regulation should take place now because "technology and the instantaneous flow of information has exacerbated the volatility between these linkages and regulatory structures are not yet designed to handle the speed and volume with which problems could multiply." Id. Hence, Mr. Solomon argues that it is preferable to act quickly to address these regulatory issues now, instead of waiting until a crisis occurs. Id.
187 Belt, supra note 176, at 120.
quirements under the 1933 and 1934 Acts. Senator D'Amato, one of the original Senate bill's sponsors, stated that the legislation was designed to "make it easier to raise capital in the securities market" and to "tighten up regulation by giving the states and the SEC distinctly separate regulatory roles." Whether this exemptive authority will allow the SEC's regulation in the area of on-line offerings to completely preempt the states' regulations remains to be determined.

The third constraint on the SEC's ability to regulate electronic markets is the lack of private sector and human resources. The SEC does not possess the resources or the technological capabilities to keep up with the growth of the electronic markets, which are fueled by private sector resources. Considering the budget constraints in the federal government, this situation is unlikely to improve any time in the near future. With respect to human resources, it will become increasingly crucial for the SEC to hire individuals experienced with technological innovations in securities trading, given the pace of change in both the markets and market related technology. Wall Street and investment companies world-wide are actively recruiting world-class computer scientists and financial theorists, and are offering them very large salaries. In light of the pay disparity between these firms and the federal government, it is questionable whether the SEC can attract the necessary human capital to effectively regulate the ever-changing, technology driven marketplace.

The final constraint on the SEC's ability to effectively regulate the electronic marketplace is temporal. Notoriously, federal regulators' decision-making cycles are much longer than those of the private sector, which has the ability and the capital to adapt to change very quickly. As a result, federal regulators face the difficulty of invariably attacking "yesterday's problem[s]." Consequently, it is imperative for the SEC to act quickly and begin regulating in the area of securities trading over electronic media. Should they fail in this task, the pace of technology may escape their grasp; the result being that they never catch-up, and are instead addressing "yesterday's problems." The more disastrous effect of failing to immediately regulate in this area is, as a panelist at the CSIS Conference noted, that the fast flow of information could result in crisis, and the necessary regulatory controls may not be in place to sufficiently resolve the problem, causing irreversible damage to the marketplace.

F. Framework Within Which the Electronic Marketplace Should Be Regulated

Beginning with regulating securities trading online, regulators need to review existing laws and reexamine their approach to regulation going into the next century. Given the pace of technological development, federal regulators need to establish regulations which reflect new market practices and are adaptable to change in order to accommodate the electronic markets. A federal regulatory mandate which encompasses the

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190 See CSIS Notes, supra note 182, at 6. Robert R. Glauber, Adjunct Lecturer, Center for Business and Government, Harvard's Kennedy School of Government, and Director of the Federal Reserve Bank of Boston, expressed his view that with the authority to react quickly given to the SEC in Senate Bill 1815 (Senate Bill 1815 has been incorporated into the National Securities Markets Improvement Act of 1996), the present 1934 Act will be able to accommodate the changes in both technology and the marketplace. Id. Whether the general exemptive authority given to the SEC will be sufficient to allow any exemptive regulation of the SEC in the area of online offerings to preempt the states regulation (such as the regulation by Pennsylvania) remains to be seen. Id.; National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C. (1996)); see Pub. L. No. 104-290, 110 Stat. 3451 (1996) (listing that Senate Bill 1815 and House Bill 3005 were incorporated into this legislation).


192 See Belt, supra note 176, at 118.

193 Id. The annual budget of the SEC is just over $300 million, which is very small compared to private sector resources which are allocated toward innovative technology in this field. Id.

194 Id.

195 Id. at 118-19. The SEC will desperately need to attract individuals experienced with the most updated technology in trading systems and "risk management techniques." Id. at 119.

196 Id.

197 See Belt, supra note 176, at 118.

198 Id.

199 Id. The private sector in the securities industry must adapt to technological change very quickly; the nature of the perpetually changing market forces it to do so. Id.

200 Id.

201 See Belt, supra note 176.


203 See generally Belt, supra note 176, at 118.

204 Id.
following principles may permit the SEC to afford meaningful regulation to the ever-changing, electronic securities market.\(^{205}\)

First, regulation of securities trading via electronic media should "facilitate capital development, not impede it."\(^{206}\) The goal of capital markets is to "transfer capital from suppliers to users, from investors to business," and regulation should assist this operation by ensuring that markets operate efficiently, cost-effectively and fairly for all participants.\(^{207}\)

A second principle that regulators should contemplate is the need to strike a balance among competing goals.\(^{208}\) The SEC's primary concern has always been investor protection.\(^{209}\) In contrast, the Commodity Futures Trading Commission's ("CFTC") focus is market efficiency, an industry-wide objective.\(^{210}\) However, since IPOs online are uncharted waters, on-line issuers also need protection.\(^{211}\) Therefore, it is crucial for the SEC to alter its traditional policy and effectively balance these competing interests between investor and issuer in a manner which will allow the market to operate efficiently, while offering protection for all parties.\(^{212}\) This balancing of interests dictates that the SEC should adopt a broader, industry-wide focus.\(^{213}\)

A third principle that federal regulators should consider is that "the benefits of regulation should exceed the costs."\(^{214}\) A well designed regulatory system should generate investor confidence in the market, preserve market efficiency, and protect against fraud.\(^{215}\) Unregulated markets have not enjoyed the success the United States has in attracting investors and, at the same time, history has proven that "overregulation prices participants out of . . . [one] market [and] into other markets."\(^{216}\)

The fourth principle that federal regulators must recognize, particularly in the area of on-line offerings, is that regulations should be integrated or synthesized.\(^{217}\) For instance, unnecessary securities laws should be eliminated, and the suggestion to integrate all federal securities laws into a single, comprehensive statutory body has surfaced.\(^{218}\) But, where would this idea leave the state regulations in the area of on-line IPOs? SEC Chairman Arthur Levitt stated that there should be a more rational division of responsibility between federal and state regulators; in the era of global markets, it is unreasonable to have fifty-two sets of standards.\(^{219}\)

The final issue that regulators should consider in drafting new regulations to cover the electronic, global securities market is that regulation should "provide clarity and certainty to market participants."\(^{220}\) Regulation by no-action letters generates confusion as to what actions are permissible, since no-action letters have no precedential value.\(^{221}\) Not only does regulation by no-action

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205 Id.
206 See Belt, supra note 176, at 120 (explaining that "design principles" of regulation in the age of electronic media should be flexible, but sturdy enough to withstand change and satisfy the needs of issuers and investors).
207 Id. Traditionally, the SEC has viewed investor protection as its primary, if not its exclusive concern. Id. However, as securities trading takes on a more technological and global nature, the SEC should take into consideration the effects of its actions on the efficiency of the markets globally. Id. at 120-21.
208 Id. at 121 (discussing the competing interests of investors and issuers).
209 Id.
210 See Belt, supra note 176, at 121. Moreover, in contrast to the SEC's traditional policy of investor protection, the banking industry's regulations, like those of the CFTC, have reflected a broader focus; the safety and soundness of the banking system. Id.
211 Id. (stating that, in the age of electronic offerings, "overreliance on one approach may come at the expense of other, [equally important] considerations").
212 Id.
213 Id.
214 See Belt, supra note 176. Regulation, by its nature, imposes costs on those regulated. Id. Nonetheless, responsible regulation may contribute to advancing the process of capital formation. Id.
215 Id. Some commentators believe that the SEC gives only minimal consideration to the costs of proposed regulations and their impact upon the regulated. Id. For example, the SEC has been criticized as failing to engage in exacting cost-benefit analysis before proposing rule changes. Belt, supra note 176.
216 Id. An overregulated market tends to discourage issuers by raising the cost of capital beyond an optimal rate of return. Id.
217 Id. at 122.
218 Id. (discussing the proposal by the American Law Institute to integrate all securities laws in this manner).
220 See Belt, supra note 176, at 122-23 (discussing the SEC's presumed preference to regulate situation by situation, in lieu of issuing industry-wide regulations).
221 Brickney, supra note 131, at 503 n.86. Following the release of the Brown & Wood no-action letter, see supra note 133, the SEC did issue the October Interpretive Release, thereby applying the information in the Brown & Wood no-action letter concerning electronic delivery of prospectuses to the industry as a whole. Id. However, the SEC has been criticized for not issuing Interpretive Releases often enough;
letters generate confusion, but failure to establish
industry-wide regulations creates unnecessary ex-
penses in terms of excess legal advice and litiga-
tion.  

Consequently, to maintain the competitiveness
of the U.S. markets, the SEC should issue across
the board regulations and understandable rules
which encourage issuers to use on-line mecha-
nisms to offer their securities.  

However, federal regulators should keep in mind that too
much regulation can produce problems, such as micromanagement.  

Therefore, regulation
should afford market participants the ability to
operate their businesses in accord with economic
considerations.  

IV. CONCLUSION

The United States securities markets have ex-
perienced a dramatic transformation with the ad-
vent of on-line securities trading. As a result, this
new market needs a regulatory framework that en-
able both market participants and regulators to
effectively face the challenges posed by the ever-
changing world of technology.

To implement this new regulatory framework,
the SEC must act quickly to draft regulations
which will assist market participants to compete
on a global level. This implies that the SEC will
issue regulations to preempt the states' regula-
tions concerning on-line offerings. Should fed-
eral regulators permit the states to assert jurisdic-
tion over a medium that is global in nature, do-
main and foreign issuers will be dissuaded
from taking advantage of this new opportunity to
raise capital, and the implications from this could
be enormous. The growth of small business in
the United States and the development of new
technology to offer and trade securities will be sti-

fled. Moreover, on a larger scale, should individ-
ual states continue to impose unnecessary restric-
tions and foreign governments decide not to
impose these unnecessary restrictions over the In-
ternet, our markets will become less competitive,
and the United States may sacrifice its dominance
in the global marketplace.

Furthermore, should the SEC not enter the reg-
ulatory arena of cybertrading quickly, the pace of
technological development will escape from its
grasp and, as a result, the SEC may never catch-up
and gain the ability to provide meaningful regula-
tion over this medium. As a consequence, the
SEC will be perpetually regulating yesterday's
problems.

131. 

222 See Belt, supra note 176, at 123. 
223 Id. 
224 Id. 
225 Id.