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COMMENT

SEcurities FRAUD OVER THE INTERNET: THE FLIES IN THE OINTMENT AND A HOPE OF FLY PAPER

Kevin Mason*

I. INTRODUCTION

Even though relatively few Americans have used it,¹ and even fewer have used it to purchase anything,² the Internet appears to be everywhere nowadays. Every major advertisement on television includes the sponsor's web-site, and even representatives of such prosaic businesses as tire-retreaders³ and sellers of 78-rpm records⁴ have their fingers in the on-line pie. The future is described as a "cyber-future"; the net as "the bringer of economic salvation."⁵ Soon, we are told, goods,⁶ services, and even our investments⁷ will be routinely and cheaply purchased in the

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¹ See Clifford Stoll, Silicon Snake Oil, 16-17 (1995) (noting that while some have stated the number of Internet users as very high, this is a "gross exaggeration" as the actual number is not known, but is probably much lower). But see Alexander C. Gavis, The Offering and Distribution of Securities in Cyberspace: A Review of Regulatory and Industry Initiatives, 52 BUS. LAW., 317, 319-20 (Nov. 1996) (describing the number of PC owners and the expectation of that number growing dramatically).

² See Stoll, supra note 1, at 106-07. While the traditional London International Financial Futures Exchange is slightly less efficient than its fully automated and on-line German equivalent, the Deutsche Terminborse, London handles three times as many trades. Id. at 92-94.


⁵ See Stoll, supra note 1, at 9-10 (describing and criticizing the National Infrastructure Initiative Progress Report's glowing predictions of a "reduc[tion] of health care costs by some $36 billion per year, prepar[ing] our children for the knowledge-based economy of the 21st century, add[ing] more than $100 billion to our Gross Domestic Product over the next decade, and add[ing] 500,000 new jobs by 1996").

⁶ See, e.g., Online Marketplace, <http://www.jup.com/newsletter/ marketplace/feature.shtml> (visited on Apr. 18, 1998) (stating that while the Internet has generally not lived up to its hype, on-line catalogs may soon eclipse paper-based catalogs in dollar volume of sales.)

⁷ See Christina K. McGlosson, Comment, Who Needs Wall Street? The Dilemma of Regulating Securities Trading in Cyberspace, 5 COMMLAW CONSPECTUS 305, 312
privacy of our homes, via computer network and modem.

One obstacle preventing the effective implementation of this vision is, as anyone who has posted e-mail messages to a bulletin board knows, the problem of "junk mail." Newsgroups are inundated with messages advertising unwanted products and services and pyramid schemes are abundant.

One can buy everything from athletic shirts to cars on-line. That sooner or later someone would decide to offer securities is a given; moreover, as the Internet is a cheap and anonymous means of mass communication, it should also come as no surprise that the Internet provides a convenient vehicle for securities fraud.

So if the Internet is so packed with dubious offers and get-rich-quick schemes, why would any honest issuer want to distribute securities on-line? The fact is, the net offers many obvious advantages (and some less obvious ones) to the issuer of securities and to secondary markets. The Internet has the potential to provide an efficient means of marketing (1997) (quoting Forrester Research as stating that by the year 2001 there will be 9.3 million Internet investment accounts). To some extent this is already becoming a reality, as many investment firms maintain on-line databases or even take orders on-line. See, e.g., <http://www.deanwhitter.com> (visited on Apr. 18, 1998).


"Newsgroups" are text-based, Internet discussion groups, similar to computer bulletin boards, and contain a series of posting from various users, about a given topic. Newsgroups are located on a network known as "Usenet" rather than on the Internet. See also Harley Hahn & Rick Stout, The Internet Complete Reference 554-56 (1996). For an example of a newsgroup, see, e.g., rec.audio.tubes.

Some examples I have personally encountered include psychic consultation type services, sales of machine tools, requests for charitable donations, and advertisements for phone-sex lines.


See Stoll, supra note 1, at 56-57 (stating it is difficult to learn the identities of those on the Internet as it is easy to be anonymous and no identification is required to be on-line). It is even possible to set up a non-existent computer, complete with accounts, files, and password protection on the Internet. Computer security monitors at AT&T did this in order to "trap" a hacker. See William R. Cheswick & Steven M. Bellovin, Firewalls and Internet Security: Repelling the Wily Hacker 167-79 (1994).
investments, especially for smaller issuers, but only if some of the problems currently endemic in the system can be solved.

Two of the thorniest problems in Internet marketing and distribution of securities are fraud and the general lack of confidence in on-line investing.

Part I of this Comment details several legitimate attempts to market securities on-line. Part I also tackles the question of why the Internet has the potential to provide a dynamic securities market. Part II examines the response by the Securities and Exchange Commission (SEC) to Internet attempts at marketing securities and electronic dissemination of disclosure documents. Part III briefly discusses types of Internet securities fraud and other problems inherent in the electronic investment marketplace. Part IV outlines a proposed partial solution to attempts at fraud and how it relates to and goes beyond such legitimate offerings of securities as discussed in Part I. Finally, several shortcomings inherent in my proposed solution are discussed.

II. Two Steps Forward: The First Internet-Based Securities Distributions and Creation of the First Internet-Based Secondary Markets

In February of 1996, Spring Street Brewery became the first issuer to market an Initial Public Offering of securities (IPO) on the Internet.14 Spring Street's subsidiary, Wit Capital, became the world's first investment bank dedicated to securities offerings over the Internet.15 Spring Street sold its small initial subscription of $1.6 million in common stock entirely over the Internet,16 and more importantly, Spring Street sold its

14 See Yadley, supra note 8, at 197-98.
16 See Wit Capital Corporation, supra note 15. However Spring Street's $1.6 million capitalization is small compared to the $3 trillion in domestic pooled funds. See Betty Krikorian, Fiduciary Standards in Pension and Trust Fund Management 36 (2d ed. 1994). Additionally, despite the novelty and publicity associated with Spring Street's position as the first Internet-based IPO, it took Spring Street several months to completely sell its subscription. See Wit Capital Corporation, supra note 15. Traditional IPOs, using underwriters, may sell out as quickly as under an hour. This fact suggests that even with Spring Street's qualified SEC approval, the investing public is not especially confident in the viability, reliability, or value of the on-line investment. However, some of Spring Street's difficulties in selling out its subscription may have stemmed from inaccurate pricing of its IPO. See generally Ernest Bloch, Inside Investment Banking 223-25 (2d ed. 1989) (discussing the wildly inaccurate price of Morgan Stanley's 1986 IPO).
securities without the use of, and consequently without paying any commission to, underwriters. An investor with Internet access merely had to download Spring Street’s prospectus, complete the forms included in the prospectus, and e-mail the forms back to Spring Street. Spring Street provided a secondary market for its securities via a web-based bulletin-board called Wit-Trade.

Wit Capital has since formed a subsidiary, Wit Brokerage, and has registered Wit Brokerage as a broker-dealer, all with the intention of profiting from a much-hoped-for boom in Internet-based securities marketing and issuing. Wit-Trade voluntarily shut down soon after commencement of operations, following a request by the SEC. After discussion and some changes, Wit-Trade was allowed to resume business a few days later.

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17 See generally 15 U.S.C. § 77(b)(11) (Law. Co-op. 1983) (An underwriter is "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking . . ."). See also William J. Grant, Jr., *Overview of the Underwriting Process, in Securities Underwriting* 25, 28 (K. Bialkin & W. Grant eds., 1985) (explaining that underwriters’ fees can range between one and thirteen percent of the value of an IPO).

18 Delivery of a prospectus at or before confirmation of sale of a security is required for all such sales of securities, unless some exemption exists. See 15 U.S.C. § 77(e) (law. Co-op. 1983). A prospectus is defined 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 . . . ." 15 U.S.C. § 77(b)(10) (Law. Co-op. 1983).


20 See id.

21 See *Wit Capital Corporation, supra* note 15. See also Securities and Exchange Act of 1934, 15 U.S.C. § 78(c)(a)(4 and 5) (Law. Co-op. 1983) (defining “broker” as “any person engaged in the business of effecting transactions in securities for the account of others . . . .” and defining a “dealer” as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise . . . .”).


23 See *Staff Clears Way for N.Y. Concern to Resume Stock Trading on Internet*, 28 SEC. REG. & L. REP. (BNA) 437 (1996) [hereinafter *Staff Clears Way*].

24 See id. Wit-Trade’s founder, Andrew Klein, a former securities attorney, praised the SEC’s willingness to work with his company and with Internet-based trading sys-
The next tentative step towards the development of a full-fledged Internet-based investment market came in June of 1996, when a company calling itself Real Goods Trading Corporation set up an electronic bulletin board to facilitate the sale of its stock. Real Goods is traded on an exchange, but the stock price and stock offerings of Real Goods have suffered from the effects of poor liquidity. To alleviate this problem, Real Goods set up a bulletin board which displayed the names and addresses of prospective buyers and sellers of Real Goods’ stock. The system did not itself execute trades. Rather, prospective buyers and sellers were to simply read the bulletin board and then contact each other if they were interested in trading Real Goods’ stock.

Before beginning “trading” activity, Real Goods requested the SEC to allow it to maintain the bulletin board without the prohibitive time and expense of registering all potential purchases and sales as “offers” and “sales” under the 1933 Securities Act. Similarly, Real Goods wanted to avoid becoming a “dealer,” “broker,” or “exchange” under the 1934 Securities Exchange Act, or an “investment adviser” under the 1940 Investment Advisers Act. Significantly, the three SEC divisions responsible for enforcing the statutes mentioned above agreed not to recommend enforcement actions “if RGTC operate[d] the system in the manner described in [its] letter.”

In July, 1996, the SEC granted a no-action letter to IPONet, a Texas company engaged in the placement of public, as opposed to private,
offerings of securities on the Internet.\textsuperscript{33} The letter contained a variety of restrictions, chief of which is that the Internet broker-dealer is responsible for any omissions or misstatements on their Internet site.\textsuperscript{34} IPONet is protected by a password, which grants access only to those deemed "sophisticated investors."\textsuperscript{35} Wit Capital is also running a "digital exchange" for the benefit of account holders.\textsuperscript{36}

Advantages of the evolving Internet distribution systems are obvious. For instance, Internet-based securities distribution systems are both cheap and fast. No underwriter is involved,\textsuperscript{37} saving the investor and the issuer\textsuperscript{38} money. No printing costs\textsuperscript{39} are involved in setting up a web-site or Internet prospectus; the issuer simply must pay to have the site professionally "set up," and no major expenses are incurred thereafter. No matter how many times the site is accessed, the cost is the same to the


\textsuperscript{34} See id.

\textsuperscript{35} Id. at 77,272 and 72,274 (determination as to which potential investors are "sophisticated" investors in the sense of the 1933 Act is performed by an electronic interactive question and answer series). See 17 C.F.R. § 230.215(e),(f) (1997) (An "accredited investor" is defined by the 1933 Act Rules as "any natural person whose individual net worth or joint net worth with the person's spouse, at the time of his purchase, exceeds $1,000,000 . . . . Any natural person who had an individual income in excess of $200,000 in each of the last two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year").

\textsuperscript{36} See Wit Capital Corp., supra note 15.

\textsuperscript{37} The value of an underwriter's services lies in the underwriter's ability to accurately set a price for an IPO, and in the ability to quickly and efficiently market the IPO. See generally BLOCH, supra note 16, at 248-73 (describing the process used to set the price for securities). The use of the Internet eliminates the issuers need to rely on an underwriter to market the security.

\textsuperscript{38} The securities provided have the same intrinsic value as securities marketed in the traditional manner, but are not sold subject to an underwriter's discount or a dealer's re-allowance. Cf. LOUIS LOSS, FUNDAMENTALS OF SECURITIES UNDERWRITING 294 (1983). "Intrinsic value" here is defined as the discounted present value of the securities' future return streams, minus any risk. Underwriting as such does not increase the value of this return stream. The issuer must pay the underwriters' commissions out of the proceeds of the distribution, the issuer must set the total value of the distribution such that it can raise needed capital and pay the underwriters. Id.

\textsuperscript{39} See Grant, supra note 17, at 31-32 (describing the costs associated with printing stock certificates). Not only are financial printers themselves expensive, but delays in printing can be costly, as such delays mean that highly paid professional staff are waiting for forms to arrive, with the staff's professional fees piling up. Id.
issuer.

Not only does using the Internet to trade and distribute securities save money, when the Internet is used to effect prospectus delivery, there is no turnaround time between the sending of a prospectus to potential purchasers and the purchaser's receiving the prospectus; e-mail and downloading are nearly instantaneous. Furthermore, it is a quick and simple matter to send a prospectus to a potential buyer of a security before the final confirmation of sale. The potential investor then has the opportunity to review the contents of the final prospectus before the sale is consummated, which is rarely the case under the present system. This system potentially provides the investor with even greater protection than exists under the conventional system. In many cases, no preliminary prospectus or selling materials are used in the conventional distribution of securities, so the investor only receives a final prospectus at the confirmation of sale. Providing the investor with a prospectus beforehand allows the investor to more carefully decide if whether to purchase that particular security.

A less obvious advantage of electronic marketing and distribution of securities is that these techniques also provide the small business issuer with increased liquidity and a wider market for capital. The Internet provides a potentially nation-wide or even a world-wide market for raising capital, where, for example, a little-known microbrewery in New York can solicit funds from anywhere in America. The Internet is accessible

40 See 15 U.S.C. § 77(e) (Law. Co-op. 1983) (section 5 of the 1933 Securities Act requires a prospectus to be delivered at or before the delivery of a registered security). All sales of securities by issuers or underwriters, and all sales by dealers before a certain time after registration, are required to be registered with the SEC. See 15 U.S.C. § 77(e)(c). See also 15 U.S.C. § 77(d) (listing exceptions to the requirements of § 77(e)(c)).

41 See Thomas Gilroy & Kenneth G. Fall, Due Diligence and 10-K Disclosure Enhancement, in PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 1997 at 391, 480 (PLI Corp. Law & Prac. Course Handbook Series No. 969)(stating that the final prospectus is required to be sent only after confirmation of the rule).

42 Id. (stating that where no preliminary prospectus or other selling materials are distributed the buyer may only receive the final prospectus).

43 This, however, ignores the effect of state securities laws, or "blue sky" laws. See discussion infra Part III.

44 Wit Capital claims that this allows small investors to directly purchase shares in IPOs and that this was previously a privilege of large institutional investors. See Wit Capital Corp., supra note 15. As will be discussed in Part III, infra, while it is true that large institutional investors are chosen as underwriters for IPOs, and that it can be profitable for smaller investors to participate in these offerings, problems of risk and valuation of the investment make participation by less sophisticated investors a risky
from almost anywhere, allowing investors trading in small stocks a wider potential market in which to trade, thereby enhancing the liquidity of small or little-known companies or funds. By allowing investors to trade directly with the electronic market, the costs and commissions associated with trades effected through a broker-dealer are eliminated.

III. THE SEC RESPONSE TO THESE FIRST STEPS: TENTATIVE APPROVAL

While the SEC has not discouraged the use of the Internet as a means for the distribution of securities, it has evinced some concern about “creating a monster,” that is allowing activity to go unregulated that may have unforeseen and disastrous consequences. To that end, the SEC has scrutinized the three offerings previously discussed above, and has made suggestions or, in some cases, required changes in the structure of each of them. As noted, Spring Street/Wit Trade voluntarily complied with the SEC’s request to shut down soon after commencing operations. Spring Street was forbidden to accept money directly from investors; payments were made to a third-party escrow account. More importantly, Spring Street agreed to provide investors with continuing disclosure about any risks associated with trading in its securities and to disclose the fact that Spring Street securities are not traded on any regular exchange and therefore, Spring Street’s shares may be illiquid. Additionally, because Wit Trade customers could appear to be holding themselves out as “dealers” if they posted “buy” and “sell” orders at the same time, Spring Street was required to warn its posters of this risk. Spring Street was required to maintain a “transaction history” for

venture.

45 This fact is not without its disadvantages. See discussion infra Part III.
46 However broker-dealers do serve a useful function. There are disadvantages to a “brokerless” system. See discussion supra Part II.
47 In fact, it might be argued that the SEC relaxed some of its registration requirements in the case of Real Goods Trading Corporation. See Real Goods Trading Corp., supra note 25, at 77,131; Recent Agency Action, supra note 31, at 960-61. See also Staff Clears Way, supra note 23, at 437 (stating that Wit Capital’s founder concluded that the SEC showed remarkable willingness to work with him).
48 See Staff Clears Way, supra note 23, at 437.
49 See <http://witcapital.com> (visited on Apr. 28, 1998). Spring Street is not an SEC-registered broker-dealer; therefore Spring Street was required to relinquish control over its funds to an independent agent.
50 See id.
51 See 5 COMM/GENERAL CONSPECTUS 305, 308. Such trades are known as two-sided; see also McGlosson, supra note 7, at 309 (describing the requirements the SEC placed on Spring Street).
customers, where the price and number of shares recently traded were to be disclosed. Records had to be maintained of "all securities transactions effected through the system and [to] make them available on request to the SEC."\(^5\)

Real Goods Trading Corporation's bulletin board was also prohibited from advertising "two-sided" trades,\(^4\) and the information the bulletin board could furnish about potential investors was limited.\(^5\) IPONet investors cannot participate in offerings made before they became IPONet customers.\(^5\)

Electronic delivery of disclosure documents from issuers to investors is also permitted under certain circumstances.\(^5\) The SEC press releases illustrate a variety of scenarios under which electronic dissemination of disclosure documents is permitted or forbidden, but the rules they outline fall into four categories.\(^5\) The investor must have notice, that is, be aware that the data has been sent or can be read on the Web.\(^5\) The issuer must know that the investor is in fact able to access the electronically transmitted data.\(^5\) The investor must be able to request and receive a "hard copy" from the issuer, and the issuer must have some sort of proof of delivery to the investor.\(^5\)

While the SEC should be applauded for its open-mindedness in allowing these experiments with Internet-based trading to go forward in the first place, there are three recurring pitfalls inherent in the SEC's approach. First, despite the standards set out in SEC releases and no-action letters, these standards do not serve to directly increase investor confidence in legitimate Internet-based securities offerings. The second problem is that the SEC standards make buying securities over the Internet unduly inconvenient for most investors. Finally, the savings realized by "printing" disclosure documents on-line rather than on paper

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\(^{52}\) Id.

\(^{53}\) Id. at n.56.

\(^{54}\) See Yadley, supra note 8, at 198.

\(^{55}\) Id.


\(^{58}\) See id., at 240.

\(^{59}\) See id.

\(^{60}\) See id.

\(^{61}\) See id.
are only largely realized by an issuer willing to limit his capital market to those investors who will not request paper copies of disclosure documents.

IV. ONE STEP BACK: THE (SOMETIMES) LESS OBVIOUS DISADVANTAGES OF ON-LINE CAPITAL FORMATION

The most obvious problem with marketing securities in cyberspace is that of fraud. In fact, the SEC\textsuperscript{62} and several states\textsuperscript{63} have already begun prosecuting several cases of securities fraud over the Internet.\textsuperscript{64} While there are many different types of securities fraud, some attributes of the Internet make it ideal, not only for such profitable but unimaginative frauds as the sale of shares in some non-existent eel ranch,\textsuperscript{65} but for more sophisticated types of manipulations.

The Internet is a relatively anonymous means of communication.\textsuperscript{66} E-mail addresses can be changed quickly and easily. There is no necessary connection between a place and an e-mail address. A user can "log on" from anywhere and immediately send or receive e-mail. A user can also easily create several different e-mail addresses, each with its accompanying persona.\textsuperscript{67} "Market manipulation" on a large scale, therefore, becomes easy on a electronic bulletin board where securities are traded. One possible method is for the manipulator to disparage the securities


\textsuperscript{63} See Yadley, supra note 8, at 195 (describing an America OnLine user's sale of $50,000 in fraudulent securities).

\textsuperscript{64} My sources list 16 cases of securities fraud prosecuted by state or Federal authorities.

\textsuperscript{65} It is important to note, however, that the increasing power and decreasing price of the personal computer make such frauds more and more feasible. It is fairly easy to set up a professional-looking web-site, and selling efforts can be amplified by the increasingly common and increasingly potent audio-video capabilities of many computers. The world-wide extent of the web, coupled with the automatic nature of the computer make it possible to reach (and defraud) would-be investors far more efficiently than is possible through, say, the telemarketing of fraudulent securities.

\textsuperscript{66} See Yadley, supra note 8, at 197 (describing fears of prosecutions based upon mistaken identity).

\textsuperscript{67} This is made much easier by the fact that most e-mail providers do not verify the real addresses and identities of their subscribers. Cf. Yadley, supra note 8, at 198 (noting the security measures required by the SEC).
traded on the board, either by publishing negative but misleading data or by posting “sell” orders at a very low price, under false names, and then purchase the securities at an undervalued price. A manipulator may also purchase securities, tout their merits under a different name, and sell them at an inflated price.

The attraction of these two schemes is that the manipulator does not have to post such false or misleading statements on the same bulletin board or exchange as the securities are traded on. Any commonly accessed service will do. A cruder variation on the above scheme is to blackmail a financially weak issuer with the threat of publishing false or misleading information to be posted on a bulletin board not controlled by the issuer.

Still another problem, related to Internet security as much as to fraud, is the problem of “hacking.” Hackers may either disrupt trading in Internet-based securities, or may simply electronically transfer the virtual securities or cash payments to their own accounts. Either result does not bode well for investor confidence, and may even result in a lawsuit against the issuer/bulletin board provider for failure to maintain adequate security.

Another technique which creates a potential for liability on the part of the bulletin board provider is where a con artist uses the names and addresses of posters on an investment-related bulletin board (such as Writ-Trade) as a “prospect list” of persons to fleece with a fraudulent offer of unregistered securities. While the fraudulent securities need not be offered “on-line,” the electronic bulletin board does provide a ready list of

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70 While the same technique may be used in theory for “off-line” securities trading, I doubt it would be as effective. Many traditional investors never read electronic bulletin boards, and may be skeptical of “virtual news” in general, if they or the markets ever hear about it. On the other hand, Internet investors are likely to be much more aware of Internet news and therefore they, and the market in which they trade, are more susceptible to such electronic manipulations.

71 See Yadley, supra note 8, at 197 (explaining that while it is more difficult to identify the manipulator behind fraudulent email messages, such manipulators cannot successfully raise freedom of expression as a sustainable defense).

72 “Hackers” are persons who intrude on a secured computer or system. See CHESWICK & BELLOVIN, supra note 13, at xiii (1994). “Hacking” is the act of intrusion itself. See id.

73 For an overview of the problems of network security, see generally id. at 3-17.
persons already favorably disposed to investments over the Internet.

Enforcement of securities laws relating to fraud is especially difficult if the users sell from off-shore and use the Internet as an inexpensive means to communicate with and thereby defraud U.S. investors.

Violations of securities law can be completely accidental. While it has been mentioned that including "links" from an issuer's web-site to other web-sites may make the issuer liable for any fraudulent activity on those other web-sites, the most daunting problem for the small Internet issuer is the problem of state securities regulations, or "blue sky" laws.

To avoid state-law liability for securities fraud, an securities issue and its issuer must comport with the blue sky laws of every state in which it is offered. These laws are not necessarily coextensive with federal securities registration laws or each other. This is an especially thorny problem because of the near-global reach of the Internet; by putting a distribution of securities on-line, the securities may in effect be "offered" in every state. Registering the securities in all fifty states is prohibitively expensive for small issuers, especially in cases where the issuer does not expect to sell many securities in Montana, but still must register there to avoid criminal or civil fraud charges. In short, the reach of the Internet itself gives rise to liability.

States have been slow to respond to the concept of Internet marketing of securities. Pennsylvania is typical of the states which have recognized this method of distribution. Issuers need not register their

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74 See SEC Release 32-7233, supra note 57, at 3131-36 (describing a hypertext link to a research report covering an Internet-based security as being akin to sending a final prospectus). This is illegal if the effective date of the security has not passed. See 15 U.S.C. § 77(e) (Law Co-op 1983).


76 See WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1528 (7th ed, 1988).

77 In addition, some states require that any "dealers (including issuers, brokers, and salesmen)" in securities register in that state. See id.

78 "[A]ll states have blue sky laws in effect." See id.

79 See generally CARY & EISENBERG, supra note 76, at 1527-29 (discussing blue sky laws or state securities regulation statutes). In addition, "40 states . . . require escrow arrangements [for promotional shares]." James F. Mofsky, BLUE SKY RESTRICTIONS IN NEW BUSINESS PROMOTIONS 35 (1971).

80 Cf. Loeb & Richter, supra note 75, at 325 (noting however that states have not relinquished jurisdiction over Internet-based offerings of securities).

81 See Blue Sky Rep. (CCH) ¶ 48,684 (Sept. 1, 1995) (This was originally conceived as a one-year administrative order, beginning January 1, 1995. The order has
Internet-based securities in Pennsylvania, as long as their distribution materials contain a disclaimer clearly stating that the securities offered are not for sale in Pennsylvania or to Pennsylvania residents. Perhaps this slow pace of development is not surprising, given the relatively low number of legitimate Internet-based IPOs compared to the number of fraudulent IPOs.

On-line issues of securities can even run into problems without violating any laws. The first problem is one of plain and simple information overload. In a world where every sort of investment information imaginable is now available on the Internet, it becomes almost impossible for the less sophisticated investor to sort out the useful information from the irrelevant, and consequently, to make rational and informed investment choices.

Plans as noble-sounding as Wit Capital’s dream of making small IPO more accessible to ordinary investors can also be disastrous. In a world where the valuation of an IPO is not an exact science, collides with the world where investors lose fortunes in Internet eel-ranch interests, there is bound to be trouble.

V. And Now For A Possible Solution . . . .

One recurring theme found throughout this discussion on Internet securities trading is both how a virtual marketplace resembles and, in some respects, differs from the physical one. In a similar vein while the concept of Internet-based trading has its attractions, the solution to many

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been extended until September 1, 1997.). Some exceptions exist. For example, Texas allows general solicitations of unregistered securities to "accredited investors." See, e.g., 7 TEX. ADMIN. CODE § 139.16 (West Supp. 1997) (State Securities Board). A California limited offering exemption to qualified purchasers also permits general solicitation. See Cal. Corp. Code § 25102(n) (West Supp. 1998) (providing for the specific requirements for such a general solicitation).


83 See, e.g., Arthur Levitt, Corporate Finance In The Information Age, 11 INSIGHTS 19 (Mar. 1997) (SEC Chairman Levitt describes the problem facing investors as "[t]oo much information" and states that "[m]ore disclosure does not always mean better disclosure").

84 See Johnson, supra note 22, at 434-35 (outlining the "unlimited investment information" available through the Internet).

85 See generally BLOCH, supra note 16, at 248-73 (discussing the underwriting process).

86 This fraud suggests that the problem of finding investors confident enough to buy securities over the Internet should be redefined as the problem of finding intelligent investors confident enough to buy legitimate securities over the Internet.
of the problems identified above resembles a common physical solution, one that relies on markets rather than government intervention, that is, the creation of one or more organized Internet Stock Exchanges, possibly similar to the National Association of Securities Dealers Automated Quotations (NASDAQ), but available to the general public, as well as to securities brokers and dealers.

Such Exchanges could eliminate or alleviate the various problems associated with Internet securities fraud in the same way that the New York Stock Exchange prevents the most egregious frauds from reaching the Big Board; by maintaining strict standards of conduct and enforcing them. The exchanges would serve as gatekeepers. By keeping shady investments out, a hypothetical exchange could simultaneously provide a "seal of approval" for the "honest" securities sold in these exchanges. By providing a fair market for non-fraudulent securities, they would increase the liquidity of their securities on a secondary market. A deserved reputation for fairness would increase the amount of money spent in these exchanges and would further promote the securities traded within, at the expense of "non-publicly traded" Internet-based securities.

The exchange would necessarily require some verification that participants are in fact, "real" persons, with known addresses. A well-
organized exchange could alleviate the problems associated with "hacking"; the exchange could control electronic "points of access" to its databases and "trading floor" and hire professional "detectives" to monitor electronic "break-in" attempts.

A formally organized exchange can work closely with the SEC to ensure compliance with all laws, rules, and regulations, and cooperate with the SEC in policing market manipulation. Obviously, the exchange would have to register as a "broker," "dealer," "exchange," and possibly "investment advisor." In addition, the exchange would be required to join the National Association of Securities Dealers (NASD). The exchange can keep files of all prospectuses of companies traded in its market and provide them to investors as needed. Such an arrangement would also benefit the SEC because if the "net grows as rapidly predicted, there is almost no way for the SEC to monitor it without outside help."

If the virtual exchange is eventually defined by the SEC as a "national exchange" within the meaning of section 18 (the recently enacted National Securities Markets Improvement Act or NSMIA) of the 1933 Act, most of the thorny requirements posed by state securities regulation are eliminated. "Covered" securities are exempt from state registration and other blue sky law requirements. Among the classes of "covered securities" are securities traded on a national exchange. A national exchange is one that has the Commission determines has listing standards substantially similar to the NYSE, NASDAQ, etc. States retain jurisdiction under NSMIA to prosecute fraud, but it is apparent that "fraud" does not mean the simple lack of state registration.

See LOSS, supra note 88, at 699-798 (discussing the requirements for becoming an exchange).

See YADLEY, supra note 8. The day after the first draft of this Comment was submitted for publication, I received an e-mail touting yet another hot deal on a stock with unlimited potential for growth and profits. When I forwarded this communication to the SEC's enforcement division at sec.enforcement.gov., I received a courteous form letter in response, stating in effect that my request for enforcement was appreciated. A few days later, I sent another e-mail to the above SEC e-mail address, detailing some questions I had in regard to this Comment. I received an identical e-mail in reply.


See id.

See Coffey, supra note 95.
While a national exchange does not paint the freewheeling picture envisioned by Wit Capital's founder, most of the savings associated with trading securities over the Internet, instead of on a traditional trading floor, are retained. Securities could still marketed directly by the issuers, could still reach just as large a market (because the exchange is open to all participants), and can be run twenty-four hours a day. Small companies can still use the exchange as a means to raise venture capital, and the exchange can still be reached from almost anywhere. Costs associated with financial printing are still largely eliminated.

The exchange would probably be financed by a fee, assessed as a percentage of dollar value of trades executed. However, the increased liquidity of shares traded on the exchange would likely be worth more to investors than the fees paid to take advantage of this liquidity. Transaction costs of trading on an Internet-based exchange would potentially still be lower than those associated with a traditional marketplace. Two tiers of brokers, those associated with the seller of securities and those associated with the buyer, would be eliminated under this scheme. An Internet exchange should be the exclusive market for trading in shares of member companies. Otherwise investors might "free ride" off the services and enhanced value provided by such an Internet-based exchange. However, it might also be argued that the New York Stock Exchange does not face a serious competitive threat from investors who read the financial papers and then sell shares of NYSE-listed companies over the counter.

An Internet-based exchange as outlined here does not solve all the problems associated with Internet trading. The "bedside manner" associated with the traditional broker-dealer would be missing. The American investing public would not be fully protected from off-shore issuers who undertake distributions on the web, whether or not they showed any fraudulent intent. As in a pure Over The Counter Internet market, accord-

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100 See supra notes 15-19.
101 But see Stoll, supra note 1, at 93-94 (discussing some of the disadvantages of running on-line trading facilities 24 hours a day).
102 If anything, such an exchange will be even more accessible than an unassociated number of private issuers scattered about the web, because there will be one, better-known net location rather than many unrelated locations.
103 This may help avoid problems with antitrust liability, which are beyond the scope of this Comment.
104 Ordinarily there is nothing to prevent a security from being listed on more than one exchange. See Loss, supra note 38, at 668.
105 In addition, such activity, if conducted regularly, would be illegal according to the provisions of the "33 Act, and "34 Act. See discussion supra Part I.
ing to current SEC regulations, a “net-based exchange will have to content itself with only dealing with investors who do not wish to be mailed paper copies of disclosure documents.” A centrally located cyber-exchange may also be more susceptible to hardware failures or system crashes. Some reliable means of continuously backing up the system will have to be devised. Otherwise a hacker might be able to purchase securities and, if unable to sell them for a quick profit, “crash” the exchange before the record of purchase is backed up and thereby erase all records of the purchase.

An equally serious problem is how to provide start-up capital for a new exchange without a large number of issues to trade or volume of trade and without imposing excessive transaction costs. Another problem involves valuation. An important duty of the underwriter in the traditional securities offering is the measured appraisal of the value of an issuer’s stock.

However, if these problems (and any others not foreseen) are solved, the Internet may provide an efficient and inexpensive means to trade a greater volume of securities with less cost than ever before, while allowing small businesses to access less expensive start-up capital and reach a greater number of potential purchasers.

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106 Even mighty NASDAQ is not invulnerable to hardware problems. Squirrel damage to transmission lines has brought the NASDAQ system to a halt on several occasions. The emergency transmission systems failed to work as advertised. See Stoll, supra note 1, at 99.