Penn State International Law Review

Volume 16
Number 3 *Dickinson Journal of International Law*

Article 3

5-1-1998

The Internet and U.S. Financial Markets

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Information intensive industries such as financial services are being transformed by the Internet. Specifically, it is the interactive, multi-media side of the Internet, known as the World Wide Web (Web), which is driving this transformation. Without the intense graphics, sound bites and other capabilities provided by the Web, the Internet would be a pretty dull place to visit.

It is precisely the growing accessibility of the Web to individual consumers which is causing many of the changes in the provision of financial services.[1] The Web simultaneously has opened and democratized access to tremendous amounts of information. Unfortunately, the Web also has afforded vast new opportunities for scam artists and fraudsters to ply their nefarious trade. These events have demanded that financial regulators re-think theories of regulation which long have been based on firm control of information within specific geographic boundaries.

I. Cheap, Efficient and Convenient Communication

In the United States, many consumers connect to the Web through a service provider, often paying a flat monthly fee for unlimited access. An affordable access price combined with the fact the Web never closes appeals to many consumers. The Web allows them to transact mundane business such as paying bills,

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1. In 1995, it was estimated that there were 30 million users of the Internet with that figure expected to double every several years. *See* Leonardi, *Road Map to the Internet*, 22 *Barrister* 1, Spring 1995, at 16.

placing orders from an electronic catalogue or receiving e-mail, engaging in research or merely seeking entertainment by "surfing the 'Net" to visit a favorite Web site, chat room or online forum.

With respect to financial services, the Web is a cheap and convenient method of communicating with brokers, retrieving market information, searching for investment opportunities and reviewing personal stock portfolios. The Web is open when stock markets and brokerage firms are closed. Individual investors now are able to review market and research data on the Web that heretofore was unavailable to them because it was proprietary or was available only to private brokerage clients or those willing to pay a fee.

Without leaving their home or interrupting their business day, ordinary investors can retrieve and review information at 11:00 p.m and e-mail instructions to brokers to be executed the next business day. The rising number of personal computers and the increasing number of individual investors participating in a booming U.S. stock market undoubtedly will contribute to the continued attractiveness to financial intermediaries of providing financial services to consumers via the Web.

II. The Darker Side of the Web

For all the glitz of high speed graphics and instantaneousness of communication, in certain respects the Web remains very much a frontier. Explorers beware! There are as many thieves, villains and fraudsters lurking in cyberspace as can be found in a typical American "Western" movie. The Web is not transparent. One cannot see who is behind the Web page or is masterminding the posting of fictitious information on various bulletin boards in an effort to push up the price of a stock.

One does not know whether the person inputting the information onto the Web is sitting in a house around the corner or in an office block halfway around the world. Familiar trademarks, logos and symbols can be migrated or changed slightly and appear on new Web sites in order to lend authenticity and inspire misplaced consumer confidence. Legitimate-looking graphics, glowing recommendations and laudatory letters can be fabricated and linked to Web sites creating a very credible illusion.

Recently, a major U.S. Internet service provider announced it had detected that fake e-mail had been sent to a number of its subscribers in its name explaining that the service provider was re-checking its records and needed to re-confirm subscribers' credit

card numbers.[2] Those subscribers who responded with their credit card numbers actually were sending them to a third party, not the service provider.[3]

How good is the service or product being offered on the Web site? Investors using online brokers to trade securities may obtain trades at a steep discount to amounts charged by full service brokerage firms; however, do they know if the online broker has the operational capacity to handle a trade when trading volume is high, such as in a market turndown when timing in the market really counts? A recent report in *Barron's* concerning online brokers cited several instances where investors were unable to log on to the broker's Web site or trading screen within the Web site during periods of high trading volume.[4] This may be of more than a passing concern as it is estimated that the $111 billion currently managed online will rise to $474 billion by the year 2000.[5]

III. The Regulatory Challenge

The Web has not changed the fundamental dilemma which financial regulators always have faced, i.e. fostering legitimate capital formation while maintaining appropriate standards of investor protection. In fact, the speed and breadth of communication the Web affords across national boundaries and the multiplicity of uses which the Web facilitates have increased the complexity of this dilemma. In the United States, regulators have seen the Web being used for legitimate business purposes such as direct offerings of securities through company Web sites, bulletin boards for trading securities, online brokerage services and investment advice, electronic delivery of mandated disclosure materials and exchange of investor opinions using chat rooms and bulletin board services. Conversely, various "get rich quick" schemes, pyramid operations and other investment frauds have found a significantly wider audience on the Web.

While information appearing on the Web no longer is restricted to dissemination within certain geographic boundaries, jurisdiction of the state very much remains tied to geography. If something appears on the Web which is accessible by anyone with a personal computer and a modem, does every state have jurisdic-

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2. *ABC World News Tonight*, Aug. 26, 1997.
3. *Id.*
4. Theresa W. Carey, *Surf's Up*, BARRON'S, Mar. 17, 1997, at 21.
5. Christopher Anderson, *Survey of Electronic Commerce*, ECONOMIST, May 10, 1997, at 11.

tion over the subject matter appearing on the Web site because the person placing material on the Web knows it can be accessed by anyone in the world with a computer? Does jurisdiction attach if the Web site only is accessed or must there be a stronger nexus with the state such as a commercial transaction or communication which occurred as a result of the access? What if the creator of the Web site intends the audience to include only nationals of the country from which it emanates but the creator lacks the technical ability to limit the audience? What if a Web site is soliciting persons to invest or participate in an activity which would be illegal in the jurisdiction in which the solicitation is made, e.g. soliciting investors in a U.S. state jurisdiction to invest in an Internet gambling operation located in the Cayman Islands?[6]

IV. Jurisdictional Guidance

In the United States, financial regulators have provided regulatory guidance on some of these jurisdictional questions. First, federal and state securities regulators have taken the position that all Internet activity occurs within jurisdiction unless a specified activity affirmatively is exempted from jurisdiction.[7] Second, communications on the Internet designed to raise capital are viewed as constituting an offer for the sale of a security which would involve general solicitation.[8]

With respect to Web sites maintained by member brokers of the National Association of Securities Dealers, Inc. (NASD), a self-regulatory organization registered with the U.S. Securities and Exchange Commission (SEC) under the federal Securities Ex-

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6. Interestingly, in recent litigation involving Lloyd's of London in the United States, an opinion of the United States Court of Appeals for the Second Circuit indicated that, in certain circumstances, it would hold valid agreements signed by investors to resolve disputes in foreign jurisdictions notwithstanding the anti-waiver provisions found in Section 14 of the federal Securities Act of 1933 and Section 29 of the federal Securities Exchange Act of 1934. *See* Roby v. Corporation of Lloyds, 996 F.2d 1353, 1361-62 (2nd. Cir.), *cert. denied,* 114 S.Ct. 384 (1993).

7. Use of Internet Web Sites to offer securities, Securities Act Release No. 33-7516, 17 CFR parts 231, 141, 271, 276 (March 23, 1998) [hereinafter Internet Release]; *see also* Resolution of the North American Securities Administrators Association Regarding Securities Offered on the Internet, adopted Jan. 7, 1996, CCH NASAA Reports ¶ 7040 [hereinafter NASAA Release 1].

8. *See* Internet Release, *supra* note 7. Since offers for the sale of securities on the Internet are viewed as constituting general solicitation, any exemptions from registration which prohibit general solicitation as a condition of the exemption would not be available.

change Act of 1934 (1934 Act)[9], the NASD takes the position that a broker's Web site is a communication to an anonymous audience and consequently, is an advertisement subject to the NASD Rules of Fair Practice (NASD Rules).[10] If "broker-dealer use only" material is sent over the Internet without security, it also is deemed an advertisement subject to NASD Rules.[11]

Treatment of these communications as advertisements requires NASD members to submit the Web site to the NASD for review and have an internal review conducted by a registered principal of the member broker prior to use. E-mail by members to specific customers is treated as correspondence, and NASD Rules on content and supervision apply although the NASD recently revised its rules to accommodate electronic correspondence (e.g., e-mail, Internet).[12] The NASD has not decided whether broker "conversations" in a public online forum will be deemed correspondence or oral communication but it has advised that brokers must assure that information being communicated under such circumstances is balanced, complete, and not misleading.[13]

V. Regulatory Safe Harbor Pronouncements

Recognizing that persons may desire to use the Web for legitimate purposes to communicate efficiently with a certain audience in a lawful manner, financial regulators in the United States have issued regulatory advices that jurisdiction would not be invoked if appropriate disclaimers are included in the Web communication.

A. State Regulation

State securities regulators were the first regulators to adopt positions relative to issuers using the Internet to make certain offers of securities and financial intermediaries using the Internet to distribute information on available products and services.[14] With respect to offers of securities on the Internet (Internet

9. 15 U.S.C. § 78a *et seq.*
10. 28 *BNA Securities Regulation & Law Report* 1306, Oct. 25, 1996.
11. *Id.*
12. NASD Notice to Members 98-11 (Jan. 1998); 63 FR 1131 (Jan. 8, 1998).
13. *See* NASD Notice to Members No. 96-50, July 1996; 1996 NASD LEXIS 60.
14. *See* NASAA Release 1, *supra* note 7; *see also* Resolution of the North American Securities Administrators Association Regarding Internet Advertising of Information on Products and Services, adopted Apr. 27, 1997, CCH NASAA Reports ¶ 2191 [hereinafter, NASAA Release 2].

Offers), state jurisdiction will not be invoked if the Internet Offer indicates directly or indirectly that the securities are not being offered in the jurisdiction, an offer is not specifically directed to any person in the jurisdiction and no sales of securities are made in the jurisdiction as a result of the Internet Offer (Internet Offer Exemption). The legend may be as specific as "the securities are not being offered in the State of Pennsylvania" or as general as "the securities are being offered only in jurisdictions where they may be sold legally."[15]

The burden is on the issuer to reply honestly to e-mail from jurisdictions where the securities are not qualified to be sold. The issuer may not direct additional solicitation to such person, including a solicitation to purchase another security of the issuer. To rely on the Internet Offer Exemption, no sales of the issuer's securities may occur in jurisdiction as a result of the Internet Offer, including any other securities of the issuer. This is consistent with the premise that the issuer did not intend to offer securities in the jurisdiction.

A similar approach has been taken by state securities regulators with respect to financial intermediaries, both in a corporate and individual capacity, that desire to use the Internet to distribute information on available products and services (Internet Communications). Internet Communications are permitted where the Internet Communication:

1. Contains a legend in which it is clearly stated that the financial intermediary may transact business only if first registered, excluded or exempted from the registration requirements of the jurisdiction and that follow-up individual responses to persons within the jurisdiction which involve effecting transactions in securities or providing investment advice for compensation will not be made absent compliance with the registration requirements of the jurisdiction or applicable exemptions or exclusions.

2. Contains a mechanism, including and without limitation, technical "fire walls" or other procedures reasonably designed to insure that prior to subsequent, direct communication with prospective customers in jurisdiction, the financial intermediary is first registered or qualifies for an exemption or exclusion from registration.

3. Does not involve either effecting or attempting to effect transactions in securities or the rendering of personalized invest-

15. *See* 64 Pa. Code § 203.190.

ment advice for compensation within jurisdiction over the Internet and is limited solely to the dissemination of general information on products and services.

4. In the case of an agent of a broker-dealer or a representative of an investment adviser, prominently discloses the affiliation with the broker-dealer or investment adviser and that the broker-dealer and investment adviser authorized the Internet Communication.[16]

B. SEC Internet Release

Advice from the SEC on use of the Internet for securities offerings and advertising of services of financial intermediaries is contained in SEC Release Nos. 33-7516, 34-39779, IA-1710, IC-23071, International Series Release No. 1125 (Mar. 23, 1998) (Internet Release). In its Internet Release, the SEC provides clarification when the posting of offering or solicitation materials on the Internet would not be considered activity taking place in the United States. The Internet Release explicitly states that the SEC is providing clarification only with respect to registration requirements and is not altering the fundamental requirements that all offers and sales of securities in the United States be registered under U.S. securities laws or made under an applicable exemption.[17]

The test adopted by the SEC is whether the Internet offers, solicitations, or other communications are targeted to the United States.[18] If issuers, broker-dealers, exchanges and investment advisers implement measures that reasonably are designed to guard against sales or the provision of services to U.S. persons or to have targeted persons in the United States with their Internet Offers, Internet postings by themselves would not result in a registration obligation under the 1933 Act. The Internet Release notes that the interpretations contained therein do not address anti-fraud or anti-manipulation provisions of the federal securities laws which *"will continue to reach all Internet activities that satisfy relevant jurisdictional tests"* (emphasis added).[19]

1. Securities offerings.—With respect to an Internet Offer, the SEC generally would not consider an offshore Internet Offer made

16. *See* NASAA Release 2, *supra* note 14.
17. *See* Internet Release, *supra* note 7, available in Westlaw, 1998 WL 128173.
18. *Id.*
19. *Id.* at 2.

by a non-U.S. offeror as targeted at the United States if (1) the Web site includes a prominent disclaimer making it clear that the offer is directed only to countries other than the U.S. and (2) the offeror implements procedures that reasonably are designed to guard against sales to U.S. persons in an offshore offer by, for example, ascertaining the purchaser's residence by obtaining mailing addresses or telephone numbers (with area codes) prior to the sale.[20] Regardless of any precautions adopted by the offeror, the SEC would view solicitations which, by their content, appear targeted at U.S. persons as made in the United States, for example, where the content of the Internet Offer emphasized a reduction in U.S. taxes as a result of the investment.[21]

In the Internet Release, the SEC recognized that, despite the best efforts of non-U.S. Internet offerors to implement safeguards so as not to target U.S. persons in an offshore offering, U.S. persons may provide false information in an attempt to participate in an offshore offering.[22] In this case, the SEC advises that, if a U.S. person purchases securities or investment services despite adequate procedures adopted by the offeror that reasonably are designed to prevent purchases by U.S. persons, it would not view the Internet Offer after the fact as having been targeted to the United States, absent indications that would put the issuer on notice that the purchaser was a U.S. person.[23] Such indications may include payment for the securities by a check drawn on a U.S. bank or provision of a U.S. taxpayer identification number or social security number.[24]

In the event that an issuer arranges to have its Internet Offer posted on a third-party's Web site, the SEC would not view the third-party's Web site as an offer that is targeted to the United States if the third-party Web service employed at least the same level of precautions against sales to U.S. persons as would be necessary for the offshore Internet offeror to employ pursuant to guidance afforded in the Internet Release.[25] The SEC appears to possess a heightened concern when an offeror, or persons acting on its behalf, uses a third-party Web site to generate interest in the

20. *Id.*
21. Internet Release, *supra* note 7.
22. *Id.* at 5.
23. *Id.*
24. *Id.*
25. *Id.*

Internet Offer.[26] In this scenario, the Internet Release warns that more stringent precautions by the offeror may be required, particularly when the Internet offeror (1) posts offering or solicitation material or otherwise causes the Internet Offer to be listed on an investment-oriented Web site that has a significant number of U.S. clients or subscribers, or where U.S. investors could be expected to search for information about investment opportunities or (2) arranges for direct or indirect hyperlinks from a third-party investment-oriented page to its own Web page containing the offering materials.[27]

The SEC also has outlined a number of concerns where a foreign issuer is making an offshore offering concurrently with a private offering in the United States.[28] It reiterates that an offering under Section 4(2) of the 1933 Act[29] may not involve any "public offering" and offers and sales of securities made in reliance on Rule 505 and 506 of SEC Regulation D may not be made through "general solicitation or general advertising."[30] Therefore, publicly accessible Web site postings may not be used as a means of locating investors to participate in a pending or imminent U.S. offering relying on those provisions of the federal securities laws. The SEC suggests that, in addition to precautions previously described in the Internet Release, foreign issuers could implement other procedures.[31] For instance, the Internet offeror could allow unrestricted access to its offshore Internet offering materials but not permit persons responding to its Internet offer to participate in its exempt U.S. offering, even if otherwise qualified to do so. Such issuers are cautioned that the posted offering materials should relate only to the offshore offering and should contain only that information, if any, concerning the private U.S. offering that is required by foreign law to be provided to investors participating in the offshore public offering.

Where U.S. issuers use a Web site in connection with an offshore offering, the SEC is concerned that there is a strong likelihood the securities initially offered and sold offshore will enter the U.S. trading markets and that U.S. issuers and investors have a much greater expectation that securities offerings by domestic

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26. *Id.*
27. *Id.*
28. Internet Release, *supra* note 7, at 6.
29. 15 U.S.C. § 77d(2).
30. 17 C.F.R. § 230.502(c).
31. Internet Release, *supra* note 7, at 6.

issuers will be subject to U.S. securities laws.[32] Based on these concerns and as a result of its experience with abusive practices under Regulation S,[33] the SEC emphasizes the need for these issuers, in addition to all other precautions detailed in the Internet Release, to implement password-type procedures that reasonably are designed to ensure that only non-U.S. persons can access the Internet Offer.[34] Under this procedure, persons seeking access to the Internet Offer would have to demonstrate to the issuer or intermediary that they are not U.S. persons before obtaining the password for the site.

2. Investment company securities.—The Internet Release offers special advice with respect to securities of investment companies. If a foreign investment fund implements measures reasonably designed to guard against sales to U.S. persons, the SEC would not consider the foreign fund's Internet Offer to be targeted to U.S. persons and therefore would not consider the Internet Offer to constitute a public offer in the United States which would subject the foreign fund to regulation and registration under the Investment Company Act.[35] The Internet Release cautions, however, that advertisement of the existence of a foreign fund's Web site in a U.S. publication may be viewed as an effort to attract U.S. persons to an Internet Offer and therefore the Internet Offer may be deemed to be targeted at the United States.[36]

If a foreign fund that is concurrently conducting a private U.S. offer and an Internet Offer uses a disclaimer that reflects the existence of two separate offers and indicates that the Internet Offer is not being made in the United States, the SEC would view this action as an indication that the fund has taken measures reasonably designed to guard against publicly selling its securities to U.S. persons.[37] The disclaimer could state that the offshore Internet Offer is not being made in the United States (or identify the jurisdiction(s) in which it is being made) and that the offer and sale of securities in the United States is not permitted except pursuant to an exemption from registration.

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32. *Id.* at 7.
33. 17 C.F.R. §§ 230.901-230.905.
34. Internet Release, *supra* note 7, at 7.
35. 15 U.S.C. §§ 80a-1 - 80a-52.
36. Internet Release, *supra* note 7, at 7.
37. *Id.* at 8.

If a foreign fund directly or indirectly provides any additional information on its Web site about the types of persons to whom offers and sales can be made pursuant to an exemption under U.S. law, or provides any other information about the private U.S. offer, including guidance on how U.S. persons may obtain purchasing information, the SEC would view such action as an indication that the foreign fund is using its Internet Offer to target the United States, except to the extent that foreign law requires the information to be disclosed.[38] Similarly, if the foreign fund provides a hyperlink, or otherwise directs U.S. persons to another source that provides information about the private offering, that also would be viewed as targeting the Internet Offer to the United States and would result in the fund making a public offer in the United States.

3. Investment advisers.—The Internet Release also provides guidance on when a foreign adviser (which is defined as an investment adviser that is organized under the laws of a jurisdiction outside the United States), offers its advisory services over the Internet. A foreign adviser providing advisory services over the Internet generally would be considered to be holding itself out an investment adviser.[39] An adviser who uses a publicly available electronic medium, such as the Internet, to provide information about its services is deemed to be holding itself out to the public as an adviser and does not qualify for the exemption contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (Advisers Act)[40] which provides a registration exemption if the adviser during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds itself out to the public as an investment adviser nor acts as an adviser to a U.S.-registered investment company or business development company.[41]

The Internet Release states that a foreign adviser may be able to rely on the exemption from registration in Section 203(b)(3) of the Advisers Act if it has fewer than fifteen U.S. clients and implements measures reasonably designed to ensure that, based on its Internet activities, the adviser is not holding itself out as an investment adviser in the United States.[42] The Internet Release suggests that such measures would include (1) a prominent

38. *Id.*
39. *Id.* at 10.
40. 15 U.S.C. §§ 80b-1 - 80b-21.
41. Internet Release, *supra* note 7, at 10.
42. *Id.*

disclaimer making it clear to whom the site materials are, or are not, directed and (2) procedures to elicit residency information such as addresses and telephone numbers to ensure that the foreign adviser will have fourteen or fewer U.S. clients.[43]

4. Broker-dealer activities.—The Internet Release states that the SEC will not consider a foreign broker-dealer's advertising on a Web site to constitute an attempt to induce a securities transaction with U.S. persons if the foreign broker-dealer takes measures reasonably designed to ensure that it does not effect securities transactions with U.S. persons as a result of its Internet activities.[44] Such measures would include (1) posting a prominent disclaimer on the Web site either affirmatively delineating the countries in which the broker-dealer's services are available, or stating that the services are not available to U.S. persons and (2) refusing to provide brokerage services to any potential customer that the broker-dealer has reason to believe is, or that indicates that it is, a U.S. person, based on residence, mailing address, payment method, or other grounds.[45]

The Internet Release contains an admonition to foreign broker-dealers that effect transactions with U.S. customers in reliance on Rule 15a-6 under the 1934 Act.[46] This rule provides an exemption from registration as a broker-dealer in the United States for foreign brokers that effect transactions in securities with U.S. customers which were not solicited.[47] The SEC advises that foreign broker-dealers that have Internet Web sites and intend to rely on Rule 15a-6's "unsolicited" exemption should ensure that the customer's transactions are not in fact solicited, either directly or indirectly, through U.S. customers accessing their Web sites.[48]

5. Foreign exchanges.—The SEC will not apply the exchange registration requirements of the 1934 Act to a foreign market that sponsors a Web site containing general advertising about the foreign exchange, disseminating quotes (including real-time quotes with counterparty identification) or allowing orders to be directed to the market through its Web site if the foreign exchange takes steps reasonably designed to prevent U.S. persons from directing

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43. *Id.* at 11.
44. *Id.* at 12.
45. *Id.*
46. 17 C.F.R. § 240.15a-6.
47. *Id.*
48. Internet Release, *supra* note 7, at 12.

orders to the market through its Web site.[49] Reasonable measures would include (1) posting a disclaimer on the Web site affirmatively stating either the countries in which the exchange's services are directly available or that the exchange's services are not available directly to U.S. persons, (2) requiring potential members or direct participants in the exchange to state their residence and mailing address, (3) refusing to allow trading on the exchange through the Web site by any person that the exchange has reason to believe or which indicates that it is a U.S. person and (4) refraining from making arrangements to provide U.S. persons with access to the exchange over the Internet indirectly through its members.[50]

VI. Facilitating Use of The Web

Recognizing that the Web offers legitimate issuers and financial intermediaries significant savings in the costs of contacting investors and providing mandated disclosures, financial regulators in the United States have issued various advices to facilitate use of the Web to communicate with investors. The more important and widely applicable advices include the following:

A. Communication Between Brokers and Investors

The NASD, with the approval of the SEC, has issued new rules concerning electronic communications between brokers and investors.[51] The new rules provide that each NASD member firm must establish procedures for the review by a registered principal of incoming and outgoing written and electronic correspondence of its registered representatives with the public relating to the firm's investment banking or securities business.[52] These procedures must be in writing and designed to provide reasonable supervision of each registered representative.[53] The current requirement to review all correspondence of registered representatives will be retained with respect to all incoming correspondence received in a non-electronic format directed to registered representatives and related to a member's investment banking or securities business.[54] Incoming electronic correspondence (which includes e-mail and

49. *Id.* at 13.
50. *Id.*
51. NASD Notice, *supra* note 12.
52. *Id.* at 1132.
53. *Id.*
54. *Id.*

facsimiles) will be subject to overall supervisory and review procedures established by member firms.[55]

If, with respect to outgoing correspondence to the public, a broker elects not to conduct either an electronic or manual pre-use review, it is required to develop appropriate supervisory procedures, monitor and test these procedures to ensure compliance, provide education and training to all appropriate employees concerning its current policies and procedures governing correspondence and update this training as policies and procedures change and maintain records documenting how and when employees are educated and trained.[56] In conducting reviews, member firms may use reasonable sampling techniques. Appropriate evidence of review would include electronic review and electronic recording.[57] The NASD provides the following guidelines for firms adopting review procedures for correspondence:

1. Specify, in writing, the firm's policies and procedures for reviewing different types of correspondence.

2. Identify how supervisory reviews will be conducted and documented.

3. Identify what types of correspondence will be pre- or post-reviewed.

4. Identify the organizational position(s) responsible for conducting review of the different types of correspondence.

5. Specify the minimum frequency of review of each type of correspondence.

6. Monitor implementation of, and compliance with, the firm's procedures for reviewing public correspondence.

7. Periodically re-evaluate the effectiveness of the firm's procedures for reviewing public correspondence and consider any necessary revisions.[58]

In adopting supervisory review procedures, members must specify procedures for reviewing registered representatives'

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55. *Id.*

56. NASD Notice, *supra* note 12 at 1132. For example, Merrill Lynch has issued a formal policy on e-mail to all its 57,000 worldwide employees and required employees to sign off on the policy. *See 2 Internet Compliance Alert*, No. 9 (May 4, 1998), p. 1.

57. Various commercial products are being made available to conduct electronic surveillance of e-mail communications. For instance, SRA International markets a product called "Assentor" to assist brokerage firms in complying with NASD rules on e-mail communications. This product uses artificial intelligence to help firms identify e-mail that may violate NASD strictures. *See 2 Internet Compliance Alert,* No. 9 (May 4, 1998), p. 3.

58. NASD Notice, *supra* note 12, at 1133.

recommendations to customers, require supervisory review of some of each registered representative's public correspondence, including recommendations to customers, consider the complaint and overall disciplinary history, if any, of the registered representatives and other employees (with particular emphasis on complaints regarding written or oral communications with clients) and consider the nature and extent of training provided registered representatives and other employees, as well as their experience in using communication media.[59] A firm, however, may not eliminate or provide minimal supervisory reviews based solely on an employee's training or level of expertise in using communications media.[60]

Supervisory policies also must (1) state that all customer complaints, whether received via e-mail or in written form, are reported to the NASD, (2) describe firm standards for the content of different types of correspondence and (3) prohibit registered representatives' and other employees' use of electronic correspondence to the public unless such communications are subject to supervisory and review procedures developed by the firm.[61] Specifically, members are to prohibit correspondence with customers from employees' home computers or through third party systems unless the firm is capable for monitoring such communications.[62]

B. Prospectus Delivery and Disclosure Issues

The SEC, in Release Nos. 33-7233 (Oct. 6, 1995) and 33-7288 (May 9, 1996) issued guidance to issuers on how a prospectus may be delivered electronically in compliance with the federal securities laws. SEC Release No. 33-7288 (May 9, 1996) discussed delivery obligations of broker-dealers. Issuers, however, must ensure that their electronic prospectus displayed on a Web site remains "evergreen."[63] Updating of disclosure, particularly to reflect amendments to the preliminary prospectus or offering circular, must be made timely.[64] As long as the offering remains open, the issuer must include all material disclosure, including subsequent

59. *Id.*
60. *Id.*
61. *Id.*
62. *Id.*
63. Use of electronic media by Broken-Dealers, Securities Act Release No. 33-7288, 17 C.F.R. Parts 231, 241, 271 and 275 (May 9, 1996).
64. *Id.*

material changes, in the electronic prospectus or offering circular.[65] In January 1998, NASD Regulation, Inc. issued a policy statement applicable to electronic delivery of information between NASD member brokers and their customers as required or permitted under NASD rules.[66] This policy statement advises member firms how to comply with the aforementioned SEC releases.[67]

C. Direct Public Offerings

A number of U.S. companies have used their Web site to sell securities directly to the public, saving the expense of an underwriter and expending only a fraction of the normal publication and distribution costs of a traditional public offering. In many cases, the issuer was attempting to capitalize on a loyal following of purchasers of its products by turning satisfied customers into shareholders.[68] The Internet Offer Exemption allowed these companies to sell securities from their Web site without invoking the jurisdiction of a state in which they did not register the securities. This exemption particularly is helpful as these types of offerings tend to be made on a regional basis.

D. Issuer-sponsored Bulletin Boards

Many companies involved in using the Web for direct public offerings of securities are small businesses whose stock is not listed or traded on a national securities exchange and where there is little chance that a broker will make a market in the company's stock. The logical next step for these companies is trying to use the Web to facilitate a market for their shares and thereby provide shareholders with some liquidity. The SEC, in the Real Goods Trading Staff No-Action Letter (June 21, 1996), stated that it would not make a company register as a securities exchange under the 1934 Act if it were to establish a bulletin board at the issuer's Web site to facilitate trading of its stock where:

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65. *Id.*

66. NASD Notice to Members 98-3 (Jan. 1998). This Notice was predicated on interpretations enunciated in SEC Release Nos. 33-7288 (May 9, 1996) and 33-7233 (Oct. 6, 1996).

67. *Id.* at 4-5.

68. Examples are public offerings made by Real Goods Trading, Inc., Spring Street Brewing, Inc. and American Accents, Inc.

1. The issuer is subject to the reporting and filing requirements of Section 13 or 15(d) of the 1934 Act.[69]

2. The bulletin board is passive and contains only the names, addresses and telephone numbers or e-mail addresses of interested buyers and sellers along with the number of shares sought to be purchased or sold.

3. The bulletin board contains no advertising.

4. Participants post the information directly onto the Web site of the issuer.

5. Only the participant can remove the posting (but the issuer may impose a maximum time limitation on the duration of all postings).

6. No transactions are effected through the bulletin board and participants are required to contact each other directly to effect the trade.

7. The issuer maintains records of all quotations posted for three years.

8. The issuer receives no compensation to run the bulletin board, does not give advice regarding any trade, is not involved in sale or purchase negotiations and does not receive, transfer or hold funds or securities incident to operating the bulletin board.[70]

E. Closed Systems for Accredited Investors

Historically, U.S. financial regulators have required registration of securities offerings which sought to use general solicitation to engender interest in the purchase of securities offered for sale to the public and precluded use of exemptions from registration where issuers employed such communications. Since U.S. regulators have taken the position that communications on the Web designed to raise capital constitute general solicitation,[71] issuers using the Web were precluded from relying upon registration exemptions even when targeting an offering to a specific category of financially sophisticated investors such as Accredited Investors.[72]

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69. 15 U.S.C.A. §§ 78m and 78o-1(d).

70. Real Good Trading Corp., SEC No Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77, 226 at 2 (June 21, 1996).

71. Internet Release and NASAA Release 1, *supra* note 7.

72. An individual is an Accredited Investor if the person had individual income in excess of $200,000 in each of the 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, or has an individual net worth or joint net worth with spouse at the time of the purchase of the securities which exceeds US $1 million. *See generally* 17 C.F.R.

In a series of actions, federal and state securities regulators have cleared the way for issuers and financial intermediaries to use the Web and employ general solicitation where access to the Web site is restricted to Accredited Investors.[73] In the SEC Staff No Action Letter for IPONET (July 26, 1996), the SEC permitted a registered broker-dealer to maintain an online electronic questionnaire which will allow it and any potential issuer to qualify a person as an Accredited Investor under SEC Regulation D[74] or a sophisticated investor under SEC Rule 506.[75] The broker-dealer will verify the information on the questionnaire and, if the investor meets the standards, the investor will receive an electronic password to the section of the broker's Web site which lists private offerings.[76]

If the investor consents, the broker may contact the investor in the future about new private offerings posted on its Web site.[77] Investors only may purchase in private offerings which are posted on the broker's Web site subsequent in time to the registration of the investor as an Accredited Investor and then only after a sufficient time has elapsed between the registration and the inception of a private offering so that the registration is not deemed to be a solicitation for a particular private offering.[78] SEC staff confirmed that posting of a notice of a private offering in the Accredited Investor Only portion of the broker's Web site does not involve general solicitation or general advertising within the meaning of SEC Regulation D.[79]

F. Angel Capital Electronic Network (ACE-Net)

The SEC Staff No-Action Letter on ACE-Net[80] addressed use of a Web site developed by non-profit academic institutions of

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§ 230.501.

73. State securities regulators have adopted a model Accredited Investor Exemption which allows use of general solicitation in offerings to be sold only to Accredited Investors. *See* Resolution of the North American Securities Administrators Association Regarding a Model Accredited Investor Exemption, adopted Apr. 27, 1997; CCH NASAA Reports ¶ 361.

74. 17 C.F.R. §§ 230.501 - 230.508.

75. 17 C.F.R. § 230.506.

76. IPONET SEC No Action Letter (July 26, 1996) at 3; *available in* 1996 WL 431821 (S.E.C.).

77. *Id.*

78. *Id.*

79. 17 C.F.R. § 230.502(c).

80. ACE-Net, SEC No Action Letter (Oct. 25, 1996); *available in* 1996 WL 636094 (S.E.C.).

higher education involved in small business capital formation. This Web site would contain a list of small corporate offerings of securities that are exempt from registration with the SEC under Section 3(b) of the 1933 Act[81] pursuant to either Rule 504 of SEC Regulation D[82] or SEC Regulation A (System).[83] SEC staff confirmed that ACE-Net would not be required to register as a broker-dealer, investment adviser or a national securities exchange if:

1. Access will be restricted to Accredited Investors who must file certain representations with the academic institution annually.

2. Upon certification, the Accredited Investor will receive a password to the System whereby such investor may peruse the listing of offerings by small companies.

3. Academic institutions provide entrepreneurs with assistance and course offerings on managerial training, financial planning and federal and state tax and securities laws.

4. Entrepreneurs or companies whose promoters, officers or directors have previous disciplinary history in the securities industry may not participate in the System.

5. No trading will take place on the system and no one involved in operating the System will participate in any securities transaction.

6. All transactions occur outside of the System directly between the listing company and the Accredited Investor.

7. The System does not:

a. Advise any listing company or Accredited Investor on the merits of any investment opportunity.

b. Participate in negotiating the terms of any investment.

c. Hold itself out as providing any securities-related services other than a listing or matching service.

d. Directly assist Accredited Investors or listing companies with closing documentation or pay referrals to attorneys involved in completing the transaction.

e. Handle funds or securities involved in the transaction.

f. Receive compensation other than a nominal, flat fee to cover administrative expenses. No fees, commissions or compensation will be contingent upon the outcome or comple-

81. 15 U.S.C.A. § 77c(b).
82. 17 C.F.R. § 230.504.
83. 17 C.F.R. §§ 230.251 - 230.263.

tion of any securities transaction resulting from a listing on the system.[84]

G. *Electronic Delivery and Presentation of Offerings by Third-party Issuers*

On December 18, 1997, the SEC staff, by means of a Staff No-Action Letter, advised that it would not recommend enforcement action against Internet Capital Corporation (ICC) or its personnel for not registering as a broker or dealer under the 1934 Act if it operated a Web site which provided for electronic distribution of prospectus materials for third party issuers.[85] For a flat fee,[86] ICC proposes to provide issuers with an environment for online securities offerings registered under Section 5 of the 1933 Act or exempt from registration pursuant to SEC Regulation A[87] or Rule 504 of SEC Regulation D.[88] This service would not be available for offerings relying upon an exemption from registration under Rule 505 or 506 of SEC Regulation D[89] in that these exemptions prohibit the use of general solicitation or general advertisement.[90]

Persons logging on to ICC's Web site may visit a corporate bulletin board area where a "tombstone" advertisement, preliminary offering document or final prospectus may be viewed on a specific company. All "tombstone" advertisements will meet the requirements of SEC Rule 134 issued under the 1933 Act,[91] together with the "red herring" prospectus meeting the requirements of SEC Rule 430.[92] Distribution of the "tombstone" advertisement and the "red herring" prospectus will be in accordance with SEC Release No. 33-7233 (6 October 1995). There will be no hyperlinks or "hot links" between the ICC Web site and any other corporate marketing information or the corporate client's Internet Web site.[93]

Upon notification by the issuer of an effective date for the offering, ICC will post the final offering document on its Web site

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84. ACE-Net, *supra* note 80.
85. Internet Capitol Corporation SEC No Action Letter (Dec. 18, 1997); *available in* 1997 WL 796944 (S.E.C.).
86. *Id.*
87. 17 C.F.R. §§ 230.251 - 230.263.
88. 17 C.F.R. § 230.504.
89. 17 C.F.R. §§ 230.505, 230.506.
90. 17 C.F.R. § 230.502(c).
91. 17 C.F.R. § 230.134.
92. 17 C.F.R. § 230.430.
93. ICC, *supra* note 85, at 2.

together with subscription documents necessary to purchase the securities being offered.[94] No subscription materials can be accessed without delivery of a prospectus.[95] Individuals accessing ICC will have the opportunity to download the prospectus materials electronically or request that the issuer deliver a printed copy of the prospectus.[96] After electronic delivery of a prospectus, ICC will have no further involvement in the transaction, including negotiations regarding prospective purchasers, record keeping of completed transactions or any reporting requirements of the issuer.[97]

In no instance will ICC function as an underwriter of a security or as a broker or dealer. ICC will not receive any commissions nor take compensation of any kind based on the sale of any security. Neither ICC nor its directors, officers or employees will have an interest in any issuer to be listed or any agent of such issuer. It also will not receive, transfer or hold funds or securities as a function of the operating system. Neither will ICC provide information regarding the advisability of buying or selling securities of companies listed. Each issuer desiring to list an offering with ICC must covenant to ICC that it is in compliance with all applicable federal and state laws and regulations.[98]

H. Third-party Sponsors of Direct Offerings, Secondary Transactions and Listings

By letter of October 14, 1996, The Direct Stock Market, Inc. (d/b/a SCOR-NET) filed a request for a SEC Staff No-Action Letter confirming that the company did not have to register as a broker-dealer, securities exchange or a clearing agency under the 1934 Act in connection with certain activities to be conducted from its Web site on the Internet.[99] SCOR-Net plans to offer certain services for which it will receive a flat fee paid by the issuer of the securities which are the subject of the transaction or the professional who lists the availability of its services on the SCOR-Net Web site.[100]

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94. *Id.* at 3.
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.*
99. Letter to SEC Division of Market Regulation from John Perkins, Esq. (Oct. 14, 1996) [author's personal files] [hereinafter Perkins letter].
100. *Id.*

SCOR-Net will provide a disclaimer that it is not a national securities exchange, securities information processor, broker, dealer or investment adviser.[101] Disclosure would be made that all applicable federal and state securities laws (including registration, anti-fraud and anti-manipulation provisions) apply to any offer made or transaction consummated as a result of a posting on SCOR-Net's Web site.[102] Offers or sales of controlled or restricted shares may be made in reliance upon the exemption in Section 4(1) of the 1933 Act[103] if the requirements of SEC Rule 144,[104] including the manner of sale requirements, are satisfied.[105]

With respect to direct offerings of securities, SCOR-Net would post the prospectus or offering circular only after registration had been granted and would provide a list of states in which registration had been granted.[106] It also would attach a warning stating that the offering cannot be sold in states where the securities are not registered.[107]

Investors would be able to download the offering information only after registering with SCOR-Net and providing certain information which would be forwarded to the issuer for purposes of the issuer determining investor suitability.[108] The investor must contact the issuer directly to effect a purchase of the issuer's securities.[109]

With respect to secondary trading, individual investors may post offers to buy or sell securities of issuers that have information on file with SCOR-Net. By terms of the engagement letter with SCOR-Net, issuers that want to use the company's services to allow investors to post buy or sell notices on the company's Web site must provide a current offering document and audited financial statement, its most recent quarterly unaudited financial statement, a report of all securities transactions within 48 hours of the issuer learning that a transaction has taken place, and a report on any transactions involving individuals or entities owning more than 10 percent of the issuer's stock.[110]

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101. *Id.*
102. *Id.*
103. 15 U.S.C.A. § 77d(1).
104. 17 C.F.R. § 230.144.
105. Perkins letter, *supra* note 99.
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.*
110. Perkins letter, *supra* note 99.

A registered broker-dealer will act as escrow agent and will provide SCOR-Net with information about secondary transactions resulting from a posting on its Web site. To participate in secondary trading on SCOR-Net's Web site, individual investors must register with SCOR-Net, list the price, name of the security, number of shares, whether they wish to buy or sell and how someone wishing to enter into a buy or sell agreement should contact them (SCOR-Net would note that these are not firm quotes and that individual investors must negotiate any final transaction among themselves) and refrain from providing a two-sided quote in which a person indicates a bid to buy at one price and offer to sell at a higher price.[111]

The individual investor would pay no money for this service, but the buyer and seller must agree to use the broker-dealer under contract with SCOR-Net to act as the escrow agent and open an account with that broker-dealer. Neither SCOR-Net nor anyone affiliated with SCOR-Net would handle any customer funds, take any orders or have any direct contact with the individual investors. The company would not take possession of, or exercise any control over, investor funds or securities.[112]

The broker-dealer will handle funds and securities in secondary market transactions facilitated by SCOR-Net's Web site. The broker-dealer will report all transactions that it consummates to SCOR-Net within 48 hours of the trade being completed and will establish and maintain a system to supervise the trading on the secondary market section of SCOR-Net's Web site which is reasonably designed to achieve compliance with all applicable securities laws and regulations, the rules of the NASD and other self-regulatory organizations. While the broker-dealer may not place offers to buy and sell on the secondary trading section of SCOR-Net's Web site, it may solicit an indication of interest. The broker-dealer also would not be permitted to post a simultaneous offer to buy and sell the same security.[113]

Trading data (including all quotations in a particular security), the amount of shares and the price will be maintained for seven days in the secondary trading area of the Web site and thereafter would be copied to text and stored in a historical quotation data base which could be accessed by any investor. SCOR-Net will post warnings that the information in the secondary trading section of

111. *Id.*
112. *Id.*
113. *Id.*

the Web site is limited to that provided by the issuer and that transactions may have occurred through other means which the issuer may not have reported to SCOR-Net. Advertising would be displayed to the extent permitted by federal or state securities laws.[114]

The third area of its Web site would be a place where broker-dealers, accountants, attorneys and others would be allowed to purchase a listing of their services but it would be separate from the secondary market trading section of the company's Web site. Information would be presented in alphabetical order with no preference or recommendation indicated.[115] To date, the SEC has not responded to the SCOR-NET request for a Staff No-Action Letter.

VII. Enforcement Actions

Both state and federal securities regulators in the United States have been active in taking enforcement actions for violations of the securities laws occurring on the Internet. These enforcement actions have involved Ponzi schemes,[116] false and misleading information,[117] fraudulent representations and omissions[118] and

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114. *Id.*

115. Perkins letter, *supra* note 99.

116. In SEC v. Western Executive Group, Inc., et al., D.C. Cal., No. 96-6938, (Oct. 22, 1996), the SEC obtained a preliminary injunction to halt a Ponzi scheme involving investment contracts for the sale and leaseback of automated bank teller machines. The investment program was offered to the public over the Internet and the defendants had raised over $3.9 million from at least 132 investors. *Id.* Investors were guaranteed repayment of principal and a yield of 17.4% per year. *See* 28 *BNA Securities Regulation & Law Report* 1343, Nov. 1, 1996.

117. In SEC v. Wye Resources, D.C., Civil Action No. 96 CV 02223, (May 28, 1997), the SEC won a default ruling against a Canadian entity for engaging in a scheme to defraud U.S. investors through dissemination of false and misleading information on various computer bulletin board services on the Internet. Wye claimed to own interests in various gold and diamond mining properties in former Zaire. *Id.* In fact, Wye had no earnings from actual mining operations. *See* 29 *BNA Securities Regulation and Law Report* 849, June 20, 1997.

118. In SEC v. Lazare Industries, Inc., M.D. Pa., Civil Action No. 3:CV-96-705, (Apr. 25, 1996), SEC Litigation Release No. 13893 (Apr. 25, 1996), 61 SEC Docket 2392 and *Pennsylvania Securities Commission v. Lazare Industries, Inc.*, No. 9510-10, (Oct. 18, 1995), Lazare was charged with engaging in a scheme to defraud at least 72 investors by making fraudulent representations and omissions of material fact on its Web site concerning an ozone/oxygen therapy for the treatment of AIDS. *Id.* It was alleged that Lazare raised at least $1.4 million from the sale of unregistered shares of stock through the Internet and converted investor funds to the personal use of the promoters. *Id.*

stock manipulations.[119] In addition to enforcement assistance provided by state securities regulators, the SEC has organized a "Cyberforce" which is a volunteer team of about 60 attorneys and other SEC staff who regularly surf the Internet looking for fraudulent activity.[120] This force, augmented by enforcement staff and referrals from state securities regulators, has resulted in a number of SEC actions involving communications on the Internet.[121]

A. A Case Study in Web Illusion

An excellent case study of the risks posed by the Web to investors is the Agency for Interamerican Finance (AIF). This official-sounding organization maintained a Web site where investors could obtain information in English, Spanish, French and German about investment opportunities in Interamerican hard currency bonds which would pay 11.75 percent annual interest for a three year term in minimum principal amounts of $2,500.[122] Principal and interest on the bonds were guaranteed up to $250,000 by Group American Pacific Financial, Ltd., S.A., a purported independent trust company.[123] In addition, those who invested at least $10,000 would be provided with 10,000 frequent flyer miles with American Airlines. Investors were to send their money to a post office box in St. John's, Antigua. Dividend checks would be drawn on the local branch of the Swiss American Bank.[124]

AIF explained that it had established its headquarters in Antigua, a "major Caribbean center for international finance" because it had a "well-earned reputation as the most confidential

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119. In SEC v. Huttoe, et al., D.C., No. 96-CV-02543, (Dec. 12, 1996), the SEC filed a complaint to obtain disgorgement of more than $12 million in alleged illegal profits from the sale of Systems of Excellence securities. The SEC alleged that the defendants were involved in market manipulation using the Internet by engaging in a systematic practice of publishing promotional coverage for other issuers in exchange for compensation. *See* 28 *BNA Securities Regulation & Law Report* 1548, Dec. 20, 1996.

120. *See SEC Expands Net Surveillance to Regions*, FINANCIAL NETNEWS, June 23, 1997, at 7.

121. *Id.* On July 28, 1998, the S.E.C. inaugerated a formalized Office of Internet Enforcement within its Division of Enforcement, *see* BNA Daily Report for Executives, 6-1, August 19, 1998.

122. SEC Litigation Release No. 14942 (June 11, 1996); *available* in LEXIS, FEDSEC Library, LITREL file; some of the information on AIF came from AIF's web site <www.aif.com> (accessed May, 1995). This address is now assigned to Associated Industries of Florida.

123. *Id.* at web page.

124. *Id.*

financial jurisdiction in the world."[125] Included in AIF's Web site was a graphic from the cover page of *Business Week* magazine featuring an article on Online Investing.[126] AIF's Web site also displayed a reprint from the "World Financial Report" which had an address of 1 Selegie Road, #09-03 Paradiz Centre, Singapore 0718. The "World Financial Report" praised AIF's hard currency bond for its high yield, safety and customer service and assigned it a rating of "excellent to extraordinary," particularly with respect to AIF's financial solvency and management team.[127]

In response to initial investigation by the Pennsylvania Securities Commission, the SEC initiated an enforcement action concerning AIF. According to the SEC Litigation Release on AIF, AIF was a total sham.[128] No bonds existed and AIF had no business operations or assets.[129] Group American Pacific Financial, Ltd., S.A. also lacked assets and business operations.[130] Both were Panamanian shell subsidiaries of Octagon Technology Group, Inc., a computer software company located in a suburb of Chicago, Illinois.[131] AIF's headquarters in St. John's, Antigua actually was a rented mail drop. The World Financial Report was a total fabrication and American Airlines was not awarding frequent traveler miles for the purchase of bonds.[132]

The SEC obtained a civil injunction against Octagon Technology Group, Inc. and its promoters which permanently enjoined them from future violations of the anti-fraud provisions of the federal securities laws and imposed a monetary civil penalty.[133]

B. Other Web Offerings

Another Web offering featured an opportunity proffered by a company named Destiny Pictures for investors to pay $100 a share to become a financial backer of a proposed film to be entitled, "Intimate Stranger," an erotic thriller.[134] The offering was

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125. *Id.*
126. *Id.*
127. *Id.*
128. SEC Litigation Release No. 14942, *supra* note 122.
129. *Id.*
130. *Id.*
131. *Id.*
132. *Id.*
133. *SEC v. Octagon Technology Group, Inc., Michael J. Tidd and Jeffrey L. Punzel*, Civil Action No. 96-1299 (D.D.C. June 11, 1996).
134. David Chen, *Internet Links Investors to Movie but the Reviews are Critical*, N.Y. TIMES, Apr. 14, 1997, at D9.

pitched as an opportunity for the "everyday guy" to "become part of the movie community" by sending $100 by credit card, wire transfer or cashier's check.[135] Destiny failed to register its stock offering with securities regulators and is the subject of investigation in California and a cease and desist order in New York.[136]

In another situation, the Web site for the FreeMarket Foundation, a self-styled charitable non-profit organization devoted to maintaining a Web site where companies can conduct initial public offerings directly to investors, was linked to a Web site for Offshore Capital Resources (OCR), an allegedly Bahamas-based company, which is conducting a $2 million offering to take companies public on the Internet.[137] Included in the OCR private placement memorandum are financial projections showing that the company, which currently has $1,000 in assets, expected to gross over $16 million by June 30, 1998 and have a net income of $11 million.[138] These financial projections carry the following caveat: "For illustration purposes only - These figures bear no relationship to reality"![139] Interestingly, John Markham, who is listed in OCRs' private placement memorandum as a director and operations specialist, also has identified himself as the chairman of the FreeMarket Foundation.[140]

C. *Hiding One's Past on the Web*

In *SEC v. Sellin*,[141] the SEC obtained a temporary restraining order against a convicted felon and repeat securities law violator who was engaged in offering promissory notes with guaranteed returns of between 12 percent and 22 percent per year that purportedly were secured and collateralized by U.S. government securities and other assets. The SEC alleged that Sellin solicited investors through at least 43 advertisements on at least 21 Internet newsgroups. The SEC also alleged that, in addition to failing to disclose that the notes were not secured or collateralized by U.S. government securities, Sellin failed to disclose "his long record of

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135. *Id.*

136. David Chen, *Two States Investigate Film Company's Online Request for Investors*, N.Y. TIMES, May 12, 1997.

137. O'Brien, *Internet Investing*, SAN JOSE MERCURY NEWS, Dec. 1, 1996.

138. *Id.*

139. *Id.*

140. *Id.*

141. SEC v. William B. Sellin II, Zaitech Holdings, Inc. and Baccaratt Holdings, Inc., S.D. Fla., Case No. 96-6825-CIV-Ungaro, (July 25, 1996); *see* 28 *BNA Securities Regulation & Law Report* 944, Aug. 2, 1996.

regulatory sanctions and criminal convictions, including a Florida felony conviction for grand larceny."[142]

Another promoter's attempt to hide his unsavory past involved e-mail solicitations to purchase stock in a company being formed to operate gambling over the Internet.[143] The disclosure documents used in connection with the solicitation failed to disclose that an executive officer of the company was subject of a permanent injunction obtained by the SEC in 1993 and was subject to another SEC action in 1996 wherein the SEC permanently barred him from associating with any broker or dealer, national securities exchange or registered securities association.[144]

C. Newsgroups, Bulletin Boards and Online Newletters

Bulletin boards have become a favorite haven for fraudsters to advertise their current scams and lure unsuspecting investors. While many newsgroups afford a legitimate means for investors to ask questions, make comments and exchange useful information, it also provides an avenue for hype and promises that often are "too good to be true." One investor found that a posting by a small company seeking only $100 in individual investments but promising a 125% return actually was being run by a 16 year old.[145]

In several recent crackdowns, the SEC has shown how lucrative it can be for persons to tout certain stocks on their Internet newsletters. In February 1997, the SEC accused George Chelekis of receiving $1.1 million in cash and 275,000 shares of stock from companies which he promoted on his Web site without disclosure to subscribers.[146] In contrast, the SEC said Chelekis had received only about $37,000 from persons subscribing to his newsletter during a 14-month period.

In other litigation, the SEC made a similar charge against a contractor for a newsletter publisher who sold his shares in companies whose prices he was inflating by writing upbeat research reports.[147] The SEC alleged that this individual made $850,000

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142. *Id.*

143. Pennsylvania Securities Commission v. The Gambler, Inc., World Wide Web Gaming and James Patrick Harrington, No. 9612-09, (Jan. 15, 1997).

144. *Id.*

145. Internet Investing, *supra* note 137.

146. SEC v. George Chelekis, KGC, Inc., and Hot Stocks Review, Inc., D.C., Civil Action No. 97CV-00374, (Feb. 25, 1997); *see* 29 *BNA Securities Regulation & Law Report* 259, Feb. 28, 1997.

147. Gary Weiss, *Web of Hype and Glory*, BUSINESS WEEK, June 16, 1997, at 108.

in free stock for touting Systems of Excellence, Inc. (whose former chairman is now in jail for stock fraud) and 17 other stocks.[148] The SEC asserts that it is not sufficient for online newsletters to explain that companies pay to place their names on the Web sites. It argues that the newletters must disclose the specific payments they receive to list each stock.[149]

Motley Fool, a well-known online investor forum in the U.S., recently announced that it will hire a staff of moderators to oversee various online discussion groups out of concern that the forum could face some potential liability for postings made on it.[150] Also, it has posted consumer warnings on its Web page and established an e-mail connection to the NASD whereby investors can file complaints directly with the NASD.[151] The NASD intends to contact other online forums and ask for their assistance in educating public investors.[152]

VIII. The Direction of Financial Regulation and the Internet

The eternal dilemma facing financial regulators of fostering legitimate capital formation while maintaining appropriate standards of investor protection has not changed with the Internet. Regulators need to be flexible to facilitate the advantages wrought by the Internet for capital formation and provision of financial services and let the market decide whether these advantages become accepted by consumers or are rejected. On the other hand, regulators have to be more innovative in their enforcement techniques and become more effective in the use of cross-agency as well as cross-border cooperative investigations and prosecutions.

In a striking example of cross-agency, cross-border and federal-state cooperation, officials from the U.S. Federal Trade Commission (FTC) and securities regulators from 21 states in the U.S. and two Canadian Provinces conducted a cooperative six month sweep of telemarketing, business opportunity, and investment scams touted on the Internet which, on July 2, 1997, culminated in the filing of 61 actions.[153] The nine civil cases brought by the FTC

148. *Id.*
149. *Id.*
150. Deborah Lohse, *Motley Fool is Wising Up Forum Staff*, WALL STREET J., Mar. 27, 1997, at C1.
151. 28 *BNA Securities Regulation & Law Report* 1034, Aug. 23, 1996.
152. *Id.*
153. Mary Gordon, *New Investment Scams Fought*, THE ASSOCIATED PRESS ONLINE, July 2, 1997.

alone represent investor losses of more than $150 million.[154] In one case, a company promised returns of up to 600% a year on partnership investments in a virtual shopping mall to be placed on the Internet.[155] The FTC alleges that the defendants converted the money for their own use and left investors with worthless stock certificates.[156]

Enforcement divisions at the state and federal level as well as within NASD Regulation, Inc., the enforcement arm of the NASD, are developing custom-designed search engines to troll through the Internet looking for investment-related Web sites, bulletin boards and online fora.[157] More agencies and organizations are devoting resources to establish their own version of the SEC's Cyberforce to detect and prosecute cyberfraud.[158] The courts are beginning to issue decisions relating to enforcement actions relating to the Internet; for example, receipt of e-mail in a jurisdiction has been held to be sufficient nexus to subject the promoter of a company to suit in that jurisdiction.[159] A search warrant to seize a computer system as an instrumentality of a crime has been held to render constitutional the seizure of all e-mail stored in that system.[160]

IX. Fighting Fire With Fire

Ideally, the Internet may be about the free flow of truthful and reliable information. The Internet, however, is a system which communicates only that information which is fed into it by humans. Thus, it is inevitable that the Internet also will contain misinformation, disinformation and omission. These, of course, are the allies of fraudsters and scam artists. The Internet, however, permits financial regulators to become better allies of the investor because it permits vast government data bases and information banks to become accessible quickly and easily to individual consumers. What the fraudster seeks to omit from the Web site can be discovered by a diligent consumer in the public disciplinary files of the regulator accessible through the regulator's Web site.

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154. *Id.*
155. *Id.*
156. *Id.*
157. Regulatory Chat, 3 FINANCIAL NETNEWS, No 24 (June 15, 1998), p. 8.
158. *Id.*
159. *Cody v. Ward*, D. D.C., No. 3:95CV169 (RNC), (Feb. 4, 1997); 20 *BNA Securities & Regulation Law Report* 267, Feb. 28, 1997.
160. *Davis v. Gracey*, CA 10, No. 95-6245, (Apr. 21, 1997); 65 *Law Week* 1166, May 6, 1997.

With this new capability comes an obligation for regulators to make as much information available to investors through the Internet as quickly and easily as possible and encourage other organizations and institutions associated with financial regulation to do likewise. Set forth below are several important Web addresses that provide research opportunities for investors or provide important investor education information.

www.sec.gov. This is the SEC's Web site. It contains access to EDGAR, the repository of all corporate filings with the SEC. Investors also can obtain information on SEC enforcement actions and file complaints online. Helpful search engines are included on this site.

www.fedworld.gov. This site is the jumping off point to finding Web sites of other agencies of the U.S. Government.

www.nasaa.org. This is the site of the North American Securities Administrators Association which represents all state securities regulators in the United States, Canadian Provincial securities regulators and the securities regulators in Puerto Rico and Mexico. It provides investor education information and, importantly, links to all State and Provincial Web sites which contain significant amounts of investor education materials, enforcement actions and broker-dealer disciplinary information. It is the best way to access information maintained at the state and provincial level.

For example, www.psc.pa.state.us is the Web site for the Pennsylvania Securities Commission (PSC). This site lists recent enforcement actions, available investor education materials, including an investor bulletin entitled, "Online Investor Schemes: Fraud and Abuse in Cyberspace," and how to check the background of your broker or investment adviser. By listing recent enforcement actions on its Web page, the PSC often receives additional inquiries from investors who had been similarly solicited or victimized. In the near future, the PSC will begin listing all securities offerings registered by the PSC so investors can check to see if an offering for which they have been solicited actually has been registered. Also, the PSC is considering issuing encrypted medallions to those Web sites of companies that are making a direct offering of securities over the Internet to indicate compliance by that company with applicable securities laws.

www.nasdr.com. This is the site of NASD Regulation, Inc., the enforcement arm of the NASD which disciplines brokers. This site allows filing of complaints online against member brokers. Currently, this site allows investors to request information on the background of brokerage firms and their registered agents. In the near future, this site will allow investors instant access to the background, including disciplinary history, of over 500,000 persons licensed in the financial services industry in the United States.[161] Until this feature is fully operational, investors's best bet to obtain this information is to contact the state in which the financial intermediary is located. State securities regulators can be found via www.nasaa.org.

www.investorprotection.org. This is the site of the non-profit Investor Protection Trust. The trust was established in 1993 with $2 million from Salomon Brothers as part of a multi-state settlement of its misconduct in the government securities markets. The trust is dedicated to serving as an independent source of investor educational materials. Investor education materials available from this site include an excellent video, "How to Prevent and Resolve Problems with Investment Professionals."

www.usps.gov/websites/depart/inspect/invest.htm. This is the site of the U.S. Postal Inspection Service which provides information on personal finance-related schemes such as charity frauds, advance fee loan schemes and land frauds.

www.ftc.gov/bcp/conline/pubs/invest/invest.htm. This is the site of Federal Trade Commission of the U.S. Government. It describes many consumer frauds currently operating in the United States with particular attention given to scams being perpetrated on the Internet.

www.investoreducation.org. This is the site of the Alliance for Investor Education which is sponsored by a number of financial services industry trade groups, stock exchanges and non-profit organizations. It seeks to promote a greater understanding of investing, investments and the financial markets. It has easy-to-use hotlinks to Web pages of member sponsors that provide more

161. 28 *BNA Securities Regulation & Law Report* 412, Mar. 22, 1996.

detailed information about their specific area of investing, e.g. financial planning, securities markets and brokerage firms.

www.aaii.com. This is the site of the American Association of Individual Investors. It is one of the hotlinks provided at www-.investoreducation.org and gives essential basic information about investing.

www/stockdetective.com. This is a site run by Axxess, Inc. that dishes dirt on what it thinks are raw investment deals for investors. A section called "Stinky Stocks" lists those stocks which it thinks investors should avoid.

Other Web sites relating to financial regulators or participants in the U.S. financial markets are:

www.bog.frb.fed.us. The Board of Governors of the U.S. Federal Reserve System.

www.psa.com. The Bond Market Association.

www.cfp-board.org. Certified Financial Planner Board of Standards.

www.icfp.org. Institute of Certified Financial Planners.

www.iafp.org. International Association of Financial Planners.

www.ici.org. The Investment Company Institute.

www.nasd.com. The National Association of Securities Dealers.

www.nyse.com. The New York Stock Exchange.

www.sia.com. The Securities Industry Association.

www.dol.gov/dol/pwba. The Pension and Welfare Benefits Administration of the U.S. Department of Labor (ERISA and pension plan issues).

X. The Way Forward

With respect to the Internet, financial regulators should focus on the use of innovative enforcement techniques, training of specialized staff, cross-agency as well as cross-border cooperation, opening of government and institutional data bases and information banks to consumers and application of balanced regulation to facilitate use of the Internet for legitimate capital formation and provision of financial services.