A Roadmap to Raising Capital on the Information Superhighway: Directions to Avoid the Potholes

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Since the Spring Street Brewery Internet stock offering in the spring of 1996, the Internet has provided a viable alternative for companies to the more traditional style of offering stock to the public that in some instances eliminates the costs involved in the registration and offering process. Younger and smaller companies are able to reach the public faster, cheaper and with seemingly less restrictions; however, it may not be the ideal opportunity for every company or for the unseasoned investor. This article provides a general outline of how a company may conduct a securities offering directly to the public over the Internet. It will also discuss the advantages and disadvantages of pursuing such an undertaking.

The increased utility of the Internet and approval by the Securities and Exchange Commission (SEC) of its useful application in the securities industry has revolutionized raising venture capital. It has enabled smaller companies that were previously considered by underwriters to be unlikely candidates “to go public” and to raise much needed capital through self-managed initial public offerings (IPOs) or what has been termed direct public offerings (DPOs).

DPOs are generally not handled by an underwriter, unlike the traditional style of financing. The Internet has also allowed larger companies to conduct secondary offerings without paying the underwriter’s fee and expenses associated with the use of an underwriter as well as the costs of printing and mailing paper documents. Finally, the “unpreferred retail investor,” or the average person, is able to participate in IPOs at the initial offering price rather than being relegated to purchasing the same securities at a higher price in the secondary market.

The Offering Process

The Internet has not changed the basic rules to the game of capital-raising, but rather has extended the capabilities of the players involved, i.e. the company, or issuer, and the investor. The process of registering and offering securities remains the same and is conducted within the parameters of the Securities Act of 1933 as amended and the rules and regulations it promulgated under the 1933 Act. The antifraud rules of the 1933 Act also apply to Internet offerings.

The 1933 Act specifically regulates the offering and sale of securities (as that term is defined under the act) and the protection of the purchasers of such securities and requires every company intending to offer securities to the public to file a registration statement with the SEC including a prospectus and any additional information concerning the company that is publicly available. The SEC reviews the information in the registration statement and, once it determines that it contains adequate disclosure of the company’s operations for investor protection, declares the registration statement effective.

Under the federal securities laws, without an effective registration statement or a qualified offering circular in the case of a Regulation A offering, or an exemption from the
Essentially, information as to analyst reports and SB-2, provide the disclosure as well as evidence of that could be offers and a few types of written forms of media. The SEC's access requirement to register under Section 5 of the 1933 Act, a company is prohibited from offering or selling a security to the public. The SEC, however, has defined the place of the Internet within the basic framework of the offering process in its October 1995 Interpretive Release, dealing with the substantive issues of electronic communications and delivery, and the May 1996 Interpretive Releases, which explained the technical amendments to the regulations.

The SEC's primary concern with respect to utilizing electronic media in the offering of securities is that any form of electronic communication substituting for paper documents provides to potential investors: (1) notice; (2) access; and (3) evidence of delivery with respect to all forms of offering materials normally provided to an investor during the course of a securities offering.

According to the SEC's October 1995 Release, electronic notice must be timely and adequate, providing investors with sufficient knowledge that company disclosure information is available. As with the mailing of paper documents, the mailing of an electronic document by e-mail, disk, CD-Ram, audio or video tape constitutes adequate notice. It is not sufficient, however, for a company to put information on a website without some type of direct notice through the aforementioned forms of media indicating that the Information is located there. The SEC's access requirement specifically demands that "electronically delivered information must result in the delivery of substantially equivalent information as would have been provided in paper form," in a medium that is not burdensome, and has an element of permanence. Essentially, an investor must receive the same information as he or she would have by paper delivery in a simple and understandable form that is capable of being downloaded or viewed for as long as the delivery requirement is applicable. Finally, the SEC requires evidence of delivery, or "reasonable assurance" that "any electronic means so selected will result in the satisfaction of delivery requirements under the 1933 Act."

Bearing these requirements in mind, a company may commence the registration or qualification process for a DPO. Depending on certain factors, including the amount of capital that a company intends to raise, there are several types of registration statements the company may utilize, which are the same forms utilized in a traditional non-Internet offering.

A company that intends to raise over $5 million must file a full registration statement on the applicable federal registration form as well as any required state registration form, but an issuer that desires to raise smaller amounts and qualifies as a small business issuer may file a Form SB-1 or SB-2, provide the disclosure required in Regulation S-B, and complete a full registration in all 50 states.

If an issuer intends to raise $5 million or less within 12 months it may use a Form 1-A under Regulation A, which provides an exemption from full registration. Additionally, a company desiring to raise $1 million may use a small company offering registration (SCOR). If a company that intends to raise over $5 million must file a full registration statement on the applicable federal registration form as well as any required state registration form, but an issuer that desires to raise smaller amounts and qualifies as a small business issuer may file a Form SB-1 or SB-2, provide the disclosure required in Regulation S-B, and complete a full registration in all 50 states.

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The registration process consists of: (1) the pre-filing period; (2) the waiting period; (3) the post-effective period; and (4) state blue sky registration.

The Pre-Filing Period

Once the company has decided to file a registration statement or offering circular or, during a traditional IPO, has commenced negotiations with a prospective underwriter, the pre-filing period is initiated, and the company is prohibited from making any communication that "conditions the market" for the securities it intends to offer. The general term for such a communication is "gun-jumping," and is violative of Section 5(c) of the 1933 Act. However, there are certain permitted types of communications: (1) preliminary underwriter negotiations; (2) promotion in the ordinary course of business; (3) restricted issuer notices under Rule 135 of the 1933 Act; (4) analysis reports under limited conditions; and (5) "testing the waters" under Regulation A.

In the context of an Internet DPO, companies with their own website need to take certain precautionary measures during the pre-filing period to ensure that the information contained on their web pages does not constitute a prohibited communication. They should remove any hyperlinks to analyst reports and any information that could be considered to condion the market, including financial forecasts, projections or other indications of the company's value, since they could be deemed to be an issuer communication outside the scope that is permitted under Rule 135. The rule of thumb to follow for removal is whether the information posted falls outside the ordinary course of business communications. The importance of such removals cannot be overstated.

Companies that do not have a website should not choose the period during a DPO to construct one, since it could be viewed as an action outside the ordinary course of the issuer business, and therefore be deemed a communication intended to "condition the market." The Waiting Period

The interim period between the date the company's registration statement is filed and the date on which it becomes effective is called the waiting period. During this period, oral offers and a few types of written offers within given limitations can be made to investors, which are: (1) tombstone advertisements (general notices traditionally published in the newspaper announcing the identity of the issuer and the securities to be offered pursuant to Rule 134 of the 1933 act); (2) preliminary prospectuses which include summary prospectuses for those reporting companies for at
least three years; (3) indications of interest; (4) promotions in the ordinary course of business; (5) analyst reports pursuant to Rules 137-139; and (6) electronic roadshows. 28 A roadshow comprises a round of meetings and presentations in and around the United States or foreign countries in which the company’s management presents the company and its operations to potential investors and answers any questions from these individuals or institutional investor representatives. 29

Any electronic communication is deemed a written offer, therefore it must conform to one of the accepted forms of written offers or else it is proscribed. 30 The company may, however, send a tombstone ad electronically as long as it conforms to Rule 135b. 31 Additionally, a company can place the traditional tombstone ad in the newspapers with a reference to a website where investors may view a preliminary prospectus. 32

The preliminary prospectus included in the registration statement may also be in electronic media, although if posted on the same website the company generally uses for its business; it should contain a disclaimer refuting any incorporation or reference to the other information of the website. 33 A suggested format to eliminate this potential problem is to post the preliminary prospectus on a separate and individual page. 34 The issuer also has the same duty as it would through paper delivery to update the preliminary prospectus with any material changes and provide sufficient notice to potential investors of the update. 35

The company may also solicit indications of interest pursuant to Rule 134(d) via e-mail as long as they are solicited along with the provision of a preliminary prospectus. 36 As previously indicated in the discussion concerning the pre-filing period, the company may continue to provide promotional information in the ordinary course of business and analyst reports in accordance with the same conditions and limitations. 37

Perhaps the most crucial activity permitted during the waiting period that has been impacted the most by the use of electronic media has been the roadshow. 38 Through a series of no-action letters, the SEC has sanctioned the electronic roadshow. The SEC will allow a roadshow to be conducted over the Internet if it involves: (1) a limited audience; (2) simultaneous or prior delivery of preliminary prospectus; and (3) measures to prevent targeted investors from downloading or retaining a permanent copy of the presentation. 39

The Post-Effective Period

At the very moment the registration statement is deemed effective by the SEC, the company may actually make and confirm sales and the post-effective period begins. 40 During this period, the issuer, or in the case of a traditional IPO the underwriter, delivers the final prospectus to investors and may also deliver supplemental sales literature as long as it is either preceded or accompanied by the final prospectus. 41 In an Internet DPO, the issuer may deliver the final prospectus electronically, and any additional sales literature, if the investor has specifically consented to that type of media being used for delivery or the issuer has confirmed the sale by regular mail including a notice in such confirmation that the final prospectus is available at a given address. 42 The SEC has stated that there is adequate delivery electronically if the investor has access to both documents in close proximity to each other, and is able to view the final prospectus if he or she is able to view or download the sales literature. 43

If, however, the company utilizes a website for delivery, it must take care to put the final prospectus on a prior or the same menu as any additional sales literature to ensure that an investor may not download sales literature prior to viewing or downloading the final prospectus and has access to the final prospectus on the page containing the sales literature through a hyperlink. 44 Analyst and research reports should be treated the same way as supplemental sales literature. 45

The final prospectus is required to be updated with material changes as is the preliminary prospectus. and must remain on the company’s website or wherever posted on the Internet for the duration of the requisite period, i.e., until the offering is exempt from registration under the broker’s exemption under Section 4(3) of the 1933 act and Rule 174. 46 The prospectus may also be delivered via e-mail if the investor consents to that medium of delivery; however, any form of delivery to which consent is not given will not constitute sufficient delivery. 47

An interesting result of the SEC’s consent to the use of electronic delivery is that it allows delivery of prospectuses and securities information in mixed media to different individuals as long as all forms comply with the applicable requirements under the federal securities laws, indicate within each form that there are other forms of prospectus that also may be obtained from the issuer, and are all filed with the SEC as a part of an appendix to the registration statement. 48 Additionally, a company must provide brokerage firms with paper versions of the final prospectus pursuant to Rule 153 for those investors who request them in lieu of electronic delivery.

Blue Sky Requirements

In addition to registration with the SEC, a corporation desiring to issue and sell securities must also register with each state securities commission or find some exemption from registration under each state’s blue sky laws, which are each state’s statutory regulations of securities offerings. 49 The North American Securities Administrators Association, Inc. (NASAA) has addressed the issue of conducting IPOs and DPOs over the Internet in order to provide a uniform

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standard after which each state could model its own regulations. NASAA’s resolution, which was adopted on January 7, 1996, encourages states to exempt Internet offers from each of their state registration requirements if the offer is not made to their residents and certain conditions are met or to accept a uniform registration statement such as a Form U-7 for offers to their residents.\textsuperscript{54}

As of the date of this article, 38 states had adopted some type of version of the NASAA resolution through statutory enactment, administrative proceeding, or no-action letter including New Jersey, which exempts any offering over the Internet under the same NASAA guidelines unless a registration statement is filed with the New Jersey Bureau of Securities.\textsuperscript{55}

According to several authors in the securities field, the greatest hindrance to Internet offerings lies in the states’ reluctance to take a uniform position on Internet-based offerings.\textsuperscript{53} While the NASAA resolution is a good starting point, the inconsistencies among each state’s adoption of the resolution result in increased costs to the issuer since an issuer must register separately with each state rather than using a uniform form. The remedy to this problem suggested by most securities authors is the adoption of federal statutory standards that would solve the state statutory differences by preempting all state regulation under the National Securities Market Improvement Act of 1996, which was enacted to preempt all state regulation of securities listed on the NYSE, ASE and National Market System of the NASDAQ as well as those sold in certain exempt offerings and mutual funds regardless of the manner of offering.\textsuperscript{56}

Until Congress legislates a preempting statute, companies are required to specifically abide by the securities laws of each state in which they intend to offer, including filing and payment of each state’s required fees which could be collectively substantial and also to ensure that their offering generally conforms to the securities laws in all 50 states for Internet offerings.

Advantages and Disadvantages of an Internet DPO

The Internet DPO offers several advantages to companies over the traditional IPO. For small issuers, an Internet DPO provides the opportunity to bypass the road of private financing, and the necessity to enlist friends, family and accredited investors as shareholders in favor of directly selling to the average investor. For both large and small issuers, an Internet DPO allows capital-raising without the costs involved in hiring an underwriter, paying printing and mailing costs, registration fees to the SEC, and, in the case of small issuers, without facing the potential rejection by an underwriter.

On average, an underwriter charges, with an expense allowance, seven to 13 percent of the gross proceeds. It is our firm’s experience that the entire costs involved in conducting an IPO for a $5 million to $8 million deal will be about 20 percent of the gross proceeds, including legal and accounting expenses.\textsuperscript{53} With a self-managed offering, a company directly pockets all of the proceeds of the offering less any expenses.\textsuperscript{56} Additionally, a company saves in overall registration expenses using a Form SB-1 or 2 and even more by using a short-form registration under Regulation A since there is no federal registration fee for filing a Regulation A offering circular.\textsuperscript{57}

In a non-Internet DPO, the smaller issuer typically is not as successful in raising adequate capital because it has to focus its efforts on the daily operation of the company, rather than actively seeking and soliciting investors. whereas the Internet provides an avenue through which the small company can list the approved offering information on its website or that of an Internet broker-dealer without losing large amounts of time from its operational focus, and investors can find the deal themselves by searching the web and arriving at the company’s website and information.\textsuperscript{58}

A company can additionally reach more investors, or sources of capital, faster and easier if it does actively solicit investors, albeit some may be less sophisticated than those ordinarily targeted by an underwriter, which can be a disadvantage.\textsuperscript{59} Finally, previously shunned “unpreferred retail investors” are granted the opportunity to participate in an IPO and avoid brokerage fees and higher secondary market prices, which allows them to invest more money in the company since they too are not paying the middleman’s fees, which could be sizable in comparison to the smaller investment that “unpreferred retail investors” generally make.\textsuperscript{60}

The disadvantages of an Internet DPO also should be considered. In addition to the continuing need to research and comply with the blue sky laws of each state as mentioned in the previous section, the foremost criticized aspect of a DPO is the elimination of the underwriter, and the important function that it serves of conducting due diligence merit review, investor contact and aftermarket support.\textsuperscript{61}

In an underwritten DPO, a large part of the underwriter’s responsibility is to act as the gatekeeper to the public. The underwriter evaluates the company, which requires the underwriter to conduct extensive due diligence including the examination of the company’s financial condition, its operations, income, its relationships with third parties, its goods or services and evaluates the merits of the offering and whether the company will be capable of withstanding the pressures of reporting its every action to the public.\textsuperscript{62}

If an underwriter does not feel that a company is ready to be sold to the
public, it will refuse to sell the deal.\textsuperscript{43} As a result of these evaluations, and ensuring that the company is a solid and stable corporation, the underwriter is protecting the investor from the risk of losing their investment because the company is unstable financially and goes under.\textsuperscript{44}

Finally, the underwriter renders aftermarket support and liquidity of the issuer's securities, which is not usually present in an Internet IPO. In a traditional IPO, the underwriter will not only act as a market maker in the securities, thereby providing liquidity in the market and stimulating demand for the shares, but will also provide post-offering analyst reports for dissemination and investor relations support.\textsuperscript{45} In a non-underwritten DPO, the issuer must either create its own liquidity through creation of its own bulletin board system, like that developed by Andrew Klein to sell his Spring Street stock, or find a broker to market some of the securities which is a difficult task.\textsuperscript{46}

Since there is no market maker moving the shares, an investor is dependent solely upon the company stimulating interest in the stock, which is a risky venture to that individual.

**Conclusion: The Road Ahead**

What lies ahead for Internet IPOs and DPOs? Many companies have targeted the IPO and DPO market as a potential goldmine and have developed companies specifically to consult and assist issuers who desire to commence an Internet IPO.\textsuperscript{47} Critics still warn that investing in small company IPOs is too risky for the average individual investor. However, many more companies are turning to this means of raising capital, and some are taking it one step further by conducting “Dutch auction-style” IPOs, and some cities have even begun offering their municipal bonds over the Internet.\textsuperscript{48}

Federal and state regulators are also taking their regulatory actions one step further, and are attempting to maintain pace with brokerages and companies on-line to ensure that fraud does not erode a gaping sinkhole in the information superhighway. History has demonstrated that securities fraud occurs more frequently at the time of increased popularity of stock offerings, and in today’s society, where financial information can be widely disseminated at the speed of light, fraud is definitely a pothole for the retail investor to avoid.\textsuperscript{49}

In this electronic age, people are using their PCs not just for entertainment and work, but also to make financial decisions and to invest in their futures. Thus, under the proper conditions and with the appropriate regulatory supervision, Internet IPOs and DPOs could lead the average investor down a path of gold and the large and small issuer down easy street.\textsuperscript{50}

**Endnotes**


2. Since 1995, the SEC has been addressing the use of electronic delivery and media in the securities field through a series of no-action letters, interpretive releases and regulations. See Note 6 infra.


5. Jeffrey J. Hass, Small Issue Public Offerings Conducted Over the Internet: Are They “Suitable” for the Retail Investor?, 72 S. Cal. L. Rev. 67, 101 (November, 1998). Hass observes that “[a]n unpreferred retail investor’s best chance to participate in a particular IPO occurs when (I) subscriptions from an underwriter’s traditional investor base (institutional investors and preferred retail investors) are insufficient to sell all the shares in the IPO and/or (2) that investor’s brokerage account is with the underwriter’s broker-dealer division or subsidiary.” Id.

6. There are still some of the same investor protections within the framework of existing securities regulations. In particular, the antifraud provisions under Section 10 of the Securities and Exchange Act of 1933 and Rule 10b-5 as well as §17(b) of the 1933 Act are equally applicable to electronic media.

Steven Wolowitz and Anthony J. Diana, Unexpected SEC Issues are Arising Online, Nat’l L.J., Feb. 9, 1998, at Bll, n.1. The SEC has reinforced this notion, stating that “electronically delivered documents must be prepared, updated, and delivered consistent with the provisions of the Federal Securities Laws in the same manner as paper documents.” Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, 60 Fed. Reg. 53,458 (Oct. 13, 1995) [hereinafter October Release]. Regardless of whether information is delivered through paper or electronic means, it should, of course, convey all material and required information.” Wolowitz, supra. The Enforcement Division of the SEC has instituted a variety of new measures to apply the old regulations to the new media of fraud, including a “Complaint Center” and “Investor Alert” sections to the SEC web page which are specifically to be utilized online by investors and Division Surveillance of the Net for investment schemes and prosecution of offtrackers.


7. McGlosson, supra note 6, at 305-306.

8. 15 USC §77e(c).