Volume 25 | Issue 4 Article 2

5-15-1998

An Innovative Link Between the Internet, the Capital Markets, and the SEC: How the Internet Direct Public Offering Helps Small Companies Looking to Raise Capital

Daniel Everett Giddings

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I. INTRODUCTION

A. *The Innovator: Spring Street Brewery*

In March 1995, Spring Street Brewing Company (Spring Street) was growing fast, had an innovative chief executive officer (CEO), and "needed funds to expand."[1] The three-year-old microbrewery needed the funds quickly[2] and lacked the financial wherewithal to access the capital contained in Wall Street's behemoth investment banks.[3] Furthermore, the owners wanted to avoid selling part of the company which would be required if they used the venture capital route.[4] Thus,

1. *See* Kerry Hannon, *Going Public to the Public; Small Businesses Can Bypass Underwriters and Save Big Money*, U.S. NEWS & WORLD REP., June 17, 1996, at 74.

2. "Spring Street . . . faced the classic [cash] crunch" that many small companies confront. *See id.* Overall, small companies have difficulty accessing equity capital to finance growth. *See* William D. Evers, Lack of Access to Capital for Small and Emerging Companies 1 (unpublished manuscript, on file with the law firm of Miller, Mailliard & Culver, LLP).

3. Given the small amounts of money involved—usually less than $5 million—and the risky nature of the companies, investment bankers do not finance start-up companies because the reward is not sufficient for the effort and compliance involved. *See* *Evers*, *supra* note 2, at 1.

4. *See* Hannon, *supra* note 1, at 74. Venture capital is equity investment in young private companies. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 339 (4th ed. 1991). For every 10 first-stage venture capital investments only two or three are successful, self-sufficient businesses. *See id.* at 341. One study of venture capital investments between 1960 and 1975 found that about one in six were total failures. *See* Blaine Huntsman & James P. Hoban, Jr., *Investment in New Enterprise: Some Empirical Observations on Risk, Return, and Market Structure*, 9 FIN. MGMT., at 44-51 (1980). Start-up companies considering Internet direct public offerings would otherwise seek capital from venture capitalists. *See* Jim Gallagher, *Cyber Stocks: Small Firms Turning to the Internet to Raise Capital*, ST. LOUIS POST-DISPATCH, Aug. 11, 1996, at E1, *available in* 1996 WL 2785138. Although venture capitalists can reap large financial returns on the start-up funding they put at

a creative solution to an imminent, and until then unsolvable, problem was needed if Spring Street was to bypass other private capital sources.

To capture the window of opportunity in the budding and growing microbrewery market, Spring Street decided to undertake a direct initial public offering (DPO) which was billed as "the first on-line prospectus" because the offering would be sold over the World Wide Web, or Internet.[5] Notices of the offering and sale were posted on Spring Street's Internet home page and on six-packs of Wit ale, Spring Street's best selling beer.[6] Trading began on March 1, 1996, and raised $1.6 million at an offer price of $1.85 with 3500 investors and 900,000 shares sold.[7] Not one cent was paid to an underwriter and no part of the company was sold to any venture capitalist.[8] Within three months, Spring Street's stock appreciated to $2, an 8% premium.[9] Although this was less than the normal premium[10] an initial public offering (IPO) experiences when it comes out on a national or regional exchange, it fulfilled Spring Street's needs.[11]

Spring Street is unique because of the background of its CEO, Andrew Klein. Before trying his hand in the microbrewery business, Klein practiced securities law for seven years at one of the top New York securities law firms—Cravath, Swaine & Moore.[12] His sophisticated

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risk, many company owners complain that the exchanged ownership interest in return for those funds is too high. *See id.*

5. *See* Gallagher, *supra* note 4, at E1; Robert A. Robertson, *Personal Investing in Cyberspace and the Federal Securities Laws*, 23 SEC. REG. L. J. 347, 385 (1996); Gary Weiss, *Online Investing*, BUS. WK., June 5, 1995, at 64, 74.

6. *See* Gallagher, *supra* note 4, at E1; *see also Spring Street Brewing Company* (visited Jan. 22, 1998) <http://plaza.interport.net/witbeer>.

7. *See* Hannon, *supra* note 1, at 74; Maxim Lenderman, *Trader Wit Takes its Business to the Net; Spring Street Brewing Co.'s Initial Public Offering Through the Internet*, BEVERAGE WORLD PERISCOPE EDITION, Apr. 30, 1996, *available in* LEXIS, News Library, Arcnws File.

8. *See* Hannon, *supra* note 1, at 74. Venture capitalists only supply 4% of the funding for start-ups and only 2% of the companies that submit proposals to obtain financing receive it. *See* Evers, *supra* note 2, at 1. Of the 98% who are denied, some are good companies that must look to other avenues for financing. *See id.*

9. *See* Hannon, *supra* note 1, at 75.

10. One study of nearly 9000 new issues from 1960 to 1987 revealed a usual premium of 16%. *See* BREALEY & MYERS, supra note 4, at 345. Small company initial public offerings (IPOs) valued under $15 million tend to yield 3% to 4% higher than large company IPOs. *See* Interview by Investor Guide with Clay Womack, President, Direct Stock Market (1996) (transcript on file with author).

11. *See* Hannon, *supra* note 1, at 74-75.

12. For the fiscal year of 1996, Cravath, Swaine & Moore was ranked seventh in total merger and acquisition deals with 40, seventh in deals for acquirors and bidders with 12, fourteenth in amount of money raised as issuer's counsel, fifth in amount of money raised as underwriter's counsel, and sixth in amount of money raised as underwriter's counsel in IPOs. *See 1997 Corporate Scorecard: Who Closed the Most*

background made dealing with the regulatory and legal ramifications easier than most CEOs will experience. Klein pointed out the benefits of the Internet DPO stating:

> We could never have afforded to do what we're doing . . . without the Internet . . . . It's pretty simple. We wanted to increase our shareholdership, raise money and wind up with a lot of beer enthusiasts owning our stock, helping us spread the word. The Internet wasn't an idea but a means to make it possible.[13]

The Internet creates a myriad of benefits for the capital markets.

B. *Benefits of Internet DPOs*

The number of Internet DPOs has proliferated, with at least thirty-five completed as of January 1997.[14] An ideal means for small companies to reach investors, these companies can learn more about Internet DPOs from the Internet itself.[15]

The most salient feature of the Internet DPO for the small company and the investor is the free access to information.[16] Information is readily available to investors by jumping through hypertext "links"[17] to download more information otherwise not available in a paper prospectus, and

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Deals and Who Raised the Most Money Last Year, AM. L., Apr. 1997 (Supp.), at 14, 16, 34, 36, 38.

13. Lenderman, *supra* note 7.

14. *See* Timothy C. Barmann, *Netting Shareholders: 2 R.I. Firms Are Offering Their Stock for Public Sale Directly over the Internet*, PROVIDENCE-J. BULL., Jan. 8, 1997, *available in* 1996 WL 7310127. IPO Data Systems maintains a list of Internet DPOs and links to the participating companies' web sites. *See* IPO Data Systems, *Direct Public Offerings via the Internet* (visited Jan. 22, 1998) <http://www.ipodata.com/dpo.html>.

15. *See IPO Data Systems* (visited Jan. 22, 1998) <http://www.ipodata.com>; Prestige IPO, *The Internet IPO: A New Opportunity for Investors* (visited Jan. 22, 1998) <http://www.prestigeipo.com/site/home.htm>; *Direct IPO: Creating Venture Funds Via the Internet* (visited Jan., 22, 1998) <http://www.directipo.com> [hereinafter *Direct IPO*].

16. *See* Rami Grunbaum, *Logos First State Company to Test IPO on Internet*, PUGET SOUND BUS. J., July 5, 1996, at 1.

17. These hotlinks connect to other pertinent data. *See* Robertson, *supra* note 5, at 352.

> For example, at the end of an advertisement for a mutual fund, there may be a reference that states, "Read the prospectus," which is highlighted in some manner. This last line is a link. If you were to click on "Read the prospectus," the program would take you directly to the fund's prospectus. This, of course, is a simple example.

Id; see also infra note 97 and accompanying text (discussing hypertext).

the low cost for the issuer ensures that these issues are here to stay.[18] Investors can buy or sell the stock through the use of E-mail, which is becoming more widely used, and more user friendly, so that investors are not intimidated when placing purchase orders.[19] To clear trades, the "SEC suggested the company find a bank or escrow agent to hold the money from transactions and post additional notices about the scant market for the stock," thus promoting the SEC's underlying purpose of protecting the investor.[20] For a company to benefit from Internet DPOs, it needs to understand the types of offerings available, the types of companies and investors that stand to benefit from DPOs, and the probability of success.

This Comment will examine the implications, laws, and business of DPOs completed over the Internet. This Comment will not explore in detail many novel issues surrounding this subject, such as secondary trading markets on the Internet. Section II will address the framework of DPOs with a focus on offering methods, company and investor profiles, and success factors.[21] Section III provides a background of the Internet, including access to information and reduction of costs.[22] Section IV covers the pertinent federal securities laws and focuses on the electronic delivery of a prospectus to ensure that optimal disclosure occurs.[23] Section V examines the statements of key SEC officials regarding Internet DPOs.[24] Section VI focuses on the potential hazards of fraud, risk, and lack of liquidity that investors need to be aware of and steps investors can take to protect against these dangers.[25] Section VII discusses the potential aspects of Internet DPOs and is intended to provide information to those interested in the offering process or looking to complete an offering.[26] This final section looks to the future of the Internet DPO and predicts how the market will look in the near future.

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18. Companies such as Interactive Holdings advertise their IPOs on the Internet by using an icon with the company name on it. An individual can click on the icon and jump directly to tombstone advertisements and the company's home page. *See How to Succeed in Business* (CNBC television broadcast, June 29, 1996) (interview with David Loring, President, Interactive Holdings), *available in* 1996 WL 8022660.

19. *See* Robertson, *supra* note 5, at 352.

20. *See* Rachel Elson, *Tapping the Web for Cash*, RECORDER, Apr. 30, 1996, at 1.

21. *See infra* notes 27-86 and accompanying text.

22. *See infra* notes 87-107 and accompanying text.

23. *See infra* notes 108-40 and accompanying text.

24. *See infra* notes 141-65 and accompanying text.

25. *See infra* notes 166-213 and accompanying text.

26. *See infra* notes 214-52 and accompanying text.

II. DIRECT PUBLIC OFFERINGS

There is a new and popular way for companies that do not have angels waiting to write big checks[27] or banks willing to loan large amounts of cash to raise capital for the expansion of a small business with a new idea.[28] For small companies interested in raising capital quickly and cheaply, the DPO is the way to go.[29] In 1995, approximately forty companies completed DPOs, compared to only twenty-eight in 1994.[30]

A. *Types of Offerings and the Governing Laws*

There are two primary offering methods for companies considering an Internet DPO. Companies seeking up to $5 million can use Regulation A as a mini-public offering,[31] or they can complete a Small Company Offering Registration (SCOR),[32] which allows a business to raise up to $1 million annually from investors in the form of common or preferred stock, options, warrants, or debt.[33]

27. "Angels are private investors who help finance growing companies." Stephanie N. Mehta, *Angel Investors Get On-Line Service*, WALL ST. J., Oct. 28, 1996, at B2. The Small Business Administration (SBA) estimates that 300,000 companies are eligible for and likely to benefit from angel funding because they are too large for SBA loans and too small to attract venture capital. *See id.* Small companies looking for angels can post their names and financial reports on the Angel Capital Electronic Network (ACE-Net) where angels can view the information and possibly invest. *See id.* To visit ACE-Net's homepage, see <http://ace-net.sr.unn.edu>. Angels invest an estimated $10 billion to $20 billion each year in some 40,000 different companies. *See id.* at B2.

28. *See id.* at B2 (explaining that pairing online investors with small businesses will create a "new generation of businesses").

29. Managers of small companies need to keep in mind that public offerings entail "a complicated process, including complying with the securities laws, conducting due diligence, making a market, [and] pricing the issue." *See* Interview by Investor's Guide with Leo Feldman, President, IPOnet (1996) (transcript on file with author).

30. *See* Hannon, *supra* note 1, at 74.

31. *See* HAROLD S. BLOOMENTHAL, GOING PUBLIC HANDBOOK § 4.07 (1996). Regulation A exempts certain offers from registration requirements. *See* Regulation A, 17 C.F.R. §§ 230.251-.263 (1997); *see also infra* notes 51-64 and accompanying text (explaining Regulation A).

32. Small company offerings are becoming very popular as 66 companies filed 135 SCOR, Regulation A, or intrastate offerings between July and September of 1996, which was almost double the amount from the same period a year earlier. *See Third Quarter Filings Set Record*, SCOR REP., Oct. 1996, at 1.

33. *See* Aldo Svaldi, *SCOR Funding to Small Firms: Little Used Option Gets Internet Boost*, DENVER BUS. J., Aug. 16, 1996, *available in* 1996 WL 10919109. "In terms of corporate finance, SCOR guards against thin capitalization and the issuance

1. SCOR Offerings

Small businesses with revenues under $25 million can set up an Internet DPO through the use of a SCOR, which was approved by the North American Securities Administrators Association (NASAA) on April 29, 1989.[34]

A SCOR is an ideal offering for the Internet DPO because it allows issuers to bypass fees charged by underwriters, lawyers, and accountants (no audit is required for companies making less than $500,000 a year).[35] Further, with a SCOR offering, there are no restrictions on the type of investor, which is particularly important in transactions over the Internet because it is nearly impossible for the seller to verify or determine the sophistication level of the purchaser or offeree.[36] Because the regulation of SCORs is left up to each state individually, an Internet issuer selling over the Web should comply with the strictest state requirements to ensure that they have not breached any laws in any state, to which they will be subject by selling on the Web.[37] Usually, businesses must answer

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of 'cheap stock' by requiring a minimum offering price of five dollars per share for common stock." Frank K.N. Chowdry, *A New Securities Registration Method in Maine*, 7 ME. B.J. 320, 321 (1992). The exercise price of warrants, options, or other rights relating to common stock must have a conversion price of at least five dollars. *See id.*

34. *See id.* at 320. Forty-eight states, including California, allow for SCOR registration with Form U-7 as the required disclosure document. *See* William D. Evers, Primer on Securities Law Issues for Non-Lawyers, 2 (unpublished manuscript, on file with the author). The North American Securities Administrators Association (NASAA) recognizes that the offer of securities over the Internet is a key development in capital formation and encourages "state securities regulators to develop a uniform policy concerning offers . . . consistent with the goals of investor protection and access to capital markets." *See* NASAA, *NASAA Resolution* (1996).

35. *See* Svaldi, *supra* note 33; *see also infra* note 63 (stating that companies with revenues not exceeding $500,000 do not require an audit).

36. *See* Svaldi, *supra* note 33. By contrast, in some Regulation D offerings, which are also non-registered, the number of purchasers is limited. For example, in a Rule 505 offering, purchasers are limited to less than 35 non-accredited investors and an unlimited number of accredited investors. *See* BLOOMENTHAL, *supra* note 31, § 2.02[5][c]. Also, in a Rule 506 offering, "[t]he issuer must reasonably believe that each non-accredited purchaser is a person who, either alone or with such purchaser's purchaser representative, has such knowledge and experience in financial and business matters that he is or they are capable of evaluating the merits and risks of the prospective investment." *Id.* § 2.02[6][b]. Securities sold under SCOR are not restricted so they can be freely traded in the aftermarket. *See* Evers, *supra* note 34, at 2. For a good discussion of SCOR offerings, see G. Michael Stakias & Jean E. Harris, *Simplifying Registration of Small Corporate Offerings: Form U-7 'SCORs,'* INSIGHTS, July 1992, at 13.

37. *See* Chowdry, *supra* note 33, at 322. "[T]here is no guarantee that one state's decision to clear a particular SCOR Form will persuade another state to do the same." *Id.*

fifty simple questions on a Form U-7 concerning the company, financial history, and primary risks to investors to satisfy the SCOR requirements.[38]

One warning: although the paper work is easy, raising the money is not.[39] As of yet, there is no solid trading market over the Internet, making it hard to distribute the shares because there are no active market makers or dealers in the issue.[40] The Internet, however, will allow individual investors to cut out the middleman and transact directly with each other.[41] On the other hand, some see the Web as "just another market channel,"[42] considering that individuals can purchase securities on E*Trade,[43] Lombard, or through America Online in its mutual funds center.[44] Usually, SCORs, like other DPOs, have a built-in group of investors—such as employees, vendors, or customers—who believe in the company and know its potential.[45] The difficulty is knowing how to raise the money, advertise, and bring in investors, which may be easier with the use of the Internet because investors have access to more information.[46]

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38. *See* Hannon, *supra* note 1, at 74; *see also* Chowdry, *supra* note 33, at 320; Stakias & Harris, *supra* note 36, at 13.

39. *See* Hannon, *supra* note 1, at 75.

40. See Direct IPO, About Direct IPO, Inc.: Direct IPO FAQ, Why are Direct Public Offerings a Win-Win, Emergency Liquidity ¶ 3 (visited Mar. 23, 1998) <http://www.directipo.com>.

41. *See What Is All the Excitement About?*, THE INTERNET IPO MONITOR, ¶ 4 (visited Jan. 21, 1997) <http://www.netipomonitor.com/excite.html> (on file with author) [hereinafter *Excitement*] (stating that investors in Internet offerings can avoid paying brokers' commissions and fees).

42. *Brewing Company Takes on the NYSE*, NetGuide, June 1, 1996, *available in* 1996 WL 8537132 [hereinafter *Brewing Company*].

43. E*Trade has formed a new unit, E*Trade On-Line Ventures, to market Internet DPOs, which is significant because it represents the first registered broker-dealer to enter the Internet DPO arena. *See Internet IPO Monitor*, THE INTERNET IPO MONITOR, ¶ 6 (Sept. 18, 1996) <http://www.netipomonitor.com> (on file with author).

44. *See Brewing Company*, *supra* note 42. E*Trade Securities Inc. executes over 8000 trades per day, more than twice as many as six months earlier. *See* James F. Peltz, *Markets and Modems: The Internet is Making Online Trading Faster, Cheaper and Easier Than Ever*, L.A. TIMES, Aug. 5, 1996, at Dl.

45. *See* Svaldi, *supra* note 33.

46. *See id.* Spring Street's home page allows investors to see a description of Spring Street's history and products, read about the master brewers, order wit merchandise, determine how to find the wit beers in their area, answer the "Wit Question of the Quarter," and subscribe to Spring Street's quarterly newsletter. *See Spring Street Brewing Company*, (visited Jan. 27, 1998) <http://plaza.interport.net/witbeer/>. In addition, investors who visit Spring Street's home page can link to Wit Capital's home

Internet DPOs are ideal for small companies that want to raise anywhere from $1 million to $4 million, especially considering that brokerage firms will not usually take these deals,[47] and if they do, they charge hefty commissions.[48] As of June 1996, small companies raised only $3 million over the Internet, but at least thirty-five more DPOs have been completed since that time.[49] Although this phenomena is a boon to small companies, executives must be confident that an Internet DPO is a right fit for their company.

2. Regulation A

Along with the SEC release of October 1995 concerning electronic media,[50] the 1992 liberalization of Regulation A made it possible for small companies to raise capital over the Internet.[51] Regulation A is the traditional vehicle for small issuers to go public because it provides an exemption from full registration, which makes the process easier and less costly.[52] Regulation A, as amended in 1992, simplifies the quantitative limitations on the use of the exemption,[53] allows marketing of securities in a substantially similar fashion to fully-registered securities,[54] and provides an "innovative 'test the waters' provision afford[ing] the issuer [a] unique opportunity to avoid . . . the hazards of an aborted registered offering."[55]

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page. *See id.* Wit Capital is an online financial services company which provides investors access to IPOs and venture capital opportunities over the Internet. *See Wit Capital* (visited Jan. 27, 1998) <http://www.witcapital.com/>.

47. *See* Sougata Mukherjee, *SEC to Allow Companies to Trade Stock on the 'Net*, TAMPA BAY BUS. J., June 21, 1996, *available in* 1996 WL 10037135.

48. *See id.*

49. *See id.*; *see also* Barmann, *supra* note 14.

50. *See* Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, Exchange Act Release No. 36,345, Fed. Sec. L. Rep. (CCH) ¶ 3200, at 3128 to 3131-12 (Oct. 6, 1995) [hereinafter SEC Release No. 7233].

51. *See* James E. Grand & Gary Lloyd, *Internet IPOs: A Potential Oasis for Small Companies*, UPSIDE, July 1996, at 92, *available in* LEXIS, News Library, Curnws File.

52. *See id.*

53. "[T]he 'sum of all cash and other consideration to be received for the securities ("aggregate offering price") in any continuous 12-month period does not exceed $5,000,000, including no more than $1,500,000 offered by all selling security holders." BLOOMENTHAL, *supra* note 31, § 4:07[3] (quoting 17 C.F.R. § 230.251(b) (1997)).

54. With some minor exceptions, procedures under Regulation A mirror the procedures for filing and processing registration statements. *See id.* § 4:07[4] (citing 17 C.F.R. § 230.251(d)(1)(i) (1997)). One example of a difference is that Regulation A requires an "offering statement," as opposed to a "registration statement." *See id.* However, they are similar in that each becomes effective on the twentieth calendar day after the filing, in most circumstances. *See id.*

55. BLOOMENTHAL, *supra* note 31, § 4.07(1).

The test the waters provision is the critical benefit for an Internet IPO because it "allows *an issuer* to publish or deliver to prospective purchasers a written document or make scripted radio or television broadcasts 'to determine whether there is any interest in a contemplated securities offering.'"[56] Usually, issuers are not allowed to prime the market during the prefiling period, but the 1992 amendment to Regulation A is unique in that, while no registered initial public offerings can test the waters, a Regulation A offering can.[57] The practical benefit is that a company can evaluate the amount of interest in its securities before selling.[58] However, the company is required to disclose information about the identity of the company and its CEO.[59] Further, the company cannot accept any money or consideration for purchase until it delivers an offering circular.[60]

Essentially, Regulation A allows "for *public* offers and sales of securities up to $5 million during any 12-month period by any issuer meeting the eligibility requirements of Rule 251."[61] Other advantages of Regulation A include virtually no restrictions on resales, no special qualifications for initial investors as to number or sophistication,[62] and the ability for an issuer to avoid a full audit.[63] The downside of a Regulation A offering is the $5 million ceiling, which may not be a problem for a small company like Spring Street, but automatically precludes participation by large companies, like IBM or Microsoft, because they seek larger amounts of capital.[64] This is of little consequence, however, because large companies can use other regulations for secondary offerings and are likely to use traditional underwriters for IPOs.

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56. *See id.* § 4.07[5] (quoting 17 C.F.R. § 230.254(a) (1997)).
57. *See* Grand & Lloyd, *supra* note 51, at 92.
58. *See id.*
59. *See id.*
60. *See id.*
61. Bloomenthal, *supra* note 31, at § 4.07[2]. Rule 251 provides the eligibility requirements for Regulation A, such as requiring any entity using Regulation A to be organized under the laws of the U.S. or Canada, any state, province, territory, or District of Columbia, with its principal place of business in the U.S. or Canada. *See* 17 C.F.R. § 230.251(a)(1) (1997).
62. This is especially pertinent to Internet IPOs. *See supra* note 36 and accompanying text (comparing SCOR offerings to other forms of offerings restricting investor numbers and qualifications).
63. *See* Grand & Lloyd, *supra* note 51, at 92. No audit is required for companies making less than $500,000 a year. *See* Svaldi, *supra* note 33.
64. *See* Grand & Lloyd, *supra* note 51, at 92.

B. Type of Company

Before the advent of the Internet, DPOs were offered by companies in the "consumer products markets such as micro breweries, food, and mail-order."[65] DPOs come from reputable companies that eventually want to trade on a major national or regional exchange, and are distinguishable from the controversial penny-stock industry.[66] The cost savings are tremendous because cutting out the underwriter, accountants, printing, and "roadshows" allows companies to go public at a cost of 6% of the total value of the issue, as opposed to a 13% average for a traditionally underwritten offering.[67] DPOs, according to Drew Field, a San Francisco securities lawyer, "are not for start-ups" and "work best for successful companies with devoted customers, or 'affinity groups.'"[68]

C. Type of Investor

DPO investors are very unique. Investors who are lured into a DPO tend to be loyal purchasers of the issuer's product who are investing for the long term or because they have a strong association with the product.[69] As these investors do not demand immediate profits, they tend to approach the investment differently than most investors.[70] "[I]t's more like buying into a business than buying a stock," says DPO specialist, Drew Field.[71] "Ninety-five percent of [investors] who participate in a

65. *See First Steps to an Internet Stock Exchange*, NEWSBYTES, Apr. 4, 1996, *available in* 1996 WL 8906690 [hereinafter *Stock Exchange*]. As of January 1, 1997, companies in a broader range of industries were taking their companies public via the Internet, including: recycling, eyewear, land development, publishing, telecommunications, forest products, express mail, health care, and household appliances. *See IPO Data Systems*, *supra* note 15.

66. *See Stock Exchange*, *supra* note 65. Usually, penny stocks are priced under $3, are not traded on an exchange, and are not "quoted on the National Association of Securities Dealers Automated Quotation System (NASDAQ) system." *See* SEC INFORMATION FOR INVESTORS: BEWARE OF PENNY STOCK FRAUD! (1988). Obtaining information about penny stock prices is nearly impossible and the investments are highly speculative. *See id.*

67. *See* Hannon, *supra* note 1, at 74.

68. *See* Jane Applegate, *DPO: A Financing Plan Based on Customer Loyalty*, AUSTIN BUS. J., Aug. 24, 1996, *available in* 1996 WL 10030429. An affinity group is a group comprised of individuals who identify with the product so much that they are likely to invest out of loyalty. *See id.*

69. *See* Hannon, *supra* note 1, at 74.

70. *See id.*

71. *See id.* Primary Care Centers of America, which is seeking $1 million in capital through an Internet DPO, wants patients, residents, and community organizations to invest in the offering. *See First Internet 'Roadshow' Launched by Small Company*, INVESTMENT DEALERS' DIG., Dec. 9, 1996, at 18. Internet DPOs have the added benefit, from a marketing perspective, of having shareholders who market the company free

DPO don't have a broker and have never bought shares directly" before, so it is apparent that loyal customers are the most likely candidates—until now.[72]

Investors must be ready to do a lot of work when investing in Internet DPOs.[73] On deals using traditional underwriters, the investor does not have to do much,[74] assuming the underwriter has already completed a diligent review of the company. With Internet DPOs, investors have only two things to evaluate when making a purchase decision.[75] Investors can look first at the business plan and second at the experience and reputation of the issuer's management.[76]

The Internet will allow small companies to broaden their investor base as more people come into contact with their products via the World Wide Web. Companies can reach investors in a grass roots fashion by creatively placing advertisements for their stock in a variety of places such as: beer labels,[77] boxes of macaroni shells,[78] or on t-shirt sales tags in Nieman-Marcus boutiques.[79] The allure of owning a piece of a microbrewery or a funky clothing company is peculiarly an American thrill which will attract investors.[80]

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of charge. *See id.*

72. *See* Applegate, *supra* note 68.

73. *See Another Bumble Bee that Can't Fly?*, SCOR REP., Aug. 1996, at 2, 4.

74. *See id.*

75. *See id.*

76. *See id.*

77. Spring Street raised $1.6 million through its Internet DPO by selling 900,000 shares of its stock to 3500 investors. *See supra* notes 1-13 and accompanying text (describing Spring Street and its trailblazing DPO).

78. Annie's Homegrown tried "to raise $3.6 million by selling 600,000 shares at $6 per share" in August 1995. Jane Costello, *Investors Should Study Risks Of Buying IPOs on the Internet* (manuscript on file with author). The average stock purchase was $580. *See* Applegate, *supra* note 68.

79. *See* Hannon, *supra* note 1, at 75. Prospective investors learned about Blue-Fish's offering from clothing sales tags at Nieman-Marcus and other stores. *See id.* Blue-Fish raised $3.9 million over a six-month period by selling $5 shares in blocks of no less than 100 shares. *See id.* Months later the stock price had risen to $7, a 40 percent appreciation, although it lost $247,000. *See* Kerry Hannon, *Blue Fish Reels in Stylish Customers*, U.S. NEWS & WORLD REP., Sept. 16, 1996, at 74.

80. *See id.*

D. *Success*

An Internet DPO does not guarantee the successful attainment of capital. In 1995, only 30% of the companies raising funds through a non-Internet DPO met their minimum fund-raising goal.[81] This low success rate is attributable to the fact that issuers spend their time running their companies and not selling their shares.[82] The Internet solves these problems because once an advertisement, prospectus, and Web site are posted, investors find DPOs on their own.[83]

"Despite a few solid DPO successes, the market for DPOs remains small. 'DPOs haven't reached critical mass yet because not enough people know about them to make a market,' says Tom Stewart-Gordon, publisher of the *SCOR Report*, a Dallas-based newsletter that tracks small corporate offerings."[84] The overall concern and reality is that the quality of some of the offerings is questionable, if not suspect.[85] However, with the onset of Internet DPO underwriters, a screening process will develop to ensure only good deals will reach the Internet investor, while maintaining the low cost of an Internet DPO.[86] In order for this financial innovation to flourish, people entering transactions must understand the breadth and growth of the Internet.

III. INTERNET

A few years ago, the Internet was a government-funded computer network with an "anti-commercial philosophy which connected universities nationwide."[87] Today, the Internet is a facilitator of the capitalist mantra, with large computer and communication companies and creative entrepreneurs trying to control the marketplace of the future by answering the question: "What will people buy"?[88]

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81. *See id.* Approximately 2000 companies have attempted DPOs, "on and off the Internet," and "only 700 [have] made it through registration" with a handful of those actually raising the desired funds. *See* Gallagher, *supra* note 4, at E1.

82. *See* Hannon, *supra* note 1, at 75.

83. *See id.*

84. Applegate, *supra* note 68. *But see Excitement, supra* note 41 (estimating that Internet DPOs may be a market worth tens of billions of dollars due to industry forecasts "that more than 500 companies will offer securities over the Internet in the next 12 months").

85. *See* Applegate, *supra* note 68.

86. *See infra* notes 214-52 and accompanying text (discussing the future of Internet DPOs).

87. Jonathan Weber, *Download This: The Dirty Secret About the Net*, L.A. TIMES MAG., Oct. 27, 1996, at 8.

88. *See id.*

Approximately thirty million households have personal computers,[89] an increase from about thirteen million in the late 1980s.[90] Of those households, about half have modems.[91] America Online, one of the premier on-line services, increased its subscription from 1.5 million in January 1995 to 3 million six months later,[92] eventually reaching 11 million by March 1998.[93] Internet usage is expected to increase from "56 million at the end of 1995 to 200 million by the year 2000."[94] One of the Internet's most important functions is E-mail,[95] which allows Internet users to transmit all types of data and information to one another.[96] There are other useful aspects of the Internet that will bring benefits to investors and issuers.

The World Wide Web, a part of the Internet, contains hypertext, which is highlighted data in the text of a document that, when "clicked," allows the individual to jump to another document or piece of information.[97] Most importantly, individuals are using this information and these systems more and more for making real decisions, not just "surfing the web."[98] For example, the financial industry's research shows a positive

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89. Forty-three percent of American households own computers, up from forty-percent in 1996. *See* Peter Burrows et al., *Cheap PCs*, BUS. WK., Mar. 23, 1998, at 28.

90. *See* Michelle Singletary, *Now, Home May Be Where the Bank Is*, WASH. POST, Jan. 16, 1995, at 14. Use of the Internet "is strongly correlated to high levels of income and education" because it is expensive. *See* Weber, *supra* note 87, at 9. "From January, 1997 to January, 1998, the average selling price of a home PC dropped 30%, to $1,169." *See* Burrows, *supra* note 89, at 28.

91. *See* Della DeLafuente, *Encyclopedias Go Electronic; Reference Publishers Enter Interactive Computer World*, CHI. SUN-TIMES, May 1, 1995, at 45. Only 10% to 15% percent of all households are connected to the Internet. *See* Weber, *supra* note 87, at 9.

92. *See On-line Computer Services Had Another Boom Year, Survey Says*, L.A. TIMES, Jan. 14, 1995, at D2; Letter from Steve Case, President, America Online, to America Online members (July 1, 1995) (on file with author).

93. *See* Marc Funther, *The Internet is Mr. Case's Neighborhood: Techies Hate It, but in Cyberspace American Online is the Only Brand that Counts*, FORTUNE, Mar. 30, 1998, at 68.

94. Interview by Investor's Guide with Tom Taulli, CEO, WebIPO (1996) (transcript on file with author).

95. E-mail is the most widely used aspect of the Internet. *See* Weber, *supra* note 87, at 10, 30.

96. HARLEY HAHN & RICK SCOTT, THE INTERNET COMPLETE REFERENCE 68-69 (1994).

97. *See id.* at 495-501.

98. *See* Weber, *supra* note 87, at 8-12, 26-30. In a survey of 10,322 Americans, 77% said they use the Internet for browsing, 53% for education, 51% for work, 41% for business research, and 36% for academic research. *See* Peter McGrath, *The Web: Infotopia or Marketplace?*, NEWSWEEK, Jan. 27, 1997, at 84.

correlation between households that own computers with on-line services and households that invest in stocks.[99] The Internet allows investors to get stock quotes (delayed 15 minutes), research a myriad of information about companies and markets, and execute trades.[100] Many everyday activities, from banking, mailing, and talking on the phone, to shopping and entertainment, are more quickly and cheaply accessible through the Web.[101]

Many companies have started to provide services that will help firms embarking on Internet DPOs. There is a company, ImSpectus, which delivers prospectuses over the Internet for use by companies undertaking an Internet DPO.[102] ImSpectus "loads a prospectus or any other SEC-related or public issue documents on the Internet [within] an hour after being cleared for printing," which makes the information readily usable and timely for the secondary markets and helps increase liquidity.[103] The electronic prospectus is just like its paper counterpart, with full color and graphics, but has the added value of "full-text search capabilities across multiple documents."[104] These capabilities are used by simply clicking a mouse, which is much easier than flipping through a paper tome in which investors often get lost or bored.[105]

Investors using electronic services to download and peruse information will be at an advantage relative to those who insist on waiting for paper documents because investors using electronic means possess real-time information and have the fastest access to searchable and relevant information.[106] Using the Internet is easier because investors can research and peruse offerings at their own pace without dealing with salesmen.[107] Of course, issuers need to be knowledgeable regarding federal securities laws relevant to these offerings.

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99. *See* Jon Birger, *Mutual Funds Find the Internet has Room for Them Too*, BOND BUYER, July 26, 1995, at 6.

100. *See* Robertson, *supra* note 5, at 364.

101. *See First Steps to an Internet Stock Exchange*, NEWSBYTES, Apr. 4, 1996, *available in* 1996 WL 8906690.

102. *See ImSpectus, Pioneer On-Line Prospectus Provider, Powers Successful Optical Cable IPO*, BUS. WIRE, June 18, 1996, *available in* LEXIS, Nexis Library, UPI File [hereinafter *ImSpectus*].

103. *See id.*

104. *See id.*

105. *See id.*

106. *See id.*

107. *See* Interview by Investor's Guide with Leo Feldman, *supra* note 29.

IV. OVERVIEW OF FEDERAL SECURITIES LAWS

The Securities Act of 1933 (Securities Act) is primarily concerned with the initial distribution process of securities; assuring the investing public that it has "full and fair disclosure of the character of securities," and preventing fraud in the sale of securities.[108] To satisfy these provisions, any company that offers securities to the public must register with the Securities Exchange Commission (SEC) and provide purchasers with a prospectus containing detailed information about the company.[109] A "prospectus" is any "notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . ."[110] There is no aspect of the preceding definition which covers prospectuses sent via E-mail or electronic transmission.

In February 1995, the SEC's Division of Corporate Finance issued an interpretive letter (the Brown & Wood Letter) stating that, as long as certain conditions are met, electronic delivery of prospectus materials satisfies the delivery requirements of the Securities Act.[111] This affirmative interpretive response by the SEC will no doubt encourage more companies to raise capital by selling securities over the Internet, given that they can satisfy the disclosure requirements set by the SEC.[112]

A. *Use of Electronic Media*

The SEC issued a more detailed interpretation, effective October 6, 1995, which focuses on the use of electronic media for delivery purposes in connection with the distribution of securities.[113] Commissioner Ste-

108. Preamble of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994). "Full Disclosure simply makes sure that the investor has the information to determine if the investment makes sense. The SEC does not pass judgement [sic] on the merits of an offering; it can be simply awful; that's O.K., as long as the investor is told so." Evers, *supra* note 2, at 2.

109. *See* Robertson, *supra* note 5, at 380.

110. *See* 15 U.S.C. § 77b-(10) (1994).

111. *See* Brown & Wood, SEC No-Action Letter, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,000, at 78,845 (Feb. 17, 1995) [hereinafter Brown & Wood]; Robertson, *supra* note 5, at 383; *see also* Howard M. Friedman, *Prospectus Delivery by E-Mail*, NAT'L L.J., June 26, 1995, at C1.

112. Before the SEC's interpretive letter two years ago, there were no companies doing Internet DPOs. *See* Barmann, *supra* note 14. Subsequent to the release, at least 35 companies have gone public over the Internet. *See id.*

113. *See* SEC Release No. 7233, *supra* note 50.

ven Wallman stated that "[g]iven the advantages afforded by electronic media, we determined that our goal should be to encourage electronic delivery of information, even to the point of preferring it over paper in the long-run."[114] With communication of relevant and material information as its fundamental goal, the SEC release states that electronic delivery of information will satisfy "the federal securities laws if such distribution results in the delivery to the intended recipients of substantially equivalent information as these recipients would have had if the information were delivered to them in paper form."[115]

Although the SEC clarified the guidelines surrounding electronic delivery of prospectuses, the issuers' compliance obligations really have not changed because the substantive requirements for delivery are the same.[116] The rules facilitating prospectus delivery on the Internet and via E-mail "reinforce the SEC's trend toward recognizing changes in the marketplace."[117]

B. Guidance Regarding Electronic Delivery

In setting forth relevant factors for meeting the legal requirements of prospectus delivery, the SEC cautions that the ultimate responsibility for satisfying the duty of delivery rests with the issuer.[118] The three factors, which are not exhaustive, are notice, access, and availability of paper versions.[119] First, the delivery must provide timely and adequate notice that new information exists, and when providing the document on the Internet, separate notice is necessary unless the issuer can show delivery to the investor was made.[120] Second, recipients must have access akin to that of documents sent through the postal mail and the opportunity to retain the information or have "ongoing access equivalent to personal

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114. Commissioner Steven M.H. Wallman, Regulating in a World of Technological and Global Change, Address Before the Institute of International Bankers 6 (Mar. 4, 1996) (transcript on file with author) [hereinafter *Wallman*].

115. *See* SEC Release No. 7233, *supra* note 50, at 3131; Gerard R. Boyce, *Offering and Trading Securities on the Internet*, N.Y. L.J., May 9, 1996, at 5; Robertson, *supra* note 5, at 387. The prospectus requirements have been amended so that an issuer is required to inform the investor that the SEC "maintains a Web site that contains reports, proxy and information statements and other information regarding registrants that file electronically." *See* Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7289, Exchange Act Release No. 37,183, [1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85, 805, at 88,014 [hereinafter SEC Release No. 7289]. The SEC's Internet address is <http://www.sec.gov>. *See id.* at 88,014 n.50.

116. *See* Deborah H. Hartzog & W.H. Johnson III, *IPO Rules Among SEC Procedural Changes*, TRIANGLE BUS. J., Sept. 13, 1996, *available in* 1996 WL 11279952.

117. *Id.*

118. *See* SEC Release No. 7233, *supra* note 50, at 3131-32.

119. *See id.*

120. *See id.*; *see also* Robertson, *supra* note 5, at 387.

retention."[121] Documents shall be accessible for as long as the delivery requirement applies.[122] This requirement is satisfied if the investor downloads the document.[123] Finally, a paper copy of the document must be furnished if the investor either asks for it or revokes consent to receive documents electronically.[124] These elements mean that "an Internet issuer must be reasonably certain that all of its potential investors have access to the Internet and can locate and download the information."[125]

C. Evidence to Show Delivery

The method of delivery must provide reasonable assurances that the investor will receive the information.[126] The SEC has revealed four indicators to guide companies if they desire to satisfy this element.[127] First, investors must consent to receiving information via electronic media and the issuer must provide reasonable notice and access to the information as described above.[128] Second, the issuer must have evidence that the "investor actually received the information;" this can be shown by electronic mail return, confirmation, downloading, or printing.[129] Third, the SEC suggests that the investor have the ability to hyperlink to a required document, such as the final prospectus, from a web site.[130] Finally, if other forms or material, such as an application form, accompanies the required information on the web site and the investor sends in the form, delivery is presumed.[131]

Given the novelty of electronic delivery of information in the context of an IPO, compliance is fact-specific and these factors are by no means exhaustive. The SEC's releases and statements provide some certainty for issuers so that the SEC can attain their goal of enhancing "the efficiency of the securities markets by allowing for the rapid dissemination of information to investors and financial markets in a more cost-efficient,

121. *See* SEC Release No. 7233, *supra* note 50, at 3131-32.
122. *See id.*
123. *See id.* & n.25.
124. *See id.* at 3131-32.
125. *See* Grand & Lloyd, *supra* note 51, at 92.
126. *See* SEC Release No. 7233, *supra* note 50, at 3131-33.
127. *See id.*
128. *See id.*
129. *See id.*
130. *See id.*
131. *See id.*

widespread, and equitable manner than traditional paper-based methods."[132] The Internet is the key to furthering the SEC's goals because it provides new and better ways to get information in the hands of investors.

D. Hyperprospectus

The advantages of a prospectus posted on the Internet are numerous. Investors can access other web sites via hypertext links.[133] This is a valuable marketing and sales tool because investors can jump to a video of an industry analyst, for example, who can explain some of the otherwise confusing information contained in the prospectus.[134] Another advantage is that investors could potentially post questions to the hyperprospectus and have them answered or allow other investors to see them.[135] These documents may also include graphics, images, and other audio information that will add more value for the investor from an information standpoint and for the issuer from a marketing perspective.[136]

The electronic delivery of a prospectus adds substantial value in that it opens up greater possibilities for the investor than a paper prospectus.[137] For instance, links can be set up on the web page containing the prospectus to allow interested investors to research specific subjects of concern, such as "fund expenses" or "risks."[138] Investors could use the links to jump directly to the part of the prospectus that contains the information they are seeking.[139] For investors seeking more information, links can take them to the home page of the company's legal counsel or accountant, where more information can be gathered that would otherwise be unavailable in a paper-delivered prospectus.[140] With all of the

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132. *See id.* at 3129.

133. *See supra* text accompanying note 17 (discussing hypertext links).

134. *See* Joshua Macht, *IPO = Internet Public Offering?*, INC. TECH., 1995, at 17, *available in* LEXIS, News Library, Arcnws File.

135. *See id.*

136. *See* SEC Release No. 7289, *supra* note 115, at 88,013. In order to ensure that EDGAR (Electronic Data Gathering, Analysis, and Retrieval) filings reflect the creative electronic documents, the EDGAR filing must include a "fair and accurate narrative description, tabular presentation or transcript of the omitted material." *See id.*

137. *See* Robertson, *supra* note 5, at 390.

138. *See id.*

139. *See id.*; *see also, e.g.*, Fidelity Investments (visited Mar. 2, 1998) <http://www31.Fidelity.com:80/misc/sitemap.html> (providing links to news and commentary, online trading, current fund price, and information about Fidelity's various funds).

140. *See* Robertson, *supra* note 5, at 391. Links represent the "incredible marketing potential" of the Internet. *See* Grand & Lloyd, *supra* note 51, at 93. Under the SEC's current regulations, companies can use graphics, pictures, and multimedia in their Internet documents. *See id.* By using an Internet DPO, an issuer can communicate di-

possibilities the Internet holds for the investor, a key issue is how the SEC responds to the new technology.

V. SEC STATEMENTS

A. Let Technology and the Market Prosper

The Internet has opened many doors for consumers. One can make travel reservations, conduct research for educational purposes, and communicate with others from remote locations at the click of a mouse.[141] Now, small undercapitalized companies can raise up to $5 million through a Registration A or SCOR offering over the Internet.[142] With this in mind, the SEC has issued many statements regarding these new phenomena.[143] The SEC believes that the best approach for regulating this innovation is for the SEC to do less, not more, as a regulatory agency.[144]

The overall sentiment of the SEC is displayed by Commissioner Steve Wallman's statement: "[t]he challenge is to maintain [a] regulatory regime flexible enough to allow for the continued development of such systems, consistent with allowing us to meet our regulatory objectives, without

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rectly with investors without having to endure a "road show" by allowing prospective investors to learn the details of the offering from a knowledgeable spokesperson. *See id.* Perhaps the most unique aspect of the Internet is that the investor can hear the pitch at any time. *See id.* "The graphic, image, and audio material in the version of a document delivered to investors and others shall be deemed part of the electronic filing and subject to the liability and anti-fraud provisions of the federal securities laws." SEC Release No. 7289, *supra* note 115, at 88,017.

141. *See* Weber, *supra* note 87, at 8-12, 26-30.

142. *See supra* text accompanying notes 31-64 (discussing rules and procedures for Regulation A and SCOR offerings).

143. One such statement was issued in a May 19, 1996 release:

> Quick and broad access to material information was one of the fundamental premises upon which the federal securities laws were adopted, and electronic distribution no doubt will benefit issuers and investors through cheaper and faster communication of information. While the Commission expects the increased use of electronic media to benefit securities markets and investors . . . it does not anticipate that the amendments will . . . result in substantial economic costs or benefits. Those benefits will be derived from advances in technology, and not from the minor technical amendments that are the subject of this rulemaking.

SEC Release No. 7289, *supra* note 115, at 88,014.

144. *See* Wallman, *supra* note 114, at 7.

imposing unnecessary or constraining basis."[145] Wallman has been on the leading edge in supporting financial innovations dealing with the Internet.[146] Wallman believes that "[n]othing is changing more quickly and more dramatically than information technology, . . . [we] really are going to find it to be increasingly difficult to do the job we are supposed to be doing under existing securities laws."[147] In fact, the SEC is gradually relaxing its filing rules so that companies can market their stocks with greater ease, particularly in the area of Internet DPOs.[148] He claims that the SEC can control prospectus delivery on the Internet and will be "tracking the activity very closely."[149] There is an immediate need for further SEC guidance because over fifty Internet DPOs were completed as of January 1998.[150]

B. Brown & Wood Letter

On February 17, 1995, the SEC's Division of Corporate Finance broke new ground when it issued a No-Action Letter providing guidance for satisfactory electronic delivery of a prospectus.[151] The SEC's response was prompted by a letter from Joseph McGlaughlin of the Brown & Wood law firm requesting advice on how to comply with the delivery requirements of the Securities Act because his clients were interested in downloading the text of a prospectus to customers via computers in a proprietary fashion.[152] The Division of Corporate Finance replied, in what has come to be known as the "Brown & Wood Letter," that:

> Based on the facts presented, it is the Division's view that the term "prospectus" as defined in Section 2(10) . . . and used in Sections 5 and 10 of the Securities Act

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145. *Id.* at 3.

146. Wallman has forced the SEC "to react to changes in electronic communication" and led the to revise how public offerings are regulated. *See The Public Sector 45*, AM. L., Jan.-Feb. 1997, at 84 [hereinafter *Public Sector 45*]. "'[Wallman is] provocative,' says John Olson, a partner in the Washington, D.C., office of Los Angeles's Gibson, Dunn, & Crutcher and former chair of the American Bar Association's committee on federal regulation of securities." *Id.* (alteration in original). Olson commends Wallman's agenda of "writing better rules, making the system better." *See id.* Wallman has led the effort to propose a new system for capital formation and to allow companies more freedom in predicting future performance without the threat of litigation if they are incorrect. *See id.*

147. *Id.*

148. *See* Sougata Mukherjee and Mark Mensheha, *SEC Eyes Major Changes in Rules*, SAN ANTONIO BUS. J., July 26, 1996, *available in* 1996 WL 10038460.

149. *See* Sougata Mukherjee, *SEC Oks Online Brokerage*, PAC. BUS. NEWS, July 29, 1996, *available in* 1996 WL 10525618.

150. *See IPO Data Systems*, *supra* note 15.

151. *See* Brown & Wood, *supra* note 111, at 78,841.

152. *See id.*; *see also* Christine Evans, *SEC Decision Allows On-Line Prospectus, Could Save Companies $$$*, CORP. FIN. WK., Mar. 13, 1995, at 1.

> includes a prospectus encoded in an electronic format (an "electronic prospectus"). In addition, if transmitted electronically as described in your letter, for purposes of Section 2(10)(a), such prospectus would be sent or given "prior to" the communications described in your letter that, but for Section 2(10)(a), would constitute a "prospectus" as defined in Section 2(10). Further, if transmitted electronically as described in your letter, such prospectus would "preced[e]" the security for purposes of Section 5(b)(2).[153]

Abigail Arms, associate director of the Division of Corporate Finance, assures corporations and underwriters that they can rely on the letter with the underlying premise that they must use similar procedures in delivering electronic prospectuses as if dealing in paper.[154]

Issuers must keep in mind that a prospectus must satisfy the reporting requirements of the Securities Exchange Act of 1934, which is designed "'to afford a measure of disclosure to people who buy and sell securities.'"[155] Companies will be required to send out 10-Ks,[156] 10-Qs,[157] 8-Ks,[158] and proxy statements.[159] As Brian Lane, Director of the SEC's Corporate Finance Division stated: "The same rules apply to Internet offerings as to those on Wall Street."[160]

C. A Pro-Active SEC

In line with the SEC's active response to the new phenomenon of raising capital through the Internet, Commissioner Wallman placed an unex-

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153. Brown & Wood, *supra* note 110, at 78,845; *see also* Evans, *supra* note 152, at 25.

154. *See* Robertson, *supra* note 5, at 384-85.

155. Robertson, *supra* note 5, at 391 (quoting LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 228 (3d ed. 1989)).

156. *See* 17 C.F.R. § 249.310 (1997). A Form 10-K is the annual report that is filed within 90 days with the SEC by a reporting company. *See* Robertson, *supra* note 5, at 391. This form discloses information relevant to the company's financial condition and business operations. *See id.*

157. *See* 17 C.F.R. § 249.308a (1997). A Form 10-Q is a quarterly report filed within 45 days after the end of each of the first three fiscal quarters. *See* Robertson, *supra* note 5, at 391. The 10-Q includes information pertaining to year-to-date financial statements, legal proceedings, and changes in shareholders' rights. *See id.*

158. *See* 17 C.F.R. § 249.308 (1997). The Form 8-K is filed within 15 days after the occurrence of any special events, such as a change in ownership of the company. *See* Robertson, *supra* note 5, at 392.

159. *See* 17 C.F.R. § 240.14a-101 (1997). A proxy statement provides shareholders with the information they need to cast an informed vote at shareholder meetings. *See* Robertson, *supra* note 5, at 392.

160. I. Jeanne Dugan, *The Dos and Don'ts of IPOs on the Web*, BUS. WK., May 13, 1996, at 10.

pected call to Andrew Klein, the CEO of Spring Street Brewery, in March 1996.[161] Klein said that Wallman "was very interested in the novel use of the technology and . . . invited [Klein] to keep in touch with him."[162] Wallman also stated that "he didn't wish to discourage financial innovations on the Internet."[163] These actions and statements show a commitment by the SEC to regulate the use of Internet DPOs cautiously, keeping in mind that the scope of these offerings is limited to small- and medium-sized companies.

The SEC's openness to this financial innovation is typical of the capital market structure in the United States as it continues to serve as a model for other nations.[164] SEC Chairman Arthur Levitt displayed his sentiments recently at a securities regulation conference:

> American investors deserve a market in which the theory of the regulator matches the reality of the regulated; in which the media anticipated by the law are the same media used in real life; in which there is no gap between the way the SEC allows investors to receive information, and the way in which investors actually do receive information . . . . [W]e will keep this debate moving forward in the weeks and months ahead—until the theory of disclosure matches the realities of the marketplace in the age of information.[165]

The SEC is embracing these changes, which can only serve to improve the process of capital formation in the United States and eventually worldwide. It is important, however, for issuers and investors to be aware of the SEC's public comments and the potential hazards surrounding the offering.

VI. CONCERNS AND POSSIBLE SEC REACTION

Realizing that the Internet will have a positive impact on financial markets, small companies, and investors in the long run, many entrepreneurs and seasoned professionals who are trying to take advantage of the Internet's potential are uncertain about possible SEC regulation.[166]

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161. *See* Grand & Lloyd, *supra* note 51, at 92.

162. *See id.*

163. *See id.*

164. In the 60 years since 1934, businesses have gone from raising $641 million to over $1 trillion. *See* SEC Chairman Arthur Levitt, Corporate Finance in the Information Age, Remarks Before the Securities Regulation Institute (Jan. 23, 1997) (transcript available at <http://www.sec.gov/news/speeches/spch135.txt>).

165. *Id.*

166. *See IPOTrade to Offer "Bulletin Board" Service*, INVESTMENT DEALERS' DIG., July 15, 1996, *available in* LEXIS, News Library, Curnws File. State securities commissions are wary of Internet IPOs. *See* Elson, *supra* note 20, at 1. The California Department of Corporations has not released state regulations pertaining to Internet DPOs, but enforcement chief Bill McDonald stated that his main concerns are "traditional securities crimes like market manipulation and insider trading." *See id.*

Although the SEC encourages the innovation and is mindful that more competition is better, the self-regulatory organizations (SROs)[167] are either slow to comment or extremely cautious.[168]

National Association of Securities Dealers Automated Quotation System (NASDAQ) spokesman Stephan Beauchesne expressed NASDAQ's "concerns about clearing and settlement, possible fraud, possible manipulation," and the likelihood that the securities would not be liquid.[169] The New York Stock Exchange declined to comment.[170] Either express or tacit approval by the SROs will be a signal that these issues have gained full acceptance and legitimacy, but until then the SEC will be the torchbearer as more and more of these offerings come to market.[171]

A. *Concerns for the Investor*

1. Risk

The financial viability of Internet DPOs and lingering legal questions are a cause for concern.[172] For one thing, even without the Internet as the offering medium, DPOs have their detractors.[173] The President of IPO Financial Network, David Menlow, avoids DPOs "like the plague,"

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167. Self-regulatory organizations (SROs) include the National Association of Securities Dealers (NASD), and the national stock exchanges—the New York Stock Exchange (NYSE) and the American Stock Exchange. *See* Mark H. Anderson, *SEC Eases Trading Curbs That Apply When Companies Issue New Securities*, WALL ST. J., Dec. 19, 1996, at B11. SROs are private entities operating under the SEC's oversight that draft and enforce their own rules. *See* Carl Sullivan, *Turf Warf*, FIN. PLAN., Nov. 1, 1996, *available in* 1996 WL 9114139. The most recent example of the SEC's oversight power is the censure of NASD for failing to enforce its own trading rules on the NASDAQ market. *See id.*

168. *See Brewer That Began IPOs on Web Plans On-Line Exchange*, WASH. POST, Apr. 3, 1996, at G1 [hereinafter *Brewer*].

169. *See Brewer*, *supra* note 168, at G1. Stocks sold through DPOs "will be difficult, if not impossible, to sell unless a company is listed on a market or a quotation service." Barmann, *supra* note 14.

170. *See Brewer*, *supra* note 168, at G1.

171. Although state and federal regulators are advancing financial innovation over the Internet, they are still faced with the monumental task of reconciling the new technology with the existing statutory structure. *See Small Business Takes on "The Street,"* SCOR REP., Aug. 1996, at 3 [hereinafter *Small Business*].

172. Because current DPOs are not very attractive to investors, the quality needs to improve for DPOs to succeed over the long term. *See* Barmann, *supra* note 14.

173. *See* Diana G. Lasseter, *Blue Fish Dresses Itself up in a DPO*, BUS. NEWS N.J., Nov. 29, 1995, *available in* 1995 WL 14349702.

because he believes the companies using such avenues are too early in their development and Regulation A disclosure allows the company to leave out many details.[174]

The concern that the investor should keep in mind is that these offerings carry more risk than larger offerings using traditional underwriters.[175] "There is an implied institutional stamp of approval when First Boston puts its name on an IPO prospectus," says Richard Grubman, President of Sycamore Capital Management.[176] "Consumers need to ask themselves how [they will] be able to track a company's progress without the follow-up and research capabilities that come with a reputable brokerage firm."[177] Stock sold through DPOs may lose support in the secondary trading market, depleting values and prices "until it falls into the penny-stock abyss."[178] Companies going public over the Internet are not very well-known and there is no liquid secondary market on which to trade at this time.[179] Internet DPOs are attractive because companies otherwise kept out of the process can raise capital more easily while allowing investors to get in on the ground floor where only venture capitalists could go before.[180]

2. Underwriters

Internet DPOs cut out the traditional underwriter, which saves on the escalating costs of printing and distributing prospectuses and lowers legal bills. However, using a traditional underwriter has significant benefits.[181] Underwriters ensure that there will be a market for the security, whereas, audience limitations in an Internet DPO may be the key factor in keeping Silicon Valley's next Netscape[182] from a direct online IPO be-

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174. *See id.*

175. *See* Costello, *supra* note 78.

176. *Id.*

177. *Id.*

178. *See* Lasseter, *supra* note 173. Currently, Internet DPOs have no public trading market. *See Excitement, supra* note 41. To sell, shareowners must find interested buyers and directly execute the trade. *See id.* As more companies go public over the Net, the demand for net-based trading systems will increase and the liquidity for the shares will increase. *See id.*

179. *See* Interview by Investor's Guide with Mark Perlmutter, President, Direct IPO (1996) (transcript on file with author).

180. *See id.*

181. *See supra* text accompanying notes 175-77 (discussing risks associated with offerings not using underwriters).

182. Netscape Communications was initially priced at $28 per share when it came out in August 1995 and traded as high as $174 in the ensuing months. *See* Lauren R. Rublin, *The Great Bull Market Charges on After a Record Year for All but the Shorts*, BARRON'S, Jan. 1, 1996, at MW5. From a valuation perspective, Netscape traded at 300 times its 1996 estimated earnings. *See* Alan Abelson, *The Inside Dope*,

cause of the uncertainty as to whether the entire issue can be sold.[183] The lack of a well-known and reputable underwriter lessens the overall credibility of the issuer. The hope is that, in time, the infant Internet IPO underwriters, such as DirectIPO[184] and Direct Stock Market, will become more recognized and will eventually provide the certainty and marketability of a large institutional underwriter for Internet IPOs.

3. Cybercrime

Securities cybercrime, a novel and unexplored issue with respect to selling shares over the Internet, is another concern.[185] The exchanges and trading systems must establish safeguards to prevent an Internet hacker from playing games with securities.[186] There is potential for unsuspecting investors, trying to create their own venture capital fund over the Internet or buying securities in a company they like, "to be done in by fraud, greed, or their own stupidity."[187]

Many people see the competing interests of good and evil at work in Internet DPOs. The good is that small companies can raise money faster and more effectively while investors can lower the amount they have to pay in commissions and fees.[188] On the other hand, there is the potential to match the "uninformed investor with [the] unproven entrepreneur."[189] The lack of full disclosure required in Regulation A and with DPOs is a concern investors are accustomed to in dealing with broker-dealers and with paper, which tends to provide confidence. However,

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BARRON'S, Nov. 6, 1995, at 3.

183. *See* Costello, *supra* note 78. Spring Street Brewery raised $1.6 million of the desired $3 million. *See* Lenderman, *supra* note 7, at 3.

184. *See infra* text accompanying notes 223-35 (discussing DirectIPO).

185. *See* Hal Lux, *An IPO over the Internet Isn't Good for Wall Street*, INVESTMENT DEALERS' DIG., May 22, 1995, at 34, *available in* LEXIS, News Library, Arcnws File.

186. *See id.* The Internet has already had problems with fraudulent investments such as "eel farms, a Costa Rican coconut chip factory, Caribbean ethanol plants" and other schemes promising a substantial return on investment. *See* Gallagher, *supra* note 4, at E1.

187. Charles A. Jaffe, *Don't Get Roped In; As More Firms Use Internet for IPOs, Investors Should Be Aware of Dangers*, CHI. TRIB., May 21, 1996, at C1.

188. *See id.*

189. *See id.* "Internet DPOs can be a very risky venture for investors who do not investigate exactly what they're buying." Barmann, *supra* note 14. "'[O]ut of every ten stocks, two will be successful, six will be brain dead and two will disappear off the face of the earth.'" Costello, *supra* note 78 (quoting John Perkins, Chairman of the Small Business Capital Access Association).

one must be aware that fraud occurs daily over the Internet, and that is a key issue the SEC is addressing.[190]

B. SEC Action

The SEC obtained a preliminary injunction in the Southern District of New York against a man offering fraudulent securities over the Internet.[191] The SEC asserted that the scheme sold shares in Costa Rican land development projects and stated, on the Web site: 20 Good Reasons for Investing in This Costa Rica Project.[192]

The possibility of fraud is imminent because the SEC has difficulty "policing the Net."[193] In fact, Andrew Klein noted that "there were a lot of people at the SEC and in the state (securities regulations) offices who couldn't see our Web site or what we were doing because they didn't have computer access."[194] Purveyors of fraud are not limited to individuals in the United States.[195] A sham company can post a Web site, attract investors, and, by the time the SEC shuts down the operation, the investors' money is long gone and likely not recoverable.[196] Fortunately, investors can take steps to protect themselves.[197]

C. Investor Protection

First, investors must check to see if the issue is properly registered.[198] The "fast fraudsters" will not be registered, so this is "bare

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190. Gary Weiss, of Business Week reported that he saw a posting on the Internet that "solicited '$7.7 million in equity investment over a 13-month period' for an unnamed product from an unnamed company that has 'no competition.'" *See* Weiss, *supra* note 5, at 74. The company included a profit and loss table with the posting that projected a first year loss of $2.5 million followed by a profitable second year based on $22.5 million in earnings. *See id.* Mr. Weiss expressed interest through E-mail and was quickly sent materials on a company called "Pocket Made Inc.," which had not registered its shares with the SEC or any state. *See id.* Pocket Made later stated that nobody invested in the offering and pulled the posting after legal counsel advised them of potential legal ramifications. *See id.*

191. *See* Gregory C. Yadley, *General Solicitation and General Advertising: Hurdles to Capital Raising by Small Businesses in the Brave New World*, CA 28 A.L.I.-A.B.A. 319, 336 (Feb. 16, 1996).

192. *See id.*

193. *See* Jaffe, *supra* note 187, at C1.

194. *Id.*

195. *See id.*

196. *See id.*

197. *See id.*

198. *See id.* Investors can find this information easily by accessing the SEC's Web-Site at <http://www.sec.gov>. *See* SEC Release No. 7289, *supra* note 115, at 88,014 n.50.

minimum" protection.[199] Second, investors need to view each investment with skepticism.[200] Wit Capital, Klein's trading firm, has received five-hundred inquiries from companies interested in doing an Internet DPO, of which about three Klein considers worthy of underwriting.[201] The sad reality is that some of the other 497 companies will find an underwriter and an unsuspecting investor will invest in the subpar issue.[202] Finally, the old adage that "patience is a virtue" is pertinent because the quality of investments will increase through time.[203] As the market for these securities matures and the screening process improves, investors can be more secure in their investment.[204] The Internet may actually serve to reduce fraud.[205]

The SEC can police Internet DPOs by merely checking out the web site, which is easy to access.[206] Because words transmitted over the Internet can be seen by anybody, regulatory bodies can monitor offerings, in contrast to offers over the phone conducted by boiler room operations where there is no way of knowing what was said.[207]

D. *Financial Concerns*

There are some other important financial considerations an issuer needs to take into account. Without an investment banker providing for an orderly secondary market through the use of market makers and dealers, there will be a lack of liquidity.[208] These issues will not "'have the

199. *See* Jaffe, *supra* note 187, at C1.
200. *See id.*
201. *See id.* Wit Capital, an investment bank dedicated to public offerings over the Internet, performs "due diligence, valuation determination, deal structure, and prospectus preparation" for the issuer. *See* Interview by Investor's Guide with Andrew Klein, President, Wit Capital Corp. (1996) (transcript on file with author). Wit Capital's goal is to sell "early-stage entities" to retail investors through Wit's digital stock market. *See id.; see* also *supra* note 46 (describing Wit Capital's function and how to access Wit Capitals Web site).
202. *See* Jaffe, *supra* note 187, at C1.
203. *See id.*
204. *See* Interview by Investor's Guide with Tom Taulli, *supra* note 94.
205. *See id.*
206. *See id.*
207. *See id.*; *see also* Interview by Investor's Guide with Clay Womack, *supra* note 10.
208. Grand & Lloyd, *supra* note 51, at 92. "If a company is not of sufficient quality to generate interest in the aftermarket, mainly through market makers, then the stock price will lag, the stock will be thinly traded, and the company's ability to get future financing will be impaired." Interview by Investor's Guide with Leo Feldman, *supra*

liquidity [of] the New York Stock Exchange,'" but they will be more liquid than a small company could otherwise imagine.[209]

Second, "cyberissues" do not have the benefit of being listed on a national exchange or with the National Association of Securities Dealers (NASD), so institutional investors, who provide a great deal of demand, will likely sit on the sidelines.[210] Thus, cyberissuers must anticipate that most of the buyers will be retail investors, which is a limited source of demand.[211] With this in mind, these thinly traded securities are subject to market manipulation because the Internet allows for uncontrolled information which can artificially "puff" stocks or allow false rumors to spread.[212] The SEC is "'aware that there is a possibility of a lot of misinformation or disinformation about companies on the Net that may confuse investors,'" but they are "giving the go-ahead for one reason: It opens the doors for additional capital for small businesses."[213] The SEC should be applauded for its open-minded and innovative approach, which leads to a bright future for Internet DPOs.

VII. FUTURE OF THE INTERNET DPO

On the surface, it appears that there is little activity in the Internet DPO market. However, this market is fast becoming the talk of Wall Street. In 1996, over $120 million was raised through Internet DPOs, and the intermediaries, such as Direct Stock Market and DirectIPO, are finished with their building phases.[214] "One company has opened a secondary trading operation for its shares and at least four . . . companies are working on digital stock markets."[215] Andrew Klein, the CEO of one of these companies, predicts that the printed prospectus will be obsolete in five years.[216] Now that the SEC has issued guidelines and the web-

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note 29. Although there are no restrictions on the transfer of DPO securities, they are generally illiquid until a secondary market is created. *See Direct Public Offerings: Basic Information*, SCOR REP. (on file with author).

209. *See* Lenderman, *supra* note 7 (quoting Andrew Klein). Because the market is dynamic due to the nature of the Internet, the lack of liquidity will be "a self-correcting problem" as investors "learn to be much more discriminating." Interview with Feldman, *supra* note 29.

210. *See* Grand & Lloyd, *supra* note 51, at 92.

211. *See id.*

212. *See id.*

213. Sougata Mukherjee, *Ruling on Internet Spawns New Breed of Cyber-Brokers*, CAP. DISTRICT BUS. REV., June 24, 1996 (quoting SEC Commissioner Steven Wallman), *available in* 1996 WL 10010659.

214. *See Internet IPO Monitor*, *supra* note 43; *see also What We Do* (visited Jan. 21, 1997) <http://www.directipo.com/what.html>.

215. *Small Business*, *supra* note 170, at 3.

216. *See* Interview by Investor's Guide with Andrew Klein, *supra* note 200.

based investment banks have had time to establish web sites and recruit the staff to compete for offerings, Internet IPOs are expected to increase rapidly.[217]

A. *Why are Internet DPOs so Important?*

"The Internet is becoming the pathway to financing that might not otherwise be available. It's also giving entrepreneurs a way to avoid losing control to venture capitalists."[218] The future of Internet DPOs is bright because it is a way for small businesses to "raise capital inexpensively and without sales commissions."[219] SEC regulators embrace the financing tool because they can monitor these offerings by merely surfing the Internet and uncovering the needed information, as opposed to covert operations that are extremely difficult to uncover.[220]

Perhaps the most significant indicator of the possibilities surrounding this market is the reaction of the competition—the investment bankers. Elaine La Roche, a Managing Director of Morgan Stanley, says that Wall Street executives view Internet DPOs with "discomfort—or a little bit of fear."[221] "The Internet is more than a new market, [i]t's a whole new ball game—and one that has serious, possibly ominous, implications for the financial service industry [because] it allows end users to bypass the middleman. It allows them to bypass us."[222] The behemoth investment banks already have Web-based competition.

B. *DirectIPO*

1. Background

There are a few companies that have been quick to attract client companies attempting to raise capital over the Internet. DirectIPO, a Marina Del Rey, California, based firm is a corporation that facilitates early-stage

217. *See Small Business*, *supra* note 171, at 1; *see also supra* notes 14-20 and accompanying text (discussing the 35 offerings being developed). For a good discussion of the companies developing digital stock markets, see *The Digital Stock Market: Lots of Ideas, But No Green Lights*, SCOR REP., Aug. 1996, at 7, 11.

218. *Going Public on Interstreet, Not Wall Street*, ZAP NEWS (ZAP Power Systems, Sebastopol, CA), Winter 1996 [hereinafter *Interstreet*].

219. *See id.*

220. *See id.*; *see also* Interview by Investor's Guide with Tom Taulli, *supra* note 94.

221. *See Interstreet*, *supra* note 218.

222. *Id.*

Internet DPOs by walking them through the entire process, with the ultimate goal of leading the client to go public on NASDAQ.[223] DirectIPO was formed in response to the SEC's October 1995 ruling.[224] The company uses its expertise in public relations coupled with an Internet hyperlink and marketing program that will attract potential investors who can download a prospectus and order stock via E-mail.[225] DirectIPO cites three primary benefits of the Internet DPO process.[226] In a matter of months, a company will gain the credibility that accompanies "public" status, establish a market value for their shares which is beneficial for purposes of acquisitions and secondary offerings, and raise up to $5 million in cash through the sale of less than 20% of the company.[227]

2. The Four Win-Wins

DirectIPO states four primary reasons why Internet DPOs are a win-win situation.[228] First, small investors act as "discount venture capitalists," buying up to 25% of the company compared to the 50% that venture capitalists demand.[229] These small investors can benefit by diversifying their portfolio, essentially creating "their own mini venture fund."[230] Second, these small investors must realize the need for patience.[231] By holding onto the stock for a year or two, investors will reap venture capital-like returns when the company sells a secondary offering on NASDAQ.[232] Third, DirectIPO requires that each company have a two to four year goal of selling on NASDAQ, which provides the necessary li-

223. *See IPO Direct: Direct IPO Corp. Formed to Help Internet Companies Go Public Using the World Wide Web*, EDGE: WORK GROUP COMPUTING REP., *available in* 1996 WL 7977538.

224. *See Direct IPO*, *supra* note 15, at DirectIPO FAQ ¶ 2.

225. *See Direct IPO*, *supra* note 15. Direct IPO's Mission Statement sums up its overall vision and goal to "give emerging Internet companies rapid access to capital through initial public offerings of stock over the Internet, directly to investors, eliminating the need for underwriters. The company will create wealth for entrepreneurs, investors and itself by creating marketable equity for new enterprises that have heretofore been left out of the investment banking and venture capital processes." *Id.*

226. *See id.*

227. *See id.*

228. *See id.*

229. *See id.*

230. *See id.*

231. *See id.* DirectIPO has developed a four step financial strategy. *See id.* First is the Internet DPO, followed by the development and growth stage looking for possible acquisitions, succeeded by market positioning through DirectIPO's public relations and marketing expertise, and finished by a NASDAQ offering where early investors may receive up to ten times the initial offering price. *See id.*

232. *See id.*

quidity.[233] Internet DPO investors should use this investment as emergency liquidity only, thus providing stability to this infant trading market.[234] Fourth, the initial strategy is to raise funding for start-ups or emerging growth companies, but the exit strategy is predicated on a secondary NASDAQ offering complete with underwriters, market makers, analysts, and a NASDAQ listing.[235]

3. Costs and Time

Although less expensive than traditional underwriting methods, Internet DPOs are not cheap or free and do not close overnight. A firm like DirectIPO may charge a fee of up to $100,000 plus five to ten percent of the shares.[236] If Regulation A is used, DirectIPO estimates a time horizon of five to ten months.[237] Other costs include attorneys,[238] an SEC audit,[239] on-line investment bankers,[240] and a web site developer.[241] Due to the elimination of "layers of intermediaries," these costs are far below that of traditional offerings creating more value in the deal that can be shared between the investors and the issuer.[242] Additionally, "transaction costs will be reduced as the printed prospectus will be replaced by digital documents, and electronic multimedia presentations will replace costly roadshows."[243]

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233. *See id.*
234. *See id.*
235. *See id.*
236. *See id.*
237. *See id.* The registration process takes four to eight months while the sale of securities takes one to two months. *See id.*
238. Attorneys will charge $10,000 to $35,000 depending on how much of the registration form the issuer correctly completes. *See id.*
239. SEC auditors charge $5000 to $15,000. *See What We Do, supra* note 214.
240. For example, IPOnet charges a $650 set up fee (including text, links, and graphics), a $1200 monthly fee to maintain the offering on IPOnet, a 10% sales commission, warrants equal to 10% of the offering, and costs. *See* IPOnet, *Types of Offerings and Estimate of Costs* (visited Sept. 11, 1997) <http://www.zanax.com/iponet/types.html>.
241. Web site developers typically charge between $35,000 and $50,000. *See What We Do, supra* note 214.
242. *See* Interview by Investor's Guide with Andrew Klein, *supra* note 201.
243. *Id.*

C. CAP$CAPE

Many of these developments sound appealing, but how can an entrepreneur actually take advantage of these offerings and cost savings? One example is Ben Ezra, Weinstein and Co.,[244] a company that "develops and markets an innovative Internet-compatible computer program," Cap$cape, that allows the entrepreneur to do much of the work himself.[245] Cap$cape's software package enables an individual[246] to complete around 85% of the prospectus, resulting in six-figure savings from that of a traditional prospectus.[247] The founder of Cap$cape, Mike Weinstein, is engaging in "populist capitalism," and his new version will allow companies to develop a prospectus that conforms to the blue sky laws of all fifty states.[248]

A real world example of what Cap$cape can do for a company is Poof Products, a small toy and foam-products firm.[249] In order to avoid being the target of an acquisition, Poof needs to raise capital to expand its marketing and sales efforts, but a small firm venture capitalist providing $5 million in funds will cost upwards of $700,000.[250] Instead, Poof can buy the Cap$cape program for $1200 and put together a prospectus for an Internet DPO at a total cost of less than $100,000.[251] Without the use of the Internet DPO, Poof Products would likely be the target of an acquisition rather than making its own plan for expansion.[252]

Finally, technology has opened the door for small companies with big ideas to raise the money necessary to capitalize on these ideas without the prohibitive cost of using venture capital or investment banks. The

244. Ben Ezra, Weinstein and Co. trades on the OTC-Bulletin Board under the symbol BNEZ with a public float of 3,000,000 common shares and 10,000,000 shares outstanding. *See The Cap$cape Times*, (visited Jan. 23, 1997) <http://www.benez.com/capscape/times>. Without the need for professional assistance, Cap$cape's software package costs $1200 and offers an optional Internet-based advisory service for $3500 that assists with the completion of 85% of a Regulation A filing with the SEC. *See id.*

245. *See id.*

246. The company beta tested Cap$cape on its own receptionist–"a woman with a high school education who whipped out a complete draft within nine hours." *See Who Needs Venture Capital if Anyone Can Do an IPO?*, BARRON'S, Jan. 20, 1997, at 10.

247. *See id.* Attorney's fees will be between $8000 and $15,000, merely to "tweak the draft" and put together the rest of the documents. *See id.*

248. *See id.* By the end of 1997, Ben Ezra, Weinstein and Co. expects to have packages that will assist in the creation of many related offering documents. *See id.*

249. *See On-Line Capitalism*, THE ECONOMIST, Nov. 23, 1996.

250. *See id.*

251. *See id.* The United States government estimates that a traditional prospectus takes 900 hours to complete, but Cap$cape's program cuts this down to 11 hours. *See id.* Of course, a lawyer still must review the documents. *See id.*

252. *See id.*

adoptive approach taken by the SEC is indicative of the advantages Internet DPOs bring to the capital markets. With a supportive regulatory environment, these offerings have the potential of creating billions of dollars of value for small companies and investors. The characteristics of Internet DPOs—lower costs, easier and faster access to information, increasing ownership, reduced regulatory burdens—are particularly American ideals, ensuring that this innovation is only the beginning of many more innovations between the Internet, the capital markets, and the SEC.

DANIEL EVERETT GIDDINGS