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Securities Law Developments

SEC Issues New Release On Use of Electronic Media (Part 1 of 2)

On April 28, 2000, the U.S. Securities and Exchange Commission ("SEC" or "Commission") issued its third interpretive release ("Release") focusing on electronic delivery, and the application of the federal securities laws to the Internet, and other electronic media.[1] The guidance provided in the new Release further clarifies and expands on the prior interpretive positions available from 1995[2] and 1996.[3] The Release examines various issues regarding consent to electronic delivery, issuer responsibility for web site content, and implications for Internet based offerings. Further, it provides illustrative examples applying the SEC interpretations, and solicits comments on additional electronic media issues.

In this Part of our newsletter, we present an overall summary of the issues discussed in the new Release. In Part 2 of our newsletter, we will address the regulatory implications for web site operators whose activities over the Internet may trigger the broker-dealer registration requirement as noted in the Release and recent no-action letters from the Division of Market Regulation.

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[1] *Use of Electronic Media,* Securities Act Release No. 7856; Exchange Act Release No. 42728 (April 28, 2000), available at <http://www.sec.gov/rules/concept/34-42728.htm>.

[2] The 1995 release focused on electronic delivery of prospectuses, annual reports and proxy solicitation material under the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act"), and the Investment Company Act of 1940 ("Company Act.") *Use of Electronic Media for Delivery Purposes*, Securities Act Release No. 7233; Exchange Act Release No. 36345 (Oct. 6, 1995), 50 FR 53458 ("1995 Release"), available at <http://www.sec.gov/rules/concept/33-7233.txt>.

[3] The 1996 release addressed electronic delivery of required documents by broker-dealers, transfer agents and investment advisors. *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisors for Delivery of Information*, Securities Act Release No. 7288; Exchange Act Release No. 34-37182 (May 9, 1996), 61 FR 24644 ("1996 Release"), available at <http://www.sec.gov/rules/concept/33-7288.txt>.

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Electronic Delivery

As set forth in the 1995 and 1996 Releases, the suitability of electronic delivery should be examined from three elements: notice, access and evidence of delivery. The deliverer should provide adequate notice of document delivery, provide adequate access to the posted document, and retain adequate evidence of delivery of the document. In the current Release, several specific scenarios are examined.

Telephonic Consent - The 1996 Release provides that informed consent to electronic delivery should be in written or electronic format.[4] The new Release specifically permits issuers and market intermediaries to obtain informed consent telephonically, so long as a sufficient record of the consent is retained and the consent is adequate to ensure its authenticity.

Global Consent - The 1995 Release provides that informed consent may be obtained for all documents relating to a single issuer, and that an issuer may rely on consent obtained by a market intermediary. The new Release provides additionally that "an investor may give global consent to electronic delivery -- relating to all documents of any issuer" in which "that investor buys or owns securities through a particular intermediary."[5] The SEC indicates that the scope of the consent must be clear to the investor. Also, the consent should comprise its own document or be a segregated section within a larger document as opposed to, for example, a provision intermingled within an account opening agreement.

Portable Document Format - The Release makes clear that documents may be delivered in Portable Document Format ("PDF"), despite the fact that special software is required to view documents in this format, so long as access to the document is not unduly burdensome.

Envelope Theory - The 1995 Release suggests that documents connected by hyperlink are considered to be delivered "as if they were in the same paper envelope."[6] The new Release attempts to resolve ambiguities about web site content raised by this so-called "envelope theory" when an issuer is in registration. The Release makes clear that information is considered part of a "Section 10 prospectus" only if an issuer (or the issuer's agent) acts to "make it part of the prospectus."[7] The Release indicates "if an issuer includes a hyperlink within a Section 10 prospectus, the hyperlinked information would become a part of that prospectus."[8] On the other hand, a "hyperlink from an external document to a Section 10 prospectus would result in both documents being delivered together, but would not result in the non-prospectus document being deemed part of the prospectus."[9]

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4 See 1996 Release, n. 23.

5 Release at 10-11.

6 Id. at 14.

7 Id. at 15.

8 Id. at 15.

9 Id. at 16-17.

Following the 1995 Release, there has been substantial uncertainty as to whether information on the same website with a prospectus will be considered delivered with the prospectus under the envelope theory. In the case of a posted preliminary prospectus, that analysis could cause other website content to be impermissible free writing. The new Release explains that information posted on a website "must be reviewed in its entirety to determine whether it contains impermissible free writing"[10] and that physical proximity of information on a web page is not dispositive for this purpose. Further, the Release also applies these principles in the context of municipal securities preliminary and final official statements.

Web Site Content

The Release addresses issuer responsibility for (i) third-party information in general and (ii) other communications during a registered offering under the anti-fraud provisions of the federal securities laws.

Issuer Responsibility for Third-Party Information - Generally, hyperlinked third-party information will be attributed to the issuer where the issuer has been involved in the preparation of that information (so-called "entanglement theory"), or where the issuer implicitly or explicitly approves the information (so-called "adoption theory"). Further, "even when an issuer remains silent about the hyperlink, the context . . . may imply that the hyperlinked information is attributable to the issuer."[11]

The Release also makes clear that confusion regarding the source of the hyperlinked information may create an impression that the issuer has adopted the hyperlinked information. Possible solutions to avoid this type of confusion involve use of an "intermediate screen" before arriving at the hyperlinked location, indicating that the viewer is now leaving the issuer's web site. This solution, however, is not dispositive on the issue. Further, if the hyperlinked information appears within a frame at the issuer's website, this would add to the appearance of adoption.

Finally, the Release indicates that "[w]here a wealth of information as to a particular matter is available, and where the [hyperlinked information] is not representative of the available information, an issuer's creation and maintenance of the hyperlink could be an endorsement" of the information.[12] Moreover, "action to differentiate a particular hyperlink from other hyperlinks on an issuer's web site, through its prominence, size or location, or to draw an investor's attention to the hyperlink" could increase the likelihood that the hyperlinked information may be "attributable to an issuer."[13]

Issuer Communications During a Registered Offering - To avoid Section 5 problems under the Securities Act, an issuer in registration should carefully review its own web site and any information on third-party web sites to which it hyperlinks to see if any such communication constitutes an "offer to

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[10] Id. at 17.

[11] Id. at 22.

[12] Id. at 24.

[13] Id. at 25.

sell," "offer for sale," or "offer" under Section 2(a)(3) of the Securities Act.[14] Any third-party information that falls within the meaning of these terms will raise a "strong inference that the hyperlinked information is attributable" to the issuer for the purposes of Section 5.[15] The Release, therefore, suggests that attribution of third-party information to the issuer is potentially more broad during the offering process and that the issuer may need to establish a different set of procedures regarding hyperlinks to third parties during the so-called "pre-filing" or "waiting" period of a registered offering.[16]

The Release re-affirms, however, the ability of the issuer in registration to maintain communications with the public, so long as the subject matter of such communications is limited to "ordinary-course business and financial information." The release listed the following examples of "ordinary-course business and financial information":

- advertisements concerning the issuer's products and services;
- Exchange Act reports required to be filed with the SEC;
- proxy statements, annual reports to security holders and dividend notices;
- press announcements concerning business and financial developments;
- answers to unsolicited telephone inquiries from analysts, security holders, and others in the communications field with legitimate business interest; and
- security holders' meetings and responses to security holder inquiries relating to these matters.[17]

As clarified in the Release, information falling within any of the foregoing categories may be made available while an issuer is in registration. This can be done in traditional or electronic format, such as posting either directly on the issuer's web site or indirectly through a link to a third-party web site. This interpretive position implies that the written communications containing such information will not be deemed to be an "offer to sell," "offer for sale," or "offer" within the meaning of the Securities Act for purposes of a Section 5 analysis. Note, however, that it is not clear whether a non-reporting issuer contemplating an initial public offering may rely on the SEC's guidance to provide similar information on its web site, to the extent that such an issuer does not have an established history of ordinary-course communications with the marketplace.

As noted, this list of ordinary-course business communications applies to both traditional and electronic communications. The limited scope of the list likely will raise concerns about whether other communications would be considered offers. For example, it is not clear that the list includes regularly scheduled conference calls held by an issuer. As the Release is reviewed and discussed, this topic probably will generate substantial debate.

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[14] Id. at 26. In any event, a hyperlink from the issuer's prospectus would cause the hyperlinked material to be a part of the prospectus.

[15] Id.

[16] The Release notes that the "safe harbor" provisions contained in Securities Act Rules 137, 138 and 139 regarding the permissibility of broker-dealers providing research, "do not extend to permit issuers to publish or distribute the same information." Id. at 26-27, n. 66.

[17] Id. at 27.

Online Offerings

The Release addresses the rapidly developing areas of online registered and private offerings. At present, the SEC reserves the development of detailed procedures for conducting online registered offerings to further staff interpretation and future rulemaking initiatives.

Online Public Offerings - To date, the Division of Corporation Finance has reviewed numerous procedures in connection with online distribution of IPOs and also has issued a no-action letter regarding the permissible procedures for conducting such an offering.[18] Many were hoping that the SEC would provide guidance in the Release to facilitate online public offerings. While pointing out the benefits and dangers associated with online public offerings, the Release concludes that it may be premature at this point to make any additional regulatory accommodations or to prescribe any specific set of procedures. The SEC will continue to analyze the issues presented as technology evolves and consider the need for possible regulatory action in the future. The Corporation Finance staff also will continue to review procedures submitted in connection with online offerings.[19] As a result, uncertainty about permissible action taken in online public offerings will remain for now.[20]

Online Private Offerings under Regulation D - The Release examines whether, and under what circumstances a third-party service provider may solicit information from potential investors to determine if they qualify as "accredited" or "sophisticated" under Regulation D, thereafter providing the selected investors with password limited access to private offerings of securities. The Release indicates that the formation and existence of a "pre-existing, substantive relationship" is central to determining whether the solicitation is a prohibited form of "general solicitation."

In the Release, the Commission indicates that some entities have ventured beyond the interpretive guidance proffered in the IPONET letter.[21] Under those facts, a registered broker-dealer used an online questionnaire to identify, and build a database of, accredited and sophisticated investors. After the investor was qualified, the broker-dealer provided controlled access to information on private offerings subsequent to the investor's inclusion in the database. The Release expresses concern that non-broker-dealer third-party service providers have "deviated substantially from the facts in the IPONET" letter by permitting the potential investor to self-identify as accredited or sophisticated.[22]

In perhaps one of the more controversial elements of the Release, the SEC appears to take the position that, in the online arena, it is necessary to have a broker-dealer involved in order to avoid a

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[18] See Wit Capital Corporation, SEC No-Action Letter (July 14, 1999).

[19] The staff's views about the application of Section 5 to online IPOs are set forth in Section VIII. a(4) of the Division's Current Issues and Rulemaking Projects Outline (Apr. 13, 2000), which is available on the SEC's website at <http://www.sec.gov/pdf/cfcr042k.pdf>.

[20] The Corporation Finance staff obtains information about possible online offerings through the comment process. For example, the staff asks for information in IPOs about whether there is an online component, and, if so for details of how it will work. The staff then discusses its views with counsel through the comment process. Since this information is not widely available, it may be difficult to learn what the staff is permitting at any given time.

[21] Division of Corporation Finance and Market Regulation interpretive letter IPONET (July 26, 1996).

[22] Release at 34.

general solicitation.[23] Part 2 of our newsletter will address in more detail the potential broker-dealer registration requirement for web site operators.

Broker-Dealer Capacity - The Release reminds broker-dealers of the need to have "adequate facilities and personnel to promptly execute and consummate all of their securities transactions."[24] In order to abide by this tenant, broker-dealers relying on electronic facilities to engage in online offerings should ensure that equipment and bandwidth are adequate to handle appropriate levels of volume at any given time.

Requests for Public Comments

Recognizing the continuing evolution of Internet technology, the Release solicits comments on a number of specific areas, as well as suggestions for identification of additional issues.

Access Equals Delivery - As investor access to the Internet increases, at what point should delivery be deemed complete merely by having the required documents posted on an issuer or third-party web site?

Electronic Notice - Given the increasing technological sophistication of the typical investor, when should a message in an investor's online account be sufficient notice of availability of electronic delivery of required documents?

Implied Consent - As noted in the Release, obtaining investor consent may pose "the most significant barrier" to electronic delivery. Under a system of "implied consent," consent to delivery could be presumed, if the investor does not affirmatively object or opt-out of electronic delivery. The Release requests comment regarding under what circumstances such a system would be desirable.

Electronic-Only Offerings - The Release solicits comments regarding whether true electronic-only offerings can be made, and whether the requirements for paper backup of certain electronic delivery may be dispensed with.

Access to Historical Information - Unlike a press release that is "published" once, the SEC noted that information posted to a web site may be considered continuously "re-published" every time an investor accesses the site. This may give rise to special liability issues under Section 10(b). The Release asks for comment on ways to facilitate the availability of historical information on the Internet consistent with federal securities laws.

Communications When in Registration - The Release asks how issuer communications should be limited during the offering process when the issuer's legitimate business activities are conducted primarily or exclusively through its web site. Additionally, how should mutual funds, which are continuously in registration, deal with hyperlinked information on third-party web sites meeting the definition of an "offer to sell," "offer for sale" or "offer?"

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[23] Release at 35-36.

[24] Id. at 37.

Internet Discussion Forums - The Release solicits comments regarding special issues raised by Internet discussion forums such as moderated discussion forums, bulletin boards and chat rooms. These issues may include the potential effects on the stock price of the issuer, broker-dealer hosting of the forums, and issuer employee participation in the forums.

Conclusion

While the SEC continues to affirm its desire to be flexible in accommodating the evolving communication and Internet technologies, many will believe that the new Release does not go far enough. The SEC's expressed concerns about potentially abusive practices in the online arena, particularly with regard to the application of Section 5, appear to be causing the SEC to be cautious. Perhaps the comments received on the Release will lead the SEC to Reassess some of its positions. As technologies continue to evolve, it is all but certain that these and related issues will require continual examination.

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