From *Spring Street* to Main Street: Will the Internet Direct Public Offering (DPO) Ever Catch On?

by Jack A. Rosenbloom

In March 1996, Spring Street Brewing, Inc., revolutionized the way capital could be raised by creating the first public stock offering on the Internet.[1] A small microbrewery in New York City, Spring Street, was looking for a novel way to raise additional capital. Andrew Klein, the company chairman and a former securities lawyer, believed that a traditional public offering would be far too costly.[2] Relying on several recent developments in securities laws, Klein devised a method of offering Spring Street stock directly to investors over the Internet, and a significant alternative to the traditional methods of raising capital was born.

Klein's use of the Internet direct public offering (DPO)[3] enabled his company to raise capital by taking advantage of the universe of individuals linked to the Internet, while bypassing many of the issues, costs, and uncertainties of raising capital through venture finance, initial public offerings, private offerings, and other traditional sources of capital.

Soon after the Spring Street Brewing Internet DPO, a number of other companies followed suit.[4] Unfortunately, since that time, the Internet DPO never really attained acceptance as a viable means of raising capital. While there is no single reason why, a number of contributing factors in the lack of acceptance can be cited. These include (1) investor concerns about reliability; (2) fraud; and (3) the lack of a reliable liquid market for securities offered via DPO. As of today, no reliable trading system for unregistered stocks has been created,[5] and advances in Alternative Trading System (ATS) laws have not been applied effectively in the context of Internet DPOs.[6]

Arguably, the most important factor in this lack of acceptance was the Internet boom of the late 1990s. During the boom, funding from venture capital was occurring at an astonishing rate, peaking at almost $100 billion in 2000.[7] Businesses with nothing more than an idea and a half finished business plan were going public at astonishing rates, peaking at 1,017 IPOs filed in 2000.[8] Businesses simply did not see the need to conduct their own Internet DPOs when more established alternatives were so readily available.

What about now? The Internet boom has long since passed, and the US economy, while showing signs of recovery, has not yet rebounded.[9] The IPO market has become extraordinarily difficult, with only 118 IPOs filed in 2003.[10] Venture capital money is also very hard to come by, as most venture capital firms are extremely selective in which companies to fund. Just less than $10 billion of venture capital was invested during the first nine months of 2003.[11]

Perhaps Spring Street's innovation simply came too early. With uncertainty in the economy and the limited sources of capital, now might be the time for Internet DPOs to finally make an impact.

This article focuses on the body of law that emerged within the federal securities laws in the early to mid-1990s and that paved the way for the Internet DPO. It will also address the initial SEC reaction to Internet DPOs, which reaction raised some of the questions and uncertainties that exist today. Those initial questions and uncertainties may still be an impediment to the widespread acceptance of Internet DPOs.

OVERVIEW OF APPLICABLE FEDERAL SECURITIES LAWS

In 1992, the federal securities laws underwent a revision that liberalized many of their provisions,[12] including the expansion of certain exempted and non-registered offering sections.[13] Prior to 1992, issuers were often limited by the restrictive provisions of exempted transactions, which many times required potential investors to be "sophisticated" or "accredited"[14] before they could purchase shares. Also, once investors purchased their shares, they were often subject to transfer restrictions.[15]

REGULATION A

Regulation A, the Conditional Small Issues Exemption,[16] was one such liberalized provision.[17] Prior to the 1992 changes, Regulation A was seldom used because it limited offerings to a maximum of $1.5 million in any 12-

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month period. For many small businesses, this was simply too small to be useful. Since its expansion, however, Regulation A has become more flexible and adaptable, thereby increasing its popularity among these small businesses.[18] Existing and proposed stock offerings have consistently chosen Regulation A when making offerings.[19]

Regulation A is a public offering exemption recognized under § 3(b) of the Securities Act of 1933.[20] Section 3(b) authorizes the Securities and Exchange Commission (SEC) to exempt certain securities from registration when it finds that the dollar amount involved in the offering is so small or that the public offering would be so limited in its character that a full public offering under § 5 of the Securities Act would be unwarranted.[21] However, the SEC's authority to exempt securities under Regulation A applies only if the aggregate offering price of the issue does not exceed $5 million.[22]

Regulation A offerings begin when an offering statement is filed with an SEC regional office.[23] The requirements of the offering statement are similar to those on a registration but are much simpler.[24]

One of the most appealing provisions of this regulation is a section that allows a company considering a Regulation A offering to test the waters by soliciting indications of interest prior to filing an actual offering statement[25] and spending its limited funds. A small business testing the waters this way need not worry that the materials used to determine interest will be deemed a prospectus under the securities laws. Regulation A specifically exempts these materials so long as they are in compliance with the guidelines set forth by the rule.[26]

Another benefit of Regulation A is the lack of restrictions on the resale of issued securities.[27] This is superior to some of the other exempted transactions, which require specific holding periods, specify particular types of investors who may make purchases, and require that securities "come to rest" or be registered before resale.[28] Regulation A also allows issuers to make secondary offerings up to $1.5 million.

Regulation A offerings will not be integrated with other exempt and registered offerings, provided there is an appropriate waiting period before stocks are offered.[29] Despite the overall liberal posture of Regulation A, the SEC reserves the right to suspend the use of the exemption if there has been non-compliance with the rule.[30]

Although Regulation A is the statute that has been used for Internet offerings, it contains no provisions that consider the effect of electronic media on an offering. Electronic media have had an independent development under the federal securities laws. Therefore, the SEC's position on electronic media must be considered in conjunction with Regulation A in the context of an Internet offering.

DEVELOPMENT OF ELECTRONIC MEDIA UNDER THE FEDERAL SECURITIES LAWS

In 1984, the SEC began using its Electronic Data Gathering, Analysis, and Retrieval System (EGDAR) to collect corporate filings.[31] EDGAR is an electronic medium that makes receiving and processing documents filed with the SEC more efficient by allowing rapid dissemination of information.[32] Also, companies no longer need to file large documents on paper, thereby significantly reduces their costs.

EDGAR's efficiency has led to more than 70 percent of all domestic public companies filing documents electronically. In fact, the system was so successful that in May 1996 the SEC began requiring all SEC-registered domestic companies to file electronically.[33]

In a 1995 release, the SEC discussed the use of electronic media for document delivery under the federal securities laws.[34] The SEC took the position that the use of electronic information distribution is promising because it enhances the investors' ability to access, research, and analyze information.[35] The SEC further noted that, because of its numerous benefits, electronic distribution of information should "not be disfavored."[36] Finally, the SEC stated that the use of electronic media increases market efficiency by allowing dissemination of market information in a more "cost efficient, widespread, and equitable manner than traditional paper based methods."[37]

The tone of the release was cautious, yet favorable. In light of the explosive level of information now available to investors, the SEC appeared to have recognized the power of electronically transmitted information.

THE SEC'S RESPONSE AND UNRESOLVED ISSUES

The initial SEC reaction to DPOs came in a correspondence issued on March 22, 1996, in response to Spring Street's Klein in which the SEC expressed several legal concerns with this new method of stock offering and the system of bulletin board trading that Spring Street had also devised.[38] The first concern was that investors relying on Internet stock trading would not be adequately protected from certain risks. The SEC then listed five specific concerns that needed to be addressed. The list was as follows: (1) proper handling

of investors funds, (2) proper handling of securities, (3) investor understanding of the risks involved in purchasing illiquid and speculative securities, (4) frequency of security price updates, and (5) methods of disclosure for company information.[39] While the SEC did not *per se* prohibit this new practice, it remained cautious in granting it a full endorsement.[40]

These initial concerns expressed by the SEC remain as some of the key unresolved barriers to widespread acceptance of DPOs and serve as the basis for this still developing body of law.[41] Some of the key issues are as follows.

RISK

Investor understanding of risk remains one of the SEC's most important concerns. The risk posed by Internet stocks offered via an Internet DPO remains extremely high. Although some safeguards may be taken, investors are essentially investing in shares that are the equivalent of non-transferable venture capital interests.[42]

PROPER HANDLING OF INVESTOR FUNDS AND SECURITIES

Proper handling of investor funds and securities is another issue of concern, due to the fleeting nature of many Internet-based companies and the lack of experience that most have with handling money and securities. The SEC has stated that the use of a third party would prevent potential commingling of funds and avoid securities handling problems, while better protecting both the corporation and the investor.[43] Although the use of a third party will likely help avoid serious conflict of interest problems and money handling issues, it will likely increase the costs of the Internet DPO.

FREQUENCY OF PRICE UPDATES AND LIQUIDITY

Along with its Internet DPO, Spring Street also created Wit-Trade,[44] the first trading mechanism designed to provide investors with a method of trading their shares, thereby attempting to provide some minimal liquidity to investors. This initial attempt was nothing more than a bulletin board that enabled buyers and sellers of Spring Street shares to negotiate trades. Since the initial deployment of Wit-Trade, several other attempts have been made to create more sophisticated trading mechanisms for Internet DPOs, most of which are now defunct.[45] An SEC ruling issued in 1998 expanded the definition of "exchanges" and approved the use of alternative trading systems, which may prove to be useful to companies seeking to mitigate trading and liquidity issues for investors by creating an "exchange" within the framework of the SEC guidelines.[46]

COMPLIANCE WITH BLUE SKY LAWS

A tedious and costly process for issuers contemplating an Internet DPO is dealing with state securities regulations. State securities laws or Blue Sky Laws[47] require issuers of securities to register their offerings in each state where securities will be sold. This process involves the preparation of financial disclosure documents and the payment of a filing fee in each state where sales are intended to take place. Compliance with these laws can be both time consuming and complicated to an issuer contemplating an Internet DPO.

CONCLUSION

While the Internet DPO may still have some promise, it has yet to overcome many of the problems it has faced since its inception in 1996. Significant risk, illiquidity, cost, and general investor disinterest still plague the Internet DPO and inhibit its acceptance as a viable tool for raising capital. Nonetheless, current economic conditions, the re-emergence of the Internet, and the continuing quest of many companies for additional capital may help to create a larger potential base of DPO offerings and investors.

One key to widespread acceptance may be the emergence of a system or a *bona fide* Internet DPO exchange for offering and trading Internet DPOs, with disclosure rules similar to those of the established exchanges but with significantly lower barriers to entry. If such a system becomes economically feasible for companies seeking capital and minimizes risk by mandating certain disclosures to reasonably protect investors, then the Internet DPO might finally attain widespread acceptance as a viable means of raising capital.

NOTES

1. "SEC Clears Trades of Spring Street Stock on Internet," *N.Y. Times*, Mar. 26, 1996, at D4. *See also* Andrew D. Klein, WallStreet.com: Fat Cat Investing at the Click of a Mouse 88 (Henry Holt and Company 1998) (Andrew D. Klein is the founder of Spring Street Brewing, Inc.).
2. *Id.*
3. The term "direct public offering" is not an exclusive term for Internet offerings; it is also used in non-Internet offerings. Direct Stock Market, Inc., is an example of a company devoted to companies that issue stock in direct public offerings. *http://www.direct-stock-market.com.*
4. Companies such as Perfect Data Corporation, Real Goods Trading Information, the Flamemaster Corporation, and the Angel Capital Network all sought to provide shareholders the opportunity to meet on a Web page and arrange potential trading transactions. *See* PerfectData Corp., SEC No-Action Letter, 1996 WL 4804429 (S.E.C.); Real Goods

Trading Corp., SEC No-Action Letter [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,226 at 77,131(June 24,1996); Flamemaster Corp., SEC No-Action Letter, 1996 WL 762990 (S.E.C.) (October 29,1996); Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (S.E.C.) (October 25, 1996).

5. In addition to the creation of "Wit-Trade" by Spring Street Brewing, Inc., several other trading systems emerged, most of which no longer exist. One system, called OpenIPO, introduced by venture capitalist William Hambrecht in 1999, still exists and has shown the most promise as a potential trading system. *See www.openipo.com.*
6. On December 8, 1998, the SEC adopted New Rule 3b-16 (known as Regulation ATS), which contained a new regulatory framework scheme for Alternative Trading Systems (ATS). The new rules require an ATS to either (1) register with the SEC as a national securities exchange in accordance with the Securities Act of 1934 or (2) register as a broker-dealer and comply with the new requirements pursuant to New Regulation ATS and its related rules. It is unclear how this new rule will affect the status of the unregistered, non-affiliated trading systems.
7. "Where the Venture Money Is Going," citing Thompson Venture Economics, Business 2.0 Jan./Feb. 2004 at 98.
8. *http://www.entrepreneur.com/Magazines/Copy_of_MA_SegArticle/0,4453, 289565——3-,00.html*, citing Hoover's Online.
9. *http://story.news.yahoo.com/news?tmpl=story&cid=568&ncid=749&e=3&u=/nm/20040208/bs_nm/economy_employment_dc.*
10. *http://www.ipomonitor.com/reviews/2003/pages/dealflow.shtml*. Readers should note that "filed" is really only the first step in the process. Many IPO filings are withdrawn or otherwise never actually come to fruition.
11. *Id.*
12. James D. Cox *et al.*, Securities Regulation: Cases and Materials, 72-78 (1996 Supplement) (Little, Brown and Company 1996).
13. *Id.*
14. Securities Act of 1933 15 U.S.C. § 77a, *et seq.*, Rule 501(a). Defines accredited investors under Regulation D as ones who are deemed to have access to registration information and possess investment sophistication. Rule 501(a) also states that both institutional investors and individuals whose net worth exceeds $1 million at the time of purchase are considered accredited investors. The accredited and sophisticated investor standards apply to Rule 506 and § 4(6) of the Securities Act. For a discussion of the sophistication requirements, *see also* Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 199 (1953) (a good place to begin the discussion of what defines a sophisticated investor).
15. Offerings brought under Rules 505, 506, and 70 and §§ 4(2) and 4(6) of the Securities Act all contain resale restrictions. Rule 504 and Regulation A do not have restrictions on resale and transferability.
16. 17 C.F.R. § 230.
17. Securities Act Release No. 6949 (1992) (discusses liberalization of Regulation A).
18. Since a low of 100 offerings in 1987, the use of Regulation A has increased dramatically as a result of its liberalization in 1992 and its use in direct public offerings. Cox, *infra* n.34.
19. Spring Street Brewing was the first Internet stock offering to be brought under Regulation A. Others have followed. It is important to note that companies have used the Internet to conduct registered public stock offerings that operate exactly as a traditional registered IPO, except they occur on the Internet. Because of the cost associated with them, they have not become popular with small and medium-size businesses. In January 1997, Directional Robotics, Inc., became the first US company to conduct an Internet-based public stock offering. However, on November 7, 1997, the corporation allowed its registration statement to expire. The company stated that the amount of subscribed funds held in escrow did not match the minimum stated in the prospectus. Constance E. Bagley and Robert J. Tomkinson, "Internet is Seeing Its Share of Securities Offerings: Rise in Web-based services for small issuers helps make online route a more viable alternative," *National Law Journal*, Feb. 2, 1998, at C03.
20. Securities Act (Regulation A is comprised of Rules 251-264 of the Securities Act). Regulation A has often been referred to as a "Mini-Registration" or "Mini-Public Offering" because it more closely resembles a registration than it does any of the other exemptions. Larry D. Soderquist, "Securities Act Registration Exemptions," Understanding the Securities Laws 123 (1995).
21. Securities Act, §3(b). Section 5 of the Securities Act is the applicable statute for a full, non-exempted public offering. There are other exempted transactions created through §3 (b).
22. *Id.* Prior to 1992, the aggregate limit for an offering under Regulation A was only $1.5 million. The revision in 1992 made the provision a more useful alternative to other exemptions. Also, prior to 1992, any exempt offerings made by a company under § 3(b) during the previous 12 months had to be aggregated. However, under the 1992 revisions, only those offerings made under Regulation A during the last 12 months need to be aggregated.
23. Securities Act, Rule 252. (Form I-A is used to create the offering statement). A filing fee of $500 is also required. Securities Act, Rule 252(f).
24. Cox *supra* n.12, at 76. (The authors cite the fact that in a Regulation A offering, circular and financial statements need not be audited, unless the issuer has prepared them for some other purpose.).
25. Securities Act, Rule 254. ("An issuer may 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.") The written document or script must be submitted to the SEC first and is subject to the anti-fraud provisions of the federal securities laws.
26. Securities Act, Rule 254(e). " Prospectus" is defined in § 2(10) of the Securities Act.
27. *Supra* n.17 (discusses restrictions on resale in several commonly exempted transactions).
28. Section 502(d) of the Securities Act states that "securities acquired under Regulation D shall have the status of securities acquired in a transaction under 4(2) of the Act and *cannot be sold without registration* under the Act or an exemption therefrom." (Emphasis added). Securities offered under § 3(a)(11) of the Act, which is more commonly known as the Intrastate Offering Exemption, have restrictions on resale's that require securities to "come to rest." The SEC states that the phrase "come to rest" is defined by a factual analysis that looks at the length of time that the securities were held by the investor. Securities Act Release 4434, 1 Fed. Sec. L. Rep. (CCH) ¶ 2270-2277 (Dec. 6, 1961).
29. Securities Act, Rules 251(c) and 254(d). Offers and sales made in reliance on Regulation A will not be integrated with certain other offerings that are specifically enumerated or those that occur more that six months after the completion of the Regulation A offering. Also, if the issuer has a "*bona fide* change of intention" and decides to register the offering instead of proceeding with the Regulation A offering, he may do so without fear of integration of offerings if (1) the offering statement has not yet been filed and (2) at least 30 calendar days have elapsed between the last solicitation of interest and the filing of the registration statement with the SEC.
30. Securities Act, Rules 258 and 262 (the "Bad Boy Provision," which will deny the exemption to an issuer or those closely associated to it who have engaged in particular types of misconduct).
31. The EDGAR system is accessible via the World Wide Web at *http://www.sec.gov.*
32. SEC Release 33-7233; 43 - 36345; IC- 21399 (Oct. 6, 1995).
33. *Id.* at 3. (The SEC stated in the releases that electronic filings via EDGAR will "encourage rapid dissemination of additional information considered valuable by many members of the investment community.").
34. The SEC discussed the use of electronic media under the Securities Act of 1933, The Exchange Act of 1934, and the Investment Company Act of 1940.
35. SEC Releases 33-7233; 43 – 36345; IC – 21399, at 2.
36. *Id.*
37. *Id.*
38. Spring Street Brewing Co., SEC No-Action Letter, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,001, at 77,201 (Apr. 17, 1996).
39. *Id.*
40. *Id.* ("Innovation and creativity are the hallmark of our nation's securities markets, contributing enormously to the most efficient capital formation system in the world. We try to encourage modernization, but it is our job, first and foremost to insure protections for public investors.").
41. No-Action Letters address individual situations on a case-by-case basis considering the specific facts in each case. The SEC has yet to issues a clear policy with regard to DPOs.

42. Shares received in return for a venture capital investment are generally non-transferable unless or until the company has a public offering or some alternative liquidity event.

43. Spring Street Brewing Co., SEC No-Action Letter, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) 77,001, at ¶ 77,201 (Apr. 17, 1996).

44. *Supra* n.1, at 95-96.

45. Examples include IPOnet and Direct IPO, both of which no longer exist. *See supra* n.5 for an example of a system that still exists.

46. On December 8, 1998, the SEC adopted New Rule 3b-16 (known as Regulation ATS), which contained a new regulatory framework scheme for "Alternative Trading Systems (ATS). The rules require an ATS to either (1) register with the SEC as a national securities exchange in accordance with the Securities Act of 1934 or (2) register as a broker-dealer and comply with the new requirements pursuant to New Regulation ATS and its related rules. It remains unclear how this new rule will affect the status of the unregistered, non-affiliated trading systems.

47. State securities laws are generally referred to as Blue Sky Laws, which is an expression that came from their initial objective of stopping promoters who were selling interests in companies having no more substance than "so many feet of blue sky." Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917). The first comprehensive Blue Sky Laws were enacted in Kansas in 1911.