SECURITIES OFFERINGS ONLINE BY SMALL, NONPUBLIC BUSINESSES

By Joseph Kershenbaum*

The growth of the World Wide Web has provided opportunities for the exchange of capital for goods and services that could not be envisioned only a few years ago. The latest trend, for example, e-tailing (online retailing), is five years old—kindergarten age—yet sales are already in the billions of dollars. On the other hand, some opportunities that held great expectation in the early days of the Web have languished. One of these is the promise of the Web as a medium that would give small, nonpublic businesses greater access to capital through online securities offerings.

The use of the Web by businesses to offer and sell securities has ranged from simple promotions disseminating very basic information about an offering to actual offers and sales of securities. Offers and sales generally have been made by small, undercapitalized companies that previously have not offered securities publicly. Despite these few occurrences,[1] the Web has not succeeded as a vehicle for capital formation by small businesses. While the securities regulatory structure, designed for the age of paper, plays a large part in the underutilization of this resource, other important considerations often are overlooked.

A primary reason for the limited use of the Web involves the inability of the issuer to attract attention to itself. The most common method used by nonpublic companies to offer securities on the Web is a direct public offering or "DPO".[2] In a DPO, the issuer bypasses investment banks and underwriters and offers shares directly to potential investors via online resources, telephone or in-person marketing.[3] Yet the Internet is "essentially a passive mechanism."[4] It is difficult, in an age where tens of thousand of new web sites are created weekly, for the issuer to stand apart from the crowd and attract the attention of those surfing the Web.[5] This difficulty is compounded because a DPO by definition excludes investment bankers,[6] who help market investment opportunities to potential investors. Therefore, an important component involved in raising the issuer's profile—in making investors aware of the company and its prospects—is missing.[7] Thus, a conundrum exists—the most common method used to sell securities on the Internet conflicts with the issuer's need to raise its visibility, because the DPO excludes investment bankers.[8]

Internet-based investment bankers have arisen, primarily serving two functions. They host prospectuses at their web sites for prospective issuers and offer consulting services to businesses that hope to go public.[9] However, the growth and effectiveness of these bankers have been limited by the lack of secondary markets for securities initially sold online.[10] Another conundrum exists—the lack of such secondary markets has resulted in a limited demand for directly offered shares.[11] As a general rule, unlisted, illiquid shares are much less attractive to investors than listed shares that are easily bought and sold.

Issuers that offer securities on the Web without using investment bankers also face questions about pricing. Investment bankers reduce risk by helping to price new offerings. As independent entities, their pricing, while not perfect, is usually "far less arbitrary than [that] used in [DPOs], which [is] set by one source: the company selling the shares."[12] Consequently, share prices may not reflect the true value of the issuance. The potential for uncertain valuation limits the appeal to investors.

Another reason the Web has not fulfilled its promise as a capital-raising vehicle involves the legitimacy of the Internet-based investment bankers themselves who, despite their limited involvement with businesses that hope to sell securities online, must overcome concerns that are common to new entities that attempt to do business in a new way. For example, investment bankers increase the potential market for an issuance by performing due diligence investigations concerning the offering and the issuer. This reduces the potential for fraud,[13] thus reducing the risk[14] to potential investors and thereby increasing the number of those who might be interested in purchasing stock. Although new investment bankers may require third-party due diligence checks for companies offering securities via prospectuses being hosted on the bankers' web sites, established bankers offer a degree of legitimacy based on reputations developed over a long period of time—reputations that reflect upon the clients they have chosen to represent. The new bankers have yet to develop this cachet.

Private companies that wish to sell their securities in initial public offerings generally require several years of revenue streams to attract Wall Street investment bankers. However, online issuers have tended to be very small in terms of revenue. Consequently, the amount of capital they have been able to raise has not been significant enough for them to be financially attractive to established bankers, who typically will not consider representing a company with less than $15-20 million in annual revenues.[15] The small size of these companies, which makes them more speculative than larger companies, may deter established bankers from risking their reputations on arguably riskier investments.[16] Additionally, the limited potential for offering after-market support services to a company trading in an illiquid market may further deter established bankers from pursuing online issuers as clients.[17] Finally, one reason that e-commerce has been successful on the Web is that costs may be reduced by avoiding brokers and other middlemen. Established bankers may be loath to invest in a mechanism which ultimately may cannibalize their profits.[18]

Some headway has been made by larger organizations in the use of the Web for securities offerings. Established public companies, such as The Home Depot, Inc., are beginning to allow investors to purchase and sell stock online through direct stock purchase plans.[19] In late 1997, entities as diverse as online banks and city governments began to offer securities on the Internet.[20] Other types of securities offerings have begun to appear online. For example, a prospectus was issued in July, 1998 for the eAnnuity™, the first variable annuity sold completely online.[21] Clearly, selling securities online is a viable concept. Yet until fundamental issues such as the problem of gaining visibility, the lack of secondary markets, the arbitrary pricing and the disinterest of established investment bankers each are addressed, the opportunity for small businesses to raise capital in cyberspace will hold great promise as an idea, but be of limited practicality in the real world.

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1. *See, e.g.,* Spring Street Brewing Company (visited Apr. 26, 1999) <http://plaza.interport.net/witbeer/> (New York microbrewery that was the first online public offering, in March, 1996); Annie's Homegrown Inc. (visited Apr. 26, 1999) <http://www.annies.com> (pasta products). *See also* J. Schulz, *97/07-Offerings Online*, Worth Online (Sept. 1997) <http://www.worth.com/articles/M9708T10.html> (discussing some of the more than 50 companies that have published offering circulars on the Web since October, 1995).

2. A second and less common method involves an issuer seeking capital by offering its securities in an online private placement. Purchasers, however, must be accredited or sophisticated investors, which requires that they meet high income and net worth thresholds or financial knowledge and experience requirements. Consequently, notwithstanding the other concerns addressed in this article, these restrictions have limited the use of this method.

3. *See* Use of Electronic Media For Delivery Purposes, 60 Fed. Reg. 53,458 (1995); Use of Electronic Media By Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940, 61 Fed. Reg. 24,643 (1996); Virtual Wall Street™, *Learn About DPOs* (visited Apr. 26, 1999) <http://www.virtualwallstreet.com/learn_DPOs.html>.

4. Eric J. Savitz, *Turned On, Tuned Out: Internet IPOs Create Sound and Fury, Signifying Next to Nothing,* Barron's, Sept. 1, 1997, at 15 (quoting Attorney James Grand).

5. An industry has arisen to help Internet-based issuers attempt to overcome this problem and to assist companies in doing DPOs. *See, e.g.,* Lutcher Brown, *Marketing Your SCOR on the Internet* (last modified May 20, 1997) <http://www.moneysearch.com/seminar1/scormarket/index.htm>; The Capital Internet Group, *How to Raise Capital Over the Internet for Your Initial Public Offering* (visited Jan. 4, 1998) formerly at <http://www.capnetgrp.com/cig-securities/bookstore.htm>; InvestorGuide, *IPOs* (visited Apr. 26, 1999) <http://www.investorguide.com/IPOs.htm> (listing 8 Internet DPO consultants).

6. A primary argument for DPOs is that the issuer nets a greater percentage of the offering proceeds by cutting out expensive middlemen. *See* Direct IPO, *The Need For Direct Public*

Offerings (visited Apr. 26, 1999) <http://www.directipo.com/Direct-Public-Offering/The-Need/the-need.html> (discussing raising capital for half the cost compared to traditional financing) ("*Direct IPO FAQ*"); Andrew Osterland, *IPOs in Cyberspace: Are Underwritings on the Internet a New Trend or Just a Fad?,* Financial World, Apr. 22, 1996, at 24, 25. Fees typically run about 10% of the proceeds for traditional underwriters. Savitz, *supra* note 4, at 15 (quoting Attorney James Grand). However, the evidence for the argument that a DPO offers savings is not clear. For example, Annie's Homegrown (*see supra* note 1) spent about 22% ($325,000) of its offering proceeds of $1.5 million on expenses related to the offering. *See* Annie's Homegrown Inc., *1995 Form 10-KSB* (visited Apr. 26, 1999) <http://www.sec.gov/Archives/edgar/data/890818/0000903893-96-000774.txt>.

A new online investment bank, tentatively called E*Offering, has attracted larger investors, in part because of the potential for cost reduction by use of the Web. In January, 1999, a group of investors including the former Chairman of investment bank Robertson Stephens & Co., the former Chief Executive and President of investment bank Cruttenden Roth Inc., and E*Trade Group, Inc., a major online brokerage firm formed several years ago, agreed to form E*Offering. *See* Rebecca Buckman, *Ex-Robertson Stephens Official, Others Seen Unveiling Online Investment Bank,* Wall St. J., Jan. 12, 1999, at C26. E*Offering initially intends to underwrite equity offerings of $25-50 million for small, high-tech firms. E*Trade Group, Inc., *E*Trade Group Launches E-Commerce Investment Bank With Prominent Group of Investors, Including Sandy Robertson* (Jan. 12, 1999) formerly at <http://biz.yahoo.com/prnews/990112/ca_e_trade_1.html>. While the proposed offering size is beyond that of the typical DPO candidate, E*Offering plans to sell up to 50% of an offering's shares to online retail investors. *Id.* It proposes to charge fees of 4 to 4.5% for initial public offerings, "compared with the standard Wall Street rate of 7%." *See* Buckman. To cut costs, it will perform traditional costly banking functions, such as distributing research and giving roadshow presentations, on the Web. *Id.*

On February 8, 1999, another new investment bank, WR Hambrecht + Co., LLC, launched OpenIPO, a new Web-based service that will bring software, Internet and consumer products companies public via the Internet. *See* Ruth Simon, *IPOs Over the Internet? Tread Carefully,* Wall St. J., Feb. 24, 1999, at C1; *see generally* WR Hambrecht + Co., *OpenIPO: Level the Playing Field* (visited Apr. 26, 1999) <http://www.openipo.com/OpenIPO/base/Home/IPOHome.htm>. As with E*Offering, it expects to cut costs by using the Web, and plans to charge fees of 3 to 5% of the amount of money raised in the IPO. *See* Craig Bicknell, *IPOs for the Everyman*, Wired News (Feb. 8, 1999) <http://www.wired.com/news/business/story/17792.html>; Jack Reerink, *Going Public Via The Internet*, TechWeb (Feb. 8, 1999) <http://www.techweb.com/wire/story/reuters/REU19990208S0004>. One way Hambrecht plans to reduce costs is to have new college graduates compare companies and offer opinions instead of hiring traditional, "big name" research analysts. *See* Lisa Bransten & Nick Wingfield, *New Company Aims to Shift IPO Playing Field,* Wall St. J., Feb. 8, 1999, at C1, C16. Hambrecht expects to increase offering prices (and therefore, its fees) by using a "Dutch auction" process, which will allocate shares to the highest bidders. *See id.* at C1. The investment bank was founded by William R. Hambrecht, the co-founder and former CEO of Hambrecht & Quist Group, a publicly-traded investment bank. *See id.* It conducted its first offering, for Ravenswood Winery, on April 9, 1999. *See* Jack Willoughby, *Offerings in the Offing: New Wine, New Bottle; The 'Net Widens IPO Access,* Barron's, Apr. 19, 1999, at 41; Lisa Bransten, *In Pioneering Online 'Auction' for IPO, Ravenswood Winery Gets Cool Response,* Wall St. J., Apr. 12, 1999, at C10. On April 19, 1999, Salon Internet, Inc. filed a Form S-1 with the Securities and Exchange Commission; it will be Hambrecht & Co.'s second offering. *See* Salon Internet, Inc., *Form S-1* (filed Apr. 19, 1999) <http://www.sec.gov/Archives/edgar/data/ 1084332/0000929624-99-000683.txt>.

7. The Spring Street offering, discussed *supra* in note 1, "provides a predictable example of what happens when a new issuer without an established reputation seeks to market its securities on its own without an underwriter or other financial intermediary. . . .[T]he average investor gambled only a very small amount [$474 per investor] (even by the standards of penny stocks) on an investment that was not associated with any well-known investment banking or brokerage firm." John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation,* 52 Bus. Law 1195, 1202-03 (1997).

8. The companies that have completed DPOs successfully have sold most of their shares to their customers, who are already aware of the company's products and its existence. *See* Barbara Grady & Austin Bunn, *Wired News: Part 3: Cutting Corners to an IPO* (Sept. 17, 1997) <http://www.wired.com/news/news/business/story/6954.html>; Savitz, *supra* note 4, at 15 (quoting Attorney James Grand).

9. Wit Capital and Direct IPO are examples of entities that offer consulting services. *See* Wit Capital (visited Apr. 26, 1999) <http://www.witcapital.com/>; Direct IPO (visited Apr. 26, 1999) <http://www.directipo.com/>. IPO.Com is an example of an entity that hosts prospectuses for online issuers. *See* IPO.Com (visited Apr. 26, 1999) <http://www.ipo.com/> ("IPO.Com"). To purchase stock, one must directly contact the issuer. *See* IPO.Com at <http://www.ipo.com/about.asp>.

10. While Web site trading does exists, "volumes are a mere trickle" and thus, "sellers aren't able to find buyers at desirable prices." *Direct IPO FAQ, supra* note 6. The Pacific Stock Exchange had a Small Company Offering Registration ("SCOR") Marketplace designed specifically for companies that have completed SCOR and Regulation A offerings, but most Internet-based issuers would not have been able to meet its minimum quantitative listing requirements. *See* Pacific Stock Exchange, *SCOR: SCOR Brochure: Part 6: The Exchange SCOR Marketplace* (visited Apr. 9, 1998) formerly at <http://www.pacificex.com/list/list_scor_broc_6.html>. The SCOR Marketplace was discontinued in April, 1998 because it did not attract any listings. *See* Pacific Stock Exchange, *Pacific Stock Exchange Likely to Drop SCOR Marketplace: Special Program For Direct Public Stock Offerings Fails to Attract Listings* (Mar. 9, 1998)

<http://www.pacificex.com/about/abt_press_scor.html>. The time and costs involved in complying with SEC accounting and reporting requirements for publicly traded stocks "didn't justify the benefits of a secondary market listing." *See id.*

11. Osterland, *supra* note 6, at 25 ("A secondary market for the unlisted, illiquid shares would go a long way toward making Internet IPOs more attractive to investors."). Some companies have done DPOs and have been accepted for listing on traditional stock exchanges, although these companies had relatively large revenue streams and were not the early-stage companies typical of DPOs. *See, e.g.,* Optical Cable Corp., Prospectus 5 & 10-11 (Mar. 6, 1996) available at <http://www.occfiber.com/public.pdf> (offering conditional on listing on Nasdaq National or SmallCap Markets); Mendocino Brewing Co., *The Mendocino Brewing Company Story* (visited Apr. 26, 1999) <http://mendobrew.com/mendo.history.html> (accepted on Pacific Stock Exchange at conclusion of offering).

12. Savitz, *supra* note 4, at 15.

13. Internet fraud may be disseminated far more widely than by traditional "boiler room" frauds, and may be perpetrated by promoters making fraudulent statements anonymously or on a misattributed basis or from a point offshore, beyond the SEC's reach. *See* Coffee, *supra* note 7, at 1222-23. Internet frauds have included offerings for telephone lottery programs, eel-farming, Costa Rican coconut groves and reverse aging water businesses. *See* SEC v. Frye, Litig. Rel. No. 14720, 60 SEC Docket (CCH) 1787 (S.D.N.Y. Nov. 15, 1995); SEC v. Odulo, Litig. Rel. No. 14616, 60 SEC Docket (CCH) 120 (D.R.I. Aug. 24, 1995); SEC v. Pleasure Time, Inc., Litig. Rel. No. 14440, 58 SEC Docket (CCH) 2659 (S.D. Ohio Mar. 15, 1995); Jerry Knight, *The Coconuts, and Other On-Line Deals; Regulators Warn About Electronic Investment Pitches,* Wash. Post, Nov. 8, 1995, at D1; Osterland, *supra* note 6, at 26.

For a discussion of other instances of Internet fraud, *see* Joseph J. Cella III & John R. Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium,* 52 Bus. Law 815, 837-44 (1997); Michael Schroeder & Charles Gasparino, *SEC Enforcement Chief Is On Hot Seat As Online Fraud Poses Host of Problems,* Wall St. J., Apr. 22, 1999, at C1; *SEC Wins Order Against Internet Offer to Create Caribbean Tax-Free Haven,* Wall St. J., Apr. 12, 1999, at C10; Andrew Fraser, *Regulators Struggle to Keep Up With Explosion of Online Fraud,* Wall St. J. (Mar. 1, 1999) <http://interactive.wsj.com/articles/SB919896165567611000.htm>; Michael Schroeder & Rebecca Buckman, *U.S. Attacks Stock Fraud On Internet: SEC Hits Promoters Touting Small Issues,* Wall St. J., Oct. 29, 1998, at C1.

14. As DPO Source, a former DPO and IPO consulting services firm, states, "[i]f you choose to purchase stock through a DPO, you are making a VERY HIGH-RISK INVESTMENT." DPO Source, *How Do I Know What I Don't Know If I Don't Know It?* (visited Apr. 26, 1999) <http://www.dposource.com/dpo-web-questions.html>.

15. *See* Direct IPO, *Direct Public Offering* (visited Jan. 14, 1999)

<http://www.directipo.com/Direct-Public-Offering/direct-public-offering.html> ("Traditional Wall Street IPOs can require a minimum of $15 million in annual revenues."); PrestigeIPO, *Frequently Asked Questions* (visited Apr. 26, 1999) <http://www.prestigeipo.com/site/faq.htm> ("Most large IBs would not consider a deal below $20 million."); Grady & Bunn, *supra* note 8.

16. *See* Direct IPO, *Traditional IPOs vs. DPOs* (visited Apr. 9, 1998) formerly at <http://www.directipo.com/trad/empower.html> ("[A] creditable underwritten IPO is out of reach to most entrepreneurs: investment bankers, known for their conservative approach to financial matters, are reluctant to stake their reputation on unproven concepts.").

17. *Cf. Direct IPO FAQ, supra* note 6 ("as long as there are no market makers and analysts for Internet traded stocks, they will remain only partially liquid.").

18. Using technology to cut costs, however, may allow bankers to keep profit margins stable while reducing overall offering expenses. *See* Buckman, *supra* note 6.

19. *See* Staff of the U.S. SEC, The Impact of Recent Technological Advances on the Securities Markets 19 (Oct. 1997). In January, 1999, The Home Depot, Inc. became the first company to offer direct stock transactions online via its web site. *See* StockPower Inc., *The Home Depot First to Offer Direct Stock Transactions Over the Internet Through Its Web Site* (Jan. 7, 1999) <http://www.stockpower.com/info/articles/homedepot_01.html>. To facilitate transactions, The Home Depot uses an interactive program, Stockclick℠ Service, developed by StockPower Inc. *See* Lisa Branstein, *Start-up Links Firms and Investors,* Wall St. J., Oct. 22, 1998, at B6. Using this program and depending on the particular company involved, investors may buy and sell stock in low dollar amounts with little or no transaction fees. They may do so at any time and need only set up an account immediately before making the purchase. They may set up automatic monthly investments and dividend reinvestments. *See* StockPower Inc., *More Information About StockPower℠* (visited Apr. 26, 1999) <https://www.dsp.stockpower.com/information/moreinfo_fs.html>.

20. *See* Dollar Bank, *November 5, 1997* (visited Apr. 26, 1999) <http://www.dollarbank.com/dollarbank/bonds.html> (offering savings bonds); Robert Whalen, *Pittsburgh Uses Internet for Pioneering GO Sale: Maturity-by-Maturity Auction Draws 26 Firms*, The Bond Buyer, Nov. 19, 1997, at 1 (regarding municipal bonds). As of April 26, 1999, MuniAuction℠, which allows NASD registered broker-dealers and dealer banks to bid on new municipal bond issues in real time at its web site, had conducted 31 electronic auctions. These auctions "have included general obligation and revenue bonds; new money, current and advance refunding bonds; current interest and capital appreciation (i.e., "zero coupon") bonds; 'AAA'-insured and uninsured bonds; tax-exempt and taxable bonds, and senior and subordinate lien bonds" and notes. *See* MuniAuction℠, *The First Municipal Bond Auction Website* (visited Apr. 26, 1999) <http://www.muniauction.com>.

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21. *See* AnnuityNet, *AnnuityNet.com* (visited Apr. 26, 1999) <http://www.eannuity.com> (prospectus issued July 23, 1998 by Lincoln Financial Direct, a unit of Lincoln National Life Insurance Co.). For a review comparing the eAnnuity™ to other variable annuities, *see* Carrie Coolidge, *E-nuities*, Forbes Mag., Jan. 11, 1999, at 267, *available at* <http://www.forbes.com/Forbes/99/0111/6301267a.htm>.