

Internet Direct Public Offerings: New Opportunities For Small Business Capital Finance

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I. INTRODUCTION

FROM ITS ORIGINS AS A MEANS OF COMMUNICATION for the United States military,¹ the Internet has become an immense force for change. It has revolutionised the way people communicate with each other and the way businesses interact with their customers. The adoption of the Internet by individuals and companies has powerful implications for securities markets, particularly for small businesses seeking capital. Small companies with rapidly expanding business need cash to finance their growth. However, small and medium sized businesses have historically found it difficult to raise sufficient capital through traditional avenues. The Internet provides innovative means to raise capital; small issuers can access equity financing more efficiently and from a deeper pool of investors than has historically been possible.²

However, conducting public offerings of securities *via* the Internet also raises many new concerns regarding the possible consequences for investor protection. Canadian securities regulators will be challenged to develop new policies that satisfy the objectives of investor protection, confidence in the market, and the efficient allocation of resources while still encouraging the benefits that the Internet can potentially bring to financial markets. This paper argues that while the Internet may be used as a tool to bridge the small business financing

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¹ For succinct introduction to the Internet, see Howard Friedman, *Securities Regulation in Cyberspace* (Bowne & Co.: New York, 1997) at 1-4 to 1-10 [hereinafter *Friedman*].

² See Andrew R. Thomson, "Taming The Frontier?: An Evaluation Of The Securities Regulation Of Internet Securities Trading Systems" (1999) 1127 *PLI/Corp* 339 at 341 (the article originally appeared in (1999) *Colum. Bus. L. Rev.* 165) [hereinafter *Thompson*].

gap, success is dependent on the support of a progressive and flexible regulatory framework.³

Part II of this paper provides a brief background to the Internet and highlights generally its importance to Canadians and Canadian businesses. Part III canvasses some of the specific problems that have traditionally affected the ability of small businesses to use public offerings to maintain or expand their operations. The section also addresses areas where the Internet may potentially aid small businesses and discusses limitations of the Internet. Part IV considers existing regulatory inhibitors that reduce the ability of small businesses to take advantage of potential Internet solutions and proposes specific regulatory facilitators. The section also examines consequences for investor protection created by public offerings of securities via the Internet and proposes.

II. BACKGROUND

A. Brief Summary of the Internet and its use in Canada

The Internet is a decentralised system of linked computer networks that facilitates communication amidst the computers connected to it. It allows computers to "talk to one another" and share information and services throughout the world. It does so by finding a path to route tiny packets of data from one computer to another, based on a standard called Internet Protocol (IP).⁴ The Internet, originally called ARPANET (after the Advanced Research Projects Agency ARPA), was conceived by the United States Department of Defence in 1969. It was originally intended to provide an indestructible means of communication between supercomputers, researchers, and the military.⁵ Its design was decentralised to allow U.S. authorities to communicate successfully even after a nuclear war.⁶

³ Although the constitutional framework in Canada ensures that securities regulation is a provincial jurisdiction, practically, there is extensive co-operation between provincial securities administrators, and the provincial securities acts are similar in wording and structure. Thus, while concepts in this paper may be applicable to various jurisdictions in Canada, the technical aspects will be discussed in the context of British Columbia.

⁴ M. Louise Turilli & Joseph Kerschenbaum, "Securities On the Internet: Changes in Laws Required to Increase Online Offerings" (1998) 70 Dec N. Y. St. B. J. 22 at 25 [hereinafter *Turilli*].

⁵ Friedman, *supra* note 1 at 1-14.

⁶ For further information see the Internet Society, *All About the Internet* <http://www.isoc.org/internet/history/> (Visited November 3, 1999). The site includes a page of hyperlinks containing several historical accounts of the development of the Internet and the World Wide Web, including accounts written by the inventors of both.

There are a number of communication services that use the Internet as their "transport medium," including some types of email, streaming media (audio and video such as Real Media™ or Windows Media™), and the World Wide Web. The Web is the perhaps the most familiar of the services, allowing the user to jump from one resource to another by clicking hypertext links. The Web allows users to "track related concepts from one web page to another, traversing the Web in a seamless fashion, regardless of the physical location of the resources or the type of computer that hosts it."⁷

The Internet has evolved from basic roots to a pervasive and powerful means of communication for Canadians. Canada ranks second only to the United States in proportion of people with Internet access. In 1996, 23% of Canadians had access to the Internet; by April of 1999, the number had nearly doubled to 41%.⁸ As more and more Canadians embrace the Web, Canadian businesses have begun to focus their efforts on using the Web as a means to provide goods and services to their customers.

B. Corporate Presence on the Web

Small and medium sized enterprises (SMEs)⁹ have not ignored the trend towards using the Internet as a vehicle for doing business. In 1996, 15.2% of small businesses were connected to the Web; by early 1999, that number had risen to more than 61%.¹⁰ Many Canadian corporations have established corporate "home pages" where corporate information and details about the company's products are provided to financial analysts, investors, and consumers. The

⁷ Turilli, *supra* note 4 at 25.

⁸ Canadian Internet Commerce Statistics, Summary Sheet (26 August 1999), Task Force on Electronic Commerce <http://e-com.ic.gc.ca/using/en/e-comstats.pdf> (Visited 3 November 1999).

⁹ Small businesses are usually defined as those having revenues of \$5 million and/or fewer than 100 employees. Collectively, they comprise a substantial portion of the Canadian economy both in terms of revenues generated and number of person that they employ. See Catherine Harris, "Small Business Report Card" (1999) *Canadian Banker* 106(3) 37 at 39. See also Kim Hanson, "Lots of Canadians Start Businesses, Now They Need to Grow Them, Study Finds" *Financial Post (National Post)* (17 October 1999) C5; Katherine Campbell, "Canada, US Set Pace In Start-Ups: International Survey" *Financial Post (National Post)* (12 October 1999) E2. For a more thorough examination of the importance of SMEs to the Canadian economy, see generally the reports by Industry Canada entitled *Small Business in Canada: Competing Through Growth* (Ottawa: Industry, Science and Technology Canada, 1990) and *Small Business in Canada: A Statistical Overview* (Ottawa: Industry Canada, 1994).

¹⁰ Canadian Internet Commerce Statistics, Summary Sheet (26 August 1999), Task Force on Electronic Commerce <http://e-com.ic.gc.ca/using/en/e-comstats.pdf> (Visited 3 November 1999).

Internet is a powerful tool for providing information and analysis in financial markets. Absent a corporate Web site, investor relations information about a particular company may be distributed in a number of ways, making it difficult and time consuming for investors to search all the online sources. Establishing a home page provides an opportunity for a company to assemble a comprehensive source of all relevant investor information. Using the Internet, a company has a tremendous ability to disseminate a wide array of relevant information to investors virtually instantaneously with relatively low costs.¹¹

C. E-Commerce

The Internet offers companies benefits beyond the efficient dissemination of information. Many corporations have begun to use the Web for electronic commerce or "e-commerce." Essentially, businesses can market and retail their products to customers over the Web, allowing them to realise efficiencies that arise from the relatively low costs required to disseminate company information from a corporate web site. Currently, Canadian e-commerce has a value of US \$5.5 billion dollars; however, that number is expected to rise to US \$70 billion by 2003.¹² Clearly, many companies are finding that operating over the Internet has become an essential component of their business plan.

D. "Secondary Market" Trading and Brokerage on the Web

One of the most important services available to persons on the Internet is purchasing and selling securities. Secondary market¹³ trading is already firmly entrenched on the Web. Many major brokerages, as well as Canada's largest

¹¹ For a fuller discussion of financial services companies' adoption of the Internet see Joseph J. Cella & John Reed Stark, "Sec Enforcement And The Internet: Meeting The Challenge Of The Next Millennium A Program For The Eagle And The Internet", (1997)1022 PLI/Corp 79 at 83- 86 [hereinafter Stark].

¹² Canadian Internet Commerce Statistics, Summary Sheet (26 August 1999), Task Force on Electronic Commerce <http://e-com.ic.gc.ca/using/en/e-comstats.pdf> (Visited 3 November 1999). Global e-commerce is expected to reach US \$3.2 trillion by 2003.

¹³ See Mark R. Gillen, *Securities Regulation in Canada*, 2nd ed. (Carswell: Toronto, 1998) [hereinafter Gillen]. He explains,

[t]he distribution of securities by issuers through trades with investors is referred to as 'primary market' trading. Once the securities have been redistributed to investors, they can be traded among investors. Trading amongst investors is referred to as 'secondary market' trading. The issuer itself is generally not in these trades. An investor is simply exchanging the securities (which represent obligations of the issuer) in return for payment from another investor.

Gillen, *ibid.* at 24-25.

banks, have established a presence on the Internet.¹⁴ Discount Internet brokerages aim to attract investors who wish to trade online at their leisure without paying the fees that a traditional broker charges.¹⁵ However, while Canadian and British Columbian securities regulators have endorsed qualified secondary market trading, thus far they have prohibited direct public offerings over the Internet.¹⁶

III. HOW INTERNET DIRECT PUBLIC OFFERINGS CAN FACILITATE SMALL ISSUER CAPITAL FINANCE

A. The Small Business Capital Barrier

The obstacles faced by SMEs undertaking traditional equity financing have been present for some time and have been identified by numerous writers.¹⁷ These financing difficulties stem primarily from three sources: regulatory compliance; the reluctance of established investment banks to underwrite small business public offerings; and the fact that retail investors often have difficulties accessing the vast majority of initial public offerings (IPOs).¹⁸ This section of the paper examines the difficulties small businesses face in their search for capital.

¹⁴ Large national banks such as the Bank of Montreal (www.investorline.com) (visited 25 November 1999), the Royal Bank (www.actiondirect.com) (visited 25 November 1999), and the Toronto Dominion Bank (www.tdbank.ca/tdbank/investctr/index.html) (visited 25 November 1999) currently maintain Internet web sites. Major brokerages including Nesbitt Burns (www.nesbittburns.com) (visited 25 November 1999), RBC Dominion Securities (www.rbcds.com), TD Waterhouse (www.tdwaterhouse.ca) (visited 25 November 1999), and Merrill Lynch Canada (www.canada.ml.com) (visited 25 November 1999) have also established a Web presence.

¹⁵ See Leah Nathans Spirer, "Merrill's Battle" *Business Week* (15 November 1999) 256. The author writes that, "[l]ike so many other financial services companies, Merrill is under siege from the Internet ... US\$30 trades are replacing full-service commissions at US\$200 a trade."

¹⁶ See British Columbia Securities Commission: Notice and Interpretation Note #97/9.

¹⁷ See e.g., Gillen, *supra* note 13 at 248-250. See generally Jeffrey MacIntosh, "Regulatory Barriers to Raising Capital for Small Firms" (1994) Canadian Financial Services Alert 6(8). For an American perspective see generally Curtis J. Milhaupt, "The Small Firm Financing Problem: Private Information And Public Policy" (1998) 2 J. Small & Emerging Bus. L. 177; Allen N. Berger & Gregory F. Udell, "The Economics Of Small Business Finance: The Roles Of Private Equity And Debt Markets In The Financial Growth Cycle" (1998) J. Banking And Finance 22 (6-8) at 613. See also Stark, *supra* note 11 at 82.

¹⁸ Jeffrey J. Hass, "Small Issue Public Offerings Conducted Over the Internet: Are They 'Suitable' For the Retail Investor?" (1998) 72 S. Cal. L. Rev. 67 at 100 [hereinafter Hass].

1. Regulatory Compliance

Small companies bear disproportionately greater regulatory compliance costs than do larger issuers.¹⁹ This is because the costs of creating a prospectus²⁰ and mailing information to potential investors are relatively fixed, regardless of the size of the offering²¹. Further, many SMEs have never undertaken a public offering before and lack valuable experience and expertise. Therefore, accessing the capital markets often requires that SMEs reorganise their corporate structure, employ auditors and legal counsel, and gather substantial information about their company necessary to properly complete a prospectus.²²

Further, start-up issuers are typically unaware of practical information essential to an offering such as at what amount shares should be priced, the most efficient way to structure the deal, and what company information should be

¹⁹ Stephen J. Choi, "Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation" (1998) 2 J. Small and Emerging Bus. L. 27 at 31 [hereinafter *Choi*].

²⁰ Issuers are required to create and deliver a prospectus pursuant to s. 61 of the British Columbia Securities Act, R.S.B.C. 1996 c. 418 [hereinafter *B.C.S.A.*]. As one author has explained,

[a] prospectus is a document which must be given to persons to whom securities are distributed. It is the document which is intended to provide information relevant to valuing the securities. The amount and type of information varies depending on the type of issuer and the specific characteristics of the particular offer. However, most prospectuses will include the following: estimated proceeds, loan and share capital structure, description of issuer's business, attributes of the securities offered, backgrounds on directors and officers, executive compensation, factors which make purchase of the security risky, arrangements with underwriters, otherwise requires full, true and plain disclosure of all 'material facts.'

As defined in *B.C.S.A.*, *supra* note 20 at s. 1(1). See Gillen, *supra* note 13 at 101-103.

²¹ John F. Olson & Daniel W. Nelson, "What Makes A Company A Good Candidate For Going Public? Criteria, Advantages, And Disadvantages Related To Going Public" (American Law Institute--American Bar Association Continuing Legal Education, 22 July, 1999) 591 at 593 [hereinafter *Olson*]. The authors state, "Economies of scale work against small companies. A major reason smaller companies do not have successful IPOs is that the cost per dollar of equity raised generally decreases marginally as the size of the offering increases, and smaller companies typically have smaller IPOs than larger companies. This decreasing marginal cost of an IPO occurs because costs associated with an IPO are, to a large extent, fixed; thus many costs are similar whether the offering is \$5 million or \$500 million." The authors estimate that "the cost of even a very small IPO of \$5 million can be several hundred thousand dollars, or more if the company's house is not in order or other difficulties arise." *Ibid.* at 599.

²² Choi, *supra* note 19 at 31.

highlighted to maximise investor interest.²³ Therefore, issuers typically retain experienced underwriters to deal with those aspects of the securities offering. However, transferring that responsibility to experts can be very costly for issuers. It has been estimated that traditionally underwritten IPOs raising \$5 million can cost the issuer hundreds of thousands of dollars.²⁴

2. Market Intermediaries

Many observers argue that high quality underwriters²⁵ are worth the cost to issuers. One reason is that underwriters can stimulate investor interest in the IPO, thereby raising the price at which the securities can be sold. Another function of underwriters, however, is to supplement the role of regulatory investor protections provided by securities legislation.²⁶ Essentially, underwriters provide four very important services: merit review, due diligence, suitability, and after-market support.²⁷

²³ Donald C. Langevoort, "Angels on the Internet: The Elusive Promise of 'Technological Disintermediation' For Unregistered Offerings of Securities" (1998) 2 J. Small and Emerging Bus. L. 1 at 13 [hereinafter *Langevoort*].

²⁴ Olson, *supra* note 21 at 599. See also C. Steven Bradford, "Transaction Exemptions in the Securities Act of 1933: An Economic Analysis" (1996) 45 Emory L.J. 591 at 603 where Bradford estimates that a typical public offering can cost from \$200,000 to \$500,000 and notes that offerings by seasoned issuers are less expensive perhaps because management has more extensive experience with the process. Such estimates represent "direct costs" and fail to take into account intangible expenditures such as senior management resources devoted to the IPO. A helpful discussion may also be found in Richard A. Booth, "The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships" (1997) 32 Wake Forest L. Rev. 79 at 90. Booth breaks down the costs involved in an IPO, explaining:

a significant cost of a public offering is the management time and dollar expense that will be incurred in connection with the offering. The public offering process will demand significant management time, particularly from the chief executive officer, the chief financial officer, and the accounting staff. Dollar costs of the offering include payment of underwriting discounts or commissions to the underwriters in exchange for their services in connection with the offering, accounting fees, and legal fees. There are also additional costs such as the cost of printing prospectuses and stock certificates, costs of retaining a transfer agent, application fees payable to the relevant stock exchange or quotation service, and the filing fees paid to the SEC, the NASD, and various state securities administrators.

²⁵ Other market intermediaries such as lawyers and accountants are also required in the public offering process. Many of the services they perform are integrated with the functions performed by underwriters. Of course, the fees charged by accountants and lawyers also add to the total cost of IPOs to issuers.

²⁶ Hass, *supra* note 18 at 96-98.

²⁷ *Ibid.* at 96.

The merit review is a complex process where the underwriter undertakes an objective assessment of the quality of the issuer, the proposed securities offering, and market interest in the particular IPO. In short, the investment bank asks: Should the securities of this issuer be offered to the public in the first place? The merit review is important to the issuer and prospective investors for two reasons. First, although securities regulators theoretically have the discretion to deny offerings²⁸, it is extremely rare for them to do so. As has been pointed out:

The practical difficulty of course, is that if the [Commission] were to attempt to pass judgment in detail on the viability of the new enterprise, it would have to have at its disposal a staggering number of highly sophisticated experts from various disciplines. The result would be an economy heavily subject to public regulation, to a much greater extent than Canadians have been accustomed.²⁹

Therefore, IPOs that have little real chance of success are terminated before the issuer commits extensive resources. Ideally, this saves issuers money and ensures that investors will have higher quality investment choices. In addition, the merit review is important because many investors buy securities wholly on the reputation of the investment bank underwriting the offering. In the words of one commentator, "these investors bet on the jockey rather than the horse."³⁰ Consequently, if an established investment bank decides to underwrite a public offering, it is a signal to the market that the IPO and the issuer should be seriously considered as a potential investment.

"Due diligence"³¹ also provides a significant measure of market-based investor protection. The B.C.S.A. imposes statutory civil liability on underwriters for

²⁸ The British Columbia Securities Commission may prohibit an offering by refusing to issue a receipt for a prospectus where the executive director considers it detrimental to the public interest to do so. See *B.C.S.A.*, *supra* note 20 at s. 65(2); *B.C.S.A. Rules*, *infra* note 37 at s. 120.

²⁹ David Johnston, *Canadian Securities Regulation* (Toronto: Butterworths, 1977) at 160. Further, as Gillen comments,

[e]ven if substantial merit discretion was undertaken by securities regulators, it might not benefit investors if the effect of it was to foreclose investments in speculative firms. This would reduce competition for established firms in capital markets. Further, investors might be prevented from purchasing shares in successful as well as unsuccessful ventures.

Gillen, *supra* note 13 at 321.

³⁰ Hass, *supra* note 18 at 96.

³¹ *B.C.S.A.*, *supra* note 20 at s. 131(6), (7) provides that a due diligence defence may be successful if the defendant can show that he or she conducted "a reasonable investigation to provide reasonable grounds for a belief that there was no misrepresentation" and the defendant did not believe "that there had been a misrepresentation." See Gillen, *supra* note 13 at 153.

any misrepresentations³² in a prospectus.³³ The underwriter's liability is based on the premise that "an underwriter is in a unique relationship with the issuer and can act as the devil's advocate to pressure the issuer for adequate and truthful disclosure."³⁴ The underwriter's liability may be avoided, however, by the affirmative defence of due diligence. Therefore, investment banks carefully scrutinise the financial health of the prospective issuer to ensure that information contained in the prospectus is accurate.

Investment banks further protect investors by performing a suitability function. "Suitability," or the "know your client" rule, refers to the determination by underwriters (or other brokers) of whether a particular investment accords with the financial objectives of a given investor.³⁵ In British Columbia, suitability flows from the B.C.S.A. requirements that all underwriters be registered to trade³⁶ and from the corresponding B.C.S.A. Rules.³⁷ Those provisions mandate that the underwriter, in its capacity as broker or investment dealer, consider a number of factors including the investor's financial status, tax status, and other pertinent information when it engages in trading securities.³⁸

Finally, many underwriters supply aftermarket support services. Typically, the underwriter's research department will write and distribute periodic reports that appraise the issuer's shares through an analysis of the company's performance and detailed projections of its near-term operating results. Such reports target an audience of institutional investors, brokers, and the financial press. In addition, for a substantial period after the time of the IPO, the underwriter will continue to provide "market making" services through analyst reports and its active relationship with major buyers and sellers of the shares.³⁹

Unfortunately, most small businesses have difficulty obtaining the services of a reputable underwriter because they lack a proven history. Consequently,

³² The definition of "misrepresentation" in the B.C.S.A., s.1(1) operates to ensure that statutory civil liability may be imposed for any omissions in addition to ordinary misrepresentations.

³³ See B.C.S.A., *supra* note 20 at s. 131(1)(b).

³⁴ Stephen P. Ferris *et al.* "An Analysis and Recommendation for Prestigious Underwriter Participation in IPOs" (1992) 17 J. Corp. L. 581 at 584.

³⁵ Hass, *supra* note 18 at 98.

³⁶ See B.C.S.A., *supra* note 20 at s. 34(1)(b).

³⁷ See *Securities Rules*, B.C. Reg. 194/97 at s. 48 [hereinafter B.C.S.A. Rules].

³⁸ Hass, *supra* note 18 at 98.

³⁹ *Ibid.* at 99.

they have trouble marketing their securities effectively.⁴⁰ Underwriters are reluctant to provide their services to small issuers for a number of reasons. The primary explanation is the focus of investment banks on the bottom line. The customary commissions expected by established underwriters simply cannot be met by the relatively small amounts of money generated by small business IPOs.⁴¹

A secondary explanation relates to the reputational concerns of underwriters. Investment banks work very hard to establish a loyal clientele. Those investors will be more interested in offerings managed by underwriters that have a history of taking successful companies public; that type of reputation is built by establishing a solid portfolio of IPOs with consistent aftermarket performance.⁴² In short:

Investment banks seek to underwrite those offerings that will prove profitable to both themselves and their investor clientele. By achieving that goal, investment banks will increase their reputational capital and consistently be able to go back to their clientele with future offerings. All this leaves the vast majority of [small issuers] without underwriters for their offerings.⁴³

A final explanation for the lack of co-operation between investment banks and small businesses relates to the general inclination of many entrepreneurs to minimise the extent of underwriter involvement. As one writer comments,

the 'do-it-yourself' maverick considering Internet IPOs will be reluctant to share any proceeds with an underwriter, much less reimburse that underwriter for out-of-pocket expenses.⁴⁴

More generally, it has been suggested that the active participation of investment banks in management decisions (often the case in small issuer IPOs) may be undesirable to entrepreneurs who seek to retain effective control over their company.⁴⁵

3. Inability of Retail Investors to Participate in Underwritten IPOs

It is not only prospective issuers who find themselves ignored by established investment banks; retail investors also find that underwriters are reluctant to in-

⁴⁰ Jill E. Fisch, "Can Internet Offerings Bridge the Small Business Capital Barrier?" (1998) 2 J. Small and Emerging Bus. L. 57 at 61 [hereinafter *Fisch*].

⁴¹ *Hass*, *supra* note 18 at 94.

⁴² *Hass*, *supra* note 18 at 95.

⁴³ *Ibid.* See also Joseph Kershenbaum, "Securities Offerings Online by Small, Non-public Businesses" (1999) 2:10 G.L.W.S.L.A.W. 14 at 14 [hereinafter *Kershenbaum*].

⁴⁴ *Ibid.*

⁴⁵ *Fisch*, *supra* note 40 at 62.

clude them in traditional IPOs. The historically limited involvement of retail investors in public offerings has created an impediment for small business capital financing. For the reasons discussed above, underwriters tend to restrict initial public offerings to institutional investors and "preferred" retail investors.⁴⁶ As one commentator has observed,

unfortunately, it is no news that underwriters make most of the shares in hot IPOs available not to the little-guy investor but to institutions, such as mutual-fund companies and pension funds, that provide a lot of trading commissions and other business.⁴⁷

In the underwriter's defence, however, its rationale has some merit, simply being:

Because [institutional and preferred] investors frequently participate in offerings that are undersubscribed, investment banks often reward them by including them in oversubscribed offerings. Simply stated, the typical unpreferred retail customer is not given the opportunity to buy shares in a hot IPO because that customer was nowhere to be found when shares in more mundane offerings were previously sold.⁴⁸

Defensible or not, the fact that "small investors often remain out of luck when it comes to getting in on the hottest initial public offerings"⁴⁹ has powerful ramifications on the practical ability of SMEs to raise capital. First, the historical inability of retail investors to access IPOs has resulted in an unfamiliarity with initial public offerings that tends to inhibit their appetite for future investment. Second, even when investors are interested in becoming involved in initial public offerings, a combination of market and regulatory factors prevent them from being notified about contemplated offerings, let alone actively participating in them.⁵⁰ Therefore, despite the fact that retail investors have demonstrated an increasing interest in IPOs and small businesses are eager to tap into their capital, regulatory and market barriers have prevented investors and small issuers from integrating their interests.⁵¹

⁴⁶ Hass, *supra* note 18 at 101.

⁴⁷ Michael Siconolfi, "Underwriters Set Aside IPO Stock for Officials of Potential Customers" *Wall St. J.* (12 November 1997) A1.

⁴⁸ Hass, *supra* note 18 at 101.

⁴⁹ Stark, *supra* note 11 at 85.

⁵⁰ See Part IV below.

⁵¹ Stark, *supra* note 11 at 85. Recently, there have been efforts to bring together small businesses and interested investors. For instance, the United States Small Business Association recently instituted "ACE-Net," a database system designed to bring qualified investors together with particular small businesses seeking equity funds. See also Langevoort, *supra* note 23 at 8 and Friedman, *supra* note 1 at 6-3. However, while the program is intended to help small businesses link up with sources of capital, only accredited investors are granted access to the system's listing of securities being offered. A number of factors restrict its ap-

The frustrations faced by small and medium enterprises in their pursuit of capital have not gone unnoticed by either government agencies or market participants. As one securities commission has stated,

issues relating to the equity capital requirements of SMEs have been addressed in a vast range of governmental and quasi-governmental reports and academic commentaries and articles, in Canada and other jurisdictions.⁵²

The situation, then, seems to be one where small issuers have a problem and retail investors may offer a solution. Further, securities regulators profess that their goal is to ensure,

without compromising the fundamental objective of investor protection, that the regulatory regime facilitates small business financing and does not impose unjustifiable impediments.⁵³

The question is, therefore, what can be done to satisfy the objectives of the relevant participants?

B. The Economic Rationales for Direct Public Offerings

Conducting direct public offerings (DPOs) over the Internet can potentially alter the underlying structure of the small issuer capital finance process in two broad senses: one, it can facilitate the more effective dissemination of information; and, two, it can encourage technological disintermediation.⁵⁴ Briefly, the first factor refers to the Internet's ability to disseminate information from companies to potential customers far more efficiently, and at a lower cost, than conventional mechanisms. The second factor relates to the Internet's potential to substitute conventional financial intermediaries typically present in public offerings of securities with more specialised and cost effective replacements. The economic rationales behind direct public securities offerings over the Internet are considered below.

1. Efficiency Of Information Dissemination

One of the most powerful properties of the Internet is its ability to transmit information virtually instantaneously from one central Web site to any person who has Internet access. In the securities offering context, the efficiency with which information can be disseminated over the Web gives rise to a number of

plication to a broad scale, including funding difficulties and the system's requirement that investors be accredited.

⁵² Ontario Securities Commission, *Task Force on Small Business Financing, Final Report* (Toronto: Queens Printer for Ontario, 1996) at 17 [hereinafter the *Small Business Financing Report*].

⁵³ *Ibid.* at 16.

⁵⁴ Langevoort, *supra* note 23 at 3.

implications for securities issuers. They include: reduced costs of distributing information; faster dissemination of information; the ability to create a centrally located corporate web site that prospective investors may find relatively easily; an enormous subscription base of hundreds of thousands of investors in Canada;⁵⁵ and the ability to use multi-media technology to present corporate data.

Of the five factors mentioned, reduced printing and mailing costs and the ease with which online materials may be updated are perhaps the most immediate attractions to small and medium sized enterprises.⁵⁶ In most public offerings, issuers must print and distribute some type of offering prospectus to potential investors and subsequently deliver an updated prospectus, reflecting any revisions, to those investors.⁵⁷ Current securities legislation requires that the prospectus be amended to reflect material changes;⁵⁸ notifying each prospective investor of each revision can cost the issuer substantial amounts of money. It has been estimated that printing costs alone can easily amount to \$50,000.⁵⁹

However, using Web-based disclosure, information displayed on an issuer's web site in conjunction with email updates can reduce these costs dramatically. An issuer can eliminate paper and choose instead to post its prospectus on the Internet where any required revisions can be implemented with minimum delay and cost. Prospective investors can be advised of any alterations through email and may subsequently view the revised document and perhaps download a copy at their leisure. The maintenance cost of such a system is approximately \$200.⁶⁰ Even if an issuer needs to supplement its Internet-based disclosure with printed materials, it will incur substantially lower costs than if it provided information entirely via traditional, paper-based mechanisms.

The central location of the disclosure materials on the issuers' Web site can also result in efficiency savings. In a conventional public offering, underwriters acting on behalf of the issuer actively search for prospective investors and determine that they are qualified. (Often, underwriters possess a database of such potential clients.) The process has been described as:

⁵⁵ According to the latest figures, about 200,000 individual Canadian investors were buying and selling their securities online in 1998, but this number is expected to reach the one million mark by 2004, an annual growth rate of more than 45%. See Brian Lewis, "Canadian Investors Flocking To Web Brokers: Beware Internet Fiction" *National Post* (27 August 1999) D4.

⁵⁶ Stephen K. Gregg, "Regulation 'A' Initial Public Offerings On the Internet: A New Opportunity for Small Business?" (1997) 1 *J. Small and Emerging Bus. L.* 417 at 433.

⁵⁷ See *B.C.S.A.*, *supra* note 20 at s. 61.

⁵⁸ *Ibid* at s. 67.

⁵⁹ Gregg, *supra* note 56 at 434.

⁶⁰ *Ibid*.

[A] cumbersome and fairly expensive one, conducted through mailings, telephone solicitations and examining records of previous investments. As a practical matter, the only entity with the natural interest and expertise to undertake this pre-qualification task was a registered broker-dealer, which would then earn a fee or commission by assisting the issuer in selling the securities to individuals on its prospect list.⁶¹

After an initial search to ascertain that the investors are qualified and potentially interested in the offering, underwriters contact the pre-qualified investor with information regarding the investment proposal.⁶² This pre-qualification task requires significant resources to be expended (albeit indirectly) by an issuer and holds no guarantee of any level of success.

In contrast, the active search costs required by a conventional IPO are avoided in the Internet public offering process. Internet DPOs enable an issuer to incur lower costs in its search for investors because a DPO is passive. Consequently, the emphasis is placed on potential investors to seek out and identify desirable transactions.⁶³ One commentator has focused on the negative implications of the Internet-based process, observing that, "the issuer must fight to make its voice heard amid the online buzz of millions of pages seeking the attention of those surfing the Web."⁶⁴

However, other writers have countered by pointing to the growth of dedicated Web sites specialising in securities offerings where an issuer may post standardised information for electronic distribution, arguing that such sites will act as focal points for prospective investors.⁶⁵ Although there is undoubtedly some loss of potential investors using what is in effect a "let them come to us" approach, any such deficit should be balanced by the much deeper pool of investors that the issuer has access to through the Internet.⁶⁶ The number of investors available through the Internet will translate into a market penetration that has not been possible for any issuer, much less a small issuer. As one commentator has stated:

The communication advantages of the Internet generate many potential beneficial effects for the securities markets. Because of the Internet's breadth, investors may obtain information on particular companies and securities, whether located domestically or abroad, at low expense and almost instantaneously. The lower cost of information will draw greater numbers of individuals into the Internet as active investors. When more

⁶¹ Langevoort, *supra* note 23 at 7.

⁶² *Ibid.* at 6. See also B.C.S.A., *supra* note 20 at s. 49.

⁶³ Fisch, *supra* note 40 at 77.

⁶⁴ Turilli, *supra* note 4 at 24.

⁶⁵ Fisch, *supra* note 40 at 76. See also *infra* note 165 where some of the new market Internet-based based intermediaries are identified.

⁶⁶ *Ibid.*

widespread investors hold information, securities prices will incorporate this information more efficiently.⁶⁷

Further, not only is it cheaper for issuers to disseminate information to investors, the potential movement of "roadshows"⁶⁸ from physical locations to cyberspace means that investors may access issuer information with minimal effort and lower costs.⁶⁹ This ability of issuers to communicate easily with the vast number of people online is a chief advantage of Internet DPOs. It is not unrealistic to project "hits" on an issuer's web page in the thousands and perhaps tens of thousands.⁷⁰ Working with those types of raw numbers, the proportional success rate can be that much lower than with more active, targeted methods. Such levels of market penetration are unprecedented.

The quality and breadth of the information available on the web site is also extraordinary. Internet-based disclosure can add substantial value in that it promises to be far more versatile than a traditional paper-based prospectus.⁷¹ Using hyperlinks, interested investors can jump to specific reports or financial charts, access audio or video presentations where an industry analyst clarifies confusing information, or link to the homepages of the issuer's legal or financial advisors. The true interactive nature of the Internet can also come into play if the issuer decides to set up a chat room or forum dedicated to questions from investors and moderated by the issuer.⁷² Such a "hyperprospectus" could not only dazzle investors in a superficial sense, but could also provide more in-depth issuer data than has historically been present in paper prospectuses. However, despite the predictions that Internet-based disclosure and DPOs may enable

⁶⁷ Choi, *supra* note 19 at 36.

⁶⁸ "Roadshow" is a term used to describe to presentations, usually organised by underwriters that "feature oral presentations by corporate management designed to stimulate interest among prospective investors, selling group members, institutional investors, analysts, and money managers." See Friedman, *supra* note 1 at 3-13 to 3-14. Presently, in British Columbia, roadshows are prohibited under by the B.C.S.A. The impact of the prohibition and recommendation that it be changed are discussed below in Part III B. 4.

⁶⁹ Choi, *supra* note 19 at 54 writes "the Internet, more than any prior technological advance ... presents a vast quantitative decrease in communication costs for a broad segment of the population."

⁷⁰ It is not unusual for popular web sites to be accessed by (or "receive hits" from) hundreds of thousands or even millions of people per day. This can be confirmed by scrolling to the bottom of many home pages where a "counter" banner is located that provides information regarding the number of hits.

⁷¹ Daniel E. Giddings, "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" (1998) 25 Pepp. L. Rev. 785 at 802 [hereinafter *Giddings*].

⁷² *Ibid.*

small issuers to provide the market with increased information at lower costs, the most pressing question for unpreferred retail investors is arguably the same as it has always been: What is the *quality* of the information provided by the issuer?

2. *Technological Disintermediation*

The degree to which investors should trust information provided by an issuer that has a strong incentive to puff or lie in order to maximise interest in its securities offerings has historically been a concern for market participants.⁷³ This issue is aggravated by the impact that Internet DPOs may have on the role of financial intermediaries who have typically advised investors on the quality of information disseminated by issuers.⁷⁴ Traditionally, in an IPO, securities are almost never sold directly by the issuer to the investor. Instead,

the issuer hires an underwriter to locate a market for its stock. The underwriter contracts with the issuer to purchase all or a portion of the offering at a discounted rate. The underwriter then sells the stock it has purchased to various brokerage firms and institutional investors at the original market price, retaining the difference between the two prices as its fee. The discount rate given to the broker varies depending upon the level of risk and the underwriter's reputation.⁷⁵

The cost of the underwriter's services is crucial for small businesses engaged in a limited public offering. For example, in an IPO of \$5 million, the aggregate ceiling of \$5 million does not increase to make up for the lost income due to the underwriter's fee. Therefore, the discount rate paid to the underwriter can mean the difference between bringing in \$3 million and \$4 million in new capital for the company.⁷⁶ Further, the amount of capital raised in public offerings may also be decreased through the commonly observed practice of underpricing securities. This refers to the situation where an underwriter excessively discounts the issuer's securities in an attempt to ensure that it sells all the shares it purchased from the issuer.⁷⁷

What if small issuers could avoid incurring substantial portions of those costs? "Technological disintermediation" refers to the potential of the Internet DPO to eliminate or reduce the role that conventional underwriters, invest-

⁷³ Bernard S. Black, "Information Asymmetry, The Internet, and Securities Offerings" (1998) 2. J. Small & Emerging Bus. L. 91 at 91.

⁷⁴ *Ibid.*

⁷⁵ Gregg, *supra* note 56 at 435.

⁷⁶ *Ibid.*

⁷⁷ Langevoort, *supra* note 23 at 12. The author suggests that underpricing is "a phenomenon that probably reflects a mix of causal factors, including liability risks, reputational risks, and a less than fully competitive market within investment banking."

ment banks, and other financial advisors have historically played in the offering process.⁷⁸ Faced with the high costs of investment banks' services or, alternatively, a complete aversion by underwriters to even provide those services,⁷⁹ it is little surprise that the possibility of eliminating the underwriting step has been described as an "entrepreneur's dream."⁸⁰

Recent developments in Internet technology combined with strong retail investor interest in small issuers' public offerings⁸¹ indicate that the dream may be on the verge of becoming reality. Indeed, one commentator states:

There is no reason why both quasi-public and private vendors cannot provide the software, and do the pre-qualification procedures necessary, to create a broad base of potential investors who can be contacted within the prevailing regulatory framework at low cost in the search for capital.⁸²

The effectiveness of the concept is buttressed by the recognition that vendors who sense a profit in such an area could provide detailed demographic information about potential investors such as their areas of interest and prior investments. This would allow issuer solicitations to be focused and presentations customised for specific audiences.⁸³ The net effect, therefore, is that in a public offering on the Internet, "underwriting costs can be dramatically reduced or eliminated entirely."⁸⁴

While the possibility that Internet DPOs could eliminate investment bankers from the equity finance process may have positive implications for small businesses seeking capital, it potentially creates new concerns for retail investor protection.⁸⁵ As discussed above, underwriters' services have traditionally been viewed as providing, in conjunction with securities regulations, an important source of investor protection. If those market protections offered by financial intermediaries disappear, the question arises: Will small investors be inundated by fraudulent issuers offering worthless securities directly to them over the Internet?

One commentator believes that the absence of intermediaries in Internet DPOs will exacerbate information asymmetry to such an extent that unsophis-

⁷⁸ Langevoort, *supra* note 23 at 11.

⁷⁹ Fisch, *supra* note 40 at 75.

⁸⁰ Langevoort, *supra* note 23 at 12.

⁸¹ Hass, *supra* note 18 at 99.

⁸² Langevoort, *supra* note 23 at 12.

⁸³ *Ibid.*

⁸⁴ Gregg, *supra* note 56 at 435.

⁸⁵ Black, *supra* note 73 at 98.

ticated investors will refuse to participate in the public offerings.⁸⁶ "Information asymmetry" refers to the problem where the issuer knows the quality of the securities being offered but the investor does not—and cannot easily find out.⁸⁷ A fundamental objective of securities regulation and market intermediaries is to reduce the gap between issuer and investor knowledge. Therefore, the main emphasis of investor protection is on transmitting issuer information to the investor such that he or she may evaluate the quality of the issuer before investing in its securities.⁸⁸

Information asymmetry is not merely a concern for investors; issuers also suffer, primarily from the related effects of adverse selection. "Adverse selection"⁸⁹ is a process where high-quality issuers leave the market because they cannot obtain a fair price for their shares while low-quality issuers remain.⁹⁰ It is a direct consequence of information asymmetry; it occurs because

Investors don't know which issuers are truthful and which aren't, so they discount the prices they will offer for all securities. That makes honest issuers less interested in offering securities, but doesn't discourage the dishonest ones. Securities that aren't worth the paper they're printed on are, after all, quite easy to produce. Paper, like talk, is cheap.⁹¹

The combined result of information asymmetry may be to drive honest issuers out of the market and drive securities prices to zero, a phenomenon sometimes called a "death spiral."⁹² Developed securities markets like Canada's have partially solved the problem through a complex set of private and public institutions that assure investors that the issuer is providing accurate information.⁹³ That being said, it is clear that securities regulators do not:

suggest that that the public must be protected against itself; rather it is a matter of ensuring that the investing public has the fullest possible knowledge to enable it to distinguish the different types of investment activity available. In such circumstances, the

⁸⁶ Hass, *supra* note 18 at 112.

⁸⁷ Black, *supra* note 73 at 91.

⁸⁸ Gillen, *supra* note 13 at 295.

⁸⁹ For a discussion of the concept of adverse selection see *Ibid* at 84-87.

⁹⁰ Black, *supra* note 73 at 92.

⁹¹ *Ibid.*

⁹² *Ibid.*

⁹³ *Ibid.*

public would have assurance that its losses are genuine economic losses, just as gains are genuine economic gains.⁹⁴

The specific concern expressed is, because Internet DPOs would enable issuers to sell securities directly to anyone with Internet access, technological disintermediation could eliminate a key source of market-based investor protections, i.e., those services that investment banks perform such as merit review, due diligence, investor suitability analysis, and aftermarket support.⁹⁵ One of the primary functions of financial intermediaries is their signalling and bonding of the informational credibility of issuer disclosure.⁹⁶ Without such an "implied institutional stamp of approval"⁹⁷ and the assurances that it affords, critics fear that investors will invest in Internet DPOs without realising that they might carry far more risk than larger, conventionally underwritten securities offerings. While it is arguable that some retail investors may be sophisticated enough to appreciate the risks involved, other individual investors may be mentally and financially unprepared for a DPO that undergoes a major devaluation.⁹⁸

Although such disintermediation concerns are not unreasonable, they can be effectively addressed by market participants and regulatory reforms. For instance, just as offerings shift to cyberspace, so will private intermediaries. The reality is that Web-based investment banks have already emerged.⁹⁹ These new types of financial advisors step into the shoes of traditional underwriters. The crucial distinction is that they do so with much more specific Internet DPO expertise and at a lower cost.¹⁰⁰ Therefore, Internet securities offerings allow more value to be shared between investors and the issuer, while still retaining a reputational element that will act against excessive discounting by investors attempting to guard against risk.¹⁰¹

Just as conventional market-based participants have begun to transform themselves to accommodate the new needs that small businesses and the Internet DPOs require, it is suggested that securities administrators should adapt regulations to incorporate the new realities generated by the Web. Therefore, to

⁹⁴ Report of the Attorney General's Committee on Securities Legislation in Ontario, (Toronto: Queen's Printer, March 1965) at para. 1.12 [hereinafter the Kimber Report].

⁹⁵ Hass, *supra* note 18 at 110.

⁹⁶ Langevoort, *supra* note 23 at 14.

⁹⁷ Giddings, *supra* note 71 at 808.

⁹⁸ Hass, *supra* note 18 at 112.

⁹⁹ Giddings, *supra* note 71 at 813.

¹⁰⁰ *Ibid.*

¹⁰¹ Black, *supra* note 73 at 92.

fully take advantage of the potential that Internet DPOs have to aid small businesses seeking capital, securities regulators must implement more progressive and flexible policies that reflect the particular needs of SMEs and the unique issues associated with the Internet.

IV. THE REGULATION OF INTERNET TRADING

BEFORE CONSIDERING SPECIFIC PROPOSALS which might encourage small businesses to take advantage of Internet DPOs in British Columbia, it is helpful to briefly examine the existing framework within which issuers may generate capital. Part A of this section provides a short background to the current regulatory regime. Part B looks at existing regulations and identifies how they might deter or prohibit small issuers from using DPOs effectively. Part C addresses how altering certain regulations might create facilitators for SME Internet equity finance. Finally, Part D considers possible ramifications for unsophisticated investor protection, and highlights two recent cases considered by the British Columbia Securities Commission involving Internet fraud.

A. Background

The 1965 *Kimber Report* has shaped modern Canadian securities regulation.¹⁰² As set out in the report, the primary objectives of securities regulation are investor protection and the efficient allocation of financial resources. Those two goals are best accomplished by promoting confidence in the market, which can in turn be achieved by requiring information disclosure and thus providing investors with "knowledge of the relevant facts necessary to permit anticipation of profits."¹⁰³ The securities regime is a "closed system" in the sense that all distributions of securities are subject to the application of the *B.C.S.A.* and securities may only be sold or traded when the disclosure requirements under the *Securities Act* have been complied with.¹⁰⁴ Generally, the disclosure provisions require that an initial offering complies with the prospectus requirement¹⁰⁵ and that any subsequent secondary market trading be supported by continuous disclosure¹⁰⁶ of reporting issuer¹⁰⁷ information.

¹⁰² Gillen, *supra* note 13 at 76. A detailed discussion may be found at 76-87.

¹⁰³ *Ibid.* at 82.

¹⁰⁴ There are a number of enumerated exemptions from these requirements. For a more in depth analysis see Gillen, *supra* note 13 at 213-258.

¹⁰⁵ See *B.C.S.A.*, *supra* note 20 at s. 61.

¹⁰⁶ The continuous disclosure provisions are contained in Part 12 of the *B.C.S.A. Rules*, *supra* note 37 at ss. 144-161.

¹⁰⁷ See *B.C.S.A.*, *supra* note 20 at s. 1(1) "reporting issuer."

Practically, under the B.C.S.A., an issuer must ask three questions when determining if a prospectus will be required:¹⁰⁸

- (i) Does the transaction involve a "security?"¹⁰⁹
- (ii) Does the transaction involve a "trade?"¹¹⁰
- (iii) Does the trade in the security constitute a "distribution?"¹¹¹

If these three questions are answered in the affirmative, then a prospectus is required before the securities can be distributed. Distributing securities to the public under a prospectus requires the issuer to comply with a number of specific statutory requirements. Several of those B.C.S.A. provisions create significant impediments to successful small business Internet DPO.

B. Existing Regulatory Inhibitors

1. Existing Exemptions

Currently, the B.C.S.A. provides a number of exemptions from the prospectus requirement. Exemptions are provided in "circumstances in which prospectus disclosure combined with civil liability for misrepresentations is considered unnecessary."¹¹² The primary rationale is that informational benefits of prospectus disclosure would be outweighed by the costs imposed on the issuer. Consequently, the B.C.S.A. sets out particular situations where securities may be distributed to investors into the primary market absent the disclosure protections usually required.

Various categories of persons may take advantage of the exemptions. "Sophisticated investors" are deemed to have the ability to gather information and assess the value of a security absent the assistance of a prospectus.¹¹³ Sophisticated investors include exempt institutions,¹¹⁴ individuals making large purchases,¹¹⁵ and individuals with a net worth above a certain level with

¹⁰⁸ Gillen, *supra* note 13 at 105.

¹⁰⁹ See B.C.S.A., *supra* note 20 at s. 1(1) "security." Note that although "security" is a defined term in the B.C.S.A., the catch-all nature of some of parts of the definition (e.g. "investment contract") require that issuers look to the jurisprudence for guidance. Specifically, the decision of the Supreme Court of Canada in *Pacific Coast Exchange v. O.S.C.*, [1978] 2 S.C.R. 112, 80 D.L.R. (3d) 529; 2 B.L.R. 212 provides a good starting point.

¹¹⁰ See B.C.S.A., *supra* note 20 at s. 1(1) "trade."

¹¹¹ See B.C.S.A., *supra* note 20 at s. 1(1) "distribution."

¹¹² Gillen, *supra* note 13 at 226.

¹¹³ Gillen *supra* note 13 at 227.

¹¹⁴ See B.C.S.A., *supra* note 20 at s. 74(2)(1).

chases,¹¹⁵ and individuals with a net worth above a certain level with investment experience.¹¹⁶ Persons who share "common bonds"¹¹⁷ with the issuer may also be able to take advantage of an exemption from the prospective requirement. These include promoters,¹¹⁸ control persons,¹¹⁹ and relatives of senior officers or directors of the issuer.¹²⁰

The subsequent resale of the securities distributed under the exemptions is heavily restricted.¹²¹ The B.C.S.A. imposes three conditions: one, the issuer must be a "reporting issuer" not in default of certain sections of the B.C.S.A.;¹²² two, the securities may not be sold until the expiration of a specified "hold period";¹²³ and, three, no unusual effort is made to prepare the market or create a demand for the security.¹²⁴ These restrictions are designed to ensure that the investors in the secondary market will not be prejudiced by insufficient information. The effect of the resale restrictions is to create conditions whereby investors will have access to information about the status of a company before the securities become freely traded.

What is common to virtually every exemption from the B.C.S.A. prospectus requirements is the focus on the *receiver* of the shares. With one exception, the B.C.S.A. does not contain any issuer-specific exemptions. This oversight does not seem to stem from securities administrators' ignorance of the concerns of small businesses or retail investors. In fact, the British Columbia Securities Commission (B.C.S.C.) recently implemented an exemption designed to address the issue. Termed the "Short Form Offering" (SFO),¹²⁵ the measure was

¹¹⁵ See *Ibid.* at s. 74(2)(4); B.C.S.A. Rules, *supra* note 37 at s. 129(1).

¹¹⁶ See B.C.S.A. Rules, *supra* note 37 at s. 128(a), (b); B.C.S.A., *supra* note 20 at s. 1(1) "sophisticated investor".

¹¹⁷ Gillen, *supra* note 13 at 235.

¹¹⁸ See B.C.S.A., *supra* note 20 at s. 74(2)(16); B.C.S.A., *supra* note 20 at s. 1(1) "promoter".

¹¹⁹ See B.C.S.A., *supra* note 20 at s. 74(2)(17); B.C.S.A., *supra* note 20 at s. 1(1) "control person".

¹²⁰ See B.C.S.A. Rules, *supra* note 37 at s. 128(a).

¹²¹ Gillen, *supra* note 13 at 221.

¹²² See B.C.S.A. Rules, *supra* note 37 at s. 142(1) and s. 142(2)(e). This provision ensures that information from continuous disclosure requirements is available to investors before the non-prospectus securities can be freely traded in the secondary market.

¹²³ See B.C.S.A. Rules, *supra* note 37 at s. 142(2)(a) and s. 142(2)(b). The duration of this hold period can vary but it is usually within the range of four to twelve months.

¹²⁴ See B.C.S.A. Rules, *supra* note 37 at s. 142(2)(h).

¹²⁵ See British Columbia Securities Commission: Blanket Orders & Rulings 99/2.

adopted by a blanket order in response to an initiative of the Vancouver Stock Exchange (V.S.E.). The SFO was designed to address the problems that listed companies have in raising funds from the small retail investor. The V.S.E. and B.C.S.C. envisioned that issuers could use it to raise capital from small investors without incurring the time and costs of preparing a prospectus.¹²⁶ As expressed by the Commission, "the Short Form Offering is intended to be a vehicle to increase the participation of smaller investors in primary offerings and enhance the liquidity of the market."¹²⁷

While the SFO is a step in the right direction, it falls far short of addressing the equity finance needs of small businesses. Although the SFO recognises the costs imposed by the prospectus requirement and consequently attempts to reduce the regulatory burden, it is of little use to small businesses. Unfortunately, before an issuer may offer securities using the SFO, it must meet the threshold requirement that it be currently listed on the V.S.E.¹²⁸ Therefore, because the SFO is restricted to V.S.E.-listed issuers, the small issuers who could most benefit from it cannot take advantage of it because they are unlikely to already be listed on an Exchange. In sum, the policy has little benefit to small businesses that are struggling to complete their first public offering of securities.

2. Registration Requirements

Another regulatory obstacle to Internet DPOs is the B.C.S.A. provision that no person may trade in securities unless the person is registered in accordance with the regulations as a dealer, or salesperson acting on behalf of the dealer.¹²⁹ Another section provides that no person may act as an underwriter unless registered as such in accordance with the regulations.¹³⁰ The B.C.S.A. sets out exemptions from these registration requirements that are analogous to the exemptions from the prospectus requirement.¹³¹

The registration requirements pose a significant impediment to Internet DPOs because they require that any trading of securities be done through registered dealers. As a consequence, direct trading from a small issuer to investors is prohibited under the Act. While there are issuer exemptions available under the

¹²⁶ British Columbia Securities Commission: Notices & Interpretation Note 99/14.

¹²⁷ *Ibid.*

¹²⁸ Vancouver Stock Exchange Policy 14, Part 6. Or the issuer must be listed on the V.S.E.'s successor, the new Canadian Venture Exchange (CDNX).

¹²⁹ See B.C.S.A., *supra* note 20 at s. 34(1).

¹³⁰ *Ibid.*

¹³¹ See B.C.S.A., *supra* note 20 at ss. 43-48.

B.C.S.A.,¹³² none of the exemptions is available to an issuer who contemplates a direct public offering over the Internet absent registered intermediaries. As the B.C.S.C. has clearly indicated:

Issuers and other securities market participants are reminded that it is presently not possible to conduct a public offering in British Columbia, including an initial public offering, on the Internet (i.e., by posting a prospectus on the Internet for the purpose of selling the securities offered under the prospectus), without the involvement of a registrant. The Securities Act requires that, where the issuer of the securities is not itself registered, the securities offered under a prospectus be sold through a person registered in British Columbia under the Securities Act to trade securities.¹³³

In effect, the B.C.S.A. indirectly requires small issuers to conduct an offering through brokers or underwriters;¹³⁴ an approach which, as discussed above, carries many disadvantages¹³⁵ because the issuer concerns of cost and access to underwriters remain.

3. Delivery of Documents

The high costs incurred by small issuers to produce and deliver a paper prospectus are, in large part, a consequence of the wording of the provisions of the B.C.S.A. For instance, a number of sections in the Act and the Rules concerning the prospectus requirements discuss the delivery of documents. Certain provisions use the phrase "send the prospectus," while others incorporate the words

¹³² See B.C.S.A., *supra* note 20 at ss. 45(8) - (21)

¹³³ British Columbia Securities Commission, *supra* note 16 at 2.

¹³⁴ Although B.C.S.A. Rules, *supra* note 37 at s. 6(2)(d)(iii) allows the registration of a security issuer that "trades in securities for purposes of distributing securities of its own issue exclusively of its own account," there are a number of corresponding requirements to the provision that can limit its use by small issuers considering an Internet DPO. For instance, the British Columbia Security Commission's Local Policy Statement 3-22 (LPS 3-22), which sets out further rules regarding registration, requires an issuer to comply with a number of supplementary requirements. These include requiring the "trading partner, director, or officer" to successfully complete the Canadian Securities Course and the Conduct and Practices Handbook Exam (it is unlikely that senior officers of small companies would have fulfilled these education requirements). Further, the issuer must also comply with B.C.S.A. Rules s. 50(1)(g) which allows a client or prospective client to demand a copy of the security issuer's most recently prepared financial statements that it has filed pursuant to B.C.S.A. Rules s. 145 (many small businesses are not subject to s. 145 which relates to continuous disclosure requirements for reporting issuers). Finally, the issuer is required to pay a registration fee of \$2,500 and comply with a number of general provisions set out in Parts 3 to 5 of LPS 3-22. In sum, the requirements of LPS 3-22 make it impractical, if not impossible, for a small business to use the registration available under B.C.S.A. Rules s. 6(2)(d)(iii).

¹³⁵ It is possible that an issuer could be registered pursuant to B.C.S.A. Rules, *supra* note 37 at s. 6(2)(d)(iii).

“print” and “ink.”¹³⁶ Such wording is associated with paper “hard copy” documents and has led to confusion on the part of issuers and their advisors regarding the validity of communicating with investors electronically. The question arises therefore: Is the terminology in the B.C.S.A. merely a reflection of the technology available at the time it was drafted, or is it evidence of a preference of the drafters for paper-based delivery systems?

Securities administrators have attempted to address those concerns through National Policy (Proposed) 11-201.¹³⁷ The policy statement indicates that there are four components to electronic delivery of a document.¹³⁸

- (i) The recipient of the document receives notice that the document has been, or will be, sent electronically or otherwise electronically made available.
- (ii) The recipient of the document has easy access to the document.
- (iii) The deliverer of the document has evidence that the document has been delivered or otherwise made available to the recipient.
- (iv) The document that is received by the recipient is not different from the document delivered or made available by the deliverer.

NP 11-201 further requires that the recipient of the document consent to the electronic delivery mechanism. Consent may flow from an express agreement between the issuer and investor, or it may be inferred if the following three criteria are satisfied: one, the recipient will receive notice of the electronic delivery of the document; two, the recipient has the necessary technical ability and resources to access the document; and three, the recipient will actually receive the document.¹³⁹

The policy enunciated in NP 11-201 provides a good basis for Internet-based disclosure. After all, one of the savings identified with an Internet DPO stems from the elimination of costly mailings of the initial prospectus materials and the continuing notification of revisions.¹⁴⁰ If issuers could take advantage of the electronic delivery mechanisms set out in NP 11-201, their costs might be reduced substantially. Unfortunately for issuers, NP 11-201 is merely a *proposed* National Policy. Therefore, because the provisions have no legal effect, it is

¹³⁶ See B.C.S.A., *supra* note 20 at s. 79, 83; B.C.S.A. Rules, *supra* note 37 at s. 95, 104.

¹³⁷ See National Policy (Proposed) 11-201 [hereinafter NP 11-201].

¹³⁸ *Ibid.* at para. 2.1(2).

¹³⁹ *Ibid.* at para. 2.1(4).

¹⁴⁰ Gregg, *supra* note 56 at 434.

conceivable that issuers could remain liable to investors who claimed that they did properly receive required material.¹⁴¹

4. "Acts in Furtherance of a Trade"

Another regulatory barrier to Internet DPOs may be traced to the definition of trade in the B.C.S.A. "Trade" includes any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the enumerated activities in the section.¹⁴² The definition of "trade," when read together with the definitions of "security" and "distribution," therefore prohibits any general solicitation of interest or "market making" by an issuer before a prospectus is filed with the Securities Commission.¹⁴³

This ban on general solicitation is particularly problematic for small issuers wishing to conduct an Internet DPO. As has been observed,

many small business owners frequently complain about the risky nature of a public offering because they have no way of assessing the viability of an offering before committing a large amount of time and money to the project.¹⁴⁴

Larger issuers are usually experienced with IPOs and have widely traded securities that provide an indication of the level of investor demand for a further offering.¹⁴⁵ Small issuers, lacking this type of information and subject to a disproportionately larger cost burden, are therefore more reluctant to devote money and managerial resources on an offering that may not justify such expenditures.¹⁴⁶

Another consequence of the B.C.S.A. definition of "trade" is the prohibition of multi-media road shows.¹⁴⁷ Presently, only institutional and other sophisticated investors have access to such presentations, despite the concern that road shows give professional investors an informational advantage over unpreferred retail investors.¹⁴⁸ Therefore, while Internet technology might seem to facilitate the creation of "virtual roadshows" that could be widely disseminated

¹⁴¹ See B.C.S.A., *supra* note 20 at s. 135 where it is provided that a purchaser of a security may have a right of action for damages or rescission against any offeror who failed to deliver required documents.

¹⁴² See B.C.S.A., *supra* note 20 at s. 1(1) "trade" (f).

¹⁴³ Gillen, *supra* note 13 at 123-124.

¹⁴⁴ Gregg, *supra* note 56 at 426.

¹⁴⁵ Choi, *supra* note 19 at 36.

¹⁴⁶ Hass, *supra* note 18 at 84.

¹⁴⁷ See Part III above.

¹⁴⁸ See Friedman, *supra* note 1 at 3-14.

in a cost effective fashion, B.C. securities legislation does not currently allow most individual investors to access such presentations. In sum, there are a number of regulatory provisions which restrict small issuers from conducting a public offering of securities over the Internet. The next section will argue that by addressing the regulatory obstacles discussed above, securities administrators can create a regulatory framework that facilitates more effective small business capital finance, but still maintains adequate levels of investor protection.

C. Proposed Regulatory Facilitators

While is undoubtedly true that current securities regulations are not the only impediments to SME equity finance,¹⁴⁹ it is likely that a recognition of the particular needs of small issuers and a more flexible regulatory regime could substantially increase the number of successful offerings in the small business market sector. Recent legislative and administrative actions by the United States Congress and the US Securities and Exchange Commission (S.E.C.) support this view. Several of the regulatory reforms suggested in this section may be traced to provisions enacted by Congress in the *National Securities Market Improvement Act* in 1996,¹⁵⁰ and the restructured 1992 *Small Business Initiatives Regulation A (Regulation A)*.¹⁵¹ Further, many reforms helpful to small issuers were proposed in the *Small Business Financing Report*,¹⁵² but they have been yet to be implemented by securities administrators. It is suggested that those reforms might be integrated in conjunction with other Internet-specific measures such that, in combination, a coherent and discrete "Small Business Internet DPO Exemption" is created. The relevant proposals are considered below.

1. New Exemptions from the Prospectus and Registration Requirements

¹⁴⁹ Fisch, *supra* note 40 at 64. Fisch argues that the inherently risky nature of small businesses is an explanation for the reluctance of investors to participate in SME offerings.

¹⁵⁰ *National Securities Market Improvement Act of 1996*, 110 Stat. 3416 (1996).

¹⁵¹ 17 C.F.R. §§ 230.251 to 230.263 (1998)

¹⁵² *Small Business Financing Report*, *supra* note 52 at 23. The Ontario Securities Commission has released a new set of proposals based on the *Small Business Financing Report*, and it is likely that certain of them will be adopted in the near future. However, all of the proposals centre around the "exempt" market, so while they may provide opportunities for small businesses, they do not address the "public" sectors of the market that Internet DPOs are aimed at. See Ontario Securities Commission, "Revamping the Regulation of the Exempt Market—A Concept Paper Prepared by Staff of the OSC" (1999) 22 OSCB 2829. The British Columbia Securities Commission has also requested comment on the OSC proposals. See British Columbia Securities Commission, "Notice and Interpretation Note #99/18."

Throughout this paper, a recurrent theme has been the disproportionate costs that small issuers face when undertaking a public offering.¹⁵³ Therefore, following the Ontario proposals, it is suggested that a new Small Business Internet DPO Exemption should be available from the prospectus requirement (with a parallel registration exemption). "Small Business" could be defined as any company with not more than \$10 million in gross revenues in its most recently completed financial year, and with market capitalisation (calculated on a fully-diluted basis prior to the proposed offering) of not more than \$35 million.¹⁵⁴

Although a Small Issuer Internet DPO Exemption would not require a full prospectus, a brief and simple offering prospectus would be required to be filed with the Securities Commission. In contrast to the lengthy and complicated long-form prospectus presently required,¹⁵⁵ the revised document would be much simpler. The most commonly envisioned form resembles a generic information document in a question and answer format. Information might include:¹⁵⁶

- (i) The business and technical background of senior management;
- (ii) The composition of the board of directors;
- (iii) An audited balance sheet for the issuer;
- (iv) Historic financial statements and auditors' reports, if any;
- (v) Length of operating history;
- (vi) The possibility of litigation regarding claims to intellectual property or other assets;
- (vii) Plans for utilization of funds raised through the investment and whether such funds are sufficient to finance the project; and,
- (viii) The liquidity of the security.

The aggregate amount that could be raised pursuant to this exemption would be capped at \$10 million. This amount reflects a special recognition of the needs of the small issuer, but reconciles the fact that the Small Business Internet DPO Exemption is intended to relax the disclosure requirements only to the extent required to balance the disproportionate burdens that small and medium-sized enterprises face. It should not be perceived as an indication that securities regulators have abandoned the philosophy that complete disclosure is a valuable mechanism to protect investors and promote liquid markets. Further, it is an-

¹⁵³ The regulatory burden facing small issuers is discussed in more detail in Carl W. Schneider *et al.*, "Going Public: Practice, Procedure, and Consequences" (1984) 25 *Corp. Prac. Commentator* 89 at 119.

¹⁵⁴ *Small Business Financing Report*, *supra* note 52 at 23.

¹⁵⁵ See *B.C.S.A.*, *supra* note 20 at s. 61.

¹⁵⁶ *Small Business Financing Report*, *supra* note 52 at 65.

anticipated that a company that successfully conducts an offering under this exemption would not need to use it in subsequent equity financings.¹⁵⁷

In addition to its role as an information vehicle, the offering prospectus could also function as a bare signaller of quality. Securities regulators would merely ensure that the required fields were completed without verifying the quality of the information. As part of an Internet DPO, it would likely be in digital form. Therefore, it is suggested that the offering prospectus could be hosted at a site such as SEDAR,¹⁵⁸ or, alternately, securities regulators could host such documents in a specific area of their Web sites. Considering the efficiency with which such an Internet prospectus can be transmitted and accessed, such a proposal should not prove to be particularly burdensome for provincial securities regulators, but would serve as a minimum starting point for investors assessing the quality of a securities offering.

Finally, to ensure that an Internet DPO can indeed be distributed from the issuer directly to the investor, securities administrators should consider creating a parallel Small Business Registration Exemption.¹⁵⁹ The criteria would be identical to that of the Small Business DPO Exemption.

2. Electronic Delivery of Documents

As discussed above, the confusion over whether electronic delivery of documents satisfies the requirements in the B.C.S.A. is still an obstacle to true Internet-based securities offerings.¹⁶⁰ The B.C.S.C. should implement a confirmation of NP 11-201, at least in the context of the Small Business Internet DPO Exemption. This would ensure that small issuers, investors, and indeed

¹⁵⁷ It is anticipated that issuers would be successful enough that they would grow beyond the small issuer criteria, or wish to raise more than the \$10 million cap on subsequent offerings.

¹⁵⁸ SEDAR is an acronym for "System for Electronic Document Analysis and Retrieval." It is the storage system for documents filed pursuant to the disclosure requirements of the B.C.S.A. It is fully accessible over the Web. NI 11-401 Delivery of Documents by Issuers using Electronic Media Concept Proposal—Requests For Comments [CSA] makes it clear that currently,

[t]he rules governing electronic filings under the System for Electronic Document Analysis and Retrieval System (SEDAR—National Instrument 13-101) apply only to filings with the Canadian securities regulatory authorities and do not affect the obligation of filers to deliver information to investors under Canadian securities legislation.

However, there is no reason why securities administrators could not permit any particular documentation to be filed on the SEDAR site.

¹⁵⁹ An exemption from Part 5 of the B.C.S.A., *supra* note 20.

¹⁶⁰ Until the small issuer's financial statements indicate that it no longer meets the criteria necessary to take advantage of the exemption. Ideally, by the time this occurs, securities administrators will have implemented NP 11-201 such that it applies to all issuers.

the market could benefit from the full efficiency savings that Web-based disclosure can potentially provide.

It is also suggested that securities regulators might also exempt issuers offering pursuant to the Small Business Internet DPO Exemption from B.C.S.A. s. 49.¹⁶¹ Section 49 prohibits persons from calling at or telephoning to any residence in British Columbia before a prospectus is delivered and the resident has requested information pertaining to the prospectus. Although the provision is meant to prevent securities dealers from engaging in "cold call" sales, it is arguable that it might also restrict Internet communication. A declaration by the B.C.S.C. that small issuers are exempt would add certainty.

3. The "Test the Waters" Provision

The definition of "trade" prohibits any general solicitation prior to the delivery of a prospectus. This imposes a significant burden on small businesses. Traditionally, "issuers send out hundreds of offering circulars in hopes that a certain percentage of these circulars will produce investors. The circulars that do not produce investors are a necessary inefficiency."¹⁶² While large, conventionally underwritten offerings using an investment bank that possess an existing clientele list of sophisticated investors might be able to justify such an approach, it is not feasible for a small issuer. Therefore, it is suggested that the securities administrators incorporate a "test the waters" provision in the Small Business Internet DPO Exemption.

A "test the waters" provision refers to an exemption from the general solicitation restrictions imposed by the B.C.S.A. definition of "trade."¹⁶³ Briefly, it allows small issuers to gauge the level of investor interest before committing scarce corporate resources to an offering. A test the waters provision is crucial to realising the full potential of an Internet DPO primarily because of the nature of passive Web-based disclosure. One of the most appealing properties of the Internet is that it can enable issuers to provide corporate information to anyone accessing the Internet in an *interactive* fashion. For instance, with a test the waters provision, an issuer can post a notice of its potential securities offering on its Web page with a return coupon such that investors may indicate their

¹⁶¹ While it is true that s. 49(3)(b) provides that any person exempted from the registration requirements in s. 45 to s. 47, the Small Business Internet DPO Exemption does not fall under any of the registration exemptions available under s. 45 to 47. Therefore, a specific exemption from s. 49 would need to be created for the Small Business Internet DPO Exemption.

¹⁶² Gregg, *supra* note 56 at 434.

¹⁶³ Thomas P. Gallagher & Courtenay C. Hansen, "A Roadmap to Raising Capital on the Information Superhighway: Directions to Avoid the Potholes" (1999) 198-AUG N.J. Law. 39 at 40.

level of interest in the investment.¹⁶⁴ Absent an exemption from a general solicitation restriction, access to the issuer's Web site would have to be constrained, and interactivity limited, eliminating one of the primary benefits of Internet-based disclosure.

The foregoing proposals are the minimum necessary regulatory measures required to implement the Small Business Internet DPO Exemption. Adopting such an exemption would be a concrete step towards reducing the barriers faced by small issuers seeking capital. However, while the exemption would undoubtedly be a valuable tool for small issuers, the immediate question concerns the consequences that such an exemption might have for investor protection.

B. Unsophisticated Investor Protection Issues

There is little doubt that a Small Business Internet DPO Exemption might carry certain risks for investors. The obvious concern is Internet fraud. In a free-wheeling, anonymous Internet securities market, are there not far greater opportunities for unscrupulous persons to take advantage of unsophisticated investors? There is no easy answer, but as one commentator has stated,

fraudulent trading schemes are obviously not unique to the Internet and, as a practical matter, the Internet is unlikely to alter substantially the nature of securities fraud.¹⁶⁵

While fraud is a problem that must be taken seriously, some writers have argued that the Internet can also lend itself to improved investor protection through rigorous detection and enforcement by securities administrators in conjunction with private protection services furnished by Web-based market intermediaries.¹⁶⁶ While an extensive examination of the implications of Internet fraud is beyond the scope of this paper, the next section briefly considers several issues and examines how they might be addressed.

1. Regulation

Although the Internet may provide new avenues for fraud, it also facilitates improved enforcement. It is suggested that while the Internet may allow fraud to be practised on a larger scale than was historically possible, the corollary is that it is also more detectable.¹⁶⁷ For instance, the same Web communication capabilities that enable fraudulent persons to contact many people with little effort also make it more likely that their activities will come to the attention to securi-

¹⁶⁴ Gregg, *supra* note 56 at 436.

¹⁶⁵ Fisch, *supra* note 40 at 80. See also Part III above.

¹⁶⁶ *Ibid.*

¹⁶⁷ *Ibid.* at 81.

ties commission staff assigned to monitor the Web.¹⁶⁸ Warning investors also becomes easier because security administrators can post information regarding suspect operations on their Web pages, a centralised location that can be constantly and easily accessed by investors.¹⁶⁹

Another form of investor protection relates to the proposed creation of a new statutory civil liability provision. The B.C.S.A. should be amended to require that issuers maintain a certain level of security on their Web sites. This would guard against non-issuer-certified information being posted on their site, for example. In effect, investors could be relatively sure that the information regarding the company and the particular offering on such a Web site was, from the perspective of the issuer, accurate. For instance, if an issuer decided to set up a forum where investors could discuss the offering, or ask the issuer questions regarding it (i.e. a "chat room"), the issuer would be required to monitor the information and verify its content. If an issuer failed to sufficiently guarantee the accuracy of the security and information on its Web site, it would be subject to the same civil sanctions that are now currently available under the B.C.S.A.¹⁷⁰ Of course, the defence of due diligence would be available to the issuer if it could prove that it had taken reasonable steps to guard against any inaccurate information or fraud.

2. Market Forces

Fraud may also be avoided through small investor use of Internet-specific financial intermediaries. Internet investment banks have arisen, primarily serving two functions:¹⁷¹ they host prospectuses at their Web sites for prospective issuers and offer consulting services geared towards offerings conducted over the Web.¹⁷² Already, infant Internet underwriters are becoming more established and gaining more and more DPO experience.¹⁷³ These new entities will guide

¹⁶⁸ Giddings, *supra* note 71 at 811 states:

[t]he SEC can police Internet DPOs by merely checking out the Web site, which is easy to access. 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.

¹⁶⁹ Fisch, *supra* note 40 at 81.

¹⁷⁰ Gregg, *supra*, note 56 at 434.

¹⁷¹ For instance, "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 Giddings, *supra* note 71 at 811.

¹⁷² Kershenbaum, *supra* note 43 at 14.

¹⁷³ Giddings, *supra* note 71 at 814. For other examples of Internet-based intermediaries, see *infra* note 160.

investors to potential investing opportunities and aid small issuers, but will do it more cost effectively than traditional investment banks.¹⁷⁴

Further, it has been argued that, given the increased risks associated with small issuer public offerings, investors will actively desire to bind themselves to market protections to ensure that they limit any risk exposure to reasonable levels.¹⁷⁵ Once the regulatory framework is altered to facilitate Internet DPOs, issuers and investors will have the freedom to select investor protections that maximise their respective objectives.¹⁷⁶ In the Internet context, the "gatekeeper"¹⁷⁷ role, historically performed by traditional underwriters, will be assumed by new market participants.¹⁷⁸ Investors and issuers will make use of private gatekeepers who provide certification services that assure the accuracy of investment information and the merit of proposed securities offerings.¹⁷⁹

Securities regulators will also play an important gatekeeping function. By diverting resources to Internet fraud detection and enforcement,¹⁸⁰ securities

¹⁷⁴ Giddings, *supra* note 71 at 815.

¹⁷⁵ Choi, *supra* note 19 at 42.

¹⁷⁶ *Ibid.* at 42 to 55. Choi explains that public regulators will set a baseline level of investor protection. Beyond that, however, investors will be able to choose protections that accord with their particular investment goals. For instance, more sophisticated investors may choose to invest in riskier securities that hold out opportunities for greater returns. More cautious investors however, will pay a premium for intermediaries that provide certification of particular issuers' offerings.

¹⁷⁷ *Ibid.* at 2. Gatekeepers restrict access to the market by assessing the viability of offerings. Both market participants and securities administrators function as gatekeepers.

¹⁷⁸ Thomson, *supra* note 2 at 355-365. Thomson discusses the role beginning to be played by specialised Internet intermediaries and the services that they provide to companies wishing to conduct public offerings and secondary market trading via the Internet. See also Fisch, *supra* note 40 at 76-78 where the services provided by Internet-specific companies such as "Direct Stock Market" and "IPOnet" are examined, and Friedman, *supra* 1 at 5-7 where the IPOnet DPO process is described in further detail.

¹⁷⁹ *Ibid.* at 43-44.

¹⁸⁰ Of course, the immediate question is: Who will bear the costs of Internet enforcement? Two observations may be made regarding this question. First, it has been suggested that,

[c]omputerised monitoring and analysis of trading and other similar technological improvements may alleviate the need for the SEC to make changes to better prepare for the potential regulatory burden. Additionally, technological change might ease the burden of reviewing the disclosures of the various issuers and trading sites.

See Thomson, *supra* note 2 at 368. Second, if Internet enforcement does result in greater expenses to securities regulators (i.e. because technological improvements are not enough to off-set the increased costs), it is not unreasonable to suggest that issuers taking advantage of Internet DPOs should pay for them. Considering the cost savings that Internet DPOs may offer to issuers and in light of the fact that there will likely be some easing of the regu-

administrators can act to shut down fraudulent operations before investors are adversely affected, and also create a deterrence effect by vigorously prosecuting issuers that violate the B.C.S.A. Therefore, it is anticipated that, in combination, the efforts of the public and private regimes will meet the challenges of investor protection in cyberspace. Recent cases support the conclusion that securities regulators will likely be able to deal effectively with securities fraud.

3. Recent Cases

Two recent decisions of the British Columbia Securities Commission demonstrate that persons using the Web in their attempts to defraud investors are not attempting to do so in a particularly revolutionary way. In *Re Turner Phillips*,¹⁸¹ the British Columbia Securities Commission considered whether the securities firm of Turner Phillips had breached various provisions of the B.C.S.A. by setting up a Web site which alleged that members were registered to trade in British Columbia and solicited clients outside the province for the purpose of effecting trades in securities. The Commission found that members of the firm had traded without being registered pursuant to B.C.S.A. s. 34(1) and had made representations contrary to B.C.S.A. s. 50(1). Consequently, the Commission imposed a number of administrative sanctions on several members of the firm. In its reasons, the Commission stated that the facts demonstrated the "ability of the unscrupulous person to use the modern technology of communications to prey on the unwary."¹⁸²

In *Re American Technology Exploration Corp.*,¹⁸³ the senior officers of a British Columbia company had set up a Web site containing fraudulent misrepresentations regarding the company's prospective gold mine in Nevada which, according to the information contained on the Web site, was worth more than \$20 billion. The Commission found that the officers of the company had violated the registration requirements of B.C.S.A. s. 34(1) and, further, had breached B.C.S.A. s. 50(1) by making misrepresentations. The Commission imposed a number of administrative sanctions, including substantial fines, and prohibited the defendants from acting as officers of any British Columbia issuer for a specified period.

Both *Turner* and *American Technology* demonstrate that, while unscrupulous persons may attempt to use the Internet as a vehicle to commit fraud, the Internet does not seem to be creating many entirely new issues around securities

latory burden by technological improvements (See Giddings, *supra* note 71 at 811), it does not seem particularly unfair to require that Internet issuers contribute to enforcement efforts (e.g. by imposing a reasonable surcharge on Internet DPO filings).

¹⁸¹ [1998] 29 B.C.S.C. Weekly Summary 92 [hereinafter *Turner*].

¹⁸² *Ibid.* at 98.

¹⁸³ [1998] 4 B.C.S.C. Weekly Summary 7 [hereinafter *American Technology*].

fraud. Indeed, in *Re American Technology*, the British Columbia Securities Commission stated that the officers of the company had merely "used the modern technology of the Internet for the old fashioned purpose of promoting shares with outrageous misrepresentations."¹⁸⁴ Therefore, while attempts will undoubtedly be made to use the Web as a tool for securities fraud, it is likely that the combined efforts of securities administrators and Internet-based market intermediaries will ensure reasonable levels of investor protection.

V. CONCLUSION

PART II OF THIS PAPER EXAMINED the background of the Internet and highlighted its increased importance to Canadians and Canadian businesses. Part III discussed the problems that small businesses have traditionally faced in their efforts to raise capital and considered how direct public offerings of securities via the Internet might function to eliminate certain obstacles. Part IV examined the existing regulatory framework and considered how it impacted on the ability of small issuers to use the Internet as a mechanism to conduct public offerings. It then introduced the concept of a "Small Business Internet DPO Exemption" and proposed specific regulatory reforms necessary to create such an exemption. Finally, the implications that the Small Business Internet DPO Exemption might have for investor protection, specifically the concern of fraud, was briefly considered in light of recent case examples.

This paper concludes that, while the Internet provides exciting new opportunities to address the issues around small issuer capital financing needs, success is dependent on the support of a progressive and flexible regulatory framework. Internet DPOs can be a vehicle to reduce the disproportionate costs that small issuers must incur to conduct a public offering of securities, and a mechanism to effectively integrate retail investors' desire to participate in IPOs with small issuers' interest in their increased involvement. While plausible concerns regarding investor protection exist, it is suggested that the creation of a Small Business Internet DPO Exemption reconciles the interests of investors, issuers, and regulators while recognising the reality that the Internet is having an increasingly important impact on securities markets.

¹⁸⁴ *American Technology*, *supra* note 183 at 15.

