

REMARKS ON THE REGULATION OF SECURITIES AND SECURITY EXCHANGES IN THE AGE OF THE INTERNET[†]

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Thank you, Professor Miller. Although I was an SEC Commissioner for six years, I am no longer a Commissioner, and I am no longer an adjunct professor at the New York University School of Law—Dean Sexton has accepted my resignation after twenty-five most enjoyable years. I am simply a lawyer in New York City, albeit one who tends to be critical of the ways in which government exercises its authority.

Professor Joseph Grundfest, of the Stanford University Law School faculty, speaking a few weeks ago at a St. John's University program here in New York, presented a draft paper that he hasn't yet published. Dealing with an aspect of the topic we are addressing today, Professor Grundfest suggested (demonstrating both the sense of humor and the insight for which he is well known) that there are four regulatory approaches that a government regulator can take when confronted with the prospect of technological change. The regulator can be "technology forcing," it can be "proactive," it can be "reactive," or it can be "obstructionist." He said that the first type of regulation, "technology forcing," is exemplified by the government's automotive efficiency standards. He said that the second type of regulation, "proactive," can be equated to the actions of regulators who are early in the adoption of new technology, and become promoters of the new technology (by way of example, perhaps, the initiation by the SEC of its EDGAR facility for receiving and disseminating reports of its 15,000 registered companies). As to the third type of regulation, "reactive," Professor Grundfest said that the marketplace itself often de facto adopts and implements new technology, and thereafter the regu-

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lators in response seek to bring themselves rung by rung up to the market's new standard. That may be the usual mode—if you would, the default mode—for most regulatory activity. Finally, speaking of the fourth type of regulator, “obstructionist,” Professor Grundfest described regulators that are ever in opposition or are so non-responsive as to be an impediment to developing technology. Although, he hurried to point out that opposition is not necessarily wrong: A conviction that the hazards involved in new technology are great, which is sometimes the case, for example with the FDA, would quite justify being obstructionist. And Professor Grundfest of course added that there aren't any really bright lines separating these four categories.

Now, let's turn to the other side of the regulatory mirror, since the specific subject of this panel is the *industry's* approaches when confronted by the prospects of technological change. The securities industry may, it seems to me, take any or all of the same four approaches that Professor Grundfest described, when confronted with the prospects of technological change. Within the industry there will be some who force technology, and some of these may push themselves over the cliff by doing so. Some will be proactive, some will be reactive, some will be obstructionist. Some of each category will fail and some of each category will, presumably, succeed. So it seems to me that my best course today would be to give you a few examples of what has in fact occurred in the Internet arena. As you will remember, the Securities Act of 1933 was the first federal regulatory statute in this field, and a few of the 1933-Act-regulated developments in capital raising will be my focus of presentation here.

The first significant development was a letter elicited from the SEC staff in early 1995 by the firm of Brown & Wood, a law firm that often acts for leading firms in the securities industry. The industry had begun to utilize screen-appearing, screen-transmitted prospectuses, those booklets that have historically been the instrumentality for the dissemination of information about a new security or about a new company engaged in distributing its securities into the public markets for the first time. Athwart the road to widespread use, however, stood the words of the 1933 Act, which define “prospectus” and prescribe when and how a “prospectus” must be delivered; the words of a slew of SEC regulations adopted under that Act; and the interpretation and implementation of all those words by the SEC staff. At the insistence of a feisty and forward-looking lawyer, Joe McLaughlin at Brown & Wood, the SEC staff released a no-action letter to the effect that a screen-appearing, screen-transmitted set of pages could be a complying “prospectus” as statutorily defined, and that the transmission of

that prospectus could satisfy the delivery requirements of the 1933 Act and its regulations.

The no-action mechanism, I should explain to you, is a favorable SEC staff response to a letter coming in from a law firm or a lawyer or a client saying, "This is what I propose to do and I think it complies with the law and the regulations." To which the staff replies not with a blessing but with (if favorable) a statement that, "Without necessarily agreeing with your legal analysis, we can tell you that, on these facts, we won't recommend that the Commission institute enforcement action against you."

Then in the spring of 1996, still only four and a half years ago, Spring Street Brewing Company, a small microbrewery here in New York, engaged in a stock offering by self-transmitting and self-distributing an on-screen disclosure document via the Internet. It didn't happen to be a "prospectus" because it was distributed under the exemption called Regulation A, but it was an Internet-distributed disclosure document. At that point, industry efforts and demands to use the Internet were well ahead of what was in most lawyers' understanding, not to speak of what was conventional and therefore law-compliant in the minds of the regulators. The large investment banking houses and their institutional clients were by then communicating with one another via the Internet as a matter of course, in the evolution of the use of computers in their regular business procedures. In the Spring Street instance, it was a young ex-Cravath lawyer, Andy Klein, who took everyone by surprise by seeking to use the Internet as the modality for transmission and dissemination of information. He hadn't asked permission; he'd cleared the standard procedures for print-on-paper distribution under his exemption; and he'd gone ahead and transmitted over the screen.

The warp and woof of securities law, in terms not only of disseminating information but also of soliciting purchases, obtaining payment, and safeguarding purchasers' funds, is a very intricate fabric, and it might very well have been predictable that *any* client was going to stumble on some trip wire in the course of seeking to complete a securities offering online. What happened, however, was not illustrative of the finest of American government regulatory practices. The staff of the SEC came together to defend its ramparts. On one telephone call there were eleven, twelve, or thirteen staff personnel talking to Mr. Klein, saying, in effect, "The wrath of the gods be upon you; you have quite clearly violated the law." And it was only when the substance of that conversation was subsequently related to an SEC Commissioner, a person who was a long-time Washington lawyer,

who was himself Internet-literate and who has gone on to use the Internet in his own entrepreneurial efforts, that the staff was *directed* to assist Spring Street in achieving compliance. Of course there were certain accommodations that Spring Street had to make, but, instead of ending up in an SEC enforcement proceeding (or even in a criminal court, which was theoretically possible but highly unlikely), by virtue of the intervention of a Commissioner the offering was allowed to find a law-compliant way to go forward.

It is difficult to summarize the areas in which the industry subsequently pressed the SEC staff to build upon the Brown & Wood no-action letter and the letter of accommodation to Spring Street Brewing Company. By the spring of 2000, half a dozen thick regulatory pronouncements and at least an equal number of significant no-action letters had issued from the SEC and its staff, prescribing exactly how to use the Internet for this and that and prohibiting a variety of other uses of the Internet for this and that. Thank goodness for people like the other members of this panel to educe for us the nuances of what is implied between the words and what are the latest staff informal pronouncements in the private capital-raising arena and in the public capital-raising arena. But to bring the topic directly into your own experience, something that you will remember while you were here in law school, it's only last December—less than a year ago, isn't it—that the dot-com market was hot on Wall Street and that initial public offerings of dot-com companies were the rage. It was then, for the first time, that one of the industry participants took the public position that the Internet and the computer screen had to be acknowledged as utilizable to effect a securities distribution without any paper at all.

After the SEC has acted to declare a registration statement effective, the conventional understanding had long been that every broker had to call each of its interested customers and say, "Yes, I talked to you a week ago (or three days ago, or four weeks ago), and you said that you might want to buy shares of this particular company in the \$18.00–\$20.00 price range. Now the offering is actually being made at \$18.50. Are you still interested in 200 (or 1,000, or 50) shares?"

If you think about that conversation, it's a very simple conversation, and it was classically (in theory at least) what happened. In 1959, when I came to the Bar, and even in 1969 and 1979, it made a lot of sense. But to try to have that conversation in this day and age, and still to get an offering done, doesn't make a lot of sense at all. Nor is there anything in the words of the rulebook that says the broker can't call his or her customer the night before, or two weeks before, and say, "Why don't you just tell me the conditions on which I can

carry you forward if you really want to buy 200 shares at something close to \$18.50. Give me some kind of conditional offer.”

The concept of a “conditional offer” had appeared in the SEC’s originally proposed version of Rule 134 but had essentially been read out of the rulebook more than forty years ago. And what Wit Capital (which is an underwriter headquartered just over on Broadway at 12th Street, above The Strand bookstore) set out to do in 1998 was to say to the SEC, “Look, we just want to communicate with our clients by computer, over the Internet. We’ll tell them everything over the Internet. They’ll tell us what they want over the Internet. We’ll tell them what’s going on as many times as you want us to tell them, and what we want from you is the ability to effectuate this distribution without having to chase our customers all day on their beepers and their cell phones to get the answer that yes, they still want what they said they wanted a day or two or three ago.” But the 1933 Act theology, that you have to communicate with the customer *after* effectiveness, stood in the way of using the screen to accomplish distributions, and continued to stand in the way for eight or nine months, through multiple conversations and several conferences with the SEC staff.

In the course of those months, I took it upon myself to go back into history and find the person who was the chairman of the SEC when the concept of “conditional offer” was put into the proposed rule, in order to be able to assure the SEC staff that nobody in 1955 had any notion that the final rule would be interpreted the way the staff had in fact interpreted it for forty years; but the answer continued for a long while to be: “No, no, you have to do this our [the SEC staff’s] way.” The ultimately persuasive element, I think, was that since Wit Capital proposed to put everything on screen, there really could be no opportunity for somebody to do a “hard sell.” I mean that on screen the salesman’s voice can’t rise; he can’t beat on you; he can’t make you keep talking to him. It’s on screen. If you want to turn him off, you turn him off. There’s nothing he can do about it. All the concern about “hard sell,” which is a legitimate concern lying at the bottom of much SEC opposition to this kind of technological adaptation, could in the last analysis be dispelled, so that ultimately in July 1999, Wit Capital received its no-action letter.

Since then there have been three additional no-action letters (one of which also bears Wit Capital’s name, the other two having been given to Bear Stearns and W. R. Hambrecht) that allow auctions of new securities on screen. You can sit at your desk and watch the auction fill in, by price and quantity. You can see it, bid by bid, on screen. That, too, took months of negotiating with the SEC staff, but

the three letters finally emerged this past summer declaring 1933-Act-permissible (subject to certain conditions, of course) what is clearly for the benefit of the customers, the markets, and the distribution process.

My colleagues here on this panel are going to talk to you about other, similar issues in securities regulation, so I can leave to them the telling of how those issues were worked out. But I urge you to remember the King Canute story that you read when you were about seven years old. Several obeisant courtiers took the King down to the seashore urging him to tell the waves to stand still. When he did so, of course, the waves didn't cease rolling up onto the beach and the courtiers (in that case) were the ones who were embarrassed. In our governmental system it tends to be the other way: It is the regulator who thinks he can tell the waves to stand still; who has convinced himself that he has the power to tell the waves to stand still; who is in fact embarrassed.

I shall conclude, if I may, on an advocacy note. The regulated and registered entities in the securities industry are moving at a speed to over-balance the force of gravity, straight out into an orbital path of Internet-based disclosure and distribution, while the government regulatory agency is, in my view, insisting that the track on which the industry runs remain a two-dimensional oval track with speed limited to approximately a five-minute mile. By a statute that was passed four years ago amending the federal securities laws, the SEC was given, for the first time, very broad exemptive authority under the 1933 Act as well as under the other laws it administers, but both the SEC and its staff have all but refused to utilize that congressional authorization in matters relating to the Internet. One might put to you, as an audience of young people coming into this field, that it's time for the SEC to step back; it's time to police fraud—the scams and the fraudulent schemes that we all see on the front page of the tabloids and in the business and legal newspapers; it's time to rethink the impact of long-standing legal practice on capital raising. It's time to nail some theses on the door, to sweep away the whole encrusted theology of 1933 Act practice as it applies to the world of the Internet, and (if I may extend the analogy just a little bit) it's time to stop the sale of indulgences, which are known in securities law practice as “no action letters,” that obstruct the adaptation of the capital-raising function, and the capital-raising markets here in the United States and abroad, to the World Wide Web.

I thank you for listening.

POSTSCRIPT

The wonderful November 2001 epilogue to these November 2000 remarks is that the “it’s time” peroration in my final sentences seems, surprisingly, to be coming true. Despite the horrible events of September 11th, the SEC Chairman has publicly embarked on a deliberate program to alleviate the impact of longstanding legal practice on capital raising, to revise staff practices regarding the scope of no-action letters, and, most importantly, to modify substantially the 1933 Act theology that had been applied to restrict the use of the Internet in capital market transactions. It promises to be an exciting new era in securities regulation.

