

THE LATEST FRONTIER: ISSUING SECURITIES AND DISCLOSURE OF PUBLIC COMPANY DOCUMENTS OVER THE INTERNET

by Alexander Ciocilteu and Howard Levine*

Introduction:

The Internet, and especially the World Wide Web, have revolutionized the process of information dissemination and retrieval throughout the world. This bottom-up revolution is still a work in progress. It was therefore only a matter of time until this vehicle touched the securities industry. Today, its effects are impacting one of the core elements of the public markets: the distribution of securities and the dissemination of information to the public. In this article, we will look at some of the securities law issues raised by the use of the Internet and the response of Canadian and foreign regulatory authorities to this phenomenon.

Broadly speaking, there are two ways for a company to issue securities to the public: by way of private placement or public offering. In the case of a private placement, a restricted number of qualified investors are solicited to invest in a company. Typically, the disclosure prepared in connection with such a transaction is summary in nature. Shares issued pursuant to this mechanism are subject to resale restrictions.

In the case of a public offering, a prospectus is prepared and filed with the securities regulatory authorities. This disclosure document is then used to solicit investments from the public at large. A prospectus contains information about such matters as the company's business, financial performance, competition and risk factors. The disclosure in the prospectus is closely regulated by the securities regulatory authorities in each jurisdiction in which investors are being solicited. Issuing securities pursuant to a prospectus has the advantage of reach, in that it permits a company to solicit all types of investors and to offer them shares that are not subject to any resale restrictions. However, the principal drawbacks of the prospectus process are its cost and the length of time which it takes. Preparing a prospectus can involve substantial costs, including accounting, legal, translation and printing fees, as well as commissions payable to the agent or syndicate of agents who market the securities to the public. As well, it typically takes approximately three months from the beginning of the process to the receipt of the funds by the company, during which time market conditions can change, placing the entire operation at risk.

Internet and Regulation of Public Companies

The Internet's allure is in its potential to impact on some of the costs associated with the preparation and marketing of a prospectus and to increase the speed of completion of an offering. The Internet offers the ability to instantaneously deliver a prospectus (once approved by the appropriate securities regulatory authorities) to the masses over the Internet, either through the use of push technology such as e-mail mailings or passively by making it available through a company's Web site.

The Internet is also having an impact on the manner in which public companies disclose material information to the public, including annual reports (which disclose year-end financial information and management's analysis thereof) and proxy solicitation materials (which provide information

about shareholdings, remuneration of senior management and matters upon which shareholders are asked to cast a vote at the company's annual meeting of shareholders). The traditional paper-based manner in which such information is disseminated involves the incurring of significant printing and mailing costs. Moreover, it requires companies to act through the intermediary of brokers as opposed to being able to send materials directly to their shareholders, a process which creates additional delays and may sometimes result in shareholders never receiving the materials.

The Internet can make the dissemination of this information faster, cheaper and more effective. Companies can simply e-mail these documents either directly to their shareholders or, alternatively, to brokers who can in turn forward the e-mail packages to their clients. This can all be achieved more rapidly and at a lower cost than is the case with paper-based materials. Similarly, shareholders can return their responses directly to the company by e-mail. The potential for efficiencies in transactional speed and reduced costs are great, as are the potential benefits of a closer, more direct relationship between the company and its shareholders.

Regulatory Challenges of the Use of the Internet

Of course, if the statements above were unqualified truths, this article would not have been published. The fact of the matter is that issuing securities and disclosing information over the Internet seems to raise as many concerns as it resolves. Some, such as security and privacy, are inherent to the Internet. Others result from the nature of the regulatory regime governing the securities industry. Below, we will discuss some of the important issues specific to the securities industry and the Internet.

Common to both the distribution of securities over the Internet and the delivery of other public company documents electronically are the issues of the reliability of the information provided, its accessibility and the means of its delivery. The overall thrust of the regulatory framework governing the securities industry is the protection of investors and its corollary, the promotion and maintenance of confidence in the integrity of financial markets. The protection mechanisms put into place in order to ensure that investors receive appropriate levels of disclosure and accurate information were designed for a paper-based system of dissemination. As a result, making documents available over the Internet re-opens many of these issues.

The current view of the Canadian securities regulators on Internet-related matters is expressed in two draft policy statements (regulatory instruments which facilitate harmonisation between provincial and federal securities regulation) which have been elaborated on the subject matter. While these policy statements are currently only in draft form, they provide useful insight into the direction that the regulators are heading in.

Disclosure of Documents Over the Internet

The basic premise underlying the new policy is that the delivery of documents through the Internet should not diminish a company's obligations as they currently exist in connection with the paper-based system. The regulators have identified five areas of concern regarding the delivery of documents over the Internet: the recipient must be notified of a delivery; the recipient must have access to the document; there must be evidence that the document has been delivered to the recipient; the information transmitted to the recipient must maintain its integrity; and companies must be cautious when using hyperlinks. We will briefly address each in turn.

Delivery of Documents

Public companies wishing to transmit documents which they are required by law to provide to shareholders must ensure that such documents are actually delivered to the intended recipient. The policy therefore requires that, at a minimum, the recipient receive notice that a document has been or will be sent electronically. The notice can take the form of an e-mail (either informing the recipient that a document is available electronically or actually transmitting the document by e-mail), a telephone call or a letter sent by regular mail. Ideally, however, before the electronic delivery of documents is effected, a company should obtain the written consent of the recipient to such means of delivery. The consent form should describe the intended means of communication and the manner in which the recipient will be informed of the availability of documents, as well as any hardware or software requirements necessary to be able to receive and have access to the information.

Access to Documents

The policy stresses that documents made available electronically must be easily accessible by the intended recipient. This means that if, for example, a document is made available on a company's Web site, the backbone system behind it must be powerful enough to provide fast access and handle high levels of traffic. Furthermore, the document itself must be formatted in a manner which would, to the extent possible, make it accessible independently of the software used by the recipient (such as by using Adobe Acrobat[™] format and providing a link to the site where the software is freely available for downloading, or by using Java applets to permit viewing). According to the policy, access also means that a recipient must have the ability to retain a permanent copy of the document, either by printing it, saving it on a hard disk or requesting it from the company.

Evidence of Delivery

Evidence of the successful delivery of electronic documents is a particularly thorny question. The policy states that delivery can be presumed by a company if it has been made pursuant to the delivery mechanism described in the consent form signed by a recipient. This legal presumption is necessary given that currently technology does not permit for confirmation of the actual receipt by the intended recipient.

The technological limitations of the Internet also create problems related to the integrity of the information received. The policy states that electronic documents should not deviate substantially from the paper format of such documents. Furthermore, electronic documents should be encoded or created with software which prevents their modification so as to ensure that the information received by the recipient is identical, both in form and content, to the original master document created by the company. As a corollary, while the policy does not specifically address this issue, it can be inferred that a company must also take measures to ensure that the electronic documents are not contaminated by viruses or bugs which can diminish their accessibility or cause harm to the recipient's computer.

Use of Hyperlinks

Finally, the policy addresses the use of hyperlinks in electronic documents. One of the advantages of the Internet is the ability to direct a user to different sources of complementary information through the use of hyperlinks. However, the policy cautions that a company which uses hyperlinks to outside information risks being deemed to have incorporated such information into its own documentation and, as a result, being held legally responsible for its accuracy and completeness.

Companies are therefore cautioned to distinguish between documents which are being delivered pursuant to legislative requirements and those which are merely being provided through hyperlinks as a matter of convenience for the recipient, and to provide the appropriate disclaimers regarding the latter.

Issuing Securities Over the Internet

In addition to the general mechanical issues discussed above, the specific question of soliciting investors over the Internet raises additional regulatory concerns regarding jurisdiction over the company issuing the securities and control over access to the offering by non-qualified investors.

A company soliciting investors either by clearing a prospectus with one or more provincial securities commissions and then placing the prospectus on its Web site or by posting a private placement offering memorandum on its Web site could be seen as soliciting investors who are resident in jurisdictions other than those in which it initially qualified its prospectus or private placement or who do not fulfil the eligibility criteria. Access to a company's Web site is universal and unrestricted. Therefore, one challenge of Internet offerings is to design the solicitation process in such a manner as to make it clear which categories of investors are qualified to participate in the offering and to put into place controls to ensure that such restrictions are respected. At one end of the spectrum, the prospectus or other offering document could simply contain a disclaimer limiting the jurisdictions from which orders can be placed and the categories of investors eligible to purchase the securities. At the other end of the spectrum, through the use of passwords or a pre-screening registration process designed to filter unauthorized persons, a company can restrict access to the Web site containing the prospectus or other offering document to people who are situated in an eligible jurisdiction and who fulfil the eligibility criteria.

In deciding what limits to place on the availability of solicitation documentation while conducting an offering over the Internet, companies should keep in mind that generally, regulators will assume jurisdiction over an offering if the offering is clearly targeted at residents of their jurisdiction (for example, pushed to them through e-mail); if there is sufficient information available on the Internet to residents of their jurisdiction so that it can be deemed to constitute an offering under the legal definitions of that jurisdiction; or if sufficient sales are generated from that jurisdiction, regardless of the information provided. Certain jurisdictions have cast a wide net in attributing to themselves jurisdiction in securities matters. For example, a company issuing securities through the Internet and located in British Columbia, Ontario or Quebec will be subject to the prospectus requirements of those jurisdictions even if the securities are being offered exclusively to persons outside those jurisdictions. On the international level, Germany will deem an offering to fall under its jurisdiction if German investors are not expressly excluded from the offering through clear language or are not restricted from accessing the documentation. In the United States, the Securities and Exchange Commission will deem an offering to fall within its jurisdiction if, in its view, insufficient steps are taken to exclude United States residents from participating in the offering. Given that legislative requirements and disclosure standards vary between jurisdictions, great care must be taken when planning an Internet offering to ensure that a company does not inadvertently become subject to the regulatory requirements of an unintended jurisdiction.

Conclusion

As the latest frontier, the Internet holds out great potential to change the manner in which securities are offered and companies communicate with their shareholders. It would seem to these writers, however, that in the short-term, the greatest impact of the Internet can be found in the electronic transmission of documents to shareholders. As we have seen above, while the current

regulatory regime is still very much evolving, the benefits of speed and lower cost can make the electronic transmission of documents very attractive. On the other hand, the offering of securities to the investing public over the Internet seems to these writers to be more of a long-term project. Currently, the so-called Internet IPOs have been in the news more because of their novelty than because of their unqualified commercial success. Important issues related to the regulation of Internet offerings remain and jurisdictional problems are only beginning to be addressed by the regulators. Furthermore, despite its reach, attempting to market an offering directly over the Internet without the backing of a brokerage firm can be risky. The presence of a brokerage firm serves to enhance investor confidence both in the primary market and in the secondary market. In our opinion, for the moment, the Internet is better suited to act as a transmission medium rather than as a forum for raising capital.

* Alexander Ciocilteu is a lawyer and Howard Levine is a partner in the securities department of Lapointe Rosenstein, a Montreal law firm specializing in commercial law and corporate finance.