Can Internet Offerings Bridge the Small Business Capital Barrier?

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Internet technology offers the potential to reduce the search and information costs associated with capital formation. Commentators have suggested that the Web will enable small business to achieve better access to the capital markets. To facilitate this access, they have suggested regulatory reforms to make Internet offerings cheaper and easier. At the same time, small business offerings have been identified as among the most risky, offering a caution to those who counsel regulatory reform. This Article examines the existing regulatory climate. State and federal regulators have adopted a number of recent reforms to facilitate the use of the Internet and to reduce the regulatory burden on small business offerings. The Article explores proposals for further reform and evaluates the existing evidence on the extent to which previous regulatory changes have affected the use of the Internet for small business capital formation. The Article observes that, despite these reforms, small businesses have had limited success to date in using the Internet as a substitute for traditional financing methods. The Article goes on to consider the effect of substituting public capital markets for traditional small business financing sources, such as banks, angel investors, and venture capital, if technological and regulatory change makes this substitution possible. In particular, the Article identifies nonfinancial benefits that banks and private equity provide to small businesses through active managing and monitoring. Shifting the source of small business capital may sacrifice these benefits, at the cost of future business performance.

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I. INTRODUCTION

A variety of factors have traditionally limited the access of small business entrepreneurs to the capital markets. These factors include the difficulty for potential investors of obtaining adequate information about small business investment opportunities, and the risks, transactional complexities, and regulatory burdens that make it costly for small businesses to exploit sources of capital. By reducing the search and information costs associated with small business capital formation, Internet technology offers new potential for small businesses to raise capital. This potential has prompted regulatory initiatives to facilitate the use of electronic technology for small business capital formation.¹

At the same time, regulators have identified small businesses as some of the riskiest investment opportunities.² Companies with small capitalizations present disproportionate risks of both business failure and fraud. These risks may be magnified by Internet-based securities transactions. The low cost and wide distribution of Internet offerings makes the Internet an easy vehicle for fraudulent securities transactions.³ Although the Securities and Exchange Commission (SEC) has made efforts to respond to this potential, its ability to address fraud in the securities markets is limited by jurisdictional constraints and the international scope of Web-based fraud.

Regulatory reform⁴ therefore appears to be a mixed blessing, offering greater access to capital for businesses at the cost of increased risk to

¹ See, e.g., Nikki Tait & Nicholas Denton, ASX to Offer Fund Raising on Internet, FIN. TIMES, June 12, 1997, at 34, available in 1997 WL 11034279 (describing an innovative plan by Australian Stock Exchange to create an alternative capital market on which unlisted small businesses could advertise for equity funds).


³ See Chat Room, FIN. NET NEWS, Feb. 24, 1997, available in LEXIS, News Library, Curves File (interviewing John Stark, SEC Special Counsel for Internet projects, who describes how cheap software and easy access make it easy for someone to commit securities fraud from the privacy of his or her own living room).

⁴ The most popular reform proposals call for expanding the degree to which issuers can market and sell securities over the Internet without complying with state and federal law registration requirements. See, e.g., Revision of Rule 144, Rule 145
investors. Evaluating the desirability of proposals to reduce the regulatory burden associated with Internet securities offerings requires an assessment of both these factors. Before adopting reform proposals, we should further examine the extent to which Internet technology is likely to enhance small business capital formation. At the same time, it is necessary to consider the Internet's potential to increase investor risk, particularly the risk of fraud. Although there is limited experience to date with the use of Internet-based securities offerings, this Article examines the existing evidence and offers a critical assessment of the potential effects of increased use of Internet technology.

An additional factor should be included in the foregoing analysis. If technological and regulatory change provides small business with better access to the public capital markets, direct public offerings may substitute for the more traditional early- and middle-stage capital sources such as banks and venture capital funds. This substitution may not be desirable. In particular, public equity holders may not provide small businesses with the benefits needed to develop. The "gap" between the cost of capital for small and large businesses may be attributable, in part, to the monitoring and managing resources provided by some capital sources. Shifting the source of small business capital may therefore create an unacknowledged cost by adversely affecting businesses that substitute public investors for angels or venture capitalists.

II. SMALL BUSINESS CAPITAL FORMATION AND THE CAPITAL GAP

The almost twenty million small businesses in the United States create many new jobs and technological developments. Statistics from the Small Business Administration (SBA) indicate that small businesses comprise almost half the Gross National Product and are a rapidly growing sector of the economy. Thus, the general economy is substantially...
affected by small business economics. At the same time, small businesses are critically dependent on adequate capital sources. "The chief cause of small business failures—after management error—is lack of capital."7

Traditionally, small businesses have had limited financing options. An entrepreneur typically funds the operations of a start-up company through a combination of personal funds and the contributions of friends and family members. Following the exhaustion of this seed money, the business must look to other capital sources.

Loans are one possible source of small business capital. Studies show that bank loans are the primary source of outside capital for small businesses.8 Nonetheless, small businesses often have difficulty qualifying for bank loans; they frequently lack the necessary collateral, operating history and proven track record. Economic fluctuations9 and changes in the banking industry may also create credit crunches that limit the amount of money available for small business loans.10 As a result, although bank loans are critical to small businesses, small businesses receive only a small share of the credit available to U.S. companies.11 Those businesses

Bwirle File (reporting that small businesses make up 47% of the U.S. Gross National Product).

7 Mario P. Borini, Give Small Businesses the Tax Break They Deserve, BUS. WK., June 18, 1984, at 11.

8 See Rebel Cole et al., Bank and Nonbank Competition for Small Business Credit: Evidence from the 1987 and 1993 National Survey of Small Business Finances, 82 FED. RES. BULL. 983, 988 tbl.4 (1996) (showing that, according to 1993 survey, banks supply more than 80% of small business credit); Diana Hancock & James A. Wilcox, The Credit Crunch and the Availability of Credit to Small Business 1 (May 23, 1997) (unpublished manuscript, on file with author) (stating that banks, particularly small banks in particular, are the primary source of credit for small business); Thomas B. Rumfelt, Small Business Owner and Chairman, National Business Owners Association, Prepared Statement Before The House Committee On Banking And Financial Services Subcommittee On Capital Markets, Securities, and Government Sponsored Enterprises Concerning H.R. 2981, The Entrepreneurial Investment Act of 1996, FED. NEWS SERV., Apr. 18, 1996, available in LEXIS, Genfed Library, Fednw File [hereinafter Statement of Thomas B. Rumfelt] (A 1993 survey by the Federal Reserve Board and the U.S. Small Business Administration found that about 95 percent of small businesses relied on depository sources (defined as commercial banks, savings institutions, credit unions, and similar lenders) as their chief financing source.).


10 For example, the degree to which consolidations in the banking industry have affected availability of small business loans remains subject to debate. See Marie Gentron, Availability of Small Business Loans Debated, BOSTON HERALD, Mar. 5, 1996, at 20, available in LEXIS, News Library, Supal File (describing two recent studies that reached different conclusions about the effect of bank acquisitions on loans to small businesses).

11 See Statement of Thomas B. Rumfelt, supra note 8 ("The U.S. Small Business Administration's Office of Advocacy found that although small companies represent about half of the U.S. economy and employment, they receive only about 10 percent of the measurable financing.")
that are successful in obtaining bank financing are most likely to be those in which the owners have sufficient personal wealth to provide personal guarantees or collateral as security.  

Bank loans may also be a problematic capital source for small businesses. The cash flow demands of debt financing can be burdensome and may limit the opportunity for growth through reinvestment of earnings. Businesses may be unable to meet interest obligations during periods of economic uncertainty. Finally, the traditional conservatism of bank loan officers may be incompatible with the risks of entrepreneurship. Loan terms that allow a bank to block risky projects or ambitious expansion may cripple business development.

Equity financing traditionally moderates the shortcomings of debt financing by providing a long term capital source compatible with the economic fluctuations and risks of a developing business. However, a variety of factors impede small business access to the public equity markets. The transaction and regulatory costs associated with an initial public offering (IPO) are substantial. In addition, many of these costs, such as the cost of the registration process under the federal securities laws, are fixed and large in proportion to the offering size for a business seeking a limited amount of capital. A small business without a proven track record may also have difficulty obtaining the services of a reputable underwriter and, without those services, may be unable to market its securities adequately. Most importantly, however, the risks associated with investment in a small business, including agency costs and informational asymmetries, as well as the basic uncertainty associated with the development of unproven products or services, are likely to render the cost of passive equity investments too high.

Private equity financing is another alternative. Venture capital funds frequently invest in small businesses at an earlier stage, before an IPO is practical. Venture capitalists typically take an active role in monitoring and managing the firms in which they invest. Active involvement together with staged financing allows venture capitalists to address the information and agency problems of the small business better than public equity. Venture capital funds typically acquire large equity stakes in development-stage businesses and assist the entrepreneur in preparing the company for an eventual public offering. The funds realize their return when the business goes public.

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12 See Robert B. Avery et al., The Evolution of Small Business Finance: The Role of Personal Wealth 21 (May 23, 1997) (unpublished manuscript, on file with author) (finding personal commitments to be an economically important feature of small business lending relationships).


14 Id.
Although the venture capital industry has received significant attention, venture capital funding is not a suitable capital resource for many small businesses. Venture capital funds focus on firms with substantial funding needs and the capacity for rapid growth—factors that tend to eliminate many small and start-up companies. Historically, venture capitalists have rejected ninety-nine percent of the businesses that seek capital from them. Moreover, venture capital funding is generally available only to firms that have successfully financed their initial growth and is not available for seed capital. Finally, the active participation of venture capitalists may be undesirable to an entrepreneur who seeks to retain control over his or her company.

Business angels have been identified as filling the resulting gap between start-up funds and other capital sources. Angels are high net worth individual investors who provide private equity financing to firms on an informal basis and typically a smaller scale than venture capital investments. Angels range from financially sophisticated investors who take an active monitoring approach to relatively unsophisticated and passive investors. Many angels have developed expertise in the industries or localities in which they invest. This experience may allow angels to evaluate a new business more accurately, thereby reducing the information costs associated with the investment. Although estimates on the actual extent of angel financing vary tremendously, angels account for annual capital investments of at least $10 billion to $20 billion.

The nature of these capital sources complicates an evaluation of the market for small business capital. It is difficult to quantify the informal and private sources of equity. In addition, when investors provide additional services—such as managing or consulting—the bundling of these services with funding distorts the calculation of the cost of capital. Thus,

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16 See, e.g., William E. Wetzel, Jr., Angels and Informal Risk Capital, SLOAN MGMT. REV., Summer 1983, at 23 ("Angels fill what would otherwise be a void in the risk capital markets by providing development funds for technology-based inventors... that do not meet the size and growth criteria of professional venture investors... ).
18 Freear et al., supra note 17, at 109.
for example, the cost of venture capital funds is considered high, but the
managerial services provided by venture capitalists are rarely reflected in
this assessment.

Despite these difficulties in measurement, funding availability for
small business is often viewed as inadequate. Commentators have
proposed a variety of regulatory and business reforms to address this "capital
gap."20 However, it is somewhat unclear what the gap entails.21 It is clear
that small businesses face limited availability and higher costs of capital
than large corporations. Studies suggest that the high cost and limited
availability of capital causes many small businesses to have difficulty
meeting their capital needs.22 Given the localized availability of some eq-
uity capital, there may be inefficiencies in the angel and venture capital
markets.23

The inability of small businesses to find adequate capital may not
indicate a market failure, however. The high failure rate of small busi-
nesses demonstrates the risky nature of small business investment; small
businesses may not generate sufficient returns to compensate investors
for assuming this risk. In addition, the inability of businesses to obtain
funding does not demonstrate the existence of underfinanced positive
net present value projects. Indeed, anecdotal evidence suggests that a
variety of implausible business propositions are successful in obtaining
investor funds.24

Accordingly, addressing the small business capital gap requires an
assessment of the reasons for the gap and, in particular, the factors that
increase the cost of small business capital. If the cost is due to agency
problems, uncertainty about the business enterprise, or impacted infor-
mation, technological change seems unlikely to address the problem.25

20 See, e.g., Ellen Golden, Chair, SBA Policy Sub-Committee, Prepared Statement
before the Senate Small Business Committee, Fed. News Serv., June 12, 1997, available in
LEXIS, Genfed Library, Fednew File (describing creation of the Small Business Ad-
ministration's "Microloan Program").
21 See, e.g., Duxbury et al., supra note 17, at 44 (evaluating explanations for capi-
tal gap in terms of market efficiency and regional fragmentation and offering alter-
native analysis based on interpersonal dynamics).
22 See, e.g., Curtis J. Milhaupt, The Small Firm Financing Problem: Private Information
23 See, e.g., Colin M. Mason & Richard T. Harrison, Closing the Regional Equity
(finding "various 'gaps'" in the supply of venture capital due to spatial investment
patterns and proposing improvements in efficiency of informal equity markets to fill
these gaps); Brian R. Talcott, Comment, Economically Targeted Investments: Using Public
Pension Fund Dollars to Close Capital Gaps in Oregon, 74 OR. L. REV. 1031, 1033 n.18
(1995) (describing lack of venture capital funding for Oregon start-ups due to small
size and geographical location of these businesses).
Formation for Small and Emerging Businesses, Conference Proceedings (Lewis & Clark,
25 See generally OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM
(1985) (examining transaction cost economics by looking at problems in economic
However, if a major factor in the high cost of small business capital is the cost of securities transactions, including search costs, the cost of assembling and communicating company information, and the cost of regulatory compliance, the Internet offers a possible solution.

Internet technology can facilitate small business access to both private and public investors. In the private equity market, the Internet offers particular potential to reduce the search costs associated with angel investing. Traditionally angels have invested locally.26 This leads to geographic variations in the availability of angel money.27 By reducing the cost of matching angels and investment opportunities on a national scale, the Internet may increase such matches. ACE-Net, the Small Business Administration's Internet-based matching service, was developed for this purpose—to facilitate the matching of angel investors with small businesses seeking capital.

The Internet may also reduce the cost of exploiting the public equity markets. The Internet provides small businesses with a low cost mechanism for communicating information directly to public investors. If public investors prove willing to invest on the basis of this information, small businesses may be able to tap the public equity markets without the cost associated with engaging investment bankers and other traditional intermediaries. One of the major limiting factors for this capital source is the regulatory cost associated with direct public offerings. Accordingly, reform proposals have advocated relaxation of the regulatory burdens associated with Internet offerings in an effort to increase small business capital access.

III. REGULATION OF SMALL BUSINESS SECURITIES OFFERINGS

Small business securities offerings are regulated by both state and federal law. In general, the federal securities laws require businesses to file a registration statement before making any public offering of securities, to refrain from selling securities until the registration statement becomes effective, and to accompany all written offers of securities with a prospectus. Traditionally, however, Regulations A and D have limited the application of these requirements to small offerings and those that are not made to the general public.28 Regulation A provides a simplified

organization); Oliver E. Williamson, Transaction-Cost Economics: The Governance of Contractual Relations, 22 J.L. & Econ. 233, 245-54 (1979) (discussing governance structures as factors in economization of commercial transactions).

26 See Duxbury et al., supra note 17, at 46 (explaining that angels "prefer to invest 'close to home'").

27 See Wetzel, supra note 16, at 27 (explaining that 75% of angels live within 300 miles of the ventures they finance).

28 Regulation A, 17 C.F.R. §§ 230.251 to .263 (1997); Regulation D, 17 C.F.R. §§ 230.501 to .508. None of the modifications described in this section eliminate the applicability of the antifraud provisions of the federal securities laws to small business securities transactions. Additionally, although Congress preempted the application
disclosure process for public offerings that are limited in size. For example, an offering under Regulation A allows issuers to furnish prospective investors with an offering circular instead of the more lengthy prospectus required by the full registration process.37 Regulation D exempts certain small and limited offerings from the registration process completely.38

The utility of these provisions has been expanded through recent regulatory reform. Beginning in 1992, the SEC adopted a series of initiatives to facilitate small business capital formation. In March 1992, the SEC proposed, and in record time adopted, the “Small Business Initiatives,”39 which were followed with additional revisions on April 28, 1993.40

The initiatives extended the application of Regulation A to larger securities offerings by increasing the dollar amount of securities that could be offered under Regulation A from $1.5 million to $5 million in any twelve-month period.41 The disclosure required for a Regulation A offering was also simplified; issuers were given the option of using a question-and-answer offering circular. Regulation A was modified to include a “test the waters” provision whereby businesses could solicit indications of interest in a proposed offering before preparing a disclosure document.42 This allowed businesses to decide whether there was sufficient investor interest in an offering prior to undertaking the necessary document preparation costs.43

The initiatives also modified Regulation D. In particular, Rule 504 was expanded essentially to deregulate, at the federal level, public offerings by private issuers44 of up to $1 million worth of securities in a twelve-

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37 See 17 C.F.R. § 230.251.
38 See id. §§ 230.501 to .508.
41 See 17 C.F.R. § 230.251.
42 See id. § 230.254.
43 Solicitations of Interest Prior to an Initial Public Offering, Securities Act Release No. 7188, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,639, at 86,885 (June 27, 1995) (explaining that “testing the waters” allows issuers to “avoid significant, unnecessary compliance costs” if there is insufficient interest in the offering). In 1995, the SEC reported that, since the “test the waters” procedures were adopted in 1992, 61 issuers submitted “testing” solicitations to the SEC, and 26 of those companies followed the solicitation with a Regulation A or registered offering. Id. at 86,886.
44 Private issuers, for purposes of Rule 504, are issuers that are not subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act. 17 C.F.R. § 200.504(a)(1).
month period. Rule 504 provides maximum flexibility to small issuers: there is no limitation on general solicitation of, or advertising to, public investors; the offering need not be limited to accredited or sophisticated investors; and the Rule imposes no disclosure requirements.\(^\text{35}\)

Other Regulation D provisions still contain some restrictions that limit their utility for small business capital formation. Rules 505 and 506 restrict the number and, in some cases, the type of investors who can be solicited.\(^\text{36}\) Securities issued under Rules 505 and 506 are deemed "restricted securities" and are subject to a holding period before they can be resold without full registration. Finally, Rules 505 and 506 prohibit general solicitation and advertising of offerings,\(^\text{37}\) including testing the waters to determine potential investor interest in an offering. Issuers who violate this prohibition have poisoned the well and lose the ability to rely on a Regulation D exemption.\(^\text{38}\)

Subsequently, the SEC has considered further changes to the regulation of small business capital formation. On June 27, 1995, the SEC solicited comments on whether Regulation D should be amended to permit some type of general solicitation or advertising.\(^\text{39}\) The SEC also considered the desirability of extending the test the waters provision from Regulation A to Regulation D offerings or to registered IPOs generally.\(^\text{40}\) To date, neither change has been adopted. Thus the restrictions of Rules 505 and 506 continue to limit issuers relying on these exemptions from broad access to the public capital markets.

Also on May 1, 1996, the SEC adopted new Rule 1001—the California exemption. The exemption was spurred by California's adoption of a small business exemption under its state blue sky laws, which was designed to aid capital formation.\(^\text{41}\) The exemption is similar in structure to Regulation D and exempts qualifying offerings\(^\text{42}\) of up to $5 million from

\(^{35}\) See id. § 230.502(c).

\(^{36}\) Rule 505 allows offerings of up to $5 million to accredited investors plus an additional 35 persons. Id. § 230.505. Rule 506 permits offerings with no dollar limit to accredited investors plus an additional 35 sophisticated persons. Id. § 230.506.

\(^{37}\) See id. § 230.502(c).


\(^{41}\) CAL. CORP. CODE § 25102(n) (West Supp. 1997).

\(^{42}\) The law exempts offerings made to certain classes of qualified investors that are similar, but not identical, to the classes of accredited investors defined by Regulation D. Small Business Registration Exemption, Securities Act Release No. 7285.
state law registration provisions. However, unlike Regulation D, the California exemption permits some methods of general solicitation. Rule 1001 creates a parallel provision exempting offerings subject to the California exemption from federal registration. In its adopting release, the SEC expressed its hope that other states would follow California's lead in adopting similar small business exemptions and explicitly stated that it would provide analogous exemptive treatment for other states.

Other recent efforts by the SEC to reduce the regulatory burden on small business have included the adoption of an integrated disclosure system for small issuers under Regulation S-B. The SEC also increased from $5 million to $10 million the asset threshold that subjects issuers to the periodic reporting requirements of the Securities Exchange Act of 1934. The SEC explained that these revisions were necessary adjuncts to the modifications to Regulation A because small issuers who successfully conducted an exempt Regulation A offering could easily become subject to the reporting requirements of the Exchange Act, thereby losing the relief from burdensome disclosure that the Regulation A exemption was designed to provide.

To date, the SEC continues to demonstrate its willingness to revise its regulatory requirements to aid small business capital formation. In 1996, it issued a concept release soliciting comment on the best way to improve regulation of capital formation while adequately protecting investors. The SEC has also been engaged in a series of town hall meet-


ings with small business entrepreneurs to discuss problems faced by small businesses in raising capital.32

The SEC's effort to aid small business capital formation has been somewhat hampered by a lack of coordination between the federal disclosure standards and the requirements of state securities laws. Most regulatory provisions relieving small issuers from the federal registration requirements have not been duplicated at the state level. Moreover, because each state can impose its own blue sky requirements, the compliance burden for a small issuer seeking capital in more than one state is compounded.

In the Small Business Investment Incentive Act of 1980,33 Congress directed the SEC to address this problem by working with state securities officials to develop a uniform exemption from registration for small issuers. Regulation D is supposed to serve as the basis for this uniform exemption. A task force of the North American Securities Administrators Association (NASAA) has been working to develop a uniform limited offering exemption (ULOE) that would free small business issuers from state law registration requirements.34 However, state regulators have, in many cases, viewed the SEC's effort to assist small issuers as unduly sacrificing investor protection.35 Accordingly, although most states have adopted some form of limited offering exemption, the ULOE itself contains more extensive requirements than Regulation D, and the requirements adopted by individual states are far from uniform.36

The ULOE also is not coordinated with Rule 504.37 Most states, however, provide a small corporate offering registration (SCOR) for the smallest offerings made pursuant to Rule 504. In 1989, state regulators approved a standardized SCOR form for offerings of up to $1 million;38 the standardized form can now be used in approximately 44 states.39 Finally, offerings made pursuant to Regulation A are generally not covered

33 Id. at 1586 n.46.
35 Campbell, supra note 56, at 188.
36 See Small Corporate Offering Registration (SCOR), 1 Blue Sky L. Rep. (CCH) ¶ 5461, at 2557 (1997) (describing uniform registration for offerings up to $1 million).
37 See id. (listing states that have adopted the SCOR form).
by any of the state level exemptions or simplifications and, because they are public offerings, are subject to the full state registration process. Thus, state regulation has continued to undercut the flexibility of the federal exemptions.60

Congress most recently attempted to address the burden of state registration requirements on capital formation through the adoption of the National Securities Markets Improvements Act of 1996 (NSMIA).62 The NSMIA gave the SEC the power to exempt securities transactions from duplicative regulation. In addition, for the first time in the history of U.S. securities regulation, Congress explicitly preempted certain aspects of state blue sky regulation. The statute preempts state securities registration, qualification and merit review63 of certain classes of “covered” securities transactions. These include nationally traded securities; securities sold to “qualified purchasers,” which the SEC has been given rulemaking power to define; and securities sold in private transactions under Section 4(2), including private placements under Rule 506.64

However, the NSMIA provides little relief for small issuers. In particular, covered securities transactions do not include offerings made under Rules 504 and 505 and Regulation A.65 Thus, with respect to the smallest offerings, Congress explicitly preserved state regulatory authority. Although the SEC has the power to extend the preemptive effect of the statute by promulgating a broad statutory definition of “qualified investors” even this power will not exempt small public offerings from state regulation.66

IV. THE REGULATORY RESPONSE TO INTERNET SECURITIES TRANSACTIONS

Technological developments have enabled small businesses to make greater use of the regulatory provisions facilitating small business capital formation. Technology—the Internet in particular—offers new methods for offering and selling securities. Businesses can distribute financial information and solicit investors through the Internet more quickly and at

60 Campbell, supra note 56, at 194 (describing state registration requirements as significantly undercutting the usefulness of Regulation A).
63 States can still impose notice requirements and, in some cases, require payment of fees in connection with sales of covered securities. 15 U.S.C.A § 77r(c)(2)(A) (1997).
65 Campbell, supra note 56, at 198-99.
66 But see Campbell, supra note 56, at 206-10 (advocating that the SEC use its definitional authority broadly to determine that all purchasers of securities in transactions exempt under Rules 504, 505 and Regulation A are “qualified purchasers”).
lower cost than was previously possible through paper-based communications. Online information posted to Web sites provides a mechanism for continually updated disclosure. Computer technology has also created a variety of new methods for trading securities, ranging from alternatives to traditional stock exchanges and broker-run order processing programs to online bulletin boards designed to allow individual investors to identify trading counterparts. Finally, businesses have begun to explore the possibility of raising capital directly through Internet solicitations and securities offerings.

Federal and state regulatory authorities have explicitly addressed the application of technological developments to securities transactions. At the federal level, the SEC has evaluated the use of Internet communications and concluded that electronic transmission may be used as a substitute for paper delivery of prospectuses and other investor communications. The SEC first authorized Internet delivery informally in a No-Action Letter issued in response to an inquiry by Brown & Wood. The letter, in addition to validating electronic delivery, specified a variety of procedures to protect investors in connection with electronic communications. These procedures included requiring that investors consent to receiving electronic disclosure, providing investors with appropriate notification when documents become available electronically, and ensuring that documents could be downloaded or otherwise stored to allow investors continual access to them.

There has been a variety of experimentation into various forms of computer-based stock trading. Much of the innovation dates back to the Seventh Circuit’s conclusion in Board of Trade v. SEC, 923 F.2d 1270 (7th Cir. 1991), that Delta system, a proprietary electronic trading system, did not constitute a stock exchange for purposes of regulation under the Securities Exchange Act of 1934. See Regulation of Exchanges, Exchange Act Release No. 38,672, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,942, at 89,630, 89,633 n.1 (May 23, 1997) (describing a variety of “alternative trading systems” including “proprietary trading systems,” “broker-dealer trading systems,” and “electronic communications networks,” as “automated systems that centralize, display, match, cross, or otherwise execute trading interest, but that are not currently registered with the Commission as national securities exchanges or operated by a registered securities association.”). Alternative trading systems present a variety of regulatory concerns. See id. (discussing two alternatives that would integrate alternative trading systems into mechanisms that promote market protection).


The use of the Internet to sell stock directly to investors is not limited to small businesses. It is now possible to buy stock directly from dozens of publicly traded companies, including companies listed on national stock exchanges. Netstock Direct maintains a Web site containing contact information for investors about corporations offering direct stock investment programs. Netstock Direct, Investing Direct Online (visited Mar. 8, 1998) <http://www.netstockdirect.com>.

The SEC subsequently formalized its position regarding electronic delivery in several releases. In an interpretive release issued in October 1995, the SEC explained that it viewed information distributed through electronic means as satisfying the delivery or transmission requirements of the federal securities laws if such distribution resulted in the delivery to the intended recipients of substantially equivalent information as if the required information were delivered in paper form. The SEC also elaborated on the procedural requirements for electronic delivery of prospectuses, proxy statements and other investor information, which it described as less stringent than the requirements previously set forth in the Brown & Wood No-Action Letter. Rather than taking a rigid, rule-based approach, the interpretive release described the standards applicable to electronic delivery. The Release granted approval to electronic delivery methods that complied with those standards, regardless of the particular electronic medium employed. The Release also set forth a series of fifty-two examples in which the standards were applied to specific fact patterns.

In a companion release, the SEC proposed technical amendments to various broker-dealer regulations that had been premised on paper delivery to conform those rules to the principles in the interpretive release. In its subsequent release adopting the technical amendments in May, 1996, the SEC enumerated the information requirements applicable to broker-dealers. The Release described various standards of conduct applicable to electronic delivery, including the need to maintain security of customer information, the requirement that the method adequately ensure delivery, and the importance of complete recordkeeping.

In addition to electronic delivery, the SEC has considered the growing use of the Internet for securities trading. Wall Street has experienced tremendous growth in the use of online trading systems, which are now used by brokers, institutional investors, and individual customers. Major

78 October Interpretive Release, supra note 71, at 53,459.
79 Id. at 53,460.
80 Id. at 53,461-66.
82 May Adopting Release, supra note 71, at 85,805.
brokerage firms increasingly provide customers with the opportunity to trade securities through online accounts.77

More controversial are alternative trading systems that allow investors to bypass the exchanges through electronic matching systems and bulletin boards. Currently, these systems are regulated, for the most part, as broker-dealers.78 This approach may compromise some of the market regulation objectives of the federal securities laws such as transparency and investor access. Accordingly, as alternative trading systems become increasingly viable substitutes for registered stock exchanges, the SEC has identified the need to consider other approaches to regulation.79 Despite these concerns, the SEC has given broad approval to Internet trading systems, so long as those systems contain sufficient investor protection safeguards. For example, with respect to online bulletin boards that allow interested buyers and sellers to post their willingness to trade on the Internet and locate potential counterparties without incurring extensive search costs or paying commissions, the SEC has issued a series of no-action letters that authorize the operation of the bulletin boards without requiring that the operators comply with the regulatory requirements applicable to broker-dealers, stock exchanges, or investment advisers.80

The SEC has also indicated its approval of Internet-based securities offerings. Spring Street Brewing Company became the first company to make an online offering of securities when, in February 1995, it posted its Regulation A offering circular on the Internet.81 Although the offering did not technically comply with the SEC’s guidelines, the SEC subse-

79 See id. at 89,630 (soliciting comments in response to technological advances and growth of alternative trading systems).
quently indicated that the combination of Internet posting and electronic delivery satisfies the requirements of a Regulation A offering. Based on the SEC's approval of the use of Internet technology, it is now possible for small businesses to sell securities over the Internet in compliance with federal law either by making a limited offering under Regulation D or by making a Regulation A offering and publishing the required offering circular on the Internet.

In addition to permitting Internet Direct Public Offerings (DPOs), the SEC has agreed that issuers may use the Internet to market securities to qualified or accredited investors without sacrificing the applicability of the relevant exemptions from registration. On July 26, 1996, the SEC confirmed to the broker-dealer W.J. Gallagher & Co. that it could post private offerings on password-protected pages of its Web site IPOnet. So long as the postings were accessible only to previously qualified members, the SEC found that they did not involve general solicitation or advertising within the meaning of Regulation D. In accordance with Regulation D and the California Exemption, IPOnet limits access to information about private placements to its members, who must complete a questionnaire and be designated as accredited, sophisticated or foreign before obtaining such access.

The SBA has developed a similar Internet Web site designed to match accredited investors with small businesses seeking capital through an offering exempt from registration under either Regulation A or Regulation D. ACE-Net, which went online on April 17, 1997, has been granted no-action relief by the SEC. The service allows small businesses to place offering materials on the ACE-Net site for viewing by prospec-

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88 An offering under Rule 504 requires no federally mandated disclosure and may be made through a general solicitation; an offering under Rule 505 or 506 may be made over the Internet if access to the offer is limited to qualified investors. See 17 C.F.R. § 230.502(c) (1997) (discussing the applicability of the ban on general solicitation to offerings made under Regulation D).


90 The SEC confirmed in a no-action letter that IPONet's posting of private offerings on password-protected pages accessible only to previously qualified members would not involve general solicitation or advertising within the meaning of Regulation D. Id.


ACE-Net does not allow issuers to market securities directly to the public; prospective angels must meet the SEC's accredited investor requirements and fill out an application before viewing offering materials. Access to specific company information is controlled by password.

Finally, the SEC has granted no-action relief to an issuer seeking to use the Internet to permit prospective investors to view road shows for public offerings electronically. Through the use of an Internet Web site, the issuer can film the presentation qualified investors typically see at a live road show and distribute the information to a broader range of investors, thus reducing information and search costs. The SEC agreed that the electronic road show does not constitute a prospectus under federal law and consented to the road show's proposed format in which prospective investors are qualified in advance and obtain access to the road show through an underwriter.

Although state securities laws continue to impose a regulatory burden upon small business securities offerings that are exempt from the federal registration process, state regulators have acted affirmatively to facilitate Internet offerings. In particular, states have addressed the fact that an Internet offering technically extends beyond traditional jurisdictional boundaries by modifying their registration requirements. Although securities offered over the Internet and sold within a state are subject to state blue sky regulation, states have exempted securities offered generally through the Internet but not sold within the state from these regulations.

Pennsylvania regulators were the first to address the issue. In August 1995, Pennsylvania issued an order providing that securities offered on the Internet would not be deemed subject to state registration requirements, provided that the securities were not sold in the state and that the offering indicated that no offer or sale of securities was being made in...

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See Flowers, supra note 86, at 1 (describing the enrollment process and fee for investors and entrepreneurs). See also ACE-Net (visited Sept. 15, 1997) <http://ace-net.sr.unh.edu/search> (explaining that ACE-Net listings are available only to accredited investors who have subscribed to ACE-Net and received a password).


See id. (describing wider availability and more cost-efficient transmission of information provided by electronic road show).

The terms of the road show also require the prospective investor to agree that copying, downloading and distribution of the road show is not permitted. Id.

See discussion supra Part III.

Spring Street's Internet offering, for example, was registered in 18 states and the District of Columbia. See Cella & Stark, supra note 77, at 823 n.40 (describing Spring Street's offering and the state law requirements).
Approximately forty-seven states have followed Pennsylvania's lead in adopting provisions exempting Internet offerings from the registration requirements of the state if the securities are not actually sold in the state. The NASAA has also adopted a resolution encouraging states to develop exemptions for Internet offerings. If states act in accordance with this resolution, it will only be necessary for Internet issuers to comply with the registration requirements of states in which the securities are to be sold, rather than being subject to the costs of fifty state blue sky law compliance.

V. SMALL BUSINESS CAPITAL FORMATION AND INTERNET OFFERINGS

A. Current Developments in Internet Offerings

Spring Street Brewing Company's initial Internet securities offering in February, 1995, raised approximately $1.6 million. After making a second Internet offering, Spring Street raised a total of almost $5 million. Following the extensive publicity surrounding the Spring Street offering, a number of issuers have attempted to market their securities directly to public investors using the Internet. These offerings are a subset of a rapidly increasing number of DPOs. In recent years, the number of companies using DPOs has increased to several hundred per year. DPOs enable issuers to bypass the high cost of Wall Street underwriters, which are generally uninterested in handling the small-scale offerings of start-up firms.
Although DPOs need not be made over the Internet—some companies have attempted to reach public investors by announcing stock offerings on product packaging or through direct contact with customers—the Internet reduces the marketing costs that, even for a small offering, can be extensive. For example, Michael Quinn, who raised $467,000 through direct contacts and advertising in the homeopathic community, incurred costs of over $100,000 in doing so. Using the Internet allows issuers to reach a broader range of potential investors at substantially lower cost.

These costs can be further reduced through the use of centralized Web sites for securities offerings, on which an individual issuer can post standardized information for electronic distribution. Several such Web sites have been created. Direct Stock Market, for example, provides a Web site for making a public offering under Rule 504 or Regulation A or a private placement under Regulation D. A recent visit to Direct Stock Market revealed a dozen current public offerings. Another online Web site, Financial Web, offers a variety of financial information including the opportunity to invest online in IPOs and to receive e-mail notification of new offerings. Financial Web's IPO offerings are handled by InvestIn Securities Corporation, a brokerage firm, and the e-mail notification is of IPOs in which InvestIn is part of the selling group of underwriters.

pursuing small scale IPOs). Companies like DirectIPO have started to fill the void, offering issuers assistance in raising amounts of capital that are too small to generate underwriter or venture capital interest. Id.

107 See Mark Kollar, Do-It-Yourself Public Offerings, INV. DEALERS' DIG., Mar. 24, 1997, at 14 (describing Annie's Homegrown, a macaroni company that publicized its offering by putting coupons with a tombstone announcement in packages of pasta).

108 See id. (explaining degree to which Internet postings can reduce printing and mailing costs associated with a small offering).


110 See, e.g., Kim Tyson, Austin Company Goes Public on Net, AUSTIN AM.-STATESMAN, Sept. 3, 1997, at D2, available in LEXIS, News Library, Curnws File (describing estimated cost for Internet public offering by Globalstatistics Corp. at $180,000 versus anticipated cost of more than $500,000 for an IPO through a traditional underwriter).


115 See InvestIn.com Securities Corp., New Issues Registration Form for IPOs, Secondaries, ADRs, Private Placements & Bridge Financings (visited Feb. 24, 1998) <http://InvestinIPOs.com/smallcapinv/register.html> (describing how investor can receive e-mail notification of IPOs by registering with InvestIn Securities Corp.).
IPOnet provides a similar, centralized Web site for both DPOs and private placements. Created by a broker-dealer, IPOnet distinguishes itself from Direct Stock Market and similar online offering sites by requiring that issuers have an independent third party investigation of the principals, company, legality, and pricing of the issue.\footnote[111]{See IPONet (visited on Sept. 15, 1997) <http://www.zanax.com/iponet> (explaining IPONet’s posting policies); Leslie Eaton, Click Here to Buy Risky New Shares, INT. HERALD TRIB., Oct. 24, 1996, available in LEXIS, News Library, Curnws File (describing creation of IPONet and efforts to use it to market shares of Javelin Systems, Inc.). A recent visit to IPONet revealed two postings of public offerings. IPONet (visited Feb. 24, 1998) <http://www.zanax.com/iponet/public.htm>.} IPOnet also allows investors to use e-mail to indicate interest in a public offering under Rule 134(d).\footnote[112]{See IPONet Letter, supra note 84, at 77,274 (verifying that electronic indications of interest would be treated equivalently to paper communications).}

Despite these efforts to create online securities marketplaces, the success of the Internet offering has been limited to date.\footnote[113]{See, e.g., Jennifer Files, Camelot on the Web, DALLAS MORNING NEWS, Apr. 9, 1997, at 1D, available in LEXIS, News Library, Curnws File (reporting that, although hundreds of companies have tried to raise capital over the Internet in the last few years, "perhaps 20 have been successful").} Few companies have succeeded in raising substantial amounts of capital over the Internet,\footnote[114]{Rafter, supra note 98, at D1.} and although the Internet offering sites have received widespread publicity, they have closed few deals.\footnote[115]{See id. (reporting that in the past year, IPONet has only closed three deals and Direct IPO has not closed any).} Most issuers using Internet offerings have been forced to turn to more traditional marketing techniques to sell the securities.\footnote[116]{See id. (reporting that months, although Santa Monica-based Direct Stock Market completed twelve deals over the course of the last year, none relied exclusively on Internet marketing).} The experience of Directional Robotics is typical: after doing extensive work to complete a Web-based offering, the company only raised $200,000 of its $5 million target, and ultimately abandoned the Internet for more traditional offering methods.\footnote[117]{Id.}

B. The Effect of the Internet on Capital Formation

To what extent should federal and state regulation of Internet offerings be modified, in order to facilitate small business capital formation on the Internet? To answer this question, it is necessary to understand the results of recent Internet offerings and to evaluate the potential for the Internet to increase small business access to capital. Although the modest experience to date with Internet offerings makes it difficult to predict their eventual impact on small business capital formation, and Internet offerings will undoubtedly become more successful as investors and issuers become accustomed to electronic offering procedures, there
are a variety of possible explanations for the limited success of recent offerings that call into question the utility of regulatory reform.

Internet Web sites are efficient ways of providing information, but the Internet may be less effective at selling securities because of consumer perception of risk, because of the absence of personalized marketing, and because it is difficult for consumers to evaluate and verify the quality of the information provided. These shortcomings are not limited to securities offerings, but may be more significant when an Internet user is evaluating information about a business opportunity rather than a product, and when the investor is contemplating the commitment of substantial amounts of capital based on this information.

In comparison to traditional IPOs, Internet offerings are passive, relying on potential investors to seek out and identify desirable transactions. In contrast, one of the services that an investment bank provides in connection with an IPO is its ability both to identify potential investors and to convince these investors to participate in the offering. It may also be the case that the informational value of an Internet posting is less substantial than it first appears. Small businesses generally have difficulty raising capital because of informational asymmetries and the inability of investors to judge the quality of the offering. These deficiencies are not remedied by the type of information that can be posted on a Web site.

In a traditional IPO, the investigation and certification provided by investment bankers and venture capitalists is critically important to the success of the IPO, in part because of the investors' inability to evaluate the offering themselves. Empirical studies have demonstrated that IPO pricing is directly related to the participation and reputation of outside professionals, such as investment bankers. The participation of reputable venture capital firms can complement underwriter certification and reduce IPO underpricing further. Eliminating these professionals may appear to save a small business substantial costs. In reality, however, the absence of underwriter participation may increase information costs for the potential investor. Investors may be unwilling to bear these costs.

See, e.g., G. Christian Hill, Adult Net Users in U.S., Canada Put at 58 Million, WALL ST. J., Dec. 11, 1997, at A11 (describing Nielsen survey indicating that 58 million adults in the U.S. and Canada use the Internet, but finding that 54% of these users say they do not intend to buy goods or services online).

See Swolop, supra note 100, at 4 (relating that investors cannot obtain independent information on the quality of DPO offerings because "no investment bankers are checking the company's references and no analysts or brokers are researching or recommending the stocks.").


Investors may also view the absence of outside expert involvement in Internet offerings as a negative signal. Investors may reasonably perceive that an issuer who bypasses the traditional underwriter route does not meet the quality standards of the investment banking community. After all, if an issuer can raise more money through a traditional IPO, why would a company that qualifies to do an IPO choose a DPO instead?\(^{122}\) Indeed, although the high cost of small business capital is sometimes attributed to market failure, it is more likely to reflect real risks associated with microcap investments for which investors require compensation. Statistics indicate that less than a third of DPOs succeed in raising their minimum offering amounts,\(^{123}\) and that approximately sixty percent of DPO issuers fail.\(^{124}\) It may be the case that microcap securities, whether marketed on the Internet or otherwise, simply are not desirable investment opportunities. The fact that a small business is seeking capital is no indication that it offers potential investors a positive net present value opportunity, and the failure of many small businesses to raise capital may result more from poor fundamentals than excessive information costs.\(^{125}\) Given these risks, to the extent that the Internet allows small issuers to bypass traditional certification tools such as the involvement of an investment bank or a venture capital fund, it may actually reduce the ability of investors rationally to evaluate these risks and thus reduce small business access to the capital markets.

In addition to the general investment risk associated with a start-up company, investors in microcap issuers also face a liquidity risk.\(^{126}\) Because small and private offerings do not create a public market for resale, only investors who are able to hold an illiquid security are a viable source of capital for most small businesses.\(^{127}\) A New York Times article de-

\(^{122}\) See, e.g., Hal Lux, The Search for the Killer APP, INST. INV., Apr. 1997, at 91 (quoting Hambrecht & Quist president Daniel Case III who stated, "To think that the Internet is going to take the place of a full underwriting with aftermarket support is silly . . . Would you take your company public without trying for the best?").

\(^{123}\) See Gruner, supra note 104, at 68 (citing statement by Bill Beatty of Washington State Securities Division that only 27% of the state's DPOs succeed in raising their minimum offering amounts).

\(^{124}\) Id.

\(^{125}\) See Rafter, supra, note 98, at D1 (describing possibility that lack of success of Internet-based IPOs may be due to poor fundamentals of issuing companies).

\(^{126}\) Illiquidity has been described as imposing a higher cost of capital on firms because it imposes a greater risk upon investors—the risk that they may not have access to their money when needed. See Douglas W. Diamond & Robert E. Verracchia, Disclosure, Liquidity, and the Cost of Capital, 46 J. FIN. 1325 (1991) (describing how increased liquidity can reduce a firm’s cost of capital); Marcel Kahan, Securities Laws and the Social Costs of “Inaccurate” Stock Prices, 1992 DUKE L.J. 977, 1020 (1992) (explaining value of liquidity to investors).

\(^{127}\) See, e.g., Sobol, supra note 4 (describing secondary market illiquidity as a problem for smaller issuers); Frank A. Taylor et al., Symposium: Closely Held Business: Problems and Solutions: The Issuance of Securities by Small and Growing Businesses: A Primer, 22 WM. MITCHELL L. REV. 1375, 1403-04 (1996) (“Only investors who are
sribing the direct offering of stock in Dalton Coffee explained, for example, that shares currently did not trade through a broker or on an exchange, but that investors could call a toll free number to be advised of developments in matching prospective buyers and sellers. For the time being, the stock, like that sold in many DPOs, was trading on "ad hoc markets."

Computer technology offers the possibility of partially reducing the liquidity risk of small business investments through the use of online trading bulletin boards. These bulletin boards, which have been created by several small issuers, allow investors to locate interested buyers and sellers by posting information on the Internet. By reducing the cost of locating interested counterparties, the bulletin boards enable investors to trade without costly commissions, and they increase the information available to investors about the market for the relevant securities.

Finally, Internet offerings present the risk of fraud. The media have publicized the popularity of the Internet as a tool for fraudulent transactions generally, and although Internet offerings are in their infancy, dishonest promoters have been quick to capitalize on the Internet's potential for cheating investors. The SEC has already identified and prosecuted promoters in connection with a variety of fraudulent Internet offerings, including pyramid schemes, false promises and sales of nonexistent securities.

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. The misrepresentations made on the Internet in recent SEC prosecutions could alternatively have been dis-

willing and able to invest in an illiquid security provide a viable source of capital under the Rule 504 and 505 exemptions.

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128 Swolop, supra note 100, at 4.
129 Id.
130 See supra note 80 and accompanying text.
133 See, e.g., Leslie Eaton, Slow Transition for Investing: Stock Market Meets Internet, N.Y. TIMES, Nov. 11, 1996, at A1 (stating that the SEC had, as of November, 1996, "brought nine enforcement actions against people trying to sell unregistered securities over the Internet"). See also Cella & Stark, supra note 77, at 837-44 (detailing SEC investigations and prosecutions for Internet fraud); SEC Office of Investor Education and Assistance, Investor Fraud and Abuse Travel to Cyberspace (visited Mar. 1, 1998) <http://www.sec.gov/consumer/cyberfr.htm> (describing cases of SEC action against Internet securities fraud).
seminated to investors by mail or telephone. Indeed, the SEC has indicated that "existing securities laws are adequate to address the issues and problems" associated with Internet securities fraud. The power of the Internet to transcend jurisdictional boundaries suggests, however, that it may be more difficult for victims and regulators to trace the source of fraudulent offers and obtain legal recourse against wrongdoers. In particular, with the ability easily to post offerings from outside the United States, rogue promoters may tax both the jurisdictional reach of the United States legal system and the practical reach of U.S. enforcement efforts.

On the other hand, although Internet fraud may be practiced upon a larger scale than in the old-fashioned boiler room, it is also more detectable. The SEC has assigned enforcement personnel to surf the Web and identify fraudulent postings before investors are injured, a procedure not available to combat traditional fraudulent offerings. The SEC has also set up its own Web site, which offers investors the opportunity

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134 See Andrew Osterland, IPOs in Cyberspace, FIN. WORLD, Apr. 22, 1996, at 24 (quoting SEC officials' description of fraudulent Internet solicitations as differing from traditional fraud only in form).


138 See, e.g., Darrell Hall, Note, No Way Out: An Argument Against Permitting Parties to Opt out of U.S. Securities Laws in International Transactions, 97 COLUM. L. REV. 57, 83-84 (1997) ("If sales of securities to U.S. investors can be effected through the Internet or other international computer networks without being subject to U.S. securities regulations, it will become much easier to perpetrate fraud on American investors from remote locations."); Eaton, supra note 133, at D8 ("Adding to the regulators' challenge is the Internet's international nature, which makes it possible for foreigners outside of the regulators' jurisdiction to try to sell fraudulent investments to Americans."); Steven M.H. Wallman, Regulation for a New World, an SEC Commissioner talks about capital formation in the age of the Internet, BUS. L. TODAY, Nov.-Dec. 1996, at 8, 10 (describing how the absence of geographic borders for Internet communications renders traditional bases for exercising regulatory jurisdiction more tenuous).

139 See, e.g., Suzanne Manning & Phyllis Diamond, Microcap Fraud, Staffing Issues Top Enforcement Agenda, 29 SEC. REG. & L. REP. 1769, 1773 (1997) (quoting SEC Division of Enforcement Director William McLucases as stating that the Internet has made it easier for the SEC to police fraud through the SEC's Web site, online complaints and SEC surveillance of Internet activity).


to report fraud electronically.\textsuperscript{142} Taking advantage of the Web’s informational capacity, the SEC has used Internet postings to warn of the promulgation of fraudulent information. For example, in December 1996, the SEC posted warnings on both its own Web site and America Online about the accuracy of posted information about the stock of Omnigene Diagnostics, Inc.\textsuperscript{143} SEC Director of Enforcement William McLucas stated that the SEC would continue to use the Internet to warn prospective investors of fraud.\textsuperscript{144} These warnings can be particularly effective in addressing the use of Internet postings to manipulate stock prices.

The Internet’s fraud potential is augmented in the case of Internet IPOs by the degree of fraud prevalent generally in small business offerings. That investors are less able to protect themselves from this fraud is evidenced by the number of lawsuits brought against small issuers such as Silicon Valley start-ups.\textsuperscript{145} The abuses in the penny stock market that led to enactment of the Securities Enforcement and Penny Stock Reform Act of 1990 (Penny Stock Act)\textsuperscript{146} typify the increased fraud potential associated with direct marketing of microcap securities to individual investors.\textsuperscript{147} Despite the restrictions imposed by the Penny Stock Act, the microcap market continues to present substantial opportunities for fraud,\textsuperscript{148} due in part to the ability of issuers to circumvent its regulations through higher pricing of individual shares.\textsuperscript{149} A variety of factors independent of

\textsuperscript{142} Endless Retesting, Fraud Tips From the Web, NAT’L L.J., July 22, 1996, at A10 (describing the SEC’s cyberspace “Enforcement Complaint Center”).

\textsuperscript{143} See Bruce Rule, SEC Internet Warning Gets Response, INVESTMENT DEALERS’ DIG., Dec. 9, 1996, at 17 (describing SEC’s posting); Leslie Eaton, Let the Cyberinvestor Beware: A Tale of Stock Promotion, Regulation and the Internet, N.Y. TIMES, Dec. 5, 1996, at D1 (describing use of the Internet to promote Omnigene Diagnostics).

\textsuperscript{144} Rule, supra note 143, at D1.

\textsuperscript{145} See, e.g., Michael Goolsby, The Orange Grove; Prop. 211: Trial lawyers Seek Their Revenge, ORANGE COUNTY REG. (Cal.), Oct. 29, 1996, at B06 (reporting that over one-half of the top 150 Silicon Valley technology firms were sued for securities fraud).


\textsuperscript{147} See, e.g., Gary Weiss, Investors Beware Chop Stocks are on the Rise, Bus. Wk., Dec. 15, 1997, at 112 (describing why relatively cheap stock is a more viable tool for defrauding investors).

\textsuperscript{148} See id. (describing extensive fraud in microcap securities market); Manning & Diamond, supra note 139, at 130 (quoting William McLucas as describing fraud in microcap securities as an enforcement priority for the SEC in 1993).

\textsuperscript{149} Under SEC Rule 3a51-1(d), “penny stock” does not include securities priced at five dollars or more per share. 17 C.F.R. § 240.3a51-1(d) (1997). Thus, brokers or issuers can circumvent the penny stock rules by setting stock price above the definition. See O. Dennis Hernandez, Jr., Broker-Dealer Regulation Under the New Penny Stock Disclosure Rules: An Appraisal, 1993 COLUM. BUS. L. REV. 27, 34 (describing this option). See also Weiss, supra note 147, at 116 (describing fraud in connection with sale
the Internet contribute to this fraud and increase the risks of purchasing small business stock through an Internet IPO.

Information costs, higher risk, and the possibility of fraud all offer explanations why the high cost of small business capital may be an appropriate response to market conditions rather than evidence of a market failure. These conditions also suggest that the Internet may have a limited impact on the perceived capital gap. Although the Internet may reduce the cost of widely disseminating general business information, the regulatory and certification costs of capital formation result from real investor needs that the Internet is unlikely to render obsolete. Moreover, attempts to reduce disclosure, enforcement, or investor remedies in an effort to decrease capital formation costs may be counterproductive in that, in the absence of regulation, investors may simply demand a higher return to compensate them for the increased risk. This demand may have the net effect of reducing capital availability to small business.

C. The Effect of Internet Offerings on Small Business

Whether deregulation combined with new technology will increase small business access to capital is an empirical question. Existing data is insufficient to answer this question, although, as this Forum demonstrates, small business capital access is an attractive and important subject for continued study. The eventual success of Internet offerings is likely to depend on a variety of factors, including the degree to which online bulletin boards and other mechanisms for increasing liquidity continue to develop and the degree to which the public perceives the SEC’s Internet enforcement efforts as effective. With the growing popularity of the Internet, these subjects will receive continued attention.

Little attention has been directed, however, to the impact upon small businesses of substituting Internet securities offerings for traditional sources of financing. One of the rationales for facilitating Internet offerings is the Internet’s potential to allow small businesses to access public investor capital in a cost-effective manner. If the Internet becomes a successful tool for securities offerings, it thus has the potential to change the source of small business funding from bank loans and private equity to the public equity markets.

To date, commentators have not considered the consequences of this change upon small businesses. Indeed, the dialogue about small business capital formation focuses primarily upon the acquisition of capital as the ultimate objective. Ultimately, however, the success of a business is not measured by its ability to raise capital, but by its ability to employ its capital to generate profits. At least in the small business con-

of Java Centrale stock which, at $6 per share was not officially classified as penny stock).
text, the source of capital may not be independent of its ability to generate profits.

In particular, when a small business obtains capital from traditional sources, it typically receives more than money. The traditional capital sources used by small business—banks, angels, and venture capital funds—frequently provide managerial and monitoring services in addition to operating funds. Thus, small business capital sources may serve as active investors. Through the relationship with these investors, the entrepreneur is exposed to outsiders with business experience who have substantial control over subsequent operations. As a result, an entrepreneur with little managerial expertise may be guided into management tasks such as the formation of a business plan or the development of a marketing strategy.

Obviously, large public companies have alternative sources of managerial expertise. The traditional separation of ownership and control in the publicly traded corporation has been explained in terms of the specialization that results from delegating business operations to a professional management team. The entrepreneur of a small business is not necessarily a professional manager, however, and a small business generally lacks the separate centralized management associated with a large corporation. The board of directors in a publicly traded corporation complements management by providing additional managing and by monitoring the exercise of management discretion. Small businesses typically lack professional boards, and it is unlikely to be cost-effective for a small business to obtain these services through straight consulting agreements.

If small businesses obtain a bundle of capital funding and managerial support from the capital markets, it is alternatively possible to explain the relatively higher cost of small business capital in terms of the additional services provided. Although it is difficult to quantify the value of management, monitoring and consulting services, the small business' cost of capital should include a component of payment for these services in addition to the cost of capital funds. Because larger businesses obtain

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151 See, e.g., ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY ch.1 (1932) (identifying separation of ownership and control and emergence of specialized management in public corporation); Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301, 301 (1983) (arguing that separation of ownership and control is efficient form of specialization).

and pay for these services separately, the observed differential in cost of capital may simply reflect a difference in what is being measured.

This observation is consistent with several aspects of the existing market structure for small business capital. Debt financing, for example, is used most commonly by low-risk small businesses and those with substantial tangible assets to serve as collateral for business loans. Business projects that allow little management discretion are more likely to be funded with debt rather than equity. Because the nature of debt financing frontloads the monitoring function and limits ongoing managerial participation, bank lending is inappropriate for projects in which ongoing monitoring is required or in which there is substantial initial uncertainty risk.

The industry-specific expertise and greater involvement of private equity, on the other hand, suggests that it is deployed efficiently when private equity is the funding source for early stage high-risk small businesses. Consistent with this prediction, private equity sources are observed to be active in both monitoring and providing managerial services to the firms in which they invest. Moreover, these services appear to add value beyond the capital contribution.

The monitoring activities of venture capital funds are particularly well known. As Professor Josh Lerner, who has done much of the pioneering analysis of venture capital firms explains: “Venture capitalists are understood to provide intensive oversight of the firms in their portfolios.” It is common for venture capitalists to visit portfolio companies

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158 Indeed, both angels and venture capitalists generally seek investment opportunities close to home. See Duxbury et al., supra note 17. One reason for insisting on geographic proximity is the expectation that investors will also be involved in some managerial or consulting role.
159 Studies have found, for example, that when companies backed by venture capital go public, subsequent returns to stockholders are substantially higher than for other newly public companies. See, e.g., Marcia Vickers, Nothing Ventured, Less Gain, N.Y. TIMES, Apr. 21, 1996, at F3 (describing study by Securities Data Company finding that since 1986, public offerings backed by venture capital rose an average of 135.1%; nonventure backed companies rose only an average of 32.5%).
frequently, take board positions, and participate actively in the timing and terms of an eventual public offering by the portfolio company. Studies find that these activities increase the value of the portfolio companies.

Similarly, angel investors generally are active investors who, in addition to money, provide contributions ranging from technical or marketing support to strategic planning. A survey study conducted by William Wetzel found that eighty-four percent of angel investors expected to play an active role in their portfolio companies, ranging from board membership, to a consulting role, to part or full time employment. The utility of an angel’s participation in the business is enhanced by the fact that angels frequently have substantial expertise in the industry in which they invest. Wetzel observed almost fifteen years ago that this expertise allows angels to bring a realistic “sense of the market” to an entrepreneur. By choosing to invest in fields in which they are technically competent, both angels and venture capital funds can properly evaluate investment opportunities and can also serve as resources to assist the subsequent growth of their investment.

The recognition that traditional small business capital sources provide additional services which facilitate small business growth has important consequences for the debate over regulatory reform. If traditional sources are replaced by dispersed passive public investors, the collateral monitoring and managing services are likely to be eliminated. By seeking money through an online DPO instead of from an angel investor, a start-up firm may lose the ability to benefit from a seasoned professional with industry expertise. As a consequence, the firm may have to seek additional managerial support from outside consulting or instead operate less efficiently.

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161 Christopher B. Barry et al., The Role of Venture Capital in the Creation of Public Companies: Evidence from the Going-Public Process, 27 J. Fin. Econ. 447, 448 (1990) (documenting substantial representation of venture capitalists on boards of firms in which they invest).

162 Lin, supra note 121, at 56.

163 See, e.g., Barry et al., supra note 161, at 448 (finding that venture capitalists’ expertise and experience can have an influence on the decisions of investors). See also Lin, supra note 121, at 55 (finding venture capital participation results in lower IPO underpricing for portfolio companies than for comparable companies that lacked prior venture capital funding).

164 See Prowse, supra note 19.

165 Wetzel, supra note 16, at 27.

166 See John D. Aram, Attitudes and Behaviors of Informal Investors Toward Early-Stage Investments, Technology-Based Ventures, and Co-investors, 4 J. BUS. VENTURING 333, 334 (1989) (finding that angels tend to have worked in ventures similar to those in which they invest).

167 Id. at 336.
Replacing active private equity with public investors also reduces the degree to which the capital source can effectively monitor entrepreneurial decision-making. Agency costs are a core problem for any business that utilizes capital from investors who do not control business operations. These agency costs constitute a central concern of both state corporation law and the federal securities laws, and the governance of the large, publicly held business has evolved to address agency problems through a variety of mechanisms.

One of the challenges posed by small businesses is that the mechanisms for addressing agency problems, including the transparency of the public equity markets, board monitoring and so forth, are absent. Small business entrepreneurs may have incentives to pursue negative present value projects or projects with unacceptably high variances. The structure of private equity financing, such as the staging of venture capital investments, reduces these agency costs. Small businesses that have access to capital without the constraint of these controls may make decisions that are inconsistent with long term profitability.

Finally, small businesses can be adversely affected by the demands of public investors. Investors may second-guess entrepreneurial decisions, lack the patience necessary to realize the value of research, and pressure a business to adopt governance changes or obtain regulatory approvals to cater to investor needs. Investor demands for liquidity, for example, can force a business to develop a secondary trading market in its securities, which ultimately may require the small business voluntarily to adhere to federal disclosure standards in order to obtain broker participation. A business that obtains capital from dispersed public investors may also be pressured to disseminate sensitive business information broadly. This disclosure may put the business at a competitive disadvantage relative to those businesses relying on private sources of funding. Even

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110 See, e.g., Gompers, supra note 154, at 1461-63 (describing role of staged financing); Curtis J. Milhaupt, The Market for Innovation In the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate, 91 NW. U. L. REV. 865, 886 (1997) (describing how terms of venture capital stock purchase agreement, including “staged financing as well as registration rights, information rights, and board representation for the venture capitalist” are structured to minimize agency costs).
111 See Phillip S. Scherrer & Timothy J. Mathison, Thinking of Going Public? An Overview, in CAPITAL SOURCES FOR REAL ESTATE, Apr. 1, 1997 (describing how an IPO renders the original owners of the company answerable to the demands of the shareholders).
112 See id. (describing how required disclosure after an IPO makes firm information available to competitors).
without this disadvantage, regulation may force entrepreneurs who have used public equity to engage in more rigorous and costly disclosure.\textsuperscript{175}

\textbf{D. Further Reflections on Regulatory Reform}

The foregoing discussion suggests the need to consider more carefully the nature of traditional small business financing before embracing suggestions for regulatory reform to expand small business access to public equity through Internet offerings. The debate over the advisability of regulatory reform is complicated by an additional effect of Internet technology: its ability to blur the line between small private offerings and national, or even international, securities transactions. Because the Internet permits an issuer to transmit offering information virtually instantaneously across the globe, and may even remove the issuer’s ability to control the extent to which its information is disseminated, Internet offerings require us to rethink the manner in which the United States has traditionally regulated the securities markets.

The federal securities laws were originally directed to the national securities markets.\textsuperscript{174} For a variety of reasons, Congress focused its attention on large publicly traded companies\textsuperscript{175} and the national stock exchanges.\textsuperscript{176} Although various provisions of federal law, particularly the antifraud provisions, apply to small and local transactions, regulation of smaller transactions was relegated primarily to state blue sky laws.\textsuperscript{177} This specialization has persisted. The expansion of registration exemption provisions for small and private offerings reflects a policy judgment that these transactions are more appropriately regulated at the state level. Similarly, although the Securities Markets Improvement Act of 1996 now preempts state blue sky registration requirements for national issuers, state regulation of the microcap market is retained.\textsuperscript{178}

\textsuperscript{175} See, e.g., Joel Seligman, Remarks at AALS Annual Meeting, Section on Business Associations (San Francisco, Jan. 8, 1998) (describing how less rigor in financial records and internal controls maintained by Silicon Valley start-ups can create increased risk of liability under federal securities laws).


\textsuperscript{176} See, e.g., Landreth Timber Co. v. Landreth, 471 U.S. 681, 698 (1985) (Stevens, J., dissenting) (“The legislative history of the 1933 and 1934 Securities Acts makes clear that Congress was primarily concerned with transactions in securities that are traded in a public market.”).


\textsuperscript{179} See generally Campbell, supra note 56, at 179 (finding the NSMIA ineffective in removing the burden of state regulation from small issuers).
The Internet erases the traditional line, however, between local and national transactions. To the extent that an issuer offers its securities over the Internet and sells stock via e-mail or fax, its offering is appropriately regarded as within the national securities markets, regardless of size. Who then should determine the regulatory standards applicable to the offering? More importantly, does the existing division of authority between state and national government, a division based primarily on the size of the offering, continue to make sense? Although, as described above, the SEC has been actively developing ways to combat Internet fraud, state regulators have also started to bring actions. The need for efficient division of responsibility and conservation of enforcement resources is apparent.

A more persistent concern is that, at the same time that the Internet is increasing the impact of small business offerings, regulatory reform efforts, such as the move to exempt Internet offerings from state registration requirements, coupled with state and federal exemptions for small Internet offerings may be effectively transforming regulation of Internet DPOs from a prophylactic disclosure structure to one that merely reacts to and combats fraud. The original promulgation of the federal securities laws was based on congressional perception that such a structure was an ineffective means of regulating the national securities markets. Proponents of regulatory reform need to explain why technological developments since the 1930s have rendered that perception obsolete.

VI. CONCLUSION

Regulatory and technological developments have created new flexibility for small businesses seeking to raise capital. Internet-based securities offerings provide one of the most radical opportunities for change as they enable businesses to reach large numbers of investors rapidly and at lower cost than ever before.

In evaluating the Internet opportunity, however, it is necessary to look beyond the media hype of increased capital access. Although an Internet offering has the potential to lower barriers to capital formation, its success depends upon the investor’s willingness to replace traditional sources of information and indicia of financial soundness. The Internet’s significance for small business capital formation thus remains an open question.

Finally, it is important to recognize that even if Internet offerings enable small businesses to reach new sources of business capital, shifting the nature of capital providers may have significant consequences for small business development. Bank loans and private equity provide

managerial and monitoring services that may be vitally important to small business success. Entrepreneurs who chose to forgo these services pay less for capital in the short term, but may sacrifice the ultimate success of their business as a result.