Université de Montréal

"The Impact of Internet on the Canadian Securities Market, Offering Process and Regulations and Appropriate Regulatory and Enforcement Procedures"

par

E. Marian Tremblay

Faculté de droit

Mémoire présenté à la Faculté des études supérieures
en vue de l'obtention du grade de
Maître en droit (LL.M.)

Août, 2000

Université de Montréal
Faculté des études supérieures

Ce mémoire intitulé :

"The Impact of Internet on the Canadian Securities Market, Offering Process and Regulations and Appropriate Regulatory and Enforcement Procedures"

présenté par :

E. Marian Tremblay

a été évalué par un jury composé des personnes suivantes :

Président-rapporteur: Vilaysoun Jr. Loungnarath

Directeur de recherche: Karim Benyekhlef

Membre du jury: Stéphane Rousseau

Mémoire accepté le : **19 décembre 2000**

À ma famille et à elle

Remerciements
Acknowledgments

Je dois des remerciements à mon directeur de mémoire Prof. Karim Benyekhlef pour ses conseils et commentaires sur les différents projets de mémoire. Je tiens également à remercier les personnes suivantes qui m'ont aidé ou encouragé lors de la rédaction de mon mémoire:

I owe many thanks to my director Prof. Karim Benyekhlef, for his assistance and comments on the various drafts of the text. I also owe a great debt of gratitude to the following people who either helped me or encouraged me:

Anne-Marie Laurin
Nathalie Leblanc

L'impact d'Internet sur le marché, le processus d'offre publique et la réglementation des valeurs mobilières canadiennes et les procédures réglementaires et de mise en application appropriées

Sommaire

Internet a changé les pratiques commerciales dans plusieurs domaines, incluant l'industrie des valeurs mobilières. Il permet la démocratisation du processus d'offre publique en accroissant l'accessibilité à l'information de même qu'entre les intervenants de l'industrie. Cependant, un climat d'incertitude règne parce que des questions pratiques et juridiques subsistent et peuvent nuire à la confiance des investisseurs.

Le texte vise à présenter les émissions de valeurs mobilières sur Internet et à étudier comment la réglementation sur les valeurs mobilières et ses principes peuvent s'appliquer dans un tel contexte. Notre hypothèse est que malgré le fait qu'un véhicule différent soit utilisé, les mêmes principes peuvent être appliqués, quoique des modifications et/ou interprétations soient nécessaires afin de clarifier certaines ambiguïtés. Par ailleurs, une autre hypothèse est qu'Internet influencera largement l'émission de valeurs mobilières, comme c'est le cas présentement avec d'autres activités commerciales. De plus, Internet constitue un médium de communication très utile pour l'émission de valeurs mobilières, tout particulièrement pour les petites entreprises qui ont difficilement accès aux marchés des capitaux traditionnels. Finalement, considérant la fluidité et la globalité d'Internet, il sera difficile de mettre les lois en application, ce qui rendra nécessaire un changement dans le rôle des commissions des valeurs mobilières ainsi que des organismes internationaux oeuvrant dans ce domaine.

La réglementation sur les valeurs mobilières comporte des objectifs précis et il importe de les garder à l'esprit, quelque soit le médium de communication utilisé. À certains égards, Internet peut être considéré comme une révolution dans le domaine des communications car il compte déjà plus de 300 000 000 utilisateurs et cette population croît rapidement. Pour les investisseurs, Internet offre des avantages considérables, permettant d'avoir accès par eux-mêmes à des renseignements de toutes sortes sur les valeurs mobilières, du confort de leur foyer. De plus, l'information est récente et disponible en tout temps et certains sites Internet permettent d'intégrer cette information pour en rendre la lecture encore plus facile et utile.

En ce qui concerne l'émission de valeurs mobilières, Internet offre également des avantages majeurs. Les offres peuvent être publicisées facilement rejoignant une audience en tout temps et permettant de communiquer information et documents de façon rapide et efficace. Jamais un médium de communication n'a permis de rapprocher autant les émetteurs des investisseurs potentiels. Dans ce contexte, le rôle des courtiers pourrait être remis en question puisque les émetteurs peuvent faire la promotion et distribuer eux-mêmes leurs valeurs mobilières.

Après les émissions de valeurs mobilières historiques de Spring Street Brewing, Inc. aux États-Unis et de e-minerals Exploration Corp. au Canada, il aurait été permis de croire qu'une explosion de telles émissions aurait lieu, permettant aux petites entreprises d'avoir enfin accès aux marchés des capitaux à un coût raisonnable. Cependant, le rôle des courtiers est davantage qu'un simple accès aux investisseurs. En effet, les courtiers prêtent leur réputation, leurs clients, leur équipe de recherche et d'analyse, et peuvent même parfois contribuer efficacement à assurer le succès d'une émission lorsque la demande semble plus faible qu'elle n'avait été prévue. C'est pourquoi Internet pourrait davantage être un outil de promotion et de communication pour les émissions de valeurs mobilières au Canada. D'ailleurs, plusieurs entreprises ont déjà réalisé que l'avenir des émissions de valeurs mobilières au Canada réside dans une forme hybride d'offre publique alliant les méthodes traditionnelles et nouvelles.

Afin qu'Internet devienne un outil offrant aux petites entreprises le moyen d'accéder aux marchés des capitaux plus facilement et à un moindre coût, certaines réformes seraient souhaitables pour leur permettre de tester le marché et d'avoir accès à un système de négociation de titres comprenant des critères conçus spécifiquement pour elles, ce qui pourrait leur offrir la liquidité à laquelle leurs actionnaires s'attendent. D'autres réformes seraient également souhaitables en ce qui concerne les critères à remplir pour préparer et déposer les prospectus ainsi qu'en rapport avec les obligations de divulgation qui s'avèrent souvent trop onéreuses pour de telles entreprises.

La réglementation canadienne sur les valeurs mobilières est applicable aux émissions de valeurs mobilières sur Internet. Réalisant qu'il existe des ambiguïtés dans la législation, les autorités réglementaires canadiennes ont publié des avis afin d'éclaircir certains points. Ainsi, malgré le fait qu'Internet offre toutes sortes de possibilités quant à l'intégration des éléments multimédias dans la forme électronique d'un prospectus, les autorités réglementaires sont d'avis qu'un tel prospectus doit être en tous points semblable au prospectus traditionnel en format papier. Parmi les dispenses de déposer un prospectus qui semblent pertinentes aux émissions de valeurs mobilières sur Internet, il faut noter celles relatives à certains acquéreurs avertis et à certains types d'emprunts garantis par les autorités gouvernementales ou des institutions financières canadiennes, qui semblent mal exploitées par ceux-ci.

Pour effectuer une émission de valeurs mobilières sur Internet, un émetteur doit s'inscrire à titre d'"émetteur-placeur" car une disposition de la législation sur les valeurs mobilières permet déjà aux émetteurs de placer eux-mêmes leurs titres sans l'aide d'un courtier. Malgré certaines exigences, une demande d'inscription d'exercice restreint pour un tel émetteur n'est pas trop onéreuse ni complexe.

Les autorités réglementaires canadiennes ont également cru bon de clarifier certaines autres questions relatives aux conflits de juridiction, aux présentations ou "road shows" sous forme multimédia, à la promotion des titres avant la réception du permis pour le prospectus final, à la livraison de documents sous forme électronique et à la responsabilité pour fausse représentation surtout eu égard aux liens hypertextes se trouvant dans un prospectus.

Quant à la réglementation et la mise en application de la réglementation sur les valeurs mobilières, Internet présente de nouveaux défis qui demandent aux autorités nationales ainsi qu'aux organismes internationaux de valeurs mobilières une coopération accrue et une assistance mutuelle afin d'identifier les nouvelles formes de criminalité qu'apporte Internet et ceux qui les commettent. Les organismes déjà en place doivent redoubler d'ardeur, adopter de nouvelles procédures et peut-être assumer un nouveau rôle afin de mettre en application avec efficacité la réglementation sur les valeurs mobilières. L'uniformité de la législation entre juridictions permet aux autorités de collaborer plus facilement et le "netiquette" s'avère également utile pour la mise en application de lois sur Internet par les utilisateurs d'Internet eux-mêmes.

Finalement, la réglementation des valeurs mobilières sur Internet est possible non seulement par des moyens législatifs, mais également par le biais de moyens technologiques tels des programmes informatiques ou des configurations techniques. Ces nouvelles méthodes de réglementation offrent des avantages par rapport aux méthodes traditionnelles car elles permettent une réglementation à la source et adaptée selon des besoins particuliers. Par conséquent, les autorités réglementaires et législatives devront apprivoiser Internet et les autres développements technologiques afin de les utiliser et même d'en influencer le développement dans le but de réglementer le marché des valeurs mobilières sur Internet, de mettre en application cette réglementation et ultimement de protéger les petits investisseurs efficacement.

List of Abbreviations

A.S.A.:	*Alberta Securities Act*, S.A. 1981, c. S-6.1, as amended
ATS:	Alternative trading systems
B.C.S.A.:	*British Columbia Securities Act*, R.S.B.C. 1996, c. 418, as amended
Bill C-6:	*Personal Information Protection and Electronic Documents Act*
CDN:	Canadian Dealing Network
CSA:	Canadian Securities Administrators
DPO:	Internet public offering of securities without the use of an underwriter
Exchange Act of 1934:	*Securities and Exchange Act of 1934*, 17 C.F.R. (1994)
IOSCO:	International Organization of Securities Commission
NASAA:	North American Securities Administrators Association
NASD:	National Association of Securities Dealers, Inc
O.S.A.:	*Ontario Securites Act*, R.S.O. 1990, c. S.5, as amended
O.S.C.:	Ontario Securities Commission
PICS:	Platform for Internet Content Selection
Q. Regs:	*Quebec Regulations* under the Quebec Securities Act
Q.S.A.:	*Quebec Securities Act*, R.S.Q., c. V-1.1, as amended
Q.S.C.	Quebec Securities Commission
SEC:	*Securities and Exchange Commission*
Securities Act of 1933:	*Securities Act of 1933*, 17 C.F.R. (1994)

THE IMPACT OF INTERNET ON THE CANADIAN SECURITIES MARKET, OFFERING PROCESS AND REGULATIONS AND APPROPRIATE REGULATORY AND ENFORCEMENT PROCEDURES

TABLE OF CONTENTS

THE IMPACT OF INTERNET ON THE CANADIAN SECURITIES MARKET, OFFERING PROCESS AND REGULATIONS AND APPROPRIATE REGULATORY AND ENFORCEMENT PROCEDURES

INTRODUCTION

Internet has changed traditional commercial practices in numerous fields and the securities industry is no different. It has allowed the democratization of the securities offering process and increased accessibility to information and among securities industry players. However, for the Internet securities industry to thrive, a stable and predictable investment climate must prevail; investors' confidence must be maintained and uncertainties must be diminished.

There are issues such as security and confidentiality casting a shadow ever present for certain investors. Another definite source of uncertainty is the applicability of existing securities legislation and the lack of recognized and institutionalized legal boundaries. These regulatory issues coupled with the uncertainty regarding liability exposure may curtail the establishment of a fully integrated Internet securities market. Indeed, where instability, unpredictability and conflicts in applicable legislation may prevail, a clear legal framework would be required for an Internet securities market to flourish.

This text aims at presenting Internet securities offerings and at studying how securities regulation principles may apply to them. Through this paper, we will demonstrate that Internet securities offerings are largely inspired from traditional offerings and share similar characteristics. We will also examine what is the impact of Internet on the securities market and on the securities offering process in Canada and what new roles must be played by regulatory organisations in the enforcement of securities rules. We will submit that even if Internet allows small enterprises to by-pass underwriters to market and distribute securities, thereby increasing accessibility to equity financing, the traditional securities market will not be threatened by such a medium. In fact, reforms are required to fully exploit the potential Internet offers to such small enterprises.

A general background on securities regulation,[1] Internet[2] and their encountering[3] is the subject of the first chapter which also discusses the impact of Internet on the securities market and on securities offerings.[4] Issues relating to Internet as a financing vehicle for small enterprises will also be considered in the first chapter.[5] Thereafter, an analysis of the applicability of the existing Canadian legislation to Internet securities offerings is presented and an examination of the impact Internet has on traditional securities offerings, with occasional comparisons with the U.S. experience.[6] Finally, the last chapter places a particular emphasis on appropriate regulation and enforcement procedures for the Internet environment.[7]

Before discussing Internet, securities offerings and their recent encountering, it is useful to review a few provisions of securities regulation in Canada to understand the fundamental principles and be able to apply those to a new environment: Internet.

I. Background on Internet and Securities Offerings in Canada

A. Essentials on Securities Offerings Regulation

Securities laws exist to regulate the industry and achieve certain well-established objectives. These objectives are to protect investors especially from unfair, improper and fraudulent practices, to maintain the confidence of all participants in the system and to provide securities at fair prices

---

1 See *infra* notes 8-29 and the accompanying text.

2 See *infra* notes 38-42 and the accompanying text.

3 See *infra* notes 46-51and the accompanying text.

4 See *infra* notes 39-67and the accompanying text.

5 See *infra* notes 71-92 and the accompanying text.

6 See *infra* notes 93-206 and the accompanying text.

7 See *infra* notes 207-251and the accompanying text.

through an efficient capital market.[8] Securities regulators try to meet those objectives through different mechanisms built into the securities regulation framework. These mechanisms include registration and prospectus requirements, standards for timely, accurate and efficient disclosure of information and restrictions and prohibitions on certain activities and practices.[9]

In Canada, the mechanic of securities offerings regulation relies upon fundamental concepts such as "security", "trading", "issuer" and "distribution". The term "security" may be defined in different manners but it is commonly referred to as a share of any class or series of shares or a debt obligation of a company and includes a certificate evidencing such a share or debt obligation.[10] "Trading" means in short "any sale or disposition of a security for valuable consideration".[11] However, depending on the context and the object of the regulation, the definition of trade may vary.[12] An "issuer" is defined as any person or company that has outstanding securities, or issues or proposes

---

8 See the discussion about securities market efficiency in GILLEN, Mark, *Securities Regulation in Canada*, 2nd Ed. (Carswell: Toronto, 1999) at pp. 53-66[hereinfter "Gillen"].

9 Gillen, *supra* note 8 at p. 63-65.

10 Section 2(1) of the *Canada Business Corporations Act*, R.S.C., 1985, c. C-44. The securities acts of the Canadian provinces, except the *Quebec Securities Act*, R.S.Q., c. V-1.1, as amended [hereinafter the" Q.S.A."], define "security" as "any bond, debenture, note or other evidence of indebtedness, share, stock, unit, unit certificate, participation certificate, certificate of share of interest, preorganization certificate or subscription..." see at s. 1(v)(v)*Alberta Securities Act*, S.A. 1981, c. S-6.1; as amended [hereinafter the "A.S.A."], s. 1(1)*British Columbia Securities Act*, R.S.B.C. 1996, c. 418; as amended [hereinafter the "B.C.S.A."] and s.1(1)*Ontario Securities Act*, R.S.O. 1990, c. S.5, as amended [hereinafter the O.S.A.]. The Q.S.A. provides at s.1 that it applies to several forms of investment including any "security recognized as such in the trade, more particularly, a share, bond, capital stock of an entity constituted as a legal person, or subscription right or option to purchase".

11 S. 1(x)(i) A.S.A., s.1(1) B.C.S.A., s. 1(1) O.S.A. Under the Q.S.A., the term "trade" is not defined specifically but in defining "distribution", the situations that would constitute a trade, as defined in the other provincial acts referred to above, are captured.

12 From a securities offering perspective, it is the vendor that is the object of the regulation whereas the legislation attempts to protect the purchaser. As a matter of fact, the provincial securities acts specifically provide that a trade excludes a purchase of a security, or an act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of a trade. As such, when the object of the regulation is the trading on behalf of others and those involved in such activities, the definition of "trading" would include the "participation as a trader in a transaction in a security... on the floor of or through the facilities of an exchange" at s. 1(x)(ii) A.S.A., s. 1(1) B.C.S.A., s.1(1) O.S.A.

to issue securities.[13] Finally, "distribution" means generally "a trade in a security of an issuer that has not been previously issued or in previously issued securities of an issuer that have been redeemed or purchased by or donated to that issuer".[14]

i. Prospectus Requirement

One of the fundamental principles of securities regulation in Canada is that no person or company shall trade in a security. However, there are exceptions to this principle. One of the important exceptions is the prospectus requirement: every person or company intending to make a distribution of securities, or in other words offering securities for sale that have not previously been offered for sale, shall prepare and file a preliminary and a final prospectus and obtain a receipt from the securities commission of each province where the securities are to be offered.[15] To use our concepts, there is a requirement to produce a prospectus whenever a "trade" in a "security" constitutes a "distribution".

The prospectus provides potential investors with a presentation of the issuer, its business and affairs as well as details about its financial statements, capitalization, management and board of directors and also particulars about the securities offered.[16] In fact, what is required in a prospectus is often described as the full, true and plain disclosure of all "material" facts about the securities offered.[17]

---

13 S. 1(j) A.S.A.; s. 1(1) B.C.S.A. s. 1(1) O.S.A.; and s. 5 Q.S.A.; .

14 S. 1(f)(i) A.S.A., s. 1(1) B.C.S.A., s. 1(1) O.S.A. and s. 5 Q.S.A. define "distribution" in details which may be broadly summarized as the endeavour to obtain or the obtaining, by an issuer, a firm underwriter, a subscriber, a purchaser or by an agent, of securities of a corporation that have not previously been the subject of a prospectus, or of purchasers for such securities.

15 S. 81 A.S.A.; s. 61 B.C.S.A. s.53 O.S.A. and s. 11 Q.S.A.

16 The form of prospectus and the information it contains will vary depending on the type of issuer and the nature of the offering. See for example, *Alberta Forms* 12-15, *British Columbia Forms* 12-15, *Ontario Forms* 12-15 and *Quebec Schedules I* and *II*.

17 S.84 and 90 A.S.A., s. 63, 68 and 69 B.C.S.A., s. 56, 58 and 59 O.S.A. and s.5 and 32 Q.S.A.

Normally, the issuer will receive comments from the securities commissions where the prospectus has been filed which must be addressed before a commission will issue the final receipt. The final receipt will also be contingent upon the issuer filing a final prospectus and the supporting documentation.[18]

Once the offering is completed, other disclosure obligations are imposed on the issuer. Indeed, continuous disclosure in the form of periodic statements, proxy circulars, insider trading reports and timely reporting is required.[19]

ii. Prospectus Exemptions

To avoid the prospectus requirement, one may use one of the prospectus exemptions found in the legislation. Generally, prospectus exemptions are available in cases where the prospectus normally required and the protection provided to investors through civil liability recourses are considered unnecessary.[20]

In traditional offerings, there are numerous exemptions from the prospectus requirement available and exempt offerings have grown and represent the majority of offerings made in Canada.[21] These exemptions from the prospectus requirement are available depending on the nature of the trades and the securities traded. Furthermore, a discretionary exemption may be obtained from a securities commission where an application is made by an interested person or company for a trade, intended trade, security, person or company where a securities commission is satisfied that to do so would not be prejudicial to the public interest and upon certain terms and conditions as may be considered

---

18 *Ibid.*

19 Gillen, *supra* note 8 at p. 169-212.

20 *Ibid* at p.226-227.

21 Specific exemptions and their availability in the context of an Internet securities offering will be discussed below in chapter II.

necessary by a securities commission.[22] We shall review these exemptions in greater details in Chapter II.

To provide prospectus exemptions, Canadian securities regulators have adopted the concept of the "closed-system".[23] Under this concept, securities purchased under an exemption can be resold subject to specific restrictions. Under the concept of a closed-system, all offerings of securities must respect Canadian legislation on the matter.[24]

Usually, secondary market traders rely on a prospectus and on the requirement of continuous disclosure to evaluate the securities and base their investment decisions. If a distribution is exempted from the prospectus requirement, the secondary market trading will be effected within the closed market in reliance on the exemption. Reliance on the exemption ensures that trading remains within the closed market. As a result, the exemption will be available to purchasers who do not need to know the information which would normally be contained in the prospectus.

If a purchaser wants to dispose of securities following a purchase under a prospectus exemption, another exemption must be obtained to stay inside the closed system otherwise there is a deemed distribution of such securities which is subject to the prospectus requirement.[25] Thus, for trading to

---

22 S.116(1) A.S.A., s.76 B.C.S.A., s.74 O.S.A. and s.263 Q.S.A.

23 The closed-system approach has been adopted in most Canadian provinces including: Alberta, British-Columbia, Newfoundland, Nova Scotia, Ontario, Quebec and Saskatchewan. Manitoba, New Brunswick, the Northwest Territories and the Yukon do not use the closed-system approach but one that gives similar results. Having restricted our analysis to Alberta, British Columbia, Ontario and Quebec, we will not discuss the system used in the other provinces.

24 The system is said to be closed because openings for unregulated distributions of securities are not possible. It is also said to be closed because offerings exempt from the prospectus requirement will have to have a secondary market trading restricted to a narrow group of persons who are believed not to need the information contained in the prospectus. Thus, a closed market for secondary trading in those securities not supported by continuous disclosure will be formed out of this narrow group of people.

25 S. 109, 109.1, 110 and 111 A.S.A., s. 140-143 *British Columbia Rules*, s. 72 O.S.A. and s.5"distribution" (3) Q.S.A.

occur outside of the closed market, adequate information has to be provided to the investors. Adequate information is provided by the issuance of a prospectus, if not already issued, and through resale restrictions which include that the securities have remained within the closed market for a certain period of time called the "hold period"[26] and that continuous disclosure requirements be observed by the issuer.[27]

iii. Registration Requirement

Another important precept of Canadian securities regulation is the registration requirement. Securities laws provide that no person shall "trade" in "securities"unless this person is registered.[28] Exemptions from registration are available in certain specific cases, such as an isolated trade by a person not usually engaged in this activity, as those situations do not raise the kinds of issues that registration requirements were meant to address. Other exemptions are also available for trades in which there is a corresponding prospectus exemption.[29]

---

26 See for example, s.109(3) A.S.A., s. 140(2) *British Columbia Rules*, s.72(4) O.S.A. and s.58 Q.S.A.

27 Gillen, *supra* note 8 at p. 213-226.

28 The legislation provides further that no person shall underwrite issuances of securities or give advice with respect to investments in securities unless registered, see s. 54(1) A.S.A., s.34(1) B.C.S.A., s.25(1) O.S.A. and s. 148 Q.S.A..

29 S. 65(1) A.S.A., s. 45(2) B.C.S.A., s.35(1)O.S.A. and s.157 Q.S.A..

iv. Elements of Comparisons from U.S. Securities Regulation[30]

In the U.S., securities law principles are similar. For example, securities have to be registered with the *Securities and Exchange Commission*[31] and with the agencies that oversee transactions in each state before being offered to potential investors.[32]

Indeed, the *Securities Act of 1933*[33] requires that a registration statement be filed with the SEC before securities are offered for sale to the public. The basic registration statement consists of two principal parts. The first part is the prospectus in which the issuer is required to put the essential facts regarding its business operations, financial condition, and management. The second part contains additional information required and made available for the public through the SEC.

In the U.S., there are various offering vehicles from which an issuing company may choose in accordance with its business capacity and needs. Some of these vehicles may require SEC registration while others are exempt. In some cases, there is a maximum amount of capital that can be raised in a 12 month period. In other cases, the review agency is not the SEC but the "State", which means that the issuer must file its prospectus and other documents in each state in which it wishes to sell its stock. At other times, offerings are restricted to certain investors.

The *Securities Act of 1934*[34] requires issuers in the U.S. to make "full disclosure" of all material facts before they offer their securities to the public. In enforcing this law, the SEC has no authority to

---

30 LOSS, L. & SELIGMAN, J., "Fundamentals of Securities Regulation", 3rd Ed., (New York: Little, Brown & Company, 1995) [hereinafter "Loss & Seligman"].

31 Hereinafter the "SEC".

32 By comparison, in Canada, there is no federal commission. Hence, securities have to be registered in all provinces where the securities are to be issued.

33 S. 5 *Securities Act of 1933*, 17 C.F.R. (1994) [hereinafter the "*Securities Act of 1933*"].

34 *Securities and Exchange Act of 1934*, 17 C.F.R. (1994) [hereinafter the "*Exchange Act of 1934*"].

evaluate the quality of a new issue or to pass judgment on the merits of each offering. Rather, the "disclosure" requirement allows issuers to offer their securities for sale if they have disclosed sufficient and accurate information about the business they conduct or propose to conduct. The *Exchange Act of 1934* also requires the "continued disclosure", on a periodic basis, by publicly held companies to keep shareholders informed of business operations, financial condition, and management of each issuer unless, in the following fiscal years, it falls within one of the exceptions.[35]

As in Canada, there are certain alternatives to registration under the *Securities Act of 1933*, and exemptions from the *Exchange Act of 1934* reporting requirements. For small businesses interested in making a securities offering and qualified to take advantage of them, these alternatives and exceptions are attractive as they ease the burden of regulation and enable these companies to "go public" and raise capital more easily.[36]

While the tendency is to "go public", issuers also have the possibility of making "private" offerings which are exempt from registration with the SEC. Indeed, sections 3(b) and 4(2) of the *Securities Act of 1933* provide an exemption from registration for transactions by an issuer not involving any public offering. Regulation D establishes the "private placement" exemptions from registration. It must be noted that Regulation D was adopted to coordinate the various limited offering exemptions and to integrate the existing requirements applicable to private offers and sales of securities.[37]

---

35 The reporting obligations may be suspended when the shares of a company are held by less than 300 investors or, when the company had less than $5 million in assets in the last three fiscal years, all shares offered were held by less than 500 investors (except in the two fiscal years immediately following the registration). See Loss & Seligman at p.256.

36 The emphasis of the present text being on Internet securities offerings from a Canadian perspective, U.S. securities regulation principles will not be discussed further.

37 Regulation D is comprised of Rules 501-508 promulgated under the *Securities Act of 1933*.

Theoretically, to achieve securities regulation objectives, and especially the protection of small investors, activities and operations involving securities such as their distribution and trading are supposed to be subject to the same laws and regulations and the enforcement vehicles should not change because the medium of communication changed. In practice, the arrival of Internet in the securities industry has challenged this perception and forced securities regulators to review the legislation and in some cases to adapt. This is why Internet is sometimes considered a revolution.

B. The Internet Revolution

The boundless nature of Internet allows individuals to communicate information and data to anyone around the world as easily as to a next-door neighbour. Recently, statistics suggested that there are more than 300 million Internet users and that this population still grows very rapidly.[38] Therefore, Internet represents a growing market of investors readily available to any issuer.

In many areas, the introduction and development of Internet are advantageous and yield important savings in costs. For example, Internet may be used to facilitate the execution, submission or distribution of documents on-line, thus reducing the costs of printing, binding and postage. The speed with which these documents are submitted may also be substantially increased.

From any perspective, the advantages of Internet are numerous. Savings in time, energy, human capital and other resources are enormous and difficult to evaluate. People continuously demand efficient, accessible and improved services, and Internet is one medium of communication to bring it to them.

There are other advantages in using Internet to provide goods and services. Services provided through Internet are generally accurate. They should be free from errors or at least as accurate as their

---

38 See Freespeech statistics at http://www.freespeech.org/terrabay/Internet%20users.html (last visited August 24,2000).

users. In terms of reliability, apart from the occasional system or network failures and the possible technical breakdowns, with its growing speed, Internet is increasingly reliable. If well-developed, flexibility, the capacity to support the widest range of services, and user-friendliness, the relative ease for any person to use the medium, may become its inherent qualities. Finally, Internet is accessible to anyone who owns a computer and a Web browser, regardless of the computer's ownership and location. In fact, Internet offers the advantage of being accessible from almost anywhere in the world. Combined with its functionality potential, the concept of the one-stop shopping place, these advantages could transform Internet into the most revolutionary development in the securities industry since the introduction of computers.

C. The Impact of Internet on the Securities Market

More particularly for investors, Internet offers advantages that were previously unavailable. Foremost is the convenience of being able to access different sources of stock market data and information. Information is available at any time and anxious investors no longer have to wait until regular office hours to request information from their broker. In addition, this information can be accessed from the convenience of a home, office or anywhere else an investor can have Internet access and especially since the introduction of portable devices.

Internet users are no longer limited to outdated news through periodic sources such as newspapers or even television and radio news broadcasts. As soon as press releases are communicated, Internet users may access that information. Such rapid dissemination of information is especially beneficial to small investors as the timely data allows them to make more enlightened decisions. At least theoretically, information and trading decisions communicated more rapidly should, as a result, lead to a more efficient capital market.

Internet also offers a wide variety of tools to help serious investors. Such analysis tools range from simple graphs and charts of historical data, to complex technical analysis tracking the movement of

stock prices. Investors also have the choice of using on-line portfolio tools that can automatically place a buy or sell order when certain events are triggered such as an increase or decrease in stock prices. All these elements serve the user by providing them with better information and better tools for making better investment decisions.

Another positive feature of using Internet is its novelty. As more tools and services are offered on Internet, some investors enjoy the opportunity to explore new ways to invest their money. For example, with the growing popularity of Internet, an increasing number of investors strive to become Internet-literate. At the same time, new and inexperienced investors may learn at their expense the level of risk involved.[39]

Today, with such a strong and growing interest in tech stocks and on-line trading, Internet is increasingly used to advertize IPOs and make securities offerings to the online community. In the U.S., any search engine will provide a list of Web sites where such securities are offered.[40] In Canada, although the choice has been more limited, a growing number of offerings are available to the Internet investment community fuelled by the recent hype of "going public" and investors' hunger for tech stocks.

With regard to security, confidentiality and privacy issues, opinions differ but there remain uncertainties. Generally, these issues are not ignored by investors and may prevent a few from using the medium. For example, institutional and other large investors may also be reluctant to invest large sums of money through Internet as long as its security has not been fully demonstrated.

It must be noted that Internet securities players exercise constant pressure on research and development to reduce the uncertainty and risk of a technical nature and on securities regulators to

---

39 On the risks for new investors, see generally DESMOND, Greg, "Internet Stock Offerings", at http://www.personal.law.miami.edu/~froomkin/seminar/papers/desmond.htm (last visited June 20, 2000).

40 See for example IPOnet at http://www.e-iponet.com (last visited August 23, 2000); IPO.com at http://www.ipo.com (last visited August 23, 2000).

provide guidelines on the applicability of securities legislation towards the establishment of a fully integrated Internet securities market. Indeed, new technological developments for signature encryption and for electronic transfer of funds and the success of Internet shopping, banking and trading have largely contributed to reassure Internet users about its security.[41] Hopefully, these developments and many others will continue increasing the confidence of investors.[42] However, as we shall present in the next section, the presence of factors of uncertainty and risk have not prevented a number of companies to surf the wave and become pioneers in Internet securities offerings while regulators attempted to clarify certain legal uncertainties.

D. The Impact of Internet on Securities Offerings

In the securities industry, Internet has attractive features for the distribution and trading of securities. For instance, in a securities offering, Internet may help providing an economical and effective means of publicizing the offering and of disseminating information and documents. Internet may also help bringing together and providing direct access to issuers, brokers/dealers, investors and securities regulators.

In most traditional securities offerings, an underwriter registered as a broker/dealer is also hired by the issuer. An "underwriter" is a person or company that accepts to purchase securities with a view to distributing them, or that offers for sale or sells securities in connection with a distribution.[43] Thus, investment bankers performing the role of underwriters will assist the issuer in the preparation of the offering, advising them on the offering process and pricing and will effect the distribution and sell the securities on behalf of the issuer. Issuers will choose their underwriters on the basis of their

---

41 See generally GOLLMANN, D. *Computer Security*, (John Wiley & Son Ltd: New York, 1999) 336 p.

42 Technological issues being well beyond the scope of the present text, they will not be discussed further.

43 S. 1(y) A.S.A., s. 1(1) B.C.S.A., and s.1(1) O.S.A. "Brokers" are persons or firms acting as agents or links in the trading of securities between buyers and sellers whereas "dealers" are persons or firms buying and selling securities for their own account which helps maintain a market for a stock. See s.1(d) A.S.A., s.1(1) B.C.S.A., s.1(1) O.S.A. and s.5 Q.S.A.

commission fees, which normally vary between 6% and 9% of the proceeds of distribution, their reputation, to generate interest and maintain confidence in the offering, and their research, analysis and publication, to sustain the interest of investors after the distribution. Finally, if the securities do not sell, issuers want an investment banker that will use its network and make efforts to convince investors to purchase them. Traditionally, the selling function of securities has been performed by one or more underwriters with a network of retail branches. In these branches, there are brokers who are linked to their clients to whom securities are offered.

Offerings involving companies with a sound financial situation and a promising future often land in the hands of institutional or other large investors such as banks, trust companies, life insurance companies, pension funds and investment funds. Small investors never hear of those issues which may stay at the institutional level or, ultimately, reach them but often, at a much higher price once the securities trade in the secondary market.

On the other hand, small enterprises with a weaker financial background are sometimes unable to raise capital as they either fail to find a sufficient number of private investors or get rejected on the basis of their inability to afford legal and investment bankers' commission fees. Indeed, small enterprises with limited resources or a less appealing profile have difficulty raising capital when they are not completely excluded from "going public". Ultimately, they will have to return to financial institutions to borrow at high interest costs or more often their founders will have to turn to venture capital firms or sell the company.

One of the possibilities for small issuers to avoid those accessibility problems is to contact purchasers of the securities directly. They sometimes use this approach especially where the founders may call friends and relatives who may be interested in investing in their company. Another possibility is to make a private placement.[44] A private placement may either be arranged by the issuer or by an investment banker that sells the securities directly to a small group of institutional investors

---

44 Please see *infra* note 105.

already interested in purchasing the securities. In most cases, underwriters are still required because issuers rarely have access to a pool of interested large investors.

However, with Internet, a new bread of issuers have emerged that rely on a forgotten legislative provision which allows them to issue and trade their own securities as dealers.[45] Indeed, direct "self-underwritten" Internet public offerings often referred to as "direct public offerings" or "DPOs" are now available. As we shall present in details below, DPOs may be offered by an issuer directly to the public and are used increasingly. In practice, such offerings avoid or at least diminish certain marketing costs but their main attractive feature is the possibility to avoid high commission fees since the issuer may conduct part of the process and seek investors by itself. Traditionally, it was rare to find a company already connected to a network of investors willing to invest in its stocks. Today, Internet may have changed the rules of the game.

i. Spring Street Brewing or the Marriage of Internet and DPOs

In February 1996, Spring Street Brewing, Inc.[46] a New York-based micro brewery, was the first U.S. company that made a direct public offering of its stock through Internet.[47] Its success was instantaneous and the company raised $U.S.1.6 million without any underwriter. The idea came from the president of the company who realized that Internet technology could be used to offer stocks of his company to investors surfing the Web.

---

45 This relates to a subcategory of dealers referred to in most Canadian securities acts as "security issuers". This subcategory was generally used by issuers that would raise capital by calling upon friends and relatives and sophisticated investors.; see s. 16 *Alberta Rules* passed under the A.S.A., s.6 *British Columbia Rules* passed under the B.C.S.A., s.98 *Ontario Regulations* passed under the O.S.A. and s.192 *Quebec Regulations* passed under the Q.S.A.

46 Hereinafter "Spring Street". The complete history of Spring Street may be found at www.netscapeworld.com/netscapeworld/ solutions/spring_street/main.html (last visited June 20, 2000)

47 For ease of reference we shall hereinafter refer to any Internet public offering of securities without the use of an underwriter as a "DPO".

After obtaining the opinion of the SEC,[48] Spring Street placed on the company's Web site the documents required to make such a distribution in the U.S.: an offering circular and a subscription agreement. As in any other normal distribution of securities, investors interested in the shares of Spring Street were invited to study the documents. Once a decision to invest was made, investors had to send a payment by cheque or money order to receive their share certificates.

On February 27, 1996, the company announced that it would launch a bulletin board system on March, 1, 1996, Wit-Trade, as a digital secondary trading mechanism for its shares. However, three weeks later, the company issued a public statement to inform its shareholders that it voluntarily suspended the trading of its stock as the SEC requested to ascertain compliance with federal securities law. On March 25, 1996, the SEC informed Spring Street that trading could resume as long as the company would comply with certain specific requirements. The SEC wanted Spring Street to hire a bank or escrow agent to hold investors' funds and certificates. They also recommended to post information on the company's Web site about recent trading and the risks of buying illiquid stocks.

At the time, the success of Spring Street has attracted the attention and interest of securities lawyers, public officials, business leaders and commentators.[49] Notwithstanding liability and security issues, these people recognized that Internet was an effective means of soliciting investors, selling securities and creating a secondary public trading market while bypassing entirely underwriters. With millions of Web investors expected worldwide, the value of such an offering mechanism was undeniable.

---

48 Hereinafter the "SEC".

49 Many articles on the subject were published including: "Internet Offerings; On-Line Capitalism", *The Economist*, (23 November 1996), at 92; DE TORO A. & BERKOWITZ E., "Trade Wind; the Arrival of On-Line Securities Offerings", *The Los Angeles Daily Journal*, (27 June 1996), at 7; BOYCE, G.R., "Offering and Trading Securities on the Internet", *New York Law Journal*, (9 May 1996), at 5; WEIRICK, B.P., "With the Internet Craze Reaching the Public-Offering Markets, State, Federal and Foreign Regulators are Scrambling to Catch Up with Technological Advances", *The National Law Journal*, (6 May 1996), at B5; SILVERMAN, A.J., "Make Me an Offer On-Line; Securities Regulation on the Internet", *Legal Times* (8 July 1996) at 20.

Following Spring Street's success, several other U.S. companies attempted to make on-line offerings.[50] However, these offerings, such as Interactive Holdings Corp.'s, were not received with as much enthusiasm and, in some cases, issuers raised only a fraction of the amount targeted.[51] Thereafter, a number of different approaches were used to either distribute or advertise new offerings via Internet. For example, early in 1996, Berkshire Hathaway, Inc., a large U.S. public company, set the stage and demonstrated the importance and seriousness conferred by large industry players to Internet. The company completed an underwritten public offering partly by Internet, using the Web site of Salomon Brothers, Inc., an international U.S.-based investment bank. Such large publicly traded companies have the power and the resources to make traditional securities offerings. Nevertheless, as the case of Berkshire Hathaway proves, they have an interest in having and using Internet, where permitted, to advertize their offering and communicate with the public.

ii. Internet Private Placements

After the Spring Street public offering, the status and future of Internet private placements were still uncertain. Once their securities were registered, U.S. issuers could place offerings materials and advertize on Internet, but the same could not be said about private placements.

Indeed, for private placements conducted under Regulation D and Rules 505 and 506, general advertising and solicitation are prohibited: "Neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising."[52] Thus, any advertisement, article, notice or other communication in connection with a solicitation had to

---

50 See generally LOEB, Ronald M. & RICHTER, David J., "Electronic Offerings: Securities Law in the Age of the Internet", *Advanced Securities Law Workshop*, (Practising Law Institute, Corporate Law and Practice Course Handbook Series, 1996).

51 ASTARITA,Mark J., "SCOR Registration", *SEC News*, http //www.seclaw.com/docs/scor.html (last visited August 23, 2000).

52 S.4(2) of the *Securities Act of 1933* and see also at the state level for example s.25102(f) of the *California Corporate Securities Law of 1968*, as amended.

be limited and only qualified persons could be solicited. These hurdles were seen as important impediments for the development of Internet private placement offerings. The alternative was to direct the offering to pre-qualified clients but under this scenario, the advantages of the Web and its huge development potential seemed to be lost.

In July 1996, the SEC demonstrated once again its leadership and progressive attitude towards the application of information technology in the securities industry. The SEC offered issuers of private placements the opportunity to exploit Internet. The SEC issued a "No-Action Letter" which waived many concerns.[53] In the letter, the SEC affirmed that, assuming the content of the solicitation is appropriately limited, it would not take any action against the issuer for violation of the general solicitation rule provided a pre-qualification mechanism is used.

The first broker-dealer to receive permission from the SEC to make such a private placement over Internet was W.J. Gallagher & Co. Inc. through its Internet site called IPOnet.[54] The procedure that allowed IPOnet to receive permission from the SEC, which has been followed by several others since IPOnet made the debut, is simple. First of all, the home page does not refer to any specific offerings. Secondly, visitors are asked to complete via e-mail or ordinary mail an on-line questionnaire to determine whether they qualify as "accredited" investor or not. Information about the private offerings is then made available in a password-protected page. Only investors who are accredited are given a password to view the offerings. The qualification decision is then made by a broker/dealer. Thus, when approved, the user name and password provided allow accredited investors to download the prospectus and offering memorandum or have hard copies mailed to them.

---

53 *IPONET*, SEC No Action Letter (July 26, 1996). Although SEC No-Action letters are not rulings that would be binding on other issuers and are strictly limited to the facts of the case presented, they provide insight into the opinion of the SEC on particular issues. However, the letter offers no guidance as to exemptions from registration other than Rules 505 and 506 of Regulation D. See generally, Stovsky, M. D., "Private Securities Offerings on the Internet", *Cyberlaw*, http://www.cyberlaw.com/privoff.html (last visited August 23, 2000).

54 "SEC clears first brokerage for Net private placements", http://www.webfinance.net (last visited August 23, 2000)

In its July 1996 "No Action Letter", the SEC specified that the qualification of investors and the postings of offerings in a password-protected page would not be considered a form of "general solicitation" or "general advertising" which are prohibited by statute.[55] Therefore, the pre-qualification procedure would not be considered a general solicitation. Potential investors are only allowed to purchase securities once their qualification is submitted and approved. Finally, the invitation to complete the questionnaire has to remain generic in nature without referring to any specific issue.

With this interpretation of the SEC, other online broker/dealer have adopted the same approach and an important number of online private placements have occurred.

iii. e-minerals

In Canada, Internet has made a strong debut and the proportion of investors on Internet is similar to what is seen in the U.S. However, the Canadian investment community in the traditional market and on Internet is much smaller and the securities market does not offer the same capacity to absorb securities offerings. This could explain why, according to our research, there has been only one DPO from a Canadian issuer.[56]

The first Canadian DPO on Internet occurred on January 5, 1999. e-minerals exploration corp.,[57] a Canadian mining company, made the first public offering of securities exclusively on Internet without the use of an underwriter, a pure Canadian DPO. The offering was made exclusively for investors in the province of Ontario. Investors could subscribe for common shares of the company

---

55 Rule 502 c) *Securities Act of 1933, Regulation D.*

56 CRITCHLEY, Barry, "First Public Offering via Net", *The National Post,* January 6, 1999, at pp. D-1 and D-2.

57 Hereinafter "e-minerals".

at the e-minerals prospectus web-site[58] by completing the online subscription agreement and submitting it to the company by Internet.

As representatives from the company and its legal counsels stated after the offering,[59] e-minerals was confronted with numerous challenges and issues being the first issuer in Canadian history to complete a DPO via the Internet. Among others, the company had to deal with securities law, jurisdictional and security issues.[60]

The e-minerals offering was what is referred to as a "best efforts" offering. Subscribers had to entrust their funds with an institution recognized by securities regulators which undertakes to remit those funds to the subscribers if the minimum amount they had indicated was not raised.

To a certain extent, the e-minerals offering was, at the time, more advanced than most U.S. DPOs. Indeed, as stated by company representatives after the offering:

> "The e-minerals offering was a seamless, completely online transaction from beginning to end. The investor logged on the e-minerals Web site, accessed the prospectus, and could directly enter their relevant information onto the subscription form. This differed from the offerings done in the United States, most of which allow the investor to access the prospectus online, and provide a subscription form, which can be down loaded [sic], printed and completed by the investor. At this point however, the form had to be returned to the issuer through the conventional mail, along with payment for any shares purchased through the traditional methods of cheque, cash or money order. For example, the first online offering in the U.S. Spring Street Brewery utilized the Internet in its offerings, there was no

---

58 See at http://www.e-minerals.com [hereinafter "e-minerals Web site"] (last visited August 23, 2000).

59 BOYLE P. James, and MISETICH, Linda E., "e-minerals: Canada's First IPO Over the Internet", *Insight Conference April 27, 1999*, (Toronto: Insight, 1999)[hereinafter "Boyle"]; and FARRELL, Patrick V., "Mining the Web for Capital", *Insight Conference April 27, 1999*, (Toronto: Insight, 1999)[hereinafter "Farrell"].

60 The regulatory hurdles involved in making an offering in Canada will be reviewed in the next chapter.

> broker involved and the issuer accessed the public directly, the investor could not complete all aspects of the transaction directly online."[61]

Not just the mode of subscription but the method of payment in e-minerals' offering was rather innovative, as described in its prospectus:

> "In order to subscribe for Common Shares, investors must first confirm their Ontario residency, receipt of this prospectus and suitability for them of investment in Common Shares. The Online Subscription Agreement must be accompanied by full payment in Canadian funds of the subscription price for Common Shares subscribed for under the Best Efforts Offering. Payment may be made over the Internet by Visa, MasterCard and American Express using the e-minerals prospectus web-site's online payment system. The respective credit card issuers will charge the Company a transaction fee ranging from 3.25% to 4.25%, the cost of which is included in the estimated expenses of this Issue."[62]

Investors could also subscribe for common shares of e-minerals in a more traditional manner by downloading and returning a duly completed online subscription agreement by mail to the office of the company. After a few weeks, e-minerals was successful at raising almost $Cdn. 400,000 from investors who logged onto its Web site which is, we have to admit, a relatively small amount for an IPO.

Following their distribution, the shares of e-minerals were traded in the "secondary market" through the Canadian Dealing Network System, a computerized quotation system keeping track of stock prices of unlisted securities traded over the counter.[63]

---

61 Boyle, *supra* note 59 at p.15-16.

62 e-minerals Final Prospectus (January 5, 1999), at p. 23, on SEDAR at http:www.sedar.com.

63 See on the Canadian Dealing Network [hereinafter "CDN"]the symbol of e-minerals: EMIN/CDN.

Hence, with its "seamless, completely online transaction from beginning to end" and its payment mechanism allowing investors to buy securities on credit directly online using traditional credit cards, e-minerals was not only a pioneer in the history of Canadian securities offerings but also in the world annals of securities offerings.

A few months after its offering, e-minerals continued its development and decided to broaden its scope and acquired a privately-held firm to provide Web consultancy services.[64] The company also attempted to develop strategic alliances with Web developers and hosting services. The plan was to become a multi-media services and financial information firm with links to news services, stock quotations and even online trading.[65]

iv. Recent Canadian Developments

Following e-minerals' DPO, much of the activity of issuers in connection with Internet securities offerings in Canada has evolved around the posting of prospectuses and other selling materials, the solicitation of interest and the delivery of prospectuses and sales confirmation.

On the investment banking side, certain Canadian investment banking firms have departed from their traditional role and imitated their U.S. counterparts. For example, Groome Capital Corp.,[66] a small Canadian investment bank, has started to offer a full range of services over the Internet including a Web site for private placements. As seen in the U.S., pre-qualified investors have access to password-protected pages where are posted prospectuses for securities offerings in which such clients may participate. Similarly, a group of high profile investment bankers have formed another

---

64 See "e-minerals to Broaden Business; Internet IPO Firm to Step Out into Cyberspace" Press release of e-minerals at http://www.e-minerals.com.

65 A visit of e-minerals Web site reveals that most of these services are not offered, yet (last visited August 23, 2000).

66 See http://www.groome.com (last visited August 23, 2000)

firm called baystreetdirect.com Inc.[67] which is the first Canadian Web site to list securities offerings, private and public, and alerting subscribers, which are pre-qualified investors, about those new offerings.

As we stated earlier, if there are issues of legal and practical uncertainty in connection with Internet securities offerings in the U.S., this uncertainty is even greater among Canadian securities actors. Indeed, partly as a result of the lack of guidance from Canadian securities regulators, the smaller size of the Canadian securities market and the slower pace of adoption of Internet as a tool of commerce as compared to the U.S., there has been a lower level of activity for Internet securities offerings in Canada which could explain the relatively slow development of e-minerals since its IPO. However, this uncertainty and the desire of Canadian securities regulators not to hinder the development of the Canadian Internet securities market, while remaining concerned with the protection of investors and the application and enforcement of securities legislation, have prompted Canadian regulatory authorities to adopt certain national policies, as we shall review in greater details in the next chapter.

v. The Nature of Internet Securities Offerings

After this brief introduction to Internet and securities offerings, because there are distinctions to observe and before discussing the applicability of existing regulation to Internet securities offerings, it is useful to define the nature of an Internet securities offering. An "Internet securities offering" may be understood as an offering of securities whereby Internet is the only one or one of several media of communication used by the issuer to reach the public. One may also categorize Internet securities offerings according to products offered, degree of technology integration and level of participation of intermediaries.

The securities "products" offered on the traditional market vary in nature, quality, value and purpose. Common shares, preferred shares, warrants, bonds and debentures are considered the main

---

67 See http://www.baystreetdirect.com (last visited August 23, 2000)

"products" issued in traditional offerings. Unless prevented from evolving one way or another by securities regulators or market forces, Internet securities offerings should provide "products" similar to the ones seen in the traditional market.[68]

As a technology proposition, Internet securities offerings may be perceived along a continuum where they may have no Internet or other technology components (a paper-based offering entirely offline without any exposure on Internet which is difficult to imagine today considering the importance of the medium and the fact that most offerings have at least some degree of Internet exposure) or have all their components Internet or technology-based (an entirely online paperless offerings where all the steps normally found in an offering are online from prospectus access to payment of the shares and including the filing of the documentation).

Securities Offerings

Online (paperless) < ---------- Hybrid ---------- > Offline (paper-based)

Internet securities offerings may also be divided according to the market participants and intermediaries involved in process.

An Internet disintermediated offering, which we defined earlier as a DPO, is where the issuer contacts potential investors directly to sell them the securities. As we shall discuss in further details in the next chapter, the issuer must comply with regulatory requirements including the prospectus and registration requirements and obtain the required receipt and register itself as a dealer to effect the trades without the intervention of an underwriter. An intermediated offering is where the issuer complies with the prospectus requirement, obtains the required receipt from securities commissions,

---

68 Historically, DPOs in the U.S. have consisted mostly of stocks of Internet and tech-related companies considering the growing interest of online investors in Internet and tech companies but other products were gradually introduced, such as preferred stocks, bonds or debentures, and commercial paper of different companies. See for example notes or bonds called SmartNotes offered directly by GMAC at http://www.gmacfs.com/notes/smart (last visited August 23, 2000).

relies on a registration exemption and has an underwriter which is registered as a broker/dealer to conduct the offering and effect the trades. As we shall see below, Internet may be extremely useful in both intermediated and disintermediated offerings.

As we stated above, disintermediated offerings do not require the participation of underwriters as the issuer trades in the securities directly with potential investors. However, because of the registration requirement, and as we shall discuss further in the text, the issuer must follow a certain process which includes the obligation to register itself as a dealer to contact the potential investors and effect the trades.[69]

In a disintermediated Internet offering, the issuer must price the offering, prepare the prospectus with its legal counsel and post it on its Web site or a special Web site promoting such offerings, accept subscriptions for its securities and collect the funds paid by each investor. The whole process may occur online. The investor, after hearing about the offering from word of mouth or from a special Web site promoting such offerings,[70] will read information about the issuer and the offering and if interested in purchasing securities, may review the prospectus and complete the online subscription agreement.

In intermediated offerings, Internet may be used in one of several ways, but principally to market the offering and distribute the documentation. The underwriter will be chosen carefully to perform important functions as the issuer lacks the network, the reputation, the resources and the expertise to price the offering and assess the risk associated with price fluctuations in the market and how investors may receive the stock. Thus, the underwriter will use its own resources to find and contact potential investors interested in the offering and act as agent in selling the securities.

---

69 See *infra* note 137.

70 An example already cited of such a Web site is "baystreetdirect.com", see *supra* note 67.

Where Internet is used in an intermediated offering, the prospectus and general information about the offering are posted on a Web site but the selling function of the offering is performed by the underwriter or a syndicate of underwriters. Depending on the technology capacity of a dealer and the computer literacy of the potential investors, part or most of the selling function may be performed online including the trading as more and more dealers offer online trading capabilities.

E. Internet as a Financing Vehicle for Small Enterprises[71]

No recent development other than the arrival of Internet has driven small enterprises and investors so close together. For small enterprises, Internet means access to capital at much more reasonable costs and the possibility of a direct and permanent contact with shareholders and the public. For small investors, aside from the above-mentioned advantages, Internet provides the opportunity to access, on an equal footing, offerings that often were only available to selected investors. Although Internet may help small enterprises in the offering process, there are serious limits and challenges to the use of Internet in securities offerings.

Considering the stringent, complex and cumbersome nature of the legislation relating to public offerings, issuers must inevitably hire at high costs legal counsel specializing in securities law to deal with the regulatory process and requirements of an Internet securities offering. Such lawyers must not only be familiar with securities law but be comfortable with technology and technological issues to transpose securities law concepts online. Hopefully for small enterprises, technological developments which have already appeared will eventually allow to by-pass lawyers entirely. Yet, at the present time, there are discussions as to whether Internet may replace underwriters.

---

71 This section is largely inspired from ALLEBACH, Mark A., "Small Business, Equity Financing, and the Internet: The Evolution of a Solution?" in 1999 4 Va. J.L. & Tech. 3 [hereinafter "Allenbach"].

i. The Role of Underwriters

As we stated above, one of the revolutionary aspects of Internet securities offerings is the elimination of underwriters and other traditional intermediaries towards disintermediated offerings. Such intermediaries are normally required in most traditional securities offerings. However, with Internet, issuers may at last have direct access to thousands of potential investors without having to rely on underwriters.

As underwriters and other intermediaries are by-passed, the cost of the offering may be significantly reduced for the issuer. Indeed, as much as 10% of the offering sometimes goes to pay the underwriter's commission. In some cases, there is evidence that underwriters tend to underprice a stock to ensure the success of the offering which in turn reduces the capital that these issuers wanted to raise.[72] Consequently, one may ask how essential are underwriters in the offering process and whether Internet may perform most of the underwriters' functions.

In general, there seems to be skepticism among current established securities players about the role that Internet may play in the securities offering process.[73] Much of the skepticism is based on the conservatism of those players and their reluctance to have new technology dictating the manner of conducting an offering. In reality, the market rules and, over the last few years, the quantity of tech companies going public and their desire to integrate technology into their offering have forced underwriters to adapt. However, the skepticism is also related to the perception vehiculed in the securities market about the indispensable role of underwriters. Issuers have no contacts with potential investors and no skills or expertise to solicit and deal with potential investors and to prepare and conduct an offering. In addition, there is very limited access to the securities market without the participation and the name of one if not several reputable underwriters printed on the offering

---

72 MAHONEY, Paul G., "Technology, Property Rights and Information, and Security Regulation", 75 Wash. U.L.Q., 815, 823 (1997) [hereinafter "Mahoney"].

73 LANGEVOORT, Donald C., "Toward More Effective Risk Disclosure for Technology-Enhanced Investing", 75 Wash. U.L.Q. 753, 756-57 (1997) [hereinafter "Langevoort"]; and Mahoney, *supra* note 72 at p. 823.

documents. Therefore, the market has allowed underwriters to play a role increasingly important in the offering process and to charge huge fees which are sometimes considered not well-deserved.

In fact, underwriter's functions in the securities offering process are much more than a simple access to potential investors. Underwriters lend their reputation to a securities offering as the reputation of the underwriters is an important driving factor behind the investors enthusiasm, interest and confidence in a securities offering.[74] Indeed, in several cases, a highly reputable investment banking firm as lead underwriter can make a securities offering a successful one. It also has the ability to organize a group of underwriters to form a syndicate to help sell and distribute the offering. If the underwriter also has a solid client base which can absorb a substantial portion of the offering the success of the process is more likely. Once the stock is traded on an exchange, the solid underwriter will also help to sustain investors interest in the stock by issuing periodic reports on the company and having its research analysts following the stock or making presentations to investors groups about the company. The research and analysis functions of the underwriter are also important at the offering stage as they are an important part of the planning of such an offering.[75] At the point where investors interest in the stock is not as high as planners had anticipated, the underwriter may contribute effectively in ensuring the success of an offering by having its brokers push the stock to convince investors to buy.

Questioning the role and importance of traditional underwriters is a different way of asking whether there is another securities industry on Internet ready to be exploited or whether Internet is simply complementary to a well-established traditional securities market. In our view, before DPOs threaten the market share of traditional underwritten offerings, there are a number of legal and practical hurdles that will have to be resolved. For example, finding a pool of investors, maintaining their

---

74 Langevoort, *supra* note 73 at p. 756.

75 BAGLEY, Constance E. and TOMKINSON, Robert J.,"Internet is Seeing its Shares of Securities Offerings", Nat'l L.J., Feb.2, 1998 at C3 [hereinafter "Bagley"]

confidence and providing a means to increase the liquidity of their stocks have been and will remain challenges facing Internet securities issuers.

This is why we expect Internet used mostly by small enterprises incapable of going public through traditional means interested in Internet as a securities offering mechanism and other companies relying on traditional underwriters using Internet as an advertizing and communication vehicle. This opinion is shared by most Internet-based investment banking firms that have been established, such as Wit Capital Corp., to provide Internet specialized investment banking services and to support and promote on-line securities offerings.[76] These investment banking firms understand and respect the role and importance of traditional underwriters, do not pretend to replace them but rather to complement them, and promote their services accordingly.[77]

While practical issues may prevent certain Internet securities offerings, there are particular issues which must be addressed for Internet to make equity financing more accessible small enterprises.

ii. Internet as an Equity Financing Vehicle for Small Enterprises

Access to capital has been a problem for small enterprises for decades. A series of systemic problems in the current market structure makes equity financing very difficult for them. However, new technologies may help to alleviate part of the problem. But can Internet truly help small enterprises to access equity markets?

---

76 Following the success with Spring Street its founder created Wit Capital Corp., the world's first investment bank and brokerage firm dedicated to arranging Internet-based public offerings. Through its affiliate, Wit SoundView, Wit Capital Corp. has evolved into a full service investment bank. See http://www.witcapital.com (last visited August 23, 2000).

77 For example, Wit Capital Corp. offers investment banking services focusing on Internet in collaboration with traditional underwriters.

Part of the problem with equity financing relates to costs. Because much of the cost of a securities offering is fixed, the cost of capital is higher for smaller offerings. Also, potential investors are sometimes worried about the lack of liquidity of stocks which makes Internet securities offerings even more difficult considering that there is often no secondary market. Indeed, when they decide to sell, investors want enough liquidity for the market to be able to absorb the stock without an important loss in stock price. Furthermore, as we stated earlier, one of the setbacks of equity financing is finding investment banks to assist in the process of a securities offering which is sometimes impossible. In the U.S., investment banks rarely want to handle deals for less than $10 million U.S. In Canada, this amount goes down to $Cdn 1,500,000. Therefore, small businesses are left with venture capital firms which may invest at lower levels.

However, when small enterprises think about public equity financing it is sometimes because venture capital is no longer an option. To complete this picture of systemic problems, it seems that the present structure is established to facilitate financing for larger businesses while there is no equivalent structure for small enterprises which face considerable barriers to access capital.

Going public is an objective for most founders entrepreneurs especially in the technology sector as it allows these founders to almost instantaneously become rich. Beyond this objective, for any company, there are several advantages to going public. Once, the IPO is completed and the stock maintains its value, companies may be in a position to raise additional capital through the public which is something any growing company requires. Not only may access to capital be done more easily after the IPO but it may be done at substantially lower costs. Furthermore, being public means that a company may make an effective use of stock options and other stock rights in plans designed to attract and retain valuable employees.

In addition, public companies tend to enjoy more visibility and at times, prestige. For example, public companies are followed by research analysts and the media are more receptive to publish or broadcast their announcements and press releases. With visibility and prestige comes credibility

which may be invaluable for certain small enterprises with suppliers and customers often suddenly more confident doing business for companies once public. Finally, public companies have securities which are generally more liquid and marketable which is an advantage for owners as well as any other person holding stocks in such companies.

Among the disadvantages of going public, one must first state the cost of a securities offering. Indeed, the cost of accounting, legal, printing and registration fees to which must be added the cost of the underwriter's commission may result in total cost which may be as high as 35% of the offering price in some securities offerings.[78] Once the company is public, the continuing cost associated with disclosure obligations and updating other information constitute another burden. Also, management of the company may change the focus from long to short term as they tend to concentrate on the stock price and its continued growth. In the long run, such a vision may be counter productive. In addition, the freedom of the management is lessened as a result of the requirements to have important decisions taken to the board or even to the shareholders for approval. Other disadvantages, which are somewhat less prevalent, include the loss of control for the company's owner especially when large blocks of shares are held by institutional investors and the general loss of privacy when important information must be disclosed, considering the disclosure obligations of public companies. In this way, information that the company would rather preserve or retain confidential has to be disclosed.

Even if going public is the objective of most small enterprises, it is not clear how Internet will truly alleviate the problem of costs and fees. What is becoming increasingly clear about Internet is that it may not and will not replace traditional underwriters. Internet remains a medium of communication providing an easier access to investors. But, Internet has the potential to shake the foundations of what is known to be one of the most conservative industries in Canada. Indeed, Internet is attractive and constitutes an excellent marketing tool. Under the current system and

---

78 TIMMONS Jeffrey A. and SANDER Dalea, "Everything you (don't) want to know about raising capital", in *Finance for Corporate Growth*, 91 Harvard Business Review Paperback ed. 1991.

structure, it seems that an issuer making an Internet securities offerings with several Internet-based components can draw the attention of a greater number of potential investors or, in certain cases, it may contribute to raise more capital than through traditional means.

In many cases, companies with a good product or service or with a particular element of interest for potential investors will find their way through traditional means. Hence, DPOs seem to be for companies which offer securities of a lower quality than those which would be offered by a reputable investment bank. They are also perceived to be for non-conformist companies, innovative but less serious in their approach which may or may not be well interpreted by investors. Consequently, one may conclude that what is developing on Internet and is most likely to be successful is an hybrid form of offering with internet-based and traditional components.

Examples of such hybrid offerings may be found on the Web site of Wit Capital Corp.,[79] the pioneers in Internet securities offerings who rapidly understood the industry dynamics and founded an Internet investment banking firm. Wit Capital does not seek to completely by-pass traditional underwriters. Instead, the firm tries to connect issuers and potential investors registered as members of its firm and to offer to small investors a piece of what is normally a traditional IPO lead managed by some reputable investment banks. In a nutshell, Wit Capital tries to eliminate certain intermediaries and reduce transaction costs by offering new issues to smaller less sophisticated investors instead of following the approach of most traditional underwriters which keep new offerings to preferred customers such as institutional investors. In its objective to promote stability and avoid day traders or bargain hunters, Wit Capital goes one step further, in preventing investors from quickly"flipping" shares acquired, by instituting a policy whereby a propensity of certain investors for "flipping" securities is identified and results in loss of priority in subsequent offerings. Wit Capital also offers similar online services for private placements trying to match issuers with its members. Unfortunately, while bringing some novelty, the approach taken by Wit Capital does little to help

---

79 http:\\www.witcapital.com (last visited August 23, 2000).

small enterprises accessing capital more easily. Nevertheless, it exploits one of the abilities of Internet which is to provide low cost widespread distribution of information.

Reputable investment banks have started to understand not only the importance of Internet but the role that it can play and the favourable image that it brings to such firms. In the U.S., some of the important investment banking firms have acquired online brokerages in order to bring reputation and expertise to established Internet organizations.[80] Once again, while improving the image of some of these investment banks and providing new services to their clients, these initiatives offer little comfort to small enterprises.

Considering their deep roots, their importance and the fact that few issuers in need of capital are willing to criticize their role and status, traditional underwriters are unlikely to lose their predominant position. Businesses at the growth stage are capital sensitive and most would be reluctant without resources or a united voice to question the predatory attitude or gluttony of underwriters. Therefore, in our view, the importance of Internet securities offerings in Canada will grow but should remain marginal compared with traditional offerings. Only hybrid offerings and small offerings seem to have a future on Internet.

After a period of adjustments which should allow to decrease some of the uncertainties surrounding Internet securities offerings and with an increasing number of initiatives incorporating Internet components, more securities will be offered through Internet but to which investors?

iii. Reaching Potential Investors Through Internet

To provide an indication of the great potential of Internet in the securities industry, numbers are often cited, such as the volume of individuals with access to Internet or the millions of investors doing

---

80 Donaldson, Lufkin & Jenrette created DLJ Direct and BancAmerica Robertson Stephens created an alliance with E*Trade.

online trading. This potential brought much enthusiasm at the infancy stage of the Internet securities industry and provoked a reaction on the part of issuers sending a message to underwriters that at last they could survive without them. This phenomenon formed the basis of the disintermediation movement. However, while it is true that there are millions of Internet users, one may be skeptical about the number of "interested" investors in an Internet securities offering.

After excluding investors without computers, all disinterested and absent-minded viewers, interested investors are more likely to be people who already trade online or who have an interest in technology companies or initiatives and risky investments and who are not disturbed by the legal, technical, security and perhaps privacy issues and uncertainties surrounding those offerings. Who is left? Do Internet issuers truly have access to potential investors on Internet?

Because simply posting an offering on a Web site is not sufficient to attract investors, if any, issuers must consider alternatives. While the offering conducted by e-minerals was successful, it is the media coverage of this offering that ensured its success. Other issuers have to rely on firms providing an online advertising and promotion Web site for small offerings. After the service is established and the name of the firms is circulated, a number of potential investors may visit the site regularly and start paying real attention to new offerings. Once a group of issuers list their offerings on the same Web site, it may be possible to generate enough traffic to start being noticed by investors and hopefully to draw their attention to the securities being offered. An example of firms offering such online services is, in the U.S., Direct Stock Market[81] and in Canada Groomecapital.com[82] and e-minerals itself which, after its successful IPO, attempted to transform itself into an investment banking firm without the success it probably anticipated. While Direct Stock Market lists both DPOs and traditional offerings with Internet components, Groomecapital's Web site presents mostly traditional offerings as the number of DPOs in Canada is very limited.

---

81 http://www.dsm.com (last visited August 23, 2000).

82 http://www.groome.com (last visited August 23, 2000).

With a larger number of DPOs in the U.S., there is space for a firm such as Angel Capital Electronic Network ("ACE-Net") which was established by the U.S. Small Business Administration and which lists small corporate securities' offerings.[83] Thus, issuers interested in making securities offerings of 250,000 $ to 5,000,000 $ (U.S.) may place their offerings on-line with ACE-Net. In October, 1996 the SEC approved the concept[84] and today several states have followed the concept and imitated ACE-Net. As the number of investors attracted to such smaller offerings will increase, a greater number of investors will have confidence in the system especially if governmental authorities are involved. Contrary to several innovations described above, those are initiatives that can truly foster the establishment and promotion of a vibrant Internet securities' market for small enterprises.

Another issue that may be problematic for small enterprises is the type of investors that most likely will be interested in their securities. The average Internet investors seems relatively unsophisticated and younger. Therefore such an investor has limited investment experience and unfortunately for issuers, more modest financial resources. This was confirmed in a survey which found that a greater proportion of young investors between age 18 to 34 tend to use on-line sources in their investment activities.[85] Although the limited resources of younger investors could be problematic today, it announces a bright future for Internet securities offerings. Nevertheless, those offerings give access to a target group of potential investors who might not otherwise be fully exploited.

At the same time, there is a significant number of investors surfing from one Web site to another in search of the next success story at a bargain price. Some of those investors are professional buyers while others are more opportunistic, looking for small enterprises approaching the IPO stage at

---

83 BIGNESS, John, "Net to Link Investors and Startups", Ch. Trib. March 19, 1998, at p.1 [hereinafter "Bigness"].

84 Angel Capital Electronic Network, SEC no-action letter, at http://www.sec.gov (October 25, 1996); On the states that have established ACE-Net see Bigness, *supra* note 83.

85 SEC Reports to the Congress: "The Impact of Recent Technological Advances on the Securities Markets", Part IV.C.7 (1997) at http://www.SEC.gov/ news/ studies/techrp97.htm.

which point the gains are possible. The behaviour of such investors creates volatility in a stock which is why issuers prefer avoiding them.

Finally, one would tend to think that Internet is a good vehicle to offer securities to investors who are technologically sophisticated. However, these tech investors are also the ones who most likely focus on technology and neglect investments, because of a lack of time or interest. However, one must admit that those investors may be more likely to use Internet for their investments than traditional means, more receptive to those types of offerings and the issuers making them and perhaps generally more comfortable with the vehicle than ordinary investors. To the contrary, Internet securities offerings and especially DPOs may miss the opportunity of attracting traditional investors who have a general aversion towards technology and less conservative means of investing.

Consequently, Internet may give small enterprises inexpensive access to a pool of potential investors and at the same time may fail to attract their attention. The investors likely to invest through Internet may not be the ones that issuers would prefer to have as shareholders. This is why issuers must prepare the distribution, identify their target investors and market their securities offering intelligently. Reforms could also introduce a more favourable structure, mechanisms and tools to overcome the weaknesses of Internet securities offerings and allow small enterprises to fully exploit the medium and access equity capital more easily.

iv. The "Testing the Waters" Mechanism

In the U.S., Internet offers the possibility of exploiting the "test the waters" mechanism, something which should be adopted in Canada. The *Securities Act of 1933* provides the possibility for Regulation A issuers to test the response of investors to their offerings by allowing solicitation without violation of Section 5 of the *Securities Act of 1933*. Such a possibility is very useful for small issuers with limited resources and such a procedure should be adopted by Canadian securities regulators to allow them to test the market before their Internet securities offering.

The SEC has already approved the on-line posting of testing the water material, even if what the legislation authorizes is the use of "written document" or "scripted radio or television broadcast" to test the waters.[86] This is one noticeable advantage of Internet as an offering vehicle; the issuer only has to prepare a Web page or a mass e-mail which is more effective and less costly than preparing, printing and mailing traditional documents. While the effectiveness of Internet in testing the waters is obvious, there is no certainty that the material ever reaches its audience. However, since the offering vehicle for the ultimate targeted audience is the same, testing the waters through Internet for DPOs makes sense. Although a lack of response might be due to several factors including the failure of investors to notice the materials or the lack of investors' enthusiasm at a particular moment, it may be a relatively effective and inexpensive means to assess the response of potential investors to an offering. In such cases, testing the waters amounts to "testing the medium" or "testing the offering vehicle".[87] In other words, the issuer not only tests the interest of investors for the offering, but also the approach and the vehicle used, thereby reducing uncertainty and costs. Such a mechanism is advantageous to small enterprises and it should be introduced in Canada.

v. Secondary Market

One of the greatest weaknesses associated with Internet securities offerings is the low liquidity of the issued stocks. The liquidity of a stock is important to investors who have to ascertain that they may sell their stocks easily without having to take a large discount. Sometimes, to compensate for the lack of liquidity and to ensure the success of an offering, some issuers may offer their securities at a substantial discount. In traditional offerings, the underwriter may act as the market maker for the stocks especially in cases where the stock does not qualify for traditional exchanges such as NASDAQ or the TSE. With DPOs, the risk associated with removing intermediaries such as

---

86 Angel Capital Electronic Network, SEC No-Action Letter SEC No-Action Letter, 1997 Decisions Transfer Binder, Fed. Sec. L. Rep. (CCH) 77,305, at 77, 516 (October 25, 1996), see also at http://www.sec.gov.

87 Allebach, *supra* note 71 at p.22.

underwriters is exacerbated by the fact that underwriters may not perform their market maker functions to compensate for a lack of liquidity of a stock.

For this reason, the Internet securities industry has witnessed several initiatives over the last few years to circumvent this problem. This is how "alternative trading systems" or "ATS" came into existence.

ATS are established to centralize, match, cross or execute trading orders out of traditional securities exchanges. Sometimes, ATS match and execute orders in various ways which is more or less what is found in traditional markets. Other less sophisticated systems exist such as "Internet bulletin boards" or "IBB" which are often maintained by the issuer and where investors and shareholders can post bid and ask prices to buy or sell their stocks. BBS provide relatively inexpensive systems for issuers to increase liquidity of their stocks and for shareholders and investors to adjust their holdings. As only enough information is contained on the Web site for interested parties to contact each another, BBS usually do not match offers or settle trades.[88]

Considering that more sophisticated ATS' which mirror traditional exchanges have difficulty in the U.S., it is unlikely that a viable ATS would survive in Canada. For example, the Arizona Stock Exchange is an ambitious system which still struggles to obtain the volume to make it a real alternative for secondary trading of small issuers' stocks.[89]

ATS' and IBB's attempt to provide a means to increase liquidity in stocks. In truth, they seem to offer a pale alternative to traditional exchanges. In some cases, they only provide a means to post investors' intention to buy or sell which falls short of increasing liquidity in a stock.

---

88 BARTHOLOMEW, David M. and MURPHY, Dena L., "The Internet and Securities Regulation: What's Next?" 25 SEC. Reg. L. J. 177, at p.187 (1997) which describes the request made by Real Goods Trading Corporation in its application for a SEC No-Action Letter.

89 See generally Bagley, *supra* note 75.

In the U.S., the SEC has already stated that it would not take action against issuers operating such bulletin boards.[90] In Canada, securities regulators have taken steps to create a framework to allow competitive operation of traditional exchanges and ATSs and trading in a fair and transparent manner. The CSA have introduced two proposed documents to provide a regulatory framework of operation for traditional markets, such as recognized exchanges and recognized quotation and trade reporting systems, and new markets, such as ATSs.[91]

Unfortunately, even if such ATS' offer the opportunity for shareholders and interested investors to meet and post information about their trading intentions, it does not offer the kind of liquidity expected by investors. If a structure or a special stock exchange is not put in place in Canada for Internet securities to be listed, DPOs will always remain a marginal phenomenon.

Considering the number of problems that still have to be overcome, it is doubtful whether Internet truly helps small enterprises to access capital more easily. In Canada, the situation is even more problematic considering the size of the market. At this moment, it seems that there is no clear consensus among industry players as to whether Internet will ever constitute an alternative securities industry.[92] In any event, Internet clearly provides some advantages over and above traditional means of communication and offers various new marketing tools at a low cost which indirectly helps smaller enterprises. In small increments, such advantages will improve access to capital for such companies even if, at least in the short or medium-term, Internet does not provide them with a reliable and viable alternative to traditional offering mechanisms.

---

90 See the Flame Master Corp., SEC no-action letter (Oct. 29, 1996) at http://www.sec.gov; Perfectdata Corp., SEC no-action letter (Oct. 5, 1996) at http://www.sec.gov; and Real Goods Trading Corp., SEC no-action letter at http://www.sec.gov (June 24, 1996).

91 Notice of Proposed National Instrument 21-101 Marketplace Operation, and Notice of Proposed National Instrument 23-101 Trading Rules, at http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/ats.pdf (last visited August 23, 2000).

92 See RAFTER, Michelle V., "On-line IPO's falling short of expectations", *L.A. Times*, May 26, 1997 at p.B2 who argues that successful Internet securities offering are rare and will probably continue; and BROCKHOFF, Anne, "Clear off Internet run away for wave of IPO launches", 16 Kansas City Bus.J. 26 (DEC.15, 1997) (who expects continuous growth for Internet securities offerings).

Practical limitations exist making access to equity capital difficult for small enterprises even with the arrival of Internet. Reforms might be desirable in certain areas including the introduction of procedures to "test the waters", a Web site listing securities offerings such as ACE-Net and alternative trading systems with listing requirements that truly allow small enterprises to list their shares to provide liquidity to their shareholders.

As we shall see in the next chapter, Canadian legislation on securities does not facilitate financing by small enterprises either as statutory obligations apply whether a securities offering is paper-based or Internet-based. Consequently, other reforms would be welcomed by small enterprises especially relating to prospectus and disclosure requirements.

II. Regulation of Internet Securities Offerings in Canada

A. The Regulatory Approach; Interpretive Guidance

With the introduction of Internet, the legal requirements for securities offerings should not change albeit some required adjustments and interpretations. In fact, as we shall explain further below, the approach which seems to be preferred by regulators is to favour flexible legislation which is technology friendly and neutral.

On January 1, 2000, National Policy 47-201 entitled "Trading Securities Using the Internet and Other Electronic Means" came into force.[93] NP 47-201 is an initiative of the Canadian Securities Administrators ("CSA") to provide the CSA's views on issues relating to the use of electronic media in securities offering. The underlying premise of NP 47-201 is that the basic principles of securities regulation should not change whether the medium used is paper or Internet-based.

Considering the increasing popularity of Internet, the CSA considered that several issues including jurisdiction, registration and other statutory requirements relating to Internet securities offerings and trading required and justified the issuance of a separate national policy. Furthermore, the CSA thought that its views should be set out on certain compliance requirements such as the maintenance of distribution lists and the distribution of information during the "waiting period", that is the time between the issuance of a receipt for the preliminary prospectus and the issuance of a receipt for the final prospectus.

---

93 See at http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/47-201_19991217.html [hereinafter "NP 47-201"] (last visited August 23, 2000). NP 47-201 was issued by the CSA and was adopted in all of the jurisdictions of the CSA. Similar initiatives have been introduced in other western jurisdictions such as United Kingdom, Australia and Germany; see generally MONDSCHEIN, Lisa A., "The Solicitation and Marketing of Securities Offerings Through the Internet", 65 Brooklyn L. Rev. 185 and BLAKE, R. C., "Article: Advising Clients on Using the Internet to Make Offers of Securities in Offshore Offerings", 55 Bus. Law. 177.

Concurrently with NP 47-201, another national policy, NP 11-201 entitled "Delivery of Documents by Electronic Means", came into force on January 1, 2000.[94] The CSA issued NP 11-201 to state its views on securities documents delivery by electronic means. As a general principle, the CSA wanted to state clearly that it is favourable to the delivery of documents by electronic means. As we shall review below, the CSA seized the opportunity to put forth the elements to show good delivery: notice of delivery to the recipient, access of the recipient to the document, evidence of delivery and non-corruption or alteration of the document in the delivery process.

It must be stated that as a result of the constant and rapid change of Internet and information technology, the CSA decided not to impose mandatory rules nor to change substantive securities law requirements which may suddenly become obsolete with new technology. Instead, NP 47-201 and NP 11-201 set out guidelines allowing securities market participants to determine how they will best meet the requirements of corporate and securities law. This is why we may state that the approach which seems to be favoured by Canadian securities regulators is to have legislation that is technology friendly and neutral and to avoid to the extent possible amending substantive rules.

Similarly, in the U.S., the SEC has adopted a hands-off approach with the venue of Internet. They have tried to avoid readdressing securities issues through specific legislation. Reference to existing legislation by analogy to the paper-based world seems to be preferred.

The SEC has also publicly stated that it wants to encourage and facilitate the use of Internet in the securities industry.[95] As the SEC already indicated in its interpretative releases,[96] its belief is that

---

94 See at http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/11-201_19991215.html [hereinafter "NP 11-201"] (last visited August 23, 2000). NP 11-201 was issued by the CSA and was adopted in all of the jurisdictions of the CSA.

95 See "Use Of Electronic Media For Delivery Purposes" *Securities Act of 1933* Release No. 33-7233, *Exchange Act of 1934* Release No. 34-36346, *Investment Company Act* Release No. 21,400, 1995 WL 588462 (Oct. 6, 1995) at http://www.sec.gov/rules/concept/33-7233.txt (last visited August 23, 2000).

96 *Ibid.*

Internet enhances the efficiency of the securities market as it helps to disseminate information rapidly and in a more cost-efficient, widespread and equitable manner.

As in Canada, the SEC requires that electronic documents be prepared, updated and delivered consistent with existing laws; that the delivery of documents via Internet be as certain as paper delivery; and that investors have effective access to all information required to be disclosed, and the opportunity to retain it.[97]

Although somewhat different, the U.S. experience may sometimes provide an indication of developments to come in Canada and serve as a useful model of comparison and inspiration.

B. The Impact of Internet on Securities Offerings Regulation

i. The Prospectus on Internet

To use the concepts we have introduced earlier, no matter what medium of communication or distribution is used, there is a requirement in Canada to produce a prospectus whenever a "trade" in a "security" constitutes a "distribution". As a result, it is important for companies or individuals selling or promoting different products on Internet to understand and keep in mind the meaning of "trade", "security" and "distribution" in the securities context and under what circumstances a prospectus is required as there are penal, administrative and civil sanctions applicable when an issuer fails to file a prospectus when it is required.[98]

---

97 *Ibid.*

98 On the penal sanctions applicable see s.161(1)(e) A.S.A. , s.155(1)(b)&(d) B.C.S.A.,s.122(1)(c) O.S.A.and s.195(3) Q.S.A.. These sanctions include fines of $500 to $1,000,000 and imprisonment for up to 5 years less a day depending on the province. Several administrative sanctions may be imposed by securities commissions and administrators including a cease trade order, denial of exemption, suspension of registration or directing compliance, which vary from province to province. See for example s.164, 165, 166 and 166.1 A.S.A., s.161 or 164 B.C.S.A., s.127 and 128 O.S.A. and s. 264 and 265 Q.S.A. A civil action may exist for a failure to provide a prospectus where it was required. The action would be to declare the "contract" of purchase void and to recover the price paid for the securities. See generally Waddams, S.M., *The Law of Contract*, 2nd ed.

To make an Internet securities offering in Canada, an issuer must prepare and file a preliminary and a final prospectus with the securities commission of the province where the offering is intended to be made. Detailed provisions governing the filing process and the content of the prospectus is found in the securities legislation of each province.[99] Although the use of the Internet prospectus is permitted, Canadian securities regulators have not completely embraced the technology.

One of the interesting features of Internet is the possibility to use multimedia communication features. Multimedia communications offer the possibility of making presentations to viewers with sound, images and animation combining text, video, graphics, charts and photographs.

The use of multimedia communications in prospectus and mandated disclosure documents is an issue that was addressed by the CSA in its recently published national policies. Pursuant to s. 3.4 of NP 11-201, the views of the CSA on the subject are the following:

> "It is recommended that any information presented through multimedia communications that cannot be reproduced identically in non-electronic form not be included in statutorily required disclosure documents."

In considering what is meant by "reproduced identically in non-electronic form", one should air on the side of conservatism and conclude that any multimedia communication, presentation or document that cannot be reproduced or described precisely in writing should not be included in a prospectus nor any disclosure document required by securities legislation.

The logic behind this guideline is that the CSA wants to provide to all investors equal access to information about a company without discrimination on the basis of technological capabilities.

(Toronto: Canada Law Book 1993). See also under the civil law of Quebec art.1417, 1418 and 1422 *Civil code of Quebec*.

99 *Supra* notes 15-16.

Publicly available information about a company, such as historical data, figures or financial statements, may be compiled and disseminated by the use of CD-Rom's and other multimedia communication forms. In case of doubt about whether it is appropriate to use multimedia communication, as when investors' understanding of a proposed offering would be materially enhanced, the CSA has stated that the matter may be discussed.[100]

In terms of substance, no simpler requirements exist for Internet securities offerings and a prospectus prepared for such an offering should not be very different from a prospectus prepared in a traditional offering. The information provided may differ, however, regarding the plan of distribution on Internet.[101]

For example, Item 2 of *Schedule 1* of the Q.S.A. requires the issuer of securities that are not being offered by underwriters to outline their plan of distribution. In the case of a best efforts offering, the issuer must also indicate on the first page the minimum amount required to be raised, the maximum amount that could be raised, and the latest date that the offering is to remain open.

To this effect, the preliminary prospectus filed with the *Ontario Securities Commission* by e-minerals contained this short mention:

> "It is expected that primary solicitation will be by the way of direct offering on the Internet, which may be reviewed by prospective investors at the Company's web-site at www.minnissabik@dpo.on.ca."[102]

In its final prospectus, the plan of distribution was also the object of a short mention:

---

100 *Supra* note 93 at p.14.

101 *Supra* notes 15-16.

102 e-minerals Preliminary Prospectus, *supra* note 62 at p. 18.

> "It is expected that primary solicitation will be by way of a direct offering on the Internet. Prospective investors may review the Company's prospectus online at its prospectus web-site by accessing the Company's web-site at www.e-minerals.com."[103]

Therefore, it seems that the advantages of Internet, technology and multimedia will be curtailed as the Internet prospectus must simply be a copy of the prospectus found in a traditional offering except that it is offered in digitalized form and that the plan of distribution, in case of a DPO, describes specifically that the offering will be made by way of a direct offering on Internet. Apart from press releases and communication with investors at times when promotional and advertising restrictions found in securities legislation do not apply,[104] the use of multimedia communication is not recommended.

Considering that prospectus requirements apply whether the securities offering is paper-based or Internet-based and that Internet offers features and advantages that should be exploited, securities regulators should consider reforms to allow the integration of multimedia components and to increase accessibility to equity financing for small enterprises which, with simpler forms or structures, could have requirements less cumbersome for them.

ii. Prospectus Exemptions for Internet Securities Offerings

Internet securities offerings may be interesting and advantageous from the perspective of some issuers relying on prospectus exemptions. As a matter of fact, prospectus exemptions offer many advantages including the fact that they allow the avoidance of several legislative requirements such as costly prospectus and continuous disclosure. Thus, the prospectus requirement exemptions are

---

103 *Ibid* at p. 22.

104 S. 109 (3) A.S.A., s. 140(2) *B.C. Rules*, s. 72(4) O.S.A.

attractive to them and it is a worthwhile exercise to investigate which exemption might be useful in the context of an Internet securities offering by a Canadian issuer.[105]

Generally, prospectus exemptions are available when prospectus disclosure and civil liability for misrepresentations are not considered necessary for the protection of investors. Several prospectus exemptions are available on the reasoning that investors do not have to know all the information that the prospectus would contain, that the information that would be provided by the prospectus is not new or that it would be provided in other documents than the prospectus.[106]

a. Exempt Institutions and Purchasers

The legislation assumes that a prospectus is not required for "sophisticated investors" to determine whether they should invest in a stock. Thus, offerings to certain institutions such as banks, trust companies and insurance companies as well as certain specific institutions such as the Federal Business Development Bank, Her Majesty in Right of Canada or of a province, a municipal corporation or a public board or commission in Canada, are exempt from the prospectus requirement.[107] This exemption applies only when the exempt institutional purchaser is acting as a principal and not when they act as agent for other investors, except in the case of trust companies which are presumed to be purchasing as principal when acting as agent or trustee for accounts that are fully managed by them.[108] The belief is that those institutions have the means to acquire the type of information that would be contained in a prospectus.

---

105 These exemptions are available by virtue of the securities acts and regulations of certain provinces of Canada. There exists many other exemptions contained in the acts and regulations of the various provinces which could also be available for Internet securities offerings which are not presented in this paper.

106 Gillen, *supra* note 8, at p.226-258.

107 S.55(2)(1) B.C.S.A.; S.72(1)(a) O.S.A.; and S.43 and 44 Q.S.A.

108 S.55(1(a) B.C.S.A.; S.72(2) O.S.A.; and S.45 Q.S.A.

There exists other sophisticated investors referred to as exempt purchasers who are considered as such because of their investment expertise or the quantity of securities that they purchase. The prospectus exemption applies to them in case only when they act as principal. To be considered an exempt purchaser, certain elements have to be considered such as the size of the investment funds managed and the expertise of the staff.[109]

To the extent that a Web site allows to qualify potential investors as it is done commonly with a password-protected page making no reference to any offering, these exemptions could be used. Therefore, a firm with a Web site may establish in advance a list of exempt potential investors by contacting them directly or offering them directly on its Web site to become members. Alternatively, a codification or verification system could be established to identify all those Canadian exempt institutions and purchasers or to verify information provided by them. As a result, an extranet or Internet-based system could be put in place allowing exempt institutions and purchasers to be informed of new exempt Internet securities offerings and allowing them to participate and subscribe in a completely integrated online system.

b. Large Purchases and Sale to Dealers and Underwriters

Another exemption is available for large purchases or when the trade involves the issuance of a security as consideration for assets.[110] To the extent that a registered dealer is purchasing as principal from another registered dealer, there is also an exemption available. As such, those registered dealers are also sophisticated investors.[111] The same applies to sales made by a person or an underwriter to

---

109 S.55(2)(3) B.C.S.A.; S.71(1)(c) O.S.A.; and S.44(12) Q.S.A.

110 S.55(2)(4) and (5) B.C.S.A.; and S.118(1) and (2) B.C. Regulations; S.71(1)(d) and S.72(1)(l) O.S.A. and S.21(3) and (19f) Regulations; and S.51 Q.S.A. Note that an offering memorandum may be required in some provinces when there is advertising for the distribution. See S.127 B.C. Regulations; S.21(2) O. Regulations; and S.51 Q.S.A.

111 S.55(2)(6) B.C.S.A.; S.72(1)(q) O.S.A.; and S.43 and 44(9) Q.S.A.

another underwriter acting as purchaser.[112] When a trade in securities is made to a registered dealer or underwriter as consideration for services performed related to the distribution of securities of the issuer, another prospectus requirement exemption applies.[113]

Unfortunately, many of these exemptions relate to specific cases, such as trades made from one registered dealer or underwriter to another. In these cases it is difficult to discern a pattern that could be repeated and prove useful or profitable to small issuers in the Internet context except in relation to cases where a pre-screening of potential investors is feasible, as we described above.

In the case of the above-mentioned large purchases, the only requirement is a proof that the investor paid a large amount for the stocks purchased. The practical implications of this exemption are that the large purchases required by provincial legislation are probably beyond what small investors are willing to pay for stocks offered through a DPO.[114] Therefore, the use of this exemption might be limited except in cases where the potential investor with large amounts to invest has been pre-qualified to determine his or her investment capacity.

In the case of securities offered through a prospectus exemption, an important inhibiting factor to consider is that any subsequent trade by any of those people or institutions is deemed to be a distribution requiring a prospectus, unless specific conditions for resale are respected.[115] Thus, to resell securities without a prospectus or reliance on an exemption, the issuer must be a reporting issuer not in default of its reporting obligations and the required hold period must have been respected to assure an adequate base of information about the issuer and the security.[116] As a result,

---

112 S.55(2)(15) B.C.S.A.; S.72(1(r) O.S.A.; and S.43 and 44(9) Q.S.A.

113 S.55(2)(24) B.C.S.A.; and S.43 and 44(9) Q.S.A.

114 The amount is $97,000 in most Canadian provinces except in Ontario and Quebec where it is $150,000.

115 S.133(2) and 134(2) B.C. Regulations; S.72(4) O.S.A.; and S.5(3) and 58 Q.S.A.

116 *Supra* note 104.

these securities are not freely tradeable which diminishes the attractiveness of the vehicle or limits the use of this type of Internet securities offering.

c. Sophisticated Investors

Other exemptions apply in the case of investors considered "sophisticated". In those cases, people have to meet a test of sophistication based on an individual's net worth and investment experience or on advice from a registered dealer.[117] It is believed that the test serves to prove that these investors do not require the protection of the information contained in the prospectus and the statutory civil liability sanction for misrepresentation. However, an offering memorandum with a right to rescission or damages against the issuer or vendor reasonably similar to the statutory right of action offered in cases of offering by prospectus has to be given to those investors.[118] The advantage of the offering memorandum over the prospectus is that it is not as time consuming or costly to prepare, principally because the offering memorandum is not revised by securities commissions.

One of the very important limitation aspects of those exempt offerings is that they are not to be accompanied by advertisement or promotional expenses. Such a condition diminishes their use on Internet unless procedures are used to circumvent this problem. Those procedures are already in place in the U.S. and to some extent in Canada through the use of password-protected pages accessible to pre-qualified investors only. Those pre-qualified investors would have to be sophisticated or exempt potential investors. Such structure could be used although it must be stated that each purchaser must act as principal and the number of purchasers must not exceed a specified number which may vary from province to province.[119] One factor of uncertainty remaining relates

---

117 S.107(1)(p) and (q), s.128 (a) and (b) British Columbia Rules, s. 72(1)(p) O.S.A. and s.47 and 48 Q.S.A.

118 S.126(b) B.C. Regulations; and S.21(1)(a) and (3) O. Regulation; and S.221 Q.S.A.

119 In most provinces including Alberta and British Columbia, the limit is 50 purchasers, exempt in Ontario where the limit is 25 purchasers or 50 purchasers in case of government incentive securities and in Quebec where it is 25 subscribers or 50 subscribers in case of tax shelter securities, see s.107(1)(p)(i) and (q)(i) A.S.A., s.128(a) British Columbia Rules, s.72(1)(p) O.S.A. and s.47 and 48 Q.S.A.

to the interpretation of the additional qualification in certain provinces where solicitations are not to be made to more than a specified number of persons.[120] Finally, it must also be noted that as with other exemptions, resale of stocks purchased under these exemptions are subject to resale restrictions.[121]

d. Investors with Common Bonds

Exemptions may be available for investors who have common bonds with the issuer. These people include incorporators and promoters who would help the business in its organization or financing, control persons, who hold a sufficient number of voting rights on securities of the issuer, and friends and relatives of the issuer or, where the purchaser is a company, whose shares are beneficially owned by the spouse, parent, brother, sister or child of a senior officer or director of the issuer or of an affiliate of the issuer. Those common bond potential investors being already reachable by issuers, in those cases Internet's value-added as an offering vehicle is more limited and as such would not prove so useful except as a communication vehicle.

e. Small Issuers Financing

To facilitate financing by small issuers, because the costs of producing a prospectus can be relatively high for small offerings, some exemptions are targeted to private issuers.[122] The private issuers must not be a reporting issuer or a mutual fund and its shares issued and outstanding must be subject to

---

120 In Ontario, for example, solicitations may not be made to more than 50 persons and to no more than 75 persons in case of government incentive securities, see s.72(1)(p) O.S.A.

121 S.133(2) and 134(2) B.C. Regulations; and S.72(4) O.S.A.; and S.58 Q.S.A.

122 S. 115(a) and 66(j) A.S.A., s.75(a) and 46(j) B.C.S.A.; S.73(1)(a) and S.35(2)10 O.S.A.; and S.54 Q.S.A.

restrictions on transfer. The securities of a private issuer must be beneficially owned, directly or indirectly, by not more than 50 persons and must also not have been distributed "to the public".[123]

This exemption could be used in the context of an Internet securities offering was it not for the requirement that the stocks may not be offered for sale to the public. Once again, a Web site that does not advertise nor solicit any trade in a password-protected page style could be used. In such a Web site, pre-qualified investors could review documentation of issuers although the fact that the securities may not be owned by more than 50 investors limits the widespread use of Internet in such circumstances although a door of opportunities for small issuers remains open. The question to consider becomes what a Web site hosting such offerings would demand from small issuers just to post their offering documentation. To allow more small enterprises to take advantage of this exemption, the limited number of purchasers could be increased.

f. Government and Financial Institutions Securities

Issues of bonds, debentures or other evidences of indebtedness guaranteed by the governments of Canada, the provinces, the United Kingdom, the U.S. or any state, district or commonwealth are exempt, on the basis that those securities are relatively safe investments.[124] The same applies to bonds, debentures or other evidences of indebtedness of a municipal corporation in Canada, including debentures issued for vocational school purposes, guaranteed by a municipal corporation in Canada or secured by or payable out of rates of taxes levied under the law of a province on property in the province and collectible by the municipality.[125] Bonds, debentures or other evidences of indebtedness of, or guaranteed by, banks, loan or trust companies, or insurance companies are

---

123 For a discussion on the meaning of the words "to the public", see *S.E.C. v. Ralston Purina*, 346 U.S. 119 73 S.Ct.981 (1953), and *R. v. Pipegrass*, (1959), 29 W.W.R. 218, 23 D.L.R. (2d) 220 (Alta C.A.).

124 S.115(a) and 66(a)(i) A.S.A., s. 75(a), 46(a)(i) and (ii) B.C.S.A.; s.73(1)(a) and s.35(2)1(a) O.S.A.; and s.3(1)(15) and s.41(1) Q.S.A.

125 S.115(a) and 66(a)(ii) A.S.A., s. 75(a), 46(a)(iii) and (ii) B.C.S.A.; s.73(1)(a) and s.35(2)1(b) O.S.A.; and s.41(2) Q.S.A.

securities for which an exemption can also be claimed except if they are subordinate in right of payment to deposits held by the issuer or guarantor.

This exemption is based on the reasoning that in Canada, those financial institutions are relatively large and stable. This is why certificates or receipts issued by a trust company or a credit union for money received for guaranteed investments might be included in this category, as well as commercial papers having a term to maturity of not more than 12 months.[126]

This last exemption is interesting and attractive to all those institutions. Indeed, contrary to several other exemptions, the basis of this exemption is not the potential investor but rather the type of issuer. As such, certain types of bonds, debentures and other evidence of indebtedness guaranteed or issued by a government authority or a certain type of company may be offered on Internet without the need of a prospectus. Considering that their presence is minimal on Internet, it seems that those authorities and institutions still have to seize the full potential and opportunities that Internet may offer to them in terms of direct financing.

g. Other Exemptions

Finally, other specific exemptions exist from province to province and securities commissions have also the authority to grant exemption orders for certain issues where it is not prejudicial to the public interest. This is the case where a particular transaction does not correspond to any of the exemptions provided in the acts and regulations.[127]

---

126 See s.115(1)(a), 66(b) and (d) A.S.A., s. 75(a), 46(b) and (d) B.C.S.A.; s.73(1)(a), s.35(2)2 and 4 O.S.A.; and s.41(2) Q.S.A. In most cases, the commercial paper must have a minimal denomination of $50,000.

127 S.116(1) A.S.A., s.76 B.C.S.A., s.74 O.S.A.; and s.263 Q.S.A.

In determining whether it is prejudicial to the public interest to grant an exemption order, securities commissions will consider the benefits likely to be derived from enforcing the prospectus requirement against the costs of the requirement. Factors to be considered include:

> "(i) the need of the purchasers to know the kind of information that would be provided by a prospectus;
> (ii) any common bonds the purchasers might have with the issuer;
> (iii) the extent to which the information that would be provided by a prospectus is already available;
> (iv) the extent to which a market for the securities exists such that available information is likely to be reflected in the market price;
> (v) the existence of another regulatory mechanism that will protect investors;
> (vi) the degree of risk likely to be associated with investments in the particular securities; and, perhaps also,
> (vii) the existence of any policy directed towards promoting the particular type of investment."[128]

Increasing accessibility to equity financing for small enterprises could be a policy to promote under an exemption order.

Each exemption maybe accompanied by terms and conditions for its application. Such terms and conditions may include disclosing certain facts or numbers or providing a contractual right of action or of withdrawal to investors.

If a particular type of transaction occurs with sufficient frequency, as we would hope would be the case eventually for certain types of Internet securities offerings and products, securities commissions may consider issuing a blanket order. Where the proposed transaction meets the requirements of such an order, no application to the commission is required for the exemption order to be obtained.

---

128 Gillen, *supra* note 8 at p. 257-258.

It is difficult to determine under what circumstance exemption orders and perhaps blanket orders could or should be sought. However, considering the rapid development of Internet, securities regulators may be solicited and prompted to act.

h. Resale Restrictions

It must be noted that by respecting certain resale restrictions, people who would purchase securities under certain exemptions could resale shares to the public as long as certain conditions assuring adequate continuous disclosure have been met. Continuous disclosure usually takes the form of financial statements, proxy circulars and material change reports issued regularly from the issuing company. As we stated above, the resale restrictions come into effect by deeming the resale to be a "distribution" subject to a prospectus requirement.[129] As a result, the resale of securities also requires either the issuance of a prospectus or the prospectus exemption. However, such resales of securities are not deemed to be offerings if certain conditions are met:

> (1) the issuer is a reporting issuer not in default of any requirement of the applicable act or regulations,
>
> (2) the securities resold have remained within the closed-market for a certain minimum period of time, and
>
> (3) no extraordinary commission or consideration has been paid in respect of the trade nor has any unusual effort being made to prepare the market or create a demand for the securities.[130]

---

129 SS. 133 and 134 B.C. Regulations; S.72(4), (5) and (6) O.S.A. and ss.17 and 19a Regulations; and S.5(3) Q.S.A.

130 S.13(2) B.C.; S.72(4) O.S.A.; and S.58 Q.S.A.

Consequently, the prospectus exemptions are numerous but only a few would seem to have a viable future as Internet securities offerings in Canada. Those possibilities, including the exempt institutions and purchasers, sophisticated investors and especially the government and financial institutions securities should be something that each issuer should investigate carefully, after considering the cost of implementing such a system.

iii. Disclosure Obligations

As we stated earlier, once the prospectus is filed and the offering is completed, issuers are still subject to disclosure obligations. Continuous disclosure requirements are imposed on reporting issuers in the form of periodic statements, proxy circulars, insider trading reports and timely reporting is required.[131]

With the arrival of Internet, small issuers may at last reduce commission fees paid to underwriters and other intermediaries involved in the distribution and marketing of the offering. However, after incurring the costs of complying with the prospectus requirement or exemption, in the form of legal fees or otherwise, small issuers still have to face the costs associated with disclosure requirements. As confirmed by NP 11-201, these documents may be communicated to investors through Internet at a lower cost. But, Internet could be seen as a vehicle to assist small enterprises in accessing equity capital and exploiting different financing possibilities if other forms of disclosure become available to them.

This is why alternative forms of disclosure of information should be considered by regulators to lessen the regulatory burden on issuers while still providing investors with information to make enlightened decisions. Voluntary disclosure, assistance from professional analysts and third party certification are among the options available.

---

131 Gillen, *supra* note 8 at p. 169-212.

One of the possibilities that has been suggested is to let issuers voluntarily disclose information to investors.[132] It is argued that voluntary disclosure may enhance the value of the issuer and reduce information costs to investors and therefore, issuers have the incentive to voluntarily disclose such information.[133] However, because of the tendency for companies to think that information is confidential or should not be released to competitors, issuers may in fact be reluctant to voluntarily disclose all information. Furthermore, it is also less likely that a company would disclose information that would negatively affect its stock price.

To provide information to investors and as an alternative to the disclosure requirements, professional analysts research and reports are another valid alternative. Indeed, brokers/dealers have research departments that provide regular reports on a number of companies. As the number of Internet securities offerings would grow, a greater number of on-line professional analysts would appear and specialize in Internet securities offerings, following those issuers and providing regular information and reports about them.[134] The infrastructure is already in place as analysts from brokerage and independent research services firms already perform this function. The work performed by those analysts would supplement the information provided by issuers. As those analysts also search for information which does not emanate from issuers and evaluate and verify the information provided by issuers, investors may have a more complete picture of an issuer thereby providing investors with a better evaluation of the value of a company. Finally, analysts that specialize in certain industries

---

132 ROUSSEAU, S., "The future of capital formation for small and medium size enterprises: Rethinking initial public offering regulation following the restructuration of Canadian Stock Exchanges", (Montréal, 1999) paper derived from the author's doctoral dissertation completed in 1999 at the University of Toronto, portions of which have been presented at the 29th Annual Workshop on Commercial and Consumer Law held at McGill University in 1999, at p.33-39 [hereinafter "Rousseau"]; see also BENSTON, G. "Required Disclosure and the Stock Market", (1973) 63 Am. Econ. Rev. 132; and BENSTON, G. "The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements", in MANNE, H.G., (Ed.), *Economic Policy and Regulation of Corporate Securities* (Washington: American Enterprise Institute for Policy Research, 1969) 23.

133 *Ibid* at p.33-35.

134 *Ibid* at p. 42; see also GOMBERS, P. A. "Optimal Investment, Monitoring, and Staging of the Venture Capital", (1995) 50 J. Fin. 1461 at 1466-1467.

have specific knowledge which allows them to better evaluate projects and prospects disclosed by issuers.[135]

Considering the reluctance of issuers to voluntarily disclose information to investors and the disadvantages that it may entail, third party certification of information may provide a solution or another alternative method of disclosure. With the use of outside specialists acting as certification agents, the quality of the information provided by issuers and the investor's confidence in such information are both increased. Assuming that the independency of such agents is preserved, reliable information could be transmitted to investors to their benefit.[136] Of course, certifying agents have to be recognized and reputable firms are required for this alternative to be viable.

Disclosure obligations and their costs constitute an important factor preventing small enterprises from making a securities offering. Considering that Internet securities offerings offer a cheaper method of accessing investors and equity financing, alternative methods of disclosing information to such investors should be considered. Issuers may be reluctant to voluntarily disclose information about their activities and financial situation, but as we have outlined they also have incentives to do so. Furthermore, with the introduction of third party certification agents that could attest as to the quality of the information provided and the research functions already performed by professional securities analysts, investors would obtain information about companies which would arguably be equivalent to the traditional continuous disclosure system.

---

135 LOWENSTEIN, L., "Financial Transparency in Corporate Covenants: You Manage What You Measure", (1996) 96 Col. L. Rev. 1335 at 1354.

136 Rousseau, *supra* note 132 at p. 48; GILSON, R.J. & KRAAKMAN, R.H., "The Mechanism of Market Efficiency", (1984) 70 Va.L.Rev. 549 at 604.

iv. Registration Requirement

As stated above, to trade in securities or underwrite issuances of securities, a person must be registered.[137] Alternatively, an exemption from registration may be sought and is what is usually relied upon for traditional paper-based offerings.[138] Indeed, the issuer will rely upon a registration exemption and the underwriter, registered as a broker/dealer, will effect the trades on behalf of the issuer.

However, as first seen in the DPO of e-minerals, an issuer may decide to distribute its own securities without a broker/dealer in which case it must register itself as a "security issuer". For any issuer planning to distribute its own securities, it is imperative to register itself as the trading or underwriting of securities without registration is subject to penal sanctions.[139]

This is confirmed by s.2.2(3) of NP 47-201, which states that registration requirements of Canadian securities legislation apply to the posting of a prospectus or the offering of document on Internet, as such a posting or offering constitutes an act in furtherance of trade in that jurisdiction. Consequently, the person or company posting the prospectus or offering the document must: (i) be registered to trade with the securities commission of the Canadian province having jurisdiction; (ii) obtain an exemption from registration requirements for the distribution in the particular jurisdiction; or (iii) insure that all enquiries related to the document are forwarded to a registered dealer in the particular jurisdiction.

Pursuant to s.2.3 of NP 47-201, it must be noted that a person or company in British-Columbia, Alberta or Quebec that would distribute securities outside those jurisdictions via Internet would be deemed to be trading within those jurisdictions and would have to respect applicable registration and

---

137 S. 54(1) A.S.A., s.34(1) B.C.S.A., s.25(1) O.S.A. and s. 148 Q.S.A.

138 S. 65(1) A.S.A., s. 45(2) B.C.S.A., s.35(1) O.S.A. and s.157 Q.S.A.

139 S.161(1)(c) A.S.A., s.155(1)(d) B.C.S.A., s.122(1)(c) O.S.A. and s.202 Q.S.A.

prospectus requirements in those provinces although it may be possible to obtain relief from the authorities in appropriate circumstances. In Ontario, the securities commission will assert jurisdiction over market participants on a case by case basis, applying the legal tests as circumstances require. The CSA commented, for example, that the OSC would still review the "nature of parties' conduct in Ontario" to determine whether they should assert jurisdiction but could, in certain circumstances, even if an investor is located outside Ontario. Although CSA's views are obscure on this issue, these guidelines confirm that, from an issuer perspective, it is less favourable to offer securities from British-Columbia, Alberta or Quebec to other provinces as an issuer in those provinces still has to comply with local requirements even if the offering is made outside of those jurisdictions.

Taking the example of a Quebec-based issuer making a DPO in the province of Quebec, we shall review the steps, requirements and conditions for the registration of such an issuer.

A Quebec issuer that intends to make a DPO plays a dual role: it is a securities issuer, and it acts as a dealer for its own securities.[140] S.148 Q.S.A. requires of a person who trades in securities to register with the Q.S.C.[141] The conditions that every person intending to trade in securities has to meet are fixed by regulations.[142]

To register as a securities dealer, the candidate must apply to be registered as a dealer with a "restricted practice" in one of the prescribed categories:[143] "security issuer, for the issuer which intends to limit its activity to the distribution, without a prospectus exemption, of a security issued by it;"[144]

---

140 Under the Q.S.A., a dealer means any person "distributing a security for his own or another's account" s. 5 Q.S.A.

141 Hereinafter the "Q.S.C."

142 S. 150 Q.S.A. and Title V Q. Regs.

143 S. 190-192 Q.S.A.

144 S. 192 Q.S.A.

Such an applicant must also fill out Form 2,[145] which requires the following information:

- personal information and financial situation (section A); and
- integrity (section B): previous registration; refusal, suspension or withdrawal of rights conferred by registration; crimes, court proceedings, bankruptcy, demands for settlement.

Contrary to other applicants, a security issuer is not required to provide information on debt securities,[146] on admittance, refusal or suspensions to stock exchange or dealers' association[147] and on insurance or surety.[148] A security issuer is also exempted from adding to the registration form the financial statements and auditor's report usually required from applicants.[149]

Thereafter, the approval of the prospectus of such a security issuer will be subject to the following conditions:

(1) the issuer files a preliminary prospectus with the Q.S.C.;

(2) the issuer files, no later than at the time it files a preliminary prospectus, its application for registration as a security issuer;

(3) the issuer files, at the time of filing the final prospectus, a list of the subscribers that were solicited;

---

145 S. 195 Q.S.A.

146 Form 2, Question 7(6).

147 Form 2, Question 12.

148 Form 2, Question 17.

149 S. 195 Q. Regs.

(4) the issuer files, when the distribution has been completed, a list of all subscribers indicating their name and the number of securities issued to each;

(5) the senior executives of the issuer and their associates may not subscribe to securities that form part of the offering except to the extent that a declaration of that fact is made in the prospectus.

When the above conditions are respected, the Q.S.C. grants a conditional registration as a security issuer. Registration must be obtained prior to the issuance of the receipt for the final prospectus.[150]

The applicant must add to the application form a certified copy of the resolution of the board of directors of the company authorizing one or more senior executives to sign the application form and all related documents.[151] Applicants must also include with their application for registration the required fees,[152] otherwise the rights conferred by the registration are automatically suspended.[153] The fees have to be paid within a delay of 30 days from the date they become due, which means 30 days from the date of application.[154] To maintain the registration, annual fees must also be paid.[155]

As a security issuer applicant, the issuer is not required to answer Question 17 of Form 2 with respect to insurance or surety nor to provide proof of insurance or bonding providing the coverage

---

150 S.25 *Quebec Regulations* under the Q.S.A.[hereinafter "Q. Regs"].

151 Chapter 11 of Title VI, Q. Regs.

152 The fees are prescribed by s. 271.5 and ss. Q. Regs. (currently $1,500).

153 S. 197.Q. Regs.

154 S. 200 Q. Regs.

155 S. 199 Q.Regs. as prescribed under Chapter II, Title VI of the Q.S.A.

usually required,[156] on the basis that the Q.S.C. may grant an exemption to certain dealers with restricted practice. [157]

Finally, the rights conferred on a security issuer by registration are suspended when the distribution is interrupted or terminated or when the registration is cancelled. The suspension is lifted when the security issuer resumes the distribution or commences the distribution of another security.[158] However, the Q.S.C. may automatically cancel a registration of a dealer when the period of suspension exceeds one year.[159]

In short, in the context of a DPO, Canadian securities legislation already provides a mechanism for issuers to effect the distribution of their own securities. Although it could be made easier for small issuers to obtain such a registration, the application procedure is not unreasonably expensive nor complicated.

As a matter of fact, it must be noted that among the comments received by the CSA relating to NP 47-201, a recommendation was made to favour access to equity capital for small enterprises. The recommendation was that it should be easier for Canadian companies to raise funds through DPOs by eliminating the "security issuer" dealer category to allow companies to sell securities without first having to be registered. According to the CSA, the issue of registration categories will be referred to staff involved in ongoing regulatory initiatives to harmonize the registration system. Therefore, issuers may expect legislative reforms in the registration system for dealers in Canada but there are no indication that the current structure would not stay in place for the "security issuer" category as long as the registration requirement is not cumbersome, costly and thus prohibitive for issuers.

---

156 S.213 Q. Regs.

157 S. 196 Q. Regs and s. 263 Q.S.A.

158 S. 201 Q. Regs. Q. Regs. impose other conditions for the continued registration of a security issuer which involve mostly condition relating to the maintenance of records; see s. 220 et ss. Q. Regs.

159 S. 201.1 Q. Regs.

v. Other Relevant Issues

a. Jurisdictional Issues

Anyone in the world having access to Internet can access information posted on a Web site. Considering the global nature of Internet, it is important to consider what could be considered an offering made in a Canadian jurisdiction.

To reduce ambiguities, the CSA provided guidance in NP 47-201 on the issue of jurisdiction. First, NP 47-201 defines "trading in securities" as the posting on Internet, by any person or company, of a document offering or soliciting trades of securities when that document is accessible to persons or companies in a Canadian jurisdiction.[160]

However, according to s. 2.2(2) of NP 47-201, the posting on Internet of a document offering or soliciting trades of securities is not to be considered a trade or, when applicable, distribution in a Canadian jurisdiction if: (i) the document posted contains a prominently displayed disclaimer clearly identifying the jurisdictions or foreign jurisdictions where the offering or solicitation is qualified, and that no Canadian jurisdiction is included in this list; and (ii) the persons or companies offering or soliciting trades take reasonable precautions not to sell those securities to anyone resident in a Canadian jurisdiction.

b. Distribution Lists Requirement

The distribution lists requirement is to effect that any person or company that distributes securities under a prospectus must record the names and addresses of all persons or companies to whom a copy of the preliminary prospectus was sent. Pursuant to section 2.5(1) of NP 47-201, the distribution lists requirement, in the Canadian jurisdiction where it is required, still applies whether a preliminary

---

160 S.2.2 of NP 47-201.

prospectus is distributed in paper form or by Internet. This requirement applies whether the persons or companies only browse a Web page containing a preliminary prospectus or actually downloads such a prospectus.

In the eyes of Canadian securities regulators, no relief from this requirement is necessary or warranted for Internet securities offerings as technology allows to monitor the persons who have access to a preliminary prospectus or require a written or electronic consent form from each recipient. Furthermore, the requirement does not deter, in their mind, individuals from participating in such offerings. The guideline is based on the reasoning that persons and companies who download or view an electronic version of a preliminary prospectus should be provided with amendments to such a prospectus, if any.[161]

c. Multimedia Roadshows

One of the natural application of multimedia communications consists in offering investors the possibility of multimedia "roadshows". Traditionally, during the "waiting period", issuers solicit prospective investors through presentations that involve slides, conferences and meetings. With Internet, it has never been so easy to offer prospective investors presentations about the issuer and even a company tours 24 hours a day.

Although less popular that they once were, roadshows are still being used by some issuers to introduce the company and its management and business to selected investors. In theory, roadshows are designed to enhance and complement the efforts of underwriters to market the offering and to build long-term interest for the issuer and its stock among institutional investors, portfolio managers and research analysts. However, in practice, roadshows have become less popular as they are attended by brokers with little interest in the issuer except in their capacity and resources to impress

---

161 NP 47-201 Comments, *supra* note 93 at p.10.

them with outrageous meals and gifts. As a result, the use of roadshows has decreased dramatically over the last few years.

Conceptually, roadshows make sense; issuers present themselves and invest time and other resources to introduce themselves and to explain to their future shareholders the nature and future of their business. In the traditional way, roadshows are expensive as they involve presentations in hotels and conference centers and branch visits nationally from one city to another.

Internet roadshows may allow issuers to make real time presentations and virtual tours of the issuer's facilities and offices the whole supplemented with multimedia presentations about the issuer's products or services.[162] In the U.S., the success of Internet roadshows is seen through the astonishing success of Net Roadshow, Inc.[163] At its Web site, Net Roadshow provides potential investors with a number of roadshows ready to be viewed. Only pre-qualified investors may view roadshows. This allows Net Roadshow to control access to materials and those who may view the material. The approach taken by Net Roadshow is relatively simple: a traditional roadshow is filmed and webcasted from the Web site. As a result of Net Roadshow's first Internet roadshow, an offering underwritten by PT Alex Brown raised $U.S.55 million after 200 viewers tuned in. Although it is difficult to estimate the impact of a roadshow on the success of any offering, considering the low cost involved, it is one of the best investments for an issuer.[164] Internet roadshows offer almost the same advantages as traditional roadshows but allow substantial savings in time and money. Issuers may invest wisely into a good product to attract potential investors' attention and interest. Furthermore, to maximize its usefulness, issuers may exploit the interactive and multimedia features offered by different softwares to make those roadshows as real and as interactive as possible. At

---

162 See generally SCHULTE, Stephen J., "IPO Roadshows Today: A Primer for the Practitioner", in *How to Prepare an Initial Public Offering* (PLI Corporate Law and Practice Course handbook Series, 1997) at p.491.

163 See at http://www.netroadshow.com (last visited August 23, 2000).

164 The SEC has approved the transmission of roadshows over the Internet on the 23 of July, 1997. See Net Road Show, inc., SEC no-action letter, at http://www.sec.gov (July 23, 1997).

scheduled point in time, live question periods may be held to provide potential investors with the opportunity to ask questions and evaluate the qualities and strength of the issuer's executive team.

In Canada, the first Internet roadshow was held recently. OnX Incorporated was the first issuer to use Internet for a live and interactive roadshow.[165] Other issuers have made oral presentations in the past over the phone but OnX went several steps further in providing a live presentation by its lead underwriter and chief executive as well as a question and answer session. The roadshow was also presented on WebTV.[166] In approving the roadshow, the O.S.C. imposed only one condition: that the roadshow be open to all retail brokers not only institutional investors. In Canada, the cost of producing one Internet roadshow is equivalent to a fraction of the cost of a traditional roadshow presentation in a hotel. Above all, the Internet roadshow allows to streamline this part of the offering process and allows a uniform message to be sent to interested brokers whether they are in large centers or not.

NP 47-201 provides some guidelines as to the use of electronic roadshows during the waiting period. In a nutshell, Canadian securities regulators do not object to issuers or underwriters holding roadshows over the Internet as long as the "waiting period"and other securities law requirements are respected. The guidelines at s.2.7 of NP 47-201 provide that:

> (i) before transmission of a roadshow, a copy of the filed preliminary prospectus must be made available to each viewer, and the roadshow should remind the viewer through visual statements that the roadshow does not contain all of the information found in the preliminary prospectus which must be reviewed for complete information;[167]

---

165 "OnX Broadcasts its Message", *National Post*, April 4, 2000 at p.B2.

166 WebTV at http://www.webtv.com.

167 NP 47-201 further states that a copy of the preliminary prospectus can be provided to prospective investors according to NP 11-201.

(ii) access to roadshows should be controlled by the issuer or the underwriter with password or other means, to identify the viewers and ensure that a preliminary prospectus was offered to them (NP 47-201 specifies that any persons or companies that are "prospective purchasers" under the securities legislation of the particular Canadian jurisdiction considered may be invited to view a roadshow); and

(iii) issuers and underwriters must take reasonable steps to prevent copying, downloading or further distribution of roadshows and, as such, a roadshow should not be transmitted to the viewer unless that person or company agrees not to copy, download or further distribute the roadshow transmission.

Thus, information disclosed in a roadshow must not be inconsistent with the preliminary prospectus filed with the authorities which, in any event, takes precedents over the information contained in a roadshow.

It is interesting to note that several of these guidelines do not have an equivalent in traditional roadshows. For example, there is no requirement under Canadian securities legislation to identify persons or to provide a prospectus before one's attendance at a roadshow. Nevertheless, the guidelines are meant to protect investors and in the opinion of the CSA, encourage greater use of multimedia communication and Internet roadshows.[168]

d. Advertising

NP 47-201 has not changed the substantive rules concerning advertising. S. 2.6 of NP 47-201 states that persons or companies should be aware that the posting of new information on a Web site during a period of distribution may be considered advertising in certain Canadian jurisdictions where it is restricted during, for example, "the waiting period". Thus, the rules governing the distribution of

---

168 NP 47-201 Comments, *supra* note 93 at p.13.

material prior to and during the prospectus clearance process must be respected. Consequently, it will not acceptable to distribute promotional material on a Web site and issuers will have to be careful before updating their Web site during the clearance process. Except for press releases relating to the offering, such as to announce the signing of an underwriting agreement or the filing of a preliminary prospectus, and for material change reports, interim financial statements and other distribution of a similar and non-promotional nature, the posting of information or documents on a Web site during a distribution could be considered a breach of advertising restrictions.[169]

Considering that the CSA notes that the posting of new information on a Web site during a period of distribution may be construed as advertising, [170] all materials posted by an issuer on its Web site prior to an Internet securities offering should be reviewed by its legal counsel to determine whether it is acceptable from a securities law perspective.

An issuer may forward a preliminary prospectus to any person[171] or distribute advertising documents provided that these advertising documents bear one of the notices required[172] and adequately reflects the information presented in the preliminary prospectus, without distorting it by selective presentation or by adding misleading statement[173].

In light of new possibilities offered by Internet and multimedia communication, the rules relating to restrictions on promotion and advertising should perhaps be reviewed. A review process similar to the one used for prospectus could be put in place to review multimedia communication to be

---

169 S. 99 A.S.A., s. 78(2) B.C.S.A., s. 65(2) O.S.A. and s. 21(1), (2) and (3) Q.S.A.

170 S. 2.6 of NP 47-201.

171 S. 21(2) Q.S.A.

172 S. 99 and 100 Q. Regs.

173 S. 6(3) and 21(2) Q.S.A.

incorporated into prospectus or statutorily required disclosure documents. Otherwise, technological innovations may not be fully exploited as they ought to be.

e. Electronic Delivery of Documents

NP 11-201 was principally adopted to provide guidelines to market participants about the delivery of documents by electronic means, which is an expression used not to be confined by terms which are not evolutive such as Internet.

The purpose of the policy as stated in s. 1.2 of NP 11-201 is to state the views of Canadian securities regulators on the issue of delivery of documents required by securities legislation.

NP 11-201 applies to delivery of documents which include prospectus, financial statements, trade confirmations, account statements and proxy-related materials. S.1.3 of NP 11-201 clearly establishes that proxies, voting instructions and other documents delivered by securityholders and investors to issuers are not required to be delivered by statute.

At the outset, s. 1.4 of NP 11-201 specifies that it provides no waiver of any requirements of securities legislation relating to content, accuracy, currency, amending of information or timing or delivery of documents or information which are still applicable in all circumstances. Similarly, documents delivered by Internet should not be less complete, timely, comprehensive or confidential, as the case may be, than the paper version of a document.

S.2.1(1) of NP 11-201 establishes the principle that electronic delivery of documents may be effected in a manner that satisfies the delivery requirements. However, there are four basic components to the electronic delivery of a document:

1. The recipient of the document receives notice that the document has been, or will be, sent electronically or otherwise made available;

2. The recipient of the document has easy access to the document;

3. The deliverer of the document has evidence that the document has been delivered or otherwise been made available to the recipient; and

4. The document that is received by the recipient is not different from the document delivered or made available by the deliverer.

Briefly stated, the components required to show good delivery are: notice of delivery to the recipient, access of the recipient to the document, evidence of delivery and non-corruption or alteration of the document in the delivery process. At s. 2.1(3) of NP 11-201 it is stated that if any of those components are absent, the effectiveness of the delivery is uncertain and could be questioned.

(1) Delivery of Documents

NP 11-201 specifies at s. 2.2 that notice of the electronic delivery of documents must be provided which may be done in any manner such as electronic mail, telephone or communication in paper form. Transmission of documents by electronic mail will be sufficient notice to a recipient and does not require a separate notice. However, a separate notice should be provided where the deliverer intends to place documents on a Web site at the disposal of intended recipients to retrieve or download. Even if an intended recipient consented to monitor regularly a Web site for delivery of documents, s. 2.2(4) NP 11-201 states that such delivery would ideally be supplemented with a separate notice informing the intended recipient of such delivery. In fact, once an intended recipient provides an electronic address, it is relatively simple to send such a separate notice.

As described further in the next section, s. 2.3(1) of NP 11-201 provides that consent from the intended recipient should be obtained to ensure that this person has the necessary technical ability and resources to access the document to be delivered. As per s.2.3(2) of NP 11-201, it is stated that there are certain aspects of access that are fundamental to electronic delivery and that cannot be waived by a consent. First, deliverers should take reasonable steps to ensure that electronic access to documents is not burdensome or overly complicated.[174] In that sense, quick downloading, appropriate formatting and general availability must be ascertained. Canadian securities regulators want to ensure that deliverers have the technology to support the demand. They have learnt a lesson from brokerage firms offering online trading which were not capable of handling the volume of transactions. Second, intended recipients should have access to documents for whatever period of time is appropriate and relevant, given the nature of the document.[175] Third, documents should be sent in a way that enables the intended recipient to retain a permanent record of documents, if so desired.[176]

A world with no paper is not for today. According to Canadian securities regulators, those wanting to establish an entirely paperless system will have to wait considering the current technological climate and the fact that not all investors have the ability to utilize electronic communications.[177] However, market participants must be cautious to comply with all of the securities legislation obligations which, at times, may require specifically paper documents to be filed or delivered.[178] It is not appropriate at this time, according to Canadian securities regulators, for issuers and market participants, including brokers and dealers, to use an entirely paperless system and in any event, they

---

174 S.2.3(3) of NP 11-201.

175 S.2.3(4) of NP 11-201.

176 S.2.3(5) of NP 11-201.

177 NP 11-201 Comments, *supra* note 94 at p.8.

178 For example, in s. 119.6 Q. Regs, the expression "mail" may not be interpreted as to include electronic delivery of documents. Please also refer to the section entitled " Outstanding Issues" which discusses the interaction of NP 11-201 with NI 54-101

recommend to make available at no cost to investors paper versions of documents.[179] In fact, refusal, on the part of a market participant, to deliver a paper version of certain documents may constitute a breach of securities legislation.[180]

On the issue of formatting, documents delivered electronically should follow the formatting requirement set out in the SEDAR Filer Manual.[181] Furthermore, the paper version of documents may be altered to follow those requirements.[182] In our view, documents to be delivered by Internet should be converted in an electronic format rather than being scanned. Scanned documents are difficult to transmit, store and retrieve and may even be difficult to view. However, as the integrity of certain documents need to be preserved, it is not advisable to reformat all documents in an electronic format. For example, if certain documents such as the articles of incorporation of a company are simply hyperlinked to the prospectus, it is not necessary nor appropriate to reformat such a document which could probably be scanned. For other documents that are delivered, although documents delivered do not have to be in SEDAR-acceptable format, for consistency purposes and to avoid conversion related problems, it is preferable to format documents delivered by Internet according to SEDAR formatting requirements.

(2) The Consent Agreement

The deliverer should obtain the consent of an intended recipient and deliver the documents in accordance with such consent. As per s.2.1(4) of NP 11-201, once given, the consent is evidence that

---

179 S. 2.3(6) of NP 11-201.

180 See for example, s.119.6 Q. Regs.

181 System for Electronic Document Analysis and Retrieval is the system used in Canada to file electronically information and document with Canadian securities authorities. The SEDAR Filer Manual sets out the standards, procedures and guidelines to be used by electronic filers and filing agents when they prepare electronic format documents and transmit them to the securities regulatory authorities using the SEDAR system. See at http://www.sedar.com/sedar/sedar_filer_manual.htm (last visited August 23, 2000).

182 As such, signatures may be typed rather than appearing in graphical form and text usually required to be in red ink in paper version of document may appear in capital letters using bold face type.

the deliverer and the recipient have agreed on all relevant aspects concerning the manner of the electronic delivery of documents. With such consent being duly obtained and documents being duly sent in accordance with the terms of such consent, there is inference that:[183]

(1) the recipient will receive notice of the electronic delivery of the document;

(2) the recipient has the necessary technical ability and resources to access the document; and

(3) the recipient will actually receive the document.

If consent is not obtained, the deliverer bears a heavier burden of proving that recipient had notice of, access to and ultimately received the document. In such circumstances, deliverers should obtain evidence of delivery of a document to an intended recipient.[184] In the end, the deliverer will have to satisfy securities regulators and, in certain cases, a court, that appropriate and reasonable means were used to effect delivery. Subject to securities legislation, the deliverer may also use any means at its disposal to deliver a document.[185]

Therefore, a deliverer should prepare a consent agreement to be executed by the intended recipient which should provide:[186]

1. the list of documents or types of documents that will be delivered electronically;

---

183 S. 2.4(1) and s. 2.1(5) of NP 11-201.

184 S. 2.4(2) of NP 11-201.

185 S. 2.1(6) of NP 11-201.

186 S. 2.5(2) of NP 11-201.

These could include: preliminary and final prospectus, prospectus amendments and supplements, offering memoranda and other offering documentation, notices, confirmations, subscriptions forms, proxy circulars and statements, and any other document which is required by securities legislation.

2. the procedure to be used for the electronic delivery, including whether or not a separate notice will be provided, and such is the case, how and when that notice will be provided;

For example, if the deliverer wants to deliver documents by placing them on a Web site or by a third party provider, the consent must provide for such method of delivery and for the method of notice of delivery that will accompany such delivery.

3. the technical requirements for proper electronic retrieval of documents;

In most cases, documents will be made available from a Web site where the document will be posted and from where it may be read and printed. A separate notice should be sent to intended recipients to direct them to the Web site address where the document will be posted. The notice should also include the technical information to read and print the documentation.

4. the softwares required for proper viewing of documents;

The software required to view and print the documents should be listed and, for example, an external hyperlink to the software maker's Web site could be provided, where the software may be obtained and clear instructions might be available.

5. a specific provision stating that the intended recipient acknowledges that a paper copy of any document will be provided at no cost to any intended recipient when so requested;

6. the length of time that a document will be available for viewing and downloading;

Considering that the length of time that a document is available may vary from one document to another it may not be appropriate to provide this information in the agreement. Rather, the agreement should contain a clause indicating where this information will be provided such as in a separate notice sent to each intended recipient about each particular document or at the top of the page where the actual document will be posted.

7. a specific provision stating that the intended recipient acknowledges that a paper copy of any document will be provided at no cost to any intended recipient if electronic delivery fails;

8. the procedures that will be used by the deliverer to maintain the confidentiality of information regarding the intended recipient (considering the requirements of federal and provincial legislation applicable on the subject);

9. a specific provision stating that the intended recipient acknowledges that his or her consent may be revoked or changed, including any change in the electronic mail address to which documents may be delivered, as the case may be, at any time;

10. a specific provision stating that the intended recipient is not required to consent to electronic delivery of documents.

The consent agreement to be executed by each intended recipient must be carefully drafted to include all the above provisions. Receipt by a deliverer of a consent from an intended recipient before delivery of documents and according to the requirements stated above, should satisfy the notice,

evidence and access components of electronic delivery of documents if the delivery respects the terms of the consent agreement.[187]

Such consent agreement, according to s.2.5(4) of NP 11-201, is valid for delivery of more than one type of document on an ongoing basis, so that the consent does not have to be requested each time a document has to be delivered. However, blanket consents covering "any documents" must be used with caution. Ideally, the consent agreement will provide specifically and adequately to deal with the distinctions of each type of document.[188]

NP 11-201 contemplates the use of the same consent agreement with an intended recipient for more than one deliverers. As a result, brokers, dealers or agents requesting an intended recipient to enter into a consent agreement for more than one deliverers should made clear to the intended recipient that consent is being sought for the delivery, including future deliveries, of documents by more than one deliverer and obtain an acknowledgement from the intended recipient that the method of electronic delivery to be used by each deliverer is acceptable to such recipient.[189]

On the one hand, it is reasonable to consider a consent to electronic delivery to be valid until the deliverer is notified otherwise by the intended recipient.[190] Canadian securities regulators also consider that a request for a paper version of a document does not constitute a revocation of a prior consent to electronic delivery if there is no other indication of revocation of consent.[191] On the other hand, it is inappropriate for a deliverer to require that a recipient agrees to electronic delivery of documents as intended recipients should be under no obligation to consent to electronic delivery as

---

187 S.2.5(1) of NP 11-201.

188 S.2.5(5) of NP 11-201.

189 S.2.5(6) of NP 11-201.

190 S.2.5(7) of NP 11-201.

191 S.2.5(8) of NP 11-201.

a condition of doing business.[192] However, for greater certainty, specific provisions covering these issues should be added to the consent agreement for clarity purposes and to avoid any misunderstanding between the parties.

The consent agreement should also provide a representation from the intended recipient that the information about his/her residency is accurate and truthful and an acknowledgment that there is reliance on this information to determine the applicable jurisdiction of residence of an intended recipient and therefore his/her eligibility to an offering. The intended recipient should also undertake to notify of any change in the personal information as soon as it occurs and a notice should be sent from time to time to each intended recipient, to remind them to change the personal information, if necessary, and perhaps of certain particular provisions.

A clause in the consent agreement should also specifically provide that the intended recipient consents to delivery of documents by a third party provider acting as agent and to referrals to such a third party, including SEDAR if such is the case, for access and delivery of documents. Indeed, NP 11-201 specifies at s.2.1(7) that generally, valid delivery can be made by a third party provider of a document that agrees to act as agent for the deliverer. However, referring an intended recipient to such a third party provider of a document, and even to SEDAR, may not constitute valid delivery unless the intended recipient has expressly consented to such method of delivery.

As recommended by s.2.3 NP 11-201, the intended recipient should also acknowledge in the consent agreement, to the extent possible, possession of the necessary technical ability and resources to access documents using the method chosen for delivery by the deliverer.

Aside from the consent provisions and the provisions listed above, the agreement may include any other terms and conditions which should, in the opinion of a legal counsel, be found in such an agreement such as language, governing and applicable law and successors and assigns clauses.

---

192 S.2.5(9) of NP 11-201.

The consent agreement may be supplemented by a notice on a Web site. However, it is not recommended to have a consent agreement simply posted on a Web site that the intended recipient does not have to sign and which may or may not be read by viewers. Indeed, as recent caselaw on the subject suggests,[193] it may not be considered enforceable in all circumstances, as it must be proved that it was read by the intended recipient. Instead, it is preferable to enter into a specific consent agreement with each intended recipient.

An "I consent" click should be provided for each provision, written in clear language, to ensure that the intended recipient reads and consents to all clauses. Furthermore, the email address as well as the mailing address and the phone number and any information required or necessary about each intended recipient should be a "required field" to complete the agreement. Intended recipients should receive notice be email of any amendment or supplement to the text of the agreement to which he/she would have to consent. If the intended recipient is not a physical person, a resolution authorizing a physical person to act on its behalf should be required or a representation to the effect that the person is an authorized representative should be required.

(3) Non-Corruption and Non-Alteration

The last component required to have valid delivery of electronic documents is non-corruption and non-alteration of documents in the delivery process.[194] The deliverer must ensure, to the extent possible, that no alteration or corruption of a document occurs during the delivery process. If there are deficiencies in the completeness or integrity of a document, authorities might raise questions as to whether the document has in fact been delivered. This issue may not be dealt with in the consent agreement. To this effect, s. 2.6(2) of NP 11-201 states:

---

193 *Ticketmaster Corp.* v. *Tickets.com Inc.* (U.S. Dist. Court, C.D. Cal.) March 27 2000.

194 S.2.6(1) of NP 11-201.

> "Deliverers should ensure that all reasonably appropriate and necessary technical steps are taken to ensure that documents sent by electronic delivery arrive at their destination in a complete and unaltered form. These steps may entail adopting appropriate security measures to ensure that a third party cannot temper with the document"

Deliverers should have a plan to deal with cases where electronic delivery of documents fails for any reason. In such cases, an alternative method of delivery, in paper form or otherwise, should be used.[195]

Finally, NP 11-201 states that although it is possible to deliver documents electronically sooner than in paper form by regular mail, electronic delivery of documents should be made contemporaneously with the mailing of the paper version.[196]

f. Confidentiality and Privacy Issues

Confidentiality must be preserved at all times in the communication and delivery of information or documents involving investors and in the storage of investors' related information. First, companies should pay special attention to provincial and federal legislation on personal information and privacy, if applicable, as there are strict obligations to respect. Second, all steps should be taken to ensure that confidentiality is preserved in the communication and delivery process. In particular, a failure to preserve the confidentiality of documents delivered by Internet, such as trade confirmations, may constitute a breach of obligations owed to clients under securities law.[197]

---

195 S.2.7 of NP 11-201.

196 S.2.8 of NP 11-201.

197 S.3.2 of the NP 11-201.

g. Misrepresentation and Hyperlinked Information

Material misrepresentation or misstatement[198] is a threat for any issuer or vendor as the liability of the person or company that caused the misrepresentation, misstatement or omission may be engaged.[199] The liability arises where a purchaser buys a security during the distribution period if the misrepresentation existed at the time of purchase. In such cases, the investor is deemed to rely on the misrepresentation and the proof of receipt, comprehension or reliance on the information does not have to be established.[200]

One of the particular features of Internet is the possibility to move internally within a document and externally to link a Web page to another. Consequently, an issuer's Web page may link to other Web pages providing relevant information on subjects relating to the issuer, its industry, its products and services and other related subjects. However, where external information is hyperlinked, there is a risk of being liable for misrepresentation found in the hyperlinked information.

S. 3.3(3) of NP 11-201 provides that one may become liable for the accuracy of hyperlinked information. Furthermore, as per s. 3.3(4) of NP 11-201, it should be clear which document constitutes the original document being provided or delivered pursuant to mandatory disclosure requirements and which document is not. Consequently, practical applications may be used to reduce liability exposure when using hyperlinks.

Furthermore, appropriate statements and headings should be found on each Web page and every page of a document on Internet to remind viewers of the nature and quality of the document being consulted.

---

198 See the general discussion about statutory liability in Gillen, *supra* note 8 at p.145-168.

199 S. 168(1) A.S.A., s.131(1) B.C.S.A. and s. 130(1) O.S.A.

200 S. 168(1) and 169(1)(a) A.S.A., s. 131(1)(a) and 132(1) B.C.S.A. and s. 130(1)and 131(1) O.S.A.

For example, during its DPO, e-minerals took appropriate steps to reduce liability exposure for misrepresentation found in its Internet prospectus considering that hyperlinks were used. Not only did the company use warnings and disclaimers[201] but it also limited the movements of viewers while in the prospectus. This is how the company approached and recommend other issuers to handle the liability exposure issue:

> "*e-minerals* took a very unique approach to the incorporation by reference concern. Instead of viewing the extension of liability as a problem, the Company embraced the idea that now potential investors should have more complete access to corporate documents. A prospectus will often reference a particular document or agreement, without providing it in the prospectus itself, at best providing that the document may be viewed at the issuer's offices during normal business hours. With an online prospectus, you can access that material by a link within the prospectus. The issuer felt comfortable incorporating primary source documents into the prospectus via the hyperlink to be included in the certification as "full, true and plain disclosure".
>
> No additional section 130 [O.S.A.] concerns are engaged by these controlled links, all of which existed inside the prospectus Web site envelope. A user could only return to the prospectus from a linked primary source document. Exit from the prospectus Web site was only through an exit page which also contained appropriate warnings and disclaimers.
>
> There are no links that allow a user to access another external, unrelated Web site while in the prospectus web pages. This is a vital feature to ensuring that the issuer and its officers, directors and experts are not held accountable for any information other than that which they have reviewed and approved in the preparation of the prospectus. Otherwise, there is a danger that all the information on the hyperlinked Web sites will be considered incorporated by reference into the company's prospectus. Particular care was taken to isolate the prospectus web pages from the issuer' general Web site and home page in order to insure that a user can not consider the

---

201 Please refer to e-minerals Prospectus, *supra* note 62, containing the warnings and disclaimers used by the company. See also generally Boyle, *supra* note 59 at pp. 23-25.

> entire *e-minerals* Web site or outside hyperlinks as included in the prospectus. Otherwise the potential investor may be led to rely on all the information in those other sites, exposing the issuer and its officers, directors and experts to much wider and unforseen section 130 liability.
>
> Careful construction of a Web site can avoid any potential for misunderstanding, as well as ensuring that suitable disclaimers and cautionary language are included. The prospectus materials require segregation from the rest of the Web site to ensure the integrity of the information remains constant. There should be no question when a Web user is either inside the prospectus, or by using gateway and exit pages, as well as indicators to show entrance and exit, outside the prospectus Web site, thereby limiting the exposure created by section 130 of the *Securities Act* (Ontario)."[202]

In a nutshell, an issuer posting its prospectus on the Web must give access for entry and exit to the prospectus Web pages only through one gateway page containing warnings and disclaimers in clear terms.[203] While in the Internet prospectus, the viewer should only be able to link to information within the prospectus, from one section to another. When other corporate documents are available online, the prospectus may also be hyperlinked to those documents referred to in the prospectus such as the articles of incorporation and bylaws of the company as well as a non-confidential material contracts or documents of the company. In case of uncertainty about the content of hyperlinked information, it might be preferable to air on the side of caution and refrain from providing the hyperlink.

At s. 3.3 (4) of the NP 11-201, the CSA requires to always clearly distinguish using appropriate headings on each page which documents sent by Internet are governed by statutory disclosure requirements and which documents are not.

---

202 Boyle, *supra* note 59 at p. 23-25.

203 *Supra* note 201.

Finally, it must be remembered that paragraph 7.2(e) of the SEDAR Filer Manual prohibits hyperlinks between documents. Therefore, it is not appropriate to use hyperlinks for documents filed on SEDAR.

Once again, NP 11-201 does not contain mandatory rules but rather guidelines on the appropriate conduct according to the CSA and on how one may reduce liability exposure. Ultimately, liability for questions of misrepresentations in hyperlinked information is a question of law which depends on the facts of each case.

In cases of misrepresentation, the investor has a right of rescission or damages against the issuer, any underwriter who signed the prospectus, the directors of the issuer at the time the prospectus was filed and any person that consented to any part of the prospectus, the latter being liable as to his or her part. Such a recourse would be available for a misrepresentation found in an Internet prospectus distributed in the context of an Internet securities offering made where the recourse exists.

As explained by Gillen in his section on misrepresentation, to avoid liability, a defendant must prove:

(i) knowledge of the misrepresentation on the part of the investor;

(ii) the impugned party had no knowledge or did not consent to the prospectus being filed and "reasonable general notice" of the lack of knowledge or consent must be given by that defendant;

(iii) the defendant withdraws consent to a prospectus upon becoming aware of such misrepresentation after the filing or sending of the prospectus with "reasonable general notice" of the lack of knowledge or consent also given by that defendant;

(iv) reliance on an expert's opinion or report where the defendant did not believe that there was a misrepresentation in the prospectus and had no ground to believe it or where the prospectus misquoted or took out of context the expert's report and the "reasonable investigation" and "reasonable general notice" also exist in this case; and

(v) a general due diligence defense is also available which is a proof that the defendant has conducted a reasonable investigation as to provide reasonable grounds for believing that there was no misrepresentation.

Therefore, those who may face liability must conduct extensive investigations to verify all claims, statements and hyperlinks in the prospectus. Furthermore, as evidence, in case of an action taken against them, those facing liability should keep written records of all their due diligence investigations. Finally, they should regularly review Web pages with such hyperlinks to ensure that they do not change.

h. Outstanding Issues

The CSA has indicated that it intends to pursue several issues outstanding relating to information technology in the securities market including (i) the establishment of a mechanism by which issuers and other market participants can obtain relief from provisions of securities legislation precluding the use of information technology for delivery or other purposes, (ii) the "à propos" of using Internet for proxy-solicitation and voting process and (iii) the use of authentication techniques for digital signatures purposes.[204] However, on the issue of electronic signatures and other authentication technologies acceptable to Canadian regulators to replace manual signatures, the CSA stated that it intended to review the alternatives available "as resources would permit".[205]

---

204 NP 11-201Comments, *supra* note 94 at p.13.

205 NP 47-201Comments, *supra* note 93 at p.13.

It is difficult to determine the interaction between NI 54-101, Policy on Communication with Beneficial Owners of Securities and NP 11-201. Integration of NI 54-101 and NP 11-201 is suitable to facilitate the use of electronic delivery methods in the procedures for communications with beneficial owners of securities. This is why it is important for market participants to be cautious and determine where electronic delivery of documents is precluded. The Canadian securities regulators have stated that they were considering possible solutions including permitting applications for exemptions from certain legislative provisions that currently preclude the use of electronic delivery of documents. They have also indicated that they will undertake to liaise with provincial and federal authorities responsible for corporate statutes to assist in the process of removing legislative impediments to electronic delivery of documents.[206]

Information technology is important and useful to improve communication with securityholders and investors and Canadian securities regulators wanted, by the adoption of NP 11-201 and 47-201, to ensure that statutory delivery obligations would be respected while recognizing and accommodating technological developments without undermining investor protection.

As we have seen, securities law principles apply to Internet securities offerings although there are distinctions and peculiarities which securities regulators tried to address through NP 47-201 and NP 11-201. However, very little was done to accommodate equity financing by small enterprises considering the opportunity Internet and multimedia offer to review the structure and implement more favourable procedures such as multimedia prospectus and alternative disclosure systems.

---

206 NP 11-201 Comments, *supra* note 94 at p.10.

III. Regulation and Enforcement of the Internet Securities Market

For both investors and issuers, Internet may represent an unexplored and most importantly unregulated market. Securities legislation serves an important protective and functional purpose and the uncertainty surrounding its application on Internet could make some of the securities market players nervous. Risk, instability and enforcement issues are some of the factors that cause the discomfort. Having a structured framework and protective procedures through regulation becomes necessary if not required to meet securities regulation objectives. However, as we shall see below, effective regulation of the Internet securities market may not be possible through traditional enactment, surveillance and enforcement procedures and such regulation goes well beyond our national frontiers.

A Task Force established by the International Organization of Securities Commission[207] stated on this issue:

> "Electronic communication and interactivity may not fit neatly within the parameters of statute, regulations and directives originally intended for a telephone and paper-based environment, thus creating unnecessary regulatory burdens or unintended regulatory gaps".[208]

Information technology developments may have to be incorporated into the existing securities regulation framework without undermining the objectives of securities regulation. Similarly, securities regulation policy objectives may have to be incorporated into technological advancements to further the objectives of securities regulation. This proposal is the subject of the present section on the regulation and enforcement of the Internet securities market.

---

207 Hereinafter the "IOSCO Task Force". For more information about the International Organization of Securities Commission [hereinafter "IOSCO"], see at http://www.iosco.org (last visited August 23, 2000).

208 IOSCO Technical Committee's Internet Task Force Report, September 13, 1998, at p.2; see at http://www.iosco.org (last visited August 23, 2000).

A. Challenges of a New Medium

The IOSCO Task Force recognizes that Internet itself does not necessarily provide new types of securities fraud, but it provides an ideal environment where traditional frauds can flourish. As a result, regulators have a new task requiring them to identify which traditional securities frauds can also be perpetrated on Internet.

To illustrate this fact, U.S. officials have recently reported that they arrested members of a crime organization in an attack on securities fraud which is the biggest single crackdown on securities fraud in U.S. history.[209] Members of five mob families have conducted a $U.S. 50 million stock fraud exploiting investors' crave for technology stocks and used beatings and threats to intimidate brokers and force them to cooperate with them, which activities are similar to their fraudulent activities in the traditional market.

Considering the challenge that Internet frauds and crimes represent and the difficulty to regulate and enforce securities legislation on Internet, stricter regulations might be required to insure that appropriate control procedures are put in place at all levels by all actors especially those through which such frauds and crimes are ultimately perpetrated such as brokers/dealers. Furthermore, law enforcement officials must be provided with the power and resources necessary to perform their surveillance and enforcement work. Otherwise, all the legislation in the world will prove useless. As one author stated:

> "Crime follows money, and it follows weak policing. Canadian law enforcement organizations such as the RCMP and the Ontario Securities Commission have complained for years that they don't have the same sort of resources to investigate stock frauds as exist in the United States, where the SEC has laid far more charges and closed down more operations [...] Canadian law enforcement officials

---

209 McFARLAND, Janet, "Officials Ill-Equipped to Keep Organized Crime Out of the Securities Business", *Globe & Mail*, June 17, at B9.

> have been greatly assisted by the enforcement actions of crime fighters in the United States. But they need to signal themselves that Canada is not an easy mark for securities fraud, slowing the trend northward before it goes too far."[210]

Another traditional type of financial fraud is price manipulation. Individuals sometimes also make false or misleading statements on Internet to influence the price of securities. A Web site, a bulletin boards system, a discussion group, or simply mass e-mails can easily provide means for anyone to try and manipulate stock prices. As we stated above, because Internet allows individuals to hide their identity or the source of the information, manipulating prices can more easily be accomplished while protecting investors is rendered more difficult.

Fraudulent offerings can also be found on Internet. Securities regulators have already discovered unregistered people offering securities for sale or unregistered securities being sold to the public via Internet.[211] Fraudulent advice can also be very easily provided using Internet.

The security and integrity of Internet as a communication medium poses different challenges for securities regulators. Without knowing the extent of such fraudulent uses of Internet, we could easily imagine individuals with intimate knowledge of securities systems interfering and re-routing orders of payment or purchase or sale of shares on Internet.

Internet is a relatively new mode of communication for everyone, including securities regulators. Surveillance on Internet represents a new challenge for regulators. They need to discover new methods to conduct surveillance and to become more acquainted with new technology to the extent of influencing it, as we shall see below. Moreover, considering the increasing number of Internet users and the large quantity of information transferred, the surveillance of Internet can represent a heavy burden on regulators' resources if they want to detect illicit activities effectively.

---

210 Ibid.

211 For a casedigest on different subjects relating to securities, see the Web site of Cyber Securities Law at http://www.cybersecuritieslaw.com/lawsuits/suits_home.htm.

To address jurisdictional and conflicts of laws issues, commissions from various countries or jurisdictions may have to adopt a common approach. In collaboration with institutions that already exist, such a common approach could standardize and regulate Internet securities offerings in the entire Internet securities market.

However, the policing of Internet for fraudulent and criminal activities has important limitations. It is almost impossible logistically to monitor every investment related Web page, bulletin board, news group or chat rooms. Furthermore, securities commission, stock exchanges and national association of dealers, for example, only have authority over their members. As a result, an infraction must be perpetrated by a registered broker/dealer or another member otherwise the regulatory powers of those authorities are limited.

It seems also that enforcement measures will not be adequate to recover lost money or force the violator to pay and refrain from committing a subsequent offense. Indeed, although securities regulators have investigative capabilities and subpoena power, resource or geographical limitations could impede their regulatory efforts and actions.

Internet is also challenging because, contrary to newspapers, magazines, or other media on securities and investments, Internet may allow "commentators" to remain anonymous. "Remailer" sites can be used to obscure senders' identity while providing them with a pseudonym. "Anonymiser" softwares can also be used to hide the identity of senders, and the source of the information. Even worst, "spoofing" or using the identity of other users and altering or falsifying e-mail messages is also rendered possible on Internet. These capabilities provide securities regulators with greater challenges than they would normally encounter in the ordinary market. As a result of the use of Internet, it is difficult to ascertain the exact identity of the users and the source of the information since it can emanate from multiple sources and tracking and locating offenders is in itself a challenge. As a result of the anonymity offered by Internet which would otherwise not be available

in the investment industry, there is the added possibility that the individuals behind an issuer be a sham.

Thus, considering that Internet may raise different issues which would not normally arise in the traditional market or at least which would take a different shape and form or be presented using different technological tools, existing laws on securities may need to be reviewed so as to ensure that they are technology friendly and applicable to new technologies, the whole in cooperation with other national regulatory bodies as we shall discuss in the next section.

B. Appropriate Regulatory and Enforcement Procedures

i. The Need for Standardization, Cooperation and Mutual Assistance

The increasing use of Internet for securities offering purposes has raised numerous questions about the application of state securities laws. Over the last few years, several U.S. securities regulators and commentators have attempted to address those questions. In Canada and other western countries, very few articles have been written on the subject. The question becomes who, if not securities commissions, may regulate the Internet securities market effectively?

a. NASAA and NASD Regulation

In the U.S., to address questions of enforcement and to bring a uniform and standardized regulatory approach, the NASAA[212] created a committee. The committee recommended a first resolution which was adopted by the members of NASAA.[213] In its resolution, NASAA encourages U.S. states to adopt a standardized regulation to permit Internet securities offerings as long as issuing companies

---

212 *North American Securities Administrators Association*, at http://www.nasaa.org [hereinafter "NASAA"](last visited August 23, 2000).

213 *NASAA, Comment letter responding to SEC Release No. 33-7233*, 34-36345 (December 14, 1995). To date, many more US states have enacted such orders.

indicate specifically where they are registered to sell the securities. The resolution is not binding upon the member states but rather indicates a position suggested.

The proposal suggested by NASAA which exempts companies from registration requirements for certain Internet securities offerings, was inspired from an order initially introduced in the state of Pennsylvania. In August 1995, the Pennsylvania Securities Commission adopted three rules that must be observed by Internet issuers. To avoid registration while not violating Pennsylvania regulations regarding securities offerings, an issuer:

1) must put language in the Internet material clearly stating that the offering is not intended for Pennsylvania residents;

2) cannot have any direct communication with state residents;

3) cannot sell to Pennsylvania residents.[214]

Following this NASAA initiative, a similar standardized approach was adopted in many western jurisdictions including Canada on several Internet securities offering issues including jurisdiction.[215] Such a standardized approach helps securities regulators chasing crime perpetrators and surfing different jurisdictions with their conflicting national laws that often prevail.

On a different issue, another U.S. securities organization, the National Association of Securities Dealers, Inc.,[216] recognized its new responsibilities with Internet and other technologies and

---

214 Ibid, at p.3.

215 See NP 47-201. Initiatives from other western countries may be reviewed on the Web site of Cyber Securities Law at http://www.cybersecuritieslaw.com/biblio/non_us_initiatives.htm.

216 See generally http://www.nasd.com (last visited August 23, 3000).

established in 1996 NASD Regulation.[217] NASD Regulation's mission is to regulate the securities market for the ultimate benefit and protection of investors.

An initiative such as NASD Regulation was successful at implementing different cooperation and enforcement programs such as the INSITE Program[218] to tackle on issues relating to technology and Internet while exploiting their potential. As stated by NASD Regulation about the INSIDE Program:

> "The more effective use of emerging technologies offers the potential for NASD Regulation to monitor activities and patterns on a more timely basis and to deal with potential problems at the earliest possible time. Doing so effectively should result in increased compliance and enhanced investor protection."[219]

NASD Regulation will oversee the activities of securities firms and their branch offices as well as the registered securities professionals and certain stock markets. NASD Regulation intends to pursue securities fraud or stock manipulation perpetrated on Internet aggressively.

However, these initiatives remain local while Internet is a global network. Thus, should new legislation be adopted by all jurisdictions? In case of violation, how are securities laws of a particular jurisdiction going to be enforced if the violators are abroad? How to deal with jurisdictional and conflicts of laws in foreign countries? Are there means to help securities regulators to meet their policy objectives while not impairing the development of the Internet securities market? In our view, the limited role played by an international securities organization such as IOSCO in the last few years could finally be reviewed to give this institution a more important function.

---

217 See generally the NASD Regulation at http://www.nasdr.com (last visited August 23, 2000) [hereinafter "NASD Regulation"].

218 See generally at http://www.nasdr.com/5500.htm

219 Ibid.

b. IOSCO

IOSCO is an international body of securities commissions from around the world. The four primary purposes behind the establishment of IOSCO, as stated in its by-laws, are cooperation, exchange of information, establishment of standards for an effective surveillance of international securities transactions and providing mutual assistance. The relevancy of those purposes has been confirmed with the arrival of Internet in the securities industry. Internet also means that those purposes could be attained more easily through the use of a new medium of communication and surveillance. At the same time, a new series of issues have to be addressed, as we will discover in the present section.

In 1996, IOSCO's technical committee has created the IOSCO Task Force to investigate the new issues IOSCO faces considering the increasing use of Internet in the securities industry. The mandate of the IOSCO Task Force was:

> (1) to identify common regulatory and enforcement issues presented by Internet,
>
> (2) to suggest possible ways by which regulators and market participants can use the Internet to further the goals of IOSCO and to combat securities frauds and violations, and
>
> (3) to determine whether it is possible for IOSCO and its members to develop an approach to address regulatory enforcement issues.[220]

---

220 IOSCO Task Force, see IOSCO Web site at http://iosco.org (last visited August 23, 3000).

A report was submitted by the IOSCO Task Force in September 1997 which outlined Internet opportunities and challenges for the securities industry regulators concerning enforcement issues.[221] The IOSCO Task Force recognized that the Web is challenging from an enforcement perspective and indicated that it was concerned with numerous issues. Indeed, from the comfort of a living room almost anywhere in the world, Internet allows individuals and entities to disseminate information about the value of securities to a large number of people, provide investment advice, and make offerings for the purchase or sale of securities instruments. Similarly, the creation of bulletin boards, which allow individuals to post written messages in a particular location on the Internet for readers to post responses or new messages, is also a matter of great concern from a regulation perspective. Bulletin boards or newsgroups, as they are sometimes called, are challenging for securities regulators because they are used to disseminate information to a large number of people in order to stimulate online conversations about a particular stock or topic while remaining anonymous if desired. They are perceived as an ideal medium for users wanting to spread rumours and manipulate prices. Like bulletin board systems, e-mail can also be used to disseminate information on the Internet to wide audiences. The particular feature of e-mail is its popularity. e-mail is the primary use of Internet and probably represents the Internet function having the largest portion of users. As any individual with an e-mail account may send information to a large number of people while remaining anonymous, enforcement represents a challenge for IOSCO.

All these technologies and new ones that appear almost daily present challenges for regulators and will continue to do so in the near future as more and more users have access to them. These challenges are present because, by definition, the Internet is boundless and global, crossing political and legal frontiers with unlimited access and almost no control. Furthermore, using Internet to disseminate information proves to be rapid and inexpensive. In a matter of seconds, anyone can send information at almost no cost. Finally, the quantity of information that can be transferred using Internet can be quite substantial. As the IOSCO Report summarizes:

---

221 "Report on Enforcement Issues Raised by the Increasing Use of Electronic Networks in the Securities and Futures Field," *IOSCO Internet Task Force*, September 1997, at http://www.iosco.org/docs-public/1997-report_on_enforcement_issues.html (last visited August 23, 2000) [hereinafter the "IOSCO Report"].

> "As a result, the Internet allows a wide range of financial services providers to access a broad customer base, whether domestic or international, and to provide large quantities of detailed information quickly, and at little cost. [...] using the vast quantities of information available on the Internet can be challenging to regulators."[222]

Considering that when using Internet it is possible to be anonymous and to hide the source of information or to duplicate or multiply the sources of the information, it becomes more difficult for regulators to identify and locate fraud perpetrators. On this issue, the IOSCO Report suggests that:

> "Regulators should consider whether they can obtain, when necessary, information from Internet access providers about the identity of those using the services and whether informal or formal arrangements with such providers would be useful.[223]"

Collecting evidence on Internet can also provide a challenge to IOSCO. Not only is it difficult to trace communications and determine the source of the information but foreign laws and regulations to be respected can vary widely from domestic laws, so as to require regulators to become familiar with laws and regulations of different countries not only on securities matters but also, for example, on evidence, privacy and charter matters. Therefore, the need for cooperation and mutual assistance through established organizations such as IOSCO becomes imperative.

Yet, Internet has an interesting feature that may help reducing criminal activity: Internet broadcasts content to the world. The issuer who will set up a fraudulent company and site to swindle investors may draw any securities regulators' attention. Hence, regulators should embrace technology such as Internet because contrary to traditional means of securities distribution where there is no possibility of knowing what a particular broker is saying on the phone, Internet provides surveillance capabilities. However, there remains a difficulty for securities commissions around the world to police Internet as it may exacerbate conflicting national laws and jurisdictional issues.

---

222 IOSCO Report, *supra* note 221 at p. 4.

223 *Ibid* at p.6.

Finally, as we stated above, cooperation between securities regulators is essential. The reason is simple, only through sharing of information and mutual assistance, can securities regulators from all over the world learn about the latest type of crimes or newest way to commit fraud on Internet, and how to successfully prosecute them, so as to decrease the chance that individuals perpetrate the same crime in different jurisdictions or be imitated by other individuals. Finally, where new technical expertise is developed to trace or catch illegal activities, it can be shared between securities regulators. Thus, unless there is reliance on cooperation and mutual assistance between national securities commissions and other regulatory organizations, each commission will have to search and police violators on its own and ultimately, small investors will be the victims. Consequently, national securities agencies and commissions, the NASAA, NASD Regulation, IOSCO and investors will have to work closely to build safeguards to protect investors and prevent abuses in the market. However, as we shall now present in the following section, there are complementary means of policing Internet as another of its surprising features is that sometimes, Internet polices itself!

ii. Internet Securities Market Self Regulation

Self regulation on Internet or "netiquette" refers to certain Internet procedures or to the tendency of Internet users to be resentful towards Internet being used illegally or improperly. Those users want Internet to remain a community free of crimes and they investigate suspicious matters and make complaints or reports about abusers to regulators. Those methods will have to be encouraged as they prove to be among the most effective to combat illegal activities.

When the efforts of the Internet community are supplemented by those of the securities regulators, enforcement may be even more effective. In a statement released on December 6, 1996,[224] the SEC announced that it would join efforts with other organizations and establish procedures to promote disclosure, efficiency and easy public access to information regarding private class action securities

---

224 SEC Web Page to List "Designated Internet Sites" Maintaining Information on Pending Securities Fraud Class Action Litigation, SEC Statement 96-135 (December 6, 1996) [hereinafter "SEC Statement"].

fraud litigation using Internet. The intention of the SEC is to inform investors about federal securities fraud class action litigation. Investors will not only be able to know about these litigation cases but also to follow their development.

Documents relating to securities cases could eventually be filed in this or any similar manner. In fact, a central system could be established in each country or with the IOSCO. Other approaches considered would include the use of special search engines able to detect specific securities related activities. If more than one system exists, a central system could direct investors to the one applicable to the company they are interested in. In itself, the SEC site,[225] as well as those of Canadian securities commissions, generally provide information to investors about cases of fraud and other criminal activities.[226]

Legal documents such as cases on securities fraud and information on securities laws and regulations may be made available on Internet and classified and simplified for public consultation. These documents provide a lot of information to investors about securities fraud and can constitute one of the best ways to educate investors. Publicly filing these documents on Internet and making them accessible to all users may be done at a very low cost. Cases can also be made available for Internet users to consult.

In addition, informational releases and e-mail and phone complaint centres are among other possibilities that have to be made available on Internet and some, like the National Fraud Information Center[227] have already been established.

---

225 See http://www.sec.gov/enforce.htm.

226 See also the Alberta Securities Commission at http://www.albertasecurities.com, the British Columbia Securities Commission at http://www.bcsc.bc.ca/investorinfo/default.asp, the O.S.C. at http://www.osc.gov.on.ca/en/Investor/investoralert.html and the Q.S.C. at http://www.cvmq.com/english/What_s_new/Brochures/brochures.html.

227 See generally http://www.fraud.org.

Thus, encouraging education and self-regulation are other means that can be employed by securities regulators to prevent illegal activities. Investor education, online information, disciplinary history of firms and individuals, press releases and messages to alert investors about improper conduct and consumer complaint centres are some of the ways that securities regulators can also use to enforce securities regulation on Internet.

iii. Securities Regulation Through Technology

The Internet securities market is confronted with an unstable and uncertain environment with multiple governing laws, changing national rules and conflicting legislation. Confusion and conflicts in regulation is counter-productive for the development of an Internet securities market. Thus, market players must find ways to offer more stability and predictability so that all players have enough confidence for the Internet securities market to thrive.

Where substantive standards, jurisdictional authority and enforcement powers conflict in a state of the art global network such as Internet, innovative solutions must be found to achieve rule making objectives. Contrary to the traditional views on the subject, not only governments and organizations through laws, orders, conventions and cooperation may provide the tools for rule making, but also technicians and programmers through technological tools and system design choices. Indeed, network designs and standards, system configurations, user preferences and technical choices are a means to create and implement a form of regulation.

In a provocative article on the subject entitled "Lex Informatica: The Formulation of Information Policy Rules Through Technology"[228], Joel R. Reidenberg argues that there are technical solutions to policy problems inherent in the regulation of, amongst other things, content, personal information and intellectual property on Internet. He refers to such rule making process as Lex Informatica. In

---

228 REIDENBERG, Joel. R., "Lex Informatica: The Formulation of Information Policy Rules Through Technology"; *Texas Law Review*, February 1198, Vol. 76, No. 3, at p. 553. [hereinafter "Lex Informatica"]. Most of the discussion in this section is derived from Lex Informatica.

his view, Lex Informatica is a useful policy device that policy makers can and should look into as an extra legal instrument that may be used to achieve objectives that are not otherwise attainable by conventional laws and attempts by governments to regulate across jurisdictional line. Therefore, policy makers in the securities industry should use strategies and procedures offered by technology to achieve their policy objectives. The application of this theory is particularly useful in light of the number and complexity of laws in the securities market.

a. Borrowing from Other Areas

The objectives of securities regulation are the protection of investors and the creation and maintenance of an efficient capital market. For the protection of investors, Web sites offering securities to the public already incorporate technology components. For example, to ensure compliance with the sophisticated investor requirements for private placements, several Web sites use a password-protected mechanism whereby interested investors are invited to complete a personal data profile to be qualified and be allowed to register. If the system is linked to a database to verify the accuracy of the data entered by the interested investor, the system achieves the objectives of the law.

Technological barriers as much as laws may be circumvented and as such, a technological system may offer an efficiency guarantee equivalent to legislation. Similarly, for the furtherance of an efficient capital market, securities regulation imposes on issuers disclosure requirements. On Internet, such requirements are not only respected but are easier to meet as an issuer may easily give access to or provide its information and documents to its shareholders online. As we argued above, the objectives of the legislation may be achieved by alternative procedures such as voluntary disclosure, third party certification agents and professional analysts.

Certain legal policy areas are subject to change and challenge on Internet including content, personal information and the preservation of ownership rights. These areas each present conflicting policies

in each jurisdiction and show a lack of harmonization across national borders. In those areas, technological procedures have been introduced which can contribute to our discussion on regulation through technology for securities matters.

On the issue of content, history has shown that regulation through legislation may be doomed to fail. Indeed, the example of the United States with the *Communications Decency Act*[229], which was a law which was partly declared unconstitutional by the Supreme Court of the U.S., attempting to impose liability on information service and access providers that disseminated offensive material to minors, proves that legislation may not always be the solution to rule making, and especially on Internet.

Instead, technological filtering devices such as the Platform for Internet Content Selection[230] seem well suited and accepted as a means to resolve policy problems while accommodating different standards, values and preferences which differ from one nation to another[231].

With the PICS solution, technical specifications are used to define a standard format for rating labels describing Internet material and a standard mechanism for distributing those labels. Using PICS, access to information on the Internet is restricted while not imposing legal restrictions on the dissemination of content on Internet. The practical implications of such an approach are significant as several problems associated while legal standards may be avoided. For example, because of conflicting national laws, information providers may sometimes face liability for acts that are legal where performed but illegal where they are viewed by users. Similarly, certain rights or freedoms in one jurisdiction may be a risk of liability in another jurisdiction. With technological standards, there are no conflicts of laws and no such liability exposure.

---

229 §502. 47 USCA §223 (West Supp. 1997).

230 Hereinafter "PICS".

231 PICS was developed by the World Wide Web Consortium. For more details see "Platform for Internet Content Selection" (last modified July 18, 1997) at http://www.w3.org/PICS/ (last visited August 23, 2000) and for explanation of the PICS technology and its development, see RESNICK, Paul and MILLER, James, "PICS: Internet Access Controls Without Censorship", *Communications of the ACM*, Oct. 1996, at. 87, 87-93.

There are numerous other advantages in using technology as a rule making tool. Different content evaluation standards may be applied to the same information on a Web site while allowing different users to use different filter criteria. Therefore, in different jurisdictions, it is possible to segment permissible content. Similarly, if laws conflict between different jurisdictions, technological standards may be used to filter content that may be illegal. Even within a single jurisdiction, in cases of incompatible standards, it is possible to use technology to accommodate such incompatible standards. Ultimately, technology allows individual choice of filtering rules.

One of the greatest advantages of such technological approach is the automatic enforcement. Indeed, the rules are enforced before any action is perpetrated and the enforcement is not only in one jurisdiction but across frontiers.[232]

Issues of protection of personal information of Internet users also have to be addressed. This represents a major challenge for policy makers as information technology allows communication of information instantaneously. As in other areas, national laws on the subject are numerous and conflicting. In the U.S., public concern for invasion of privacy is high and the debate continues for the establishment of privacy standards. Europeans have been more active in the establishment of legal rules for the protection of personal information and the development and application of privacy standards in global networks is a constant source of debate and concern. In Canada, the federal government just enacted new legislation on the protection of personal information, the *Personal Information Protection and Electronic Documents Act*[233] which received Royal Assent on April 13, 2000. The privacy provisions of Bill C-6 come into force on January 1, 2001. With Internet, the supervision of exchange of information and the actual enforcement of the different national laws are extremely difficult. For those reasons, policy makers may have to rely on technological means to achieve their policy objectives.

---

232 Softwares such as Cyber Patrol or Microsoft Internet Explorer content adviser allow individual choice of filtering rules and automatic enforcement.

233 S.C. 2000, c.5 [hereinafter "Bill C-6"].

Labels and software filters may also be used to resolve conflicting legal privacy rules on Internet as they allow users to determine what use will be made of their personal information. However, PICS, software filters and configuration arrangements with labels are not complete without the participation of third parties to label and to assign appropriate ratings to Web sites[234].

The value of technology as a regulation instrument is undeniable. Countries with strict privacy legislation such as European countries and Canada may feel some comfort at the presence and use of such mechanisms. In the absence of standard national laws on the subject, personal information about individuals can be protected without enforcement problems normally associated with extra-territorial legal standards. Of course, these techniques require practical work for the establishment of a certain infrastructure including certification agents and trusted third parties which have to be recognized by most countries with such data protection legislation but policy makers have to adopt a new attitude towards technology and perhaps adopt it for rule making purposes.

On issues of ownership rights, the questions are not as sensitive in the securities industry. However, it is worth mentioning that technological standards, procedures and architectures may be put in place to enable intellectual property producers to choose the type of protection they want, to negotiate the use of their intellectual property and perhaps to express rules on the use of this intellectual property. A simple example is a file downloaded in Adobe PDF format[235] which allows the document to be viewed and printed but not to be modified. Indeed, automation of permission and payment procedures for the use of protected works can be used such as the services offered by the Copyright Clearance Centre[236]. Similarly, trusted systems may be put in place to allow intellectual property producers to enforce rules to be imposed on the use of their intellectual property. Such a trusted

---

234 These techniques are reported and discussed in Lex Informatica although it is unknown whether any development have taken place in this area.

235 Software that allows to only view and print files in a certain format which maintaining the graphics. See http://www.adobe.com/products/main.html (last visited August 23, 2000).

236 http://www.copyright.com (last visited August 23, 2000).

system requires an intermediary between the producer and the final user to ensure that the conditions for use and access are respected.

One example of the use of Internet technology in the furtherance of regulation and enforcement efforts relates to an issue that is often underestimated by Internet users: the difficulty to resolve disputes involving parties online. Considering the global nature of Internet and their lack of capacity to enforce a judgment or implement sanctions abroad, securities regulators should start considering alternative dispute resolutions procedures. Such technological mechanisms have already been established by Canadian organizations to provide services on-line and offer an effective and often less expensive means of resolving international or national disputes with assistance from experts in all areas.[237]

Thus, through the use of technology, new policy tools could help the efforts of securities regulators and policy makers. For example, a technology similar to PICS could be used by issuers in their offering process to ensure that the prospectus and related documentation are only accessible in certain jurisdictions where registered or by pre-identified viewers such as exempt institutions and purchasers. At the same time, conscious of the traditional limitation of legal means, technology offers countless possibilities for regulation while offering numerous advantages.

b. Technology vs. Legislation

By its nature, Internet imposes challenges to policy makers. Among the problems associated with Internet as a global network, are choice of law problems and different national legal standards which, with a decentralized network such as Internet, amount to an incentive to circumvent national laws and avoid law enforcement powers. However, for a global network such as Internet, it is not appropriate to have local laws being imposed which vary in degree and nature from one jurisdiction

---

237 eresolution is such an organization based in Montreal, Canada, see at http://www.eresolution.com (last visited August 23, 2000).

to another creating confusion and conflicts. Though a harmonized legal regime for the Internet securities industry would be ideal, it is unrealistic to think that it may be achieved even if the efforts of organizations such as IOSCO are useful.

Policy makers will not accept standardized laws as the requirements and priorities are different from one jurisdiction to another. Therefore, a certain degree of flexibility is required. Through the use of technological standards and procedures, customized and flexible rules may allow policy makers to avoid the limitations of legal standards that were outlined above. Indeed, jurisdictional issues have to be addressed, and where activities take place in one jurisdiction rather than the other, technology offers efficient rule making capabilities. It is understandable for policy makers to impose laws in their own jurisdiction but most are reluctant to impose laws on activities taking place in a foreign jurisdiction. With technology as a means of rule making, the jurisdiction is the Internet network itself. Such technological rules are imposed by those who provide the technology and put it in place. Since geographical location is irrelevant, rule making is across borders and jurisdictional and choice of law issues may be avoided.

Even in cases of conflict of rules between different networks, because the standards would be incompatible for technical reasons or otherwise, chances are these technical impediments may be addressed more easily than jurisdictional issues usually associated with legal requirements. As a matter of fact, software programs or other technical solutions to translate or convert standards may be used to address those difficulties. Furthermore, risk of liability resulting from conflicting national rules may be avoided through the use of technology.

Because of a shift from control over content to control over technology different rules may apply to different users and recipients. Users themselves have the authority to make decisions about what they receive as a particular user may configure a computer with particular rules. In the same way, an ISP can impose certain rules on its members. Consequently, with such flexibility offered by technology,

standard national laws become less necessary as securities offerings in one jurisdiction are not necessarily in contravention of laws of another jurisdiction.

Beyond flexibility, technology offers customization advantages. Customization is required because users have to have freedom of contract which may not always be suitable nor permissible in all contexts. Indeed, public order legal provisions may not be waived in certain circumstances, and the negotiation of international contracts may be complex and often unlikely to give any kind of choice to users. With technological standards and configurations, particular rules are applicable in different circumstances depending on an individual choice or local requirements which, by the same effect, empowers those who have to make decisions. Technological configurations may be set up to follow different rules in different circumstances or locations. On this point, Mr. Reidenberg indicates in his article Lex Informatica:

> "For example, automatic data purges may be set for European data to comply with data privacy laws [...] but not set in parts of the network where laws do not require it. Alternatively, technological choices may be made to give individuals various configuration options such as PICS-based content screening. [...] Similarly, technological standards may be used to customize rules for transnetwork differences. Protocols exist, for example, to connect on-line service providers such as America Online (AOL) to the Internet. [...] At the same time, technical choices may be developed to accommodate differences in network and national information policy rules. If rules for content evolve differently in various states, users may receive differentiated access. [...] Lex informatica offers a panoply of opportunities in configuration choice and frequently allows users to override standard system configuration.[238]"

Finally, wherever the user may be situated, that particular rule may apply to such an user through the use of techniques such as security filters and translators. For example, a password to access data may be used wherever the user or the data are located. Similarly, translators convert a rule or a data from

---

238 Lex Informatica, *supra* note 228 at pages 579 and 580.

one system to another for execution with translation mechanisms such as anonymization of data, use of an anonymous remailer or encryption-decryption operations.

A constant problem with national laws is their enforcement from one jurisdiction to another. Internet makes rules enforcement extremely difficult because of its fluid and global nature. Ultimately, rule violators are increasingly difficult to identify, find and prosecute. While legal means rely on ex post enforcement against rule violators, technological means allows automated monitoring of information access use which is in effect instantaneous. Technological means offer ex ante measures of self-execution. Indeed, filters and translators control the information before any violation is perpetrated. Only permissible actions take place. Furthermore, technological devices have been and will be developed to monitor compliance with rules and even legal norms and to enforce them. Information access and use may be monitored through techniques such as data tagging to identify the applicable rules[239], data sniffers[240] and search engines to locate data users or use and other organizations, either private or public, established to verify system compliance. Secured viewers and encrypted data provide other means to regulate and enforce by technological means.

Security wrappers may also be placed around information wherever it goes on Internet to assure that information is only used by authorized individuals for permitted use through trust management technology such as PolicyMaker.[241]

---

239 http://www.doi.org (last visited August 23, 2000) for information about digital object identifier (DOI) which is a technique to link users of digital materials to their rights holders themselves.

240 http://www.iss.net (last visited August 23, 2000) for information about sniffer as a technique to search for specific data.

241 PolicyMaker verifies the authority of particular users to perform permitted actions and however it does not yet offer "downstream" activities. See generally BLAZE, Matt, FEIGENBAUM, Joan and STRAUSS, Martin, "Compliance Checking in PolicyMaker Trust Management System", AT & T Labs Research, at http://www.research.att.com/resources/trs/TRs/98/98.3/98.3.2.abs.html; and also KEROMYTIS, A. D., "The KeyNote Trust-Management System" at http://www.cis.upenn.edu/~angelos/keynote.html.

Data sources may specify rules imposing restrictions on manipulations of information at remote sites through some technological means such as encryption devices. Through such a technique, encrypted data is only provided with a secured viewer giving control in distant locations to the source providers. Java Applets[242] is such a technique which allows to preserve the source control of the data at remote locations. The encrypted work is protected and only trusted users can view or print. Through such techniques, control or regulation of information is possible from the source and throughout Internet.

There are also disadvantages associated with the use of technology for rule making purposes. Because of the flexibility in technological configurations, standards may be circumvented especially at the user level. Some of the configuration standards used as rules and located on the user's computer may be by-passed by computer-wise users to establish different rules. At a higher level, technological standards built into the network make it more difficult for users to circumvent them. For example, if only information with selected codings is permitted on the system, it is very difficult for a user to circumvent such a network rule. However, if a technological rule is established at the network level, it is costly and difficult to change.

Rules imposed at the user level are less complicated to change and also probably less costly. However, to ensure standardized and effective control, such rules must be imposed at the network level. Finally, the cost and complexity of amending technological rules at the network level are far less than implementing and changing national laws or standardizing them from one jurisdiction to another.

Furthermore, even if a law is enacted to deal with a certain situation, public policy or other interests groups may intervene to challenge such a law or contest its constitutionality. In Canada, through the Canadian *Charter of Rights and Freedoms*, laws that tend to restrict the rights and freedoms of Canadians are often successfully challenged. However, should policy makers consider that a certain

---

242 See generally http://www.javasoft.com/applets

fundamental principle be established, legislation may be adopted which does not mean that technological rules are not to be used to complement or supplement such legislation.

In effect, technological rules may complement legislation and at times may even act as a substitute when they are better able to achieve policy objectives. One must recognize that legislation remains useful to impose liability on various actors while providing immunity or safe harbours for the implementation of technological rules. Indeed, technological rules are not appropriate nor suitable for fraudulent or other criminal activities. However, a Web site with a label or some other kind of certification by a trusted third party may provide a means to inform users that they do not deal with a recognized and certified organization. National laws are also useful to sanction evasion of rules. If any rule is circumvented or in case of violation of any rule, laws are necessary to sanction those behaviours. In practice, national laws are necessary to convict and where applicable sanction wrongdoers. As we discussed in the previous section, netiquette can also be a substitute as a sanction mechanism where the Net community intervenes to control, punish or prevent the actions of wrongdoers.

In essence, technological rules and national laws have to complement one another to provide effective means of regulating the Internet securities market. National laws alone are not sufficient, as we have demonstrated, and in certain cases drafting national laws to regulate a changing and fluid environment such as Internet may be difficult. Policy makers must have a clear idea of what their objectives are and consider amending those rules regularly.

Considering the variety and fluidity of Internet and its securities industry, tailoring legislation to such an industry is a difficult task and requires rules that can deal with complex and changing situations necessitating customized rules.

At times, technological standards have resulted from the work of a single firm success in a competitive market or from a collaboration within an industry to establish a standard. Collaboration

with certain industries instead of inhibition in their development might help the securities regulators and policy makers. They must realize that they have to become partners with technological experts in the development of new technologies, and be open and flexible to promote the growth and the development of the industry, while remaining proactive and visionary to determine new trends. Perhaps at such a point, they will surely rest at the forefront of their rule making objectives and technological developments will help to achieve them.

It is not advocated here that governments and rule makers should fund technological developments but their participation can be in the form of work to establish and promote standard bodies to help developing technological standards. In Canada, these organizations have been successful in the past. The Canadian Standards Association Code for the Protection of Personal Information[243] is an example of such a successful organization. This association is the result of government, industry and consumer groups working together to define standards. Encouraging the establishment of policy objectives in technology will only help securities regulators and policy makers and increase their effectiveness. Consequently, technological organizations and institutions have to be looked at favourably by governments and rule makers who ultimately will have to join them. Such organizations include the Internet Engineering Task Force[244], the Internet Society[245], the World Wide

---

243 http://www.csa.ca (last visited August 23, 2000). See also BENNETT, Colin, "Privacy Codes, Privacy Standards and Privacy Laws: The Instruments for Data Protection and What They Can Achieve"; in *Visions for Privacy in the 21st Century,* (New York: Colin Bennett Ed.,1998).

244 http://www.ietf.org. The IETF works in the development of new Internet technical standards. It is a self selected organization composed of different Internet market participants including network designers, operators and researchers and focus on protocol engineering and development of Internet.

245 http://www.isoc.org (last visited August 23, 2000). ISOC is a non-governmental international organization which coordinates Internet working technologies and applications through the promulgation of voluntary standards.

Web Consortium[246] and other standards organizations like ISO[247], the European Telecommunications Standards Institute[248] and other organizations such as Committee T-1[249], IOSCO, NASAA and CSA.

At this early stage, Internet represents a difficulty for regulators. However, things may soon turn around and Internet could just as well assist regulators in tracing violators and in enforcing rules. In the U.S., the SEC has shown a willingness to encourage new innovations. SEC Commissioner Steven Wallman has openly stated that the SEC does not want to discourage financial and technological innovations on Internet[250]. In Canada securities commissions are somewhat slower at taking a position on Internet securities issues. According to Edward Waitzer, Chairman of the O.S.C., regulators should be able to make use of "intelligent systems" to search on-line filings for discrepancies or to analyse insider trading reports. Waitzer predicts that new approaches will be advocated to police the Internet which will make regulators focus on transactions rather than geographic areas and what is posted in them. As a result, no matter where they are situated, when violators will take money from good faith investors, regulators will come after them.[251]

As we stated above, policy makers will have to understand, recognize and encourage technological rule making and learn how to take advantage of it, otherwise they risk being left behind or marginalized.

---

246 http://www.w3c.org (last visited August 23, 2000). W3C is an international industry consortium with the MIT Laboratory for Computer Science (U.S.) and the Institut National de Recherche en Informatique et en Automatique (France) promoting standards for the evolution of Internet and interoperability between Web products.

247 http://www.iso.ch (last visited August 23, 2000).

248 http://www.etsi.org (last visited August 23, 2000).

249 http://www.t1.org (last visited August 23, 2000).

250 SEC Green Light, at 1.

251 "Canadian securities regulators worry about the Internet", http://www.webfinance.net (last visited August 23, 2000)

Furthermore, because of the need of cooperation between jurisdictions in their rule making and enforcement process, efforts might be of limited use without the help and assistance of technology. As a result, rule makers have to start being increasingly involved and acquainted with technology people and their organizations. Understanding technological rule making will also mean recognizing the trends, adopting innovative procedures and being able to directly influence technology in the direction of their policy objectives.

Technological standards and configurations may constitute one of the best rule making tools available to policy makers. Because of the global nature of Internet, the difficulty to adopt rules that apply throughout the Internet and the limits of the enforcement efforts of authorities, technology may at once be the source of distress and the salvation of securities regulators and policy makers.

Conclusion

With Internet, investors have much more control in their hands. In a matter of seconds, any time of the day and from almost anywhere in the world, they have direct access to any issuer's Web site. As we discussed, while most Canadian investors who use Internet might be interested in Internet securities offerings, there are very few of such offerings as a result of the size of the Canadian market, the slow pace of adoption of Internet as a tool of commerce in Canada, and also because of some serious practical and legal uncertainties relating to this new medium of communication.

At the same time, as they allow to by-pass underwriters to market and distribute securities, Internet securities offerings at last offer a mechanism for small enterprises to raise equity capital at a more reasonable cost and for small investors to access securities offerings that were once unavailable. In truth, Internet could drastically improve accessibility to equity capital for small enterprises but reforms in securities legislation would be required in certain areas, such as prospectus and disclosure requirements, to lessen the burden imposed by statutory obligations.

New roles must be played by securities commissions and other regulatory entities with the introduction of Internet in the securities industry. Internet being global and fluid by definition, it will require securities commissions from around the world to cooperate to effectively control and enforce each others' legislation. Organizations such as IOSCO should be called upon to play a greater role in the Internet securities market. Although Internet and its community offer by themselves means of policing the network, new policies and procedures may have to be implemented embracing technology which, in itself, may become a regulation mechanism.

This text aimed at introducing Internet securities offering in Canada and at studying the applicability of securities regulation principles to them. Internet securities offerings are derived from traditional offerings and share similar characteristics. In our view, Internet securities offerings will not replace the profitable and established traditional market. It will only influence the distribution of securities

in Canada. So far, after having identified a number of uncertainties and clarified a few others, the only certainty seems to be the existence of imperfect people with imperfect technology striving for a perfect world.

Bibliography

Legislation

Canada

Alberta Securities Act, S.A. 1981, c. S-6.1, as amended
British Columbia Securities Act, R.S.B.C. 1996, c. 418; as amended
California Corporate Securities Law of 1968, as amended
Canada Business Corporations Act, R.S.C., 1985, c. C - 44, as amended
Civil Code of Quebec
Ontario Securities Act, R.S.O. 1990, c. S.5, as amended
Notice of National Instrument 21-101 Marketplace Operation, and Notice of National Instrument 23-101 Trading Rules, at http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/ats.pdf

U.S.

Securities Act of 1933, 17 C.F.R. (1994), as amended
Securities and Exchange Act of 1934, 17 C.F.R. (1994), as amended

Caselaw

R. v. Pipegrass, (1959), 29 W.W.R. 218, 23 D.L.R. (2d) 220 (Alta C.A.)
S.E.C. v. Ralston Purina, 346 U.S. 119 73 S.Ct.981 (1953)
Ticketmaster Corp. v. *Tickets.com Inc.* (U.S. Dist. Court, C.D. Cal.)(March 27, 2000)

Doctrine

ALLEBACH, Mark A., "Small Business, Equity Financing, and the Internet: The Evolution of a Solution?" in 1999 4 Va. J.L. & Tech. 3, at 22

ASTARITA,Mark J., "SCOR Registration", *Sec News*, http //www.seclaw.com/docs/scor.html

BAGLEY, Constance E. and TOMKINSON, Robert J.,"Internet is Seeing its Shares of Securities Offerings", Nat'l L.J., Feb.2, 1998 at C3

BARTHOLOMEW, David M. and MURPHY, Dena L., "The Internet and Securities Regulation: What's Next?" 25 SEC. Reg. L. J. 177, at p.187 (1997) which describes the request made by Real Goods Trading Corporation in its application for a SEC No-Action Letter

BENNETT, Colin, "Privacy Codes, Privacy Standards and Privacy Laws: The Instruments for Data Protection and What They Can Achieve"; in *Visions for Privacy in the 21st Century,* (New York: Colin Bennett Ed., 1998).

BENSTON, G. "The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements", in MANNE, H.G., (Ed.), *Economic Policy and Regulation of Corporate Securities* (Washington: American Enterprise Institute for Policy Research, 1969) 23

BENSTON, G. "Required Disclosure and the Stock Market", (1973) 63 Am. Econ. Rev. 132

BIGNESS, John, "Net to Link Investors and Startups", *CHI.TRIB*. March 19, 1998, at 1

BLAKE, R. C., "Article: Advising Clients on Using the Internet to Make Offers of Securities in Offshore Offerings", 55 Bus. Law. 177

BLAZE, Matt, FEIGENBAUM, Joan and STRAUSS, Martin, "Compliance Checking in PolicyMaker Trust Management System", AT & T Labs Research, at http://www.research.att.com/resources/trs/TRs/98/98.3/98.3.2.abs.html

BOYCE, G.R., "Offering and Trading Securities on the Internet", *New York Law Journal*, (9 May 1996) at 5

BOYLE P. James, and MISETICH, Linda E., "e-minerals: Canada's First IPO Over the Internet", *Insight Conference April 27, 1999*, (Toronto: Insight, 1999)

BROCKHOFF, Anne, "Clear off Internet run away for wave of IPO launches", 16 Kansas City Bus.J. 26 (Dec.15, 1997)

"Canadian securities regulators worry about the Internet", http://www.webfinance.net

CELLA III, Joseph F. and STARK, John Reed, "SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium; A Program for the Eagle and the Internet.", *The Business Lawyer*, Vol.52, May 1997, at 821

COFFEE, John C. Jr., "Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation", 52 Bus. Law. 1195

CRITCHLEY, Barry, "First Public Offering via Net", *The National Post,* January 6, 1999 at D-1 and D-2

DE TORO A. & BERKOWITZ E., "Trade Wind; the Arrival of On-Line Securities Offerings", *The Los Anglels Daily Journal*, (27 June 1996) at 7

DE TORO A. & BERKOWITZ E., "Trade Wind; the Arrival of On-Line Securities Offerings", *The Los Angeles Daily Journal*, (27 June 1996) at 7

DESMOND, Greg, "Internet Stock Offerings", at http://www.personal.law.miami.edu/~froomkin/seminar/papers/desmond.htm

"e-minerals to Broaden Business; Internet IPO Firm to Step Out into Cyberspace" Press release of e-minerals at http://www.e-minerals.com

FARRELL, Patrick V., "Mining the Web for Capital", *Insight Conference April 27, 1999*, (Toronto: Insight, 1999)

GILLEN, Mark, *Securities Regulation in Canada*, 2nd Ed. (Carswell: Toronto, 1999)

GILSON, R.J. & KRAAKMAN, R.H., "The Mechanism of Market Efficiency", (1984) 70 Va.L.Rev. 549

GOLLMANN, D. *Computer Security*, (John Wiley & Son Ltd: New York, 1999) 336 p.

GOMBERS, P. A. "Optimal Investment, Monitoring, and Staging of the Venture Capital", (1995) 50 J. Fin. 1461

GRAND E., James & LLOYD, Gary, "Internet IPOs: A Potential Oasis for Small Companies", *Upside Publishing*, http://upside.com/texis/mvm/story?id=34712c14c

"Internet Offerings; On-Line Capitalism", *The Economist*, (23 November 1996) at 92

KEROMYTIS, A. D., "The KeyNote Trust-Management System" at http://www.cis.upenn.edu/~angelos/keynote.html

LANGEVOORT, Donald C., "Toward More Effective Risk Disclosure for Technology-Enhanced Investing", 75 Wash. U.L.Q. 753, 756-57 (1997)

LOEB, Ronald M. & RICHTER, David J., "Electronic Offerings: Securities Law in the Age of the Internet", *Advanced Securities Law Workshop*, (Practising Law Institute, Corporate Law and Practice Course Handbook Series, 1996)

LOSS, L. & SELIGMAN, J., "Fundamentals of Securities Regulation", 3rd Ed., (New York: Little, Brown & Company, 1995)

LOWENSTEIN, L., "Financial Transparency in Corporate Covenants: You Manage What You Measure", (1996) 96 Col. L. Rev. 1335

MAHONEY, Paul G., "Technology, Property Rights and Information, and Security Regulation", 75 Wash. U.L.Q., 815, 823 (1997)

McFARLAND, Janet, "Officials Ill-Equipped to Keep Organized Crime Out of the Securities Business", *Globe & Mail*, June 17 at B9

MONDSCHEIN, Lisa A., "The Solicitation and marketing of Securities Offerings Through the Internet", 65 Brooklyn L. Rev. 185

OnX Broadcasts its Message", *National Post*, April 4, 2000, at B3

"Platform for Internet Content Selection" (last modified July 18, 1997) at http://www.w3.org/PICS/

RAFTER, Michelle V., "On-line IPO's falling short of expectations", *L.A. Times*, May 26, 1997, at B3

REIDENBERG, Joel. R., "Lex Informatica: The Formulation of Information Policy Rules Through Technology"; *Texas Law Review*, February 1198, Vol. 76, No. 3, at 553.

RESNICK, Paul and MILLER, James, "PICS: Internet Access Controls Without Censorship", *Communications of the ACM*, Oct. 1996, at 87

ROSENOER, J. "CyberLaw; The Law of Internet", (Springer: New York, 1997), at 313

ROUSSEAU, S., "The future of capital formation for small and medium size enterprises: Rethinking initial public offering regulation following the restructuration of Canadian Stock Exchanges", (Montréal, 1999)

SCHULTE, Stephen J., "IPO Roadshows Today: A Primer for the Practitioner", in *How to Prepare an Initial Public Offering* (PLI Corporate Law and Practice Course handbook Series, 1997) at 491

"SEC clears first brokerage for Net private placements", http://www.webfinance.net

SESIT, Michael R., "Seven Banks Plan to Launch Online Currency Trading", *Wall St. J. Interactive* Ed. June 7, 2000

SILVERMAN, A.J., "Make Me an Offer On-Line; Securities Regulation on the Internet", *Legal Times* (8 July 1996) at 20

STOVSKY, M. D., "Private Securities Offerings on the Internet", *Cyberlaw*, http://www.cyberlaw.com/privoff.html

TIMMONS Jeffrey A. and SANDER Dalea, "Everything you (don't) want to know about raising capital", in *Finance for Corporate Growth*, 91 Harvard Business Review Paperback ed. 1991

WADDAMS, S.M., *The Law of Contract*, 2nd ed. (Toronto: Canada Law Book 1993)

WEIRICK, B.P., "With the Internet Craze Reaching the Public-Offering Markets, State, Federal and Foreign Regulators are Scrambling to Catch Up with Technological Advances", *The National Law Journal*, (6 May 1996) at B5

WEISS, Gary , "On-Line Investing", *Business Week*, June 5, 1995, at 70

WRIGHT, B., "The Law of Electronic Commerce", (New York: Little, Brown & Co. 1991)

World Wide Web sites

www.adobe.com/products/main.html
www.albertasecurities.com
www.baystreetdirect.com
www.bcsc.bc.ca/investorinfo/default.asp
www.copyright.com
www.csa.ca
www.cvmq.com/english/What_s_new/Brochures/brochures.html.
www.cybersecuritieslaw.com/lawsuits/suits_home.htm
www.cybersecuritieslaw.com/news.htm#15
www.cybersecuritieslaw.com/biblio/non_us_initiatives.htm
www.doi.org
www.dsm.com
www.e-iponet.com
www.e-minerals.com
www.eresolution.com
www.etsi.org
www.fraud.org.
www.freespeech.org/terrabay/Internet%20users.html
www.FXall.com
www.gmacfs.com/notes/smart
www.groome.com
www.ietf.org
www.iosco.org
www.ipo.com
www.iso.ch
www.isoc.org
www.iss.net

www.javasoft.com/applets

www.nasaa.org
www.nasd.com
www.nasdr.com/5500.htm
www.netroadshow.com
www.netscapeworld.com/netscapeworld/ solutions/spring_street/main.html
www.osc.gov.on.ca/en/Investor/investoralert.html
www.sec.gov
www.sec.gov/enforce.htm
www.sedar.com/sedar/sedar_filer_manual.htm
www.sedar.com
www.t1.org
www.w3c.org
www.witcapital.com

Other

e-minerals Final Prospectus (January 5, 1999), on SEDAR at http://www.sedar.com.

IOSCO Technical Committee's Internet Task Force Report, September 13, 1998, at p.2; see at http://www.iosco.org

"Report on Enforcement Issues Raised by the Increasing Use of Electronic Networks in the Securities and Futures Field," *IOSCO Internet Task Force*, September 1997, at http://www.iosco.org/docs-public/1997-report_on_enforcement_issues.html

SEC Reports to the Congress: "The Impact of Recent Technological Advances on the Securities Markets", Part IV.C.7 (1997) at http://www.sec.gov/ news/ studies/techrp97.htm

NASAA, Comment letter responding to SEC Release No. 33-7233, 34-36345 (December 14, 1995)

"Report of the Attorney General's Committee on Securities Legislation in Ontario", (Toronto: Queen's Printer, 1965)

Perfectdata Corp., SEC no-action letter (Oct. 5, 1996) at http://www.sec.org

Real Goods Trading Corp., SEC no-action letter at http://www.sec.org (June 24, 1996)

"Use Of Electronic Media For Delivery Purposes" *Securities Act of 1933* Release No. 33-7233,