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SEC ISSUES GUIDANCE ON THE USE OF ELECTRONIC MEDIA

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The U.S. Securities and Exchange Commission has issued guidance to issuers and market intermediaries on the use of electronic media. The guidance addresses issues in three areas: delivery of documents mandated under the federal securities laws (which represents an update of prior guidance); issuer liability for content on web sites, both when in registration and when not in registration; and principles that issuers and market intermediaries should consider in the context of online offerings of securities.

In addition, the SEC specifically has requested comment on various related issues. The SEC has also raised certain issues in the context of online private placements that it expects will be addressed through discussions between the SEC staff and third-party service providers and/or possible reconsideration by the staff of positions on broker-dealer registration.

This memorandum summarizes the guidance given by the SEC, the issues on which it has requested comment and the online activities that it finds troublesome and in need of further regulatory responses.

The guidance, which the SEC staff had been drafting for over a year, became effective May 4, 2000.

I. Electronic Delivery

The SEC has published interpretive guidance twice before, in 1995 and 1996, on the use of electronic media to deliver information to investors. The 1995 guidance focused on delivery of prospectuses, annual reports and proxy materials under the various federal securities laws, and the 1996 guidance focused on delivery of mandated disclosure by broker-dealers, investment advisers and transfer agents. The guidance addressed three fundamental concepts for effective delivery**C**notice, access and evidence of delivery**C**but left open various questions of interpretation.

The SEC now has clarified that:

- **$** issuers and intermediaries may obtain consent to electronic delivery telephonically, provided a record of the consent (preferably setting forth whether or not the consent is Aglobal@ and the form of media to be used) is retained;

- **$** intermediaries may request consent on a Aglobal@ multi-issuer basis to deliver all documents of any issuer in which an investor buys or holds securities through such intermediaries, provided the consent is informed (*i.e.*, where investors are informed of the medium to be used and that there may be costs involved, and are apprised of the time and scope of the consent and of the right to revoke the consent); and

- **$** issuers and intermediaries may deliver documents in PDF format, with appropriate measures to ensure that investors can access the documents easily (*e.g.*, by informing investors of the requirements necessary to download materials or providing them with the necessary software and assistance at no cost).

The SEC has also addressed certain ambiguities as to appropriate web site content when an issuer is in registration, and in particular, whether the posting of a prospectus on a web site causes everything on a web site to become part of the prospectus, and whether information on the web site

that is outside the scope of the prospectus, but in close proximity, would be deemed free writing (*i.e.*, a communication, other than a prospectus, constituting an offer of securities).

The SEC has stated that information on a web site should be deemed part of a prospectus only if an issuer, or other person acting on its behalf (such as an underwriter), acts to make it part of the prospectus. Thus, when an issuer includes a hyperlink within a prospectus, the hyperlinked information would be deemed part of the prospectus. The SEC views the inclusion of a hyperlink to an external web site or document as demonstrating an intent to make the information part of the communication.

When embedded hyperlinks are used, the hyperlinked information must be filed as part of the prospectus in the effective registration statement and will be subject to Section 11 liability. An issuer may not use embedded hyperlinks exclusively to satisfy line item disclosure requirements in a securities filing. In addition, an embedded hyperlink does not in itself satisfy any line disclosure requirement for incorporation by reference. In order for a document to be incorporated by reference in a filed document, the filed document must include a statement to that effect listing the incorporated document.

Hyperlinks from an external document to a prospectus would not result in the non-prospectus document being deemed part of the prospectus. Both documents would be deemed delivered together and the non-prospectus may nonetheless be subject to Section 12 liability.

As for free writing in the context of an offering, the SEC cautions that content on an issuer's web site must be reviewed to determine whether the information constitutes free writing, whether or not a prospectus is posted on the site. The SEC will continue to raise questions concerning information on a web site during the pendency of an offering that is inconsistent with the issuer's prospectus or that might constitute an Aoffer@ under the securities laws.

II. Web Site Content

A. General Responsibility for Hyperlinked Information

The SEC has addressed 10b-5 liability on the part of an issuer for material misstatements and omissions in third-party information hyperlinked to the issuer's web site. This guidance is particularly relevant to hyperlinks to analyst research reports.

The courts and the SEC generally have looked to two theories for imposing liability on issuers for statements made in materials ostensibly prepared by third-parties (such as analyst research reports). The first theory **C** Aentanglement@**C** turns on the issuer's involvement in the preparation of the information prior to its publication. The second theory **C** Aadoption@**C** turns on whether the issuer has endorsed or approved information after its publication. Before a trier of fact can address, in the context of third-party information, whether the elements of a 10b-5 claim have been established, and whether reliance and injury occurred, either entanglement or adoption must be established.

The SEC guidance sets forth a non-exclusive list of factors relevant to deciding whether an issuer has adopted information on a third-party web site to which it has established a hyperlink. The guidance does not address entanglement.

1. What has the issuer said about the hyperlinked information and what is implied by the context in which the issuer places the hyperlink?

The SEC believes that when an issuer embeds a hyperlink to a web site within a document required to be filed or delivered under the securities laws, the issuer should be deemed to have adopted the hyperlinked information. When the issuer is in registration and hyperlinks to information that constitutes an Aoffer@ under the securities laws, but that is not embedded within a document, it has created a strong inference of Aadoption.@

2. What precautions has the issuer taken to avoid investor confusion?

The SEC has identified the presence or absence of precautions against confusion as another factor to be considered. If the web site presents an intermediate screen informing an investor that it is leaving the issuer's web site or setting forth disclaimers of responsibility, there is less likelihood of confusion. The SEC cautions that such steps will not insulate an issuer from liability for hyperlinked information when the circumstances otherwise point to adoption. The SEC felt compelled to state specifically that disclaimers alone cannot insulate an issuer from liability and to remind issuers that specific disclaimers of anti-fraud liability are contrary to the policies underlying the federal securities laws.

3. Has the issuer directed investor attention through selective hyperlinking?

Where a wealth of information is available on a particular subject, and an issuer hyperlinks to a narrow portion of the information, a hyperlink could be deemed an endorsement of the selected information. An issuer that establishes and terminates hyperlinks to third-party information depending on the nature of the information about the issuer, could also establish adoption during the period the hyperlink is in effect. Also, presentation of information in a manner that disproportionally influences an investor's decision to view third-party information may suggest adoption.

B. Content of a Web Site During Registration

The SEC traditionally has viewed the dissemination of information about an issuer at around the time of an offering and outside the registration statement as nonetheless constituting an Aoffer@ for purposes of the securities laws and thus potentially as Agun-jumping.@ The SEC over the years has identified ordinary course business and financial information, as well as statements covered by various safe harbors, as not constituting Aoffers.@ Information on an issuer's web site, as well as information on a third-party web site to which the issuer has established a hyperlink, must be analyzed in the same manner.

The SEC has provided guidance with respect to the ordinary course exclusion in the context of non-reporting issuers. A non-reporting issuer with a history of ordinary course business communications through its web site should be able to continue providing information consistent with traditional SEC guidance. A non-reporting issuer preparing for its IPO and establishing a web site at about the same time may not be able to take advantage of the ordinary course exclusion. The content may be deemed to condition the market for the offering, due to the lack of familiarity of the marketplace with the issuer.

III. Online Offerings

A. Public Offerings

The SEC has reminded issuers that various principles underpinning the regulation of public offerings apply equally to Internet communications:

- offering participants may not sell, or make contracts to sell, securities before effectiveness of a registration statement (and thus, no offers to buy may be accepted and no part of the purchase price can be received until effectiveness); and

- written offers must be made by means of a prospectus, oral offers may be made as soon as a registration statement is filed, and following effectiveness free writing materials may be disseminated so long as they are accompanied or preceded by a final prospectus.

Although the SEC has granted no-action relief for online IPOs, it declined for the time being to respond to requests by online brokers for additional regulatory accommodations for online offerings. The SEC staff expects to continue to review practice, procedures and technology involved in registered online offerings to determine whether future regulatory action is warranted.

B. Private Placements

The SEC, beginning in 1996, has issued interpretive guidance to broker-dealers and persons affiliated with broker-dealers seeking to build a base of accredited investors and other sophisticated investors for future private placements, through online questionnaires. The SEC views posting of private placement materials on the Internet, without sufficient procedures to limit access solely to accredited investors, as inconsistent with the prohibition against general solicitation in Regulation D.

In a 1996 no-action letter to IPOnet, the staff took a favorable no-action position on the general solicitation issue in the context of procedures designed to limit access to a web site posting private placements. The procedures contemplated a password-protected site offering access to private placements to investors after the broker-dealer/affiliate sponsoring the site had determined that investors had the requisite accredited status or sophistication. Prospective investors could purchase securities in private placements posted on the site only after the investors had been qualified by the broker-dealer/affiliate and had opened an account. This guidance was based on a long-standing principle applied to broker-dealers seeking to build their databases of potential customers from a pool of previously unknown investors, namely, that the absence in this context of a Apre-existing, substantive relationship@ between the issuer, or its broker-dealer/placement agent, and an offeree would constitute general solicitation and deprive the issuer of its ability to rely on a private placement exemption for the offering.

The SEC has raised concerns about third-party service providers that are neither registered as broker-dealers nor affiliated with registered broker-dealers and decline to follow the current guidelines to establish the absence of general solicitation. Troublesome practices include the use of certifications as to accredited status or sophistication that merely involve the checking of a box, as opposed to the completion of questionnaires providing information needed to form a reasonable belief as to accredited status or sophistication. Sites offering self-accreditation may raise general solicitation issues.

The SEC encourages third-party providers to work with the SEC staff to resolve securities law issues raised by their activities, and is quick to add that, although the interpretations on Apre-existing, substantive relationships@ have been limited to procedures established by broker-dealers in the context of traditional broker-dealer/customer relationships, there may be circumstances in which a third party, other than a registered broker-dealer, can establish a Apre-existing, substantive relationship@ necessary to avoid a general solicitation. The SEC notes, however, that the market may have misinterpreted a no-action position granted to the operator of a site (Lamp Technologies) that

posts offerings by hedge funds as extending the Apre-existing, substantive relationship@ doctrine to solicitations conducted by third-party providers other than registered broker-dealers. The SEC views its no-action position as permitting only private hedge funds to satisfy the no-general solicitation requirement through Apre-existing, substantive relationship@ procedures even though they are not registered broker- dealers.

In addition to the general solicitation issue, web site operators must also consider whether their activities trigger broker-dealer registration (*i.e.*, are they effecting transactions in securities or inducing or attempting to induce the purchase or sale of securities). The existing no-action relief does not address the question of whether these operators must in fact register as broker-dealers. In the *IPOnet* no-action letter, IPOnet was not required to register as a broker-dealer, because an affiliated broker-dealer maintained overall supervision of IPOnet's activities. The SEC requested the staff to consider whether the activities of a web site operator, such as the activities described in the *Lamp Technologies* letter, should trigger broker-dealer registration.

IV. Request for Comments

The SEC has requested comment on a variety of issues, including:

- should the SEC move to an Aaccess-equals-delivery@ model, under which investors would be assumed to have access to the Internet, allowing delivery to be accomplished solely by an issuer posting a document on its or a third party's web site?

- should the SEC reconsider its position that posting account messages on the Internet is not sufficient notice?

- are there circumstances in which consent to electronic delivery should be implied?

- how to facilitate availability of historical information on the Internet, in view of the general concern that a statement posted on a web site is republished for securities law purposes each time it is accessed by an investor or each day it appears on the site (in contrast to a press release in paper form, which is issued only once)?

- how can an issuer whose web site is its business and who is in registration avoid gun jumping issues?

- should issuers and broker-dealers that host online discussion forums (such as Achat rooms@) adopt and maintain best practices, and should issuers adopt best practices for employee participation in these forums?

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This memorandum provides only a general overview of the SEC guidance and request for comment on the use of electronic media. This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content.

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