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SHOULD THE SEC REGULATE THE CYBER SECURITIES MARKET?

A RESPONSE TO PROFESSOR FRANKEL

OMRI YADLIN*

Tamar Frankel proposes a model for regulatory adaptation to changing environments, and specifically, to the Internet. Frankel is a well-known expert in the field of securities regulation, hence, her focus on the regulation of the emerging cyber capital market. In order to demonstrate her theory, Frankel examines the response of the United States Securities and Exchange Commission ("SEC" or "Commission") to two phenomena: prospectus delivery via the Internet and issuer trading sites. Frankel contends that insofar as prospectus delivery is concerned, the Internet merely provides a new vehicle for information transfer, and therefore, the SEC justifiably has chosen to regulate this activity by analogy from its current rules. Issuer trading sites, on the other hand, are a new feature for which the pre-Internet rules are unsuitable, and hence, provides Professor Frankel with an excellent paradigm for examining her theory on the way in which law should adjust to changing environments.

Frankel identifies four types of mechanisms that can create and adapt law: legislatures, administrative agencies, courts, and markets. After ruling out legislatures and courts, Frankel arrives at the conclusion that optimal regulation of trading sites can be achieved only through cooperation between the market and the SEC. Indeed, the SEC moves in this direction. The SEC's broad definition of the term "exchange" ensures that agents undertaking a new, innovative trading strategy would approach the Commission, reveal their plans, and re-

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3. See Frankel, supra note 1, at 1340.
4. See id. at 1327.
5. See id. at 1347-50.

1355
quest the removal of regulatory constraints. This dialogue improves the SEC's understanding of emerging technology and its uses, and highlights deficiencies in the prevailing regulatory scheme. Frankel's claim is that this evolutionary, common law type of process should lead to efficient regulation of the Internet.

In the first Part of this response to Professor Frankel’s paper, I attempt to challenge her conclusion that the market should not be the sole regulator of issuer trading sites. I then move to examine the effect of the Internet on the regulation of prospectus delivery and, more generally, on the regulation of information flow on the market. I conclude with a discussion of Frankel's proposed model for cooperation between the SEC and the market.

I. SHOULD ISSUER TRADING SITES BE LEFT ALONE?

Frankel rejects the notion of allowing the market to act as the sole regulator of issuer trading sites. At the foundation of this conclusion lies Frankel's claim that “nothing concerning trading sites suggests that the fundamental policies of ensuring investor confidence and facilitating capital formation should be changed. These remain the main guides to the institutional structures of the market. Inexpensive enforcement of trades must be secured. Prices must be published. Segmentation should be avoided.”6 I do not dispute Frankel's contention that investor confidence and efficient capital formation must always be important goals for any stock market regulator—including regulators of Internet trading sites. However, it is not at all clear that the means of achieving these goals should never be altered and that the SEC should be given responsibility for achieving these objectives.

Federal securities laws enhance investor confidence primarily by fostering market liquidity. Mandatory disclosure, the ban on insider trading, the regulation of brokers and dealers, etc. are all designed to constrain bid-ask spreads and to facilitate a liquid market. In light of this goal, it seems essential, as Frankel suggests, to secure “inexpensive enforcement of trades” and to publish prices.7

Liquidity, however, is not the only instrument for ensuring investor confidence. Shareholders of close corporations, for example, do not enjoy the same level of liquidity as shareholders in publicly-

6. Id. at 1349.
7. See id.
traded firms, but are equipped with superior means for monitoring the firm's agents, which serve also to maintain shareholder confidence.

In the old days, the cost of expressing a voice in a publicly-traded firm was so high that exit was seen as the only feasible remedy for dissatisfied investors. Securities laws were introduced to enhance the liquidity of the markets and to reduce the cost of exit. However, the Internet may have changed this cost-benefit analysis. The low cost of communication in cyberspace enables firms to provide their shareholders with a relatively cheap monitoring vehicle. Via the firm's website, shareholders can keep a close tab on the firm's affairs, and they can express their opinions and even vote by electronic ballot. Consequently, some investors may agree to waive the protection of securities laws and to slightly reduce their liquidity in exchange for the opportunity to influence the firm's direction.

Arguably, some firms may even prefer a lower level of liquidity because it encourages investors to collaborate with one another and to engage more intensively in monitoring activities, rather than following the "Wall Street rule." Liquidity and control are substitutes, and the appropriate mix of voice and exit may vary for each firm, depending on its size, industry, and relations with customers or with employees. Therefore, the SEC should not concern itself with "inexpensive enforcement of trades" on issuer trading sites and should not subject these sites to any of its liquidity-enhancing rules. Trading rules, just as governance issues, should be determined by the firm's articles and subject to the minimal restrictions of state corporate law.

We can find support for this conclusion in the history of securities legislation. The traditional division between securities regulation and corporate law is based upon market practices that developed in the nineteenth century. Costs of trade outside the exchange floor were high, and therefore, firms preferred to list their shares and to comply with the exchange listing requirement and trading rules. The legal borders between securities regulation and corporate law mirrored the market division between exchange rules and corporate contract.

10. See Paul G. Mahoney, The Allocation of Government Authority: The Exchange as
The development of issuer trading sites represents an attempt of a few publicly-held firms to take back control of trading. These issuers are trying to isolate their firms from the national stock market and to detach themselves from certain institutions that control the stock market—namely, broker-dealers, exchanges, and the SEC. These issuers do not take advantage of the infrastructures of the national stock market and should not be forced to bear its disadvantages. In this isolated setting, there is no reason why the firm's trading rules and governance rules should be subject to two different bodies of law.

II. REGULATION OF PROSPECTUS DELIVERY

Professor Frankel claims that "the underlying policies of the securities acts are not adversely affected by the use of the Internet to deliver prospectuses. In fact, by reducing the costs of capital formation, the securities laws' policies are advanced." This claim is indisputable. However, I disagree with Frankel's claim that, in the area of information transfer via the Internet, the SEC can opt for the route of "regulation by analogy" rather than "start anew."

The Internet revolutionized the way in which information is circulated, the way in which we search for information, and the way in which we communicate and interact with one another. Federal securities laws would have been drafted very differently had the Internet been available in 1933. Subsequent implementation and interpretation of these laws would have taken a very different course had the Internet been in the background. This technological revolution, therefore, forces us to rethink the fundamental principles of section 5 of the Securities Exchange Act of 1933 ("1933 Act") and of other disclosure rules.

Section 5 is based on the assumption that, whereas issuers can easily address the public, it is very expensive for investors to respond and ask for clarifications. Given this assumption, Congress sought to set disclosure standards that would reduce to a minimum the risk of incoherence and eliminate any need for the investor to inquire about the information furnished. Hence, section 5(b)(1) of the 1933 Act ensures that during the waiting period any written or broadcasted offer for sale is made only by means of a prospectus that meets the re-

11. Frankel, supra note 1, at 1335.
12. Id. at 1336.
quirements of section 10. Similar constraints do not apply to oral offers, arguably because in such a direct communication, the offeree can respond and ask the offeror to clarify her statement.

The limitations of section 5 on free speech during the pre-filing and waiting periods deprive investors of access to material information. Thus, section 5 curtails the issuer's ability to promote the offering and forces firms to disseminate information on an unequal basis. Oral communications are made solely to underwriters and institutional investors, whereas the public has access only to information included in the prospectus.

These limitations prevent the market from taking advantage of one of the most important features of the Internet: it is interactive. Thus, it synthesizes the advantages of television, radio, and the print media with those of the telephone or a face-to-face conversation. Via the Internet, offerees can access issuers' files, and offerors can open the door to investor inquiries. Moreover, issuers can set up a chat room so that any communication between a firm's agents and an investor would be accessible to the public at large. In this setting, therefore, the distinction between oral and written communication becomes meaningless. Issuers and underwriters should be free to conduct road shows on the Internet and to invite the public to participate in such presentations. Such a relaxation of section 5 would provide more information to the public, on a more equal basis, and would allow issuers to test the waters before they jump into the capital market pool.

Section 5 of the 1933 Act is not the only area in need of "a new start." The regulation of proxy contests seems anachronistic as well, considering the Internet's cheap accessibility for shareholders and the opportunities it offers for dialogue and collaboration between share-

15. Issuers may be exempted from section 5 if they can show that "the offeree could realistically take advantage of his access to ascertain the relevant information." Doran v. Petroleum Management Corp., 545 F.2d 893, 904-05 (5th Cir. 1977).
16. Indeed, the SEC allows issuers and underwriters to conduct electronic road shows, but access to these road shows is limited to certain authorized viewers consisting primarily of institutional investors and investment advisors. See Bloomberg L.P., SEC No-Action Letter, in 1997 SEC No-Act. LEXIS 1023, at *7-8 (Oct. 22, 1997).
17. This "equal access" claim does not imply that the SEC should force issuers to make all their oral representations available on the Internet. Issuers and underwriters may have a legitimate interest in providing more information to institutional investors who, in return, provide the issuer and the underwriter useful information about demand for the offering.
holders and for direct monitoring of the firm’s management. The Internet, therefore, intensifies the adverse effects of proxy rules on shareholder activism.\textsuperscript{18}

The Internet also may provide added force to the call to disimply a private right of action under Rule 10b-5\textsuperscript{19} and to return to the explicit private remedy of section 18 of the Securities Act of 1934 ("1934 Act").\textsuperscript{20} The section 18 remedy is subject to two constraints: (1) liability is restricted to misstatements in documents filed with the SEC; and (2) plaintiffs must demonstrate their actual reliance on a misstatement.\textsuperscript{21} But in actuality, before the Internet age, access to SEC files was costly and investors were not able to distinguish between disclosures that were filed with the SEC and those less trustworthy statements which were not filed. Moreover, the reliance threshold was too difficult and too expensive to overcome.

In response to these deficiencies in section 18, federal courts recognized a private cause of action under Rule 10b-5.\textsuperscript{22} In light of investor inability to identify filed documents, courts could "conceive of no rational purpose which would be furthered by creating a structure where liability for material misrepresentations adversely affecting investors would vary tremendously depending upon whether the statement happened to be filed with the SEC."\textsuperscript{23}

The next step taken by federal courts was to relinquish the reliance requirement by adopting the fraud on the market theory.\textsuperscript{24} This move saved plaintiffs the heavy burden of proving actual reliance and opened the door to a flood of class actions under Rule 10b-5.

The cheap access to the SEC site in the Internet enables investors to easily identify filed disclosures and to discount the veracity of information that was not filed. Furthermore, the Internet might offer a new means of demonstrating reliance. For example, the fact that a trader surfed through a misleading filed document shortly before trading can be used as a proxy for her reliance. Therefore, if we still adhere to the rationale underlying the constraints of section 18, we

\textsuperscript{18} For an interesting story that illustrates this point, see Carole Gould, \textit{Turning the Tables: This Time, a Shareholder Is Being Sued}, N.Y. TIMES, Apr. 19, 1998, at B7.


\textsuperscript{21} See id.


\textsuperscript{23} Ross v. A.H. Robins Co., 607 F.2d 545, 556 (2d Cir. 1979).

\textsuperscript{24} See Basic Inc. v. Levinson, 485 U.S. 224, 251 (1988).
can recapture its advantages by disimplying the private right of action under Rule 10b-5. Firms will be able to decide which of their voluntary statements they wish to support with a warranty by filing it with the SEC site and which of their disclosures are too speculative and risky to guarantee. Hence, the amount of information available to the public is likely to increase. The reliance requirement would ensure that compensation is afforded only to informed traders who gather and analyze publicly-available information, thereby operating the invisible hand of the efficient market.

III. FRANKEL'S PARADIGM OF COOPERATION BETWEEN THE SEC AND THE MARKET

Professor Frankel recognizes the advantages of market experimentation, but she believes that the SEC should stay in control of this mammoth laboratory. Under Frankel's model, the SEC fulfills two functions in this experimentation process. Its first role is to design the experiment. Through its no-action letters, the SEC sets limits on market activities and prohibits overly-risky experiments. "[T]he stakes are too high," claims Frankel, "to allow promoters to break . . . new grounds in shaping the new institutions for markets." 25 The SEC's second role is to observe the market and to draw conclusions from the experiments. Frankel predicts that the SEC will adopt the best practices or customs developed in the market and will ban the bad practices. 26

My skepticism rests on two grounds. First, even if we have confidence in the SEC's competence to distinguish between good and bad practices, once the SEC decides to enforce a good practice, that practice might lose its efficiency. The 1933 and 1934 Acts are good examples of laws founded on market practices. Thus, for example, having noticed that reputed underwriters conduct investigations of the issuer's affairs, Congress decided to enforce this practice by holding underwriters liable for any misstatement included in a registration statement unless they can prove they have conducted such a diligent investigation. 27 However, by bolstering reputed underwriters' conscientious investigations with legal liability, Congress changed the practice, arguably for the worse.

The second reason for my skepticism is Frankel's assumption

25. Frankel, supra note 1, at 1349.
26. See id. at 1350-51.
that the SEC is capable of distinguishing between good and bad practices. I find this assumption troubling, especially given the fact that the SEC controls the laboratory and prohibits experimenting with unorthodox methods. In this sense, Frankel's concept of experimentation is very different from what transpired in the context of the 1933 Act. The 1933 Congress stepped in and examined practices and customs that developed in a (relatively) free market. I suspect that several efficient practices would not have evolved had the federal government overseen this market throughout its formative years during the nineteenth century. For example, a nineteenth century regulator might not have approved of experimenting with the fixed price offering, which is still the dominant method of floating a public offering. This speculation is supported by the fact that a few years after the securities laws were enacted, the government brought criminal proceedings against seventeen investment bankers, claiming that the fixed price offering method violates the Sherman Act.\textsuperscript{28} The court rejected the government's theory, primarily because the fixed price offering was adopted by the 1933 Act as the model method for making a public offering. It took finance scholarship another three decades to develop insightful economic justifications for this floating method.\textsuperscript{29}

Just as a nineteenth century regulator, unfamiliar with contemporary finance scholarship, could not grasp the efficiency of the fixed price offering, regulators today cannot comprehend the sociology of human interaction and of institutions on the Internet. Thus any attempt to regulate these experiments is likely to restrict the evolution of efficient practices.

Consider, for example, trading sites. Although the SEC approved their establishment, it imposed several constraints on their operation. The most significant limitation is that the issuer is not permitted to make a market for its shares. Frankel's assumption that "nothing concerning trading sites suggests that the fundamental policies of ensuring investor confidence and facilitating capital should be changed" necessarily leads her to the conclusion that if issuers are not making a market in the "real" world, they should not be allowed to do so on their Internet trading sites.\textsuperscript{30}

\textsuperscript{29} For example, see Kevin Rock, Why New Issues are Underpriced, 15 J. FIN. ECON. 187, 188-89 (1986).
\textsuperscript{30} See Frankel, supra note 1, at 1349.
However, the reasons for excluding issuers from the market-making business in the "real" world do not necessarily hold with regard to issuer trading sites. Arguably, this ban is designed to serve the issuer's interest in that it facilitates a more competitive market for its shares. The issuer is typically better informed than other dealers and, therefore, is able to set narrower bid-ask spreads. In the face of such an unequal playing field, dealers would refrain from making a market for the issuer's shares. Consequently, any issuers who wish to draw dealers into the market for their shares must refrain from competing with them. The prohibition on issuer market-making, just like disclosure rules and the ban on insider trading, is designed to protect the broker-dealer industry and to facilitate a competitive stock market.

In the isolated setting of the issuer trading site, on the other hand, there seems to be no reason to prevent issuers from playing an active role in the market for their outstanding securities. Such issuers are trying to bypass intermediaries (underwriters, market-makers, etc.), and they certainly are not interested in attracting independent dealers to make a market for their shares. Hence, there is no need to subject these issuers to any of the intermediary-protection rules. Indeed, as Frankel points out, the lack of intermediaries raises some difficulties with enforcement of trades. Arguably, however, the requirement that issuers play a passive role in the operation of their trading sites precludes the evolution of efficient enforcement mechanisms, i.e., mechanisms operated by the issuer.

Frankel further suggests that issuers' control of trading sites threatens the integrity of the sites, as issuers may use their dominant position to manipulate the market. Although I have some reservations regarding the ability of issuers to manipulate the market, especially when investors are aware of the issuer's dominant position, I do agree that this favorable position enables the issuer, like any other monopolist, to charge extreme markups. However, this threat hardly justifies imposing a total ban on issuer market-making. Issuers would be able to solicit investments in their securities only if they were to provide a mechanism that restricts their ability to exploit their dominant position. For example, issuers could commit, in their initial

31. See id. at 1343-44.
32. See id. at 1344-45.
public offering, to a fixed or a maximum markup. The SEC's refusal to allow issuers to make a market for their shares prevents the evolution of such practices. Consequently, we might never know if these practices are efficient.

Despite my criticism, I join Frankel in her call for cooperation between the SEC and markets. My concept of cooperation, however, is quite different from Frankel's. In my view, the primary role of the SEC in cyberspace should be to facilitate competition between public and private regulators by drawing clear borders between Internet jurisdictions. The SEC may compete with other regulators, but it should not use any coercive means to control cyberspace.

Competition between regulators can be efficient only if firms are free to choose a regulator and if investors can move easily from one jurisdiction to another. Just as firms can opt for their applicable corporate law, they should be free to opt for their preferred lawmaker and enforcer in the area of securities regulation. Firms should be allowed to contract for the most appropriate cyber "jurisdiction," whether governed by the SEC, a state, or a foreign or a private regulator, and to list their shares with the cyber jurisdiction they select. Similarly, investors should be free to surf through these jurisdictions and to play the most efficient one. The low transaction costs of shifting from website to website ensure a more efficient playground for competition between regulators, and should yield better rules.

Currently, however, instead of taking this pro-competitive role, the SEC responds to competitive pressures by discriminating between actors on the basis of their ability to evade SEC jurisdiction: Regulation S, and Rules 506, 144, and 144A all determine borders according to geography, citizenship, and sophistication, and they thus force firms to incur enormous legal fees in order to find their way through or around this regulatory maze. Investors have great difficulty distinguishing between the different market segments and knowing which standards apply to each transaction they undertake. They can all be saved from this mass of confusion if entrepreneurs were allowed to pick the regulator of their choice. This is probably the only safe way to enable firms and investors to make optimal use of the Internet without bearing the risk of being subject to a number

34. See Mahoney, supra note 10, at 1497-99.
36. See id. § 230.506.
37. See id. § 230.144.
38. See id. § 230.144A.
of jurisdictions, each prescribing different, sometimes conflicting, rules.

The move from coercion to consent should not necessarily reduce the amount of business that the SEC regulates. The SEC has a comparative advantage in the enforcement business and will probably remain the most effective sheriff in the global town. Many entrepreneurs would still be interested in offering their investors the protection of SEC enforcement. The SEC would be able to condition its enforcement services on the adoption of contractual terms that lower its enforcement costs. The SEC market power in the enforcement business, therefore, would enable the SEC to keep or even increase its share of the global market.

The model of cooperation I am suggesting still leaves room for coercive enforcement, but only in cases where a given trading activity has a spill-over effect on the SEC market. For example, some trading systems take a free ride on stock exchange transparency. Under such circumstances, SEC intervention to protect stock exchange property rights may be justified. Issuer trading sites, on the other hand, do not raise any spill-over problem, for these issuers do not list their shares on any of the regulated exchanges and do not use the services of other regulated intermediaries. Hence, the SEC should not enforce its rules on such trading sites unless the operator of the site chooses the SEC as its preferred regulator.

IV. SUMMARY

The 1933 Act, the 1934 Act, and the regulations pursuant thereto have been the subject of debate since their promulgation. Frankel's position in this debate clearly is in support of maintaining these laws. Although she recognizes the need to adapt the old rules to new technology, she believes that the philosophy of the regulation should remain the same and that the SEC still should be in full control of the cybermarket.

In response, I have tried to point out the ways in which prevailing regulation and SEC intervention may impede the evolution of an efficient cyber stock market. The territorial approach of federal securities laws restricts the ability of entrepreneurs and investors to take full advantage of the cheap travelling costs in cyberspace. Similarly, limitations on issuer and investor freedom of speech, which were based on the 1930s technology, do not allow agents to interact as effectively as the new technology now affords. Hence, although I en-
dorse Professor Frankel's call for cooperation between the Commission and the market, I believe that such cooperation would lead to more efficient results if it were to be based on consent rather than on coercion.

Frankel contends that after sixty-five years of securities regulation, it is costly to revolutionize the whole system, to forego the mandatory character of these laws, and to move to contracts. But the Internet provides us with a relatively inexpensive opportunity to do just this: to create a competitive environment on the Internet while maintaining the current infrastructure and mandatory rules of the "real" world. As long as the securities at stake are not traded simultaneously on any of the regulated stock exchanges, the SEC can treat the Internet trading site as a foreign stock exchange. Artificial as this may be, we can transcend geography in cyberspace, yet stand with both feet securely planted in the real world. In the long run, our experience with the Internet may teach us that we should encourage competition between regulators in the real world as well.

39. See Frankel, supra note 1, at 1331-33.
40. See Mahoney, supra note 10, at 1491-96.