

§ 12.02 Blue Sky Regulatory Authority in Cyberspace

At the baseline, the exercise of Blue Sky regulatory authority is grounded either in an act amounting to an offer or sale of securities, or in conduct amounting to engaging in the securities business. Critical definitions control, and section 414(c) of the Uniform Act thus sets the scope of Blue Sky regulatory authority broadly:

[A]n offer to sell or to buy is made in this state, whether or not either party is then present in this state, when the offer (1) originates from this state, or (2) is directed by the offeror to this state and received at the place to which it is directed (or at any post office in this state in the case of a mailed offer).¹

Drafters of the Uniform Act addressed electronic offers and sales of securities only in terms of excluding from the key definition of “offer” such radio and television programming which is received within a state but which originates from a different state.² Although the Revised Uniform Act expanded the exclusion in 1985 to cover offers by “other electronic communication” originating outside the state as well as radio and television broadcasts,³ and may thus be said at least to contemplate something akin to Internet communications, it is certain that neither the drafters of the original Uniform Act nor those of the Revised Uniform Act could have envisioned the extent to which the Internet has emerged as a dominant means of electronic commerce and communication, and the extent to which it today allows access to investors. It is certain, however, that Blue Sky administrators have historically acted on the basis of purposeful activity and communications directed into their states. In setting the scope of regulatory authority, the Uniform Act expressly defines authority in terms of “any act

¹ Unif. Sec. Act § 414(c).

² Section 414(e) of the Uniform Act provides in pertinent part: “An offer to sell or to buy is not made in this state when . . . a radio or television program originating outside this state is received in this state.”

³ Section 801 of the Revised Uniform Act provides in pertinent part that “[a]n offer to sell or to purchase made in a radio or television program or other electronic communication received in this State which originates outside this State is not made in this State.” Rev. Unif. Sec. Act § 801(g) (emphasis added).

For purposes of determining whether an electronic communication *shall* be considered as originating within the state, the Revised Uniform Act includes among four categories a communication supplied by an electronic network with the signal originating from outside the state for redistribution to the general public in the state. *Id.*, § 801(h)(2).

instrumental in effecting prohibited conduct” being done in the state, whether or not either party is present in the state at that time.⁴

The vast potential of the Internet in the establishment and support of eventually seamless worldwide securities markets carries an equally vast potential for the fraud and abuse that drive Blue Sky regulation. State regulators have therefore set out to respond effectively and efficiently to meet the dangers while fully recognizing that there are practical and proper limits on the scope of their authority in cyberspace.

In the simplest sense, the Internet is a medium of communication.⁵ Any communication amounting to an offer to sell a security that is directed into a state, by any medium, triggers application of Blue Sky laws and regulations as to issuers and all intermediaries involved in it. Unless preempted by the National Securities Markets Improvement Act of 1996 (NSMIA),⁶ or eligible for an exemption, an offer triggers state registration and qualification requirements for issuers, and licensing requirements for intermediaries; offers are also subject to scrutiny under antifraud provisions in all cases. A major challenge

⁴ Unif. Sec. Act. § 414(f).

But see Rollin v. William V. Frankel & Co., 996 P.2d 1254 (Ariz. App. 2000), in which the court held that Arizona state courts could not exercise personal jurisdiction over Nasdaq market-makers where it could not be shown that the market-makers had purposefully directed their activities toward Arizona. *Rollin* did not involve a challenge to the scope of regulatory authority under the Arizona Blue Sky law; however, the focus in the case on the role of electronic networks in connection with offers, purchases and sales of securities raises questions concerning the scope of that authority, particularly in regard to intermediary regulation and the emergence of electronic exchanges and Internet-based securities trading platforms. These issues, and *Rollin*, are discussed further in section 12.02[2], *infra*.

⁵ Under the Florida Blue Sky law, for example, the “Internet” is defined as:

[T]he global information system comprised of independent computer networks which are interconnected and share information without the use of a central processing center by use of the Transmission Control Protocol (TCP/IP) suite, to include without limitation, the World Wide Web, proprietary or “common carrier” electronic delivery systems, or similar medium.

Fla. Div. Sec., Rule 3E-100.010(3).

⁶ The National Securities Markets Improvement Act of 1996 (NSMIA), Pub. L. No. 104-290, 110 Stat. 3416 (1996), replaced, in its entirety, section 18 of the Securities Act of 1933, 15 U.S.C. § 77r. NSMIA preempted much of state regulatory authority over securities offerings that are national in character.

The impact of NSMIA on Blue Sky laws in the offering context is discussed in detail in Chapters 5 (Registration) and 6 (Merit Regulation), *supra*. Where applicable, NSMIA preempts state authority to impose registration requirements, and the enforcement of related qualification standards. It does not, however, affect the enforcement of antifraud provisions and regulations, nor does it in any manner limit state authority under Blue Sky laws in regard to licensing of intermediaries.

posed to state regulation by the Internet is the extent to which an electronic communication available generally to anyone having access to the Internet is in fact *directed* to recipients within a particular state, who may act on it, and thus fall within the ambit of protection under that state's Blue Sky law.

Long ago the so-called "red herring" legend, or disclaimer of an offer, was embraced by states in the context of the dissemination of certain preliminary offering documents or announcements relating to distributions of securities pursuant to registration under the federal Securities Act of 1933, or otherwise in "tombstone" announcements in multi-state print media. Such a disclaimer of an offer is, of course, a fiction, as a printed advertisement, or even a "red herring" prospectus, that is widely circulated is available, if not disseminated, in states in which there is no Blue Sky law qualification. As will be seen below, state Internet rules or regulations, with some common grounding in published guidance of the North American Securities Administrators Association (NASAA), have applied the same fiction to Internet communications that plainly "offer" securities to all persons who have Internet access, but which disclaim the offer to any person in a particular non-qualifying state. Offers of securities are allowed on the Internet providing that a disclosure is made stating that it is not specifically directed to any person in a particular state. An indirect offer, however, is in fact made where information on a website may be accessed by anyone interested. The key consideration, of course, is that notwithstanding the offer disclaimer, no *sales* of the securities may be made unless the securities are properly registered.⁷

Outside the offering context, state securities regulatory concerns also arise in the use of the Internet by broker-dealers and other market intermediaries for general dissemination of information on products and services. Here too, communications made on the Internet through postings on bulletin boards, displays on home pages and websites, or similar methods involve communications made generally to anyone having access to the Internet. By distributing information on available products and services through Internet communications that are

⁷ See *In re* Internet Advertising and Broker-Dealer Compliance, Wy. Sec. Div. No-Action Letter, 1997 Wy. No-Act. LEXIS 5 (Apr. 8, 1997). Wyoming exempts issuers from registration who advertise their securities through the Internet and make offers, but not sales. Sales may be made only after proper registration occurs.

As to sales, and the activities of intermediaries in regard to Internet postings that would trigger licensing requirements, "gateway" restrictions and electronic screening generally in order to avoid particular licensing requirements are discussed in section 12.02[2], *infra*.

available to persons in any state, broker-dealers, investment advisers, and their agents or representatives may be deemed to be transacting business within the ambit of Blue Sky licensing provisions. With further NASAA guidance, many states have promulgated policy statements or interpretive rules prescribing parameters that will allow such intermediaries to make Internet communications without being deemed to be "transacting business" in the state. Compliance with these requirements, coupled with other screening methods, is being employed successfully by intermediaries in the establishment and management of websites so as to limit access to individuals residing only in those states in which the intermediary and its associated persons are licensed.

Internet-based referral services that link customers to financial service providers through a website "portal" involving general advertising of those services and their availability are now common, and raise a separate set of regulatory issues relating to both advertising and broker-dealer licensing requirements. Referral services typically include general advertising of services and no direct solicitation of customers or special compensation for referrals. As discussed further in section 12.02 below, such website portals will not generally be deemed to be transacting, or engaging in, securities business in circumstances involving no direct or active solicitation in an effort to effect or attempt to effect sales of securities.⁸

Electronic publications can also implicate Blue Sky *investment adviser* regulatory requirements. Daily publication of financial information and stock predictions on a website, for example, may constitute advising others as to the value of securities, or amount to issuing or promulgating analyses or reports concerning securities, activities that meet the definition of investment adviser if the requisite compensation element is present.⁹ Whether an exemption or exclusion from the definition of investment adviser based on a bona fide "newspaper, news magazine, or business or financial publication of general, regular and paid circulation" as used in Blue Sky laws is available for an Internet

⁸ See, e.g., Kan. Sec. Comm'r, Request for Opinion No. 2001-003, 2000 Kan. Sec. No-Act. LEXIS 13 (Dec. 8, 2000) (broker-dealer and agent registration not required when a bank referred customers, through a website, to a broker-dealer for brokerage services).

⁹ Regulation of investment advisers under state Blue Sky laws is presented in detail in Chapter 11, *supra*. Particular investment adviser considerations associated with Internet publication of financial information, see, e.g., Neural Applications Corp., Del. Div. Sec., No-Action Letter, 1996 Del. Sec. No-Act. LEXIS 39 (May 22, 1996), are addressed in section 12.02[2] below.

communication is also a matter for further consideration. As a practical matter, such information presented on the Internet can be downloaded and printed in hard copy by the user if desired in such a format. Internet users would most often simply read the information from their computer screens without printing it, but the option is always available. As such, there is no real conceptual difference for purposes of Blue Sky regulation between a message sent via the Internet and one printed on paper and mailed. The "bona fide publications" exemption or exclusion that is a part of state and federal investment adviser laws may thus operate to keep Internet postings outside the scope of regulation when requisite criteria are met.¹⁰

Internet-spawned developments in e-commerce impact state Blue Sky laws in other ways. Notably, the Electronic Signatures in Global and National Commerce Act ("E-Sign"),¹¹ enacted in June 2000, directly impacts state securities laws and requirements relating to the use of offering circulars and prospectuses, and record-keeping requirements for intermediaries. E-Sign opens the door to new state provisions for maintenance of electronic records, and addresses standards for accuracy, integrity and accessibility of such electronic records. There is also continuing development and implementation of the Securities Registration Depository (SRD) system for electronic registration of securities offerings in multiple states. The SRD is based on current Internet technology.¹² And state regulators are themselves reaching

¹⁰ In *SEC v. Lowe*, 472 U.S. 181 (1985), the leading case interpreting the "bona fide publications" exclusion from the federal Investment Advisers Act of 1940, the U.S. Supreme Court established three criteria to be met in order to qualify for the publication exclusion. First, the publication must be "bona fide" in the sense that it contains "disinterested commentary and analysis as opposed to promotional material." *Id.*, 472 U.S. at 203. Second, the publication must be "of general and regular circulation," meaning that there must be no indication that the publication is timed to affect specific market activity. *Id.*, 472 U.S. at 204. Finally, the communications between the publisher and recipients must be "entirely impersonal," and cannot develop into personalized advice attuned to clients' personal investment concerns. *Id.*, 472 U.S. at 210.

¹¹ Pub. L. No. 106-229, 114 Stat. 464 (2000), codified at 15 U.S.C. §§ 7001-7031.

¹² SRD is a recently redesigned electronic filing system that enables filers and the states to access a central database through its website. The goal of the SRD is to establish a low-cost, secure and easy-to-use complete state securities filing system, although at present the system is focused on mutual fund filings through the Internet-utilizing Form NF, the Uniform Investment Company Notice Filing. SRD allows for instant access by state reviewers to record filings, and reduces file status uncertainty.

Some states have set out to develop their own electronic filing systems. Pennsylvania, for example, has implemented an electronic Uniform Investment Company Notice Filing system, and in Ohio the Ohio Automated Securities Information Submission system (OASIS) is designed, like the SRD, eventually to be a complete filing system.

out to enhance regulatory and enforcement effectiveness through Internet websites and in the implementation of Internet-based filing and retrieval systems.

In defining the scope of regulatory authority, however, the challenge in the application of Blue Sky laws and regulations in cyberspace lies in dealing with basic definitions that have set the threshold from the beginning. In the discussion below the two most common and critical issues regarding Blue Sky authority and use of the Internet are considered. Subsection [1] examines how states have grappled with the baseline notion of an "offer" of securities effectively broadcast across all boundaries. Then, subsection [2] focuses on the extent to which regulatory objectives of the states in licensing securities market intermediaries are balanced with the realities of the online environment.

[1]—"Offers" in Cyberspace

All of state securities regulation is a function of definitions. The scope of state regulatory authority under Blue Sky laws has been shown throughout the previous chapters to be set by the literal and contextual application of statutory definitions, constrained to the extent of the federal-state regulatory duopoly that is today prescribed by NSMIA. Blue Sky regulation in cyberspace is no different. An "offer" or "offer to sell" communicated via the Internet is no less an "attempt or offer to dispose of, or solicitation of an offer to buy, a security"¹³ than one made via a telephone solicitation, newspaper advertisement or mailing into the state, if it is purposely directed there. As the California Corporations Commissioner has opined:

As a general rule, every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value made by communication on a proprietary or electronic delivery system such as the World Wide Web, otherwise known as the Internet, is an "offer" or are "offers to sell" securities "in this state."¹⁴

¹³ Unif. Sec. Act § 401(j)(2).

¹⁴ Comm'r Op. 96/2C, Cal. Dep't Corp. File No. OP 6600, 1996 Cal. Sec. LEXIS 3 (Oct. 17, 1996).

The California Commissioner concluded that under the Blue Sky law, making information available via the Internet also constitutes "publishing" the information for purposes of requirements relating to general announcements regarding securities offerings and "written document" issues. Textual, "readable"-only information on a website generally accessible to the public was determined to be information "published by written document only" for purposes of a California exemption. More importantly, a "general announcement" communicated over the Internet was determined to be an