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THE "ODD-DUCK FILING" AND THE EFFICIENT MARKET THEORY: MEETING SEC REGISTRATION REQUIREMENTS FOR INTERNET FREE STOCK PROGRAMS

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I. INTRODUCTION

When this Note was first conceived in 1999 Internet companies were the "hottest" stocks traded on financial markets the world over, and investors were hoping to invest early in the next Yahoo!, AOL, or Amazon.com. At the same time, Internet start-ups instituted stock giveaway programs. Internet users were asked to "register" on a particular web site, which usually entailed providing nothing more than their name, e-mail address and certain other demographic information. In return the user received shares of stock in the company for no monetary compensation. On its face, these programs seemed to be a perfect synergy of investor desires: an investment that provides no monetary risk, the possibility, while slim, of great returns, and the business goals of product marketing. However, the Securities and Exchange Commission (SEC) deemed these free stock programs an event of sale in violation of the Securities Act of 1933 (the "33 Act" or the "Securities Act") because there was no effective registration statement.[1] In response, Web Equity Capital, Inc.,[2] a company with no defined business as of yet, filed with the SEC what had been called an "odd-duck filing."[3]

This Note will address the issue of free stock giveaways and examine the "odd-duck filing" under current SEC rules. Part II will examine the development of free stock programs and their effect on Internet start-up companies. Part III will examine four cease-and-desist

1. *See* Theodore Sotirakis, Securities Act Release No. 33-7701, 70 S.E.C. Docket (CCH) 309 (July 21, 1999); Joe Loofbourrow, Securities Act Release No. 33-7700, Exchange Act Release No. 34-41631, 70 S.E.C. Docket (CCH) 306 (July 21, 1999); WowAuction.com Inc., Securities Act Release No. 33-7702, 70 S.E.C. Docket (CCH) 311 (July 21, 1999); WebWorks Marketing.com, Inc., Securities Act Release No. 33-7703, Exchange Act Release No. 34-41632, 70 S.E.C. Docket (CCH) 312 (July 21, 1999) [hereinafter CEASE & DESIST ORDERS].

2. *See* Web Equity Capital, Inc., Securities Act Registration Statement Form S-1, *at* http://www.sec.gov/edaux/searches.htm (Aug. 25, 1999).

3. *See* Judith Burns, *Web Start-Up Registers 10 Billion Shares with SEC*, DOW JONES NEWS SERVICE, Aug. 2, 1999, *available at* WL, SECNEWS.

orders issued by the SEC, prior SEC rulings and SEC policy. Part IV will analyze the "odd-duck filing" under the current disclosure requirements and Part V will analyze the "odd-duck filing" under the Efficient Market Theory.

II. FREE STOCK GIVEAWAY PROGRAMS AND THE INTERNET

Free stock giveaway programs are not new. They became increasingly popular in 1999 with small closely-held internet companies as a marketing concept, to creatively publicize a company's name and products.[4] They have, however, drawn the ire of the SEC. A typical free stock program entitles a user/shareholder to shares of company stock in return for "registration," which entails providing the issuer with personally identifiable data.[5]

Free stock programs seem to represent a synergy between the desires of investors and companies alike. Investors seek a way to increase their wealth by maximizing potential return while, at the same time, minimizing risk. However, these two ideals are opposed to one another, since a general rule of finance is that to increase return an investor must increase his/her risk.[6] At the same time, companies seek to create interest in their product/service and company name through low cost marketing.

Free stock programs seem to meet both of these goals. While investors potentially increase their wealth by receiving stock in exchange for registering on the web site, they are not exposed to any financial risk in return for the stock. There has been no true investment decision because there has been no monetary investment. Companies are able to create interest in their product/service without making any initial outlay of cash. This is especially beneficial to an internet start-up with limited available capital because it brings together company needs and investor desires. Investors are exposed to no monetary risk while enjoying the albeit slim possibility of great financial gains should the internet start-up become a successful company. Several internet

4. *See* Stephen J. Schulte & Steven J. Spencer, *US: The SEC Staff Says Free Stock is Not Free,* MONDAQ BUSINESS BRIEFING, June 1, 1999, *available at* 1999 WL 8709992.

5. *See* Mark J. Dorsey & Peter H. Schwartz, *SEC Update: "Free" Stock, Shareholder Web Sites, and the Third Internet Fraud Sweep,* 3 No. 3 GLWSLAW 23, Aug. 1999.

6. *See generally* STEPHEN A. ROSS ET AL, FUNDAMENTALS OF CORPORATE FINANCE (4th ed. 1998) (providing principles in finance).

start-ups have used programs such as these to generate interest in their web sites.[7]

However, the SEC, members of Congress, and journalists have not taken such a favorable view of these programs. Internet free stock programs have been described in the press as the "high in the insanity index"[8] and the internet as "shaping up as the great and enduring instrument of profitless prosperity for the diverse commercial hordes feverishly gathering to exploit it."[9] At the same time, some have viewed stock giveaways on the internet as "examples of the participatory energizing fun that is characteristic of this revolutionary new medium."[10]

In March 1999, Rep. Edward J. Markey, ranking minority member of the House Commerce Subcommittee on Telecommunications, Trade and Consumer Protection, submitted a letter to the SEC. This letter asked for clarification on the legality of free stock giveaways in response to two unsolicited "spam" e-mails his office received offering free stock via the Internet.[11] Markey expressed concern that despite the fact that investors in "free stock presumably lose nothing if . . . the stock turns out to be worthless, such stock distributions may have a 'distorting' effect on interstate commerce."[12] Markey also addressed issues regarding the effect free stock programs may have upon the issuer's market. Here, the possibility exists that if consumers purchase the product/service based upon an offer of free stock, both competition and efficiency in that market may be undermined.[13]

The SEC has also turned an inquisitive eye towards free stock programs. The SEC addressed the issue from the view of the investor and

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7. *See* Sarah Hewitt & Gerard R. Boyce, *Web Offerings and the SEC*, N.Y. L. J., Mar. 11, 1999, at 5. The article details the efforts of travelzoo.com, a Bahamas-based online travel company, exit23B.com, a shopping site for electronics, interactive games, music and videos, and E-Compare, an online book distributor, to use free stock programs to generate interest in their sites. Both travelzoo.com and exit23B.com completed their offering before the SEC took its position against free stock programs, while E-Compare voluntarily suspended its free stock distribution because of SEC concerns.

8. Alan Abelson, *Up & Down Wall Street: Internet Implosion*, BARRON'S, Aug. 9, 1999, at 5, *available at* WL 19353790.

9. *See id.*

10. Denis T. Rice, *Free Stock on the Internet: What's the Problem?*, 4 CYBERSPACE LAWYER 10, July/Aug. 1999.

11. *See* Linda C. Quinn & Ottilie L. Jarmel, *Securities Regulation and the Use of Electronic Media*, SE 10 A.L.I. - A.B.A. 811 (1999).

12. *Electronic Commerce: Markey asks SEC to Answer Questions Regarding 'Free Stock Offerings' on Internet*, SECURITIES LAW DAILY (BNA), Apr. 1, 1999, at d2.

13. *See id.*

the investor's right to full and fair disclosure. In response to complaints received from investors SEC Enforcement Director Richard H. Walker said "Free stock is really a misnomer in these cases. While cash did not change hands, the companies that issued the stock received valuable benefits. Under these circumstances, the securities laws entitle investors to full and fair disclosure, which they did not receive in these cases."[14]

Concerns were raised that the issuer was receiving value through these techniques by spawning a fledgling public market for their shares, increasing their business, creating publicity, and increasing traffic to their web sites.[15] In response to these concerns the SEC has issued four administrative cease-and-desist orders.[16]

III. THE SEC'S RESPONSE TO FREE STOCK PROGRAMS: THE CEASE-AND-DESIST ORDERS

The Securities Act of 1933 requires registration when securities are "sold" for the purposes of the Act.[17] Sections 5(a) and 5(c) of the Securities Act, in part, prohibit the use of the mails or any interstate means to sell or offer to sell any security through jurisdictional means unless a registration statement is in effect or has been filed with the Commission as to such security, or an exemption from the registration provisions applies.[18] Section 2(a)(3) of the Securities Act defines "sale" and provides:

> The term "sale" or "sell" shall include every contract or sale or disposition of a security or interest in a security, for value. The term "offer to sell," "offer for sale," or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value. The terms defined in this paragraph and the term "offer to buy", as used in subsection (c) of Section 5 shall not include preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer). *Any*

14. Press Release, *SEC Brings First Actions to Halt Unregistered Online Offerings of So-Called "Free Stock," at* http://www.sec.gov/news/webstock.htm (July 22, 1999).

15. *See id.*

16. *See* CEASE & DESIST ORDERS, *supra* note 1.

17. *See* Securities Act of 1933, §§ 5(a) - (c), 15 U.S.C. §§ 77(e) – (g) (West 1997).

18. *See id.*

> *security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been offered and sold for value.* The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person which right cannot be exercised until some future date, shall not be deemed to be an offer or sale for such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such security.[19]

Stock giveaway programs are a disposition of stock under Section 2(a)(3) of the Securities Act of 1933. The issue is whether the free stock is actually given for "value."[20] If they are determined to be given for "value," then a registration statement is necessary for the issuer to be compliant with the '33 Act.[21] The SEC determined in four cease-and-desist orders that the "internet free stock" programs violate Sections 5(a) and 5(c) without an effective registration statement.[22] In each of the proceedings the SEC relied upon *American Library Association v. Pataki*[23] for the premise that the internet is an instrument of interstate commerce and thereby within the jurisdiction of the SEC.[24] The SEC determined that value was given, thereby making the free stock offers sales under the Securities Act.[25]

In each of the four proceedings the SEC took the position that "the lack of monetary consideration for the shares does not mean that there was not a sale or offer for the purposes of Section 5."[26] "Thus, a

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19. Securities Act of 1933, § 2(a)(3), 15 U.S.C. §§ 77(e) – (g) (West 1997) (emphasis added).

20. *See* Rice, *supra* note 10.

21. *See id.*

22. *See* CEASE & DESIST ORDERS, *supra* note 1.

23. 969 F. Supp. 160, 173 (S.D.N.Y. 1997).

24. *See* CEASE & DESIST ORDERS, *supra* note 1.

25. *See id.*

26. Theodore Sotirakis, Securities Act Release No. 33-7701, 70 S.E.C. Docket (CCH), at 310 (July 21, 1999); Joe Loofbourrow, Securities Act Release No. 33-7700, Exchange Act Release No. 34-41631, 70 S.E.C. Docket (CCH), at 308 (July 21, 1999); WowAuction.com Inc., Securities Act Release No. 33-7702, 70 S.E.C. Docket (CCH), at 311 (July 21, 1999); WebWorks Marketing.com, Inc., Securities Act Release No. 33-7703, Exchange Act Release No. 34-41632, 70 S.E.C. Docket (CCH), at 314 (July 21, 1999).

gift of stock is a 'sale' within the meaning of the Securities Act when the purpose of the 'gift' is to advance the donor's economic objectives rather than to make a gift for the simple reasons of generosity."[27] The SEC determined that the issuer benefited from the free stock giveaway because it attracted additional people to its web site and the issuer can then generate revenue from advertisers as a result of this traffic.[28]

There is available precedent that on the surface may support this contention. However, in each of the cease-and-desist orders the SEC failed to make an in-depth legal analysis of the issue and stated its findings in conclusory terms. This section will review each of the four cease-and-desist orders and the SEC precedent on the issue of free stock and "value" under Section 2(a)(3) of the Securities Act.

A. The Cease-and-Desist Orders

In *In re Theodore Sotirakis*,[29] the SEC found the issuer's promise to give securities to the public in exchange for the recipients agreement to register and/or to link the Kinesis web site to their respective web sites constituted a sale of securities.[30] The SEC held individuals who registered for Kinesis stock and/or created a link to the Kinesis web site conferred value to the issuer in the form of free advertising and enhanced name recognition for the issuer.[31]

In *In re Joe Loofbourrow*,[32] the SEC also ordered the issuer to cease his free stock program.[33] Loofbourrow's Company, ASC, would give ten shares of free stock to each individual who filled out an on-line registration form.[34] "In addition to requiring registrants to provide their names, home addresses, and e-mail addresses, the form included a series of questions aimed at insuring that registrants had read through the portions of Loofbourrow's web site that discussed the 'financial partner' offers."[35] From July 1995 to May 1999, Loofbourrow established and maintained internet web sites that solicited the public to purchase "financial partner" interests in ASC. Through these web

27. *Id.*
28. *See id.*
29. Theodore Sotirakis, Securities Act Release No. 33-7701, 70 S.E.C. Docket (CCH), at 309 (July 21, 1999).
30. *See id.* at 310.
31. *See id.* at 309.
32. Joe Loofbourrow, Securities Act Release No. 33-7700, Exchange Act Release No. 34-41631, 70 S.E.C. Docket (CCH) 306 (July 21, 1999).
33. *See id.* at 309.
34. *See id.* at 307.
35. *Id.*

sites, Loofbourrow promised that ASC financial partners would receive fixed annual returns in exchange for a set minimum investment amount. Between July 1995 and October 1996, Loofbourrow's web site indicated that ASC planned to raise "seed capital" of $60 million. From October 1996 to May 1999, Loofbourrow's web site indicated that ASC planned to raise "seed capital" of $4 million. No one invested money in ASC in connection with Loofbourrows financial partner offers.[36] Loofbourrow also represented on the web-site that individuals would receive additional "free" stock in exchange for referring others to his web site.[37] The SEC determined that "the primary purpose for the 'free' stock offering was to generate publicity for ASC and encourage members of the public to become 'financial partners' by investing capital in ASC."[38]

The SEC also found that Loofbourrow had made fraudulent statements: that ASC had "100 times" greater potential than companies such as Wal-Mart and Microsoft; that ASC planned to build the world's largest aerospace manufacturing plant; that ASC had an "extensive plan" to resume lunar exploration no later than 2004; that the free stock program provided "an ideal way" for investors to save for "a future college education or for retirement."[39] The SEC determined that "the 'financial partner' interests were clearly offers to dispose of securities 'for value' in the form of the capital that Loofbourrow required individuals to invest in ASC."[40] As for the free stock, the SEC found that Loofbourrow benefited "because it attracted additional people to his web site and increased the chances that members of the public would invest capital in ASC through the 'financial partner' interests."[41] Furthermore, by allocating shares of free stock to the public, "Loofbourrow increased the possibility that a market would exist for ASC shares when and if he decided to incorporate and issue the stock he promised."[42]

The conduct in *In re WowAuction.com, Inc.*[43] was closer to a traditional free stock program than was Loofbourrow's. WowAuction repre-

36. *Id.*
37. *See id.*
38. *Id.*
39. *See id.*
40. *Id.* at 308.
41. *Id.*
42. *Id.*
43. WowAuction.com Inc., Securities Act Release No. 33-7702, 70 S.E.C. Docket (CCH) 311 (July 21, 1999).

sented on its web site that the company would give away free stock under two circumstances.[44] First, an individual who registered with WowAuction would receive three free shares.[45] Second, a registered user would receive another free share, up to a maximum of seven, for every person who listed the user as a reference when registering.[46] In addition, WowAuction stated that it would give 10,000 shares of stock to five registered users in a random drawing.[47] The SEC viewed the free stock program as an attempt "to attract visitors to the web site and to generate interest in WowAuction and WowAuction's planned future public offering."[48] The SEC determined that the free stock giveaway program violated the 33 Act because the program benefited WowAuction by attracting additional people to the web site and generating interest in the planned direct public offering which would bring a monetary benefit to the company.[49]

The final cease-and-desist order was *In re WebWorks Marketing.com.*[50] WebWorks operated out of Trance D. Cornell's home, and marketed residential and business long distance telephone service through an Internet web site.[51] WebWorks represented that it would disseminate free stock to individuals under the following circumstances: (1) an individual who registered with WebWorks would receive three shares of free stock; (2) a registered individual would receive another free share, up to a maximum of ten additional shares, for every person who listed the registered user as a reference upon registering; (3) an individual who subscribed to the long distance service offered by Telco Communications Group, Inc. would receive 25 shares of stock; and (4) the individual would receive an additional 25 shares of stock if he remained a customer of Telco for six months.[52] The SEC determined that Cornell and WebWorks disseminated the stock via the internet to induce customers to enter into and maintain contracts for long distance telephone service marketed by WebWorks, to attract visi-

44. *See id.* at 311.

45. *Id.*

46. *Id.*

47. *See id.*

48. *Id.*

49. *See id.* at 312.

50. WebWorks Marketing.com, Inc., Securities Act Release No. 33-7703, Exchange Act Release No. 34-41632, 70 S.E.C. Docket (CCH) 312 (July 21, 1999).

51. *See id.* at 313.

52. *See id.*

tors to the web site, and to generate interest in WebWorks.[53] WebWorks was also found to make material representations of fact as to the number of customers it had, that it was "the Internet's fast growing company," and that "each share [of WebWorks] should be worth approximately $38.40 based on a complex equation that I don't expect you [the investor] to understand at this point."[54] The SEC determined that there was "value" because the free stock program attracted additional people to the web site and the program "generated interest in WebWorks and any future public offering; such increased interest 'obviously' would benefit WebWorks."[55]

In each of the cease-and-desist orders, the SEC makes short shrift of the legal analysis. Each order relied on the same legal framework and the orders all were issued on the same day.[56] The entire "analysis" consists of three sentences:

> [1]Section 2(a)(3) of the Securities Act defines "sale" or "sell" to "include every contract of sale or disposition of a security or interest in a security for value." [2]The lack of monetary consideration for the shares does not mean that there was not a sale or offer for sale for the purposes of Section 4. See, e.g. Capital General Corporation, 54 SEC Docket 1714, 1728-29 (July 23, 1993)(Capital General's "gifting" of securities constituted a sale because it was a disposition for value, the "value" arising "by virtue of the creation of a public market for the issuer's securities."). See also SEC v. Harwyn Industries Corp., 326 F.Supp. 943 (S.D.N.Y. 1971). [3] "Thus a gift of stock is a "sale" within the meaning of the Securities Act when the purpose of the "gift" is to advance the donor's economic objectives rather than to make a gift for the simple reasons of generosity."[57]

The definition of sale is left purposely broad by the statute to give the SEC great control and power to determine the transactions that require registration.[58] The definition includes every "attempt or offer

53. *See id.*
54. *See id.*
55. *See id.*
56. *See* CEASE & DESIST ORDERS, *supra* note 1.
57. *See id.*
58. *See* Value, Securities Act Release No. 33-929, 17 C.F.R. § 231.929 (July 29, 1936).

to dispose of . . . a security . . . for value."[59] The term "value" is purposely not defined in the '33 Act.[60] The regulations and definitions were left broad to "prevent any circumvention of the registration requirement by devious and sundry means,"[61] this is one reason for the broad and liberal interpretation of the Securities Act.[62] Therefore, the existence of a "sale" under the '33 Act depends on the definition of "value." The SEC has generally taken the position that "value" includes "all ordinary forms of consideration, such as cash, property, services, or the surrender of a legal right."[63] The SEC has never articulated a test to determine what does and does not constitute value. However, it has issued interpretive releases and other administrative order rulings on the issue. While the SEC does have great control on the issue, and is not bound by prior administrative orders or Interpretive Releases,[64] it should still strive for consistency. The SEC has never tackled the issue of free stock programs as described above, but rather has faced the free stock issue previously in the context of dividends,[65] employee pension plans,[66] gifts of stock to replace compensation[67] and stock incentive plans.[68]

B. Prior SEC interpretation of "value"

This section will review the cases relied upon by the SEC in the cease-and-desist orders discussed above. It will also review the administrative rulings on free stock programs in other contexts in order to search for consistency in the definition of "value" and to determine if the ruling in the cease-and-desist orders were supported by precedent.

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59. *Id.*

60. *See* Employee Benefit Plans, Securities Act Release No. 33-6188, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 1051, 2073-15 (Feb. 1, 1980).

61. SEC v. Harwyn Industries Corp., 326 F. Supp. 943, 954 (S.D.N.Y. 1971).

62. *See id.*

63. *See* Employee Benefit Plans, Securities Act Release No. 33-6188, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 1051, 2073-15 (Feb. 1, 1980).

64. *See Harwyn*, 326 F. Supp at 956 (*citing* SEC v. Culpepper, 270 F.2d 241, 248 (2nd Cir. 1959) ("prior practice does not estop the Commission from changing its view in the interest of protecting the public against possibly fraudulent activities")).

65. *See* Value, Securities Act Release No. 33-929, 17 C.F.R. § 231.929 (July 29, 1936).

66. *See* Employee Benefit Plans, Securities Act Release No. 33-6188, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 1051, 2073-15 (Feb, 1980).

67. *See* Solid State Scientific Devices Corp., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,519 (Feb. 10, 1971).

68. *See* Keene Corp., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,475, at 81025 (Oct. 26, 1971).

The SEC relied upon a federal court ruling in *Securities and Exchange Commission v Harwyn Industries Corporation*[69] and the cease-and-desist order in *Capital General Corporation.*[70] Harwyn dealt with free shares in the context of a "spin off";[71] the company would "spin-off" to its shareholders shares of a newly created subsidiary without registration under the Securities Act.[72] This has the effect of converting the subsidiary into a publicly traded vehicle without '33 Act registration, and it immediately generated a higher market capitalization for the promoters.[73] Harwyn spun-off its shares in each subsidiary to its own shareholders, including Harwyn control persons, as a stock dividend.[74] The SEC argued that the result was to give the control persons of Harwyn and the owners of the private companies an immediate and valuable market in the subsidiaries' shares.[75] Harwyn argued that they did not receive any value for the shares, they were simply free distributions and therefore no "value" was given.[76] The court rejected Harwyn's argument and found that for the purposes of Section 2(a)(3) of the Securities Act, 'value' need not flow in a direct line from the immediate transferee of shares back to the transferor.[77] "Instead, it saw 'value' flowing to Harwyn from outside companies and their defendant owners who infused operating assets into Harwyn's subsidiaries in exchange for the benefit of immediate public markets in the subsidiaries' stocks."[78] Thus, the court collapsed the spin-offs into the creation of new trading markets, holding that "the spin-off distribution of shares, and trading in the after-market, were inextricably bound together, with benefits flowing to all defendants."[79] In coming to this determination, the court relied upon the "overall purpose [of the Securities Act] which is to provide adequate disclosure to members of the investing public, rather than engage in strangulating literalism."[80]

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69. 326 F.Supp 943 (S.D.N.Y. 1971).

70. Cease-And-Desist Order, 54 S.E.C. Docket 1322, 1993 WL 285801 (S.E.C.) (July 23, 1993).

71. *See Harwyn*, 326 F.Supp. at 945.

72. *See id.*

73. *See* Rice, *supra* note 10.

74. *See id.*

75. *See id.*

76. *See id.*

77. *See id.*

78. *See id.* at 954.

79. Rice, *supra* note 10 (citing *Harwyn*, 326 F.Supp. at 954).

80. *Harwyn*, 326 F.Supp at 953.

Capital General Corp.[81] involved "the 'back door' creation of a public trading market."[82] Capital General was a closely held corporation that created sixty-nine "shell" subsidiaries as merger vehicles.[83] Capital General then sold the shells to promoters and private companies for fees while retaining substantial shares in each.[84] It then distributed the shares of the shells for no monetary compensation to persons throughout the United States.[85] Here, as in Harwyn, there was a claim that the distribution of the shares was a gift because no money was paid.[86] Furthermore, Capital General argued that even if it is required to register, "no purpose would be served by filing a registration statement since the persons receiving shares are not called upon to make an investment judgment."[87] While not disclosed, it appears the issuer was relying upon the SEC position in the employee benefit plan context,[88] discussed below. The SEC considered the plan a scheme to avoid registration.[89] The SEC rejected the argument because it failed to take into account the fact that distribution does not cease at the point of receipt by the initial distributees of the shares, but continues into the trading market involving sales to the investing public at large, thereby quickly creating a trading market in the shares of the issuer.[90] The determinative factor in deciding that the plan was in fact a sale was that "[no] independent business purpose"[91] existed for the distribution of the shares. "Rather, the shares were distributed [as ostensible gifts] so that control of the issuer could be transferred by [Capital General's owner] . . . for significant value following the distribution."[92]

81. Cease-And-Desist Order, *supra* note 70.

82. *See* Rice, *supra* note 10.

83. Cease-And-Desist Order, *supra* note 70.

84. *See id.*

85. *See id.*

86. *See id.*

87. *See id.*

88. *See* Employee Benefit Plans, Securities Act Release No. 33-6188, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 1051, 2073-15-16 (Feb. 1, 1980) ("'value' in the traditional sense may be present in the exchange, no useful purpose is served by applying the Act's registration provisions where employees have no investment decision to make with respect to the proposed conversion").

89. Cease-And-Desist Order, 54 S.E.C. Docket 1322, 1993 WL 285801 (S.E.C.) (July 23, 1993).

90. *See* In Re Capital General Corporation, SEC Cease-And-Desist Order, 54 S.E.C. Docket 1322, 1993 WL 285801 (S.E.C.) (July 23, 1993).

91. *Id.*

92. *Id.*

Both of the precedents relied on by the SEC in issuing the cease-and-desist orders are distinguishable from the internet free stock programs. The acts in *Harwyn* and *Capital General* "involved a corporation that created stock in other corporations and then used such stock to attract valuable assets and to generate public markets where none existed." In fact they were acting as "underwriters" to the stocks.[93]

The SEC found "value" in *Harwyn*[94] because operating assets were infused into the company's subsidiaries in exchange for immediate public markets in the subsidiary stock.[95] This is distinguishable from the internet free stock programs. In these programs no assets were flowing into the issuer and there was no public market for the stock.

In *Capital General*[96] the SEC found that "value" was given because the transaction was a transfer of control to others, who would then infuse the shell with capital while the original Capital General insiders would reap benefits from the shares that they held. The free stock programs detailed above did not involve any transfer of control and the original control person of the issuer was still responsible for creating capital.

Furthermore, the Internet programs do not create a market in the securities because they were not on any exchange. As well, they do not increase the trading value of any affiliated shares because they are not connected to any other stock or spin-off. Nor are the SEC's arguments, that the issuers received value in additional traffic to their web sites, supported by any evidence or data as to that fact. Based on the foregoing, the SEC's reliance on *Harwyn* and *Capital General* is inconsistent with the holdings in those cases because there was no transfer of control or creation of a public market for the stock.

The SEC has ruled on "value" in situations similar to the free stock programs, such as employee benefit plans,[97] dividends,[98] gifts of stock to replace compensation[99] and stock incentive plans.[100] In the context

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93. *See* Rice, *supra* note 10.

94. 326 F.Supp 943 (S.D.N.Y. 1971).

95. *See id.*

96. Cease-And-Desist Order, 54 S.E.C. Docket 1322, 1993 WL 285801 (S.E.C.) (July 23, 1993).

97. *See* Employee Benefit Plans, Securities Act Release No. 33-6188, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 1051, 2073-15 (Feb. 1, 1980).

98. *See* Value, Securities Act Release No. 33-929, 17 C.F.R. § 231.929 (July 29, 1936).

99. *See* Solid State Scientific Devices Corp., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,519 (Feb. 10, 1971).

of stock dividends, the SEC determined that a waiver of a right constituted "value."[101] When a cash dividend is declared, the shareholder immediately becomes a creditor of the corporation and cannot be divested of these rights by subsequent act of the board giving stock in lieu of cash.[102] If the security holder elects to take the stock then the security holder would be giving up value, in essence its claim to a cash dividend in return for stock, requiring registration of the transaction and making the securities the subject of a sale.[103] These programs are distinguishable because the shareholder in the Internet free stock program was never entitled to cash which was later replaced by stock. Here, the shareholder registered and received the stock. Had the issuer promised a cash payment for registration and then substituted stock, it would be analogous to the situation in the release.

Stock incentive plans have also come under SEC scrutiny. A stock incentive plan, whereby a corporation proposes to issue not more than 3,000 shares of its issued and outstanding shares as "prizes" to organizations that are the distributors of the corporation's products, must comply with the registration requirements of the Securities Act.[104] The SEC relied upon the fact that "the shares will be distributed as an incentive to generate greater sales."[105] This also can be distinguished from free stock programs because in the case of Internet free stock programs there is no prior business relationship. Furthermore, the "prizes" in the stock incentive plans were tied to the amount of sales.

A "gift" of a company's stock to employees whose compensation had been decreased is a sale under the Securities Act where there is a relationship between the salary reduction and the distribution of stock.[106] This can also be distinguished because the stock in the Internet free stock program was not in lieu of monetary compensation which the issuer was obligated to give the shareholder.

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100. *See* Keene Corp., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,475, at 81025 (Oct. 26, 1971).

101. *See* Value, Securities Act Release No. 33-929, 17 C.F.R. § 231.929 (July 29, 1936).

102. *See id.*

103. *See id.*

104. *See* Keene Corp., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,475, at 81025.

105. *Id.*

106. *See* Solid State Scientific Devices Corp., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,519.

In response to *International Brotherhood of Teamsters v. Daniel*[107] the SEC addressed "value" in the context of employee benefit plans.[108] In that release, the SEC made several interpretations. In one interpretation the SEC took the position that while a conversion from one form of plan to another constituted value in the traditional sense, "no useful purpose is served by applying the Act's registration provisions where the employees have no investment decision to make with respect to the proposed conversion."[109] The SEC also addressed registration in the context of non-contributory pension plans.[110] In non-contributory pension plans there are no direct, identifiable contributions by employees,[111] and the employee's labor would be considered a contribution "only in the most abstract case."[112]

The Internet free stock programs are most analogous to the employee benefit plans. In both situations, no investment decision has been made and the shareholder can only receive gains while not bearing the risk of any financial loss. In light of the Employee Benefits release, the inconsistencies of the cases relied upon by the SEC, and the distinguishability of prior instances where the SEC has found "value" the SEC should have found that no "value" was conferred in connection with the internet free stock program and thereby that no violation of the '33 Act occurred.

As noted above, the SEC is not bound by prior rulings,[113] as such it could have found "value" conferred on other grounds, but the analysis used by the SEC is flawed. Without any basis in the applicable stat-

107. 439 U.S. 551 (1979) (the Court held that the interest of employees in involuntary, noncontributory pension plans are not securities and are therefore not regulated by the Securities Act).

108. *See* Employee Benefit Plans, Securities Act Release No. 33-6188, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 1051, 2073-15 (Feb. 1, 1980).

109. *Id.*

110. *See id.* at 2073-7.

111. *See id.* at 2073-8.

112. International Bd. of Teamsters v Daniel, 439 U.S. 551, 560 (1979). The SEC was of the view that a plan where an employee is permitted to invest his share of the employer's contribution in various investment media (including company stock), or to accept cash and defer a portion of the employer's award in the form of company stock, or to elect cash or stock upon a distribution by the plan; because of the nature of these actions, which appear to involve investment decisions, the SEC for some time declined to take a no action position. However, as a result of *Daniel* the SEC took the view that registration should not be required with respect to investment elections in noncontributory plans. *See* Employee Benefits Release at 2073-77.

113. *See* SEC v. Harwyn Indus. Corp., 326 F. Supp 943, 956 (S.D.N.Y. 1971) (*citing* SEC v. Culpepper, 270 F.2d 241, 248 (2d Cir. 1959) ("prior practice does not estop the

utes the SEC did find that "value" had been conferred, thereby requiring registration under the '33 Act. As a result, Web Equity Capital filed an "odd-duck" registration statement.

IV. Registration Requirements and the "Odd-Duck Filing"

The SEC has declared that free stock programs constitute sales under Section 2(3) of the Securities Act[114] and, therefore, under Section 5(a) of the Securities Act, the issuer must file a registration statement.[115] In response to the SEC's position on free stock programs, Web Equity Capital has filed an "odd-duck" registration statement with the SEC.[116] It is considered odd because as a new company with only a business plan, it lacks any financial statements, has only one significant corporate tie and start-up capital from the sole original shareholder. The registration statement contains all sections of a traditional registration statement. However, it lacks financial statements as there is very little information to disclose about the corporation because it had only existed for one month prior to registration. Web Equity registered its shares for the sole purpose of instituting a free stock program through its internet web site. This section will review the Web Equity "odd-duck filing" under the current disclosure requirements of the Securities Act.

Section 6(a) of the Securities Act sets forth procedural requirements pertaining to the registration of securities.[117] Section 7(a) describes the information to be contained in a registration statement.[118] Disclosure requirements as to financial statements are governed by Regulation S-X, while disclosure as to non-financial information are prescribed on the various forms, which make applicable specific items of Regulation S-K.[119]

Web Equity Capital, Inc. filed a registration statement with the SEC on From S-1.[120] The content of Form S-1 is prescribed by the

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Commission from changing its view in the interest of protecting the public against possibly fraudulent activities")).

114. *See* Cease & Desist Orders, *supra* note 1.

115. *See* Securities Act of 1933, § 5(a), 15 U.S.C. § 77(e)(a) (West 1997).

116. Web Equity Capital, Inc., Securities Act Registration Statement on Form S-1.

117. *See* Securities Act of 1933, § 6(a), 15 U.S.C. § 77(f)(c) (West 1997).

118. *See* Securities Act of 1933, § 7(a), 15 U.S.C. § 778(c) (West 1997).

119. *See* Regulation S-K, promulgated under the Securities Act of 1933.

120. *See* Web Equity Capital, Inc., Securities Act Registration Statement on Form S-1.

registration and prospectus provisions of Regulation S-K.[121] The SEC has characterized the information provided by the issuer to the investor on Form S-1 as "issuer oriented" and "transaction oriented," the former relaying basic information about the issuer and the latter giving information regarding a particular offering.[122] Both "issuer" information and "transaction" information are material to investors and must therefore be part of a registration statement.[123]

Regulation S-K standardizes the information required as it relates to: (1) the content of the front cover page; (2) the inside front cover page and the outside front cover page; (3) the summary and risk factors section; (4) a use of proceeds section; (5) a dilution section; (6) a description of the securities; (7) pricing information; (8) ratio of earnings to fixed charges; (9) a description of the plan of distribution; (10) information pertaining to selling security holders; (11) if appropriate, disclosures relating to and the interest in the registrant of named experts; and (12) information with respect to the registrant.[124]

Finally, assuming that all information disclosed by Web Equity Capital complies with the anti-fraud provisions of the '33 Act and that all the limited information of a company such as Web Equity Capital has been disclosed, some would argue that this odd duck filing, even if all the information the company has is disclosed, should still be rejected by the SEC.[125] It is argued that the SEC should not allow this type of filing because the issuance of a large amount of stock will create an artificial market for the security, regardless of its lack of an operational business. This argument fails to take into account the efficient market theory, however, which the SEC and the Supreme Court have accepted.[126]

V. THE EFFICIENT MARKET THEORY

The Efficient Market Theory (EMT) generally posits that "the pricing mechanisms of organized capital markets efficiently incorpo-

121. *See* HAROLD S. BLOOMENTHAL ET AL., SECURITIES LAW SERIES, SECURITIES LAW HANDBOOK 243 (1999).

122. *See id.*

123. *See id.*

124. *See id.*

125. *See* Linda C. Quinn & Ottilie L. Jarmel, *Securities Regulation and the use of Electronic Media,* SE 10 A.L.I. - A.B.A. 811 (1999); *Electronic Commerce: Markey Asks SEC to Answer Questions Regarding 'Free Stock Offerings' on Internet,* SECURITIES LAW DAILY (BNA), Apr. 1, 1999, at d2.

126. *See id.*

rate information; or, in other words, that the prices of securities traded in such markets always reflect all available information."[127] Therefore, the capital markets upon which our economic system depend, are believed to act efficiently.[128] This section will analyze the "odd duck filing" in the context of the EMT and conclude that, based upon the EMT, the "odd-duck filing" should be adequate for disclosure under the '33 Act.

Three distinct forms of the EMT exist.[129] First, the EMT's weak form states that the current price of a security traded in the capital markets reflects all data about the security's earlier prices.[130] The weak form asserts that it is impossible to predict a security's future price fluctuations based upon the current price. Second, "the semi-strong version suggests that a security's current market price reflects all currently available public information, not merely information incorporated into prior prices."[131] Lastly, "the strong version posits that a security's price incorporates all information, regardless of whether the information is generally available to the public."[132]

The semi-strong form of the EMT has gained the most acceptance and has had the most impact upon legal doctrine.[133] The semi-strong form posits that a security's market price reflects all currently available public information, and its acceptance affects the securities field. The SEC's integrated disclosure system is premised upon the EMT. In adopting the integrated disclosure system the SEC noted that "the [new] concept of integration also proceeds from the observation that information is regularly being furnished to the market through periodic reports under the Exchange Act . . .[t]o the extent that the market accordingly acts efficiently . . . there seems [to be] little need to reiterate this information."[134]

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127. *See* Carol R. Goforth, *The Efficient Capital Market Hypothesis—An Inadequate Justification for the Fraud on the Market Presumption*, 27 WAKE FOREST L. REV. 895, 896-7 (1992).

128. The EMT is an economic theory, and it has been criticized. However, it has gained acceptance in certain areas of securities law, and for the purposes of this paper the theory's assumptions will not be argued on economic grounds. It is assumed to be true to the extent that it has been accepted in the securities regulation field.

129. *See id.*

130. *Id.* (citing to JAMES H. LORIE & MARY T. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 71-72 (1st ed. 1973)).

131. *Id.*

132. *Id.*

133. *See id.*

134. Proposed Comprehensive Revision to System for Registratin of Securities Offerings. Securities Act Release No. 33-6235, 45 Fed.Reg. 63,693, 63,694 (Sept. 2, 1980).

The EMT has also been accepted by the Supreme Court in the fraud on the market doctrine.[135] The fraud on the market doctrine was developed in the context of security fraud cases. Prior to *Basic Inc. v. Levinson*,[136] a plaintiff was required to prove that he/she relied upon a misstatement or omission in making the investment decision. The fraud on the market doctrine adopted by the Court created a three-fold presumption of reliance: (1) that the misrepresentation affected the market price; (2) that a purchaser relied on the price as an indication of value and thereby relied upon the misrepresentation in the purchase; and (3) that the reliance was reasonable.[137]

The fraud on the market theory derives from the notion that "in an open and developed securities market, the price of a company's stock is determined by the available material information."[138] The Court did not examine the validity of EMT, stating that it was not the Court's task to do so.[139] The Court did accept that the fraud on the market theory may rely upon the assumptions and theory of the EMT.[140]

The Supreme Court's and the SEC's acceptance of the EMT has a significant impact on the review of the "odd-duck filing." Under the integrated disclosure system the filing must be reviewed in the context of the semi-strong form of EMT. Therefore, the price of the stock will reflect all the information available. This available information includes Web Equity's lack of an operational business, a business plan or any operating history. If, as is assumed for the purpose of this Note, all of the limited information of Web Equity is disclosed, and the anti-fraud provisions are adhered to, the market itself will ensure that no artificial market is developed in the security. Based upon the EMT, if the "odd-duck filing" has all relevant information, even if it is lacking historical data, it should be accepted by the SEC.

VII. CONCLUSION

Free stock programs have come under fire and the SEC has issued four cease-and-desist orders to stop such programs. The SEC's rulings

135. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988).

136. 485 U.S. 224 (1988).

137. Robert Norman Sobol, *The Benefit of the Internet: The World Wide Web and the Securities Law Doctrine of Truth on the Market*, 25 J.CORP.L. 85, 90 (1999).

138. *Basic Inc.*, 485 U.S. at 241-42.

139. *See id.* at 242.

140. *See id.*

are inconsistent with previous administrative orders and court decisions. The SEC has wrongly decided that registration required under such programs constitutes value and, in turn, a sale requiring registration under the Securities Act. In response, Web Equity Capital has submitted a registration statement to the SEC that, based upon current registration requirements and the Efficient Market Theory, is adequate disclosure under the Securities Act. As a result, this free stock program should be approved by the SEC. Through its use of the "odd-duck filing," Web Equity has shown others how to effectuate a free stock giveaway program on the Internet and comply with the registration requirements of the SEC.

Jason Hubschman