The Lifting of Restrictions on the Use of Electronic Media for the Delivery of Prospectuses: An Unfinished Job

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On 26 March, 2001 a Cabinet order was promulgated allowing securities companies and issuers to deliver documents such as prospectuses using electronic media such as the Internet. The order came into force on 1 April. Unfortunately, the order ignores the realities of the Internet and the way it is used, and, as a result, there is little prospect of securities companies actually using electronic media to deliver prospectuses for mutual funds and other financial products to their customers.

1. Lifting of Restrictions on the Use of Electronic Media for the Delivery of Documents

1) Need for electronic media to deliver documents

There are a number of situations involving securities trading when securities companies and issuers are required by law to provide investors with certain documents. Examples include (1) primary or secondary offerings of shares or bonds and offerings by investment trusts (mutual funds), when prospectuses have to be sent to investors; (2) customer orders to buy and sell securities, when securities companies have to send customers execution confirmations; and (3) takeover bids, when shareholders have to be sent takeover prospectuses. These are all examples of disclosure requirements in the broad sense of the term, and it is essential that investors receive these documents so that they can form a proper judgment and take responsibility for it.

At present, securities companies and issuers usually send investors such documents by conventional mail. However, more than 60 securities companies already accept orders from customers via the Internet to buy and sell shares, bonds and mutual funds, and more than 2 million customers have opened accounts for this purpose in Japan. There is therefore a growing demand for documents to be delivered using the same medium rather than conventional mail. If this were allowed, securities companies and issuers would be able to save some of the costs they currently incur in printing and posting such documents, while investors would be able to refer to them whenever they wanted, print them out or save them on their computer's hard disk without having to file away reams of paper.

In the United States, the leader in the use of the Internet, securities companies and issuers are already permitted to send prospectuses and execution confirmations electronically (following the publication by the Securities and Exchange Commission of a no-action letter in February 1995 and two interpretive releases on this subject in October 1995 and May 1996), and the method is used widely (see below for further details).

In the United States, companies now actually use the Internet (in what might be called "Internet finance") to send investors prospectuses on public equity offerings and raise capital without having to use an underwriting securities company as an intermediary. Between February 1995 and February 1996 a New York attorney, Andrew Klein, succeeded in raising $1.6 million in capital from 3,500 retail investors for Spring Street Brewery, the micro brewery he founded in 1993, by posting prospectuses and other offering materials on the company's Website.1

Because of the difficulty of attracting a sufficient number of investors in a short space of time amid the plethora of information posted on the Internet, Internet finance has still to become an established means of raising venture capital. Nevertheless, as a means of raising capital from the general public without having to use an intermediary, it offers considerable potential. Moreover, Internet finance would not have been possible if the law had not permitted issuers to send prospectuses electronically. Furthermore, although not exactly the same thing, Internet investment banks have already achieved some success in using the Internet to provide offering materials and raise capital more cheaply than would have been possible by conventional means.2

2) Background to Japanese legislation

In Japan, investment professionals were quick to point out the need to allow securities companies and issuers to send documents electronically in what has, after all, been called the "Internet age." A recent example of this is the April 2000 report ("The Growth of Electronic Trading in Financial Services and the Regulatory Provisions Governing It" [in Japanese]) by a study group set up by the Financial Supervisory Agency (as it was then). The report pointed out the need to allow

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1 For further details of Spring Street Brewery's Internet financing see S. Osaki, Intanetto Fainansu [Internet Financing], Nihon Keizai Shimbunsha, 1997, and for Andrew Klein's own account see A. D. Klein, WallStreet.com, Henry Holt, 1998.

2 Klein, the originator of Internet finance, has also founded a number of other companies, including Wit SoundView and Offroad Capital, which specializes in private placements. Wit Capital has also established an operation in Japan, Wit Capital Securities, in partnership with Mitsubishi Corporation.

securities companies and issuers to send documents electronically and made a number of specific recommendations on how this might be done.4

In the meantime, the May 2000 revision to the Securities and Exchange Law allowed prospectuses to be sent to investors via the Internet as attached files. More precisely, the revision contained the following provision: "Anyone required to send an prospectus shall, where a Cabinet order so stipulates, be allowed to make the contents of the prospectus (instead of the prospectus itself) available via an electronic data network or by any other means stipulated by Cabinet order." In such cases, under the revision, the prospectus would be regarded as having been sent (Securities and Exchange Law, 27-30-9). This provision was due to come into force between June 2001 and June 2002 originally.

However, in November 2000 the Diet passed the Law Governing Legislation on the Use of Information and Communications Technology for the Delivery of Documents (the so-called "IT Omnibus Law"), which brought forward the lifting of restrictions on the electronic delivery of prospectuses to 1 April, 2001. In addition, the law extended the coverage from prospectuses (as originally envisaged) to documents such as execution confirmations sent by securities companies.

The Law's objective was to facilitate the Mori Cabinet's "IT Revolution" by allowing all the different types of "documents" covered in different laws to be delivered or sent electronically via the Internet. The comprehensive nature of the law and the way in which it tries to overcome barriers between individual government departments reflect an awareness that progress in using the Internet would be impeded if matters were left to endless discussions within hierarchical departments.

In January 2001 the related government orders were passed and anyone wishing to send such documents electronically was required to obtain the agreement of customers in advance. However, further progress on how such documents might be delivered had to wait until a new Cabinet order was passed.

This was the background to the Cabinet order entitled Cabinet Order Concerning Financial Services Agency Cabinet Orders Related to the Enforcement of the Law Governing Legislation on the Use of Information and Communications Technology for the Delivery of Documents (Cabinet order No. 18) that was promulgated on 26 March, 2001. When the order came into force on 1 April, the electronic delivery of prospectuses at last looked as though it would become a reality.

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[4] As a member of the group the author took part in its discussions.

2. The Cabinet Order's Detailed Provisions on the Electronic Delivery of Documents and Their Shortcomings

1) Methods of electronic delivery

This Cabinet order stipulates the methods by which securities companies and issuers may deliver prospectuses and other documents electronically. There are three such methods. (In the following we shall quote the text of the order referring to prospectuses, but the same methods apply to other documents.)

Method 1: "Where the contents of a prospectus are sent via a communications network linking a computer used by the provider of the prospectus to the computer used by the recipient and stored in a file on the recipient's computer."

Examples would be where a securities company sends an electronic file containing the contents of a prospectus to a customer, who then saves it on his hard disk, or where a securities company sends a prospectus as an electronic file attached to an e-mail to a customer, who then saves it on his hard disk.

Method 2: "Where the contents of a prospectus stored on a computer used by the provider of the prospectus are made available via a communications network for a customer to read, who then stores the contents in a file on his computer."

An example would be where a securities company makes a file (e.g., a PDF file) of a prospectus available for investors to read on its Website, who then download the file and store it on the hard disk of their computers.

Method 3: "Where the contents of a prospectus are stored in a file produced on a medium that can be used to store a certain amount of data (e.g., a magnetic disk, CD-ROM or the equivalent) and then delivered."

An example would be where the contents of a document are sent by conventional mail to the address of an investor as data stored on a floppy disk or CD-ROM rather than as a paper document.

2) Shortcomings of the Cabinet order

Requirement that files be downloaded

Although the Cabinet order could be said to be rather late in coming (in that it allows something that has existed in the United States for more than five years), it was potentially very significant. In practice, however, it is doubtful whether, as a result of the order, securities companies and issuers will send prospectuses and other offering materials or transaction reports electronically via the Internet. This is because the order's provisions disregard the distinctive characteristics of the Internet and the way in which it is actually used.

Under the order it is not enough for an investor to receive a file of a prospectus from a securities company as a file attached to an e-mail or to read it at the securities company's Website: he must actually store (i.e., save) the file in a file on his own computer (presumably on its hard disk) before the document is considered to have been "delivered."

However, there is no easy way for a securities company to check whether a customer has actually saved on his hard disk a file with an prospectus that he has received or read. One possibility would be for a securities company to ask a customer who has placed an order via the Internet whether he has downloaded the file with a particular prospectus and only to allow him to conduct the transaction if he clicks the "yes" button. However, this would not rule out the possibility that the customer might click the "yes" button by mistake and the securities company execute the order even though the prospectus had not been “delivered” as required by the order insofar as the customer had not downloaded the file. Unsatisfactory delivery of prospectuses will incur administrative sanctions on a negligent securities company imposed by the FSA.

There are also shortcomings when it comes to customer convenience. Some of the prospectuses from mutual funds and companies that are planning to go public are more than 100 pages long when printed out on paper, so the electronic file is likely to be large. Depending on how a customer is able to access the Internet, he might have to spend some considerable time downloading such a file. As a result, many customers might prefer not to download it.

In the United States, downloading is not a requirement

Basically, the very notion that a file with a prospectus cannot be considered to have been received unless an investor has downloaded it is questionable.

In the United States, the SEC's February 1995 no-action letter (see above) states the conditions under which an electronic prospectus is considered to have been "delivered."5 The nine conditions are as follows:

It must disclose the same information as a hard copy of the prospectus.

An investor must have agreed in advance to receive the prospectus in electronic form.

The company issuing the electronic prospectus must inform investors as soon as it is made available to them.

Where an electronic prospectus is being delivered by an intermediary (e.g., a securities company), the party responsible for distributing the circular (i.e., the issuer) must check that investors have given their agreement and have been informed.

During the period when the prospectus is required to be distributed, it must be made freely and constantly available via the specified communications system.

The prospectus must be made available either in a printable format or in such a way that it can be accessed at any time.

If an investor so requests, a hard copy of the prospectus must be sent free of charge.

The final version of the prospectus must be made available via the system until an investor decides whether or not to buy the securities, and he must be informed of this.

If a securities company wishes to send additional sales information together with the prospectus, it must ensure that it meets the following three conditions: it must (1) state that the circular has already been sent electronically; (2) indicate how an investor may access the file on the system; and (3) inform the investor that he may request a free hard copy of the prospectus from the issuer or the underwriter.

These conditions (presented slightly more succinctly) remained basically unchanged in the releases that followed.6 This is because the releases stipulated that the following two conditions had to be met if prospectuses and other materials were to be considered as having been delivered and therefore equivalent in that respect to hard copies: (1) investors must be informed by telephone, fax, letter, e-mail, etc., that they have been sent an electronic prospectus, and (2) they must be able to access the information. As far as the first of these two conditions is concerned, investors are not required to be informed separately if the prospectuses and other materials have (with their advance agreement) been sent by conventional mail on a CD-ROM or floppy

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5 Re: Brown & Wood, February 17, 1995, SEC No-Act. LEXIS 281.

6 Use of Electronic Media for Delivery Purposes, SEC Release, No. 33-7233; 34-36345; IC-21399 (October 6, 1995). For the significance of this release see S. Nakamura, "Intanetto o Riyo Shita Kabushiki Boshu" [Private Equity Offerings and the Internet], Junkan Shoji Homu [Commercial Law Review], No. 1454, 1997. The revisions to the wording (which assumes that documents are hard copies) to reflect technological changes were proposed in Release No. 33-7234 (October 6, 1995) and adopted in Release No. 33-7289 (May 9, 1996).

disk or as a file attached to an e-mail. However, if such a file is available for downloading on a Website, investors must be informed of this separately.

As far as the second of these two conditions is concerned, investors must be able to use the prospectuses and other materials in the same way as a hard copy of a document sent by conventional mail. In other words, investors must be able to save the information and access it at any time. Moreover, if an investor so requests, the securities company or issuer must send him a hard copy of the prospectuses and other materials by conventional mail even if he has already received a copy of the documents in electronic format.

There is a list of 52 hypothetical cases appended to the October release in order to make it as easy as possible for issuers and securities companies acting on behalf of issuers to put them into practice. One example (case no. 35) is of a mutual fund displaying the file of a prospectus on the Internet so that investors can download it or print it out. "Delivery" is considered to have taken place if the mutual fund can reasonably demonstrate that an investor has actually accessed the file with the prospectus.

In its report (see above) the study group set up by the former Financial Supervisory Agency recommends that there should two requirements when documents are delivered electronically: (1) investors must be able to use the data in the same way as if hard copies of the documents had been sent, and (2) the data must be just as clear, reliable and easy to store as hard copies of the documents. The report also argues that, although, in general, delivery cannot be said to have taken place simply because an investor has accessed the data of a document posted on a financial service company's Website and documents should be sent as an attachment to an e-mail, there may be cases (depending on the nature of the document) where posting a document on a Website should be sufficient. As an example of this the report gives documents of an informative nature (such as prospectuses) and suggests that consideration should be given to making it impossible for a customer to purchase securities unless he downloads information and to enabling a customer to download a prospectus during the period of subscription for the securities concerned.

Throughout, the report takes the view that the nature of each type of document needs to be considered in order to decide what exactly should constitute "delivery." Also, although the report may appear similar to the Cabinet order in its emphasis on downloading, it does not take the same inflexible view that "delivery" cannot be considered to have taken place unless downloading has been completed. In this respect, the SEC release is similar in that it emphasizes being able to download as well as whether or not downloading has taken place.

Conclusion

It has been said that in its attempt to cut across departmental boundaries and deal with many different types of electronic document delivery in one fell swoop the Cabinet order has ignored their specific nature and how they are used by reducing the "delivery" requirement to the common denominator of whether the person receiving the document electronically has saved it in a file on his computer.

Admittedly, most of the Cabinet and ministerial orders that were passed at the same time incorporate the same definition of "delivery." However, the Regulations Relating to the Enforcement of the Law Governing the Travel Industry do allow "information in files on a travel operator's computer to be made available so that a traveler can read it via a communications network if files for storing this information are not available on his computer" (25-4-1-c). It is not clear why this was allowed, but it does suggest that the above Cabinet order might have been more flexible in its definition of "delivery."

As far as investor protection is concerned, simply being able to download a file with a prospectus is not exactly the same as actually having downloaded it. For example, some make take the view that the fact that a file with a prospectus has been uploaded to a securities company Website in itself poses the risk that the securities company may have tampered with the file and that, if this is the case, virtually forcing investors to download the file enables them to submit the file as proof.

However, this is a pretty extreme case and hardly sufficient grounds for making it more difficult for securities companies and issuers to deliver prospectuses via the Internet. Moreover, unlike execution confirmations, the details of which will vary from one investor to the next, it would presumably be possible to prove that a prospectus had been tampered with from the testimony of and evidence from other investors who had read, downloaded or printed it out—even if the file had been tampered with on the Internet and the securities company had tried to conceal the fact.

It would also appear that in the course of the debate about the Cabinet order the argument was made that technological advances would make it easier for files to be downloaded from the Internet and that, as a result, investors would not be disadvantaged—even by the current wording of the order. While this view is not altogether unreasonable, it is also possible that, as permanent connections to the Internet become commonplace, an increasing number of investors will consider it sufficient if they are able to refer to documents of an informative nature (such as prospectuses) whenever they want without having to download them each time. In no way can Cabinet orders such as this that disregard modern developments be said to further investor protection. Let us only hope that the order will be revised as soon as possible to make it operate more flexibly.