

Electronic Communication On the Internet

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Using this study guide.

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

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Electronic Communication On the Internet

Introduction

Advances in technology have immensely enhanced communication by allowing information to be transmitted over the Internet. With this enhanced communication, new questions have arisen concerning supervision, review, and retention of correspondence with the public. Other concerns are related to advertising, protection of the public, new trading technologies, and Internet surveillance to identify market manipulation schemes.

Regulation of Electronic Communication

The SEC has attempted to address some of these issues in Release No. 33-7288, 61 Doc. 2167 dated May 9, 1996. This release related views of the SEC regarding electronic delivery of information and meeting federal securities laws. It did not include Self Regulatory Organization Rules, but encouraged SROs to interact with broker-dealer firms to adopt rules relating to these issues. The NYSE and NASD have made efforts to revise their rules for electronic communications between members and clients.

On September 12, 1997, the NYSE proposed a rule amendment to cover the supervision of member communications with the public. The rule was approved by the SEC on December 31, 1997. Before the amendment was proposed and approved, all communications with the public relating to the firm's business required a pre-use review. The new rule is designed to recognize the role of new technologies such as e-mail and the Internet while maintaining appropriate supervision and review. Prior review of outgoing and review of incoming communication is no longer required. Member firms develop and implement their own written procedures, maintaining reasonable supervision of registered representatives' correspondence with the public regarding the member's business. Such procedures are to be tailored to the nature and size of the business. If pre-use review is not a part of a particular firm's procedures, the firm must regularly educate and train employees regarding policies and expectations for communications. Training must be documented and surveillance must be in place to ensure compliance. Periodic re-evaluation of the firm's procedures for reviewing public communications must be a part of each company's plan. Advertisements, market letters, sales literature, and research reports still require prior approval.

When the NASD revised Rules 3010 and 3110, it was their intention to coordinate the new requirements with those of the NYSE. Prior to the revision, firms were mandated to establish procedures that require a registered principal to review and endorse in writing **all** communication of its registered representatives relating to the solicitation or execution of any securities transactions. The revised rule is that members must develop written guidelines for the reasonable supervision by a registered principal of incoming and outgoing written and electronic communication of registered representatives with the public relating to investment banking or securities business of the member firm. Such procedures must mandate the firm to review incoming, written communication directed to registered representatives to properly identify and handle client complaints and ensure that clients funds and securities are handled according to firm guidelines. Documentation of the implementation of these supervisory procedures must be maintained. Like the NYSE ruling, these procedures must be appropriate to the size, structure, and clients of the member firm. If the guidelines do not require review of all communication prior to its use or distribution, the member firm must conduct regular education and training of appropriate employees, document the training, and use surveillance to ensure compliance. Communications regarding investment banking and securities business by registered representatives must be retained by member firms.

Electronic Delivery of Information

The NASDR will allow members to electronically send documents required or permitted by the NASD Rules to clients if the documents adhere to the provisions established by the SEC. The SEC regulations say that broker-dealers may use electronic means of communication to meet delivery obligations if:

1. The notice is timely and the fact that the information is available electronically is adequately publicized.
2. Access to the electronically delivered information is substantially equivalent to the access provided when the information is delivered in paper form.
3. Procedures are established to show that delivery obligations are met and reasonable precautions are taken to ensure that the information sent is delivered as intended.
4. Reasonable precautions are taken to ensure the integrity, confidentiality and security of personal information **and** the

recipient's informed consent is obtained prior to the electronic delivery.

The NASD has filed a proposed revision of NASD Rule IM-4120 relating to issue disclosures over the Internet. Issuers are allowed to send disclosures on company home pages. However, in order to protect investors, news should not be used on the Internet until it is sent to and received by traditional news services. This revision has not yet been approved and is currently open for public comment.

After the May 1996 SEC interpretive release was issued, the Municipal Securities Rulemaking Board issued a response regarding brokers who want to use electronic means of transmitting information. The MSRB sets standards that reinforce those set by the SEC for the transmission of official statements or bond confirmations to clients via electronic delivery means.

Electronic Advertising, Sales Literature, Public Forums and Correspondence

By and large, electronic advertising and sales literature must meet the same requirements as advertising and marketing materials in paper form. NASD Conduct Rule 2210 defines advertisement and sales literature and sets up requirements for approval and record keeping, filing mandates and review guidelines, applicable standards for communications with the public, application of SEC Rules, and standards for the use and disclosure of the association member's name. In 1995, electronic advertising became a part of Rule 2210 and NASD Notice to Members 95-71 broadcast SEC approval to include electronic messages as part of the definition of advertising and sales literature. Rule 2210 now includes items on electronic bulletin boards and messages sent directly to selected individuals or groups. Communication intended for a single client must meet certain parts of Rule 2210. The SEC amendments require that written or electronic correspondence intended for a single customer is subject to the general requirements prohibiting misleading statements, but is not subject to the specific filing and review or the disclosure requirements. As specified in Rule 2210, any communication intended for a single client is not considered sales literature. Correspondence is "...[a]ny written or electronic communication prepared for delivery to a single current or prospective member, and not for dissemination to multiple customers or the general public." **All** correspondence (including electronic) is subject to the anti-fraud provision of the federal securities laws, SEC rules, and NASD rules.

A web site is an advertisement because it uses public media to access a mass audience. Group e-mail is considered sales literature because it directs a specific message to certain groups. Individual e-mail is correspondence since it is normally an individualized client communication. Advertisements, sales literature and correspondence must all adhere to the following NASD Conduct Rules:

1. # 2110: A member must adhere to high standards of commercial honor and just and equitable principles of trade while conducting his business.
2. #2120: Members may not use any means of manipulative, deceptive, or other fraudulent devices or contrivances to make any transaction in, or induce the purchase or sale of any security.
3. # 2310: If a member recommends the purchase, sale or exchange of any security to a client, the member must have reasonable grounds to believe that the recommendation is appropriate for the given customer based upon the facts, if any, that have been disclosed by the customer regarding his other holdings and his financial situation and needs.
4. #3010: All member firms must establish and maintain a method to supervise the activities of each registered representative and associated person to ensure compliance with applicable securities laws and regulations and rules of the NASD.

State registration mandates may apply to the Internet since the Net is available in all fifty states. Using electronic communication may be labeled as solicitation of business and may require registration and/or licensing within the state.

Specific NASD Regulations

The NASD has the following specific regulations relating to websites, hyperlinks to Internet sites, Internet banner advertisements, electronic mail, electronic bulletin boards, chat rooms, and “Broker-Dealer Only” material:

Websites or sites on commercial on-line services are normally considered forms of advertising and are subject to SEC advertising rules and to NASD Rule 2210. This includes general and specific norms for communication with the public, approval, record maintenance, and filing requirements. Websites are required to include the member firm name as part of the information given to

the client. Any new member firm that has never filed advertisements before must file at least 10 days prior to use. Any product-related requirement may use the post-use filing mandates. The NASD offers guidelines regarding placement of risk disclosures and prospectus offers to firms who want to develop websites. Because websites and web pages are interconnected, disclosures may have to be placed at more than one location.

A firm's registered principal must review and approve in writing all websites and updates to websites before posting to ensure compliance with all applicable rules and regulations. This includes websites maintained by individual representatives. A comprehensive list of all domain names must be continuously maintained. Many firms include a system of ongoing spot checks of company and individual websites as part of their mandatory procedures. Information from research reports that is to be posted on websites must also have a registered principal's prior approval in writing.

A NASD member firm is prohibited from linking to a website that the member knows or has reason to know contains false or misleading information about the member firm's products or services. The NASD may mandate that the member provide all contents of any linked information for review if the member's site must be filed with the NASD. The NASD provides a safe harbor from content and filing mandates for ongoing hyperlinks to sites created by independent parties. Any hyperlink on a member firm's website is continuously at the investor's disposal. That is, the member firm has no right to alter information on the linked site and investors have continual access to the link regardless of the information concerning the member firm included there. Such information may, in fact, carry negative connotations. Any linked site could be adapted by the independent party and clients would still have access to the information available there.

Educational hyperlinks is a term used by the NASD to refer to hyperlinks to independent third-party websites whose primary purpose is to inform investors about financial issues and does not refer to the member firm or any of its affiliates.

Links to websites maintained by NASD are allowed if:

1. The page is clearly identified as "NASD Regulation" or "NASD", whichever is appropriate;

2. The appearance, position, and other characteristics of the link may not damage or dilute the goodwill associated with the NASD's or NASD Regulation's name and trademarks;
3. The appearance, position, and other characteristics of the link may not lead to the false impression that an entity is associated with or sponsored by the NASD or NASD Regulation;
4. When a link is activated by a user, it must show the site's full-screen name and not a "frame" on the linked site; **and**
5. At their sole discretion, NASD Regulation and the NASD maintain the right to revoke their consent to any link at any time.

Banner advertisements normally are made up of words, phrases, and/or graphics with a link directly to a designated homepage. The NASD has determined that banner advertisements are equivalent to an envelope in a paper transaction because the banner ad is meant to be "opened" to read the complete communication. If the sole purpose of the banner advertisement is to disclose a member firm's name and enable the user to link to the firm's homepage, no additional disclosures are mandated. But, if the advertisement mentions specific products or services, other disclosures may be necessary.

For mutual funds, mandates for disclosure are dependent of the content of the advertisement. If the banner has only a mutual fund or fund family name and links directly to a homepage that has a properly disclosed and appropriate prospectus, then the banner is not required to have a prospectus or other disclosures. If, however, the banner mentions the desirability of investing in the fund, additional disclosures may be necessary. An example of a banner that needs a disclosure is "XYZ Investments---An Excellent Performance with Positive Results!" Furthermore, NASD Rules mandate that the claims are true and substantiated on the homepage so that the investor is given a sound basis to evaluate the facts.

If sent from the home or office, electronic mail falls under the NASD Rules. Group e-mail is identical electronic mail sent to multiple parties and is considered sales literature by the NASD. It must have prior approval by a registered principal. NASD filing mandates may apply depending on the content of the mail. Individual e-mail is considered correspondence and is subject to review (under Rule # 3010---Supervision) and effective as of November 15, 1998, subject to content standards (Rule # 2210---Communication with the Public).

An electronic bulletin board is a site maintained by a company that lets users post statements and questions for comment by other users. Communications on bulletin boards by member firms or their associated people fall under the rules for advertisements because they can be seen by anyone with access to the service. They must, therefore, be reviewed by a registered principal prior to use and may be subject to filing with the NASD, depending on content.

Chat rooms are Internet sites for interactive conversations among multiple computer users. They are treated the same as radio and television public appearances, so the standards for advertising and sales literature apply. (Refer to Conduct Rule 2210(d)(1)(C)).

Statements made by member firms in public, non-moderated chat rooms are regarded as similar to oral statements made in a public forum and are not considered correspondence, sales literature or advertising. The NASD's position, however, is that if a transcript of the chat room statements can be printed, they may be considered advertising.

Chat room presentations that are scripted are deemed advertisements. They must adhere to all the requirements of NASD Conduct Rule 2210 (Communications with the Public) and require prior approval of a registered principal. Additionally, they may require filing and approval by the NASD.

Federal laws and NASD rules prohibit members and associated persons from making misleading or fraudulent statements in chat rooms relating to securities products or services. Registered representatives must follow the same rules and meet the same requirements for communication about services and securities products in a chat room as for communications before a group of investors. The member firm must supervise investment related chat room conversations by their registered personnel. The degree of disclosure and identification of member firms is a much-debated topic in the industry at the present time. Topics of concern are whether or not the communication solicits business and whether it affects prices of specific securities. Decisions for these concerns must be made on an individual, case by case basis.

Sites intended for "brokers or dealers only" normally require a password for access and, therefore, are not required to be filed for review. Such sites, however, must be open for review during NASD and SEC examinations.

Each firm's written procedures must include ways of supervising any electronic advertising used by the firm's representatives and associates.

Investor Protection Initiatives

Ensuring investor's protection is extremely difficult due to the size and speed of the Internet. NASD Regulation maintains a web page to help prevent investors from being misled by investment information found on the Internet. NASDR also reminds member firms of the suitability obligations they must follow when recommending securities offered through Internet promotionals. The NASDR web page (WWW.NASDR.com) posts educational brochures that warn clients about making investment decisions based completely on information received from the Internet and lets investors know that the purpose of some claims made anonymously on electronic bulletin boards is to manipulate securities' prices.

The NASDR web page gives investors tips on how to work with brokers, procedures that will help them avoid problems, and what to do when a broker calls them. The site also lists instructions for filing customer complaints and provides a format for on-line filing of complaints. A portion of the site is dedicated to a Public Disclosure Program so investors may request information about specific brokers. Another portion of the site is dedicated to "Notices to Members," which lists current topics out for public comment and gives investors an opportunity to file comments on-line. The site also reminds member firms of their supervisory and regulatory responsibilities and their obligations to clients when dealing with products promoted on the Internet.

Internet Monitoring by the NASDR

In the past, the NASDR staff used commercially available search engines which basically targeted suspicious price or volume movements to inspect Internet forums for stock information. But a new Internet monitoring system called NetWatch has been developed. Phase I of NetWatch is currently operational and helps NASDR target manipulative actions prior to price or volume movements. The system "crawls" about 500 Usenet Newsgroups, Nasdaq and OTC issuer sites, Bulletin Board Sites, and News Sites and gathers all new content daily. Information is taken from the Internet and downloaded daily, stored in a database, and referenced according to key words or phrases. NetWatch recognizes variations of company names so that information is grouped appropriately and is readily available for dissemination if requested. If

a particular security has an unusually high volume of Internet data transferred on a specific day, NetWatch sends “notifications” to analysts so they may investigate accordingly. Analysts are allowed to pose questions and view answers on the browser as part of their investigations. Data gathered in these investigations and any notifications posted are stored to provide historical data if needed at any future date.



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