NASD Notice to Members 96-50

Supervisory And Other Obligations Related To Use Of Electronic Media

Suggested Routing

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Executive Summary

NASD Regulation, Inc. (NASD Regulation) recently has observed a correlation between sharp increases in the volume of electronic messages relating to certain low-priced securities and dramatic increases in the price, volatility, and volume of these securities. Often, these messages are sent without attribution to a large, undifferentiated universe of Internet or on-line subscribers and contain unverified or unverifiable information concerning the merits of particular securities. This development, along with the potential that associated persons may use the Internet or other electronic media to communicate messages concerning particular securities to the investing public, raises important regulatory issues.

While NASD Regulation is not concerned about member use of the Internet or other electronic media for legitimate purposes, we are issuing this *Notice to Members* to emphasize to members their supervisory and regulatory responsibilities, as well as their obligations to customers, when dealing with stocks promoted on the Internet or other electronic media, and their supervisory obligations with respect to the use of such media by their associated persons. In addition, this *Notice to Members* solicits comment on current practices in the use of electronic media to communicate with customers and the investing public generally concerning the merits of particular securities, with a view to determining the need for further specific guidance concerning supervisory responsibilities or regulatory action.

Questions or comments concerning this Notice may be directed to Mary Revell, Assistant General Counsel, NASD Regulation, at (202) 728-8203.

Electronic Communications

Members must ensure that communications with the public disseminated through electronic media comply with the approval, recordkeeping, and filing requirements of NASD® Rules. For more information, see "Ask the Analyst About Electronic Communications" in the April 1996 issue of the *NASD Regulatory & Compliance Alert* for a detailed description of the applicability of NASD Rules to various methods of electronic communication, including World Wide Web sites, bulletin boards, group and individual e-mail, and chat rooms. Members should also review *Notice to Members 95-74*, which announced the amendment of the definitions of "advertisement" and "sales literature" in NASD Rules to include electronic messages. Members are reminded that all communications with the public, regardless of the medium, are subject to the antifraud provisions of the federal securities laws, SEC rules, and NASD Rules. In this connection, we would clarify that e-mail directed only to an individual customer, like a piece of written correspondence sent to an individual customer, is not "advertising" or "sales literature" subject to NASD Rule 2210 (formerly Article III, Section 35 of the NASD Rules of Fair Practice).

Suitability

NASD Rule 2310 (formerly Article III, Section 2 of the NASD Rules of Fair Practice) provides that in recommending to a customer the purchase, sale, or exchange of any security, a member must have reasonable grounds for believing that the recommendation is suitable for such customer on the basis of the facts available, including the customer's other security holdings, financial situation, and needs. If a principal source of a member's information about a recommended security is the Internet, on-line communications, or other electronic medium, the member should consider the need for further investigation or research before recommending the security. In general, members should review carefully the appropriateness of transactions in such securities, and should encourage customers to learn about such securities before investing in them.

Special care should be taken where a member or associated person transmits via e-mail, television, radio, or other electronic medium messages concerning a particular security to a broad universe of investors of varying financial sophistication, experience, and resources. In such circumstances, the suitability of the security should be determined with respect to each customer who responds to the message before effecting a transaction. Further, consideration should be given to the desirability of including a notice in the electronic transmission alerting the recipients of the message to the need to assess the security in the context of each customer's individual circumstances.

Disclosure Of Material Adverse Facts And Interests To Customers

When a registered representative recommends the purchase or sale of a security to a customer, he or she must not only avoid affirmative misstatements, but also must disclose material adverse facts about which the salesperson is, or should be, aware. This obligation includes disclosing any conflicts of interest that could influence the salesperson's recommendation or the customer's decision to purchase or sell the security. Particular care should be taken with respect to the accuracy and completeness of information concerning securities that have been promoted on the Internet or other electronic media.

Supervision

Members that use electronic media to communicate with customers and investors as to the merits of particular securities must ensure that their supervisory procedures appropriately cover these activities. In a broader context, members should consider the need for specific policies that address how and under what circumstances their associated persons are permitted to use such electronic media to communicate with investors. The need for supervision is particularly acute where the communication medium permits the transmission of anonymous messages to "chat rooms" or "bulletin boards" sponsored by various on-line services connected to the Internet.

Members are reminded that their internal controls and supervisory procedures should be designed to ensure that associated persons do not misuse electronic communications systems or engage in any misconduct while on-line. NASD Regulation currently is conducting a review of the need for further explicit guidance or regulatory action regarding the supervisory responsibilities of member firms in this respect.

Questions

The NASD intends to conduct in the near term a survey of its members with regard to the use by members of the Internet and on-line services. We expect the survey to be completed and the results to be compiled by the third quarter of 1996. Independent of this survey, the NASD is soliciting comment from members on the questions listed below, which are directed specifically to electronic communication with investors by members and associated persons and related supervisory issues. Members are asked to send written comments in response to these questions, by September 15, 1996, to:

Joan Conley
Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500.

1. In what ways do member firms and their associated persons use electronic media to communicate information concerning securities to their customers?

2. In what ways are these electronic media used to communicate such information to investors or members of the public who do not have an established customer relationship with the member?

3. What sorts of policies and procedures have been adopted by member firms with respect to access by associated persons to on-line services and other electronic media? What policies and procedures apply to communication with customers via e-mail, including any access restrictions or restrictions as to the nature of the message communicated?

4. What mechanisms have been put in place or considered to assure that policies and procedures in this area are being followed?

5. Specifically, to the extent that associated persons are permitted access to electronic media such as the Internet, what kind of recordkeeping and supervisory procedures are used with respect to any messages that are sent?

6. To what extent do policies and procedures differ with respect to communications relating to securities in which the member makes a market or holds a position?

7. To what extent are members aware of the use of electronic media by others to attempt to influence the price of a security? Would prophylactic regulatory measures be appropriate or useful in limiting the occurrence of this activity, and if so, what kind?