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**Broker-Sponsored Online Chat Rooms:**

**Concerns and Best Practices**

American Conference Institute  
conference on  
**Securities Trading on the Internet**

January 25 & 26, 1999  
The Waldorf Astoria  
New York City

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## Broker-Sponsored Chat Rooms:

### Concerns and Best Practices\*

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#### I. Introduction

- A. With customers clamoring for interactive investment-related content and online brokers striving to create “online communities,” online brokers have edged their way into providing chat rooms, online seminars and bulletin boards, even though securities regulators continue to wrestle with some of the thornier questions involved.
- B. When E\*trade announced last spring that it would launch chat rooms, securities regulators were reportedly caught off guard, in part because they had yet to come to grip fully with some of the policy and regulatory issues. Securities regulators expressed hedged concern, colored no doubt by widespread reports of chat room abuses. In a comment that typified the jaundiced view of chat rooms held by many securities regulators, the SEC’s Deputy Director of the Division of Market Regulation, Robert Colby, remarked that, “[i]f the postcard is the predecessor to e-mail, then the bathroom wall is the predecessor to chat rooms.” *Legal Pros, Regulators Voice Concern over Broker/dealer Chat Rooms*, Financial Net News (June 1, 1998).
- C. Since then, several online brokers, including E\*trade and A.B. Whatley, have launched chat rooms. (Other firms, including Charles Schwab & Co., Inc. and Quick & Reilly, are reportedly following suit in the near future.) By all appearances, the abuses that have occurred in unregulated chat rooms have not occurred in broker-sponsored chat rooms, which suggests that chat rooms can be operated responsibly in a broker-sponsored environment.

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- D. Still, as in other situations where a Web site incorporates user content, chat rooms can raise a host of difficult legal issues. Securities regulators have yet fully to assess how to deal with chat rooms sponsored by brokers, including defining what responsibility, if any, a sponsoring broker has for chat room content. Established legal principles can impose secondary liability on Web site operators, including brokers, for improper conduct by their users. In this environment, brokers planning to sponsor chat rooms and bulletin boards incorporating user postings should take steps both to satisfy regulatory obligations (as they evolve) and to manage the associated risks.

II. Chat Rooms – Concerns. Chat rooms raise concerns at three levels: opportunities for fraud, investor confusion, and intellectual property-related issues.

A. Fraud (Cyberfraud).

1. While chat rooms permit far more sophisticated and up-to-date dialogues among investors than their predecessor, investment clubs, they are vulnerable to fraud. For many, chat rooms conjure up images of modern-day “boiler room” operations where rogue brokers (or others) defraud unwitting investors – except that chat rooms can provide a far wider dissemination of information virtually instantaneously. It is these types of chat rooms that NASD Regulation President Mary Schapiro recently branded as having helped “fuel a bull market in microcap stock fraud.” Mary L. Schapiro, Remarks to the Society of American Business Editors and Writers (November 17, 1998) <[http://www.nasdr.com/1420/schapiro\\_11.htm](http://www.nasdr.com/1420/schapiro_11.htm)>. This concern has been fueled by the rash of touters using the Internet to hype stocks without disclosing their interests in the touted stocks, which has prompted enforcement sweeps by securities regulators. See, e.g., *SEC Conducts First Ever Nationwide Internet Securities Fraud Sweep, Charges 44 Stock Promoters in 23 Enforcement Actions; Purveyors of Fraudulent Spam, Online Newsletters, Message Board Postings, and Web Sites Caught in Effort To Clean Up the Internet*, SEC Press Release (October 28, 1998) <<http://www.sec.gov/news/press/98-117.txt>>.
2. Companies running chat rooms and message boards, like Motley Fool, Silicon Investor and Yahoo!, have recently been taking steps to discourage fraudulent postings on their chat rooms. Yahoo!, for example, shut down its message boards on Penny Stocks and beefed up its efforts to prevent participants from using multiple online identities. See *Gregg Wirth, supra*.

B. Investor Confusion.

1. Even if chat room information is not outright fraudulent, securities regulators continue to be concerned in the online brokerage context that the flurry of online information (including in chat rooms) – together with the lack of individual hand holding – can create problems of investor protection for unsophisticated investors.

2. In an important address late last year, Mary Schapiro commented that: “This disintermediation creates potential hazards for those investors who may not have the knowledge or experience to adequately determine which information is worthwhile or to use it effectively. . . . So when a customer sends a trade through this kind of system, the question is, what information or advice is he or she reacting to? Unfortunately, in a lot of cases, it may be nothing more than the kind of garbage that fraudsters used to peddle to one investor at a time through a cold call from a boiler room but can now send via the Internet to thousands in literally seconds. . . . Investors are also reacting to the information they read on Internet Bulletin Boards and in chat rooms. These venues are rife with anonymous tips, intentionally misleading information and hype.”

C. Intellectual Property Related Issues.

1. Through not intrinsically a securities-related concern, chat rooms may provide forums in which users can engage in a range of improper conduct related to others’ intellectual property or related interests. These include intellectual property infringement and, as is more typical with chat rooms, defamation and libel (so-called “cybersmearing”).
2. Companies are increasingly suing chat room participants for cybersmears. Accordingly to the *San Francisco Daily Journal*, suits in “unprecedented numbers” are being filed by companies for what they deem false and defamatory online commentary. See *M. L. Stein, Libel Suits Against Online Messages Increase*, E&P Interactive (November 11, 1998) <<http://www.MediaINFO.com/ephome/news/newshtm/stories/111198n2.htm>>. Many of these cases are brought as “John” or “Jane Doe” actions against anonymous posters seeking first to compel chat room operators to disclose the identities of the offending posters.
  - a. For example, PacifiCorp, Universal Foods, Philip Services and Itex have reportedly filed suits against dozens of “Jane” or “John Does” who allegedly posted defamatory or insider information on message boards. See *Gregg Wirth, Battle on the Boards, The Industry Standard* (November 16, 1998) <<http://www.thestandard.net/articles/display/0,1449,2492,00.html?related.144>>.
  - b. Hemispherx Biopharma is reported to have sued a short seller in September 1998 for allegedly spreading inaccurate information about the company on the Internet. *Id.*
  - c. The chairman of one public company, Legacy Software, reportedly sued three individual investors for allegedly posting defamatory postings in a Silicon Investor bulletin board (and even posted the complaint on the very

bulletin board on which the alleged improper postings appeared). See Polly Sprenger, *Dirty Laundry Airs on Stock Site*, Wired News (December 11, 1998) <<http://www.wired.com/news/news/business/story/16785.html>>.

III. Securities Regulatory Treatment of Chat Rooms. As noted above, securities regulators have yet fully to assess how to deal with chat rooms sponsored by brokers, including defining what, if any, responsibility a sponsoring broker has for chat room content. Most of the guidance in the area has come from the NASD, which has issued a handful of interpretations and statements relating to chat rooms.

A. Customer Chat.

1. Postings by customers on a broker's chat rooms or bulletin boards are not treated as advertising or sales literature or subject to NASD Conduct Rule 2210, relating to communications with the public, since they are not communications *by* a broker or its associated persons. When adopting the revised definitions of "advertisement" and "sales literature" in 1995, the NASD published several interpretations shedding light on the extent to which brokers are responsible for customer electronic communications. The NASD made clear its view that the terms "advertisement" and "sales literature" do not include customer postings. "The new definition of 'advertisement' does not . . . include communications posted by members of the public on electronic bulletin boards sponsored by NASD members; it has *never* applied to communications *by* the general public." NASD Notice to Members 95-74 (emphasis added); see also Securities Exchange Act Release No. 36076 (August 15, 1995).
2. In another context, the SEC staff has reminded broker-dealers doing business over the Internet that they should consider the extent to which they are responsible for third-party content available through their Web sites. See *Charles Schwab & Co., Inc.* (available September 18, 1997). While securities regulators might be tempted to invoke this principle in the chat room context, it is unclear how brokers could realistically assume responsibility for customer chat in sponsored chat rooms.

B. Broker Chat. Unlike customer chat, brokers are directly responsible under NASD Conduct Rules, including Conduct Rule 2210, for chat postings and other public appearances by their representatives.

1. Not Advertising, Sales Literature or Correspondence. Chat room postings by firms and their representatives are not treated as advertising, sales literature or correspondence under NASD rules. The NASD considers chat rooms a public forum using an electronic medium. "As interactive, extemporaneous conversations, chat rooms are not generally considered correspondence, sales literature, or advertising." *Ask The Analyst About Electronic Communications*, NASD Regulatory & Compliance Alert (April 1996).

2. Broker Chat Still Subject to the Standards of Conduct Rule 2210.

- a. According to the NASD, as with oral communications, representatives and their firms are “accountable under the [Conduct Rules] and the federal securities laws for what they say regarding securities products or services when participating in chat rooms.” *Ask The Analyst About Electronic Communications*, NASD Regulatory & Compliance Alert (April 1996); *see also* NASD Notice to Members 95-74.
- b. In *Member Firms Seek Guidance On Public Appearances*, NASD Regulatory & Compliance Alert (September 1997) <<http://www.nasdr.com/pdf-text/rca0997.txt>>, the NASD elaborated on the obligations of brokers and their representatives when participating in chat rooms, making clear that such activities are subject to the standards of NASD Conduct Rule 2210.
- c. As applicable to chat rooms, Rule 2210 would, according to the NASD:
  - (1) Require “full and fair description of any securities product or service” discussed and “material information such as risks or costs.”<sup>2</sup>
  - (2) Prohibit “exaggerated, unwarranted, or misleading statements or claims, including promises of specific future returns or projections of investment performance.”
- d. Even though chat by a representative is subject to Conduct Rule 2210, this does not require that the representative identify him or herself as a representative. According to the NASD in its *Internet Guide for Registered Representatives* <<http://www.nasdr.com/4040a.htm>>, “[t]he participation by RRs in investment-related chat rooms, without identifying themselves as such, is not specifically a violation of NASD rules. However, the fact that an individual is registered subjects him/her to a higher standard than members of the general public.”

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<sup>2/</sup> In the radio call-in show context, the NASD explained the operation of this requirement: “For example, in response to a caller’s question during a radio broadcast, a representative recommends a specific stock of local interest that is trading in the secondary market. This recommendation is permitted, provided the representative satisfies the disclosure requirements of Rule 2210. Thus, the representative is required to disclose certain material relationships between his firm and the security, such as that his firm makes a market in the stock. In addition, he must provide the current price of the stock and mention if there are any special risks associated with the security, e.g., that the local company issuing the stock is risky because it is still in its start-up phase.”

3. Supervision. A broker's obligation to supervise its representatives extends to chat rooms. The NASD has stressed that, if a broker permits its representatives to contribute to chat room exchanges, it must provide appropriate guidance and supervision. In this regard, the NASD has said that "[t]he 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." *Supervisory and Other Obligations Related to Use of Electronic Media*, NASD Notice to Members 96-50 (July 1996) (emphasis added).
  - a. Extemporaneous Participation. According to the NASD, if a broker permits its representatives to participate in a chat room extemporaneously, the broker must have procedures for the supervision and approval of such appearances. *Member Firms Seek Guidance On Public Appearances*, *supra*. According to the NASD,
    - (1) There should be a mechanism in place for prior approval of each public appearance.
      - (a) In this connection, a firm might require the submission of a written outline or guest list before approval.
    - (2) While a broker cannot control each statement made by a representative, the broker must provide clear guidance as to what may and may not be discussed.
      - (a) A written list of acceptable and unacceptable subjects or statements (*i.e.*, "do's and don'ts") can help.
      - (b) Firms should make clear to representatives that they may not discuss securities products they are not licensed to sell.
    - (3) Procedures should also provide for the review and monitoring of chat room presentations by representatives as they occur or later.
  - b. Scripting. According to the NASD, if participation by a representative in a chat room is scripted, the script is deemed advertising and, as such, must receive the prior, written approval of a principal. *Member Firms Seek Guidance On Public Appearances*, *supra*.
    - (1) The broker must retain a copy of each script for 3 years and note who prepared and approved the script. NASD Conduct Rule 2210(b).

- (2) Depending on the content of the scripted presentation, the type of material used, and the status of the broker, scripted material may be subject to filing with the NASD's Advertising/ Investment Companies Regulation Department under Conduct Rule 2210(c).
4. Suggested Limitations. Beyond addressing the application of its advertising and supervision rules to chat rooms, the NASD has also suggested that brokers and their representatives observe some limits in chat room discussions. *See Member Firms Seek Guidance On Public Appearances, supra.*
- a. Steer Clear of Risky Stocks. The NASD suggested that chat rooms may not be appropriate forums to discuss high risk securities because of the possibility that viewers may begin viewing the discussion at any time and could miss important information.<sup>3</sup>
- b. Don't Assume Investor Sophistication (Aim Low). Noting that “[m]ember firms and associated persons have little control over the audience for a radio or television broadcast or an on-line chat room,” the NASD urged brokers to craft their statements to suit a broad, general audience. “In preparing and supervising these mass media appearances, members must limit the message to one appropriate for a broad, general audience. One cannot assume a specific level of audience knowledge, experience, or suitability.” *Member Firms Seek Guidance On Public Appearances, supra.*
- c. Avoid Technical Jargon. “Technical terminology or jargon may also mislead or fail to enhance the audience’s understanding of the product. While a financial professional may understand that the phrase, ‘Subject to market fluctuation,’ means the investment can lose money, a first-time investor may not.” *Member Firms Seek Guidance On Public Appearances, supra.*
- d. Overall, Be Careful. In its *Internet Guide for Registered Representatives* <<http://www.nasdr.com/4040a.htm>>, the NASD urged caution in wording chat room statements. “Given the fast-paced environment of chat rooms, statements that are not carefully constructed have the potential of crossing the line between being a reasonable opinion and an exaggerated or unwarranted claim. This type of concern might arise when touting or bashing a particular stock occurs. Because of the difficulties of supervision

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<sup>3</sup>/ This point seemingly contradicts the NASD’s earlier example, discussed in footnote 2 above, of a representative recommending a risky, start-up company in a radio call-in show. In this example, the NASD, rather than urge that the representative steer clear of risky stocks, only noted the need for disclosure of the risks of start-ups. Like chat rooms, radio listeners tune in and out and, according to the NASD’s rationale, could “miss important information.”

and the potential liabilities from participating in chat rooms, many firms limit or prohibit participation altogether.”

C. Open Issues.

1. Secondary or Vicarious Liability for Chat Room Postings. One issue that has yet to come into focus in the chat room context is the extent, if any, that a chat room sponsor like a broker may have potential secondary liability for securities laws violations, including fraud, by chat room participants.
  - a. The Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”) each provide for secondary or vicarious liability in certain circumstances where the person to be held secondarily responsible controlled the primary wrongdoer or either induced or knowingly and substantially assisted in the improper conduct. *See* Securities Act § 15; Exchange Act §§ 20(a), 20(f), 21A & 15(c)(4).
  - b. A person may also be secondarily liable for securities fraud under the theory of aiding and abetting, which in the federal securities laws context requires three elements: (i) a primary or independent securities law violation that has been committed by some other person; (ii) awareness or knowledge by the alleged aider and abettor that his or her role was part of an overall activity that was improper; and (iii) that the alleged aider and abettor knowingly and substantially assisted the conduct that constitutes the violation. *See Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1009 (11<sup>th</sup> Cir. 1985); *Investors Research v. SEC*, 628 F.2d 168, 178 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); *IIT v. Cornfield*, 619 F.2d 909, 922 (2d Cir. 1980); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 94-97 (5<sup>th</sup> Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6<sup>th</sup> Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *William R. Carter*, 47 SEC 471, 502-03 (1981).
    - (1) The knowledge or awareness requirement can be satisfied by recklessness when the alleged aider and abettor is a fiduciary vis-a-vis the injured party or an active participant. *See Ross v. Bolton*, 904 F.2d 819, 824 (2d Cir. 1990); *Cornfield*, 619 F.2d at 923, 925; *Rolf v. Blythe, Eastman Dillon & Co.*, 570 F.2d 38, 47-48 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Woodward*, 522 F.2d at 97. Negligence is not sufficient.
    - (2) “Substantial assistance” is considerably more difficult to establish because the alleged aider and abettor’s conduct must be more than ministerial. Rather, it must be a proximate cause of the primary violation and generally must embrace something more than mere inaction. *See, e.g., Armstrong v. McAlpin*, 699 F.2d 79, 82 (2d

Cir. 1983); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980). If, however, the alleged aider and abettor actually knew of the violation, inaction or silence may constitute substantial assistance, especially where the aider and abettor had a duty to act or stood to benefit from its inaction or silence. *See, e.g., National Union Fire Ins. Co. v. Turtur*, 892 F.2d 199, 206-07 (2d Cir. 1989); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7<sup>th</sup> Cir. 1986); *IIT v. Cornfeld*, 619 F.2d at 923-26; *Brennan v. Midwestern Life Ins. Co.*, 417 F.2d 147, 151-55 (7<sup>th</sup> Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

- c. Viewed within this framework, it seems a bit of a stretch to say that a broker would in the ordinary case be subject to secondary liability for violations of federal securities laws occurring within chat rooms sponsored by the broker.
- (1) First, in the ordinary case, a broker could not be said to “control” chat room participants for purposes of the secondary liability provisions of Securities Act Section 15 or Exchange Act Sections 20(a) and 21A.
  - (2) Second, a broker – especially an online broker – is not typically a fiduciary vis-a-vis its customers. Therefore, it should not typically be liable for aiding and abetting except where it actually is aware or knows of its role in an improper activity and knowingly and substantially assists the conduct that constitutes the violation. Recklessness or inactivity should not suffice.
  - (3) Even, if for argument’s sake, one assumed that a broker was a fiduciary vis-a-vis its customers or otherwise judged under the lesser recklessness and inactivity tests, it is not clear what conduct by the broker in running the chat room would rise to the level of recklessness, which involves “an extreme departure from the standards of ordinary care.” *SEC v. Steadman*, 967 F.2d at 641-42 (quoting *Sunstrand Corp. v. Chemical Corp.*, 533 F.2d 1033, 1045 (7<sup>th</sup> Cir.), *cert. denied*, 434 U.S. 875 (1977)).
  - (4) Perhaps, the only types of conduct by a broker running a chat room that might suggest possible recklessness would involve the complete failure by the broker to disclose that it does not review or approve postings, although arguably this should be apparent to all chat room participants even if not stated expressly.
  - (5) Scarcely anything has been written on what conduct in connection with a chat room would support potential aiding and abetting

liability on the part of persons other than the actual posters of information.

- (a) Professor John C. Coffee, Jr. of Columbia University Law School has suggested that anonymous re-mailers might be subject to aiding and abetting chat room fraud. In this context, he stated that “[i]f the SEC were to adopt a release indicating a view that re-mailing communications, in a manner to render them anonymous, to a chat room or newsgroup known to be conducting discussions about securities prices and values could make one an aider and abetter of the original party’s primary violation,” the provision of anonymous re-mailing services might decline. John Coffee, *Brave New World?: the Impact(s) of the Internet on Modern Securities Regulation*, *The Business Lawyer* (August 1997), at text accompanying note 106.
- (b) Professor Coffee has also stated that it is not clear that chat room operators have a legal obligation to monitor chat rooms, including comments that come from anonymous re-mailers. In this context, he states “[a]ttempts to impose such a duty seem beyond the authority of the SEC, particularly when it has jurisdiction to enjoin only knowing’ aiders and abettors.” In this regard, he has further observed that, although the protections under the Communications Decency Act of 1996 (discussed below) do not extend to potential aiding and abetting liability generally, Congress seems to have intended to protect online providers from liability for suits based on a failure to monitor information content providers. *Id.* at text accompanying note 110.

2. Duty to Pre-Screen Postings? Does a broker have an obligation by virtue of its status as a broker-dealer to pre-screen postings in chat rooms it sponsors? Arguably it should not, but a broker’s obligations in this area may depend on the circumstances and what the broker says it does – or does not do – in the way of pre-screening.

- a. Challenge of Pre-Screening. Realistically, it would be extremely difficult, if not almost impossible, for a broker substantively to pre-screen postings. For each posting a broker would have to carefully, yet rapidly, review the posting, investigate the circumstances surrounding the posting and make an on-the-spot judgment. The sheer number of postings on chat rooms would create an almost impossible burden.

- b. Pre-Screening May Feed Potential Liability. Arguably, a broker's potential liability may be increased by pre-screening postings.
    - (1) First, active screening or monitoring will give the broker actual or putative knowledge of user postings and, thereby, fuel the possibility that the broker will be liable for user misconduct (other than liability for matters covered by the Communications Decency Act of 1996, discussed below).
    - (2) Second, as suggested by Mary Schapiro in her November 17, 1998 address, "if a broker-dealer operates a chat room with a moderator to ensure nothing untoward is said, are they, by implication, vouching for the quality of information displayed on the site?"
  - c. Clear Disclosure May Obviate Need. If a broker is careful to negate any implied endorsement of or "vouching for" chat room postings and to remove offending material promptly (if available in archival or other form), the need for pre-screening may be obviated. Nevertheless, any sponsoring broker will have to watch SEC, NASD and other self-regulatory organizations for pronouncements in this area.
3. Implied Recommendations? If a broker opens a sponsored chat room devoted to discussions in a specific stock, does that mean that the broker has impliedly recommended that stock?
- a. It should not, but a broker should make clear that, by operating the chat room or creating specialized chat rooms for particular stocks it does not recommend the stocks discussed.
  - b. In NASD Notice to Members 96-60, the NASD stated "[i]n particular, a transaction will be considered to be recommended when the member *brings a specific security to the attention of the customer* through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages." This statement ignited industry concerns that a broker could be deemed to have recommended a security if, for example, it makes available electronically to a customer third-party research about a security or otherwise draws the security to a customer's attention – regardless of whether a recommendation was intended or understood by the customer as having been made.

- c. In response to industry criticisms,<sup>4</sup> the NASD clarified that, in deciding whether a communication involves a “recommendation,” one should apply a “facts and circumstances” test. According to the NASD, “[t]his language was intended only to stress that recommendations may be made in a variety of ways, and that the determination of whether a recommendation has been made in any given case does not depend on the mode of communication . . . . The language was not meant to describe the content of communications that may result in a recommendation, or to suggest that every statement that includes mention of a security would be considered a recommendation. Whether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances, which the Notice was not intended to define.”<sup>5</sup>
4. Applicability of SRO Complaint Rules? Is a complaint expressed by a customer in a broker-sponsored chat room a “complaint” for purposes of NASD recordkeeping and reporting requirements under Conduct Rules 3070 and 3110(d)? Arguably, no.
- a. NASD Conduct Rules treat as “complaints” only *written* complaints. Specifically, NASD Conduct Rule 3110(e) defines “complaint” to mean “any *written* statement of a customer or any person acting on behalf of a customer alleging a grievance involving the activities of those persons under the control of the member in connection with the solicitation or execution of any transaction or the disposition of securities or funds of that customer.” Given the NASD’s statements that “as interactive, extemporaneous conversations, chat rooms are not generally considered correspondence, sales literature, or advertising,” it should follow that complaints made through chat rooms are not “complaints” for purposes of NASD rules but are more akin to oral statements, which are not treated as complaints.
  - b. Moreover, a customer posting a chat room complaint arguably is engaging in public “venting” and should not really be said to have directed the

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<sup>4</sup> See, e.g., Letter, dated December 23, 1996, to John Pinto, Execution Vice President, NASDR from Stuart J. Kaswell, Senior Vice President and General Counsel, SIA <<http://www.sia.com/sia08za.htm>>.

<sup>5</sup> See NASD Notice To Members (March 1997); see also Letter, dated January 23, 1997, to Stuart J. Kaswell, Senior Vice President and General Counsel, SIA from John M. Ramsay, Deputy General Counsel <[http://www.nasdr.com/2910/2310\\_04.htm](http://www.nasdr.com/2910/2310_04.htm)>; Letter, dated January 23, 1997, to Paul Saltzman, Senior Vice President and General Counsel, PSA from John M. Ramsay, Deputy General Counsel <[http://www.nasdr.com/2910/2310\\_03.htm](http://www.nasdr.com/2910/2310_03.htm)>.

complaint to the broker for resolution. Rather, the customer has directed the complaint to “the world,” or at least other participants in the chat room.

- c. Nevertheless, since chat rooms are at best an awkward forum to field complaints, chat room participants should be urged to take broker-related complaints “off line.”

5. Recordkeeping Requirements?

- a. Brokers are required under SEC Rule 17a-4(b)(4) to preserve for three years “originals of all communications received and copies of all communications sent . . . relating to” its business as a broker. Are brokers required to maintain copies of chat room communications on their sponsored chat rooms?
- b. This is unclear, but arguably user postings on a broker-sponsored chat room may not be “received” by the broker if the chat room is administered, for example, by a chat room hosting service. If these postings are “received” by the broker, they may not relate to the broker’s business as such.
- c. In any event, if chat room postings were deemed subject to Exchange Act recordkeeping requirements, the associated costs would be tremendous.
- d. Nevertheless, sound business practices might dictate that a broker maintain records of chat room postings for some reasonable (though short) interval of time for monitoring purposes and to assist in any lawful investigations.

6. Hyperlinks to Third-Party Chat Rooms and Bulletin Boards?.

- a. Should brokers link to third-party chat rooms? The NASD has indicated that a broker should not link to Web sites that it knows contains misleading information about the broker’s products or services. *Ask The Analyst About Electronic Communications*, NASD Regulatory & Compliance Alert (April 1996); *see also* Letter, dated November 11, 1997, Craig Tyle, General Counsel of the Investment Company Institute.
- b. At least one commentator has suggested that this rule could “easily be extended to bar linking to a website in which anonymous and non-traceable communications were known to be prevalent.” John C. Coffee, Jr., *Brave New World?: the Impact(s) of the Internet on Modern Securities Regulation*, *The Business Lawyer* (August 1997), at text accompanying note 113.

IV. Intellectual Property Related Issues. As noted above, chat rooms may provide forums in which users can engage in a range of improper conduct related to others’ intellectual property or related interests. These include intellectual property infringement and, as is more typical with chat rooms, defamation and libel. Depending on the circumstances, the sponsor of a chat room can be secondarily responsible for the infringing or improper content.

A. Intellectual Property Infringement.

1. Overview of Secondary Liability. Chat rooms theoretically could be used to infringe another person's intellectual property, whether in the form of copyrights, trademarks or trade secrets. Although the incidence of this misconduct would seem infrequent, the sponsor of a chat room could be secondarily liable for such infringement, depending on the circumstances, under theories of direct, contributory or vicarious infringement. Liability for contributory infringement generally requires knowledge of and substantial participation in the infringement. Liability for vicarious infringement generally requires the right and ability to control the infringer and the receipt of some direct financial benefit from the infringing activity.
2. DMCA "Safe Harbor". On October 28, 1998, President Clinton signed into law the Digital Millennium Copyright Act ("DMCA"). DMCA establishes several "safe harbors" insulating online service providers, including chat room sponsors, from secondary liability (for example, under theories of direct, contributory or vicarious infringement) for copyright infringement by their users. Without going into the details, a provider will not be liable under DMCA for copyright infringement by virtue of its transmitting, routing or providing connections for, infringing material through the provider's system or network, or by reason of the provider's intermediate or transient storage of such material, if certain conditions are satisfied. Specifically, a provider should not be liable if (i) the offending transmission was initiated by another person; (ii) the transmission, routing, connection or storage was carried out automatically, with no selection of material by the provider; (iii) the provider did not select the recipients of the material; (iv) no copy made by the provider was maintained on the system in a manner ordinarily accessible to anyone other than the intended recipients for a longer period than reasonably necessary; and (v) the material was transmitted without modification. In addition, to be eligible for the safe harbors, a provider must have adopted and implemented a policy providing for termination of users who are repeat infringers and take steps to inform users of the policy.

B. Defamation and Libel (Cybersmears).

1. Overview of Publisher Liability. Chat rooms more frequently pose the risk that a chat room participant would use the chat room forum for defamatory or libelous purposes. As a general matter, a person who "publishes" either information of his own creation or information created by another can be liable for any defamatory or libelous content even absent proof of specific knowledge of the content. On the other hand, a person who merely distributes information cannot be held liable for its content unless the person knew or had reason to know of the objectionable nature of the information. See W. Page Keeton et al., *Prosser and Keeton on the Law of Torts* § 113 at 810-11 (5<sup>th</sup> ed. 1984).
2. Problematical Case Law. Until 1996, the law in the area was problematical and inconsistent. For example, under a 1995 ruling in *Stratton Oakmont v. Prodigy Services, Inc.*, 1995 N.Y. Misc. LEXIS 229 (N.Y. Sup. Ct. May 26, 1995), an

online service provider that seeks to regulate the dissemination of offensive material through its service risks subjecting itself to liability because such regulation casts the online service provider in the role of a “publisher.” Specifically, the court ruled that Prodigy was a “publisher” of allegedly defamatory messages – and therefore subject to liability for defamation regardless of actual or imputed knowledge – where an anonymous Prodigy subscriber posted allegedly defamatory messages about the brokerage firm Stratton Oakmont and its president on a Prodigy bulletin board. In reaching this holding, the court noted that Prodigy held itself out as a family-oriented online service that exercised editorial control over the content of messages on its bulletin boards. Prodigy in fact regulated the content on its bulletin boards by promulgating “content guidelines,” using software that automatically pre-screened all bulletin board postings for offensive language, and using “Board Leaders” to enforce Prodigy’s content guidelines.

3. CDA Spells Relief. In 1996 Congress enacted the Communications Decency Act of 1996 (“CDA”), which provides in Section 230(c)(1) that “[n]o provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider.”<sup>6</sup> In enacting this provision, Congress specifically intended to overrule *Stratton Oakmont* and similar decisions that treated online “providers and users as publishers and speakers of content that is not their own because they have restricted access to objectionable material.” Conference Report 104-458, 104<sup>th</sup> Cong. 2d Sess. 194 (1996). The CDA expressly preempts inconsistent state laws, but does not prevent states from enforcing laws consistent with the purpose of the Section. Section 230 of the CDA provides a shield for sponsors of chat rooms since they, as “provider[s] . . . of interactive computer services,” may not be treated as the “publisher” or “speaker” of any content provided by “another information content provider,” that is, chat room participants.
4. Limits of CDA Protection. While CDA provided welcome relief to online service providers, it has some limits.
  - a. Specifically, the protections apply only to information “provided by another information content provider.” Information provided by employees and, depending on the circumstances, independent contractors and other agents, may still provide grounds for liability. Thus, for example, a broker could possibly be liable for defamatory or libelous remarks made by its employees and, perhaps, independent moderators in sponsored chat rooms.

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<sup>6/</sup> CDA also provides, in Section 230(c)(2), that “[n]o provider or user of an interactive computer service shall be held liable on account of – (A) Any action voluntarily taken in good faith to restrict access to or availability of material that the provider or user considers to be . . . objectionable, whether or not such material is constitutionally protected; or (B) any action taken to enable or make available to information content providers or others the technical means to restrict access to material described in paragraph (1).”

- b. Also, while Congress seems to have intended to protect online providers from liability for suits based a failure to monitor information content providers, CDA’s protections expressly cover only liability that would arise from an online provider being deemed a “publisher or speaker.”
5. Judicial Interpretation. Since CDA’s enactment in 1996, the courts have construed CDA’s language ostensibly as a complete bar against liability for defamatory or libelous remarks by users.
- a. In *Zeran v. America Online, Inc.*, 129 F.3d 327 (4<sup>th</sup> Cir. 1997), *cert. denied* (June 22, 1998), the U.S. Court of Appeals for the Fourth Circuit rejected Zeran’s state law claim for negligent distribution of defamatory material as preempted by the CDA. In this case, a pseudonymous AOL subscriber posted Zeran’s name and phone number on purported advertisements for highly offensive t-shirts celebrating the bombing of the Oklahoma City federal building and praising accused bomber Timothy McVeigh. Zeran learned of the posting on April 25, 1995 (the day it appeared) when he was called by a reporter. Zeran immediately notified AOL, which assured him that the notice would be removed (although AOL, consistent with its stated policy, refused to post a retraction). Zeran was inundated with calls, most of which were derogatory, and even some death threats. Although the notice was deleted by AOL the day after it was posted, a new notice appeared later that same day. Zeran again contacted AOL, which advised him that the new message would be deleted, and that AOL was taking steps to terminate the account of the pseudonymous subscriber, known only as “Ken ZZ03.” Nonetheless, similarly offensive messages continued to be posted through May 1, 1995. Zeran claimed to have received telephone calls in late April 1995, approximately once every two minutes. In April 1996, after the CDA was signed into law, Zeran filed suit against AOL for negligence. The court held that CDA immunizes online providers (and others) from liability not only for republication of defamatory statements but also for distribution of defamatory material. Whether AOL knew or should have known that “Ken ZZ03”’s defamatory statements were posted online therefore was irrelevant to the court’s decision to rule in AOL’s favor.
  - b. In *Doe v. America Online, Inc.* 1997 WL 374223 (Fla. Cir. Ct., June 26, 1997), an AOL subscriber, Russell, communicated with people in AOL chat rooms to advertise and solicit and arrange for the sale and distribution of videotapes which showed Russell and minors engaging in sexual activity. The parents of a minor in the videotapes sued AOL for various claims, including failure to exercise reasonable care to ensure that its service was not used to distribute child pornography. The Court ruled that the claims were barred by the CDA. The court held that AOL cannot be held liable under state law for the communications of a third party because AOL would be treated as the “publisher or speaker” of the information, and the CDA expressly rejects this characterization.

V. Best Practices.

- A. Many Different Approaches Possible. There are many different approaches online brokers can take in setting up sponsored chat rooms both to satisfy regulatory obligations (as they evolve) and to manage the associated risks. The approach a broker sponsoring a limited chat room (such as an online seminar with chatting among “rows”) should take may differ from what another broker sponsoring a real-time, open subject chat room should take. As with procedures generally, procedures for operating chat rooms need to be tailored to reflect the nature of the arrangements.
- B. Limit the Role of Representatives.
1. Greatest Risk. Representatives may represent the greatest risks for online brokers in the chat room context and may provide fodder for the first round of chat room enforcement cases by securities regulators. Snooping by securities regulators has uncovered that a substantial portion of postings on Internet message boards are made by representatives (who, among other things, touched off regulators’ suspicions because, in touting stocks, they used a lot of “broker jargon”). See *Gregg Wirth, Policing the Universe*, *The Industry Standard* (November 16, 1998) <<http://www.thestandard.net/articles/display/0,1449,2488.html?related.1449>>.
  2. Establish Supervisory Procedures. Brokers should establish written supervisory procedures that address whether and under what circumstances representatives may participate in chat rooms.
    - a. Some firms prohibit chat room participation outright.
    - b. If chat room participation is allowed, the procedures should set forth the firm’s procedures for pre-approval and supervision of representatives when participating in chat rooms.
      - (1) The procedures should set forth a process for obtaining advance approval of each proposed chat room presentation and describe what related materials and information should be provided to assist the supervisor in making the decision. Such related materials and information might, for example, include:
        - (a) The identity of the chat room and information on the organization operating it;
        - (b) A written outline of the representative’s proposed remarks, specifically including any securities to be discussed; and
        - (c) The names of any other participants anticipated to be participating (*i.e.*, other panelists and moderators).
      - (2) The procedures should also set forth the limits that representatives must observe when participating (with firm approval) in chat rooms, including the need to:

- (a) Provide full and fair description of any securities product or service” discussed and “material information such as risks or costs,” including whether the firm makes a market in the securities in question;
- (b) Avoid exaggerated, unwarranted, or misleading statements or claims, including promises of specific future returns or projections of investment performance;
- (c) Refrain from discussing securities products that the given representative is not licensed to sell; and
- (d) Observe other restrictions imposed by the firm, possibly including:
  - i) Steer clear of discussions of microcap, Penny and other risky stocks;
  - ii) Gear remarks to a broad, general audience that may have little if any knowledge of investments;
  - iii) Avoid technical jargon;
  - iv) Use care and precision in crafting comments;
  - v) Don’t comment on rumors;
  - vi) Don’t summarize a firm research reports;
  - vii) Don’t Make IPO recommendations (Wired, for example, was forced to post-poner its IPO because an internal e-mail was posted on an online service with 10,000 subscribers during the “quiet period”);
  - viii) Avoid words like:
    - a) “Risk free”;
    - b) “Guaranteed”;
    - c) “Limited offer”;
    - d) “My mother” – *e.g.*, “I would buy this for . . .”; and
    - e) Inappropriate language.

- (3) The procedures should also address the review and approval process, and associated recordkeeping requirements, for scripts.
- (4) The procedures should also address what steps are to be taken and by whom in connection with monitoring chat room participation by representatives. These procedures should include appropriate measures (presumably, using available search engines and outside services) to detect representatives participating in chat rooms without firm approval.

3. Training. Supervisory procedures should be supplemented with training materials (*e.g.*, a written list of acceptable and unacceptable subjects or statements that help communicate to representatives the limits they must observe when participating, with the firm's approval, in chat rooms.

C. Consider Using Moderators.

1. Moderators may be helpful in a broker-sponsored chat room, among other things, to keep conversations from drifting off-topic, stimulate discussion, answer or forward questions to the sponsoring broker, and otherwise deal with content issues and possible abusers.
2. Given Mary Schapiro's concern, quoted above, that chat participants could be lulled into a false sense of security in a moderated chat room, a broker should be clear that it is not directly or "by implication, vouching for" any information in the chat room. In this regard, a broker should inform users that they should not assume that moderators possess any special insight or information, lend special credence to their statements or assume that any statements in the chat room have been vetted or are correct.
3. Use as moderators independent contractors who are not brokers and do not have disciplinary backgrounds.
4. Train moderators on the chat room's Rules (see below) and to be alert to abuses and to challenge possible touters.

D. Establish Rules.

1. Require registration by chat room users.
  - a. Take steps to preclude anonymous participation to discourage the posting of statements that a person would not ordinarily want attributed to him- or herself.
  - b. Require users to register and specify their e-mail address and other verifying information.
  - c. Discourage "Sybils" (people using multiple identities).

- (1) Prohibit multiple active registrations.
    - (2) Consider verifying user e-mail addresses to limit chance of a user using multiple identities (although it is relatively easy for a user to get around this precaution by having multiple e-mail addresses).
  - d. Some firms may choose to limit the chance of improper postings by limiting chat room access to customers who have actually opened brokerage accounts with the broker.
  - e. Make clear that user information may be furnished to others as required by law.
2. Prohibit improper postings and conduct, including:
- a. Unlawful, defamatory, improper and indecent remarks;
  - b. Violating others' intellectual property rights or privacy;
  - c. "Off-topic" statements;
  - d. Ads or commercial solicitation;
  - e. Unauthorized posting of material, nonpublic information about companies;
  - f. Posting content that is threatening or harassing of any other individual or entity, particularly any other user;
  - g. Posting information to manipulate, or attempt to manipulate the market for any security;
  - h. Impersonation of any person or entity;
  - i. Posting offers to buy or sell any security; and
  - j. Posting of information related to a company whose securities are, at the time of the posting, in the process of registration with the SEC, where the broker is a member of the underwriting or selling group syndicate.
3. Reserve the right to monitor or remove postings and deny participation to any user.
  4. Get permission to use postings of users.
  5. Require disclosure of user's affiliations relevant to postings (*e.g.*, officer of company being discussed or registered representative of another broker).
- E. Publish "Plain English" Disclaimers.

1. Disclaim:
    - a. Responsibility for screening content or having pre-reviewed, screened or edited content;
    - b. Being a publisher or speaker of users' chat postings;
    - c. Having endorsed or agreed with the postings; and
    - d. Having recommended any security discussed.
  2. Encourage users to exercise discretion and skepticism before relying on information in chat rooms since it may be incorrect or misleading.
  3. Warn, warn, warn!
- F. Consider Topics Selection as a Means to Control Risk. Use topic or subject selection to reduce chance of problems.
1. Limit topics to investing concepts and strategies, and bar discussion of specific stocks.
  2. If discussion of particular stocks is permitted, try to limit those stocks to stocks carrying a lower relative risk of fraud or manipulation:
    - a. Exclude "microcap", Pink Sheet and Penny Stocks.
    - b. Exclude "hot issue" Internet stocks.
    - c. Exclude stocks of pending IPOs and stocks in which the broker makes a market.
  3. Exclude the broker's own stock, if it is a public company.
- G. Provide Investor Education. Stress the need to make thoughtful investment decisions and to evaluate sources.
- H. Develop a Game Plan to Deal with Problematical Participants and Content.
1. Identify an e-mail address or telephone number users may call to address concerns regarding the operation or content of a chat room.
  2. Bar repeat offenders.
  3. To the extent that chat room activity is available online in archival or other form, establish procedures promptly to remove any posting or material that the broker reasonably believes contains, or is brought to its attention as containing, misleading information about its products or services or otherwise contains inaccurate,

incomplete, misleading or inappropriate information. In some instances, it may not be possible or appropriate to delete a posting or material, and other measures may have to be taken.

- a. For example, if a broker learns that a customer has said something incorrect about the broker's services in a chat room, it may wish to send out an e-mail to the chat room participants correcting any confusion that may have resulted.
- b. If, by way of another example, an issuer challenges information stated by users in a chat room, the broker may not want to be made responsible for resolving the dispute and may simply decide to make available online the issuer's reply. These sort of matters have to be worked out on a case-by-case basis.

- I. Consider Insurance Coverage. Insurers are increasingly providing special insurance coverage for Internet-related activities, including hosting or sponsoring chat rooms.