

ELECTRONIC COMMUNICATIONS

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I. INTRODUCTION^{1/}

Electronic communications, including e-mail and instant messaging, provide practically instantaneous ways for securities industry professionals to communicate with each other, their clients and the investing public. The supervision and retention of such communications continue to pose difficult issues for the industry. This outline covers: (1) SRO rules and guidance concerning the supervision of electronic communications; (2) the review of firms' supervision of electronic communications and the storage of such information by regulators during routine examinations; (3) selected recent enforcement actions in these areas; and (4) SEC rules on the retention of electronic communications.

II. SEC AND SRO RULES AND GUIDANCE REGARDING THE SUPERVISION OF ELECTRONIC COMMUNICATIONS

A. SEC RULES

There are no SEC rules that specifically govern the supervision of electronic communications. However, in a 1996 Release, the Commission stated: "The Commission believes . . . that the rules concerning the supervisory requirements for electronic communications should be based on the content and audience of the message, and not merely the electronic form of the communication. For example, the SROs should consider whether electronic mail communications, that, as a practical matter, replace or substitute for telephone conversations, in many cases would not require advance authorization or prior supervisory review." Securities Exchange Act Release No. 7288, 61 SEC Docket 2167, at 2168 and n.5 (May 9, 1996).

B. NYSE AND NASD RULES

For many years, NYSE and NASD rules required outgoing correspondence relating to the solicitation or execution of securities transactions to be reviewed by member organizations. In light of the increasing use of e-mail and the SEC's comments noted above, in 1997 the NYSE and NASD received SEC approval to provide firms with greater flexibility in monitoring communications with the public. Specifically, the two SROs permitted member firms to develop and implement supervisory procedures based upon their structure, size, nature of business and customer base, rather than mandating the review of all outgoing communications. The SROs' amended rules and additional guidance concerning the supervision of electronic communication were announced in NYSE Information Memo 98-3 and NASD Notice to Members 98-11. Both the NYSE and NASD indicated that in conducting correspondence reviews, firms could use reasonable sampling techniques. Moreover, the regulators noted that e-mails could be reviewed electronically and that evidence of such reviews could be recorded in electronic format.

^{1/} The first three sections of this outline were drafted by Ben A. Indek of Morgan, Lewis & Bockius LLP. The section describing enforcement cases was drafted by Julia N. Miller of Morgan Lewis. The original record retention section was provided by Randall Roy of the Securities and Exchange Commission for a prior outline and updated by Ms. Miller. The views expressed in this outline are the author's and do not necessarily constitute those of the other panelists or their firms or organizations. This outline is current as of January 17, 2008.

The current NYSE and NASD rules governing the supervision of correspondence are as follows:

NYSE Rule 342.17 requires that:

[member organizations] develop written policies and procedures that are appropriate for their business, their size, structure and customers in connection with the review of communications with the public relating to their business. Where such policies and procedures for the review of public communications do not require pre-use review, they must include provision for the education and training of employees as to organizational policies and procedures, documentation of such education and training, and provide for surveillance and follow-up to ensure that such policies and procedures are implemented and adhered to.

Similarly, NASD Rule 3010(d)(2) provides that:

[E]ach member shall develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and outgoing written (i.e., non-electronic) and electronic correspondence with the public relating to its investment banking or securities business Where such procedures for the review of correspondence do not require review of all correspondence prior to use or distribution, they must include provision for the education and training of associated persons as to the firm's procedures governing correspondence; documentation of such education and training; and surveillance and follow-up to ensure that such procedures are implemented and adhered to.^{2/}

C. RECENT SRO GUIDANCE

In January 2005, under the leadership of then-Executive Vice President, Grace Vogel, NYSE Regulation created an Electronic Communications Task Force to consider, among other things, the supervisory issues affecting broker-dealers in this area. The Task Force, consisting of NYSE Regulation and NASD staff, industry experts and outside counsel, worked for more than two years to develop guidance concerning the supervision of electronic communications.

In June 2007, NYSE Regulation (Information Memo 07-54) and the NASD (Notice to Members 07-30) published proposed guidance regarding the supervision of electronic communications.

^{2/} It is important to note that NASD Rule 2211 defines correspondence to include any written letter or electronic mail message sent by a firm to one or more of its existing retail customers and to fewer than 25 prospective retail customers within a 30 calendar day period. NASD has amended Rule 2211 to require pre-approval by a principal of correspondence sent to 25 or more **existing** retail customers within any 30 calendar day period. As amended, the rule states that correspondence does not need to be approved by a registered principal prior to use unless it is sent to 25 or more existing retail customers within a 30 calendar day period and makes any financial or investment recommendation or otherwise promotes a product or service of the member. The Rule also states that all correspondence is subject to the supervision requirements of NASD Rule 3010(d). This amendment went into effect on December 1, 2006.

The SROs sought comment on the proposed guidance; 16 comment letters were received by the regulators, the majority of which supported the memoranda. On July 30, 2007, the previously announced merger of the regulatory functions of NYSE Regulation and the NASD became effective and FINRA was launched. In December 2007, FINRA issued Regulatory Notice 07-59 providing final guidance on the supervision of electronic communications.^{3/} This Regulatory Notice is described below.

1. Introduction

In light of the challenges firms face in supervising electronic communications, FINRA issued Regulatory Notice 07-59 to provide guidance for member firms to consider when developing supervisory systems and procedures for electronic communications that are reasonably designed to achieve compliance with applicable federal securities laws and SRO rules. Of considerable importance, FINRA explicitly states that “the guidance neither creates new supervisory requirements nor requires the review of every communication. Rather, it sets forth principles that firms should consider in developing supervisory systems and procedures for electronic communications to aid in accomplishing that they are reasonably designed to achieve compliance with applicable federal securities laws and SRO rules.”

The Regulatory Notice states that for the purpose of the guidance provided by FINRA, “electronic communications,” “email” and “electronic correspondence” may be used interchangeably and may also include instant messaging and text messaging.^{4/} Moreover,

^{3/} As indicated in Regulatory Notice 07-59, the final guidance is substantially the same as set forth in the proposal.

^{4/} Although not set out in Regulatory Notice 07-59, by way of background, after several years of debate within the industry concerning the supervision and retention of instant messaging, in 2003 both the NYSE and NASD provided written guidance concerning instant messaging. The NYSE’s Information Memo 03-07, which generally addressed record retention for electronic logs that capture order and execution data, also briefly covered the retention of instant messages, stating that “[M]embers and member organizations must ensure that all communications whether electronic or otherwise, including but not limited to e-mails, instant messages, and similar communication devices that relate to the firm’s business as such must be maintained and retained in compliance with NYSE Rule 440 and SEA Rules 17a-3 and 17a-4.” In Notice to Members 03-33, the NASD indicated that members must supervise the use of instant messaging in a manner that is consistent with NASD requirements for supervising e-mail messages. In spite of the perceived informality of instant messaging communications, the NASD stated that, depending on the circumstances, instant messaging could be construed as either sales literature or correspondence. Therefore, the NASD noted that compliance with applicable rules requires clear supervisory and review procedures that are followed consistently. Further, the NASD declared that members that are unable to develop and implement such adequate procedures must prohibit the use of instant messaging in customer communication. The NTM also states that, while NASD rules do not specifically require member firms to review or approve internal communications, members must be certain that they have procedures adequate to supervise employees. Finally, the NTM notes that firms must maintain copies of instant messages in accordance with SEC Rules 17a-3 and 4.

notwithstanding the use of such terminology, the guidance indicates that the manner of application of FINRA rules that specifically address particular communications with the public (for example NYSE Rules 342 and 472 and NASD Rules 2210 and 2211) will depend on the type of communication. In other words, as FINRA states in the Regulatory Notice, “FINRA expects a firm to have supervisory policies and procedures to monitor *all* electronic communications, technology used by the firm and its associated persons to conduct the firm’s business.” (Emphasis in original.)

The guidance suggests that firms may decide by employing risk-based principles the extent to which the review of internal and external electronic communications is necessary in accordance with the supervision of their activities. Nevertheless, firms must have policies and procedures for review of incoming, outgoing and internal electronic communications that are of a subject matter that require review under SRO rules and the federal securities laws.

Communications requiring such review include:

- Certain communications between non-research and research departments pursuant to NYSE Rule 472(b)(3) and NASD Rule 2711(b)(3)(A).
- Certain materials requiring pre-approval under NYSE Rule 472(a) and NASD Rules 2210 and 2211.
- The identification and reporting of customer complaints pursuant to NYSE Rule 351(d) and NASD Rule 3070(c).
- The identification of prior written approval of every order error and account designation change under NYSE Rule 410 and NASD Rule 3110(j).

When employing risk-based procedures, firms should consider how to effectively flag various electronic communications containing complaints, misconduct or other significant matters relating to reputational, financial and litigation risk. Firms also need to identify other areas that may warrant supervisory review and provide education concerning electronic communication policies and procedures to employees.

In developing and implementing such supervisory procedures, FINRA noted that existing interpretive material obligates firms to, among other things:

- Identify the types of communications subject to pre-review or post-review.
- Identify the persons responsible for conducting reviews.
- Monitor the implementation of, and subsequent compliance with the procedures for reviewing correspondence.
- Periodically analyze the effectiveness of the procedures for reviewing correspondence and consider any appropriate revisions.

- Provide that all customer complaints be reported to FINRA.
- Prohibit employees from using electronic communications unless such communications are encompassed within the supervisory procedures established by the firm.
- Conduct necessary and appropriate employee training and education.^{5/}

The Regulatory Notice provides guidance in six categories.

- Written policies and procedures.
- Types of electronic communication requiring review.
- Identification of the reviewer.
- Method of review.
- Frequency of review.
- Documentation of review.

This guidance is further described below.

2. Written Policies and Procedures

The Regulatory Notice states that effective supervisory systems begin with clear policies and procedures, which are updated to address emerging technologies. FINRA indicates that firms should provide employees with: quick and easy access to electronic communication policies and procedures; a clear list of permissible electronic communication mechanisms; an explanation of the potential consequences of non-compliance; and training on a regular and as needed basis.

3. Types of Electronic Communication Requiring Review

a. External Communications

Firms must have reasonable policies and procedures in place for supervising electronic communications that require review under FINRA rules and the federal securities laws. The Regulatory Notice states that “members may employ risk-based principles to determine the extent to which additional supervisory policies and procedures are required to adequately supervise their business and manage the member’s reputational, financial and litigation risk.”

^{5/} See NYSE Information Memo 98-3 and NASD Notice to Members 98-11.

Firms are also required to create protocols regarding the forms of electronic communications that employees may use and to take reasonable steps to monitor for compliance with such protocols.

Where firms permit employees to communicate with clients through non-member email platforms, firms are required to supervise and retain those communications.

Firms are expected to prohibit communications for business purposes from employees' own devices unless they are able to retain and supervise such materials. In the absence of such a prohibition, firms should consider requiring pre-approval for the business use of any personal electronic communications device.

Firms may consider blocking access to message boards to prevent communication through these boards for business purposes. FINRA notes that it views message boards as advertisements, and board postings must be pre-approved prior to use.

FINRA views e-faxes as electronic communications subject to supervisory review. Here, FINRA notes that it views e-faxes sent to 25 or more prospective retail customers within 30 calendar days as sales literature, which must be approved prior to use. FINRA also indicates that pre-approval is required for e-faxes sent to 25 or more existing retail customers within any 30 calendar day period that make financial or investment recommendations or otherwise promote a product or service.

b. *Internal Communications*

With the exception of the areas noted above requiring review by a supervisor, firms may use a risk-based approach to determine the extent to which the review of any internal communication is necessary in accordance with the supervision of their business.

In determining the extent to which reviews of internal communications are necessary, firms may consider: detecting when information barriers are not working; protecting against undue influence on research personnel; and segregating proprietary desk activity from other areas.

In addition, firms may consider various relevant processes, including:

- Conflict management efforts.
- Reviews of internal electronic communications completed in connection with branch or desk examinations and regulatory matters.
- Reviews of internal electronic communications that occur in connection with transaction reviews, internal disciplinary assessments and analyses of customer complaints or arbitrations.

- Reviews of internal electronic communications that take place as a result of issues identified regarding external electronic communication reviews.

4. Identification of Reviewer

Protocols for reviewing both internal and external electronic communications should address the following:

- Clear identification of the person responsible for performing reviews. Evidence of such a review may be made through the use of a log or other record from the electronic communications system that identifies the reviewer.
- The reviewer must evidence his or her supervision consistent with FINRA rules.
- Supervisors may delegate certain functions to non-registered persons. Nevertheless, according to FINRA, while a supervisor may delegate his or her duty, that person remains ultimately responsible for the performance of all necessary supervisory reviews. As such, a supervisor must take reasonable steps to confirm that any delegated functions are properly executed and should evidence performance of his or her procedures to demonstrate overall supervisory control. Where functions are delegated, protocols for the escalation of regulatory issues must be in place.
- Reviewers must have sufficient knowledge, experience, and training to adequately perform reviews. Firms should be able to demonstrate that its reviewers meet these criteria.
- Unless a firm's size and/or structure (for example, a sole proprietor) is such that it has no other reasonable method of review, individuals may not conduct supervisory reviews of their own electronic communications.

5. Method of Review

Firms should establish and implement review protocols reasonably designed to achieve compliance with applicable securities laws, rules and regulations and that are appropriate for their business and structure. Moreover, firms should monitor for compliance with the frequency, timeliness and quantity parameters set forth in their supervisory procedures. Firms should alert their reviewers as to the issues to be raised, including acceptable content.

Where firms permit the use of encrypted electronic communications, they must be able to supervise those communications and educate reviewers on the methods for such reviews.

Firms must be able to review electronic correspondence in all languages in which they conduct business. Where a reviewer is not fluent in the language used in an electronic communication, firms should require independent interpretation and review.

Under limited circumstances, firms should consider having their legal and/or compliance departments re-review electronic communications that have been previously reviewed by line supervisors and their delegates in certain situations. Re-review may be advisable when specific problems have been identified at a branch office. Firms should also consider re-reviewing selected electronic communications as part of their branch exam program.

With this guidance, firms may consider the following methods of review.

a. *Lexicon-Based Reviews*

Lexicon-based reviews use sensitive words or phrases to identify potentially problematic communications.

Firms using such systems should use an appropriate lexicon, implement reasonable security measures to maintain the confidentiality of the lexicon list and periodically evaluate the effectiveness of the lexicon.

Firms using lexicon-based reviews may determine that it is unnecessary to review each “hit;” the rationale for such a determination should be kept as part of firms’ policies and procedures.

Firms should consider routine periodic reviews of the lexicon system to determine whether any changes are necessary, including adding or deleting phrases or words. Moreover, firms should periodically check the effectiveness of the system, particularly those developed by a vendor. In assessing the effectiveness of a lexicon-based system, firms should consider the following features used by such systems:

- A meaningful list of phrases and words; the system should yield a meaningful sample of “flagged” communications.
- The ability to add and delete phrases and words on a continuous basis.
- The ability to review attachments and identify such documents that could circumvent the reviews.
- The ability to restrict access to the lexicon words or phrases.
- The ability to conduct searches that exclude trailers or exclaimers, which could flag a significant number of emails in light of the use of phrases such as “the firm does not guarantee.”

Firms should consider targeted reviews of employees’ e-mails under appropriate circumstances, for example when concerns are raised in connection with SRO or SEC exam findings, internal inspections, customer complaints or regulatory inquiries.

b. *Random Review*

Pursuant to the FINRA guidance, firms are permitted to use a reasonable percentage sampling technique under which some percentage of electronic communications are reviewed. As stated in the Regulatory Notice, “there is no prescribed minimum or fixed percentage that is required by regulation. However, the amount of electronic communications chosen for review must be reasonable given the circumstances (for example, member size, nature of business, customer base and individual employee circumstances).”

In conducting random reviews, firms may consider factors such as the percentage of electronic correspondence based on a branch office, department or business unit or the percentage of electronic correspondence for each individual. With respect to the latter, firms are cautioned not to limit the reviews to the same percentage of emails for each employee. As an example, FINRA indicates that an employee with a disciplinary history or who is subject to special supervision may warrant a review of a higher percentage of emails than other individuals.

c. *Combination of Lexicon and Random Reviews*

According to FINRA, in light of the strengths and weaknesses of any review system, firms should consider developing and implementing complimentary review techniques.

d. *Standards Applicable to All Review Systems*

Firms should develop ongoing protocols to identify and address any “loopholes” in their systems and document any additional reviews that will be conducted when these kinds of issues are identified. Firms using automated tools or systems to review electronic communications must understand the limitations of those tools or systems and consider what, if any, additional reviews are necessary in light of such limitations.

6. Frequency of Review

The frequency of electronic communications review may vary depending upon the business. The frequency of review should be related to the type of business conducted, the kinds of customers involved, the scope of the activities, the location of the activities, the disciplinary record of employees, and the volume of communications.

Firms should prescribe reasonable time frames within which supervisors are expected to complete their reviews. In developing such time frames, firms should carefully consider the type of business and the extent to which a review’s utility is diminished by the passage of time. As an example, FINRA notes that a firm with a primarily retail customer base may need to conduct more frequent reviews than an organization that exclusively services institutional investors.

7. Documentation of the Review

Firms must evidence their reviews either electronically or on paper and be able to reasonably demonstrate to regulators that such reviews were completed. The evidence should, at a minimum, identify the employee conducting the review, the communication reviewed, the date of the review, and any steps taken as a result of a significant regulatory issue identified during the review.

III. ELECTRONIC COMMUNICATIONS IN SEC, SRO AND STATE EXAMINATIONS

A. SEC

At the SIFMA Compliance and Legal Division's Fall 2007 Seminar, a senior OCIE official noted that e-mail retention requirements remain an active topic among SEC staff and the industry.^{6/}

B. FINRA

According to FINRA, one of the issues frequently found in staff examinations is compliance with the maintenance of electronic communications under SEC Rule 17a-4(f).^{7/} Additionally, in its May 2007 communication, "Improving Examination Results," the NASD (now FINRA), stated that electronic communications were an examination priority, noting "before employing electronic storage media, member firms are required to notify, in writing, their Designated Examining Authority. As of January 1, 2007 this notification is required to be made electronically pursuant to NASD Rule 3170 (see Notice to Members (NTM 06-61). NASD examiners are focusing on this filing requirement, and will continue to review this to ensure that firms' use of electronic storage media to maintain and preserve required records meet the requirements of SEC Rule 17a-4(f)."^{8/} Further, the staff listed electronic communications/storage media as one of its examination priorities at the SIFMA Compliance and Legal Division's Fall 2007 Seminar.^{9/}

C. STATE EXAMINERS

In 2006, the North American Securities Administrators Association (NASAA) undertook a review of broker-dealer examinations by state examiners in 28 NASAA jurisdictions conducted between May 1 and June 30, 2006. Out of the 321 books and records deficiencies that were

^{6/} See The Examination Process from the Regulators' Perspective outline submitted for the SIFMA Compliance and Legal Division Fall Seminar in New York City, November 13, 2007.

^{7/} See "Improving Examination Results," May 2007 at www.finra.org.

^{8/} Available at: <http://www.finra.org/RulesRegulation/ComplianceTools/ImprovingExamResults>.

^{9/} See The Examination Process from the Regulators' Perspective outline submitted for the SIFMA-Compliance and Legal Division Fall Seminar in New York City, November 13, 2007.

found in the examinations, 30 concerned e-mail correspondence.^{10/} Based on the examination results, NASAA recommended a series of “best practices” for broker-dealers, including:

Correspondence, both electronic and hard copy, must be effectively monitored by the broker-dealer, including a system of capturing and maintaining e-mails sent by registered representatives from websites and Internet Service Providers (ISP’s) outside the firm.^{11/}

IV. SELECT ENFORCEMENT CASES RELATING TO ELECTRONIC COMMUNICATIONS

A. BACKGROUND

Below is a description of 10 FINRA cases, 4 NYSE Regulation Hearing Board Decisions, 3 SEC settlements and 21 NASD actions published between January 2007 and December 2007 that relate to a firm’s responsibility to supervise, retain and/or produce electronic communications. This is a selection of the cases in these areas rather than a complete listing.

B. FINRA CASES

American Skandia Marketing, Inc., Disciplinary and Other FINRA Actions (August 2007), p.1

FINRA found, among other violations, that the firm had failed to maintain and preserve all of its electronic communications as required by SEC Rule 17a-4. It was censured, fined \$75,000 and was required to review its procedures regarding, among other items, the preservation of e-mail communications for compliance with the federal securities laws, regulations and NASD rules.

brokersXpress, LLC, Disciplinary and Other FINRA Actions (August 2007), p.5

In addition to other violations, FINRA found that the firm failed to enforce its written supervisory procedures that required a principal to print and review all incoming electronic correspondence. The firm also failed to provide notifications to NASD prior to implementing electronic storage media for primary record retention of its electronic correspondence and to capture, retain and preserve, in a readily accessible location, originals of all electronic communications sent from and received by one of its branches. It further failed to enforce written supervisory procedures regarding e-mail retention and review at one of the firm’s branch offices. The firm was censured and fined \$50,000.

^{10/} See <http://www.nasaa.org/content/Files/BDExams06.ppt>.

^{11/} NASAA Examinations Identify Top BD Compliance Deficiencies, *available at* http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/5281.cfm.

Georgeson Securities Corporation, Disciplinary and Other FINRA Actions (September 2007), p. 6

The firm was found to have failed to maintain and preserve all of its electronic communications as SEC Rule 17a-4 requires. Although the firm backed-up electronic communications at the end of each day, it failed to capture, maintain and preserve electronic communications deleted from a user's deleted items folder during the day. The firm was censured and fined \$30,000.

Castlewood Securities, L.L.C. and Fred Owen Goldman, Disciplinary and Other FINRA Actions (October 2007), p.1

In addition to market timing violations, FINRA found that the firm failed to preserve for three years, and/or preserve in an accessible place for two years, business-related e-mail communications its agents and employees sent and received. The firm was censured, fined \$250,000 and ordered to pay restitution to affected parties.

Investors Capital Corporation, Disciplinary and Other FINRA Actions (October 2007), p. 5

The firm consented to the entry of findings that some of its registered representatives sent business-related e-mail through external servers without obtaining the firm's approval. With respect to some of these instances, the firm failed to provide reasonable follow-up and review upon learning of the use of external e-mail accounts. The firm also did not timely detect and prevent such use and did not effectively enforce its procedures regarding external e-mail accounts. Further, the firm failed to retain certain business-related e-mails sent and received by its registered representatives in external accounts and failed to maintain and preserve all of its electronic communications as required by the Securities Exchange Act of 1934 and Rule 17a-4. The firm was censured, fined \$75,000 and required to review its procedures regarding the preservation of e-mail communications for compliance with the federal securities laws, regulations and NASD rules.

K-One Investment Company, Inc., Disciplinary and Other FINRA Actions (October 2007), p. 6

FINRA found that the firm failed to maintain and preserve copies of internal and external e-mail communications as required by Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-4. It also failed to implement and enforce an adequate supervisory system concerning the review of external communication. The firm was censured and fined \$50,000.

White Pacific Securities, Inc., Disciplinary and Other FINRA Actions (November 2007), p. 12

In addition to AML violations, FINRA found that the firm's systems and procedures for the preservation of electronic communications were not reasonably designed to preserve all required communications because it allowed for deletions prior to the monthly transfer of communications from individual mail boxes to a permanent storage medium and the firm did not conduct periodic reviews to determine whether the system was preserving electronic communications as required by SEC Rule 17a-4. The firm was censured and fined \$75,000.

Morgan Stanley & Co. Incorporated, Disciplinary and Other FINRA Actions (November 2007), p.28

Late in 2006, the NASD filed a complaint against Morgan Stanley for allegedly failing to provide e-mails to arbitration claimants and regulators. FINRA and Morgan Stanley settled this matter in 2007.

1. FINRA alleged that between October 2001 and March 2005, Morgan Stanley failed to provide to claimants in arbitration proceedings e-mails that pre-dated September 11, 2001, claiming that such e-mails were destroyed during the terrorist attacks. While the firm's e-mail servers were destroyed, the firm had restored millions of such messages using back-up tapes and had access to many other e-mails that were stored by employees on network and local drives. Morgan Stanley also allegedly deleted certain e-mails that had been restored by recycling the back-up tapes.
2. FINRA also alleged that the firm failed to provide to arbitration claimants certain supervisory materials.
3. Besides arbitration proceedings, Morgan Stanley failed to provide pre-September 11, 2001 e-mails in response to requests from the NASD, NYSE Regulation, and Massachusetts Securities Division.
4. Morgan Stanley consented to a censure, a fine of \$3 million and a payment of \$9.5 million into a fund established for arbitration claimants. This matter marked the first time that a pool was established to compensate customers who had brought claims in arbitration proceedings. Eligible customers have the option to: (1) accept a standard payment from the pool, or (2) waive the standard amount, request the e-mails that were not produced, and have the fund administrator determine the amount that the claimant should receive, up to \$20,000.
5. Morgan Stanley also agreed to retain an independent consultant to review its policies and procedures for complying with discovery obligations in arbitration proceedings.

First Montauk Securities Corporation, Disciplinary and Other FINRA Actions (December 2007), p. 4

In addition to various supervision violations, the firm was found to have failed to retain business-related internal e-mails because it failed to properly configure its e-mail system after a software upgrade. The firm was censured, fined \$175,000 and required to review its systems and procedures in connection with the supervisory violations.

G.A. Repple and Company, Disciplinary and Other FINRA Actions (December 2007), p. 5

FINRA found the firm's systems and procedures were not reasonably designed to achieve compliance with SEC Rule 17a-4. The firm allowed registered representatives to preserve e-mails in a manner that permitted deletion and alteration and failed to use a system in compliance with SEC Rule 17a-4 that would have preserved records in a non-erasable, non-rewriteable form. Further, the firm failed to establish and maintain a system and procedures to supervise the

activities of each registered and associated person to achieve compliance with the securities laws and regulations regarding the retention of e-mails. The firm was censured and fined \$25,000.

C. NYSE REGULATION CASES

Bishop Rosen & Co., Inc. (“Bishop Rosen”), Hearing Board Decision 06-95 (Feb. 1, 2007)

In this litigated case, NYSE Regulation’s enforcement staff alleged various violations, including that Bishop Rosen’s e-mail and instant messaging retention procedures were inadequate. The Hearing Board rejected these allegations.

1. With respect to e-mail, only the firm’s chief compliance officer, vice president of compliance, and a compliance assistant had e-mail access prior to 2002, and the firm’s practice was to print and file hard copy e-mails as needed. The Hearing Board determined that while Bishop Rosen’s procedures in this area were not best practices, they did not constitute violations.
2. The Hearing Board similarly concluded that there was insufficient evidence that the firm violated any rules with regard to retention of instant messaging in light of the fact that the instant messaging software on the firm’s computers had not been installed and/or activated.

The staff prevailed in certain other charges. Although the enforcement staff sought a \$100,000 fine, the Hearing Board imposed a censure and a \$7,500 fine based on the small size of the firm, the good faith efforts of the firm to comply with its regulatory obligations, lack of customer harm, and the fact that each violation was a first-time offense.

Morgan Stanley & Co., Hearing Board Decision 07-66 (May 9, 2007)

NYSE Regulation alleged various failures to supervise, including that Morgan Stanley failed to produce evidence that it had adequately reviewed and maintained e-mails of registered representatives’ and supervisors’ e-mail and failed to have written supervisory procedures that could have prevented such violations. Morgan Stanley consented to a censure and a \$500,000 fine.

H&R Block Financial Advisors, Inc. (“H&R Block”), Hearing Board Decision 07-96 (June 22, 2007)

Among other violations, NYSE Regulation alleged that H&R Block failed to adequately supervise correspondence, including e-mail. First, the firm’s policies and procedures required branch office managers to review a defined amount of registered representatives’ e-mails and required area managers to review a defined amount of branch office managers’ e-mails. In certain instances, such reviews did not occur. Second, in certain branch offices, the branch office manager reviewed his own incoming and/or outgoing correspondence, which reflected an inadequate supervisory system. H&R Block consented to a censure and a fine of \$45,000.

Advest, Inc., Hearing Board Decision 07-122 (September 27, 2007)

In addition to various other violations, NYSE Regulation alleged certain retention and supervisory violations concerning electronic communications through internet service providers (“ISPs”). Specifically, from March 2004 to April 2005, Advest failed to have a system in place to capture or block electronic communications sent or received through ISPs. Further, in the same period, the firm did not have sufficient written policies or procedures concerning the review of electronic communications via ISP and did not have policies for maintaining records evidencing such review. Additionally, the firm did not establish and maintain procedures for supervision and control, including a separate system of follow-up and review regarding preserving and reviewing all electronic communications. Advest consented to censure and a fine of \$275,000.

D. SEC CASES

In the Matter of Evergreen Investment Management Company, LLC, Evergreen Investment Services, Inc., Evergreen Service Company, LLC and Wachovia Securities, LLC (Admin. Proc. File No. 3-12805, Sept. 19, 2007)

The SEC settled an administrative proceeding against Wachovia Securities, LLC and Evergreen Investment Services, Inc. (registered broker-dealers), along with their affiliates Evergreen Investment Management Company, LLC, and Evergreen Service Company, LLC. In addition to market timing charges, the SEC also charged Evergreen Investment Services for failing to preserve e-mails related to its business as a broker-dealer. Each respondent consented to censures and cease-and-desist orders. The order also required the respondents to pay a total of \$28.5 million in disgorgement and \$4 million in civil penalties.

In the Matter of Regional Brokers, Inc. (“Regional Brokers”) and Patrick Lubin (Admin. Proc. File No. 3-12838, Sept. 27, 2007)

The SEC settled an administrative proceeding against Regional Brokers and Patrick Lubin for misrepresentations and other fraudulent conduct in connection with their sale of municipal securities. In addition to the trading violations, the SEC also found that the firm failed to supervise and failed to retain required correspondence (faxes and e-mails). Regional Brokers and Patrick Lubin each consented to a censure and a cease and desist order. Regional Brokers agreed to pay a \$100,000 civil money penalty.

In the Matter of MCL Financial Group, Inc. and Gary L. Flater, (Admin. Proc. File No. 3-12860, Sept. 28, 2007)

The SEC settled an administrative proceeding against MCL Financial Group and Gary Flater for failure to supervise a registered representative in connection with that representative’s alleged fraudulent conduct. In addition, the SEC found that MCL failed to preserve and Flater failed to ensure the preservation of the majority of business-related e-mail communications for certain of the firm’s offices. MCL and Flater each consented to censure and a cease and desist order. Flater agreed to pay \$60,000 in civil money penalty and was barred from association in a supervisory capacity for three years. MCL agreed to an undertaking and to pay \$60,000 in civil money penalty.

E. NASD CASES

Banif Securities, Inc. and Richard John Kailer, NASD NTM Disciplinary Actions (Jan. 2007), p. 1

Banif Securities consented to the entry of several findings, including that the firm, acting through Kailer, failed to maintain business-related e-mail correspondence sent or received by Kailer. NASD also found that the firm was unable to produce any written procedures relating to e-mail or instant messaging prior to contracting for electronic storage. The firm and Kailer were censured and the firm was fined \$45,000, of which \$20,000 was joint and several with Kailer.

Archer Alexander Securities Corporation, NASD NTM Disciplinary Actions (Jan. 2007), p. 4

NASD found that, in addition to certain market timing violations, Archer Alexander failed to preserve copies of electronic communications sent or received by personnel in its branch offices. The firm consented to censure and a \$108,450 fine, which included \$38,450.10 in disgorgement.

Stand, Atkinson, Williams & York, Inc., NASD NTM Disciplinary Actions (Jan. 2007), p. 7

Among other findings, NASD found that the firm failed to retain e-mail messages in an accessible, reviewable format, and to review incoming and outgoing e-mails during the relevant time period. The firm was censured and fined \$50,000.

Legend Merchant Group, Inc., NASD NTM Disciplinary Actions (Feb. 2007), p. 4

The firm was found to have failed to maintain and preserve business-related electronic communications. Though the firm used a vendor to preserve electronic communications, after the vendor initially captured the communications, it could not later retrieve them. Thus, the firm failed to retain those communications. The firm was censured, fined \$30,000, and required to review its procedures regarding the preservation of electronic communications for compliance with NASD rules and federal securities laws and regulations.

McKim Capital, Inc., NASD NTM Disciplinary Actions (Feb. 2007), p. 4

The firm was, among other violations, found to have failed to retain all electronic communications relating to its business. The NASD also found that the firm did not establish, maintain and enforce a supervisory system and written supervisory procedures reasonably designed to achieve compliance with SEC and MSRB rules concerning electronic communication retention. The firm was censured and fined \$20,000.

Utendahl Capital Partners, NASD NTM Disciplinary Actions (Feb. 2007), p. 7

In addition to a number of other findings, the firm was found to have failed to preserve copies of all electronic mail for three years and/or maintain electronic mail for the first two years in an accessible location. Further, NASD determined that the firm failed to maintain and enforce a supervisory system reasonably designed to ensure its compliance with applicable laws, regulations and NASD rules regarding electronic communications and other items and failed to

properly update its supervisory procedures. The firm was censured, fined \$240,000 and accepted an undertaking.

USAllianz Securities, NASD NTM Disciplinary Actions (Feb. 2007), p. 25-26

As part of a case concerning a number of alleged supervision and recordkeeping violations, the NASD found that, prior to March 2005, the firm did not have a system to capture, preserve and maintain e-mails. An interim, but unsuccessful, system was implemented in March 2005 and the firm did not have an effective system to capture and retain all e-mails sent and received by its sales force until mid-December 2005. The firm was censured, fined \$5 million and accepted an undertaking.

Itradirect. Com Corp, NASD NTM Disciplinary Actions (March 2007), p.4

The firm was found to have failed to preserve any of the of firm's internal or external electronic communications, as required by SEC and NASD rules. The firm was censured and fined \$25,000.

Wilbanks Securities, Inc., Aaron Bronelle Wilbanks and Randall Lee Wilbanks, NASD NTM Disciplinary Actions (April 2007), p.1

Among other violations, the firm and the individual respondents were found to have failed to preserve sent and received electronic communications, including inter-office memoranda, in an easily accessible place and to establish, maintain and enforce written supervisory procedures regarding the preservation of electronic correspondence. All respondents were censured. The firm was fined \$25,000, Randall Wilbanks was fined \$25,000, joint and several with the firm, and Aaron Wilbanks was fined \$20,000, joint and several with the firm.

Cantella & Co., Inc. NASD NTM Disciplinary Actions (April 2007), pp. 2-3

In addition to several reporting violations, NASD found that the firm had failed to maintain and preserve all e-mail communications. The firm was censured, fined \$65,000 and required to review its procedures concerning the preservations of electronic communications and reporting obligations for compliance with NASD rules and the federal securities laws and regulations, and to notify NASD that it has established systems and procedures to achieve compliance with those laws, rules and regulations.

Fidelity Distributors Corporation, Fidelity Brokerage Services LLC, Fidelity Investments Institutional Services Company, Inc., and National Financial Services LLC, NASD NTM Disciplinary Actions, (April 2007), pp. 12-14

NASD settled an action against four Fidelity broker-dealers for, among other violations, an alleged failure to retain e-mail in accordance with NASD rules and federal securities laws. Of note, NASD found the Fidelity firms' failure to preserve all instant messages and Bloomberg e-mail to be a violation of the relevant recordkeeping requirements. The four Fidelity broker-dealers consented to an aggregate fine of \$3.75 million. NASD also ordered the broker-dealers to undertake audits of the firms' systems, policies and procedures relating to registration and electronic recordkeeping.

Essex Financial Services, Inc., NASD NTM Disciplinary Actions (May 2007), pp. 4-5

The firm consented to an entry of findings that it had failed to maintain and preserve all of its electronic communications in accordance with SEC Rule 17a-4. The firm was censured, fined \$25,000 and required to review its procedures concerning the preservation of electronic communications for compliance with NASD rules and federal securities laws and regulations.

Bathgate Capital Partners LLC and Steven Charles Signer, NASD NTM Disciplinary Actions (June 2007), p.2

NASD found that Singer sent and received electronic communications relating to the firm's business using his own e-mail provider and failed to copy the firm on all e-mail, as required by firm procedures. The firm was found to have failed to retain and preserve all of Signer's business-related e-mail and to preserve all of it in a non-erasable, non-rewritable format. The firm's supervisory systems and procedures were not reasonably designed to achieve compliance with SEC Rule 17a-4 because they did not adequately provide for capturing, retaining and preserving Singer's e-mails when he did not copy or forward them to the firm. The firm and Singer were censured and fined \$50,000 and \$15,000, respectively.

State Street Global Markets, LLC, NASD NTM Disciplinary Actions (June 2007), p.6

The firm was found to have failed to implement an adequate supervisory system and written procedures designed to ensure that all business-related electronic communications are captured and retained. The firm's supervisory system failed to provide for effective follow-up and review or other monitoring of instant messages usage to ensure that all instant message users had properly synchronized network login passwords and that all electronic communications were being retained. Further, the firm failed to maintain and retain all business-related instant messages sent and received by its registered representatives. The firm was censured, fined \$100,000 and required to review its procedures regarding the preservation of electronic communications for compliance with NASD rules and the federal securities laws and regulations.

White Pacific Securities, Inc., NASD NTM Disciplinary Actions (June 2007), pp. 6-7

In addition to several other violations, the firm was found to have failed to retain all business-related electronic communications and did not have a supervisory system or written procedures reasonably designed to detect and prevent failures to retain required communications. The firm was censured and fined \$125,000.

Invest Private, Inc., Donald Geraghty, Scott Lee Mathis and Ronald S. Robbins, NASD NTM Disciplinary Actions (July 2007), p.1-2

In addition to a variety of other violations, NASD found that the firm failed to preserve complete e-mail communications by routinely deleting the contents of the e-mail folders for all employees who left the firm and deleting portions of the e-mail folders of current employees. Additionally, the firm, through Geraghty, failed to implement, maintain and enforce reasonable systems and procedures to ensure that all business-related e-mails were retained as required by SEC Rule 17a-4 and NASD Rule 3110. Among other penalties, the firm was censured and fined \$205,000, of

which \$67,500 was imposed jointly and severally with Mathis, \$40,000 jointly and severally with Mathis and Geraghty, and \$15,000 jointly and severally with Geraghty. Geraghty was suspended from association with any NASD member in a principal capacity for 30 days.

Pension Fund Evaluations, Inc., and Gregory George Phillips, NASD NTM Disciplinary Actions (July 2007), p 2-3

NASD found, among other violations, that the firm did not have a system to retain business-related e-mails that Phillips sent or received through his personal account and did not retain those communications. The firm was censured and fined \$7,500, jointly and severally with Phillips, and was fined an additional \$18,500.

Colonial Brokerage, Inc., NASD NTM Disciplinary Actions (July 2007), p. 5

NASD found, among other violations, that the firm did not have a reasonable system for e-mail review, although it had established a method to flag e-mails that required review through an automatic system. The firm only reviewed some of the e-mails that were flagged. The firm was censured and fined \$25,000.

Legend Equities Corporation, NASD NTM Disciplinary Actions (July 2007), p. 7

In addition to other violations, the firm's system and procedures were not reasonably designed to ensure that all registered representatives used the firm's electronic server for business-related electronic communications. The firm failed to provide reasonable follow-up and review regarding indications that registered representatives were using external e-mail accounts. As a result, the firm also failed to maintain and preserve certain electronic communications as required by SEC Rule 17a-4. The firm was censured, fined \$110,000 and was required to review its procedures regarding required disclosures to customers and the preservation of e-mail communications for compliance with NASD rules and the federal securities law and regulations.

Sandgrain Securities, Inc., NASD NTM Disciplinary Actions (July 2007), p. 9

In addition to certain reporting violations, the firm was found to have failed to preserve copies of internal and external e-mails. Among other penalties, the firm was censured and fined \$50,000.

White Mountain Capital, LLC, NASD NTM Disciplinary Actions (July 2007), p. 12

Among other violations, NASD found that the firm's written supervisory procedures were not reasonably designed to ensure compliance with the e-mail retention and review requirement and that the firm failed to maintain and preserve all of its business-related electronic communications as required by SEC Rule 17a-4. The firm was censured, fined \$100,000 and was required to review its supervisory system and procedures regarding the preservation of electronic communications and other items for compliance with NASD rules and the federal securities laws and regulations.

V. SEC RECORD RETENTION

A. BACKGROUND

SEC Rules 17a-3 and 17a-4 require a broker-dealer to create and preserve certain business records.^{12/} Paragraph (b)(4) of Rule 17a-4 requires the preservation for three years of communications relating to the firm's "business as such." This requirement dates back to the rule's adoption in 1939.^{13/} In 1997, the Commission amended Rule 17a-4 to permit required records to be retained electronically, provided among other things, that the storage system "[p]reserve[s] the records exclusively in a non-rewriteable, non-erasable format."^{14/} At that time, the Commission addressed the increased use by broker-dealers of emails. Specifically, the Commission stated in the preamble to the 1997 final rule amendment that "the content of the electronic communication is determinative," and therefore broker-dealers must retain "e-mail and Internet communications" that relate to their business as such.^{15/}

With respect to storing records electronically, Rule 17a-4 does not limit broker-dealers to using a particular type of technology such as optical disk. In 2003, the Commission made this clear by issuing an interpretation that broker-dealers may use a storage system that prevents alteration or erasure of records for their required retention period as opposed to permanently.^{16/} Specifically, the interpretation clarified that broker-dealers may use a combination of integrated hardware and software codes to preserve records for the required retention period after which the records can be deleted from the system. Under the interpretation, a broker-dealer can store records electronically on magnetic WORM disk.

B. RECENT DEVELOPMENTS

In a November 2, 2006 letter to Michael Macchiaroli, Associate Director, SEC Division of Market Regulation, from Melissa MacGregor, Assistant Vice President and Assistant General Counsel, SIFMA proposed changes to the SEC's record retention requirements, particularly with respect to Rules 17a-4(b)(4) and 17a-4(f).^{17/} As part of an effort to limit the scope of communications required to be retained under Rule 17a-4, SIFMA proposed a "Registration Plus" standard, which would require the retention of communications of registered representatives plus those individuals performing other functions that may be of regulatory interest.

^{12/} See 17 CFR 240.17a-3 & 17 CFR 240.17a-4.

^{13/} See Exchange Act Release No. 2304 (November 13, 1939).

^{14/} See Exchange Act Release No. 38245 (February 5, 1997).

^{15/} *Id.*

^{16/} See Exchange Act Release No. 47806 (May 7, 2003).

^{17/} Available at: <http://www.sifma.org/regulatory/erecords/html/resources.html> Please note that the summaries of SIFMA's November 2006, March 2007 and June 2007 letters were written by Julia N. Miller of Morgan Lewis & Bockius LLP.

Examples of functions that would fall under the “Registration Plus” scope (and whose communications would be required to be retained) include: (a) registered persons; (b) sales assistants; (c) investment bankers; (d) operations functions relating to capital and reserve functions under SEA Rules 15c3-1 and 15c3-3, handling customer funds or securities and trade execution, clearing and settlement; (e) risk management; (f) asset management functions that fall within certain definitions under the Investment Company Act of 1940, Rule 203A-3(a)(1) of the Investment Advisers Act of 1940 and Section 202(a)(25) of the Investment Advisers Act of 1940; and (g) legal and compliance functions that directly support the business functions described above.

Examples of functions that would not fall under the “Registration Plus” scope include: (a) information technology; (b) corporate administrative services (i.e., facilities, real estate, corporate travel, etc.); (c) human resources; (d) corporate communications; (e) training and education; (f) operations not otherwise included in the scope of “Registration Plus”; (g) finance, accounting payroll and tax; (h) internal audit; and (i) legal and compliance not otherwise included in the scope of “Registration Plus.”

In addition to the above proposal, SIFMA asked the SEC for some relief regarding the WORM requirements. Specifically, SIFMA proposed amending Rule 17a-4(f) to create a standard for broker-dealers that would focus on reasonable security safeguards, access controls and retrieval standards.

In a March 23, 2007 letter from Ms. MacGregor to Mr. Macchiaroli,¹⁸ following a meeting between SIFMA’s E-Records Modernization Task Force and Mr. Macchiaroli, SIFMA proposed additional revisions to Rule 17a-4(b)(4), including:

- (1) an expansion of the retention exclusion to include external e-mails as well as internal emails;
- (2) the exclusion from retention of e-mails of legal and compliance personnel who support functions outside the scope of the revised proposal. For example, firms would be required to retain e-mails sent and received by legal and compliance personnel who support business functions such as trading desks and investment banking, but would not be required to retain e-mails for legal personnel who support functions like litigation, public company reporting, tax and human resources;
- (3) the exclusion of e-mail to and from internal audit staff; and
- (4) a proposal that would require firms to implement policies and procedures that describe the functions that are excluded from the firms’ retention program.

SIFMA also suggested revisions to the electronic storage requirements under Rule 17a-4(f). Specifically, SIFMA proposed that the Rule be amended to create a principle-based standard that would include alternatives to the current WORM provision and would require firms to establish

^{18/} Available at: <http://www.sifma.org/regulatory/erecords/html/resources.html>

controls that provide reasonable assurance against unauthorized alteration, substitution, or deletion of electronic records. Such controls may include media, access or audit controls or a combination of such.

Most recently, in a June 26, 2007 letter to Mr. Macchiaroli from Ms. MacGregor,¹⁹ SIFMA provided requested follow-up to a meeting between the SIFMA E-Records Modernization Task Force and Mr. Macchiaroli in May. The letter attached a draft of the revised Rule 17a-4(b)4, which reflected changes discussed during the May meeting and clarifying edits. SIFMA also removed operations functions from the list of excluded functions for retention. SIFMA further urged the SEC staff to consider amending the WORM requirement to create a standard such that firms would have more flexibility in the method of retaining records. The letter suggested a meeting with Mr. Macchiaroli in July to discuss the issues further. No subsequent information regarding this issue has been published on SIFMA's website.

^{19/} Available at: <http://www.sifma.org/regulatory/erecords/html/resources.html>