

ELECTRONIC COMMUNICATIONS BEST PRACTICES

Ben A. Indek
Morgan, Lewis & Bockius LLP
(Moderator)

Tania Isenstein
Goldman, Sachs & Co.

Linda Riefberg
NYSE Regulation, Inc.

Howard Plotkin
Lehman Brothers Inc.

Randall Roy
U. S. Securities and Exchange Commission

NYSE Regulation Second Annual Securities Conference
New York, NY
June 19, 2006

I. INTRODUCTION^{1/}

E-mail, instant messaging, chat rooms and web sites 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 pose difficult issues for the industry. This outline covers: (1) the rules governing the supervision of certain types of electronic communications; (2) SEC rules on the retention of e-mails; (3) selected recent enforcement actions in these areas; and (3) the development of written supervisory procedures.

II. SEC AND SRO RULES REGARDING 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 to be approved prior to mailing. 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 pre-approval 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.

^{1/} The first two sections of this outline were drafted by Ben A. Indek of Morgan, Lewis & Bockius LLP with research assistance from his colleagues, Lawrence Scheer and Mark Knoll. The section describing recent enforcement cases was put together under the oversight of Linda Riefberg of NYSE Regulation. The record retention section was provided by Randall Roy of the SEC. Finally, the section on written supervisory procedures is drawn from the outstanding efforts of others who have addressed this topic, including Yoon-Young Lee of Wilmer Hale and her work on outlines presented at SIA Compliance & Legal Division seminars, particularly the outline for the 2003 Annual Seminar. The views expressed in this outline are the authors and do not necessarily constitute those of the other panelists or their firms or organizations.

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

NYSE Rule 342.17 requires member organizations to “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 “each 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.”

In NYSE Information Memo 98-3, the NYSE stated that in developing supervisory procedures for the review of communications with the public, firms must:

- “specify, in writing, the firm’s policies and procedures for reviewing different types of communications;
- identify how supervisory reviews will be conducted and documented;
- identify what types of communications will be pre-reviewed or post-reviewed;
- identify the organizational position(s) responsible for conducting reviews of the different types of communications;
- specify the minimum frequency of the reviews for different types of communications;
- monitor the implementation of and compliance with the firm’s procedures for reviewing public communications;
- periodically re-evaluate the effectiveness of the firm’s procedures for reviewing public communications and consider any necessary revisions.”^{2/}

The regulators cautioned that the above list is not exclusive and that firms must consider all appropriate factors in establishing and implementing supervisory protocols.

^{2/} NASD NTM 98-11 is substantially the same.

In addition, the NYSE mandated that the review procedures must, at a minimum:

- “specify procedures for reviewing registered representatives’ recommendations to customers;
- require supervisory review of some of each registered representative’s public communications, including recommendations to customers;
- consider the complaint and overall disciplinary history, if any, of registered representatives and other employees (with particular emphasis on complaints regarding written or oral communications with clients);
- consider the nature and extent of training provided registered representatives and other employees, as well as their experience levels in using communications media, (although a firm’s procedures may not eliminate or provide for minimal supervisory reviews based on an employee’s training or level of experience in using communications media);
- provide that all customer complaints, whether received via e-mail or in written form from the customer, are reported to the Exchange in compliance with Rule 351(d);^{3/}
- describe any firm standards for the content of different types of communications;
- address permitted and prohibited activities (e.g., lectures, seminars, mass media appearances, etc.); and prohibit registered representatives’ and other employees’ use of electronic communications to the public unless such communications are subject to supervisory and review procedures developed by the firm. For example, the Exchange would expect members and member organizations to prohibit communications with the public from employees’ home computers or through third party computer systems unless the firm is capable of monitoring such communications.”^{4/}

Both the NYSE and NASD indicated that in conducting correspondence reviews, firms could use reasonable sampling techniques.^{5/} Moreover, the regulators noted that e-mails could be reviewed

^{3/} “Among other things, NYSE Rule 351(d) requires members and member organizations to report to the NYSE statistical information regarding customer complaints relating to matters specified by the Exchange.”

^{4/} Again, NASD NTM 98-11 contains substantially the same text as NYSE Information Memo 98-3.

^{5/} It is important to note that NASD Rule 2211 defines correspondence to include any written 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. The NASD has proposed to amend Rule 2211 to require pre-approval by a principal of any correspondence sent to 25 or more **existing** retail customers within any 30 calendar day period. As amended, the rule would state that correspondence does not need to be approved by a registered principal prior to use unless it is sent to 25 or more

(continued).

electronically and that evidence of such reviews may be recorded in electronic format.

C. INSTANT MESSAGING

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 the NASD's 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.

D. CHAT ROOMS

The NASD has provided certain guidance concerning the supervision of brokers using chat rooms. In particular, the NASD has noted that participation by brokers in chat rooms is considered a public appearance that is subject to NASD guidelines concerning such appearances.^{6/} Where a firm allows a broker to participate in a chat room extemporaneously, the NASD has indicated that the firm must have procedures for the supervision and approval of such appearances. In addition, the firm must develop procedures for the review and monitoring of

existing retail customers within a 30 calendar day period. The proposed amendment would also state that all correspondence is subject to the supervision requirements of NASD Rule 3010. The proposed amendment would impose an identical standard for principal per-use approval on written letters and e-mails sent to either existing or prospective retail customers. The deadline for SEC action on the proposed amendment was recently extended to June 2, 2006.

^{6/} Guide to the Internet for Registered Representatives, available on the web at www.NASDR.com/4040.asp.

chat room presentations by brokers. In light of these issues, the NASD has stated that “because of the difficulties of supervision and the potential liabilities from participating in chat rooms, many firms limit or prohibit participation altogether.”^{7/}

E. WEB SITES

According to the NASD, web sites developed by firms or brokers must be pre-approved by a registered principal and comply with the contents of NASD Rule 2210.^{8/}

III. SELECT ENFORCEMENT CASES RELATING TO ELECTRONIC COMMUNICATIONS

A. BACKGROUND

Below is a description of 11 NYSE Regulation Hearing Panel Decisions, four SEC settlements and five NASD actions issued between January 2005 and March 2006 that relate to a firm’s responsibility to supervise and retain electronic communications.

B. NYSE CASES

Citigroup Global Markets Inc. HPD 05-023 (January 28, 2005)

Violated Exchange Rule 342 by failing to establish a system for follow-up and review with respect to properly training and supervising employees to identify emails that may contain false or misleading content. (Censure and \$350,000 fine.)

J.P. Morgan Securities, Inc.² HPD 05-001 (January 5, 2005) See also SEC Release No. 34-51200 (February 14, 2005)

Violated Exchange Rule 440, Section 17(a) of the Securities and Exchange Act of 1934 and Rule 17a-4 by failing to preserve electronic communications retaining to its business; violated Exchange Rule 342 by failing to reasonably supervise and control the activities of its employees and by failing to establish an adequate system of follow-up and review to ensure compliance with Exchange rules and the federal securities law relating to the retention of electronic communications. Regulators commenced an inquiry into research and investment banking activities at the Firm in April 2002. In connection with the firm’s failure to provide requested emails, the JP Morgan disclosed to regulators that it failed to retain and was unable to locate or

^{7/} See Id.

^{8/} See Id.

² There are also related NASD and SEC cases in which the firm was required to pay \$700,000 to the NASD and to the United States Treasury.

restore emails related to the its business. The firm also lacked adequate systems and procedures for the preservation of email. (Censure, fine of \$2,100,000 and an undertaking.)

UBS Securities LLC¹⁰
HPD 05-062 (May 19, 2005)
SEC Release No. 34-52022 (July 13, 2005)

Violated Exchange Rule 440, Section 17(a) of the Securities and Exchange Act of 1934 and Rule 17a-4 by failing to preserve electronic communications retaining to its business; violated Exchange Rule 342 by failing to reasonably supervise and control the activities of its employees and by failing to establish an adequate system of follow-up and review to ensure compliance with Exchange rules and the federal securities law relating to the retention of electronic communications. Regulators commenced an inquiry into the firm's research and investment banking activities and requested e-mail records. The firm was unable to produce all responsive email because back-up tapes could not be located, were mislabeled or corrupted. (Censure, \$2,100,000 fine and an undertaking.)

Merrill Lynch, Pierce, Fenner & Smith Inc.
HPD 05-087 (July 21, 2005)

Violated Exchange Rule 440, Section 17(a) of the SEA and Rule 17a-4. In 2001 and 2002 Merrill was the subject of repeat findings by Exchange examiners that indicated that Merrill had failed to preserve or retain electronic communications in a manner consistent with the requirements of the above rule. Merrill did not have its e-mail stored in a "write once read many" format as required by SEA Rule 17a-4(f)(2)(ii). Other emails could not be located or were not maintained. (Censure and \$10,000,000 fine (note: there were many violations beyond just email retention.))

Brean Murray & Co., Inc.
HPD 05-081 (August 5, 2005)

Violated Section 17(a) of the SEA Act of 1934 and Rules 17a-3 and 17a-4 thereunder and Exchange Rule 440 by failing to properly preserve email communications. Email must be preserved for three years by means of electronic storage media in non-writable, non-erasable format. The Firm failed to maintain emails in write once read many format. (Censure and \$175,000 fine (other violations omitted).)

¹⁰ There are also related NASD and SEC cases in which the firm was required to pay \$700,000 to the NASD and to the United States Treasury.

Moors & Cabot, Inc.
HPD 05-083 (August 5, 2005)

Violated Exchange Rule 440 and SEA Rule 17a-4 in that it failed to properly preserve electronic communications. Moore retained all incoming email on its server but not in a non-rewritable, non-erasable format, as required. Procedure for retaining outgoing email was deemed inadequate because the firm relied on individual senders for retention and could not guarantee the retention of all required communications. (Censure and \$250,000 fine (other violations omitted).)

Charles Schwab & Co., Inc.
HPD 05-110 (October 17, 2005)

Violated SEA of 1934 and Rules 17a-4(b)(4) and 17a-4(f) and Exchange Rule 440 by failing to preserve and maintain electronic communications in the required format and for the required retention periods. From June-December 2002, the firm failed to preserve and maintain internal e-mail communications. From March-December 2003, it failed to maintain instant messaging communications sent and received via Bloomberg terminals. (Censure and \$100,000 fine (other violations omitted).)

Nomura Securities International, Inc.
HPD 05-112 (October 17, 2005)

Violated NYSE Rule 440 and SEA Rule 17a-4 by failing to retain attachments to certain e-mails sent or received via Bloomberg's proprietary e-mail system. Prior to July 2003, Nomura believed that Bloomberg had the ability to retrieve any attachments as needed. In July 2003, the firm realized Bloomberg was not archiving email attachments. (Censure and \$400,000 fine (other violations omitted).)

Oppenheimer & Co. Inc.
HPD 05-190 (December 29, 2005)

During at least 2003, the firm's internal e-mail communications were not retained in the required format. (Censure and \$1,350,000 fine (other violations omitted).)

UBS Financial Services Inc.
HPD 06-005 (January 12, 2006)

While reviewing allegations that the firm failed to prevent the market-timing activities of its financial advisers, the Exchange discovered that the firm also failed to retain internal and external emails for at least 135 employees. (Censure and \$1.5 million fine for email violations (total fine much higher) and undertakings (other significant violations omitted).)

C. SEC CASES

National Stock Exchange (NSX) 2005 SEC Lexis 1178 (May 19, 2005)

The NSX consented to findings that it failed to establish email retention policies and to preserve business related emails until November 2003. (Cease and desist order and an undertaking (other violations omitted).)

Banc of America Investment Services, Inc. & BACAP Distributors, LLC 2005 SEC Lexis 1406 (June 15, 2005)

The firm consented to findings that it failed to establish adequate supervisory systems or procedures to ensure the retention of emails and failed to preserve emails. Prior to June 2001, the firm's practice was to overwrite backup tapes every 90 days. In June 2001, the firm began using a software system to store emails, but did not implement adequate systems and procedures to ensure email retention until February 2004. (Cease and desist, undertaking and \$1,000,000 fine.)

In the Matter of Merrill Lynch, Pierce, Fenner & Smith Inc. SEC Release No. 34-53473 (March 13, 2006)

The firm consented to findings that it failed to retain emails and promptly produce emails. The firm's retention and storage system caused it not to capture emailed that had been moved or deleted prior to the periodically scheduled email backups and the firm was unable to promptly access and produce emails requested by the SEC staff. (Cease and desist, \$2,500,000 fine and an undertaking.)

D. NASD CASES

Jefferson Pilot Securities Corporation NASD News Release (March 16, 2005) NASD NTM Disciplinary Actions (April 2005, p. 16)

The firm failed to retain the emails of its registered representatives. From January 2001 to December 2003, the firm's system purged stored emails after 60 days. (\$125,000 fine.)

Thomas Weisel Partners NASD News Release (March 30, 2005) NASD NTM Disciplinary Actions (April 2005, p. 13)

The firm received improper commissions in connection with IPO allocation practices. From January 1999 to third quarter of 2001, the firm failed to retain emails. (\$1,300,000 disgorgement and \$450,000 fine.)

Bisys Fund Services Limited Partnership
NASD Case# E112004043501 (February 2006)

The firm submitted failed to establish supervisory procedures designed to ensure email retention and did not follow-up and review to ensure hard-copies of emails were retained. (Censure, \$50,000 fine and undertaking.)

Tejas Securities Group, Inc.
NASD Case# E062004010901 (February 2006)

The firm failed to establish a system to maintain emails. The firm also failed to implement a system to monitor, archive and retrieve instant messages. Additional findings included a failure to evidence review of emails, prepare a needs analysis, training plan for their continuing education program and report corporate bonds through TRACE and other trading related record keeping violations. (Censure and \$225,000 fine.)

Diversified Investors Securities
NASD NTM Disciplinary Actions (March 2006, p. 21)

The firm facilitated impermissible market-timing activities and failed to retain emails from November 2000 to December 2003. (Fined \$1.3 million and ordered to pay \$950,000 in restitution to the mutual fund.)

IV. SEC RECORD RETENTION¹¹

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

¹¹ For a comprehensive treatment of the retention of electronic communication issues, see the outline used by the panelists at the 2003 SIA Compliance & Legal Division seminar.

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.

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 (e.g., 3 years) after which the records can be deleted from the system. Under the interpretation, a broker-dealer can store records electronically on magnetic WORM disk.

V. WRITTEN SUPERVISORY PROCEDURES

A. INTRODUCTION

The development of written supervisory procedures is a hot topic in the industry. Securities regulators are placing increased emphasis on the creation, maintenance and enforcement of written procedures reasonably designed to supervise firms' business activities. This heightened scrutiny has included self-regulatory organization communications to member organizations intended to provide guidance on the form and content of written supervisory procedures, evaluation of the adequacy of such procedures during the examination process, and the institution of disciplinary actions against firms alleging the lack of or inadequate written policies and procedures.

In today's regulatory climate, it is critical for compliance and legal professionals, as well as the senior management of each firm's business units, to understand and appreciate the importance of effective supervisory procedures. This section discusses several key issues relating to the development of written supervisory procedures in an effort to provide information concerning various regulatory pronouncements on this topic and to furnish practical guidance on the creation of effective written policies and procedures.

B. SELF-REGULATORY ORGANIZATION RULES

National Association of Securities Dealers

1. Conduct Rule 3010

- a. In 1988, the NASD, concerned that brokers were engaging in the offer and sale of securities to the public without adequate supervision, and particularly, when such persons conducted business at locations not subject to regular internal examinations and without direct oversight by supervisors, amended its supervisory rules.^{17/}

¹⁶ See Exchange Act Release No. 47806 (May 7, 2003).

^{17/} See NASD Notice to Members 88-84 (November 1988).

- b. The new rules required that each NASD member “establish and maintain a *system to supervise* the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the rules of [the NASD].” (Rule 3010(a)) (emphasis added).
- (i) The NASD has indicated that the supervisory system developed by each firm should be appropriately tailored to the firm’s business activities and organization. Factors to be considered include:
- (a) Products offered and types of clients (e.g., retail or institutional);
- (b) Number and geographic location of the firm’s branches and OSJs, as well as personnel;
- (c) Reporting systems, business units, and organizational structure;
- (d) Experience of firm employees, including whether certain firm personnel should be subject to heightened supervisory procedures in light of their industry record (i.e., history of customer complaints, disciplinary actions, or arbitration proceedings); and
- (e) Applicable regulatory requirements, including specific activities required in each product or back office area.^{18/}
- c. The 1988 amendments also mandated that each member firm “establish, maintain, and enforce *written procedures* to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable rules of [the NASD].” (Rule 3010(b)) (emphasis added).
- (i) The NASD has articulated several reasons why it believes written supervisory procedures are important.

^{18/} See NASD Notice to Members 99-45 (June 1999).

- (a) Written procedures provide firm personnel subject to the supervisory system, as well as supervisors, a document that explains the supervisory system and each person's specific duties and responsibilities.
 - (b) Written procedures provide "stability and continuity" within a firm as employees assume different responsibilities and/or leave.
 - (c) Written procedures allow senior management to determine whether employees are complying with the supervisory system by examining for compliance with the written procedures.^{19/}
- d. Written Supervisory Procedures vs. Supervisory System
- (i) As noted above, under NASD rules, firms are obligated to establish and implement both a supervisory system and reasonable written supervisory procedures.
 - (ii) Written supervisory procedures memorialize the supervisory system that the firm has established. A supervisory system may include automated exception and surveillance reports that monitor for unusual trading activity in client or proprietary accounts. The written supervisory procedures provide guidance about the reports generated by the surveillance system and how the supervisor is to use those materials to conduct his or her supervisory reviews.^{20/}
 - (iii) In the NASD's view, a firm may violate Conduct Rule 3010 in several different ways, including:
 - (a) Failing to establish, maintain and enforce a supervisory system.
 - (b) Failing to describe the operation of that system in written supervisory procedures.^{21/}

^{19/} See NASD Notice to Members 99-45.

^{20/} See NASD Notice to Members 99-45.

^{21/} According to the NASD, either type of violation may occur in the absence of an underlying rule violation. See NASD Notice to Members 98-96 (December 1998).

- e. Written Supervisory Procedures vs. Compliance Guidelines
 - (i) Compliance policies generally set forth the relevant rules and firm protocols that must be adhered to and describe specific prohibited practices. Written supervisory procedures, however, document the supervisory system that has been established to reasonably prevent and detect improper conduct.^{22/}

2. Guidance Contained in Conduct Rule 3010(b)

- a. The text of Conduct Rule 3010(b) provides limited guidance as to what is required in a firm's written supervisory procedures.
- b. The rule requires that the written procedures:
 - (i) set forth the supervisory system established by the firm pursuant to Conduct Rule 3010(a); and
 - (ii) "shall include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and the Rules of [the NASD]."

3. NASD Notices to Members

- a. The NASD has issued several notices concerning the requirement that firms establish written supervisory procedures.
- b. These include: NASD Notice To Members 88-84 (November 1988); NASD Notice To Members 89-34 (April 1989); NASD Notice To Members 98-96 (December 1998); and NASD Notice To Members 99-45 (June 1999).^{23/}
- c. In these notices, the NASD has identified *four keys* to creating written supervisory procedures: identification of responsible individuals, a description of the supervisory tasks, a statement of

^{22/} See NASD Notice to Members 99-45.

^{23/} In 2004, both the NASD and NYSE received SEC approval for significant changes to their supervisory and control rules. Among other things, both SROs require firms to test and verify that supervisory policies and procedures are reasonably designed to comply with applicable rules and to amend those procedures where necessary. See NASD Notice to Members 04-71 (October 2004) and NYSE Information Memo 04-38 (July 26, 2004).

the frequency of the reviews to be conducted and documentation of the completion of the required actions.^{24/} According to the NASD:

- (i) Written supervisory procedures should ***identify the specific individual(s) responsible for supervision*** -- either by name or by title and position. The NASD has recently stated that “[a] member must keep a record of each associated person who has supervisory responsibilities and the date each person was assigned those responsibilities. This must include the titles, registration status, and locations of the supervisory personnel. The written procedures also must include the business line and applicable securities laws for which each supervisor is responsible.” NASD Notice to Members 99-45.
 - (a) The NASD has noted that one purpose of its supervision rule is to allow for personnel at the firm, as well as regulators, to easily determine who is responsible for supervising a particular area and the time period for which the person was assigned the supervisory responsibility.
- (ii) Written supervisory procedures should ***describe the supervisory reviews and actions to be completed*** by the appropriate supervisor. While this part of the procedures need not be detailed, it should identify any exception reports and/or other materials or information being reviewed and the substantive area being reviewed. Where a firm uses automated systems, such systems should also be described generally in the procedures.
- (iii) Written supervisory procedures should ***describe the frequency*** of all reviews. The description should be more specific than providing for “a review” or “a review from time to time.” The frequency of reviews should be specified in the procedures (e.g., daily, weekly, monthly, quarterly, or annually). How frequently a firm conducts any given review depends upon the nature, type, or level of activity.

^{24/} See generally NASD Notice to Members 98-96. While the NASD’s guidance concerning these issues provided in this NTM related to procedures for market making activities, the broad principles may be useful in developing procedures for other business areas. See also NASD Notices to Members 99-35 and 00-44, describing supervisory issues concerning the sale of variable annuities and variable life insurance.

(iv) Written supervisory procedures should *describe how reviews* should be *documented* (e.g., initialing order tickets and/or trade blotters or completing logs or checklists that identify those reviews). The procedures should also provide for the documentation of steps taken by the supervisor as a result of the reviews (e.g., busted trades, contact with customer, etc.) The NASD “recognizes that there are a variety of ways, in addition to those noted, that reviews can be documented as having been conducted, particularly where the review is conducted on-line. Firms should document reviews in a manner sufficient to demonstrate to firm management and regulators that a review has been conducted.” NASD Notice to Members 98-96.

d. NASD has noted certain common deficiencies in firms’ written supervisory procedures. While the NASD has indicated that “[m]erely avoiding these bad practices in no way ensures that a firm’s written procedures will be found to be adequate[, a]voiding these particular practices, however, could assist member firms significantly in developing adequate written supervisory procedures.” NASD Notice to Members 98-96. In the NASD’s view, the following practices would raise regulatory concerns about the adequacy of a firm’s written supervisory policies and procedures:

(i) Reciting the applicable rules. Duplicating or restating the rules and identifying prohibited conduct, without describing the firm’s process to determine whether employees are complying with those rules, is not sufficient.

(ii) Stating that a department or unidentified person (e.g., the “Compliance Department,” “Trading Department,” or a “principal”) will conduct a supervisory review is not sufficient. The procedures should be more specific (e.g., that “John Doe will review” or “the head trader will review”). The NASD notes that the person designated to perform the review should be adequately experienced and qualified to do such a review.

(iii) Describing a review in vague terms so that a firm’s management (and regulators) are unable to determine what the review requires. For example, it is not sufficient to state in the procedures that “John Doe will review for compliance with all NASD trade reporting rules, limit order protection, etc.”

- (iv) Failing to preserve and maintain the documentation evidencing that a supervisory review has been completed.
- (v) Failing to describe the frequency of a particular supervisory review.
- (vi) Failing to reflect supervisory systems in the firm's written supervisory procedures. Firms sometimes also fail to describe the reviews they carry out in their written procedures. The NASD found that this is particularly true for firms that use automated systems to monitor for compliance with various rules.
- (vii) Failing to describe the steps the firm will take in instances where a supervisor has identified a potential deficiency. Because each such situation may be different, the NASD has stated that "general procedures, versus specific steps to be taken, will be adequate for purposes of the written supervisory procedures."
- (viii) Failing to update procedures within a reasonable period to reflect new regulatory or firm procedures.
 - (a) The NASD has cautioned that written supervisory procedures are not "static documents that can be used for an indefinite period of time without modification. A firm's existing supervisory system may become outdated or ineffective as a result of changes in the firm's business lines, products, practices, or new or amended securities laws." NASD Notice to Members 99-45.
 - (b) Reasonableness is determined in view of the relevant facts and circumstances. A rule amendment relating to a type of business that a firm conducts daily should be incorporated into the written procedures prior to the effective date of the rule change. Changes in titles or other administrative matters within a firm, however, may not warrant an immediate modification of the procedures and could be updated on a periodic basis.
- (ix) Failing to preserve and maintain written supervisory procedures that were in used in the past.

New York Stock Exchange

Like the NASD, the NYSE also requires that its member organizations establish reasonable supervisory systems to prevent and detect violations of the securities laws by their employees, as well as to establish written supervisory procedures.

1. NYSE Rule 342(b)

- a. This rule provides that the “general partners or directors of each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities’ laws and regulations.”
 - (i) The rule further requires that “this person should delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control.”
 - (ii) Finally, under Rule 342(b), “this person shall establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.”
- b. The NYSE has interpreted Rule 342(b) to require that firms create and maintain, a “written and dated ‘table of supervision’ identifying the person with overall responsibility for the organization’s internal supervision and control and compliance with applicable regulations as well as those individuals to whom such specific duties have been delegated.” NYSE Interpretation Handbook Rule 342 (a) & (b)/01.
 - (i) “Both the individual and the specific duty entailed (by geographic area department and business activity) must be evident.” Id.
 - (ii) The table should be maintained on a current basis and any superseded pages retained by the firm.

2. NYSE Rule 342.16

- a. This rule concerns the establishment of supervisory policies regarding brokers and their transactions and customer accounts. “Such policies and procedures should be in writing and be designed to reasonably supervise each registered representative.”

- (i) The NYSE has provided little guidance on what is required with respect to these written policies, stating that “[t]he duty to maintain a written statement of supervisory procedures should be reflected in a distinct and specifically identifiable manual of such procedures, whose provisions are to be enforced by the member organization. A copy of this manual is to be kept at the principal office and at each branch office of the member organization.” (NYSE Interpretation Handbook Rule 342.16/02).
- (ii) The NYSE also distinguishes these written supervisory procedures from compliance manuals. The NYSE has stated that “a principal method for ensuring that firm personnel are aware of and comply with the organization’s house rules, Exchange requirements, SEC regulations, and other applicable provisions of law, is by the maintenance of a timely, accurate and complete written manual of procedures and practices with which all such firm personnel are expected to comply. Consequently, member organizations are expected to maintain a form of compliance manual appropriate to the type of firm involved, its size and product lines engaged in by it and to make copies available to all appropriate firm personnel.” (NYSE Interpretation Handbook Rule 342.16/03).

C. SEC RULES

With one exception, the federal securities laws and SEC rules *do not require broker-dealers to affirmatively* create and maintain written supervisory procedures. This is in contrast to the requirements of the SROs described above.

1. Section 15(f) of the Securities Exchange Act of 1934

- a. This provision requires firms to “establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such [firm’s] business, to prevent the misuse . . . of material, nonpublic information by such [firm] or any person associated with such [firm].”

2. Section 15(b)(4)(E) of the 1934 Act

- a. This provision authorizes the SEC to impose sanctions on a broker-dealer if the Commission finds that the broker-dealer or any of its associated persons have “failed reasonably to supervise, with a view to preventing violations of [certain enumerated provisions of the federal securities laws] by another person who commits such a violation, if such other person is subject to his supervision.”

- b. Section 15(b)(4)(E) also provides that a firm “shall not be deemed to have failed reasonably to supervise another person, if there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and [the firm] has reasonably discharged the duties and obligations incumbent upon [it] by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.”

D. GUIDANCE ON THE DEVELOPMENT OF WRITTEN PROCEDURES

In creating written supervisory procedures for their firms, compliance and legal professionals should consider the following steps in that process:

- 1. Determine what areas of the firm need new or revised procedures. This can be accomplished by:**
 - a. Review of SRO and SEC pronouncements and disciplinary cases
 - b. Discussions with business personnel
 - c. Results of regulatory or internal examinations
 - d. Networking with colleagues at other firms
- 2. Collect and analyze relevant information and materials, including:**
 - a. NTMs and Information Memos, SEC reports, disciplinary actions
 - b. Sample procedures provided by seminar participants
 - c. Procedures used by other firms
- 3. Meet with and discuss relevant issues with the area’s employees and management**
 - a. Determine how the business is conducted and what steps the supervisors already take to monitor their area’s activity
 - b. Ascertain what computer or manual reports are used to monitor the business
 - c. Find out what supervisors may have done at their prior firms or what their colleagues do at other firms
 - d. Discuss what reviews are reasonable and practical to accomplish and how those actions can be documented

4. Develop draft supervisory procedures

- a. The procedures must be tailored to the firm's business and personnel and be reasonably designed to monitor those activities and employees
- b. The procedures should attempt to incorporate the four keys identified by the NASD and NYSE (identification of responsible personnel, description of steps, frequency of reviews and documentation of completion)
- c. A general description of the actions to be taken by the supervisor in the event potential problems are detected should be included in the procedures
- d. The procedures should be user-friendly and clearly articulate the duties and responsibilities of the supervisor
- e. Provisions for the delegation by the supervisor, to another qualified principal, should be included in the procedures
- f. The procedures should include some way to document that the supervisor has completed the required reviews (e.g., periodic certification)

5. Review the draft procedures with the business area's employees and management

- a. Ensure that they understand and can carry out the tasks described in the procedures
- b. Obtain any comments from the business unit and incorporate them into the procedures, if appropriate. Discuss reasons for not modifying the procedures (e.g., requirements of rule mandate that some step be taken)

6. Finalize and implement the procedures

- a. Ensure that the supervisor obtains a copy of the written procedures in a timely manner

7. Periodically assess whether modifications to the procedures are necessary