

# **ELECTRONIC COMMUNICATION**

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## **I. INTRODUCTION<sup>1/</sup>**

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) electronic communications in regulatory examinations; (4) selected recent enforcement actions in these areas; and (5) 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.

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<sup>1/</sup> 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 sections describing examination priorities and enforcement cases were put together by Julia Miller of Morgan Lewis. The record retention section was provided by Randall Roy of the SEC for a prior outline, except as noted. 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.”<sup>2/</sup>

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

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<sup>2/</sup> 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);<sup>3/</sup>
- 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.”<sup>4/</sup>

Both the NYSE and NASD indicated that in conducting correspondence reviews, firms could use reasonable sampling techniques.<sup>5/</sup> Moreover, the regulators noted that e-mails could be reviewed electronically and that evidence of such reviews may be recorded in electronic format.

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<sup>3/</sup> “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.” NASD Rule 3070(c) is similar in nature.

<sup>4/</sup> Again, NASD NTM 98-11 contains substantially the same text as NYSE Information Memo 98-3.

<sup>5/</sup> 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 (continued).

NYSE Regulation created an Electronic Communications Task Force to consider the supervisory, retention and technology issues affecting broker-dealers. The Task Force, consisting of NYSE Regulation and NASD staff, industry experts and outside counsel has substantially completed its work on the supervision of electronic communication. It is anticipated that the regulators will issue a memorandum providing guidance on this topic to the industry. As of the writing of this outline in January 2007, the memorandum had not been published.

### **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 NASD indicated that members must supervise the use of instant messaging in a manner that is consistent with NASD's requirements for supervising e-mail messages. In spite of the perceived informality of instant messaging communications, NASD stated that, depending on the circumstances, instant messaging could be construed as either sales literature or correspondence. Therefore, NASD noted that compliance with applicable rules requires clear supervisory and review procedures that are followed consistently.

Further, 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**

NASD has provided certain guidance concerning the supervision of brokers using chat rooms. In particular, NASD has noted that participation by brokers in chat rooms is considered a public

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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.

appearance that is subject to NASD guidelines concerning such appearances.<sup>6/</sup> Where a firm allows a broker to participate in a chat room extemporaneously, 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 chat room presentations by brokers. In light of these issues, 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.”<sup>7/</sup>

#### **E. WEB SITES**

According to 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.<sup>8/</sup>

### **III. ELECTRONIC COMMUNICATIONS IN SEC, SRO AND STATE EXAMINATIONS**

#### **A. SEC**

At the SIFMA Compliance and Legal Division’s Fall 2006 Compliance Seminar, senior SEC staff noted that e-mails were a current examination priority at OCIE.<sup>9</sup>

#### **B. NASD**

Robert Errico, EVP of Member Regulation at NASD highlighted a number of topics and regulations that would be priorities in future NASD examinations in a May 17 letter to firms. Included among the emphasized items was the use of e-mail. As Mr. Errico stated:

Pursuant to SEC Rule 17a-4, firms are required to establish an adequate system for the retention of all e-mail relating to their business as such. Additionally, all e-mail sent from a registered representative to a customer relating to the firm’s investment banking or securities business, irrespective of where the e-mail originates, is subject to the applicable NASD rules regarding communications with the public, as well as NASD rules regarding the supervision, review and retention of such correspondence.<sup>10</sup>

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<sup>6/</sup> Guide to the Internet for Registered Representatives, available on the web at [http://www.nasd.com/RulesRegulation/IssueCenter/Advertising/NASDW\\_006118?sourceNodeID=606](http://www.nasd.com/RulesRegulation/IssueCenter/Advertising/NASDW_006118?sourceNodeID=606)

<sup>7/</sup> See Id.

<sup>8/</sup> See Id.

<sup>9</sup> See Morgan, Lewis & Bockius LLP’s November 20, 2006 Memo regarding the SIFMA–Compliance and Legal Division Fall Compliance Seminar in New York City, November 13, 2006

<sup>10</sup> *Available at:* <http://www.nasd.com/exampriorities>

Additionally, in its May 2006 communication, “Improving Examination Results,” NASD expressed 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. Our examiners will focus on the filing of the required notification with NASD, and will continue to review to ensure that the use of electronic storage media by member firms to maintain and preserve required records meets the requirements of SEC Rule 17a-4(f).<sup>11</sup>

Further, NASD staff listed electronic communications as one of its exam priorities at the SIFMA Compliance and Legal Division’s Fall 2006 Compliance Seminar.<sup>12</sup>

### C. NYSE

NYSE Regulation has also put an emphasis on electronic communications, recently listing supervision of electronic communications as an exam priority.<sup>13</sup>

### D. STATE EXAMINERS

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 which were found in the examinations, 30 concerned e-mail correspondence.<sup>14</sup> 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) [*sic*] outside the firm.<sup>15</sup>

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<sup>11</sup> Available at: [http://www.nasd.com/RulesRegulation/ComplianceTools/ImprovingExamResults/NASDW\\_016582](http://www.nasd.com/RulesRegulation/ComplianceTools/ImprovingExamResults/NASDW_016582)

<sup>12</sup> See Morgan, Lewis & Bockius LLP’s November 20, 2006 Memo regarding the SIFMA–Compliance and Legal Division Fall Compliance Seminar in New York City, November 13, 2006

<sup>13</sup> See Id.

<sup>14</sup> See <http://www.nasaa.org/content/Files/BDExams06.ppt>

<sup>15</sup> NASAA Examinations Identify Top BD Compliance Deficiencies, available at [http://www.nasaa.org/NASAA\\_Newsroom/Current\\_NASAA\\_Headlines/5281.cfm](http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/5281.cfm)

#### **IV. SELECT ENFORCEMENT CASES RELATING TO ELECTRONIC COMMUNICATIONS**

##### **A. BACKGROUND**

Below is a description of 17 NYSE Regulation Hearing Board Decisions, 2 SEC settlements and 5 NASD actions issued between January 2006 and December 2006 that relate to a firm's responsibility to supervise, retain and/or produce electronic communications.

##### **B. NYSE REGULATION CASES**

###### **National Financial Services, LLC HBD 06-199, November 13, 2006**

Consented to censure and a fine of \$125,000 for, among other violations, allegedly failing to preserve and supervise e-mails. The firm allegedly failed to preserve electronic communications in a non-rewritable, non-erasable format and allegedly failed to establish and maintain adequate supervision and control procedures with respect to the retention and review of electronic communications.

###### **Bear Wagner Specialists HBD 06-195, November 6, 2006**

Consented to censure and a fine of \$35,000 for allegedly failing to supervise e-mails. The firm allegedly did not have reasonable supervision and control procedures regarding the review of electronic communications and allegedly failed to establish and implement written procedures for the review of electronic communications between firm employees and the public.

###### **Bear Hunter Structured Products HBD 06-194, November 6, 2006**

Consented to censure and a fine of \$55,000 for allegedly failing to preserve and supervise e-mails. The firm allegedly failed to properly preserve electronic communications, failed to establish or implement written procedures concerning the review of electronic communications with the public, and allegedly failed to reasonably supervise and control the preservation and review of electronic communications.

###### **First Albany Capital, Inc. HBD 06-175, October 11, 2006**

The firm consented to censure and a \$100,000 fine for alleged violations relating to, among other issues, conduct and procedures regarding research reports, review of branch office manager correspondence and retention of e-mail during the period July through September 2003.

NYSE Regulation alleged that the firm failed to have adequate procedures regarding review of correspondence with the public. Branch office managers were responsible for reviewing their own correspondence and e-mails sent by branch office managers were not approved before being

sent. Further, the firm failed to retain its e-mails and instant messages in the WORM (write once, read many times) format.

**Bernard Herold & Company**  
**HBD 06-158, August 24, 2006**

Consented to censure and a fine of \$50,000 for allegedly failing to preserve and supervise e-mails. The firm allegedly failed to retain its electronic communications in a non-rewritable, non-erasable format and allegedly failed to establish supervision and control procedures regarding the retention and review of electronic communications.

**Wachovia Capital Markets, LLC, et al.**  
**HBD 06-150, 151, and 152, August 1, 2006**

Three subsidiaries of Wachovia Corporation consented to a \$2.25 million fine and findings that they failed to adequately supervise or retain electronic communications. These charges were related to alleged e-mail production issues that occurred during NASAA's investigation into conflicts of interest involving research analysts. The firms allegedly failed to adequately retain e-mail from January 1999 through September 2002.

SPRU examinations in 2002 and 2003 allegedly revealed that one of the subsidiaries was not maintaining e-mail in a WORM format. In addition, this subsidiary allegedly did not retain e-mails from employees from a firm it acquired.

Another subsidiary allegedly failed to adequately retain e-mails from its branches because of unrecorded system errors. NYSE Regulation also alleged that these two subsidiaries had systems failures that caused the firms to violate NYSE Regulation rules regarding retention of e-mails and instant messages.

The third subsidiary was charged with not retaining e-mails for 3 years before 2002 and having a system in place that did not backup e-mails that were deleted by employees from their e-mail inboxes.

Based on these charges, all three entities were charged with a failure to supervise.

**CIBC**  
**HBD 06-140, July 17, 2006**

Consented to censure and a fine of \$200,000 for, among other violations, allegedly failing to supervise e-mail communications. The firm allegedly failed to reasonably supervise and provide appropriate supervision and control procedures with respect to electronic communications, to ensure that Bloomberg messages were reviewed.

**Daiwa Securities America, Inc.**  
**HBD 06-137, July 10, 2006**

Consented to censure and a fine of \$250,000 for, among other violations, allegedly failing to preserve and supervise instant messages and e-mails. Additionally, according to NYSE

Regulation, several firm employees did not adequately evidence their review of a sampling of 10% of their subordinates' e-mails, as required by firm policy.

**UBS Financial Services, Inc.**  
**HBD 06-116, July 5, 2006**

The firm consented to censure and a \$175,000 fine for alleged violations during 2003 and 2004 concerning, among other issues, failing to exercise reasonable supervision and control with respect to the review of communications, trade corrections, review of trades in customer accounts, records of customer addresses, and restriction of accounts in which customers reneged on trades.

According to NYSE Regulation, the firm's written policies and procedures during the relevant period required supervisory personnel to review at least 15% of the email messages of each branch office employee. During the relevant time period, supervisory employees in three branch offices reviewed less than 15% of the email communications sent and received by certain employees. In several instances, no e-mails of certain employees were reviewed.

**Westminster Securities Corporation**  
**HBD 06-84, June 29, 2006**

Consented to censure and a fine of \$72,500 for, among other violations, allegedly failing to supervise e-mails. The firm allegedly failed to supervise electronic communications with the public, including instant messages, facsimiles, the use of external email systems and communications through a firm-sponsored website.

**Scott & Stringfellow, Inc.**  
**HBD 06-98, June 26, 2006**

The firm consented to censure and a \$175,000 for alleged violations relating to, among other issues, placing customers in unsuitable classes of mutual fund shares, and supervision of research analysts' e-mails during the period January 2003 through March 2003.

NYSE Regulation alleged that the firm did not have adequate procedures regarding the review of communications sent by the research department within the firm and that research analysts' e-mails sent within the firm were not reviewed prior to transmission on any systematic basis.

**Kabrik Trading LLC**  
**HBD 06-13, May 10, 2006**

Consented to censure and a fine of \$50,000 for, among other violations, allegedly failing to preserve and supervise e-mails. The firm allegedly did not properly retain electronic communications, did not conduct supervisory reviews of electronic communications and had no written policies relating to such a review.

**Quick & Reilly, Inc., et al.**  
**HBD 06-38, 39 and 40, May 10, 2006**

The settlement involved allegations against three firms, Quick & Reilly, Fleet Specialists, Inc. and Fleet Securities, Inc. All three companies are subsidiaries of Quick & Reilly / Fleet Securities, Inc. Quick & Reilly and Fleet Specialists, Inc. consented to censure and a fine of \$200,000 and Fleet Securities, Inc. consented to censure and a fine of \$350,000 for allegedly failing to adequately supervise or retain electronic communications.

All three firms were charged with having inadequately retained e-mails from April 2001 to November 2002. In addition, Debt Capital Markets, a subsidiary of Fleet Specialists, Inc. allegedly failed to retain e-mail from September 2000 to November 2002 and January 14 to February 15, 2003.

The firms were also charged with a supervisory failure based on the charge noted above.

Fleet Specialists, Inc. was also charged based on allegations that supervisors at Debt Capital Markets did not review the e-mails of its registered representatives.

**Morgan Stanley & Co., Incorporated**  
**HBD 06-80, May 5, 2006**

The firm consented to censure and a \$2.5 million fine to NYSE Regulation as part of a total payment of \$15 million to the SEC, NYSE Regulation and NASD for allegedly failing to timely provide requested e-mails to regulators.

According to NYSE Regulation, the firm allegedly omitted tens of thousands of e-mails from its production during the Research Analyst investigation, made misstatements about its e-mail productions, reviewed its e-mails in an untimely manner and copied over back-up tapes with relevant e-mails after receiving NYSE Regulation requests.

The alleged conduct described above also led to a failure to supervise charge.

**Prudential Equity Group, LLC**  
**HBD 06-24, April 18, 2006**

The firm consented to censure and a \$850,000 fine for alleged violations relating to e-mail retention and maintenance of supervisory logs.

The firm allegedly deleted logs documenting the firm's supervisory review of e-mails from 140 branches for a period of over three years. The firm also allegedly allowed clients to e-mail the firm's brokers using the firm's web site and did not preserve the e-mails or subject them to supervisory review.

The firm was also charged with failing to timely report the issue to NYSE Regulation after discovery.

**York Securities, Inc.**  
**HBD 06-56, April 18, 2006**

Consented to censure and a fine of \$25,000 for, among other violations, allegedly failing to preserve and supervise e-mails. According to NYSE Regulation, the firm failed to retain electronic communications in a non-rewritable, non-erasable format and did not provide adequate supervision and control procedures regarding the retention of electronic communications.

**Adams Harkness, Inc.**  
**HBD 05-183, February 15, 2006**

Consented to censure and a fine of \$200,000 for, among other violations, allegedly failing to preserve and supervise e-mails. The firm allegedly failed to preserve business-related electronic communications and did not have written policies and procedures regarding the review of certain kinds of electronic communications with the public.

**C. SEC CASES**

**In the Matter of Bear, Stearns & Co, Inc.**  
**SEC Release No. 34-54806 (November 21, 2006)**

The firm consented to findings that it failed to supervise its employees with respect to unauthorized e-mails and faxes that contained sales materials regarding securities offerings during the quiet period. The firm's failure to effectively implement its policies regarding pre-approval and post-transmission review of those communications caused it to fail to detect or prevent the communications at the time they were transmitted. (Censure, cease and desist, and an undertaking.)

**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**

**Harris Williams, LLC nka Harris Williams & Co.**  
**NASD NTM Disciplinary Actions (December 2006, p.3)**

It was found that the firm's procedures were not reasonably designed to ensure compliance with email retention requirements because they did not provide for adequate follow-up and review to ensure that hard copies of email communications were being retained. The firm also did not

maintain and preserve all e-mails as required by Exchange Rule 17a-4. (Censure and \$50,000 fine.)

**Morgan Stanley DW, Inc.**  
**NASD Press Release (December 19, 2006)**

Late in 2006, NASD brought an enforcement action against Morgan Stanley for allegedly failing to provide emails to arbitration claimants and regulators. NASD charged Morgan Stanley with routinely failing to provide emails to regulators and claimants in arbitration proceedings. NASD also alleged that Morgan Stanley falsely claimed that millions of emails had been destroyed during the September 11, 2001 attacks on the World Trade Center, where its email servers were housed. In its complaint NASD alleges that: Morgan Stanley restored on back-up tapes millions of pre-September 11 emails shortly after the attacks; Morgan Stanley retained many of the emails because many emails were maintained by individual users' computers and thus never affected by the attack; Morgan Stanley later destroyed many of the emails by overwriting back-up tapes and allowing users of the firm's email system to permanently delete the emails over extended periods of time; and Morgan Stanley violated recordkeeping rules by destroying many of the emails, failing to implement procedures regarding email retention and failing to implement adequate procedures governing searches for emails in response to requests by regulators and claimants in arbitration proceedings. This matter is currently in litigation.

**AIG Affiliate American General Securities, Inc.**  
**NASD NTM Disciplinary Actions (May 2006, p. 20-21)**

The firm was found to have participated in direct brokerage violations and failed to maintain electronic communications. The firm also failed to establish and maintain a supervisory system and procedures reasonably designed to detect such violations.  
(\$1.1 million fine)

**Bisys Fund Services Limited Partnership**  
**NASD NTM Disciplinary Actions (February 2006, p. 4)**

The firm was found to have 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 NTM Disciplinary Actions (February 2006, p.3)**

The firm was found to have 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 its continuing education program and report corporate bonds through TRACE and other trading related record keeping violations. (Censure and \$225,000 fine.)

## V. SEC RECORD RETENTION<sup>16</sup>

### A. BACKGROUND

SEC Rules 17a-3 and 17a-4 require a broker-dealer to create and preserve certain business records.<sup>17</sup> 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.<sup>18</sup> 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."<sup>19</sup> 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.<sup>20</sup>

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.<sup>21</sup> 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.

### B. RECENT DEVELOPMENT

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).<sup>22</sup> As part of an effort to limit the scope of communications required to be retained under Rule 17a-4, SIFMA has proposed a "Registration

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<sup>16</sup> 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.

<sup>17</sup> See 17 CFR 240.17a-3 & 17 CFR 240.17a-4.

<sup>18</sup> See Exchange Act Release No. 2304 (November 13, 1939).

<sup>19</sup> See Exchange Act Release No. 38245 (February 5, 1997).

<sup>20</sup> *Id.*

<sup>21</sup> See Exchange Act Release No. 47806 (May 7, 2003).

<sup>22</sup> Available at: [http://www.sia.com/comment\\_letters/15118.pdf](http://www.sia.com/comment_letters/15118.pdf) Please note that this summary of SIFMA's November 2006 letter was written by Julia Miller of Morgan Lewis & Bockius LLP.

Plus” standard, which would require the retention of communications of registered representatives plus those individuals performing other functions that may be of regulatory interest.

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.

SIFMA requested a meeting with SEC staff to further discuss its proposal.

## **VI. WRITTEN SUPERVISORY PROCEDURES**

### **A. INTRODUCTION**

The development of written supervisory procedures remains a hot topic in the industry. Securities regulators continue to place emphasis on the creation, maintenance and enforcement of written procedures reasonably designed to supervise firms’ business activities. This heightened scrutiny has included 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, 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.<sup>23/</sup>
- 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 [NASD].” (Rule 3010(a)) (emphasis added).
  - (i) 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

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<sup>23/</sup> See NASD Notice to Members 88-84 (November 1988).

- (e) Applicable regulatory requirements, including specific activities required in each product or back office area.<sup>24/</sup>
- 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 [NASD].” (Rule 3010(b)) (emphasis added).
  - (i) NASD has articulated several reasons why it believes written supervisory procedures are important.
    - (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.<sup>25/</sup>
- 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

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<sup>24/</sup> See NASD Notice to Members 99-45 (June 1999).

<sup>25/</sup> See NASD Notice to Members 99-45.

supervisor is to use those materials to conduct his or her supervisory reviews.<sup>26/</sup>

(iii) In 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.<sup>27/</sup>

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.<sup>28/</sup>

## 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 [NASD]."

## 3. NASD Notices to Members

a. NASD has issued several notices concerning the requirement that firms establish written supervisory procedures.

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<sup>26/</sup> See NASD Notice to Members 99-45.

<sup>27/</sup> According to NASD, either type of violation may occur in the absence of an underlying rule violation. See NASD Notice to Members 98-96 (December 1998).

<sup>28/</sup> See NASD Notice to Members 99-45.

- 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).<sup>29/</sup>
- c. In these notices, NASD has identified **four keys** to creating written supervisory procedures: identification of responsible individuals, a description of the supervisory tasks, a statement of the frequency of the reviews to be conducted and documentation of the completion of the required actions.<sup>30/</sup> According to NASD:
  - (i) Written supervisory procedures should **identify the specific individual(s) responsible for supervision** -- either by name or by title and position. 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) 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

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<sup>29/</sup> In 2004, both 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).

<sup>30/</sup> See generally NASD Notice to Members 98-96. While 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.

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.
- (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.) 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.<sup>31</sup> While 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 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

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<sup>31</sup> See Improving Examination Results: Frequently Found Violations Update, May 2006, available at: [http://www.nasd.com/RulesRegulation/ComplianceTools/ImprovingExamResults/NASDW\\_016582](http://www.nasd.com/RulesRegulation/ComplianceTools/ImprovingExamResults/NASDW_016582)

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"). 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. 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, 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) 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 used in the past.

## NYSE Regulation

Like NASD, NYSE Regulation 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 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**