

Supervision Challenges in a Changing Electronic World

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Topics To Be Covered

- Supervising electronic records under FINRA rules and guidance.
- Techniques for supervising new technology.
- Effective procedures for the supervision of electronic records.
- FINRA examination priorities and findings regarding electronic communications.

SEC & SRO Rules Regarding Supervision of Electronic Communications

- The federal securities laws contain certain supervisory provisions.
- However, no SEC rules specifically govern the supervision of electronic communications.
 - In May 1996, the SEC urged the SROs to adapt their rules to accommodate use of electronic communications.
 - SEC said that supervision of electronic communications should be based on the content of the message not on its form; asked if e-mails should be pre-approved.

SEC & SRO Rules Regarding Supervision of Electronic Communications (continued)

- In 1998, NYSE and NASD rule changes allowed for flexibility in monitoring communications with the public.
 - Rules permit firms to develop and implement supervisory procedures based upon their structure, size, nature of business and customer base.
 - Pre-use approval is required in specific circumstances.
 - Where pre-use approval not required, firms must:
 - Provide for education and training of employees on policies and procedures.
 - Document such education and training.
 - Implement surveillance and follow-up procedures to monitor for adherence to firm policies and procedures.

FINRA Guidance Regarding Supervision of Electronic Communications

- FINRA Regulatory Notice 07-59 (December 2007)
 - Overview
 - Development of WSPs
 - External communication review
 - Internal communication review
 - Identification of reviewer
 - Method of review (lexicon and/or random)
 - Frequency of review
 - Documentation of review

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

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

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Overview (continued)
 - Communications requiring such review include:
 - Certain communications between non-research and research departments.
 - Certain materials requiring pre-approval.
 - The identification and reporting of customer complaints.
 - The identification of prior written approval of every order error and account designation change.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

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

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- External communication review
 - “Members may employ risk-based principles to determine the extent to which additional supervisory policies and procedures are required to adequately supervise their business and manage the member’s reputational, financial and litigation risk.”
 - Non-member e-mail platforms
 - Firms are required to supervise and retain those communications.
 - Message boards
 - Firms should consider blocking access to message boards.
 - E-faxes
 - E-faxes are electronic communications and subject to review.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Internal communication review
 - With the exception of the areas described above, firms may use a risk-based approach to determine the extent to which the review of any internal communication is necessary in accordance with the supervision of their business.
 - In determining the extent to which reviews of internal communications are necessary, firms may consider:
 - Detecting when information barriers are not working.
 - Protecting against undue influence on research personnel.
 - Segregating proprietary desk activity from other areas.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Internal communication review (continued)
 - Firms may also consider various relevant processes, including:
 - Conflict management efforts.
 - Reviews of internal electronic communications completed in connection with branch or desk examinations and regulatory matters.
 - Reviews of internal electronic communications that occur in connection with transaction reviews, internal disciplinary assessments and analyses of customer complaints or arbitrations.
 - Reviews of internal electronic communications that take place as a result of issues identified regarding external electronic communication reviews.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Identification of reviewer
 - Clear identification of the person responsible for performing reviews.
 - The reviewer must evidence his/her supervision consistent with FINRA rules.
 - Supervisors may delegate certain functions to non-registered persons. Nevertheless, according to FINRA, while a supervisor may delegate his or her duty, that person remains ultimately responsible for the performance of all necessary supervisory reviews. Where functions are delegated, protocols for the escalation of regulatory issues must be in place.
 - Reviewers must have sufficient knowledge, experience, and training to adequately perform reviews.
 - Unless the firm is extremely small (e.g., sole proprietor), individuals may not conduct supervisory reviews of their own electronic communications.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Method of review
 - Encrypted communications
 - Firms must be able to supervise encrypted communications and educate reviewers on how this can be accomplished.
 - Foreign languages
 - Firms must be able to review electronic correspondence in all languages in which they conduct business.
 - If the reviewer is not fluent in the language, the firm should require independent interpretation and review.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Method of review (continued)
 - Re-review of electronic communications
 - Firms should consider having their legal and/or compliance departments re-review electronic communications that have already been reviewed by line supervisors and their delegates in certain situations.
 - Re-review might be advisable when specific problems have been identified at a branch office.
 - Firms should also consider re-reviewing selected electronic communications as part of their branch exam program.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Method of review (continued)
 - Lexicon-based reviews
 - Firms should use an appropriate lexicon.
 - Reasonable security measures to keep the list confidential should be taken.
 - The efficacy of the lexicon should be periodically evaluated.
 - A meaningful list of phrases and words.
 - The ability to add and delete phrases and words on a continuous basis.
 - The ability to review attachments and identify such documents that could circumvent the reviews.
 - The ability to restrict access to the lexicon words or phrases.
 - The ability to conduct searches that exclude trailers or exclaimers.
 - Firms should consider targeted reviews of employees' e-mails under appropriate circumstances.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Method of review (continued)
 - Random reviews
 - There is no prescribed minimum or fixed percentage that is required by regulation; the amount of electronic communications chosen for review must be reasonable given the circumstances.
 - In conducting random reviews, firms may consider factors such as the percentage of electronic correspondence based on a branch office, department or business unit or the percentage of electronic correspondence for each individual.
 - Firms may use both lexicon and random reviews.
 - Firms should develop ongoing protocols to identify and address any “loopholes” in their systems and document any additional reviews that will be conducted when these kinds of issues are identified.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Frequency of review
 - The frequency of review may vary depending on the business.
 - The frequency of review should be related to the type of business conducted, the kinds of customers involved, the scope of the activities, the location of the activities, the disciplinary record of employees, and the volume of communications.
 - Firms should prescribe reasonable time frames within which supervisors are expected to complete their reviews.

FINRA Guidance Regarding Supervision of Electronic Communications (continued)

- Documentation of the review
 - Firms must evidence their reviews either electronically or on paper and be able to reasonably demonstrate that such reviews were conducted.
 - The evidence should, at a minimum, identify the reviewer, the communication reviewed, the date of review and the steps taken as a result of any significant regulatory issues identified.

Techniques for Supervising New Technology

- Designate Responsible Staff for New Systems
 - Designate responsible staff within Legal, Compliance and IT to coordinate regarding new IT systems with messaging functionality (including in-house new products).
 - Limit authority to approve new systems.
- Engage the IT Procurement and Development Processes
 - Identify starting points in the IT procurement and development processes to identify new systems early in the process.
 - Ensure that staff are aware that requirements apply to more than e-mail.
 - Don't overlook third party and web-enabled systems that may sit outside of your IT infrastructure.
- Limit Systems for Supervision and Archiving
 - Require new systems to integrate into a single supervisory and archiving process. Avoid the proliferation of one-off solutions.

Techniques for Supervising New Technology

- Leverage an Approved Messaging System List
 - Maintain an approved messaging system list. Ensuring that staff are familiar with the list of approved systems will highlight the need for approval of new systems.
- Utilize Available Technology
 - To help identify – and block – messaging components of outside websites.
 - Limiting the risk of communications occurring outside the firm’s supervisory system is key.
 - Implement a clearing process that includes IT & Compliance to address employee requests to “unblock”.
- Create a Review Process for Updates of Existing Approved Systems (i.e. Bloomberg, etc.)
 - Make vendors aware that updates require review before rollout.

Techniques for Supervising New Technology

- Make “New Technology Plans” an Agenda Item at Regularly Scheduled Meetings Between Compliance and Desk Heads.
- Train, Train, Train
 - Require periodic training on supervision of electronic communications.
 - Include employees at all levels, and relevant support groups such as Operations and IT.
 - Incorporate this into the required annual Supervisory Training for senior managers.

Effective Procedures

- FINRA Regulatory Notice 07-59 contains the following guidance regarding the development of WSPs.
 - Quick and easy access to electronic communication policies and procedures.
 - A clear list of permissible electronic communication mechanisms.
 - An explanation of the potential consequences of non-compliance.
 - Training on a regular and as needed basis.

Effective Procedures (continued)

- Over the years, the NASD provided substantial guidance concerning the development of effective written supervisory procedures.
 - NASD NtM 98-96
 - NASD NtM 99-45
- In these Notices, the NASD 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.
 - Documentation of the completion of the required actions.

FINRA Examination Priorities and Findings

- Policies and Procedures
 - Using vague language in procedures.
 - Relying on boilerplate procedures that do not reflect actual supervisory practices.
- External Communications
 - Not monitoring for possible use of prohibited electronic communication devices/methods.
 - Allowing the use of outside e-mail accounts for business use without a system for retaining the e-mails.
 - Not maintaining all incoming and outgoing correspondence relating to a firm's business.
- Internal Communications
 - Not reviewing internal communications.
 - Reviewing internal communications but failing to respond to red flags identified in reviews.
 - Not maintaining records of internal communications.