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OUTSIDE COUNSEL

BY JEFFREY PLOTKIN

Broker-Dealer Regulations Concerning E-Mail

The press has reported that several major broker-dealers are in trouble with securities regulators for failing to preserve e-mails that could have been produced in pending investigations concerning the practices of research analysts.[1] Such reports are surprising because, over five years ago, the Securities and Exchange Commission specifically stated that its record retention rule required broker-dealers to preserve all e-mails related to its business for at least three years.

Broker-dealers also have run into trouble with securities regulators for failing to comply with other regulations applicable to e-mail, such as the NYSE and NASD rules requiring broker-dealers to conduct appropriate supervisory review of incoming and outgoing e-mail.[2]

Given the current regulatory climate, broker-dealers must ensure they comply with all regulations applicable to e-mail.

Regulatory Framework

SEC Rule 17a-4(b)(4), written prior to the advent of e-mail, requires broker-dealers to preserve for a period of not less than three years, the first two years in an "accessible" place, the "[o]riginals of all communications received and copies of all communications sent by such member, broker or dealer (including inter-office memoranda and communications) relating to his business as such."[3]

The SEC has provided scant guidance concerning what constitutes an e-mail that is "related" to a broker-dealer's "business as such."[4] The NYSE and NASD have pronounced that member firms "possess the legal capacity to insist that mail addressed to their offices be deemed to be related to their business, even if marked to the attention of a particular associated person, if they advise associated persons that personal correspondence should not be received at the firm."[5]

As such, prudent broker-dealers should adopt procedures requiring the preservation of all e-mail communications of all employees involved in their investment banking or securities business.

In 1997, the SEC promulgated Rule 17a-4(f) to allow broker-dealers to employ electronic storage media to maintain required records.[6] Because e-mails are, by their very nature, electronically transmitted and stored, broker-dealers properly should follow Rule 17a-4(f) with respect to preserving e-mails.

Among the numerous requirements of Rule 17a-4(f), a broker-dealer must:

- give prior notice to its designated examining authority that it will be utilizing electronic storage media to preserve its records;
- provide its own representation, or one from a "storage medium vendor" or other third party with appropriate expertise, that the selected storage media meets the conditions of the rule;
- preserve the records exclusively in a non-rewritable, non-erasable format;[7]
- verify automatically the quality and accuracy of the recording process;
- serialize the original, and if applicable, duplicate units of storage media, and time-date the information for the required period of retention;
- have the capacity to readily download indexes and records stored electronically to an acceptable medium for the regulators;
- store, separately from the original, a duplicate copy of the record stored on any medium acceptable under the rule;
- organize and index accurately all information maintained on both the original and any duplicate storage media;
- have in place an audit system providing for accountability regarding inputting of records preserved to electronic storage media; and
- designate at least one third party who has access to and the ability to download information from the firm's electronic storage media to any acceptable medium, who must file with the firm's designated examination authority certain undertakings with respect to the records.

Supervisory Issues

Historically, NYSE and NASD rules required principals of broker-dealers to review and approve all incoming and outgoing correspondence of registered representatives to ensure compliance with applicable securities laws and regulations.[8] These rules generally have required a so-called "pre-use" review of all outgoing communications to the public.

The explosion of e-mail traffic at broker-dealers rendered impracticable the requirement that all correspondence with the public be reviewed prior to distribution. Effective Feb. 15, 1998, the NYSE and NASD amended their rules to allow individual broker-dealers the flexibility to design supervisory procedures relating to e-mail that are appropriate to the individual firm's structure, nature and size of business and customer base.[9] This flexibility includes the option to eliminate pre-use review of all incoming or outgoing e-mail.

Jeffrey Plotkin *is a member of Eiseman, Levine, Lehrhaupt & Kakoyiannis and a consultant for KVS, Inc., a provider of e-mail archiving and management software.*

Broker-dealers, in adopting e-mail review procedures under the new rules, must, inter alia:[10]

- identify what types of correspondence will be pre- or post-reviewed;
- identify the organizational position(s) responsible for conducting review of the different types of correspondence;
- specify the minimum frequency of the reviews for each type of correspondence;
- monitor the implementation of, and compliance with, the firm's procedures for reviewing public correspondence;[11] and
- periodically re-evaluate the effectiveness of the firm's procedures or review public correspondence and consider any necessary revisions.

Under the new rules, however, broker-dealers are still required to monitor the correspondence of each of their registered representatives, and must adopt procedures to ensure the same.[12]

In recognition of the heavy burdens imposed by the supervisory regulations, especially on larger firms, the NYSE and NASD now allow broker-dealers to utilize "reasonable sampling techniques" in conducting their reviews of e-mail correspondence.[13]

Customer Complaints

The filing of any written customer complaint to a broker-dealer, including a complaint submitted by e-mail, triggers many regulatory requirements.[14] For instance:

- The NASD requires broker-dealers to keep a separate record of all written complaints of customers, along with a separate record of any action taken by the member in response to the complaint;[15]
- The broker-dealer must amend the Form U-4 of a current registered representative who is the subject of certain written customer complaints;[16]
- Broker-dealers must submit periodic reports to the NYSE and NASD containing statistical and summary information regarding customer complaints;[17] and
- Effective May 2003, the SEC will require that broker-dealers maintain a record:

> As to each associated person of each written customer complaint received by the member, broker or dealer concerning that associated person. The record shall include the complainant's name, address, and account number; the date the complaint was received; the name of any other associated person identified in the complaint; a description of the nature of the complaint; and the disposition of the complaint. Instead of the record, a member, broker or dealer may maintain a copy of each original complaint in a separate file by the associated person named in the complaint along with a record of the disposition of the complaint.[18]

Broker-dealers have run into trouble with securities regulators for failing to comply with regulations applicable to e-mail.

Prudent broker-dealers should adopt written procedures specific to customer complaints received via e-mail, including the manner in which such complaints may be discovered, reviewed, handled, filed, and reported.

Conclusion

While e-mails allow broker-dealers "timely and efficient communication with customers, prospective customers, and others,"[19] the very speed and ease of the medium raises substantial compliance issues and headaches.

To avoid any potential regulatory problems, broker-dealers should educate themselves concerning the regulations applicable to e-mail, adopt specific e-mail compliance and supervisory procedures tailored to their business and e-mail traffic, and vigilantly follow and enforce those procedures.

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(1) See, e.g., Gretchen Morgenson, Regulators Say Morgan Stanley Did Not Keep E-Mail Records, N.Y. Times, Nov. 22, 2002, at C1.

(2) See Preferred Trade, Inc., Exch. Hearing Panel Dec. 01-209 (Dec. 11, 2001) ("The Firm's policy did not ensure that supervisors were receiving all outgoing e-mails"); TD Waterhouse Investor Services, Inc., Exch. Hearing Panel Dec. 01-3 (Jan. 10, 2001) (the firm failed to adequately respond to customer complaints received via e-mail and failed to report the complaints to the NYSE).

(3) 17 C.F.R. §240.17a-4(b)(4) (parenthetical in original). NASD Conduct Rule 3110 and NYSE Rule 440 incorporate by reference the record retention requirements of SEC Rule 17a-4. Effective May 2, 2003, Rule 17a-4(b)(4) will be amended to require a broker-dealer to preserve, for the same applicable time period, the following:

> Originals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such, including all communications which are subject to rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public.

Exchange Act Release No. 44992 (Oct. 26, 2001).

(4) In 1997, the SEC issued an "interpretation" of the rule that "for record retention purposes under Rule 17a-4, the content of the electronic communication is determinative, and therefore broker-dealers must retain only those e-mail . . . communications (including inter-office communications) which relate to the broker-dealer's 'business as such.'" Exchange Act Release No. 38245 (Feb. 5, 1997).

(5) NASD Notice to Members 99-3 (Jan. 1999); NYSE Interp. Memo 98-1 (Jan. 14, 1998). Additionally, the NYSE and NASD expect that member firms will prohibit communications with the public from employees' home computers, or through third party computer systems, unless firms are capable of monitoring the communications. See NASD Notice to Members 98-11 (Jan. 1998); NYSE Info. Memo 98-3 (Jan. 14, 1998).

(6) See Exchange Act Release No. 38245 (Feb. 5, 1997).

(7) In adopting the rule, the SEC stated that an electronic storage medium would be acceptable only if it allowed for digital data recording in a non-rewritable, non-erasable format, such as write once, read many ("WORM"). See Exchange Act Release No. 38245 (Feb. 5, 1997).

(8) See NASD Rule 3010(d); NYSE Rule 342.16. These regulations do not require broker-dealers to review internal e-mails among its employees. Nonetheless, broker-dealers would be well advised to adopt voluntarily specific review procedures with respect to internal e-mails. See Merrill Lynch Announces Agreement with New York State Attorney General, Merrill Lynch Press Release (May 21, 2002), available at http://www.ml.com/about/press_release/05212002-1_ag_agreement_pr.htm (to settle charges that Merrill Lynch research analysts, who derided certain stocks in internal e-mails, issued enthusiastic reports on the same stocks in order to win or keep investment banking business, Merrill Lynch agreed to pay a $100 million fine and set up a system to monitor e-mail messages between its investment bankers and equities research analysts).

(9) See NASD Conduct Rule 3010(d)(2); NYSE Rule 342.17. If a firm's procedures eliminate the requirement of pre-use review of outgoing correspondence, the firm's procedures must provide for (1) education and training of employees concerning the firm's procedures and policies governing correspondence, (2) documentation of such education and training, and (3) surveillance and follow-up to ensure that such procedures are being implemented and complied with. See NASD Notice to Members 98-11 (Jan. 1998); NYSE Info. Memo 98-3 (Jan. 14, 1998). These new rules do not apply to communications that are widely distributed to the public, such as advertising, sales literature, and research reports. See NASD Conduct Rule 2210(b) and (c); NYSE Rule 472(a) and (b).

(10) These requirements are outlined in NASD Notice to Members 98-11 (Jan. 1998), and NYSE Info. Memo 98-3 (Jan. 14, 1998).

(11) "As an example of appropriate evidence of review, e-mail related to the member's investment banking or securities business may be reviewed electronically and the evidence of review may be recorded electronically." NASD Notice to Members 98-11 (Jan. 1998); NYSE Info. Memo 98-3 (Jan. 14, 1998).

(12) The SEC has stated that it "would expect a broker-dealer to consider providing heightened supervision for a registered representative with a history or pattern of customer complaints, disciplinary actions or arbitrations." Exchange Act Release No. 39511 (Dec. 31, 1997). The NASD and NYSE jointly have recommended that, where appropriate, member firms should restrict registered representatives with troubled pasts from using e-mail altogether. See NASD Notice to Members 97-19 (April 1997).

(13) NASD Notice to Members 98-11 (Jan. 1998); NYSE Info. Memo 98-3 (Jan. 14, 1998). The NYSE and NASD have noted that "given the complexity and cost of establishing adequate systems for effectively reviewing electronic communications," member firms may decide to continue to require pre-use review of all outgoing electronic communications. Id.

(14) A broker-dealer's written procedures should require employees who receive customer complaints to bring such complaints to the attention of designated supervisory personnel. See NASD Notice to Members 97-19 (April 1997).

(15) See NASD Conduct Rule 3110(d).

(16) See NASD Form U-4 at Item 14I(3)(a).

(17) See NASD Conduct Rule 3070(c); NYSE Rule 351(d).

(18) 17 C.F.R. § 240.17a-3(a)(18), as amended, effective May 2, 2003. See Exchange Act Release No. 44992 (Oct. 26, 2001) (the records required to be maintained under the new 17a-3(a)(18) "must include complaints received electronically from customers").

(19) NASD Notice to Members 98-11 (Jan. 1998).