

SROs Propose Joint Guidance Regarding the Supervision of Electronic Communications

Overview

On June 14, 2007, the NASD and NYSE (collectively, SROs) proposed Joint Guidance regarding the review and approval of electronic communications.¹ Recognizing the challenges that member firms face in developing supervisory systems and procedures in an ever-changing technological environment, the SROs proposed the Joint Guidance to provide greater clarity on (i) member firms' obligations with regard to the review of various types of electronic communications, and (ii) the types of policies and procedures that firms should put in place.

The proposed Joint Guidance is a welcome development, as the SROs last amended their rules regarding the supervision of electronic communications almost 10 years ago.² The Joint Guidance is notable in that it: (i) discusses the written policies and procedures that firms must develop for supervising both internal and external communications of registered and unregistered personnel, (ii) permits delegation of certain review functions to non-registered personnel, (iii) describes policies and procedures for third-party platforms and personal devices, and (iv) provides additional guidelines for lexicon-based and random reviews of electronic communications. The comment period expires on July 13, 2007.

1. Written Policies and Procedures for Internal and External Communications

As a threshold matter, firms must establish written policies and procedures for the use and supervision of electronic communications—both internal and external—that are updated on a regular basis to address new technologies that firm personnel may use. These policies and procedures should apply to both registered and unregistered personnel.

Except for those internal and external communications that specifically require supervisory review under SRO rules, firms may use risk-based principles to determine the extent to which the review of any communications is necessary. For example, the Joint Guidance suggests that firms consider reviewing internal communications to (i) detect when a firm's information barriers are not working to protect customer or issuer information, (ii) protect against undue influence of research personnel contrary to SRO rules, and (iii) monitor that proprietary trading desk activity is segregated from other areas of the firm, as required by the firm's policies.

2. Individuals Responsible for Reviewing Electronic Communications

Procedures for reviewing internal and external electronic communications should address the functions and qualifications of the reviewer and, in particular, the following areas:

- **Identification of Supervisor(s):** The supervisor(s) responsible for reviewing electronic communications must be clearly identified in the procedures.³
- **Documentation:** Supervisors must evidence their supervision as required by SRO rules, irrespective of whether the review entailed material presented electronically or on paper. Evidence of review may be satisfied by use of a log or other record from the electronic communication system that identifies (i) the reviewers, (ii) the date the material was reviewed, and (iii) any follow-up steps that were taken pertaining to identified significant regulatory issues.
- **Delegation:** In the course of supervising electronic communications, a supervisor may delegate certain

functions to persons who **need not** be registered. However, the supervisor remains ultimately responsible for the performance of all necessary supervisory reviews, irrespective of whether he or she delegates functions related to the review. Accordingly, supervisors must take reasonable and appropriate steps to ensure delegated functions are properly executed and should evidence performance of these steps sufficiently to demonstrate overall supervisory control. Where review functions are delegated, the procedures also must provide a protocol to escalate regulatory issues to the designated supervisor or other appropriate firm personnel.

- **Training and Qualifications of Reviewers:** All reviewers must have sufficient knowledge, experience, and training to adequately perform the reviews. Also, firms must be able to review electronic correspondence in all languages in which they conduct business with the public.

The SROs' guidance regarding delegation is significant and a welcome development because it provides firms with more flexibility to assign to non-registered persons certain functions relating to the review of electronic communications. While the NASD previously has issued guidance allowing firms to delegate certain review functions to non-registered persons, this guidance does not apply to electronic communications.⁴

3. Third-Party Platforms and Personal Devices

The Joint Guidance reminds firms that they must develop systems to supervise and retain all of their employees' electronic communications with customers—whether or not such communications occur through firm networks or third-party platforms. For example, if an employee uses a third-party communication system (e.g., Bloomberg, AOL Instant Messenger, or message boards) or personal electronic devices to communicate with customers, the firm is required to retain those communications and supervise them to the same extent as communications received over the firm's network.

Firms that prohibit employees' use of any non-firm platforms should consider blocking access to them and conducting periodic tests to confirm that the blocking device is functioning as designed and intended. In addition, all firms should consider requiring employees to (i) obtain pre-approval for business-related use of a personal electronic device, and (ii) periodically certify that they are in compliance with the firm's policies and procedures.

4. Methods of Reviewing Electronic Correspondence

The Joint Guidance discusses two acceptable methods for supervising electronic correspondence,⁵ which firms may consider: lexicon-based reviews and random reviews.

a. *Lexicon-based reviews of electronic correspondence:*

Firms using lexicon-based reviews should:

- Adopt words or phrases that (i) contain industry jargon, and (ii) may signal problematic communications.
- Maintain confidential lists of search words and phrases, and periodically evaluate and update the lists as needed.
- Make informed decisions regarding how best to utilize the surveillance tools they have chosen. For example, a firm that conducts lexicon-based reviews may determine that it is not necessary to review each and every lexicon "hit" in order to maintain an effective review system.
- Conduct periodic inquiries as to the effectiveness of the system (especially if the system is that of a vendor) to ensure that the system is functioning properly.
- Consider conducting targeted, concentrated reviews of employees' correspondence when warranted (e.g., when concerns are raised in connection with regulatory examination findings, internal audits, customer complaints, or regulatory inquiries).

b. *Random Review of Electronic Correspondence:*

Firms also may use a reasonable percentage sampling technique, whereby some percentage of the electronic communications is reviewed. While 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 (e.g., firm size, nature of business, customer base, and individual employee circumstances).

- c. **Combination of Lexicon and Random Review of Electronic Correspondence:** Firms should consider using a combination of lexicon and random reviews, given the strengths and weaknesses of any single review tool. For example, use of a lexicon system, alone, may be inadequate where (i) the system is incapable of reading documents or attachments that are password protected or encrypted, or (ii) the use of image files, such as JPGs, may be used to pass information through lexicon filters undetected.

Conclusion

The proposed Joint Guidance provides a framework for members to enhance their current policies and procedures for reviewing electronic communications. As communications technology continues to evolve, it is important for firms to periodically evaluate their supervisory procedures and systems to ensure that all internal and external electronic communications are being supervised and retained in accordance with SRO rules.

NOTES

1. See *NASD Notice to Members 07-30*; *NYSE Information Memo No. 07-54* (Joint Guidance). The term “electronic communication” includes, among other things, e-mails, instant messaging, text messaging, E-faxes, podcasts, and weblogs.
2. In the past, the SROs required that member firms review all correspondence (including electronic communications) of their registered representatives relating to the solicitation or execution of any securities transactions. In 1998, recognizing that the growing use of electronic correspondence such as e-mail made adherence to this requirement difficult, the SROs amended their rules to allow members the flexibility to design supervisory review procedures to review, instead, a reasonable sampling of electronic communications on a post-use basis. See *NYSE Information Memo 98-3* (January 16, 1998) and *NASD Notices to Members 98-11* and *99-03*. See also NYSE Rule 342.17 (Offices-Approval, Supervision and Control - Review of Communications with Public) and NASD Rule 3010 (Supervision). Note, however, that electronic “correspondence” is a subset of electronic communications. As such, certain types of electronic communications, such as research reports and sales literature, still require supervisory pre-approval and may not be reviewed on a post-use, spot-check basis.
3. Unless a firm’s size and/or structure (e.g., a sole proprietor) is such that the member has no other reasonable alternative for reviewing an individual’s electronic communications, an individual may not conduct supervisory reviews of his or her own electronic communications.
4. See *NASD Notice to Members 99-03* (allowing unregistered persons who have received sufficient training to review written, non-electronic correspondence).
5. See *supra*, endnote 2.

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