

NYSE and NASD Jointly Propose Guidance Regarding Supervision of Electronic Communications

June 27, 2007

The New York Stock Exchange LLC (NYSE) and the National Association of Securities Dealers, Inc. (NASD) have proposed guidance (the “Proposal”) for their members, member firms and organizations (collectively, “Members”) with respect to the supervision of electronic communications.¹ The pace of technological innovation in electronic communications and the scope of possible communications subject to review by Members highlight the need for this guidance. The Proposal emphasizes application of risk-based principles and, if adopted, will likely require substantial changes to Members’ supervisory policies and procedures. The Proposal is styled as a joint request for comment, and comments are due by July 13, 2007. The relevant background and a short summary of the Proposal are set forth below.

Background

A key aspect of any Member’s supervisory procedures is implementing appropriate review of both internal and external electronic communications. The review of electronic communications has become more challenging in recent years due to the sharp rise in the use of email. Moreover, use of other available technology, such as instant messaging, texting, and message boards, as well as new voice communication technology, has highlighted the need to modernize supervisory procedures related to review of electronic communications. Against this backdrop, the NASD and NYSE (the “SROs”) issued the Proposal to guide Members in the development of their supervisory policies, procedures, and controls.²

The Proposal has important implications for Members. The risk-based approach in the Proposal is consistent with a broader emphasis on risk management promoted by the SROs and the Securities and Exchange Commission³ and suggests Members should focus on risk areas when drafting their supervisory procedures. Moreover, Members should recognize that electronic communications are different. The

ease of communication through electronic means results in tremendous volume of such communications but also allows for review by specialized software on a large scale. Finally, the Proposal is the first significant statement by the SROs on this topic since 1998,⁴ and it offers new guidance on the types of electronic communications that require review, the individuals responsible for review, and the methodology, frequency, and documentation of review.

Discussion

In the Proposal, the SROs state that the guidance is not intended to address every regulatory issue that might arise in connection with the supervision of electronic communications. Moreover, the Proposal emphasizes that the SROs do not wish to establish a safe harbor with respect to potential supervisory or compliance deficiencies. The Proposal instead sets forth existing principles and then provides new guidance in six areas.

General Principles Set Forth in the Proposal

The Proposal begins by reviewing existing interpretive materials on electronic communications and distilling the following key requirements:

- Identifying types of correspondence that will be reviewed;
- Identifying the relevant personnel responsible for conducting reviews;
- Monitoring the implementation of procedures for reviewing public correspondence;
- Periodically re-evaluating the procedures’ effectiveness;
- Reporting customer complaints to the SROs;
- Prohibiting employees⁵ from using electronic communications not subject to supervisory review; and
- Conducting education and training.

The Six Guidelines

1. Written Policies and Procedures

The Proposal emphasizes the significance of establishing clear policies and procedures for the supervision of electronic communications, and notes that these policies and procedures must be updated to reflect the use of new technologies, such as weblogs and podcasts. Although the SROs establish no timetables, the Proposal provides, by way of example, that policies written five years ago may well be outdated. The Proposal also requires Members to provide their employees with easy access to these policies and procedures, a clear list of permissible electronic communication mechanisms (along with a statement that others are prohibited), an explanation of the consequences of non-compliance, and training on a regular and as-needed basis.

2. Types of Communications Requiring Review

The Proposal divides the guidance in this area into external and internal communications. Regarding external communications, the Proposal restates the importance of establishing reasonable policies and procedures, and suggests use of risk-based principles. A risk-based approach is consistent with the move to risk-based principles in regulatory oversight of broker-dealer firms.⁶

In addition, external communication policies and procedures must identify the permissible forms of communication with the public, for example, broker-dealer-supplied email accounts. If the Member prohibits use of particular communications through blocking mechanisms, the Member must test the effectiveness of these mechanisms. Under the Proposal, a Member should prohibit an employee from communicating with the public from his or her own electronic device unless the communication is necessary, the method can be justified, and the broker-dealer is capable of supervising the communication. Further, if a Member permits an employee to use alternate communication systems, the Member must retain and supervise these communications. The concern in this area appears to be eliminating back-channels of communication that cannot be properly policed.

Regarding internal communications, Members may employ risk-based principles in reviewing communications, except for particular areas required to be reviewed by a supervisor. Special consideration must be given to issues such as detecting when information barriers are insufficient to protect customer

or issuer information, preventing undue influence on research personnel, and determining when it is necessary to wall off the Member's proprietary trading desk activities from other parts of the firm. Members also may need to pay extra attention to electronic communications that occur in connection with examinations, regulatory inquiries, or investigations; communications related to transaction reviews, internal disciplinary reviews, and customer complaints; and communications resulting from issues identified in external communications reviews.

3. Identification of Responsible Persons

The SROs believe that Members' procedures should identify persons responsible for conducting reviews, and that as evidence of review a record should be made to identify the individual reviewers. The Proposal allows for delegation of the review function; however, the actual reviewers must have sufficient knowledge, experience, and training, and may not conduct supervisory reviews of their own communications. If the review function is delegated, a supervisor must remain accountable for the review of these communications and take reasonable steps to ensure that any delegated functions are executed properly.

4. Methods of Review

According to the Proposal, Members should tailor review procedures to their particular business. Use of off-the-shelf procedures is not acceptable unless they are substantially revised.

Reviewers should be aware of material to be examined and the issues that might arise. For example, if a Member permits encrypted electronic communications, the Member must be able to monitor and supervise those communications. Similarly, if a Member conducts business in a foreign language, that Member must be able to review correspondence in that language. Merely opening a communication will not be deemed a sufficient review.

The Proposal suggests that Members may use a "lexicon-based review," a "random review," or a combination.

- *Lexicon-Based Reviews.* For a lexicon-based review, which is a review based on the appearance of sensitive words or phrases, Members must take precautions to ensure that their list of words remains confidential. It may not be necessary to review all lexicon hits, but Members should consider review of the lexicon itself and the effectiveness of the system, particularly if obtained from a vendor.

- *Random Reviews.* For a random review, the Proposal requires Members to choose a percentage sampling technique, although the guidance prescribes no fixed percentage. The size of the sample would vary depending on circumstances such as Member size, nature of business, customer base, and individual employee circumstances.
- *Combination of Lexicon-Based and Random Reviews.* Considering the shortcomings of any single methodology, the Proposal suggests that Members consider complementary review techniques.

The SROs also provide that if circumstances warrant, Members should have their legal or compliance departments review emails previously reviewed by supervisors.

5. Frequency of Review

Although the SROs did not mandate timeframes for recurring reviews, the Proposal suggests that factors relevant to establishing reasonable timeframes for conducting reviews include the type of business conducted (i.e., the market sensitivity of the activity), the type of customers involved, the scope of activities, the location of the activities, the disciplinary record of covered persons, and the volume of communications subject to review. In addition, factors relevant to establishing timeframes for completing reviews include the type and method of the review.

6. Documentation of the Review

Finally, the Proposal requires Members to document their reviews, electronically or on paper. Such evidence should identify the reviewer, the communication reviewed, the date, and any steps taken as a result of the review.

Conclusion

The Proposal attempts to provide useful guidance to Members on the appropriate supervision of electronic communications without establishing safe harbors or bright line rules that may be susceptible to circumvention. Comments on the Proposal must be submitted to the SROs by July 13, 2007.

- 1 See NASD Notice to Members 07-30 (June 2007), available at www.nasd.com/RulesRegulation/NoticestoMembers/2007NoticestoMembers/NASDW_019297.
- 2 The proposed approach is consistent with recent regulatory trends. Supervision continues to be a high priority for the SEC's examination program and the SEC staff is looking for written supervisory procedures that are up to date, thorough, and carefully implemented. See Mary Ann Gadziala, Associate Director, SEC Office of Compliance Inspections and Examinations, Speech by SEC Staff: "The Regulatory Focus on Broker-Dealer Legal and Compliance Issues," June 7, 2007, available at www.sec.gov/news/speech/2007/spch060707mag.htm.
- 3 See, e.g., Lori Richards, Director, SEC Office of Compliance Inspections and Examinations, Speech by SEC Staff: Financial Services Institute: First Annual Public Policy Day, "An Update on the SEC's Examination Program," October 13, 2004, available at www.sec.gov/news/speech/spch101304lr.htm.
- 4 See NYSE Information Memo 98-3 (January 1998) and NASD Notice to Members 98-11 (January 1998).
- 5 Although the Proposal uses the word "employees," it presumably applies to all associated persons, including those who may be independent contractors.
- 6 See *supra* note 3.

We hope that you have found this summary of the Proposal to be helpful. Based upon the proposed guidelines, it may be advisable for certain broker-dealers to update their existing procedures to ensure compliance. If you have any questions or comments about these proposed guidelines, please contact the Mayer, Brown, Rowe & Maw attorney with whom you regularly work, or feel free to contact any one of the following attorneys:

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