Notice to Members

JULY 2003

SUGGESTED ROUTING

Legal and Compliance

Senior Management

Operations

Trading and Market Making

KEY TOPICS

Electronic Communications

Communications with the Public

Recordkeeping

INFORMATIONAL

Instant Messaging

Clarification for Members Regarding Supervisory Obligations and Recordkeeping Requirements for Instant Messaging

Executive Summary

NASD is clarifying for members their supervisory obligations and recordkeeping requirements with respect to instant messaging.

Questions/Further Information

Questions concerning this *Notice* may be directed to Mary Sue Fisher, Special Counsel, Regulation Policy, Department of Member Regulation at 202-728-8277, or Thomas A. Pappas, Associate Vice President, Advertising Regulation at 240-386-4553.

Background

The Securities and Exchange Commission (SEC) issued key releases in 1996 and 1997 that guide the use of electronic media by broker/dealers. The first release discussed the use of electronic media to deliver information to customers (Electronic Delivery Release); the second described the application of recordkeeping requirements to electronic communications (Electronic Records Release).[1] Although electronic communications technology has evolved rapidly in the intervening years, these releases established a basic principle that underlies current regulatory policy. The SEC stated in the Electronic Delivery Release that:

> SRO 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.[2]

The Electronic Records Release extended that principle to broker/dealer recordkeeping requirements, prescribing that:

> [f]or 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 and Internet communications (including inter-office communications) which relate to the broker/dealer's "business as such."[3]

NASD has followed these precepts in adopting, amending, and interpreting NASD rules governing communications with customers and the public (2200), suitability (2310), research analysts and reports (2711), supervision (3010), and books and records (3110). These rules accord members flexibility to use a variety of approaches, including innovative technologies, if their use is subject to an effective program of supervision and complies with applicable recordkeeping requirements.

Communications with the Public

NASD recognizes that evolving technologies may offer multiple functions that do not fit neatly into traditional supervisory categories. NASD therefore published the *Internet Guide for Registered Representatives* to assist registered representatives and firms in their use and supervision of electronic communications with the public.[4] The *Internet Guide* first lays out the general compliance requirements that apply to all forms of communication with the public; it then discusses how specific types of electronic media fit within existing supervisory categories. For example, the *Internet Guide* treats group e-mail as "sales literature,"[5] individual e-mail as "correspondence," publicly available Web sites as "advertisements," and chat-room discussions as "public appearances."

NASD developed the *Internet Guide* relying on the same basic principles established in the SEC's Electronic Delivery and Electronic Records Releases: the content and audience of each type of electronic communication determine the appropriate supervisory and recordkeeping treatment. These principles also form the basis of the "facts and circumstances" test adopted by NASD in its policy statement concerning online suitability.[6]

Instant Messaging

Instant messaging is a developing technology that can pose supervisory and recordkeeping challenges for member firms. Instant messaging alerts users when other users are online and enables those users to communicate in real time. Instant messaging was originally introduced as an add-on to subscription Internet services, but has a growing presence in business communication. Consumer versions of instant messaging did not provide business users with tools to monitor or archive instant messaging communication. Many firms determined that they could not adequately supervise instant messaging communications and banned the use of instant messaging for communication with the public.

Other firms have allowed use of instant messaging, reasoning that instant messaging is less formal than e-mail and paper-based communication and need not be subject to the same requirements. However, lack of formality of instant messaging does not exempt it from the general standards applicable to all forms of communication with the public. Members should evaluate instant messaging according to the "content and audience" of the instant messaging communications.

Members must supervise the use of instant messaging consistent with the required supervision of e-mail messaging. Depending on the circumstances, instant messaging could be either sales literature or correspondence.[7] Compliance in each of these situations depends on clear supervision and review procedures that are consistently followed.[8] If a member is unable to establish an adequate supervisory program, the member must prohibit the use of instant messaging in customer communication.[9]

Members must also ensure that their use of instant messaging complies with applicable SEC and NASD recordkeeping requirements. Messages exchanged on many popular instant messaging platforms cannot be saved or subsequently retrieved, making them inappropriate for communications that must be retained as firm records. Members that permit instant messaging must use a platform that enables the member to monitor, archive, and retrieve message traffic.

Internal Communications and Recordkeeping Requirements

NASD Rule 3010 requires

> each member to 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 [NASD] Rules….

NASD rules do not specifically require member firms to review or approve internal communications. However, members must be certain that they have procedures adequate to supervise the activities of each registered representative and associated person, including their use of electronic communications technology.

Members must also assure themselves that their use of electronic communications media enables them to make and keep records, as required by SEC Rules 17a-3, 17a-4, and NASD Rule 3110. Recent SEC and NASD enforcement actions serve as a forceful reminder that

> Rule 17a-4 is not limited to physical documents…. [I]nternal e-mail communications relating to a broker or dealer's "business as such" fall within the purview of Rule 17a-4.[10]

SEC Rule 17a-4(b)(4) and NASD Rule 3110

> require firms to preserve for a period of not less than three years, the first two years in an easily accessible place, originals of all communications received and copies of all communications sent by the firm or its employees relating to its business. Those rules apply to electronic communications….[11]

NASD urges members to evaluate their internal use of instant messaging in light of their supervisory and recordkeeping requirements. NASD recognizes that technology enhances business opportunities, increases public access to market information, and supports regulatory compliance. Nonetheless, the preference of employees to use instant messaging to communicate does not alter the obligation of the firm to keep relevant records. NASD members must ensure that their use of instant messaging is consistent with their basic supervisory and recordkeeping obligations.

Endnotes

1 SEC Release No. 34-37182 (May 1996) (Electronic Delivery Release); SEC Release No.34-38245 (Jan. 1997) (Electronic Records Release).

2 Electronic Delivery Release at 5.

3 Electronic Records Release at 16.

4 The *Guide* is available on the NASD Web Site at *http://www.nasdr.com/4040.asp*.

5 The treatment of group e-mail will be modified by amendments to Rule 2210, approved by the SEC on May 9, 2003. *See,* SEC Release No. 34-47820 (May 9,2003), 68 Fed. Reg. 27116 (May 19, 2003). The amended definition of "correspondence" in Rule 2210 includes any written letter or electronic mail message distributed by a member to one or more existing retail customers and fewer than 25 prospective retail customers within a 30-day period. The rule change takes effect on November 3, 2003. In the interim, NASD has taken a no-action position with respect to group e-mail sent to institutional accounts, provided that the e-mail is subject to the same supervisory system as individual correspondence. *See,* Letter from Alden S. Atkins, General Counsel, NASD Regulation to Yoon-Yung Lee, Wilmer, Cutler & Pickering, (Dec. 7, 1999) available at *http://www.nasdr.com/2910/2210_07.asp*.

6 *NASD Notice to Members 01-23*.

7 *See,* note 5 for a discussion of recently approved amendments to Rule 2210.

8 The essential elements of the supervisory program are discussed in *NASD Notice to Members 98-11*.

9 Id. *Notice to Members 98-11* states that supervisory policy and procedures must "prohibit registered representatives' and other employees' use of electronic correspondence to the public unless such communications are subject to supervisory and review procedures developed by the firm. For example, [NASD] would expect members to prohibit correspondence with customers from employees' home computers or through third party systems unless the firm is capable of monitoring such communications."

10 *See*, In Re Deutsche Bank Securities, Inc., Goldman, Sachs and Co., Morgan Stanley & Co. Incorporated, Salomon Smith Barney, Inc., U.S. Bancorp Piper Jaffray Inc., Letter of Acceptance, Waiver and Consent No. CAF020064 (Nov. 2002) p.5.

11 *See, In Re Robertson Stephens*, Letter of Acceptance, Waiver and Consent No. CAF030001 (Jan. 2003) p. 12.