TRAPS IN ELECTRONIC COMMUNICATIONS

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INTRODUCTION

Broker dealers are as much in the relationship business as they are in the knowledge business. Therefore, communication with clients and the public for business is a way of life for broker dealers. Years ago, this simply consisted of the transfer of physical documents from hand to hand. The SEC, pursuant to their authority under Section 17(a)(1), promulgating Rule 17a-4.[1] Rule 17a-4 requires the preservation of communications relating to the business of a broker dealer for three years.[2] However, the form of communication is not limited to physical documents, firms must also preserve electronic documents.[3] Under their overall duty to protect investors, the SEC and self-regulators have begun aggressively targeting the lack of retention of communications. The conundrum that faces a broker dealer is what communications do I retain, how do I retain them, and how do I monitor them.

Electronic communications ("ECOMS") traditionally refer to electronic mail. However, this thinking is too narrow for the technological capabilities of today's firms. Tools such as instant messaging and text messaging have introduced an instantaneous communication medium and have created an operating flexibility not envisioned only thirty years ago. Though these new technologies were not in the mind's eye of regulators when they created document retention rules, regulators have begun to recognize and adapt to these new challenges. Therefore, firms must also recognize that these new communication capabilities require monitoring preservation.[4]

In recent years, regulators have focused on Ecoms because they provide useful, embarrassing, and incriminating information. Nowhere was this more evident than in the Merrill Lynch analyst scandal.[5] The scandal involved Merrill Lynch analysts, publicly promoting companies that they were privately saying were awful companies. In the analyst scandal, emails were one of the primary weapons used against one of Merrill Lynch's superstar analysts, Henry Blodgett.[6] The emails revealed Blodgett privately trashing the stocks he was publicly promoting, essentially proving the prosecution's case.[7] These emails and comparable Ecoms from wirehouse firms eventually led to the voluntary separation of the banking and analyst functions within the financial services industry and an agreement that Merrill Lynch would pay a $100 million

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[1] Securities Exchange Act of 1934 § 17(a)(1).

> Every national securities exchange, member thereof, broker or dealer who transacts a business in securities through the medium of any such member, registered securities association, registered broker or dealer, registered municipal securities dealer, registered securities information processor, registered transfer agent, and registered clearing agency and the Municipal Securities Rulemaking Board shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title.

[2] 17 C.F.R. 240.17a-4.

[3] *In re Deutche Bank Securities*, S.E.C. Rel. No. 34-46937 (Dec. 3, 2002) (stating, "[r]ule 17a-4 is not by its terms limited to physical documents.").

[4] NASD Notice to Members, 03-33 (July 2003) (NASD documents are now found under FINRA. However, the documents are still referred to under their NASD names).

[5] Henry Blodgett.

[6] Affidavit of Petitioner, *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 53473, 2006 SEC LEXIS 591 (Mar. 13, 2006).

[7] *Id.*

penalty.[8] Ecoms provide, and have provided, a treasure-trove of information that only a few years ago would not have been available to regulators, or in the Blodgett case, Elliot Spitzer, New York's attorney general.[9] The information gained from Ecoms is more accurate than relying on recollections of phone conversations and other non-electronic forms of communication. With information like this available, regulators will focus more on Ecoms and firms should focus even more attention to their use and retention.

II. Regulatory Requirements

In a world that has evolved to an intricate web of electronic communications, and which is in a constant state of innovation and development, the brokerage industry faces compliance challenges beyond those experienced in any previous environment. Regulatory knowledge trails technical development and, accordingly, guidance is often wanting when needed. Further, regulators often want to maintain maximum flexibility in dealing with emerging areas of compliance, and they wait for experience to give direction to their policy and rule-making development. The net result is that firms are often "on their own" in developing supervisory procedures to apply to evolving technologies, and must often walk in uncertainty until regulatory experiences catches up with the reality of firm procedures.

However, guidance does emerge over time, and even if regulation trails technology, standards are developed which firms must address and the failure to do so can have devastating results as reflected in the $1,450,000,000 civil judgment against Morgan Stanley in 2005 for its inability to reliably produce emails[10], the $15,000,000 regulatory resolution in a related matter in 2006,[11] and the August 2006 proceedings against the Wachovia firms for failing to preserve electronic records resulting in a fine of $2,250,000.[12] These are just leading cases in a long string of proceedings against firms for failing in some respect to have adequate systems for identifying, capturing, storing, retrieving, and producing electronic communications and for improper destruction or loss.

Many regulatory proceedings include counts relating to ECOM failures, but since sanctions are not broken out independently, the amount of sanction attributable to ECOM violations is not possible to discern. However, it is clear that an Ecom failure can be a catch all for the regulators to bring an action.[13]

The starting point in establishing retention systems is determining content and structure Electronic communications traditionally refer to electronic mail. However, that definition is too narrow to describe the myriad of communication tools available to firms today and technologies

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[8] Press Release, Office of New York State Attorney General Eliot Spitzer, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices (May 21, 2002).
[9] The states have taken a very active role in combating fraudulent activity among firms. The Merrill Lynch analyst scandal was brought and settled by the New York Attorney General, without any significant involvement from the federal regulators or any SRO.
[10] *Coleman Parent Holdings, Inc. v. Morgan Stanley & Co.*, No. CA 03-5045 AI, 2005 WL 679071 (Fla. Cir. Ct Mar. 1, 2005); *Coleman Parent Holdings, Inc. v. Morgan Stanley & Co.*, No. CA 03-5045 AI, 2005 WL 674885 (Fla. Cir. Ct Mar. 23, 2005).
[11] *SEC v. Morgan Stanley & Co. Incorporated*, Litigation Release No. 19693, 2006 SEC LEXIS 1052 (May 10, 2006).
[12] *In re Wachovia Capital Markets, LLC*, NYSE Hearing Board Decision 06-150 (Aug 1, 2006).
[13] In 2006 the NASD and NYSE included an Ecom retention violation, mostly revolving around emails, in over 40 disciplinary actions.

that will continue to develop into the future. Generally, at the least the following are required communications that must be kept:

1. Obviously, emails sent from and received at the firm.
2. Communications sent from and to personal email accounts, PDAs.
3. Entries into blogs or chat rooms by representatives or other personnel talking business. (Representatives touting penny stocks has been a hot button for regulators.)
4. Entries on websites owned, operated, or controlled by representatives. (It is surprising what one can find on these sites.)
5. POD-casts prepared for customers by representatives of the firm.
6. Instant messaging with customers and co-workers.
7. Off-server text messages sent from phone to phone.
8. Webcasts.

Recently one SEC official, Charles Liao, assistant regional director of the Securities and Exchange Commission Los Angeles regional office, has indicated that a broker or dealer using a phone for business purposes must preserve the messages left on that phone.[14] This includes any messages left on a cell phone that is used for business purposes. He acknowledged that tracking and keeping telephone messages might be problematic. However, he stated if there is a problem preserving the messages you should not use the underlying technology.[15]

In addition, in speaking with regulatory personnel on the federal, state, and self-regulatory level, they usually define electronic communications to include any business communication that is sent or received and can be preserved by electronic means. Therefore, while Voice over IP (VoIP) is presently not being treated by the industry as required preservation, it may be included in the future. However, no guidance on this topic has apparently been issued. VoIP is a unique problem because it is in an electronic medium that flows through a server, therefore there may be ways to preserve the data within the system and if preservation is possible the communications require preservation.

However, the rule only requires the preservation of communications pertaining to an entity's business as a member, broker, or dealer.[16] The SEC has stated that it is the content of the communication that is determinative when deciding whether to preserve an Ecom.[17] However, email sent to customers from any origin, business or personal, will be subject to preservation requirements.[18] Purely personal, non-business communications, while using the same method of delivery as business communications, may be excluded from any retention program. Rule 17a-4 also focuses on the internal communications of a firm.[19] Again, Rule 17a-4 only requires the preservation of internal communications relating to a firm's "business as such".[20] When thinking of the regulatory requirements pertaining to the preservation of Ecoms, the cases teach us the following:

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[14] *Keep Tabs on Cell Phone Messages, Says SEC Official*, www.compliancereporter.com (Nov. 5, 2007).
[15] *Id.*
[16] 17 C.F.R. 240.17a-4.
[17] Reporting Requirements for Brokers or Dealers under the Securities Exchange Act of 1934, Rel. No. 34-38245 (Feb. 5, 1997).
[18] Letter from Robert C. Errico, Executive Vice President Member Relations, NASD, to unnamed NASD member (May 17, 2006).
[19] 17 C.F.R. 240.17a-4(b)(4).
[20] *Id.*

- It is the content of the communication that is determinative of whether the communication must be preserved.[21]
- Your firm must preserve internal communications related to its "business as such."[22]
- Retaining every Ecom may be the only way to capture all relevant Ecoms, though firms are not required to retain Ecoms if they do not relate to the business.[23]
- If a system purports to capture all relevant communications, your firm must ensure that it, in fact, does do so, and must periodically test to confirm that the system is still working.[24]
- There must be the adequate measures and rules in place to ensure the proper working of the retention software. If there are known deficiencies with a retention system, the deficiencies must be addressed immediately
- The SEC and self-regulators measure prompt production in days and weeks, not many weeks and months.[25]
- If there is a large volume request, negotiations should occur early in the process as to the proper amount of time in which to produce the communications.
- If the record retention program is part of a broader system of backup and retention, such as disaster planning, it must ensure the preservation of relevant communications for the appropriate amount of time. [26]
- If a preservation system does not contain centralized, real time preservation capabilities, there are many instances when Ecoms can be destroyed before the backup period.[27] Guard against this!

There is some light in the darkness. In a recent administrative ruling, an administrative judge found a firm in compliance with Rule 17a-4, ruling against the SEC. In that case, the administrative law judge found that the company provided individual mailboxes for employees to conduct business, provided supervisory manuals stating to retain emails for three years, and took good faith steps to comply with the regulations, including spending over $6 million to create systems that would comply.[28] Of great concern was the decision of regulators not to give adequate weight to that effort[29] No compliance system reaches perfection, and the degree of

[21] Reporting Requirements for Brokers or Dealers under the Securities Exchange Act of 1934, Rel. No. 34-38245 (Feb. 5, 1997).
[22] 17 C.F.R. 240.17a-4(b)(4); see also *In re UBS Securities*, S.E.C. Rel. No. 34-52022 (July 13, 2005) (again, only preserving those Ecoms which related to a firms business as such).
[23] *See* 17 C.F.R. 240.17a-4(b)(4).
[24] *In re UBS Securities LLC,* S.E.C. Admin. Proc. Rel. No. 34-52022 (July 13, 2005) (Respondent had not been able to retain or locate certain individuals' emails. Although there had been a log created suggesting that the emails were backed-up, in fact, they had not been).
[25] See *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 53473, 2006 SEC LEXIS 591 (Mar. 13, 2006), (In one instance, the respondent was unable to produce any emails of targeted individuals for nearly seven months. Overall, the respondent required between two and fifteen months to produce the requested emails.)
[26] *In re Deutsche Bank Securities, Inc.*, S.E.C. Admin. Proc. Rel. No. 34-46937 (Dec. 3, 2002) (The respondents retained communications as a part of their disaster recovery or business continuity plans but "discarded, or recycled and overwrote their back-up tapes and other media.").
[27] *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 53473, 2006 SEC LEXIS 591 (Mar. 13, 2006).
[28] *In re Raymond James Financial Services, Inc*., 2005 SEC LEXIS 2368, 128, 185-87 (SEC Sept. 15, 2005), *adopted* 2005 SEC LEXIS 2995 (SEC Nov. 21, 2005).
[29] *Id.*

deviance from perfection that is acceptable to regulators is not defined among regulators. When does the cost of compliance exceed the value of the system or enhancement involved? When does inadvertent human error become a violation of law? How often must supervisory system verify compliance and to what degree? These are questions without answers.

Technology is moving faster than ever. Instant messaging (IM) and text messaging are the newest widely used forms of electronic communication. Officials from FINRA (at the time of statement the NASD) have stated that the FINRA would treat text messages the same way they would treat IMs or emails.[30] Text messages are a particularly difficult subject because they do not reside on a company's server system. The way most text messaging works is that messages are sent from one user's phone through cellular phone towers to the recipient user's phone. The messages reside in the memory of each user's phone. Therefore, centralized storage of such messages is difficult without controlling the user's phone. IM's work the same way in that normally each individual computer stores the messages and the user may choose to delete the message trail upon exit of the application. However, because the messages go through a gateway it is possible for a company to store and retrieve such messages. In fact, many vendors are actively touting this ability. However, many companies have decided that they cannot preserve IM communications and have prohibited their use.[31]

Although firms are required to implement record retention programs, they cannot begin without the proper regulatory notifications. Before employing any retention system, a firm must notify their regulatory body at least 90 days before beginning its use.[32] In the notification, you must provide a representation that the system meets the standards established under Rule 17a-4.[33] Therefore, this requires the verification of any third party systems a firm may employ. If those systems are not properly working, indemnification from the third party will not prevent regulatory sanctions.

Accordingly, firms must periodically test their retention systems against the underlying regulatory requirements.[34] The test should ensure that the systems are adequately capturing and processing information.[35] Implementation of a system and an initial check are not good enough. Each firm should establish a verification procedure that they will implement at an appropriate amount of time.

In determining a violation of § 17(a)(1) and its rules, regulators need not prove that the violation involved scienter.[36] All that is needed to establish a violation of 17a-4 is willfulness. Willfulness does not mean that the actor knew that they were violating the law,[37] only that the action violating the law was intentionally committed.[38]

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30 NASD Notice to Members, 03-33 (July 2003).
31 Id.; *SEC Interpretation: Electronic Storage of Broker-Dealer Records*, Release N. 34-47806 (May 2003).
32 17 C.F.R. § 240.17a-4(f)(2)(i).
33 *Id.*
34 Robert C. Errico, Executive Vice President NASD, Member Regulation, *Letter to NASD Members*, http://www.finra.org/web/groups/corp_comm/documents/home_page/p016638.pdf (May 17, 2006) (stating "[a] firm that relies on electronic systems for compliance should test the operation of those systems against the underlying rule requirements on a periodic basis to ensure that the systems are adequately capturing and processing information.").
35 *Id.*
36 SEC v. Drexel Burnham Lambert Inc., 837 F. Supp. 587, 610 (S.D.N.Y. 1993), *aff'd sub nom.* SEC v. Posner, 16 F.3d 520 (2d Cir. 1994).
37 Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (citing United States v. O'Hagan, 139 F.3d 641, 647 (8th Cir. 1998).
38 *Id.*

Most of the firms that have been fined for their retention deficiencies knew about the problems and failed to correct them. In some cases, the firms knew about the problems for three years before they attempted to address the problem.[39] Ignoring a retention problem will lead to disastrous results.[40] Reporting that you have retained and produced all requested documents will also lead to disastrous results and look like the firm has something to hide.[41]

If a firm can show a good faith effort to comply with the rules, it may not be seen as a willful violation of Rule 17a-4. Good faith effort encompasses providing written instructions to users on which Ecoms to retain and for how long to retain them, providing users with specific resources to store retained Ecoms, and spending an appropriate amount of resources to come into compliance.[42] The administrative law judge in *Raymond James* noted that although Raymond James provided the preceding items, they could have done more.[43] However, because there was no evidence of bad faith or a lack of effort the judge found that Raymond James had not willfully violated Rule 17a-4.[44]

III. ORGANIZING AND RETRIEVING

Defining which Ecoms to capture and then securing them is only the start of the process. However, there is surprisingly little guidance on this subject from regulatory authorities. Vendors are often the best source of such guidance, since their products are tested by inspections around the country. If such products pass often enough, presumably they meet regulatory standards. There is no "Good Housekeeping Seal of Approval" given out to such systems so there is no certainty that they are adequate. Even if adequate at that moment in time, they may become inadequate as regulatory requirements, technology, experience, and compliance problems dictate changes.

There are certain things we do know about expectations for the organization and availability of Ecoms. Ecoms are to be organized and indexed as they are being preserved and must be available to the regulators on examination.[45] However, regulators have not defined or articulated their expectations of organization. Nor have they defined what "available for examinations" entails. However, some regulators may expect the same day production of Ecoms for onsite examinations.[46] In addition, firms can find guidance in other SEC rules. Rule 204-2(g) of the Investment Advisors Act states that records must be kept in a format that allows easy location, access and retrieval.[47] It is safe to assume that the minimum that regulators are seeking is a basic indexed search function.

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[39] *In re* UBS Securities LLC, Exchange Act Release No. 52022, 85 SEC Docket 2752 (July 13, 2005).
[40] *Id.*
[41] *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 53473, 2006 SEC LEXIS 591 (Mar. 13, 2006) (despite the knowledge of the deficiencies in their retention system, the respondents represented to regulators that the system had captured all relevant emails).
[42] *In re* Raymond James Fin. Servs., Inc., 2005 SEC LEXIS 2368, *185-87 (Sept. 15, 2005), *adopted* 2005 SEC LEXIS 2995 (Nov. 21, 2005).
[43] *Id.*
[44] *Id.*
[45] *See In re* Robertson Stephens, Inc., Exchange Act Release No. 47144, 79 S.E.C. Docket 850 (Jan. 9, 2003); *see also* Mary Ann Garcia, Associate Director, Securities and Exchange Commission, Remarks at Books and Records Compliance Countdown (Mar. 24, 2003).
[46] *Id.*
[47] 17 C.F.R. § 275.204-2(g) (2008).

IV. PRE-REGULATORY PRODUCTION REVIEW

Firms are faced with demands for production of Ecoms in conjunction with inspections, investigations, arbitrations, and occasionally litigation. These productions demand focus on the volume and breadth of documentation as well as the speed regulators require for the production of documents.

A. The Gathering Process

After reviewing the regulatory demand, the firm must begin the process of gathering the Ecoms for review. This has historically been almost exclusively emails, but as technology evolves the demands from regulators grow broader and production becomes even more burdensome. A properly planned and executed retention and production protocol will ease the burden and increase the accuracy of producing requested documents. When the letter or subpoena requesting documents arrives, a firm must have the ability to immediately disable destruction functions that may be available.[48]

Regulatory requests normally involve Ecoms created in a specific time period, which may vary from a few weeks to several years. The first concern of the firm is to attempt to narrow the scope of the request. Narrowing the scope of the request does two things: it saves time and provides insight into what regulators may ultimately be seeking. Several narrowing strategies may work:

1. If your systems are good enough, you may be able to agree with the staff on a production based on certain key words in the Ecoms.
2. You may be able to limit the Ecom production to specific individuals
3. You may be able to provide a lesser time period with a request that the regulators review that production to determine if they wish to proceed further.
4. You may be able to urge that the regulators accept alternative information initially (such as an overall submission from the firm or summaries of potential testimony).
5. You may offer that the firm will provide the analysis through independent counsel, or other examiner, and provide a report. This outside source needs to be extremely credible.
6. In extraordinary circumstances, you may consider waiving the attorney client privilege and having counsel (in-house or outside) prepare a summary to be offered.
7. You may decide to appeal up the ladder, within FINRA or SEC, if the demand is clearly excessive, or the time too short, and the staff is unwilling to compromise.

In response to a request, production must become a priority and must be done in an organized and timely fashion.[49] It may be done often through agreement with regulatory staff on a rolling basis. Production must be done timely if you wish to obtain recognition for cooperation or, alternatively, not be taken to task for the failure to cooperate. The nature of the case is likely to dictate the flexibility of the staff with on-going matters receiving little tolerance, while older

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[48] *In re* Southwest Securities, Inc., Exchange Act Release No. 51002, Investment Advisers Act Release No. 2341, Investment Company Act Release No. 26721, 84 S.E.C. Docket 2316 (Jan. 10, 2005).

[49] *See* Electronic Storage of Broker-Dealer Records, Exchange Act Release No. 47806, 80 S.E.C. Docket 403 (May 7, 2003).

matters where problems have ceased normally receive more latitude in time and manner of response.

B. Evaluation of Ecoms

Once the Ecoms comes to the lawyers, the process of analysis begins. It may be horribly dull to read thousands of irrelevant emails, but the task must be accomplished, since it takes only one or two needles in the haystack of Ecoms to have devastating results. Lawyers are generally looking for:

1. Ecoms on point, which reflect a violation of the law and would be relevant to the scope of the investigation that the firm believes it is confronting.
2. Ecoms not on point, but which raise issues which regulators may consider establishing a new investigative track to pursue.
3. Ecoms which are on point, but which can be misconstrued, so that at the time of production the firm may consider providing an explanation which eliminates or mitigates the construction that a person reading the Ecom out of context might assume.
4. Ecoms that reflect a failure in supervision on a routine basis as prescribed in the firm's WSPs.
5. Ecoms which reflect a failure to pursue red flags.
6. Ecoms which reflect a failure of management to adequately deal with problems presented to it.
7. Ecoms which reflect a lack of concern by management on matters relevant to the investigation.
8. Ecoms which reflect a lack of attention to staffing, quality of supervision, past problems by representatives or their supervisors (In its settlement, Morgan Stanley had to agree to provide more in-depth training to its staff on email retention law and policy.[50]).

9. Ecoms which reflect badly on persons who may be the target of the investigation, even though the contents of the Ecom are not directly relevant to the investigation.
10. Ecoms which show a systematic failure of compliance oversight.

There are many other nuances which lawyers will target in their reviews. It is essential that reviews reveal problems prior to the time that they are transmitted to regulators, so that the firm has the opportunity to put the information in context in its accompanying correspondence to regulators. Early disclosure lets the firm avoid misperceptions, and shed the most favorable light on information which is provided at the time of production or afterwards. In addition, regulators want production organized; however, the definition of "organized" in the minds of investigators is often not clear. Therefore, it is important to clearly identify mutual expectations and try to negotiate away differences if possible. In addition, counsel will maintain a book of critical documents or a computerized storage and retrieval system for them. Privileged documents should be identified as such and maintained in separate files.

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[50] SEC v. Morgan Stanley & Co. Inc., Litig. Release No. 19693, 87 S.E.C. Docket 2865 (May 10, 2006).

Document destruction can have devastating effects on a firm. In the *Southwest*[51] case, the SEC imposed a $10,000,000 fine (including other violations) on the respondent for deleting emails every 31 days and allowing users to delete emails from the system. Firms should issue clear instructions to affected parties, and those involved in document destruction to prevent erasure of any materials relevant to the investigation. Firms should take control over deletion by installing a centralized procedure for preventing user destruction of Ecoms. The consequences to Arthur Andersen from the Enron criminal proceedings, though it was ultimately found not to be guilty of a crime, clearly illustrate the importance of avoiding improper or problematic document destruction.[52]

V. PROBLEMATIC EMAILS

A. Discovery

Careful review of the emails is essential. It is a task born in ennui, nourished in tedium, and periodically climaxing in receipt of another batch for a new target of the investigation. If not done carefully, the firm and its counsel will be caught by surprise. It is also important to look for gaps in production either in the form of missing emails or in emails with questionable dates.

B. Follow-up

Once the Ecoms have been sorted, analysis begins. In a firm's analysis of Ecoms, the examiner should know what is in the Ecom before delivering them to regulators. However, this is not always possible because of volume and time. An Ecom analysis should cover the following:

- Is the communication subject to a privilege; is it a business communication; or is it within the requested batch and must be produced.
- If the latter, is there anything about it that causes concern?
- If there is a concern, should the Ecom be the subject of further inquiry to ascertain the background?
- Are the facts in the Ecom correct, or is further information available that would correct a misapprehension on the part of the sender? Is there confusion about what was said at a meeting or in instructions given that should have been corrected at the time (and perhaps was orally) but for which there is no corrective track in writing?
- Is the Ecom clear, or subject to multiple interpretations (there may be a substantial risk that suspicious regulators will grade the interpretation least favorable to the firm)? Many Ecoms sound much worse than they actually are, because there is no context to the communication. Giving a regulator context to the Ecom will establish a true meaning of its words.

There are many facets to weighing the contents of an Ecom, and each must be examined to have a full picture if the consequences of the Ecom are serious. You may find a "smoking gun."

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[51] *In re* Southwest Securities, Inc., Exchange Act Release No. 51002, Investment Advisers Act Release No. 2341, Investment Company Act Release No. 26721, 84 S.E.C. Docket 2316 (Jan. 10, 2005).

[52] United States v. Arthur Andersen LLP, 374 F.3d 281, 284 (5th Cir. 2004), *rev'd* 544 U.S. 696 (2005).

People do stupid things, and then talk about them. On one hand, a pattern of violations may emerge. On the other hand, there may be instructions about how to do the stupid thing from a supervisor or co-worker. As an example of the prior, in an e-mail referring to a stock he was recommending, Henry Blodget of Merrill Lynch stated, "[W]hat a POS that thing is."[53] Representatives and supervisors too often say foolish things in Ecoms, treating them as though they were confidential. They also share them indiscriminately with devastatingly adverse results. Further, the Ecoms may also be the source of documents that specifically rebut the allegations contemplated by regulators. It is essential (and often more difficult) to seek out the documents that establish these points.

C. Disclosure

When faced with a request for documents a firm may react in a few different ways. One can simply turn over the requested or subpoenaed documents to regulators, listing what is provided and then waiting for a response. At times that is an adequate. However, there are other considerations. How much does the firm want to be seen to cooperate by organizing the documents? Does the firm really believe that regulators will give credit for cooperation? If so, will the credit be significant both monetarily and in sanctions, or does the regulator—for whatever reason—have a different agenda? Is the discussion of or potential for credit, merely a device to ease the making of their case? In a world where there was mutual trust between regulators and firms, it would be an easier decision. In the uncertainty of the present environment, it is difficult to determine cooperation credit.

An even more important question is whether the information provided needs explanation, clarification, correction, elucidation, or admission, and if so, when, if at all. The great, unanswered question is how many Ecoms actually get reviewed by regulators. Certainly the truth is that many are not reviewed, despite the fact that they have been requested and produced. If reviewed, they may not be understood. All this complicates decisions on timing and nature of disclosure. In fairness, if regulators are requesting items, they have an obligation to review them, but in truth, firms generally aren't upset if the review is not done unless the review would have revealed materials in mitigation, or substantiate that the firm was acting professionally and in accordance with laws, rules, and its internal procedures. When planning a defense, assume that key emails have not been adequately read or understood, and emphasize important aspects of the Ecoms.

When providing the required Ecom, one can use a wide range of methods of response and organization. There are many levels of strategic consideration, but no certain answers in the present regulatory environment of substantial sanctions, aggressive punishments, and increased targeting of individuals.[54]

D. Criminal Consequences

[53] Complaint: Henry Mckelvey Blodget, http://www.sec.gov/litigation/complaints/comp18115b.htm (Apr. 28, 2003).

[54] *See* Sara Hansard, *SEC Said to Crack Down Harder*, InvestmentNews.com, June 12, 2006.

Firms generally want to use the same counsel for potential respondents unless there is a painfully obvious conflict of interest. Two factors are changing the underlying basis for consideration of this issue and often mitigating in favor of separate representation. First, the FINRA and NYSE are hiring more attorneys from the Justice Department, SEC, and other federal agencies resulting in a dramatic increase of aggressiveness toward the industry. Attorneys from federal agencies bring with them a vastly different approach than those with self-regulatory backgrounds.

The other consideration is the increased criminalization of the securities laws. In evaluating Ecoms, it is essential to bear in mind the possibility of criminal action in egregious cases. Ecoms can lead to an immediate decision to recommend additional outside counsel for potential respondents/defendants. Sanctions have rocketed upwards in the past three years, and there is no end in sight. Agencies keep score by the amount of fines and length and number of sanctions. Even if criminal charges are avoided, the consequences can be devastating to firms.

VI. Words of Wisdom

A. Rules for Email Creation:

- *Big Brother is Reading Your Emails.* Don't say anything in an Ecom that you don't want the firm or a regulator to read. Avoid putting it in writing if it does not need to be.
- *Opinions Count - Often against You!* Don't express opinions in your Ecom. Express them by direct personal or telephonic contact.
- *Grabbing Things from the Internet and Sending Them Can Be Bad.* Taking internet material and attaching it to an Ecom can be bad for many reasons. Do so with care, and remember what you attach you may be deemed to endorse.
- *Regulators Have NO Sense of Humor.* Avoid using sarcasm, cynical humor, or anything derogatory in your Ecoms, since regulators tend to take them literally. They can be read as admissions of wrong-doing even when that is not the intent.
- *Don't Admit Screw-Ups in an Ecom.* Regulators will use admissions of internal errors or mistakes to establish violations of law.
- *Use the "Dragnet Approach" to Ecom Drafting.* Ecoms should focus on the facts, just the facts. This does not preclude recommendations, but even they should be considered in light of the way they will be read by regulators.
- *Copy Only Those with a Need to Know.* Don't get carried away with copies. Send them only to people who really need to have them.
- *Never Denigrate Another Person or Firm in an Ecom.* Don't say anything in an Econ that you would not want someone else to say about you.
- *In Communicating Through Ecom with Your Customers, Remember that You Are Creating Exhibits for an Arbitration Proceeding.* Your communications to customers can be used against you. Put only those things in your Ecoms which you would be willing to have a regulatory attorney examine you on during your testimony.
- *Don't Think You Can Erase Ecom.* Deleting an Ecom does not remove it from electronic retrieval. Absent stripping a hard disk clean, there is almost nothing that cannot be retrieved.

- *Ecoms Can Contain Red Flags.* When a supervisor receives an Ecom that raises issues of compliance, it is essential that the supervisor follow up on that information and that somewhere the supervisor have preserved written evidence of having done so.
- *Metadata is Bad Data.* Metadata can provide unintended consequences. The retention of entire keystroke histories can lead to serious consequences in future litigation. However, removal of metadata in documents presented to regulators may be deemed an improper alteration of documents.

B. Regulators Love Ecoms

They help by making it far easier to bring cases. Ecoms present the worst of both worlds for firms. On the business side, Ecoms represent a speed and ease of communicating that has reduced costs and increased productivity. However, Ecoms represent a double-edged sword when it comes to compliance. On the one hand, they tend to be very informal and often lacking in detail that the sender assumes the recipient knows. On the other hand, they tend to be long enough to clearly identify a problem, and when they violate the guidance set out above, can be devastating to the firm and the individuals involved in sending, receiving, or being copied on the Ecoms.

Recent cases have clearly spelled out the risks to the firms. They fall into categories of inadequate systems, non-retention, destruction, untimely production, and willful violation of the record keeping rules. Business as usual in the firm is an invitation to horrible results in investigations. Firms must continually rethink internal policies to recognize and control the risks. It is necessary to educate **all** users of Ecoms on their importance. The amazing thing is how many firms have failed to drive home the importance of proper Ecom use to their employees or independent contractor agents.

CONCLUSION

Ecoms are the new frontier in enforcement actions. The demand for Ecoms will increase in the future and the burden placed on the firms to produce them will increase. Regulators and regulations move nowhere as fast as technology does. No one can predict the next new technology that will revolutionize the broker dealer industry. However, regulators have clearly interpreted Rule 17a-4 as including the retention of hard and electronic communications. Therefore, firms must develop comprehensive retention plans based on the following directive. Analyze old and new Ecom technology, prohibit use of new Ecom technology if it cannot be retained; create and distribute policies and procedures on the use of Ecoms; integrate technology into centralized retention system; develop a verification system that will ensure the proper retention of the Ecoms; and develop a retrieval process to ensure prompt production.

Regulators are focused more than ever on the treasure trove of information Ecoms may provide in an investigation. That is why examinations will focus more intensely on the Ecom retention systems. Therefore, firms must ensure the compliance of its systems by periodically testing the systems and documenting such tests. Regulators will have no mercy on an unverified system, even those systems created and implemented by third parties. Therefore, firms must become compliant today, or risk receiving one of the ever-increasing fines tomorrow.