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The Evolution Of FINRA E-Mail Disciplinary Cases

Law360, New York (April 19, 2010) -- In 2002, regulators for the first time brought enforcement actions against broker-dealers relating to e-mail issues. Since that time, as technology and usage have changed, these types of cases have evolved.

In the Beginning

Firm: "We've got mail!"

Regulator: "We want it."

In December 2002, the U.S. Securities and Exchange Commission, NASD (now, FINRA) and the New York Stock Exchange brought the first e-mail enforcement actions against five broker-dealers, finding that they violated Section 17(a), Rule 17a-4, NYSE Rule 440 and NASD Rule 3110 by failing to preserve e-mail, and that they violated NYSE Rule 342 and NASD Rule 3010 by failing to establish, maintain and enforce supervisory systems reasonably designed to ensure compliance with the rules and laws relating to the retention of electronic communications. The fines totaled $8.25 million, or $1.65 million per firm.

At the time, many firms understood these rules to include e-mail but employed a manual "print to paper" system of e-mail preservation, requiring representatives to determine on a case-by-case basis whether their e-mails needed to be retained, and to print out and file any e-mails that did. Many firms also had automated systems in place that would capture and store e-mail electronically on backup tapes in case of a system outage or other computer failure, but not for the purpose of production to regulators.

The securities regulators disagreed with the firms' understanding of their regulatory requirements, and over the next few years, the regulators (and in particular, FINRA) brought dozens of cases for various failures to properly retain e-mail communications. Over time, these cases have evolved, and the more recent enforcement actions have implications that go well beyond the retention issues central to the early e-mail cases.

Evolution

Rep: "IM, TM; Cn U rd ths?"

FINRA: "We don't care if you call it LMNOP; we want all electronic communications."

- Messages sent via instant messaging, Bloomberg e-mail and text messaging must be retained just like e-mail.

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Some in the industry have argued that electronic messages sent via instant messaging, text messaging and other emerging technologies should not be subjected to review and retention rules; are fundamentally different from e-mails because they are “merely a convenient substitute” for voicemails (which are not required to be retained — yet); and are often not sent through the member firm’s computer-controlled electronic compliance and surveillance systems.[1]

Nevertheless, in April 2007, FINRA fined four affiliated firms $3.75 million in a settled action for, among other things, failing to preserve communications sent via IM and Bloomberg. In June 2007, a firm was fined $100,000 in a settlement for failing to have a supervisory system and written supervisory systems regarding IM and failing to preserve IM. FINRA found that the supervisory systems failed to ensure review and preservation of IM and failed to ensure that “all IM users had properly synchronized their passwords.” That same year, in a Regulatory Notice, FINRA specifically stated that text messaging is no different from e-mails and needs to be supervised and retained if it is being used by representatives.[2]

Individuals may face liability as well. In February 2010, one registered principal was fined $5,000 and suspended for 45 days from acting in any principal capacity for permitting at least one of his firm’s representatives to use IM even though the firm did not maintain and preserve such communications.

- Firms must retain and supervise certain communications made by representatives on social networking sites like Facebook, Twitter and MySpace.

The rules that apply to communications made on social networking sites depend on their context; they may, for example, qualify as advertisements, sales literature, correspondence, independently prepared reprints, institutional sales literature, or public appearances.[3] Chat room participation, for example, is considered a public appearance, and the same requirements therefore apply as if the representative were “speaking in person before a group of investors.”[4]

Blogs and bulletin board postings are generally considered advertisements and thus have content requirements.[5] One broker was fined $25,000 and suspended for 60 days in February 2010 based on findings that he posted comments regarding a competitor insurance company’s stock on an internet message board without written approval from a principal of his member firm, and that the comments were misleading.

Rep: “E-mail me at Joe.Rep@I’ll-Make$4U.com.”

FINRA: “Retain and supervise outside e-mail accounts, or wire monetary sanction to finesRus@finra.org.”

Firms must ensure that registered representatives are using firm e-mail accounts or firms must retain and monitor external accounts used by the representatives for business. With all these emerging electronic communications platforms, it is becoming increasingly difficult for firms to keep track of what their representatives are saying and where they are saying it. Nonetheless, FINRA’s position has been clear about the need to retain and supervise all e-mails, regardless of where or how the representatives are sending them.

In July 2007, a firm was fined $110,000 in a settlement where the firm, among other things, failed to ensure that all representatives used the firm’s electronic server for business-related e-mails. Similarly, in October 2007, a firm settled an action and was fined $75,000 for failing to preserve, review, or retain emails sent using external accounts. Franklin Ross was expelled from FINRA in January 2008 for, among other things, failing to have any system, written supervisory procedures or policies relating to email retention and allowing representatives to use personal email accounts.

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Finally, in March 2010, a broker-dealer was fined $100,000 in a settled action because it failed to keep all business-related e-mails in an easily accessible place by allowing its investment advisor clients to keep their own e-mails, which were not easily accessible to the broker-dealer.

Firm's computers: "System is busy; please try later."

FINRA: "Supervise system and e-mails, or be fined. Do not pass Go; do not collect $200."

- Firms must ensure adequate review of e-mails. Retention is great, but if a firm doesn't review some of those e-mails, FINRA might ask, "What's the point?"

Enforcement actions have, of course, made this point. In December 2009, a firm and three of its affiliates were fined $1.2 million for failing to have an adequate system of e-mail correspondence review; the failure allegedly contributed to the firm's inability to detect a fraudulent outside business activity being conducted by one of its brokers who used the firm's own e-mail system to conduct the outside business.

FINRA has also brought cases where there was no customer harm. In September 2008, FINRA settled a case where a firm was fined $175,000 because it failed to have adequate procedures relating to the review of e-mail correspondence as well as failure to document that review. In July 2007, a firm was fined $25,000 where it flagged e-mails for review, but failed to review all of the flagged e-mails.

- Firms must supervise their systems and their capabilities. Supervision goes beyond ensuring that a compliant retention and review system is implemented; the system needs to be maintained as well.

In December 2007, a firm settled a case with FINRA for $175,000 because, in part, it failed to configure its e-mail system properly after an upgrade and failed to supervise the e-mail system. Similarly, in December 2008, FINRA settled another action, fining a firm $350,000 where the firm, among other things, had inadequate systems and procedures in place to detect and prevent malfunctions in the firm's email archive system.

Most recently, the National Adjudicatory Council in December 2009 affirmed findings and sanctions against a firm's president for failing to reasonably supervise because, among other things, he allowed the firm to replace its books and records software system with a substantially less expensive system that (surprise, surprise) did not work as well.[6] While this case did not involve e-mail retention, it is possible that a similar result might occur had the case involved an email retention system.

Firm: "We call it, 'Expanding our business development opportunities.'"

FINRA: "With regard to e-mail disciplinary actions, as Monty Python would say: 'We're not dead yet.'"

These cases show that as technology evolves, broker-dealers and registered representatives begin using the technology differently, and the regulators react to that usage. While we can't predict what future actions will be, we do know there will be future actions. As FINRA might put it in a text message (in homage to an iconic uber-enforcer), "ILLBBAK."

--By Brian L. Rubin (pictured) and Christian J. Cannon, Sutherland Asbill & Brennan LLP

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[1] See e.g. July 16, 2007 Letter from NAIBD to NASD (providing comments to proposed joint guidance regarding the review and supervision of electronic communications, NTM 07-30), available at www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p036375.pdf.

[2] See FINRA Regulatory Notice 07-59.

[3] See Guide to the Internet for Registered Representatives, available at www.finra.org/Industry/Issues/Advertising/p006118.

[4] See id.

[5] See id.

[6] See FINRA Compl. No. E072005017201 (NAC Dec. 16, 2009).

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