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VIA TELECOPIER & FIRST CLASS MAIL

August 21, 1998

Mr. Michael A. Macchiaroli
Associate Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: Draft Division of Market Regulation Legal Bulletin Regarding E-Mail Record Retention Requirements

Dear Mr. Macchiaroli:

The purpose of this letter is to provide you with some initial feedback on behalf of the membership of The Bond Market Association (the "Association") on the Division's draft legal bulletin, dated July 29, 1998 (the "draft bulletin"), regarding broker-dealer recordkeeping obligations under Exchange Act Rule 17a-4(b)(4) in the context of e-mail communications. We have shared the draft bulletin with a small group of legal and compliance professionals from Association member firms, and this letter is based upon their reactions and responses. We believe, however, that the views expressed herein are generally representative of the views of the Association's broader membership.

In general, we commend the staff's effort to supply market participants with additional guidance concerning their e-mail recordkeeping obligations. We believe the draft bulletin reflects the staff's recognition that the increasingly widespread use of e-mail and other forms of electronic communications presents significant regulatory issues and practical considerations for broker-dealers that are not adequately addressed by existing rules and rule interpretations. We appreciate the staff's continued efforts to work with industry representatives to resolve these matters.

Accordingly, we offer the following comments, reactions and questions in response to the draft bulletin. Although we are providing this letter as a preliminary response to the draft bulletin, we would be pleased to present our suggestions in the form of specific, proposed language for a revised interpretive document, should you so desire. We also welcome an opportunity to discuss further these points with you and other appropriate Division of Market Regulation staff at your earliest opportunity.

I. Staff Legal Bulletin

As a preliminary matter, our members expressed a general lack of familiarity with a "staff legal bulletin," and are interested in developing a better understanding of its nature, scope

of application and legal effect. In particular, we would like to discuss with the staff its reasons for selecting this mechanism, and whether (and to what extent) the substantive legal comfort it provides may differ from that provided by, for example, a staff no-action or interpretive letter.

II. "Business as Such"

We appreciate the staff's effort to provide further guidance on factors that relate to a determination of whether a particular communication relates to a firm's "business as such," and in particular, the explicit exclusion from this category of e-mails that are of a purely social or personal nature.

Nevertheless, members of the Association continue to believe that even with this additional guidance, the term "business as such" would still encompass an exceptionally broad range of communications. Without further definitional guidance, or an elaboration what "business as such" means in the context of electronic communications, Association members believe that they will continue to be subject to an essentially undefined, open-ended retention obligation. Individual determinations of which e-mail communications relate to a firm's "business as such" are likely to be inconsistent and subject to continuing practical and interpretive uncertainty. Devising and implementing record retention practices and procedures for e-mail communications that fall within this broad, largely undifferentiated category will be extraordinarily time-consuming, administratively burdensome and expensive—especially if, as discussed below, a new requirement is introduced to save all e-mails for some specified time period. Given the much greater volume and more informal character of electronic communications as compared with those effected in physical form, we do not believe that simply applying retention procedures used for paper-based communications to e-mails and other forms of electronic communications is a workable solution.

For the above reasons, the Association reiterates its previous recommendation to the staff that the term "business as such" be refined, and interpreted to include "business related to the buying and selling of securities," thus requiring at a minimum the retention of those electronic communications that:

(1) mention a security by name in an investment context;
(2) actually involve opening or closing an account;
(3) contain an investment recommendation;
(4) involve an order to buy or sell a security; or
(5) concern a customer complaint.

Beyond these categories, we remain willing to discuss with the staff other specific, objectively identifiable categories of business-related electronic communications that would be subject to retention requirements. In addition, the Association proposes that such communications be required to be retained only if they are sent to a party external to the firm. If, however, the staff or the Commission is not prepared to exclude internal electronic communications from the record retention requirements, then the Association

believes that only those business-related communications (as defined above) that take place between registered personnel, between registered personnel and non-registered personnel.

Notwithstanding the staff's apparent willingness to adopt a procedural safe-harbor for the retention of electronic communications consistent with the requirements of Rule 17a-4(b)(4), and the additional guidance it proposes concerning the exclusion of purely personal communications from the scope of the term "business as such," our members continue strongly to believe that the narrower and more objective approach to identifying business-related communications set forth above constitutes the most effective, cost-efficient and desirable means of enabling the selection of relevant communications from the huge volume of electronically generated messages, without imposing undue burdens on broker-dealers. We appeal to you to reconsider the merits of this basic approach before proceeding to issue the draft bulletin, or other interpretive guidance, in the area of electronic communications record retention.

III. Comments on General and Specific E-Mail Retention Procedures

In the introduction to Section III of the draft bulletin, the staff indicates that "The Division believes that broker-dealers that apply similar policies and procedures as those they have been using for their paper communications to their electronic communications, such as e-mail, *would satisfy the recordkeeping requirements under 17a-4(b)(4)"* [emphasis added]. The Association supports the staff's direction, to the extent that the foregoing statement suggests that compliance with Rule 17a-4(b)(4) may be achieved by implementing and enforcing adequate policies and procedures for the retention of electronic communications. In other words, we understand the draft bulletin to state that as long as a firm can demonstrate that it has put into place and is diligently observing supervisory policies and procedures reasonably designed to identify and capture business-related electronic communications, the isolated failure of that firm (acting in good faith) to accomplish this result would not, by itself, constitute an actionable violation of the Rule. We believe that such an approach would be consistent with regulatory guidance the SEC and various self-regulatory organizations have recently supplied concerning the review and supervision of electronic and other correspondence, which also embrace a "reasonable supervision" standard.

As discussed above, we are generally supportive of a regulatory approach to electronic communications record retention that is based on having in place adequate supervisory procedures. Nevertheless, we remain concerned that within this basic framework, several of the staff's proposed, minimum procedural requirements are either inappropriate, or unnecessarily burdensome. In particular, many of these specific procedural requirements appear to go well beyond reasonable procedures that broker-dealers employ for paper communications. Moreover, some of these requirements are detailed to the point of being inconsistent with the procedural safe-harbor that the staff seems otherwise willing to establish. Our specific comments on these proposed, minimum procedural elements follow.

A. Basic Retention Requirements and Time Periods

The draft bulletin would require broker-dealer e-mail recordkeeping systems to save, by default, each e-mail (both internal and external) unless specifically designated for deletion. In addition, broker-dealers would be required to save all e-mail for at least 90 days from the date the e-mail was sent or received, including e-mail designated as not related to the broker-dealer's business as such. The entire e-mail would be required to be retained, if any portion is designated for retention.

The staff indicates in Question 6 of Section IV of the draft bulletin ("Frequently Asked Questions") that the purpose of requiring the retention of all e-mail for a short period of time is to facilitate the application of reasonable supervisory procedures to review the integrity of the broker-dealer's e-mail retention system. The Association agrees that the sufficiency of a broker-dealer's supervisory procedures relating to the categorization of e-mail correspondence for record retention purposes must be susceptible to periodic review. However, we do not believe that it is necessary to require all e-mails to be retained, nor to require their retention for 90-days or any other specific time period, in order to achieve this result.

As a preliminary matter, it should be recognized that requiring the retention of *all* e-mails, for any specified time period, would represent a dramatic expansion of current regulation, which requires retention only of correspondence relating to a broker-dealer's business as such. We would object to any proposed guidance that would expand that requirement indiscriminately to include the full range of broker-dealers' electronic communications. As described in our prior correspondence, a large percentage of such communications (especially internal message traffic) does not relate in any way to broker-dealers' business activities per se. Instead, such correspondence has proliferated as a substitute for other forms of informal communication, such as telephone calls and in-person conversations, as to which record retention requirements have never applied. A requirement to retain all e-mail messages in a manner that permits selective review and retrieval, even for a brief time period, would be tremendously burdensome, costly and impractical, in light of (a) the large and rapidly-growing volume of such communications, and (b) the fact that many firms—particularly larger ones that operate functionally and geographically dispersed offices and branches—maintain multiple, independent e-mail and other electronic communications systems.

Moreover, and more importantly, requiring the retention of *all* electronic communications for a specified time period is not necessary to achieving the staff's goal of facilitating the application of reasonable supervisory procedures to review the integrity of the broker-dealer's e-mail retention system. Instead, this goal could be achieved more simply if the staff were to specify that, as a required element of a firm's supervisory procedures relating to the retention of electronic communications, there must be mechanisms in place for (1) periodic reviews or audits of the sufficiency of those procedures, (2) the results of which are available for and susceptible to review and verification, and (3) which involve the review of, at a minimum, statistically valid samples of deleted as well as retained electronic correspondence, in order to determine the integrity and effectiveness of such

procedures. As long as these elements are present, it would be unnecessary to require the retention of all e-mails—even those that are patently unrelated to a broker-dealer's business—for any specified period of time after their creation.

A firm might comply with the supervisory requirements outlined above by, for example, periodically arranging for the capture of all e-mail and other electronic correspondence generated by the firm over a specified time period, and reviewing the accuracy of designations made regarding the "business related" character of such communications. Other review and sampling methods meeting the basic criteria outlined above should similarly be permitted. In this way, firms would still be able to document and demonstrate the sufficiency and reliability of their supervisory procedures for designating e-mails for retention, without being automatically required to retain all e-mails, or to do so for any predetermined period of time.

B. Procedures for Reviewing and Designating E-Mails

The draft bulletin sets forth several minimum requirements that broker-dealers would need to meet in establishing procedures for designating e-mails as not relating to the firm's business as such.

As proposed, broker-dealers would be required to identify which employees are responsible for making this designation. The draft bulletin suggests, for example, that the employee sending or receiving the e-mail may be assigned this responsibility. Association members would not object to this requirement as long as it is made clear, as is implied by the above-cited example, that such employee identification may be accomplished by assigning e-mail designation responsibilities generically to persons who perform specified job functions, as opposed to a requirement to identify specific individuals. For example, we agree that it should be possible for a broker-dealer to establish procedures in which all senders, or all receivers, of e-mail communications are responsible for designating such communications as not relating to that broker-dealer's business as such. Alternatively, firms should have sufficient latitude to place this responsibility, should they choose, on registered representatives (whether or not they are senders or recipients of e-mail messages), or to other functional employment categories or personnel classifications.

The draft bulletin also proposes that broker-dealers must adopt specific guidelines for employees to follow when designating an e-mail as not relating to its business as such. Here again Association members would not have an objection, as long as firms retained sufficient latitude to devise individual, firm-specific guidelines that are consistent with their varying organizational structures, administrative practices and scope of their business operations.

The draft bulletin would also require the broker-dealer's internal audit or compliance officer to withdraw an employee's ability to designate e-mails if it is determined that improper designations are being made. In addition, the draft bulletin indicates that "special procedures" must be adopted with respect to e-mail to or from employees who

have been sanctioned by a regulatory authority or are the subject of customer arbitration proceedings.

As a preliminary matter, in most instances the daily supervision of employees who are sending, receiving and designating e-mail communications traffic will be performed by management personnel (for example, a branch manager) having direct supervisory responsibilities, rather than an internal audit or compliance officer. Compliance officers are not and should not be made responsible for fulfilling supervisory functions. We therefore question, as a technical matter, whether the draft bulletin properly allocates the responsibility for withdrawing employees' ability to designate e-mails. Association members believe that such responsibilities are, and should in all cases remain within the purview of designated supervisory personnel.

Moreover, we question whether it is necessary or desirable for the draft bulletin to prescribe withdrawal of an employee's ability to designate e-mails as the only remedy in situations where improper designations are made. We believe that managers and supervisors should have more flexibility in responding to such situations, and in determining and implementing appropriate responses. In this regard, we appreciate the discussion in Question 4 of the "Frequently Asked Questions" section. This discussion indicates that, at least in the case of a single improperly designated e-mail, determining whether to withdraw the employee's ability to designate e-mail should be based upon a facts and circumstances inquiry. This discussion further indicates that broker-dealers should develop and document reasonable policies and procedures for making such determinations. We would hope that a similar approach would be permissible in all situations involving the improper or inaccurate designation of e-mails, and that the determination of whether and when to withdraw an employee's ability to perform this function ultimately rests with appropriate supervisory personnel of the broker-dealer.

Association members would also regard as problematic a generalized requirement for "special procedures" to be adopted in the case of e-mails to or from employees who have been sanctioned by a regulatory authority, or who are the subject of customer arbitration proceedings. No subject matter limitations are proposed to be attached to the nature of regulatory sanctions or arbitration proceedings that would give rise to this "special procedures" requirement. In addition, these procedures would be required even in the case of employees who are the subject of alleged and unadjudicated customer complaints and arbitration proceedings. As a result, a wide range of employee conduct that is completely unrelated to the use and content of internal and external communications would be covered. Given the broad sweep of such actions, and the large number of employees that may be subject to such sanctions or proceedings at any point in time, we believe that this requirement is overly broad. Among other things, significant expenses would be associated with designing and implementing systems and procedures to track employees who would be subject to such a requirement.

As an alternative, we would propose that the draft bulletin be modified to require that in developing e-mail designation procedures and reviewing their sufficiency on a continuing basis, broker-dealers be required to give special consideration to the application of those

procedures to persons who may be operating under heightened regulatory supervision. For example, both the SEC/SRO/NASAA *Joint Regulatory Sales Practices Sweep Report* and the NASD's recent amendments to NASDR Rule 3010 regarding tape recording of telephone conversations recognize the need for special supervisory procedures, and a heightened level of scrutiny, for registered representatives having troubled regulatory and compliance records. The identification of such individuals, and the specific types of special supervisory procedures and increased scrutiny to be applied to them, are matters that are left to the judgment of an individual broker-dealer. We believe that a similar approach would serve the goals of achieving greater regulatory consistency, while avoiding the costs, burdens and administrative difficulties associated with mandating the adoption of specialized e-mail designation procedures for an unnecessarily broad group of broker-dealer personnel.

C. Audit and Compliance Review Procedures

The final group of minimum procedural requirements for e-mail record retention practices set forth in the draft bulletin relates to ongoing audits and reviews of the adequacy and sufficiency of those practices. In this regard, the draft bulletin indicates that a broker-dealer's internal audit or compliance department would be required periodically to review e-mail designation practices using samples that are statistically valid with no less than a 95% confidence level. In addition, broker-dealers would be required periodically to perform key-word searches of e-mail that has been designated as not relating to the firm's business as such, using a list of key words set forth in the broker-dealer's policies and procedures that typically relate to its business as such (*e.g.*, the words "buy," "sell," "trade," "authorize," "stock," "bond," "customer" and "account"). Finally, broker-dealers would be required to make and preserve records of their internal review of their e-mail retention practices, including, at a minimum, error rates and copies of e-mails incorrectly designated as not relating to the firm's business as such, the name(s) of employees incorrectly designating e-mails, and the names of the senders and recipients of such incorrectly designated e-mails.

As discussed above, the Association's members agree that the integrity of a broker-dealer's supervisory procedures relating to the categorization of e-mail correspondence for record retention purposes must be susceptible to periodic reviews and audits. We further agree that such reviews and audits should be capable of replication, and generate statistically valid results concerning the effectiveness of those procedures in identifying and designating e-mails that do not relate to a firm's business as such. However, we strongly believe that it is neither necessary nor desirable to prescribe the nature, conduct or timing of such audits with the level of detail and specificity contained in the draft bulletin. Within the parameters suggested in this letter, these matters should be left to the discretion of individual broker-dealers in developing, implementing and reviewing the effectiveness of their supervisory procedures. We do not believe that the staff should seek to impose an overly detailed, inflexible and potentially unworkable set of audit and review standards that all broker-dealers would be required to meet. Firms' individual supervisory procedures are and would continue to be subject to ongoing regulatory

review; to the extent that the procedures followed by any given broker-dealer were deemed ineffective or insufficient, appropriate remedial action could be pursued.

IV. Frequently Asked Questions

In general, and in the context of a staff legal bulletin, Association members agreed that this section offers a useful means of providing additional interpretive guidance to broker-dealers when developing and implementing e-mail retention procedures. In addition to the discussion contained in question number (5), we suggest adding a clarification or elaboration elsewhere in the bulletin specifying that, consistent with prior staff guidance, "communications" that may be subject to record retention do not include drafts, but only the final versions of those communications.

V. Conclusion

Again, the Association appreciates the opportunity to review and provide the foregoing comments on the draft bulletin, and looks forward to work with the staff to address and resolve the important interpretive issues it represents. We would be pleased to discuss our views and recommendations with you in more detail. Please contact the undersigned, or Paul Saltzman, Association Senior Vice President and General Counsel, at 212.440.9400 to arrange such an opportunity.

Sincerely,

GEORGE P. MILLER
Vice President,
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