Compliance and Legal Challenges of Social Media and New Communications Technology

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A. Regulatory Guidance

FINRA Rule 2210

FINRA Rule 2210 addresses a member firm's communications with the public. It discusses requirements for retail communications, correspondence, institutional communications, recordkeeping, filing requirements for retail communications and review procedures, exclusions and exemptions from filing requirements, content standards (including comparisons, disclosure of fees, expenses and standardized performance, testimonials, and recommendations), and public appearances.

FINRA Rule 2210 treats interactive electronic forum posts, such as social media status updates, as retail communications rather than public appearances[1]; however, the Rule specifically excludes these posts from both the principal pre-use approval requirements and the filing requirements. See FINRA Rules 2210(b)(1)(D)(ii) and 2210(c)(7)(M).

SEC staff, however, has taken the position that certain interactive content posted on a real-time electronic forum (i.e., chat rooms or other social media) should be filed under the filing requirements of Section 24(b) of the Investment Company Act of 1940 or Rule 497 under the Securities Act of 1933, even if it is not required to be filed with FINRA under FINRA Rule 2210. See U.S. Securities and Exchange Commission, Division of Investment Management, IM Guidance Update No. 2013-01 (March 2013).

Member firms must have the ability to supervise the business-related content their associated persons are communicating on social media sites, including possible suitability determinations if recommendations are made. Suitability rules apply to recommendations made through social media sites. Firms should develop procedures to supervise interactive electronic communications that recommend specific products. A registered principal should review the content unless the recommendation conforms to a previously approved template.

[1] NASD Rule 2210 defined "public appearance" to include participation in an interactive electronic forum. The Rule neither required principals of member firms to approve public appearances prior to use nor required firms to file public appearances with FINRA.

A registered principal must review prior to use any social media site that an associated person intends to use for business. The principal may only approve a social media site if the principal has determined the associated person can and will comply with applicable rules.

Firms must understand the difference between interactive communications and static content. FINRA views “interactive communications” as typically real-time and involving a dialog with third parties. Interactive material does not require principal approval prior to use if it is supervised in a manner similar to the way member firms supervise correspondence and institutional communications. Under the rules, if a firm allows associated persons to use interactive communications prior to principal approval, then the firm’s written supervisory procedures should provide for: (a) the training of associated persons on the procedures and the content standards of the communications rules; (b) how the firm will surveil these communications to test for compliance; (c) what actions will be taken if problems are detected; and (d) documentation of any findings and the corrective actions taken.

FINRA views static content as typically posted for the longer term and lacks the immediacy of a real time conversation. Most static material must be approved by a registered principal prior to use, and sometimes may be required to be filed with FINRA.

FINRA's advertising rules and guidance do not apply to an associated person's personal use of social media. However, firms must educate their personnel on the difference between personal and business uses of social media. If firm personnel use a personal site for business, then this may result in a situation where the firm is unable to retain records of business-related communications as required.

FINRA Regulatory Notice 19-31

This Notice responds to questions from member firms regarding how they comply with FINRA rules when communicating with customers when using websites, email and other electronic media. FINRA wishes to work with

members about expanding their use of alternative and innovative design techniques – such as technology that offers customized information – in their marketing communications to help investors better understand their products and services and to ensure fair and balanced presentations. FINRA is interested in ways that members can make such communications more interesting and informative and improve the effectiveness of disclosure.

For example, members can use icons, illustrations, cartoons, animations, short videos, audio signals, pictograms and other media or emerging technologies to alert investors about important disclosure matters. FINRA suggests shorter, more concise disclosures appropriate to the content of the communication and integrating disclosures into the marketing message rather than in a separate footnote or disclaimer.

Certain communications - non-promotional communications, post-sale communications, or educational communications - do not require as much disclosure detail. Members may design flexible approaches which set forth basic information relevant to the content and any potential risks involved.

FINRA Regulatory Notice 17-18

This Notice sets forth Q&As relating to text messaging, personal communications, hyperlinks and sharing, native advertising, testimonials and endorsements, correction of third-party content, and BrokerCheck. The Notice reminds member firms of the recordkeeping, suitability, supervision and content requirements for social media communications and sites.

FINRA Regulatory Notice 11-39

This Notice addresses social media websites and the use of personal devices for business communications. It discusses recordkeeping and supervisory requirements for these websites and personal devices. It also addresses links to third-party sites and data feeds.

Firms are responsible for content on a linked third-party site if the firm has adopted or has become entangled with its content. A firm adopts third-party content if it indicates on its site that it endorses the content of the third-party

site. A firm becomes entangled with a third-party site if it participates in the development of the content of the third-party site.

Firms must adopt procedures to manage data feeds into their websites. Firms must be familiar with the proficiency of the data vendor and its ability to provide data that is accurate. Firms must understand the criteria followed by vendors in gathering or calculating the types of data that feed into the website. Firms should regularly review data feeds for any red flags and should promptly take measures to correct any inaccurate data.

FINRA Regulatory Notice 10-06

This Notice provides guidance on blogs and social networking websites. It addresses recordkeeping and suitability responsibilities. It discusses interactive electronic forums and the supervisory and content requirements applicable to them.

FINRA Regulatory Notice 07-59

With the challenges of technological innovations in the area of electronic communications, FINRA issued this Notice to provide guidance to member firms in the establishment of supervisory systems and procedures for electronic communications that are reasonably designed to achieve compliance with applicable federal securities laws and self-regulatory organization rules. This guidance addresses the review and supervision of electronic communications, applicable policies and procedures, the review of electronic communications (both external and internal), and appropriate methods of review.

NASD Notice to Members 03-33

This Notice primarily addresses instant messaging and emphasizes that content, supervisory, and recordkeeping requirements apply equally to instant messaging as to other forms of electronic communications.

FINRA News Releases and Alerts

FINRA periodically issues news releases and investor alerts regarding the use of social media and electronic communications. Here are some examples:

- Investor Alert, FINRA Warns Investors regarding the Potential Risks of Using Social Sentiment Investing Tools (April 3, 2019). These are tools offered by financial services firms that seek to aggregate or analyze social media data from various sources (e.g., Twitter or Facebook)

- Investor Alert, FINRA Warns that Messaging Apps Are Latest Platform for Delivering Pump-And-Dump Scams (September 2, 2015)

- FINRA, SEC Warn Investors: Don't Trade on Pump-And-Dump Stock Emails (June 12, 2013)

- FINRA Warns of Facebook-Linked Pre-IPO Scams (March 15, 2011)

- FINRA Warns Investors of Social Media-Linked Ponzi Schemes, High-Yield Investment Programs (July 15, 2010)

- FINRA Issues Guidance to Firms, Brokers on Communications with Public Through Social Networking Web Sites (January 25, 2010)

SEC Office of Compliance Inspections and Examinations Risk Alert on Electronic Messaging (December 14, 2018)

The SEC Office of Compliance Inspections and Examinations ("OCIE") conducted a limited-scope examination initiative of registered investment advisers designed to obtain an understanding of the various forms of electronic messaging used by advisers and their personnel, the risks of such use, and the challenges in complying with certain provisions of the Investment Advisers Act of 1940 ("Advisers Act"). OCIE's examination focused on whether and to what extent advisers complied with Advisers Act Rule 204-2 (Books and Records Rule) and adopted and implemented

policies and procedures as required by Advisers Act Rule 206(4)-7 (Compliance Rule).

The OCIE Risk Alert set forth practices that may assist advisers in complying with both the Books and Records and Compliance Rules in the areas of policies and procedures, employee training and attestations, supervisory review, and control over devices.

FINRA 2020 Risk Monitoring and Examination Priorities Letter (January 2020)

The FINRA 2020 Risk Monitoring and Examination Priorities Letter (the "Priorities Letter") addressed firms' compliance with obligations relating to FINRA Rule 2210, as well as related supervisory and recordkeeping requirements. FINRA Rule 3110(b)(4); FINRA Rule Series 4510; and SEC Rules 17a-3 and 17a-4. The Priorities Letter stated that FINRA will review how firms review, approve, supervise and distribute retail communications regarding private placement securities via online distribution platforms, as well as traditional channels. It highlighted "Communications via Digital Channels" and noted the challenges posed to firms through digital communications and set forth certain factors that firms should consider in the use and supervision of digital channels.

The Priorities Letter stated that the use by firms, registered representatives, and customers of an increasingly broad array of digital communication channels (e.g., texting, messaging, social media or collaboration applications) may pose challenges to firms' ability to comply with obligations related to the review and retention of such communications. FINRA may consider the following, among other factors, when reviewing firms' use and supervision of digital channels:

- Does the firm have a process in place to evaluate new tools available to its registered representatives to determine whether there are digital communication channels that should be captured, included in the firm's routine electronic communications supervisory reviews and stored in accordance with books and records requirements?

- Is the firm periodically testing its systems to ensure these communications are being captured for review and retention?

- Do the firm's supervisors know the "red flags" they should keep in mind during their routine supervisory reviews which may indicate that a registered representative is communicating through unapproved communication channels?

- Are the firm's supervisors following up on such red flags, which include, but are not limited to: email chains that include non-approved email addresses for registered representatives; references in emails to communications with a registered representative that occurred outside approved firm channels; or customer complaints mentioning such communications?

B. SEC Proposed Advertising Rule

In November 2019 the SEC proposed amendments to modernize its rules under the Investment Advisers Act addressing advertisements and payments to solicitors. The proposed amendments are intended to update the rules and apply a principles-based approach to reflect changes in technology, meet the expectations of investors seeking advisory services, and conform to the evolution of industry practices. SEC Release No. IA-5407 (November 4, 2019).

The proposed rule updates the definition of "advertisement" to include any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes investment advisory services or that seeks to obtain or retain advisory clients or investors in any pooled investment vehicle advised by the advisor. Proposed exclusions from the definition are:

- live oral communications that are not broadcast;

- responses to certain unsolicited requests for specified information;

- advertisements, other sales materials, or sales literature that is about a registered company or a business development company and is within the scope of other SEC rules; and

- information required to be contained in a statutory or regulatory notice, filing, or other communication.

The proposal would permit the use of testimonials and endorsements, subject to specified disclosures, including whether the person giving the testimonial or endorsement is a client and whether compensation has been provided by or on behalf of the adviser. The proposed amendments also permit third-party ratings, subject to specified disclosures and certain criteria pertaining to the preparation of the rating.

The proposal would include tailored requirements for the presentation of performance results based on an advertisement's intended audience, with specific protections extended to retail customers such as the presentation of net performance alongside any presentation of gross performance and the presentation of the performance results of any portfolio or certain composite aggregations across one, five, and ten-year periods.

The proposal would be designed to amend Form ADV to provide additional information regarding advisers' advertising practices to help facilitate the Commission's inspection and enforcement capabilities.

C. Recordkeeping Requirements relating to Social Media & Electronic Communications

Firms and their registered representatives must retain records of communications related to their "business as such." The "business as such" requirement is based on the content of the communication, and not the type of device or technology used to receive or send the communication.

SEC Rules 17a-3 and 17a-4 set forth the recordkeeping requirements for broker-dealers. Rule 17a-3 sets forth twenty-three (23) broad categories of business records which must be made and preserved by a broker-dealer. The Rule's scope includes, inter alia, transactional, customer, financial, marketing, and employment records.

Rule 17a-4 sets forth additional records which a broker-dealer must preserve. These include, inter alia, financial records, corporate documents,

communications relating to the broker-dealer's business, and compliance, supervisory, and procedures manuals.

These Rules provide retention requirements which vary from 3 years to 6 years (with the first 2 years in an easily accessible place) though the life of the broker-dealer, depending on the type of record.

Rule 17a-4(f) sets forth requirements for the preservation of electronic records on electronic storage media. A broker-dealer must provide notice to its DEA ninety (90) days prior to employing electronic storage media that it will maintain records electronically and identify the storage medium being used. The broker-dealer must provide a representation, or one from the storage medium vendor or other third party having appropriate expertise, that the selected storage medium meets the following conditions:

- Preserves the records on a non-rewriteable, non-erasable format (the SEC has historically insisted on WORM technology to meet this requirement);

- Verifies automatically the quality and accuracy of the storage media recording process;

- Serializes the original, and if applicable, duplicate units of storage media, and time-dates for the required period of retention the information placed on such electronic storage media; and

- Has the capacity to readily download indexes and records preserved on the electronic storage media.

A broker-dealer using electronic storage media must file with its DEA an undertaking:

- That it will promptly furnish electronic records to the SEC, SRO, or state regulator upon their reasonable request; and

- That it will provide access a) to the information maintained on the storage medium and b) for downloading of such records.

If the broker-dealer engages a third-party vendor to maintain its records electronically, the vendor must certify in writing that the records are the

property of the broker-dealer and will be surrendered promptly upon the request of the broker-dealer. The third-party vendor must also undertake in writing to permit examination of the broker-dealer's books and records by SEC representatives and promptly furnish to the SEC true, correct, complete, and current hard copies of any or all of any part of such books and records.

The CFTC's Amended Rule on electronic recordkeeping became effective on August 28, 2017. The rule eliminated the requirements of mandatory storage in WORM and "native format" and instead adopted a technologically neutral and flexible approach that takes into account recent changes in technology, but which nevertheless requires that regulatory records be retained "in a form and manner that ensures the authenticity and reliability of such records." The amended rule also eliminates the requirements that a firm engage a third-party technical consultant and that the consultant file certain representations with the CFTC regarding access to the entity's electronic regulatory records.

On November 14, 2017, SIFMA submitted to the SEC a petition for rulemaking to amend Rule 17a-4(f) to follow the lead of the CFTC and eliminate WORM and certain other Rule 17a-4(f) requirements. SIFMA argued that WORM is an ineffective BCP or cybersecurity tool, that it is ineffective for the dynamic content of current technologies, that it hinders innovation, places U.S. broker-dealers at a competitive disadvantage, and that it results in unnecessary high costs. SIFMA is currently in discussions with the SEC about the future of WORM.

D. Recent Disciplinary Proceedings involving Electronic Communications and Social Media

1. Electronic Storage and WORM

Over the last several years FINRA has brought a number of disciplinary actions based on failures to comply with Rule 17a-4(f) requirements for electronic recordkeeping, including inadequate WORM compliance. FINRA has noted that the volume of sensitive financial data stored electronically by broker-dealers has increased exponentially. It mandates that these electronic records must be complete and accurate, not only to assist FINRA and other

regulators in their efforts to protect investors through periodic examinations, but also to ensure that member firms can carry out their audit function. FINRA also considers WORM to be an essential protocol for protecting investors from hackers looking to gain access to sensitive financial information stored electronically.

A few recent material disciplinary actions in the electronic communications storage space are:

- December 2016 – FINRA announced actions against 12 firms, including Wells Fargo (FINRA AWC No. 2016049784101), RBC (FINRA AWC No. 2016049821601), RBS (FINRA AWC No. 2016048685301), and LPL (FINRA AWC No. 2014043539001), for significant procedural and supervisory deficiencies relating to the preservation of broker-dealer and customer records in a format that prevents alteration (WORM) and fined them an aggregate of $14.4 million.

- June 2017 – FINRA fined HSBC $1.5 million (FINRA AWC No. 2017053137201) and six other firms a combined total of $900,000 for procedural and supervisory failures to ensure that customer records could not be altered or destroyed.

- June 2017 – FINRA fined various broker-dealer affiliates of Massachusetts Life Insurance Company $750,000 (FINRA AWC No. 2016052647801) for failing to maintain approximately 2,400,000 electronic brokerage records in WORM format.

- July 2017 – FINRA fined State Street Global Markets LLC $1.5 million (FINRA AWC No. 2016051821601) for failure to maintain electronic records in a WORM format.

- September 2017 – FINRA fined Virtu Financial Capital Markets LLC $175,000 (FINRA AWC No. 2016051831201) for failure to retain electronic records relating to approximately 46 million market-making transactions in WORM format.

Certain of above disciplinary actions also included various other Rule 17a-4(f) violations:

- Failure to provide 90-day notice to the DEA prior to using electronic storage media;

- Failure to implement an audit system regarding the inputting of records in electronic storage media;

- Failure to maintain duplicate copies of records;

- Failure to obtain an attestation from the broker-dealer's third-party vendor; and

- Failure to design, maintain, and enforce a reasonable supervisory system for recordkeeping.

2. Social Media

A few recent disciplinary actions relating specifically to the use of social media are:

- August 2017 – FINRA censured and fined Growth Capital Services, Inc. $35,000 (FINRA AWC No. 2013034981501) for failing to maintain records of its supervision of registered representatives' business-related websites and failing to approve and supervise registered representatives social media accounts as required by NASD Rules 2210 and 3010, FINRA Rule 2010, and SEC Rules 17a-3 and 17a-4.

- June 2019 – After a hearing before FINRA's Department of Enforcement Office of Hearing Officers, DreamFunded Marketplace LLC (FINRA OHO Decision No. 2017053428201) was expelled from membership and its founder and representative banned for making false and misleading statements on its crowdfunding Portal platform and on their social media accounts, resulting in violations of FINRA Rule 8210 and Funding Portal Rules 200(b).

- July 2019 – FINRA ensured and fined PlanMember Securities Corporation $90,000 (FINRA AWC No. 2015047824201) for violation of FINRA Rule 3110 by failing to establish, maintain, and enforce a supervisory system, including written supervisory procedures,

with respect to the review of its registered representatives' business-related websites and social media.

E. Lessons Learned and Best Practices

- Broker-dealer firms should periodically review their policies and procedures for IT and storage processes and written supervisory procedures for WORM storage and data retrieval.

- They should ensure that records retention obligations of the business supervisor are addressed in the written supervisory procedures.

- They should integrate records retention and WORM compliance into checklists for new businesses and/or products and institute a training program as to records retention and WORM.

- Firms should create indices for WORM storage folders and maintain duplicate copies by system and product.

- They should assure that WORM storage and retrieval policies and procedures are subject to internal audit which should test retrieval of electronic data from WORM storage on a periodic basis.

- Broker-dealers should periodically review their document retention schedules for all books and records, physical or electronic.

- With respect to third-party vendors, broker-dealers should confirm that these vendors are storing data on WORM, including messages such as Bloomberg chats with attachments.

- They should periodically review their vendor contracts and undertakings and confirm that third-party vendor and notice requirements have been addressed.

- Firms should implement and periodically review policies and procedures relating to the use of social media and business-related websites.

- Firms should permit only those forms of electronic communications for business purposes that they determine can be used in compliance with books and records requirements.

- Firms should specifically prohibit business use of apps and other technologies that can be readily misused by employees.

- Firms should regularly conduct training to appropriate personnel regarding records storage and the use of social media and periodically send out reminders to employees as to what is permitted or prohibited.