Regulation of Instant Messaging as a Book and Record Under the Securities Exchange Act of 1934, as amended, and the Commodity Exchange Act, as amended

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SUMMARY

Instant Messaging ("IM") is one of the fastest growing internet applications involving electronic communications. The recent debate about IM in the financial services industry is related to the books and records requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the Commodity Exchange Act (the "CEA"), as amended. IM is a book and record under Exchange Act Rules 17a-3 and 17a-4 if it is a communication related to a broker-dealer's "business as such." IM is a book and record under the rules of the Commodity Futures Trading Commission (the "CFTC") if the communication is related to the futures business or is a communication with the public. Technology currently exists to preserve IM pursuant to the requirements of the rules of the Exchange Act and the CFTC. However, the CFTC, the National Association of Securities Dealers Regulation, Inc. (the "NASDR"), the National Futures Association (the "NFA") and the New York Stock Exchange, Inc. (the "NYSE") and the Securities and Exchange Commission (the "SEC") have not taken a formal position as to the treatment of IM as a book and record. This White Paper discusses the background of IM, the authority of the SEC and the CFTC over books and records, and describes prior NASD, NFA, NYSE, SEC and CFTC releases and interpretations which have discussed the need to recognize the evolution of electronic communication in applying the books and records requirements. Finally, this White Paper offers a new paradigm for evaluating the need to preserve and supervise electronic communications based on the content and audience of such communications in order to protect the investor and the integrity of the financial markets.

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I. INTRODUCTION

> "Over the last decade or so, this country's vaunted system of disclosure, financial reporting, corporate governance and accounting practices has shown serious signs of failing to keep up with the needs of today's investors, our economy, and new technology that makes rapid communications not only possible but essential. The latest example—a most tragic and unprecedented one—is the failure of Enron." [emphasis added][1]

Electronic communications have revolutionized the way commerce and communications are conducted. In many ways, electronic communications have replaced traditional ways of conducting business. Electronic communications, which includes, but is not limited to, e-mails, group e-mails, bulletin boards, chat rooms, websites and more recently, instant messaging ("IM"), continue to supplant telephone conversations and written correspondence. In turn, this has produced dilemmas for the private and public sectors which need to consider the necessity of regulating internal and external communications based on the content and audience of the communication, and not merely as to its form of transmission. The dilemmas produced by the role of electronic communications and, more specifically IM, center around protecting market integrity (which includes investor interests and business interests), preserving an audit trail, protecting governmental interests (related to domestic and foreign affairs), protecting intellectual property and deterring and preventing certain activities (which includes, but is not limited to market manipulation, money laundering, insider trading,[2] defamation, flaming, spoofing[3] and abusive sales practices). In addition, the current war on terrorism requires a heightened awareness of the need to consider regulating and monitoring the use of electronic communications such as IM with respect to the activities of certain criminal individuals, groups and organizations.

In addition, under the rubric of "Homeland Security," it is more important than ever before to recognize the role of IM to communicate and coordinate between a myriad of public and private organizations in the defense of the United States from all enemies both foreign and domestic, whether dealing with financial institutions or even public or private health care entities. In turn, this contributes to the necessity of understanding how to secure, archive and supervise IM.

This paper will explore the regulatory landscape with respect to electronic communications in the arena of the financial services industry in the United States, and in particular, with respect to IM. In addition, this paper will generally discuss issues related to non-compliance with current books and record rules and requirements. Finally, the paper will introduce a new paradigm to evaluate the extent to which IM should be maintained as a book and record based on the content and audience for such communications.

II. WHAT IS INSTANT MESSAGING?

According to the Congressional Research Service, Instant Messaging ("IM") is one of the fastest growing services on the Internet. IM combines the immediacy of a telephone call with the network presence of e-mail to create an instantaneous system for exchanging messages between two people. In the simplest form, IM applications are used for the synchronous exchange of text messages. However, recent developments in IM technology also now allow users to exchange files, pictures and even view messages.[4] Another way of looking at IM is as a hybrid between an e-mail and a chat room discussion. IM can be accessed by a desktop computer or laptop computer with an Internet connection. In addition, more recently, wireless phone communications and PDAs (personal digital assistants such as a Palm Pilot or Blackberry) have become increasingly web-enabled with IM features. These last two remote wireless methods have greatly expanded the potential usages of IM in daily life.

Although earlier forms of synchronous chat technology, such as UNIX "talk" features and Internet Relay Chat (IRC), have existed for over a decade, the current incarnation of IM did not become widely available until 1997.[5] In the early 1990s, AOL introduced the concept of a "buddy list" as part of their Internet service provider services delivered to consumers. Subsequently, in the late 1990s a number of players entered the market with free IM services including Yahoo! Messenger, Mirabilis ICQ, Microsoft Messenger and other smaller players. The AOL Instant Messenger network is the leading provider of instant messaging to the general public with Microsoft MSN and Yahoo! Messenger following closely behind.[6]

III. HOW CAN INSTANT MESSAGING BE USED?

Originally, IM was seen as a way for younger users, often using unusual "screen names" to communicate. However, as IM has grown in popularity and functionality, some industry observers predict that IM will grow into a $6 billion market as it becomes an important business tool.[7] According to some estimates, nearly 50% of "*Fortune* 500" companies are expected to utilize IM for business by 2002.[8] IM time in the U.S. workplace more than doubled in 2001 according to Jupiter Media.[9] According to Jupiter Media, "Workers in September [2001] logged 4.9 billion IM minutes compared to 2.3 billion minutes during the same month in 2000, a 110 percent jump."[10] In comparison, at-home use rose 48%, from 9.2 billion minutes in September 2000 to 13.6 billion minutes in September 2001. The number of instant messengers at work increased 34 percent through this same period, from 10 million to 13.4 million, while the home-user tally jumped 28 percent from 42 million to 53.8 million."[11]

In another survey, conducted by Osterman Research (the "Osterman Survey") of Seattle, Washington, in March 2002, the findings indicate that the spread of IM can best be described as "pervasive."[12] The Osterman Survey found that IM is used (officially or unofficially) in approximately 84% of organizations it surveyed, and this usage is expected to climb to 89% during the next 12 months. In addition, in organizations with more than 1,100 e-mail users the official use of IM is approximately 34% with respect to business applications. It should also be noted that 75% of respondents did not block the use of IM for various reasons, including, but not limited to: no official policy on IM usage or there was a lack of awareness regarding IM's usage in the corporate setting.[13] This data would tend to suggest that the role of IM has evolved faster than the ability to understand or control its use.

There are a number of potential business uses for IM in the financial services sector. One way currently being used is to provide online service for buyers and sellers. IM also provides the opportunity to interact with a trader who can answer questions and facilitate a purchase or a sale without having to disconnect from the Internet and make a telephone call.[14] Another use for IM is to support communication and collaboration in a "virtual office where team members may be located in different areas of the country or the world. IM also provides a means to communicate directly with colleagues during meetings and negotiations.[15]

The financial services industry is beginning to embrace IM. According to two published reports, UBS Warburg, L.L.C. and Thomas Weisel Partners are using IM to communicate.[16] More specifically, Thomas Weisel Partners archives and supervises instant messaging through the use of a back-end server solution deployed within its corporate network.[17] According to one published report, UBS Warburg has set up IM that permits employees to form topic-based groups to simultaneously inform hundreds of colleagues and clients of critical developments. In 1998, the company began permitting select clients to receive messages. UBS Warburg also allows clients to send buy and sell orders via IM. According to Andy Konchan, a UBS Warburg e-commerce executive, "Our salespeople can take information from within UBS Warburg and filter it according to our clients' preferences…we get to the client faster than anyone else."[18]

According to Forrester Research analyst Navi Radjou, the next five years will bring widespread adoption of IM in connection with self-monitoring devices. For example, UBS Warburg sees the addition of artificial intelligence software to its system as the next plausible step, and envisions software that could add a level of judgment, determining which information is important to a trader or client and alerting the trader or client via IM.[19] It certainly seems conceivable that future applications of IM technology could encompass automated delivery of financial advice and other more sophisticated activities requiring regulators to clarify the regulatory implications of utilizing the medium of IM.

The use of IM by the financial services industry in areas involving trading activity, recommendations and advice, and marketing and sales communications with the public are exactly the types of activities for which books and records requirements were created. These requirements were enacted to protect the integrity of the market and investors. To this end, the NASD has identified issues related to electronic communications in a recent policy announcement that touched upon its usage with respect to suitability issues.[20]

Another example of the commercial application of IM is the decision of retailer Lands' End to give instant messaging to customers, who can obtain real-time answers to their questions. According to Lands' End the average customer using IM to talk with a customer service representative spends 8% more than one who does not. In addition, a Lands' End customer using IM is 67% more likely to buy than an online shopper not using IM.[21]

IV. SECURITIES AND EXCHANGE COMMISSION

A. JURISDICTION

The financial services industry in the United States of America and, in particular, the broker-dealer segment, is closely regulated by the Securities and Exchange Commission (the "SEC"). The SEC's authority over broker-dealers was granted by Congress in the Securities and Exchange Act of 1934, as amended (the "'34 Act"). Section 15(a) of the '34 Act prohibits any person from acting as a broker-dealer unless registered with the SEC or exempted. Further, Section 17(a)(1) of the Exchange Act authorizes the SEC to promulgate rules and regulations requiring broker-dealers to make and keep certain books and records as necessary or appropriate for the protection of investors.[22] As a result, in 1939 the SEC adopted Rules 17a-3 (17 CFR 240.17a-3) and 17a-4 (17 CFR 240.17a-4).[23]

The SEC, multiple self-regulatory organizations ("SROs") and the various State Securities Regulators share oversight responsibilities with respect to broker-dealers. However, the SEC has preeminence over the SROs and the various state securities regulators. At the same time, the SEC, through an act of Congress[24] has delegated responsibility for the day-to-day regulation of broker-dealers to the SROs, which includes, but is not limited to, the National Association of Securities Dealers Regulation, Inc. (the "NASDR") and the New York Stock Exchange (the "NYSE"). In addition, the '34 Act regulates the financial soundness of broker-dealers. To this end the SEC has adopted rules regarding the capital structure of broker-dealers.[25] In addition, the broad reach of the SEC's authority also includes the expansive definition of the terms "brokers" and "dealers."[26] It should be noted that relatively few entities are exempted under the federal securities laws of the '34 Act. The most important exemptions are for 1) banks, 2) firms that deal in exempt securities, 3) persons who do business exclusively intrastate and who do not make use of any facility of a national securities exchange, and 4) foreign brokers who have only indirect contacts with investors.[27]

The overall authority of the SROs is captured in the NASD's expansive requirement that broker-dealers are expected to "observe high standards of commercial honor and just and equitable principles of trade."[28]

The authority of the various state securities regulators is broad with respect to examination responsibilities, investigating and enforcement authority over broker-dealers. However, the National Securities Markets Improvement Act of 1996 prohibits states from establishing books and records that differ from the SEC's rules. In other words, the states are restricted from placing <u>additional</u> record-keeping [<u>which includes books and records</u>] rules on broker-dealers.[29] [emphasis added]

In sum, the interests of the federal authorities, SROs and the various states have multiple goals. These goals are carried out through various laws, rules and interpretations that are designed to protect the investor, prevent fraud and manipulation, protect financial solvency and to prevent and deter abusive practices that may not amount to fraud, but rather amount to violations of rules of custom and trade practices.[30]

B. BOOKS AND RECORDS

SEC Rule 17a-3 requires broker-dealers to make certain records, including trade blotters, asset and liability ledgers, income ledgers, customer account ledgers, securities records, order tickets, trade confirmations, trial balances and various employment related documents.[31] Rule 17a-4 specifies the manner and length of time that the records maintained by broker-dealers must be preserved. In combination, Rules 17a-3 and 17a-4 require broker-dealers to create and preserve a comprehensive record of all securities transactions the broker-dealer effects and of the securities business in general. The SEC views these requirements as the primary means of monitoring compliance with the securities laws, including anti-fraud provisions and financial responsibility standards.[32]

Initially, Rule 17a-4, when adopted in 1939, required broker-dealers to maintain records in paper form for the first two years of the specified retention period, and on microfilm thereafter.[33]

C. RELEVANT SEC RELEASES

In 1970, the SEC amended Rule 17a-4 to allow the books and records to be stored immediately on microfilm.[34] By 1991, the Securities Industry Association ("SIA"), on behalf of its broker-dealer members, requested that the SEC amend 17a-4 to allow broker-dealers to store records electronically.[35] In 1992, the SIA requested of the SEC, through a no-action request, that broker-dealers be permitted to use an electronic storage technology known as "optical disk" (also known as "WORM" or write once, read many). [36] The SIA estimated that the savings from switching from microfilm to optical disk would range from $250,000 per year for a medium-sized firm to $1.6 million a year for a large firm.[37] It is clear the SEC is interested in evaluating technologies with respect to record retention as they develop and it is also apparent that a cost-benefit analysis was used, in part, to justify WORM utilization by broker-dealers for the ultimate benefit of the investor. In 1997 the SEC, in adopting a release regarding electronic storage of media ("Electronic Storage Media Release"), in many respects, codified the SEC's prior no-action letters regarding Rule 17a-4 with respect to electronic storage.[38]

The Electronic Storage Media Release made reference to an earlier SEC Release from 1996 which provided analysis and guidelines that applied equally to broker-dealers, investment advisors and transfer agents regarding the electronic delivery of information by such parties.[39] In a key section of the 1997 Electronic Storage Media Release the SEC discussed its beliefs regarding the requirements governing communications with customers. In particular, it recommended that SROs work with broker-dealers to adapt rules regarding the supervisory requirements for electronic communications.[40] In addition, the SEC recommended that the SRO rules concerning the supervisory requirements for electronic communications "should be based on the content and audience of the message and not merely the electronic form of communication." [emphasis added][41]

The 1997 Electronic Storage Media Release went on to discuss the type of e-mail that needed to be retained, and at the same time, used the words "Internet" and "electronic systems" in addition to the word "e-mail" to describe electronic communications:

> "The Commission understands that broker-dealers use e-mail and the Internet to communicate important information relating to the broker-dealer's business internally, to customers, and to the general public. The Commission is also aware that many broker-dealers use such electronic systems to communicate about issues unrelated to the business of the broker-dealer" [emphasis added] [42]

It would appear that the SEC recognized the reality that technology would evolve from e-mail to other forms and methods of electronic communications as the Internet evolved. The SEC addressed this issue by requiring, for record-keeping purposes, that "the content of the electronic communication is determinative, and therefore broker-dealers must retain only those e-mails and Internet communications (including inter-office communications) which relate to the broker-dealer's 'business as such.'"[43] [emphasis added]

A conclusion that can be drawn from these statements and various SEC Releases is that the SROs should be primarily focused on the content and the audience when determining the supervisory requirements and not merely the method by which such communications are transmitted.

Technology has evolved since the time of the first SEC Release regarding the electronic delivery of information by broker-dealers, investment advisors and transfer agents. Since 1996, there have been numerous SEC Releases and Interpretative opinions attempting to clarify issues related to the electronic delivery of information and, more specifically, the record-keeping responsibilities for electronic communications.[44] It should also be noted that in May 2001 the SEC issued an interpretation that held that the record retention requirements of Rule 17a-4 were in compliance with the federal Electronic Signatures Act of 2000.[45] In addition, the SEC determined that requirements of Rule 17a-4 did not impose unreasonable costs on the acceptance and use of electronic records.[46]

To this end, it is more important than ever before to consider the latest innovations in technology that will benefit investors and broker-dealers with respect to maintaining the integrity and transparency of financial markets. Ultimately, the point of preserving communications is to preserve an audit trail and protect investor assets. To this end, it should be noted that there currently exists technology to archive the communication medium of instant messaging.[47]

D. SELF-REGULATORY ORGANIZATIONS

1. The National Association of Securities Dealers Regulation, Inc. and Electronic Communications

NASD Rule 2210 governs the way NASD member firms and their registered representatives communicate with the public. The NASD divides communications into four broad categories. The first, "advertisements," includes materials published or designed for use in a:

a. newspaper
b. magazine or periodical
c. radio
d. television
e. telephone or tape recording
f. videotape display
g. signs or billboards
h. motion pictures
i. telephone directories (other than routine listings)
j. electronic or other public media[48] [emphasis added]

The second category is "sales literature," which means any written or electronic communication which does not meet the definition of an advertisement. Sales literature includes, but is not limited to:

a. sales literature
b. circulars
c. research reports
d. market letters
e. performance reports or summaries
f. form letters
g. telemarketing scripts
h. seminar texts
i. reprints or excerpts of any other advertisement
j. published text [49]

Advertising and sales literature must receive approval by a registered principal prior to use.[50]

The third category is "correspondence," which means any written or electronic communication to be delivered to one person.[51] However, incoming and outgoing correspondence, whether written or electronic, must be reviewed by a registered principal and an internal record must be kept of such communications. The member firm has to have procedures that are appropriate to its business, size, structure and customers for the review of incoming and outgoing correspondence with the public relating to its investment banking or securities business.[52] Where pre-use review is not required, there must be evidence of education and training of associated persons as to the firm's procedures governing

correspondence. If one compares the preceding requirement with the SEC requirements for preserving all communications, including electronic communications having to do with a broker-dealer's "business as such," it would appear that the NASD and the SEC requirements are similar in scope. However, the inconsistency in the use of different language to describe broker-dealer communications in nearly the same way has resulted in lengthy debates about what is actually meant by both the NASD and SEC definitions. The debate centers on the SEC's view that all communications need to be preserved while the NASD's view and focus has been on external communications. Notwithstanding the inconsistency in the SEC and NASD rules with respect to communications, the NASD requires that appropriate supervisory rules be put in place for most communications, including electronic communications. It should be noted that the NASD, with the assistance of the NASD's e-brokerage committee, has provided guidance to firms and associated persons that use electronic media in the context related to on-line suitability.[53]

The fourth category is "public appearance." A public appearance is defined as a participation in a seminar, forum radio or television interview or other public speaking activity that may not constitute an advertisement.[54] General application of standards apply and pre-review use of comment is not required, and participants in public appearances should seek the permission of their firms before participating.

To assist its member firms the NASD has issued guidelines with respect to the treatment of electronic communications by registered persons. These guidelines are based on the mode of communication.[55] These guidelines can be separated into two columns and based on the mode of communication and level of required supervision.

TYPE OF COMMUNICATION	***SUPERVISORY DESIGNATION***
1. single e-mail	- correspondence
2. group e-mail	- sales literature (except for e-mail to qualified institutional accounts)
3. chat room	- public appearance
4. bulletin board	- advertisement
5. web page	- advertisement
6. research report (known audience)	- sales literature
7. research report (unknown audience)	- advertisement
8. instant messaging	- not defined

IM is currently being used by NASD member firms for a variety of uses. IM is used as a substitute for e-mail to conduct some of the following activities, which include, but are not limited to conveying, news and research, placing orders to buy and sell at the institutional level and to submit inquiries at the retail level to registered representatives. This being the case, it is more apparent than ever that IM should be deemed a communication that must be preserved as a book and record to prevent misappropriation of customer funds and maintain the integrity of the markets. The ongoing debate as to the various applicable modes of communication should not prevent the regulatory community from exercising its duty to protect the public interest by requiring the preservation of IM related to a broker-dealer's business. (See Section VII for further discussion)

2. The New York Stock Exchange, Inc. and Electronic Communications

In 1998 the New York Stock Exchange (the "NYSE") issued an Information Memo regarding the supervision and review of communications with the public.[56] The NYSE issued new guidelines for the supervision, review and retention of communications in order to respond to evolving technologies that were affecting the manner in which NYSE member firms and associated persons were communicating with the public. The NYSE recognized that "…e-mail [and the] Internet" would continue to raise new questions about the capacity to supervise such communications. The NYSE in amending Rule 342 ("Offices – Approval, Supervision and Control"), Rule 440 ("Books and Records") and Rule 472 ("Communications with the Public") acknowledged that each member firm should have the flexibility to adopt and implement its own supervisory procedures relating to communications with the public, based on the firm's structure, the nature and size of its business, and its customer base, rather than having a pre-use review requirement.[57] However, at the same time, the NYSE reminded member firms to continue to provide appropriate supervision of the "public communications" of their registered representatives, consistent with their overall duties.

First, the issue of whether IM is a book and record is settled by NYSE Rule 440's reliance on the books and records requirements of SEC Rules 17a-3 and 17a-4, as amended.[58]

Second, NYSE Rule 342 requires a standard of <u>reasonableness</u>:[59]

1. procedures for supervision of communications with the public are <u>reasonable</u> [emphasis added];

2. if a manual or electronic pre-use review of outgoing correspondence is not utilized, then appropriate supervisory procedures must be implemented and complied with and there must be evidence of supervision; and

3. records must be maintained to document how and when employees are educated and trained.

Third, certain communications under NYSE Rule 472 still require pre-approval. These communications include advertisements, market letters, sales literature and research reports. The standards found in NYSE Rule 472 are based on content and not on the mode of communications to the public.[60]

In further guidance, the NYSE indicated that customer complaints received by e-mail or in written form have to be reported pursuant to NYSE Rule 351(d). Interestingly, the NYSE indicated it expected member firms to prohibit the use of electronic communications unless the firm is monitoring such communications.

The NYSE's approach is a practical one because it gives member firms the ability to craft a supervisory system based on the content of the communication as opposed to the mode of communication.

V. COMMODITY FUTURES TRADING COMMISSION

A. JURISDICTION

The Commodity Futures Trading Commission (the "CFTC") was created by Congress in 1974 through the Commodity Exchange Act (the "CEA") as an independent agency with the mandate to regulate commodity futures and options markets in the United States.[61]

The CFTC has several responsibilities including the review of proposed futures and options contracts, the oversight of the National Futures Association (the "NFA") (a self-regulating organization), market surveillance, final approval of Commodity Exchange rules and oversight of the compliance activities of the commodity exchanges and the NFA. The goals of the CFTC include protecting market participants against manipulation, abusive trade practices and fraud.[62]

B. BOOKS AND RECORDS

Pursuant to the record-keeping rules of the CEA found in Rule 4.23, with respect to commodity pool operators ("CPOs") and Rule 4.33 with respect to commodity trading advisors ("CTAs") the following books and records must be maintained: acknowledgements required by Rule 4.21(b) and 4.31(b), as well as the original or a copy of each report, letter, circular, memorandum, publication, writing, advertisement or other literature or advice distributed by CPOs and CTAs. Rule 1.31 requires, among other things, that records be preserved for a period of five years and be readily accessible during the first two years of the five-year period. Rule 1.31(b) provides that copies may be preserved on microfilm, microfiche or optical disk as non-rewritable, (write-once read-many ("WORM")) media.[63]

C. RELEVANT CFTC RELEASE

In a CFTC Final Rule Release from August 21, 1997 regarding the use of electronic media by CPOs and CTAs for the delivery of disclosure documents and other materials (the "1997 CFTC Release") the CFTC permitted CPOs, CTAs, and Futures Commission Merchants ("FCMs"), whether or not registered with the SEC, to use guidelines set forth by the SEC in connection with recordkeeping requirements for broker-dealers. In other words, a CPO, CTA or FCM may maintain required records pursuant to CFTC Rule 1.31 or as permitted by the SEC's guidance in Exchange Act Release No. 34-38245, 62 FR 6469 (Feb. 11, 1997).[64]

D. SELF-REGULATING ORGANIZATION

1. The National Futures Association and Electronic Communications

The National Futures Association (the "NFA"), the self-regulating organization responsible for the oversight of CPOs and CTAs and associated persons, has attempted to address the issue of information technology by issuing guidance on the acceptable standards for the supervision of electronic communications. In drafting the guidance the NFA relied

upon the NASDR's and NYSE's interpretations regarding supervision of electronic communications.[65]

NFA Compliance Rule 2-9 requires members of the NFA and its associated persons with supervisory duties to "diligently supervise its employees and agents in the conduct of their commodity futures activities for or on behalf of the member."[66] In interpreting Rule 2.9 the NFA recognized that e-mail and internet-based communications enabled members to communicate with customers more frequently and efficiently.

In NFA Notice to Members 1-99-16 ("NTM 1-99-16") the NFA determined that "the use of 'futures-related e-mail' by its employees and agents is basically the same as its duty to supervise other forms of correspondence.[67] [emphasis added] It should be noted that the supervisory requirements announced in NTM 1-99-16 were not limited to e-mails and websites. The notice mentioned another aspect of electronic communications, "chat rooms (to conduct business or after-hours electronic trading activity)" and suggested the absence of a discussion of other types of activities did not mean members had no supervisory obligations related to such activities. This would suggest that IM would be deemed a communication necessitating supervision under NFA Compliance Rule 2-9 and 2-29 (Communications with the Public and Promotional Material).[68]

With respect to e-mail the NFA requires its members to have supervisory procedures that 1) are in writing; 2) identify by title the person responsible for the review; 3) specify the frequency of the review of e-mails and how such review is to be conducted; and 4) categorize what types of e-mails will be reviewed or post-reviewed.[69]

With respect to websites and the requirements for supervision, the NFA made an interesting observation that "Members' procedures should adequately address features unique to electronic communications, e.g., streaming-script containing real-time market news." This language appears to take into account the use of IM as a mode of communication that requires supervision by member firms.[70]

Under NFA Rules 2-10 (Recordkeeping) and 2-29(f) (Communications with the Public and Promotional Material; Recordkeeping) the NFA requires that correspondence, e-mails and promotional materials be preserved pursuant to the requirements of the CFTC Regulation 1.18 and 1.32 through 1.37, and for the period required under CFTC Regulation 1.31.[71] Based on the discussion in the reliance on the NTM 1-99-16 regarding electronic communications and in conjunction with the CFTC's release on the delivery of electronic information it is apparent that IM should be considered a book and record under the CEA in order to protect the investor and to improve market transparency. Further, the CFTC's reliance on the SEC's interpretations indicates the degree to which the SEC and CFTC mirror each other's goals, objectives and methodologies with respect to the supervision of electronic communications.

VI. MECHANICS OF PENALTIES FOR NON-COMPLIANCE

The failure to comply with the SEC, NASD, NYSE, CFTC and NFA rules and regulations regarding 1) record-keeping requirements; 2) supervision of written and/or electronic communications with the public; and 3) promotional and sales material as used by broker-dealers, CTAs, CPOs and other associated persons (even unlicensed), by persons responsible for supervision and at the firm level, are enormous.[72]

First, one has to consider the myriad number of federal agencies, SROs and state government entities that may have jurisdiction over the conduct of the broker-dealer, CTA, CPO or other associated person. An individual or firm can be charged with violations by various regulatory authorities for matters that mirror each other.

Second, one has to consider that the mission of regulatory authorities is generally to protect the investors and strengthen market integrity through "vigorous, even-handed and cost-effective self-regulation."[73] In other words, the various SROs are going to be aggressive in their approaches with respect to enforcing "books and records" requirements.

Third, the violation of rules involving electronic communications are an ever-increasing financial burden to broker-dealers, CPOs, CTAs and other associated persons because of the sheer volume of potential multiple violations resulting from failing to supervise or preserve billions of electronic communications in accordance with the various requirements of governmental authorities and SROs. The costs related to preparing a Wells Submission and resulting litigation expenses are not inconsequential.[74]

For purposes of discussion this section will focus primarily on the NASD (the NASD as an SRO has primary responsibility for the majority of broker-dealers in the United States). A violation of NASD rules and regulations relating to record-keeping requirements and supervision of electronic communications can result in censure, suspension, expulsion and/or monetary fines for individuals and firms, from $1,000 to $100,000 in egregious cases. The firms and/or responsible individual(s) can be suspended for up to thirty business days or, in an egregious case, for a lengthier period of up to two years. It should be noted that the types of charges that can be filed against an individual and or firm can generally be described as follows: 1) record-keeping violations; 2) failure to discharge supervisory obligations; 3) failure to supervise and 4) deficient written supervisory procedures.[75]

As a further penalty, both the NASD and NYSE publish the results of disciplinary actions taken against members and individuals in the *New York Times* and the *Wall Street Journal* on a regular basis. In addition, a record of the disciplinary action is made available to the public on the CRD. The publishing of a disciplinary action can severely impact and harm a firm's or individual's reputation. The cost of non-compliance in the electronic communications age has the potential of creating a financial nightmare for firms and individuals, who need to weigh the potential of enormous monetary disciplinary actions against the cost of acquiring technology to assist in supervising electronic communications. Never has the expression "better safe, than sorry" been more applicable.

VII. A NEW PARADIGM: CONTENT AND AUDIENCE

The technology to archive and supervise IM is currently being utilized by financial institutions.[76] Those instant messages related to the business of effecting securities, commodity and futures transactions should be archived. The next issue becomes supervision, which should be required of those communications which are associated with the activities of the member firm related to effecting securities, commodity and futures transactions. The parameters of the supervisory review should be based on the content and audience of the communication. However, as it is an instantaneous medium, manual pre-use review of IM would destroy its functionality in fast-moving markets. Therefore, any review would have to be with the assistance of software that could identify key words and phrases. A real-time electronic review could identify issues for compliance departments.

In analyzing IM related to a financial services provider (e.g., broker-dealer, CPO, CTA and FCM), the following additional indicia might assist in identifying those instant messages that need to be archived and reviewed at some point in the communication stream involving, but not limited to the following:

1. Marketing and sales communications;

2. IM related to the opening, maintenance, administration or closing of accounts or solicitation of trades;

3. IM related to answering of questions or engaging in negotiations involving accounts or related transactions;

4. IM related to acceptance of orders, canceling of orders, selecting among market-makers or routing orders/contracts for customers to market for execution;

5. IM related to the handling of customer funds or other financial instruments;

6. IM related to the provision of investment advice;

7. IM related to clearance or settlement;

8. IM related to extension of credit;

9. IM related to broker-to-broker communications; and

10. IM related to CPO, CTA and FCM communications related to the commodity and futures business of effecting transactions.

The indicia described above were developed in, in part, from two (2) earlier SEC No-Action Letters related to on-line service providers and compensation arrangements.[77] It should be noted that the above-described activities are just some of the myriad types of electronic communications which can and should be archived and preserved as a book and record.

Communications regarding matters unrelated to the business of effecting transactions in the financial services industry should clearly not be part of the record-retention requirements.

VIII. CONCLUSION

IM is here to stay!

The evolution of communications in building the financial markets of the past century can be traced from hand-signals at the corners of exchanges, by the ticker-tape on the exchange floors, through the telegraph strung across America, from the telephone booth, the portable phone, the squawk box, the Bloomberg terminal, the mainframe, the personal computers, the laptop, the Palm Pilot and Blackberry, through the Postal Service, Federal Express, telefax, facsimile, pneumatic tubes, e-mail, chat rooms, bulletin boards, websites and now, to Instant Messaging. In every instance, a buyer and a seller may have wanted to get together, two or more friends may have wanted to share ideas, corporate officers may have wanted to transmit transactional instructions, brokers may have wanted to answer questions presented by investors, and customers of brokers may have wanted to reach their accounts maintained by that same broker. Information, news and research constantly require speedy delivery. This ever-increasing demand for the faster delivery of information, news and research by firms and individuals has resulted in the discovery of IM as a tool to assist with trading activities.

The regulatory angst related to the usage of IM in the financial markets stems from a misunderstanding regarding the role of technology in permitting investors more immediacy with financial markets. IM gives firms and individuals that utilize the technology of immediacy the ability to access a playing field in the financial market that will continue to become more level as times goes on. The use of IM to convey trades, news, research, advice and recommendations at a speed previously available only to traders at an exchange or those with access to electronic trading terminals will likely increase trading activity. The resulting issue is related to the adequate supervision of IM. If a firm can manage and supervise the content of such communications, and do so without reference to the mode of such communications, then the concern of adequate supervision can be ameliorated. To this end, there exists technology to preserve instant communications and to supervise and manage its ever-increasing usage.

IM at the retail level enables brokers to communicate with customers in a “virtual” setting with respect to investment decisions. Likewise, at the wholesale level market participants are able to communicate instantaneously with counterparts and conduct more efficient trading activity utilizing IM. As result, the use of IM assists in reducing exposure to a firm and individual for trading errors due to the ability to communicate in a manner faster than e-mail or even a telephone call.

Regulators need to accept the role of IM in the financial markets. The danger inherent in regulators not recognizing the increasing role of IM and, in turn, not developing appropriate supervisory requirements, could adversely impact market transparency if, for example, institutional traders could conduct one-on-one trading outside current monitored systems. Such a scenario could open the door to potential market manipulators. At the same time, market participants should also accept the reality that if IM is preserved and supervised in a manner that promotes and protects the integrity of the markets and investor assets, then

all participants in the market place will ultimately benefit. A market system that is perceived as promoting a level playing field with increased transparency can assist in attracting new and confident investors in the financial markets.

IX. ENDNOTES

[1] Harvey Pitt, Public Statement by SEC Chairman: "Regulation of the Accounting Profession," Jan. 17, 2002, http://www.sec.gov/news/speech/spch535.htm

[2] "SEC and U.S. Attorney Bring Charges Against 19 Individuals Including Wall Street Professionals for $8 Million Insider Trading Scheme," SEC Press release, Mar. 14, 2000 (use of IM to transmit inside information) http://www.sec.gov/news/press/2000-33.txt

[3] While this White Paper is not focused on the improper uses of electronic communications it should be noted that there are at least two SEC-related cases regarding electronic communications that mention IM in the fact-pattern related to the charge of spoofing. In re Joseph R. Blackwell, *et al*. Exchange Act Release No. 45018 (Nov. 5, 2001); http://www.sec.gov/litigation/edmin/33-8030.htm. *See also*, consent order related to SEC v. Joseph R. Blackwell, *et al*, Case Number 1:01CV02297 (D.D.C.)(Nov. 5, 2001)

[4] Jeffrey W. Seifert, *Instant Messaging on the Internet: Interoperability Issues of Competition and Fair Access,* Analyst, Library of Congress, April 26, 2001

[5] *Id.*, quoting Patricia Fusco, "AOL Instant Messaging Interoperability is a Non-Issue," *InternetNews,* June 28, 2000

[6] *Supra* note 4. See also, http://www.ostermanresearch.com/results/surveyresults_im0302.htm

[7] *Supra* note 4, quoting Patrick Ross, "AOL Time Warner Can't be Trusted on Access, Hill Panel Told." *New York Times,* October 6, 2000

[8] Michael Gowan, "Get in the Messaging Business," *PC World,* May 24, 2000

[9] "Workers Double IM Time, AOL Still Tops." *Newsbytes,* Nov. 15, 2001

[10] *Id*.

[11] *Id*. (Jupiter Media Metrix sampled 60,000 individuals in the U.S. to reach its conclusions.)

[12] http://www.ostermanresearch.com/results/surveyresults_im0302.htm. (Total responses to survey was 164 companies; mean e-mail users per organization was 10,684; and, median e-mail users per organization was 1,500) (Survey conducted March 12 – 18, 2002).

[13] *Id.*

[14] Tischelle George and Sandra Swanson "Not Just Kid Stuff," *Informationweek,* Sep. 3, 2001 (regarding UBS Warburg). See also, *PR Newswire* "FaceTime Communications and SRA International, Inc., Partner to Deliver Integrated Solutions for Financial Services Regulatory Compliance," Nov. 12, 2001 (regarding Thomas Weisel Partners)

[15] *Id*.

[16] It should be noted that Thomas Weisel Partners, an investment bank and a NASD / NYSE member firm in San Francisco, California, is utilizing the services of FaceTime Communications and SRA International, Inc. to archive and supervise the IM utilized by its traders and employees in accordance with SEC Rules 17a-3 and 17a-4 and the SRO rules with respect to the supervision of electronic communications. *PR Newswire,* "FaceTime Communications and SRA International, Inc., Partner to Deliver Integrated Solutions for Financial Services Regulating Compliance," Nov. 12, 2001

[17] FaceTime IM Auditor enables information technology departments to manage and monitor IM communications across public IM networks including AOL, MSN and Yahoo! through a back-end server solution. IM Auditor permits the user to audit all IM conversations, archive data to a database, retrieve data, install keyword watch lists for monitoring content of messages to ensure propriety of business communications and display disclaimer notices. See, Henry Baltazar, "FaceTime Curbs IM," *E-Week,* March 25, 2002, for a technical discussion of the updated FaceTime IM Auditor 2.0, which acts as a proxy server so compliance and IT managers can monitor communications sent over IM client software both entering and leaving the corporate network.

[18] Tischelle George and Sandra Swanson "Not Just Kid Stuff," *Informationweek,* Sep. 3, 2001

[19] *Id*.

[20] It should be noted that the NASDR has established an electronic brokerage ("e-brokerage") committee that meets quarterly. The membership includes NASDR staff, academicians, lawyers, industry and non-industry participants. The committee discusses relevant e-brokerage issues. A recent e-brokerage committee pronouncement regarding on-line suitability can be found in NASD Notice to Members ("Suitability Rule and On-line Communications") 01-23 (April 2001), http://www.nasd.com/pdf-text/ntm0123-es.htm

[21] *Supra* note 16

[22] 15 U.S.C. §78q(a)(1)

[23] Exchange Act Release No. 2034 (Nov. 13, 1939), 4 FR 4578 (Jan. 2, 1939)

[24] Maloney Act of 1938, 15 U.S.C. §780-3

[25] 17 CFR 240.15c3-1 and 15c3-3

[26] §3(a)(4) of the '34 Act

[27] 17 CFR 240.15a-6

[28] NASD Manual, Conduct Rules, Rule 2110

[29] Pub. L. No. 104-290, 110 Stat. 3416 (1996)

[30] *Securities Regulation, Cases and Materials*, Eighth Ed. Jennings; Marsh, Jr.; Coffee, Jr.; Seligman. Part III, Chapter 11 (1998)

[31] 17 CFR 240.17a-3

[32] Exchange Act Release No. 44238 (May 1, 2001), 66 FR 22916 (May 7, 2001); http://www.sec.gov/rules/interp/34-44238.htm

[33] Exchange Act Release No. 2304 (Nov. 13, 1939), 4 FR 4578 (Jan. 2, 1940)

[34] Exchange Act Release No. 8875 (Apr. 30, 1970), 35 FR 7644 (May 16, 1970)

[35] *Supra* note 30, Letter from Edward I. O'Brien, President, SIA, to William Heyman, Deputy Director, Division (May 1, 1991)

[36] *Supra* note 30, Letter from Michael P. Udoff, Chairman, *Ad Hoc* Record Retention Committee, SIA, to Michael Macchiaroli, Assistant Director, Division (May 19, 1992).

[37] *Id.*

[38] Exchange Act Release No. 38245 (Feb. 5, 1997), 62 FR 6469 (Feb. 11, 1997)

[39] Securities Act Release No. 7288 (May 9, 1996) 61 FR 24644 (May 15, 1996) (the SEC's "May 1996 Interpretative Release"*)*

[40] *Supra* note 36

[41] Exchange Act Release No. 38245 (Feb. 5, 1997) 62 FR 6469 (Feb. 11, 1997), quoting Securities Act Release No. 7288 (May 9, 1996) 61 FR 24644 (May 15, 1996)

[42] Exchange Act Release No. 38245 (Feb. 5, 1997) 62 FR 6469 (Feb. 11, 1997), Exchange Act Release No 34-38245 [1996-1997 Transfer Binder] Fed. Sec. L. Reps. (CCH) ¶ 85,902, at 89,204 (Feb. 5, 1997) (Reporting Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934)

[43] *Id*.

[44] Securities Act Release No. 7233 (Oct. 6, 1995), 60 FR 53458 (Oct.13, 1995) ("October Interpretative Release"); Securities Act Release No. 7289 (May 9, 1996), 61 FR 24652 (May 15, 1996); Exchange Act Release No. 37850 (Oct. 22, 1996), 61 FR 55593 (Oct. 28, 1996) ("Proposing Release"); Exchange Act Release No. 40518 (Oct. 2, 1998), 63 FR 4404 (Oct. 9, 1998) ("Re-proposing Release"); Exchange Act Release No. 44992 (Oct. 26, 2001), 66 FR 55818 (Nov. 3, 2001), http://www.sec.gov/rules/final/34-44992.htm (Final rule: Request for comments on Paperwork Reduction Act burden estimate).

[45] *Supra* note 30, *see* Electronic Signatures Act of 2000, Pub. No. 106-229, 114 Stat. 464 (2000)

[46] *Supra* note 30

[47] *Supra* note 15

[48] NASD Manual, Conduct Rules, 2210(a)(1)

[49] NASD Manual, Conduct Rules, 2210(a)(2)

[50] NASD Manual, Conduct Rules, 2210(b)(1)

[51] NASD Manual, Conduct Rules, 2210(a)(3)

[52] NASD Manual, Conduct Rules, 3010(d)(2)

[53] *Supra* note 18

[54] NASD Manual, Conduct Rules, 2210(d)(1)(C)

[55] *Internet Guide for Registered Representatives,* http://www.nasdr.com, (last updated Jan. 22, 2001)
[56] New York Stock Exchange Information Memo No. IM 98-03; www.nyse.com (1998)

[57] *Id.*

[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] 1 U.S.C. § *et seq*. (1994), as amended by the Commodity Futures Modernization Act of 2000 (the "CFMA") Pub. L. No. 106-554, 114 Stat. 2763

[62] http://www.cftc.gov/cftc/cftcglan.htm

[63] 17 CFR §1 *et seq.* (04-01-01 Edition)

[64] http://www.cftc.gov/foia/fedreg97/foi970722a.htm

[65] "NFA Issues Notice to Members Outlining Supervisory Procedures for E-mail and the Use of Websites," http://www.nfa.futures.org/news/newsfactsactions/n/sept99_6.html

[66] NFA Rule Book, Rule 2.9. Supervision

[67] http://www.nfa.futures.org/news/notices/not9916.html

[68] http://www.nfa.futures.org/compliance/manual/mcompliance_b.html

[69] NFA Rule Book, Notice to Members 1-99-16 (1996)

[70] *Id*.

[71] 17 CFR §1, *et seq*.

[72] It should be noted that governmental authorities and the SROs conduct regulatory inspections and examinations and advise and warn firms and individuals about potential violations prior to filing disciplinary actions, to allow firms and individuals to correct potential violations.

[73] NASD Sanctions Guidelines, http://www.nasdr.com/sanctions_guidelines/sg_overview.htm

[74] In a Wells Submission a broker-dealer or associated person is permitted to explain to the regulators why disciplinary action should not be taken against the firm and/or individual for a violation of the federal securities laws, rules and regulations and/or relevant SRO rules and regulations.

[75] "NASD Sanctions Guidelines;" NASD Manual, Conduct Rules 2110, 3010, 3110, and, SEC Rules 17a-3 and 17a-4

[76] *Supra* note 14

[77] See Charles Schwab & Co., Inc. I & II, SEC No-Action Letters (Nov. 27, 1996 and Jul. 17, 1997) (Letters discussed the activities that the on-line service provider would not provide to customers of Schwab and therefore was not a broker-dealer under Section 15(a) of '34 Act. The two letters gave a relevant description of the traditional activities of a broker-dealer.)

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