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A legal update from Dechert's Financial Services Group

SEC Increases Scrutiny of E-mail in Investment Adviser Examinations

Introduction

The Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") recently has increased its focus on e-mail during routine inspections of investment advisers. Comprehensive reviews of e-mail, including draft e-mails, have become a routine part of OCIE inspections. In certain cases, OCIE examiners have reviewed all e-mail sent to and from firm executives within a certain time period, because the staff believes this practice will provide an understanding of the firm's overall compliance culture. At an industry conference in June 2004, Gene Gohlke, associate director of OCIE, stated that examiners might "ask for one or two months of e-mails from senior people" at the beginning of an examination. These requests could include the firm's CEO, CFO, CCO, and portfolio managers, among others.

Statements from OCIE staff suggest that OCIE is now taking the position that:

- It is entitled to review all e-mails retained by a registered adviser, except for e-mails that contain privileged attorney/client communications, regardless of whether they are covered under the investment adviser recordkeeping rules discussed in the section that follows; and
- If an adviser does not retain all e-mail, then it should implement a policy of surveying e-mail to make sure that e-mails that should be retained under the recordkeeping rules are being appropriately retained.

E-Mail Recordkeeping Rules for Investment Advisers and Comparison to Requirements for Broker-Dealers

The recordkeeping rules for SEC-registered investment advisers with respect to e-mail are substantially more narrow than those imposed on broker-dealers registered with the National Association of Securities Dealers, Inc. ("NASD"). Unlike the broker-dealer record-keeping rules, the investment adviser recordkeeping rules do not expressly address e-mail or require its retention.

Section 204 of the Investment Advisers Act of 1940 (the "Advisers Act") and Rule 204-2 there-under impose certain recordkeeping obligations on SEC-registered investment advisers. Section 204 provides the SEC with broad rulemaking authority to require an investment adviser to make and preserve "records" as defined in Section 3(a)(37) of the Securities Exchange Act of 1934 (the "Exchange Act"). Section 3(a)(37) of the Exchange Act defines records broadly to include "correspondence, memorandums, . . . and other documents or transcribed information of any type, whether expressed in ordinary or machine language." The use of this broad definition of records in Section 204 provides the SEC with the authority to capture electronic records, such as e-mail, under the recordkeeping rules promulgated under Section 204. Rule 204-2 of the Advisers Act details the various records an adviser must create and maintain, including ledgers, checkbooks, bank statements, and certain written communica-tions, among others. Currently, advisers are only required to retain e-mails, including

internal e-mail communications, that fall under the categories of records set forth in Rule 204-2(a).

NASD Rule 3010(d)(2) and (3) require a broker-dealer to supervise and retain "written (i.e., non-electronic) and electronic correspondence with the public relating to its investment banking or securities business . . . ." NASD Rule 3110 requires NASD members to comply with Rule 17a-4 of the Exchange Act. Rule 17a-4(b)(4) requires a broker-dealer to maintain "[o]riginals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such . . . ." The "business as such" standard of Rule 17a-4(b)(4) basically requires a broker-dealer to maintain all of its internal and external business-related electronic communication. Accordingly, under Rules 3010(d) and 17a-4, NASD-registered broker-dealers must maintain all of their internal and external business-related electronic communications and have a system in place to review them.

SEC-registered investment advisers that are also NASD-registered broker-dealers are subject to both the Advisers Act and the NASD recordkeeping requirements.

Preparing an E-Mail Retention Policy

Many investment advisers do not currently retain e-mail or have a written policy on e-mail retention. In light of OCIE's increased scrutiny of e-mail, and the adoption of new Rule 206(4)-7 (requiring investment advisers to adopt written policies and procedures designed to ensure compliance with the Advisers Act), investment advisers should consider the adoption of a formal e-mail retention policy.[1]

An investment adviser may take either of two approaches in formulating an e-mail retention policy:

- Create a policy requiring the retention of all e-mail; or
- Create a policy requiring the retention of e-mail falling within Rule 204-2, but permitting the destruction of all other e-mail. Such a policy should provide for some method or system of surveying deleted e-mail to ensure the retention of e-mail covered under Rule 204-2.

A formal e-mail retention/destruction policy should be comprised of several facets, including: (1) the designation of an individual responsible for supervision of the policy; (2) a requirement that firm employees refrain from conducting business through any communications network not maintained by the adviser (e.g., e-mail, instant messaging, text messaging); (3) a requirement that electronic communications that fall within the applicable recordkeeping requirements are identified and preserved in the appropriate manner; (4) a description of the system or method that will be used to identify e-mails that fall within applicable recordkeeping requirements (such systems or methods may include a software tracking system that searches e-mails for key words and/or a method for random sampling of deleted e-mails); (5) a requirement that disposal of e-mails is carried out in a way that protects confidentiality; (6) education and training programs; and (7) an annual review of the policy.[2]

The written policy should be designed with the investment adviser's unique operations in mind. Each investment adviser should tailor its systems and procedures for monitoring and retaining e-mail to fit the size and structure of its advisory business. For example, a manual review process may be appropriate for a small firm, while a software-based review process may be necessary for a firm with a large number of employees.

Conclusion

In light of the SEC's increased focus on e-mail in its compliance inspections, investment advisers should promptly review their existing policies to determine whether retention of e-mail is adequately addressed. In many cases, investment advisers will need to implement more robust policies and procedures to adequately address e-mail retention.

[1] SEC officials have consistently noted that one of the main compliance concerns with respect to investment advisers is their failure to maintain and produce required books and records, including e-mail. The SEC has urged investment advisers to review the books and records requirements and adopt a policy of compliance. *See* Speeches by SEC Staff: *Put the Compliance Rule to Work: IA Compliance Best Practices Summit*, by Lori A. Richards, Director, OCIE, Washington, D.C. (Mar. 15, 2004); *Compliance Issues for Investment Advisers Today*, by Lori A. Richards, Director, OCIE, Washington, D.C. (Apr. 28, 2003); *Remarks at Books and Records Compliance Countdown,* by Mary Ann Gadziala, Associate Director, OCIE, Washington, D.C. (Mar. 24, 2003).

[2] This list is not intended to be exhaustive.

Practice group contacts

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