Supervision of Electronic Communications of Employees of Registered Investment Advisers

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The use of electronic communications, including social media, by advisory employees must comply with the anti-fraud provisions of the securities laws, as well as the compliance and recordkeeping provisions of the Investment Advisers Act of 1940 ("Advisers Act"). Investment advisers dually registered as broker-dealers are also subject to the compliance and recordkeeping provisions of the Securities Exchange Act of 1934 ("Exchange Act") and FINRA rules.

Rule 206(4)-7 under the Advisers Act makes it unlawful for an investment adviser to provide investment advice to clients unless it has adopted and implemented written policies and procedures reasonably designed to prevent violations by it and its supervised persons of the Advisers Act. Additionally, Section 204A of the Advisers Act requires every investment adviser to establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of material, nonpublic information by the adviser and its supervised persons. The latter provision is substantively equivalent to Section 15(g) of the Exchange Act, applicable to broker-dealers.[1]

An investment adviser can be penalized under Section 203(e)(6) of the Advisers Act if it fails reasonably to supervise, with a view to preventing violations of the securities laws, an associated person who commits such a violation. However, an adviser will not be deemed to have failed reasonably to supervise any person if it has established procedures which would reasonably be expected to prevent and detect, insofar as practicable, any such violation. Similarly, for purposes of seeking civil monetary penalties from controlling persons for insider trading violations committed by their controlled persons, Section 21A of the Exchange Act (which applies to advisers) provides that an adviser will not be liable as a controlling person unless it intentionally or recklessly fails to establish, maintain or enforce compliance policies and procedures required by Section 204A of the Advisers Act.

The Securities and Exchange Commission ("SEC") has refrained from issuing specific guidelines on what constitutes adequate policies and procedures for preventing securities law violations. As a matter of general guidance, the SEC has stated that when evaluating its controls and compliance program, an advisory firm should first identify conflicts and other compliance factors currently creating risk exposure for the firm and its clients in light of the firm's particular operations, and then test whether its existing policies and procedures effectively address those risks. Notwithstanding the absence of specific guidelines, however, our experience suggests that the SEC staff expect advisory firms to develop and maintain a very robust set of compliance, supervisory, surveillance and testing protocols.

An adviser's surveillance program should incorporate regular and systematic monitoring of all electronic communications by employees, including randomly sampling a percentage of such communications and

[1] As of July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 15 of the Exchange Act by redesignating subsection (f) as subsection (g).

Kathy H. Rocklen
212.969.3755 — krocklen@proskauer.com

Benjamin J. Catalano
212.969.3980 — bcatalano@proskauer.com

employing a lexicon-based surveillance tool that uses search terms (keywords or phrases) to identify potentially problematic communications. Best practices may also include implementing a policy requiring all firm business to be conducted through the adviser's network and approved devices and prohibiting the use of personal email accounts, personal instant messages (IMs) or other non-sanctioned electronic methods of communication to conduct business. The firm should surveil for breaches of its policy and have the ability to block downloads to unauthorized networks. Some advisers have gone so far as to block the use of all personal smartphones and other personal devices in the workplace.

FINRA has been more explicit in providing guidance to their broker-dealer members about the types of systems and procedures necessary to comply with Section 15(g) of the Exchange Act and FINRA rules. In order to prevent and detect the misuse of material, nonpublic information or other confidential or proprietary information, FINRA expects a firm to have in place supervisory policies and procedures to monitor all electronic communications systems employed by the firm and its associated persons, including email communications and IMs. Surveillance should not be limited to electronic communications with customers (although that is one key element) and communications should be reviewed for evidence of any conduct "inconsistent with [FINRA] rules, federal securities laws and other matters of importance to the member's ability to adequately supervise its business and manage the member's reputational, financial and litigation risk." FINRA has not prescribed a minimum percentage of electronic communications that should be reviewed, but the amount chosen for review must be reasonable having regard to the member's business.

Similarly, with respect to social media, such as web blogs or social networking sites, advisers should have usage guidelines, specifying which types of social networking activities are permitted or prohibited and articulating clear guidelines with the respect to content.[2] Firms may wish to prohibit the posting of recommendations, information on specific products or services or the professional qualifications of the adviser or any employee. Of course, posting of material, non public information, rumors, sensitive customer information or proprietary information about the firm should always be prohibited. Since many third-party sites may not provide complete access to supervisory and compliance personnel, the firm's ability to monitor the use of social media sites will likely impact its policies on usage. Additionally, the firm should determine whether it can retain all required records related to social media communications. Advisers should consider requiring employees to sign-off on the firm's social media policy as part of the firm's Code of Ethics and reaffirm compliance with the Code of Ethics on an annual basis. Firms may want solicitors to agree to their social media policies as well. Advisory firms should also incorporate training on electronic communications, including social media, into their regular employee compliance training program.

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Please contact us if you have any questions regarding the topics addressed herein.

[2] On January 4, 2012, the SEC's Office of Compliance Inspections and Examination issued a National Examination Risk Alert on Investment Adviser Use of Media (Volume II, Issue 1).