Emails and the Recordkeeping Obligations of Investment Advisers

by Lori A. Martin

Since NY Attorney General Eliot Spitzer announced that he had uncovered breakdowns in the separation between the banking and research divisions in large financial service companies,[1] emails have become the prosecutorial evidence of choice. The alleged wrongdoing, according to NY Attorney General Spitzer, had been "revealed by internal email communications obtained during the investigation."[2]

Email communications in investigations of investment advisers became prominent in September 2003, when NY Attorney General Spitzer brought a now watershed New York Martin Act action against Canary Capital Partners, a hedge fund that allegedly obtained special trading opportunities with leading mutual fund families, including Bank of America's Nations Funds, Banc One, Janus, and Strong. In the press release that announced the action and settlement with Canary Capital Partners, NY Attorney General Spitzer reported that "his office has obtained evidence of widespread illegal trading schemes that potentially cost mutual fund shareholders billions of dollars annually."[3] The complaint marshaled a number of emails purportedly documenting agreements to permit market timing of mutual funds, or to provide the market timer with nonpublic mutual fund holding information.[4]

Since this time, state and federal regulators have seized upon email communications as a key tool in identifying potential wrongdoing in financial services companies. The US Securities and Exchange Commission (SEC) has initiated numerous sweep examinations of the investment advisory industry. The vast majority of those sweeps include requests for email communications by employees. John Walsh, Chief Counsel of the SEC Office of Compliance Inspections and Examinations (OCIE), offered the following explanation for the staff's requests for emails: "'I think you have to understand the regulatory environment that we're in right now . . . emails have played a critical role in showing what was going on.'"[5] Gene Gohlke, Associate Director in OCIE, concurred: "[P]erhaps you can also get a sense of where the SEC and the SEC staff is, given what has gone on out there since September [2003], where many of these (illegal) arrangements were not evident in the traditional books and records, (but) they were in email."[6] In addition to providing email communications to the SEC on request, senior SEC staff members have stated that investment advisers "should be monitoring firm email on a constant basis."[7]

In an effort to comply with regulators' requests, investment advisers have incurred significant costs to restore and produce email communications. Advisers that do not produce emails as rapidly as the staff now expects[8] have received deficiency letters relating to the timeliness of their email productions, noting that the firm should review its email systems to enhance the firm's compliance with Rule 204-2 (and, in particular, Rule 204-2(e)(1)) of the Investment Advisers Act. Repeated delays in the production of emails have also prompted the staff to request that fund boards consider whether the adviser's email retention and production policies are in compliance with the Investment Advisers Act.

Given the staff's new emphasis on the review of email communications in routine and sweep examinations, it is timely to address differences between email productions and traditional books and records examinations. This article addresses the following issues:

- The burden of email productions relative to traditional books and record examinations.
- The investment adviser's legal obligation to maintain email communications under current recordkeeping rules.
- Whether the SEC should amend the recordkeeping and compliance program rules applicable to investment advisers.

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Email Productions Are Burdensome

Books and records reviews are a familiar practice for all registered investment advisers. OCIE examiners typically ask to review such information as copies of an adviser's trading logs, minutes of board meetings, and information provided to the fund boards in connection with advisory agreement renewals. Investment advisers anticipate these requests and have maintained their books and records in a fashion that permits ready access to these materials during on-site inspections.

The staff's request to review email communications is, however, relatively new. From the perspective of the adviser, the burden of restoring and producing electronic information is greater than the burden incurred by a review of its paper documents. Magistrate Judge Nolan identified some of these differences in denying a motion to compel production of email correspondence in a civil dispute:

> [T]he Court is not persuaded by the plaintiffs' attempt to equate traditional paper-based discovery with the discovery of email files . . . Chief among these differences is the sheer volume of electronic information. Emails have replaced other forms of communication besides just paper-based communication. Many informal messages that were previously relayed by telephone or at the water cooler are now sent via email. Additionally, computers have the ability to capture several copies (or drafts) of the same email, thus multiplying the volume of documents. All of these emails must be scanned for both relevance and privilege. Also, unlike most paper-based discovery, archived emails lack a coherent filing system. Moreover, dated archival systems commonly store information on magnetic tapes which have become obsolete. Thus, parties incur additional costs in translating the data from the tapes in useable form.[9]

In a thorough analysis of the issues relating to electronic discovery (albeit in civil litigation), a group of scholarly-minded lawyers called the Sedona Conference Working Group identified some of the reasons that the restoration of electronic documents for production to an adverse party is "qualitatively and quantitatively different from producing paper documents."[10] The Sedona Working Group concluded that there were six notable differences between paper and electronic document productions.[11] Of these, three factors illustrate the burdens that many investment advisers have incurred in connection with their efforts to provide the SEC staff with email:

First, the sheer volume of electronic documents exceeds the volume of paper documents. Large corporations generate and receive millions of emails and electronic files each day. Moreover, "email users frequently send the same email to many recipients. These recipients, in turn, often forward the message, and so on. At the same time, email software and the systems that are used to transmit the messages automatically create multiple copies as the message is sent and resent."[12] Thus, in part due to the problem of weeding out duplicate records of the same email, requests for emails are by their very nature burdensome in size.

Second, some emails are incomprehensible without the email management system that created them. "It is not unusual for an organization to undergo several migrations of data to different platforms within a few years. Moreover, because of the turnover in computer systems, neither the personnel familiar with the obsolete systems nor the technological infrastructure necessary to restore the out-of-date systems may be available when this 'legacy' data needs to be accessed."[13]

Third, the storage systems for emails can be dispersed throughout a firm. Employee emails may be maintained on desktop hard drives, laptop computers, network servers, floppy disks, server backup tapes, and separate servers for Blackberry communications. To the extent that the staff requests emails for multiple employees, the dispersion of email files and backup tapes further complicates the burden associated with email production. Network server tapes may not be located at a common site. Moreover, many multinational companies employ investment professionals throughout the world to take advantage of their unique regional expertise. The investment adviser may maintain backup tapes in the country in which the employee is based. To restore and produce employee emails, multinational companies may need to identify the country in which the records reside, as well as personnel capable of identifying and restoring the emails of foreign employees.

Restoration of email communications, however, is not the only cost associated with email production to regulators. Employees now use emails for both personal and professional communications. In tone, the emails are often casual and chatty. These communications may have little, if any, relevance to a regulatory inquiry. Still other communications may contain highly confidential advice of counsel. Thus, many investment advisers review emails for relevance and privilege before turning them over to regulators.

The review is intended to further two goals. First, the investment adviser has legitimate interests in pro-

tecting against the disclosure of email that may contain attorney-client or work product privilege. Production of such information to the SEC could give rise to claims in subsequent civil litigation between investment advisers and fund investors that the investment adviser waived privilege as to all persons due to its production of the privileged material to regulators.[14] Second, the production of information to the government that has not been reviewed by company counsel "gives the government access to potentially harmful information it had not requested."[15] In the absence of review prior to production, senior management at the adviser may not even be aware of the harmful conduct disclosed in the emails.

Anecdotal evidence indicates that the costs of restoration and review of emails are staggering. Indeed, an industry lawyer recently conceded that "one of his clients has been racking up $100,000 a month in legal fees for the firm to wade through its emails to determine what to hand over" to regulators.[16] One industry vendor has stated that the cost of restoration and production is much higher for larger firms, claiming that "$500,000 to $1 million a month is a more realistic tab for larger firms looking for the retention, preservation and review of electronic mail relating to regulatory inquiries."[17] The Investment Counsel Association of American, Inc. wrote to Paul Roye, Director of the Division of Investment Management, and Lori Richards, OCIE Director, that one of their members advised it that it had spent nearly $350,000 over the past year to capture and search email.[18]

Firms that review emails for privilege prior to production to the regulators, however, may face an intangible cost associated with the delay in production associated with a privilege review: the loss of good will of the principal regulator of the industry. Some of the staff's recent comments reflect some exasperation with the industry over perceived delays associated with privilege review. Associate Director Gohlke, for example, recently made the following remarks:

> Companies have the ability and the right to assert privilege. Where it has become an issue is where, after we make a request for something like emails, the firm comes back and says, "Before we give you any emails we need to have somebody review them all and identify which ones are subject to privilege." That can take weeks or months and that is not acceptable.[19]

Against this background, it should come as no surprise that the investment advisory industry views requests for email production in routine industry sweeps as burdensome. These burdens exceed those of typical books and records inspections, and the costs associated with making emails available to the staff are significant. As advisers scramble to comply with the staff's requests for email production, however, a key question has not been fully explored: Are investment advisers obliged to maintain email communications?

I turn now to an Investment Adviser's legal obligation relating to the retention of email communicators.

Investment Advisers Are Not Obliged to Retain All Email Communications

Rule 204-2 of the Investment Advisers Act of 1940 specifies the books and records that an investment adviser is required to maintain. Pursuant to the rule, an investment adviser is required to keep and make promptly available to examining authorities certain *enumerated* books and records "relating to its investment advisory business."[20] The enumerated books and records include, for example, "cash receipts and disbursement records,"[21] a memorandum of each order given by the investment adviser for the purchase or sale of any security,[22] and any "written agreements" entered into by the adviser with any client relating to the business of such investment adviser.[23]

Rule 204-2 also enumerates record keeping obligations with respect to certain "written communications."[24] It is this latter provision that the staff cites as authority for the proposition that investment advisers should retain all email communications and produce them upon request. A closer examination of the rule, however, reveals that an investment adviser's obligation to maintain written communications is much narrower than the sweeping interpretation that the staff now ascribes to the rule. The language is illuminating. The Rule specifies that investment advisers need only retain written communications relating to:

> (i) any recommendations made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security . . .[25]

To the extent that Rule 204-2(a)(7) requires investment advisers to retain emails, it is limited to emails relating to recommendations or advice given by the investment adviser, any receipt, disbursement or delivery of funds or securities by the adviser, or the placement or execution of orders by the adviser.

The rule has additional carve-outs for documents that fall into this narrow category. Thus, investment advisers are not required to keep the following:

> (a) . . . any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser, and (b) . . . if the investment adviser sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if such notice, circular or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of such notice, circular or advertisement a memorandum describing the list and the source thereof.[26]

The limited scope of an investment adviser's recordkeeping obligations contrasts starkly to those governing broker-dealers. Rule 17a-4(b)(4) of the Securities Exchange Act of 1934, for example, requires broker-dealers to keep "originals *of all communications* received and copies of all communications sent by such member, broker or dealer (including inter-office memoranda and communications) *relating to his business as such*."[27] NASD rules include similar recordkeeping obligations for broker-dealers.[28] Failure to comply with the recordkeeping obligations of the rule can result in serious fines and regulatory action.[29]

Perhaps the most compelling evidence in support of the proposition that the rules relating to an investment adviser's books and records obligations do not extend to most email communications is that the SEC has never promulgated for investment advisers a rule as sweeping in scope as the books and records rules that apply to broker-dealers. Although OCIE staff members have suggested that advisers must monitor or review employee emails for violations of the federal securities laws, and implementation of their compliance programs under Rule 206(4)-7, the compliance program rule does not impose such a requirement. To the contrary, the adopting release that accompanied the rule expressly permitted each firm to tailor its compliance program to the nature of the firm's operations. NASD Rule 3010, by contrast, requires that *broker-dealers* review outgoing and incoming correspondence with the public. When regulators have wanted to require a regulated company to save all written communications received and sent by the company, or to review all outgoing email correspondence with the public, they knew how to do so.[30] In the absence of any regulatory authority that would have required an investment adviser to save all employee email communications (or to review employee emails for violations of the federal securities laws), it is remarkable that the SEC is now issuing deficiency letters to investment advisers for their failure to produce email communications promptly in routine examinations.

Expansion of the Investment Adviser's Recordkeeping Obligations Should Be Implemented through Rulemaking

In light of the prominence that email documents have played in recent SEC enforcement actions, the industry readily understands the staff's desire to review certain investment adviser email. However, an appreciation of the importance of emails to SEC examinations is only part of the equation. The question is not whether it would be good policy to prospectively include email communications in SEC examinations, but whether the SEC should signal a clear change in an investment adviser's recordkeeping obligations through deficiency notices, rather than through prospective notice-and-comment rulemaking. In my view, in the absence of clear rules relating to email retention or surveillance, investment advisers have been unfairly penalized for violations of legal obligations that the SEC has never, in fact, implemented. The Investment Counsel Association of America made a similar point in its letter of November 19:

> We believe the vast majority of investment advisers have a genuine desire to be cooperative and compliant regarding these and other compliance issues, but they need to know *on a prospective basis* what their legal obligations are. It is a matter of fundamental fairness that advisers not be penalized on a retroactive basis for failing to take actions that the Commission did not previously require and has yet to formally adopt.[31]

The policy reasons that support rulemaking over policy revisions through the implementation of non-published deficiency letters are clear (and are the same animating principles that supported implementation of the Administrative Procedure Act, with its attendant requirements that rulemaking should be subject to notice and comment by the regulated).[32]

First, rulemaking would clearly enumerate the

emails that advisers should retain. The SEC's failure to promulgate clear rules relating to email retention has had the unfortunate and unintended consequence that investment advisers lack meaningful guidance on the emails that ought to be readily accessible to SEC examiners. It is not sufficient for senior SEC staff members to fill the regulatory void with vague comments at industry conferences. With respect to email retention, for example, one SEC staff member told investment advisers that they should "look to NASD Rule 3010, which lays out how the NASD expects its members to deal with email" for guidance on email retention.[33]

Second, rulemaking would require the staff to give more considered thought to the kinds of electronic communications that should be part of the books and records of the firm. Although the staff publicly has stated that it has an interest in all of an adviser's emails, the reality is that the staff has closed many recent examinations even in the absence of a full production of employee emails. One industry lawyer noted that his client had produced emails to the SEC on an on-going basis—even after the examination had been closed for 10 months.[34] Because we assume that the SEC would not close an examination in the absence of a complete review of the relevant books and records, the on-going production of emails creates the appearance that the staff did not require all of the emails in order to conduct a thorough books and records sweep.

Last, rulemaking creates business certainty and enables firms to make informed technology investments. Firms routinely invest in their technology and in their people. With proper guidance as to regulatory expectations about the records they ought to maintain—and the surveillance systems they ought to employ—investment advisers can invest in appropriate email management systems and electronic storage facilities. These are not inconsequential investments and, if made, likely will come at the expense of other important infrastructure investments. These are not the kinds of investments that ought to be made because a SEC staff member has expressed the view at a conference that the enumerated books and records of Rule 204-2 include additional, non-enumerated items. The Investment Counsel Association of America separately made this observation in its letter to Mr. Roye and Ms. Richards:

> We believe it is unfair to ask investment advisory firms to make major decisions resulting in substantial investments in time and money based on anecdotal reports of SEC staff inspection requests and comments. Instead of allowing new regulatory policies to be set by inspection activities, the Commission should issue a proposed rule on this subject and give interested parties an opportunity to comment.[35]

Fortunately, some of the staff's remarks over the past year suggest that rulemaking may be in the works. *IA Week* reported in March 2004 that OCIE and the Division of Investment Management have been planning to issue guidance, either in the form of a new rule or staff legal bulletin, regarding email retention.[36] Associate Director Gohlke similarly has stated that the "SEC may 'come[ ] out with some amendments' to the Advisers Act recordkeeping rule 'which may very well go the way of broker-dealer rule' and impose a 'business as such' [the] standard, which would 'pretty much capture everything under [Advisers Act] Section 204.'"[37]

Rulemaking is the appropriate mechanism to implement these new regulatory expectations. At that time, serious discussion of the merits of particular proposals, as well as their costs and benefits—can begin.

Notes

1. Press Release (April 8, 2002).

2. *Id.*

3. Press Release (September 3, 2003).

4. *See* Complaint in State of New York v. Canary Capital Partners, LLC, et al., Index No. 402830/2003 (Supreme Court New York County, Sept. 3, 2003) ¶ 60.

5. "Aiieeemail! SEC Officials Shed Light on Email Expectations," *IA Week* (March 22, 2004).

6. *Id.*

7. Angela Salvucci, "Advisers Should Review Email Constantly, Produce It Immediately," *Compliance Reporter* (March 19, 2004).

8. Mr. Gohlke, for example, has stated that investment advisers should be prepared to provide emails to SEC examiners "within 24 hours of their request." *Id.*

9. Byers v. Illinois State Police, 53 Fed. R. Serv. 3d 740, No. 99 C 8105, 2002 U.S. Dist. LEXIS 9861 (N.D. Ill. May 31, 2002).

10. The Sedona Principles: Best Practices Recommendations & Principles for Addressing Electronic Document Production Retention & Production, 2-6 (The Sedona Conference Working Group Series, January 2004.) The Sedona Conference Working Group consists of lawyers, consultants, academics and jurists who contribute considered ideas on legal topics for the purpose of advancing law and policy.

11. The six differences identified by the Sedona Conference Working Group are (1) volume and duplicability of electronic

documents; (2) the persistence of electronic documents (electronic documents may be recovered even if the computer user is unaware that the document still exists); (3) electronic documents are dynamic and may change as a result of automatic updates; (4) metadata elements (including such information for emails as the dates that the email was sent, received, replied to or forwarded, blind carbon copy (bcc) information, and sender address book information; (5) environment dependence and obsolescence (electronic documents may require particular databases to be understood); and (6) dispersion and search ability (electronic files are often stored in shared network folders that are difficult to search). *Id.* at 2–6.

12. *Id.* at 3.

13. *Id.* at 5.

14. McKesson HBOC, Inc. v. Superior Court, 115 Cal. App. 4th 1229, 9 Cal. Rptr. 3d 812 (1st App. Dist.) (holding that McKesson waived the attorney client and work product privileges by producing report prepared for the Board's audit committee to the SEC), *review denied*, 2004 Cal. LEXIS 4901 (June 9, 2004).

15. Chris Frankie, "Costs of SEC Email Requests Skyrocketing," Ignites (December 14, 2004).

16. *Id.*

17. *Id.*

18. Letter from David G. Tittsworth, Executive Director of the Investment Counsel Association of America, to Paul F. Roye and Lori A. Richards, dated November 19, 2004 (p. 1, n.2).

19. Alison Sahoo, "SEC Lists Indicators of Good Compliance," Ignites (Dec. 1, 2004).

20. Investment Advisers Rule 204-2(a), 17 C.F.R. § 275.204-2(a).

21. Investment Advisers Rule 204-2(a)(1), 17 C.F.R. § 275.204-2(a)(1).

22. Investment Advisers Rule 204-2(a)(2), 17 C.F.R. § 275.204-2(a)(2).

23. Investment Advisers Rule 204-2(a)(10), 17 C.F.R. § 275.204-2(a)(10).

24. Investment Advisers Rule 204-2(a)(7), 17 C.F.R. § 275.204-2(a)(7).

25. *Id.*

26. *Id.* (emphasis supplied).

27. Securities Exchange Act Rule 17a-4(b)(4), 17 C.F.R. § 240.17a-4(b)(4).

28. *See* NASD Rules 3010(d)(2) and 3010(d)(3). NASD Rules 3010(d)(2) and 3010(d)(3) require a broker-dealer to supervise and retain "written 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. Accordingly, under Rules 3010(d) and 17a-4, NASD-registered broker-dealers must maintain all of their internal and external business-related electronic communications.

29. *See, e.g.*, In the Matter of Deutsche Bank Sec., Inc., Goldman Sachs & Co., Morgan Stanley & Co., Inc., Salomon Smith Barney Inc, and U.S. Bankcorp Piper Jaffray Inc., Securities Exchange Act Rel. No. 46937 (Dec. 3, 2003) (administrative proceeding in which the SEC alleged that the firms violated Section 17(a) of the Securities Exchange Act and Rule 17a-4 under the Act by failing to preserve for a period of three years or preserve in an accessible place for two years, electronic communications relating to the business of the firm and ordering the firms to pay a penalty totaling $8.25 million).

30. See Zell v. Intercapital Income Secur., Inc., 459 F. Supp. 819, 824–825 (N.D. Cal. 1978) ("The detail required by Schedule 14A, such as the revocability of the proxy, the dissenters' right of appraisal, the identity of persons making the solicitation, the financial interest of management and nominees in matters to be voted on, the remuneration and other transactions with management, and the issuer's relationship with independent public accountants, clearly shows that the SEC knew how to go about requiring disclosure of those matters it thought should be disclosed. It must therefore be concluded that in the absence of a specific requirement covering litigation involving persons such as [defendants], who are neither the issuer nor a subsidiary, disclosure is not required by the terms of the regulation"), *reversed on other grounds*, 675 F.2d 1041 (9th Cir. 1982). Cf. Olmsted v. Pruco Life Ins. Co., 134 F. Supp. 2d 508, 513 (E.D.N.Y. 2000) ("when Congress wanted to supplement the SEC's enforcement authority with a private right of action, it knew how to do so"), *aff'd*, 283 F.3d 429 (2d Cir. 2002); United States v. Bombadier, 380 F.3d 488 (dissenting opinion) (second "if" clause shows that Congress knew how to use that verb form when it wanted to), *reh'g en banc denied*, 2004 U.S. App. LEXIS 25245 (D.C. Cir. Dec. 8, 2004).

31. Letter from Investment Counsel Ass'n of Am., *supra* n.18 at 2.

32. *See generally* the rulemaking provisions of the Administrative Procedure Act, 5 U.S.C. § 553 (1966).

33. "Adviser Email Guidance on the Way," *Compliance Reporter* (March 26, 2004). *See also* "Email retention still a hot button issue for IAs," *IA Week* 2 (September 20, 2004) (quoting Division of Investment Management attorney Nancy Morris as stating that the SEC views emails as an important source of information for the Commission and for cases and that "It is the Division's view that advisers can complain about this all they want, but it would be best if they started preparing for this").

34. Frankie, *supra* n.15.

35. Letter from Investment Counsel Ass'n of Am., *supra* n.18 at 2.

36. "Aiieeemail! SEC Officials Shed Light on Email Expectations," *IA Week* (March 22, 2004).

37. *Id.*

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