

Conspicuous Compliance

Horrigan Resources



Compliance: Keeping up with e-communications

As a leading global vendor of compliance technology, Smarsh knows first-hand that capable supervision of electronic communications is a preeminent concern for compliance professionals. New regulations, recent legal precedents in the area of e-discovery, and the ubiquity of electronic communication by personnel associated with regulated business activities continue to stress the compliance programs of the enterprise.

*In the financial services industry, aggressive regulatory examinations and subsequent enforcement actions continue to bend the curve of financial compliance as registrants focus on the growing reputational and financial costs of noncompliance. The **Smarsh 2011 Electronic Communications Compliance Survey** published in May 2011 offers an inside look at electronic communications compliance practices and examination expectations among compliance professionals in the financial services field.*

In June, Horrigan Resources had the opportunity to discuss this research with Ken Anderson, Senior Communications Director at Smarsh where he manages the company's marketing and public relations initiatives. Ken shared his perspective about the research and the mindset of compliance professionals as they face the daunting challenges of electronic communications.

Ken, thanks for your time today. By way of background, can you elaborate on your company's corporate mission?

Smarsh provides hosted technology solutions to public and private sector clients for archiving and monitoring electronic communications, such as email, instant messaging and social media platforms such as Facebook, LinkedIn and Twitter. We help organizations manage and enforce flexible, secure and cost-effective compliance and record retention policies. The company, founded in 2001 by CEO Stephen Marsh, has built its reputation with clients in the financial services industry, including investment advisers, broker-dealers, banks and hedge funds. Smarsh is headquartered in Portland, Oregon, with an office in New York City.

What inspired Smarsh to sponsor this survey on electronic communications?

Betsy, as a compliance professional, you can appreciate the ongoing challenge of keeping pace with employee communications. Our focus at Smarsh is electronic communications compliance and as you can imagine, heavily regulated industries like financial services are our bread and butter. There is a palpable buzz right now around the ubiquity of social media and mobile devices in the marketplace. We see a fair amount of IT research and thought leadership on e-communications, but there were a few areas related to risk management that we

felt deserved further exploration, for a few reasons. Specifically, we believe the risk management implications of new mobile devices (like the iPad and iPhone, etc.) and the growing influence of social networking in the workplace present serious challenges for the CCO. And the compliance landscape, especially as it pertains to electronic communications, is becoming more complex. Dodd-Frank and

“The risk management implications of new mobile devices and the growing influence of social networking in the workplace present serious challenges for the CCO, and the compliance landscape...is becoming more complex.”

FINRA Notice to Members 10-06 alone evidence the need for increased policy responses by registrants facing examination scrutiny by the regulators. So we see electronic communications oversight as a major compliance issue for the regulated enterprise.

Smarsh really wanted to hear from compliance professionals, those in the field responsible for day-to-day oversight, as they implement their firm's compliance

policy and procedures. Our objective is to better understand their challenges and concerns so we can serve their needs more effectively. This research speaks directly to CCO concerns around the capture, retention, search, supervision and production of data from emerging communications channels and platforms.

How did you get the word out in soliciting participants for the survey? Did you start with your client base?

We made a conscious effort right from the start to expand beyond our client base, but at the same time, we certainly did not want to exclude our clients. We wanted to canvass a healthy cross-section of firms in the financial services industry to include those using hosted solutions and on-premise archiving solutions. The key was to hear from compliance officers, compliance departments and individuals with communication supervision responsibilities. We ultimately gathered insight from 223 respondents with compliance-related responsibilities in their regulated enterprise. Approximately 50%



represented the broker-dealer community, with another 20% from investment advisers and the remaining participants spread across hedge funds, private equity firms, insurance companies, banks, and other financial service entities. We spread the word through advertising, trade shows, compliance conferences as well as through our industry network of service partners and consultants.

We noticed that a high percentage of survey respondents have been examined by a regulator in the past 2 years. Was this your intent when you invited survey participation or simply an interesting coincidental factor?

Increased regulatory scrutiny and enforcement together represent one of the top 3 concerns shared by participants as it relates to electronic communications. The research showed that 50% of participants have been examined by a regulator in the past 12 months. Another 13% have been examined between 13 and 24 months ago. Our results in general appear to parallel the published statistics shared by the SEC, FINRA, and state regulators.

Additionally, 58% of all survey respondents expect to be examined within the next year, which is skewed slightly by a higher rate among FINRA-registered respondents. 72% of broker-dealers expect to be examined within the next year, while a far smaller number of investment advisers expect to be examined in the

same time frame, which is consistent with industry examination statistics.

What else should we know about the design of the survey itself?

The 29-question online survey was open to respondents from January through April. Questions covered current trends in electronic message compliance policies and practices, and included: (a) understanding of regulatory obligations; (b) policies and use of different communications types and devices; (c) supervision and archiving practices; (d) regulatory examination incidence and expectations; and (e) confidence in compliance policies and enforcement.

Those who participated had an opportunity to direct a charitable contribution to one of four children's charities. We are very pleased to have the opportunity to support great causes in the name of industry professionals who participated in our research study.

What were the most important takeaways from the research in terms of

the compliance risk associated with e-communications for the regulated enterprise?

Our main conclusions shouldn't be a surprise to anyone, as they put quantitative data points behind the trends that vendors and compliance professionals have been talking about. The first conclusion is that compliance represents a growing burden for firms, in light of the evolving electronic communications landscape, and these demands are growing. This holds true regardless of the regulatory body governing the business. Most respondents believe that more compliance obligations relating to electronic communications are on the way and the time and resources devoted to satisfying these obligations will increase.

Secondly, both the frequency and scope of examinations are increasing, which is putting pressure on firms. Of course, this condition is compounded by the mobile device/social networking phenomenon, as employee use of these devices and media continues to expand.



➤ **Social media is an area of compliance risk and the leading concern related to electronic message compliance, chosen by 79% of respondents.**

➤ **Only 40% are mostly or completely confident in their ability to provide requested social media messages within a reasonable time frame, and 31% have no confidence at all.**

- Smarsh research findings, 2011

The third and perhaps most interesting takeaway is that compliance officers as a whole have a very clear understanding of their obligations to retain and supervise electronic communications, but are increasingly challenged to put compliance into practice. The research highlights a significant gap between what firms know they are supposed to be doing, and what they are actually doing. By and large, industry professionals understand their obligations to manage electronic communications, but for many reasons, they are not where they need-or want to be in terms of developing and implementing a responsible policy response.

“In the case of mobile messages and social media, 60% of respondents do not have compliance policies in place and 70% are not archiving these media...”

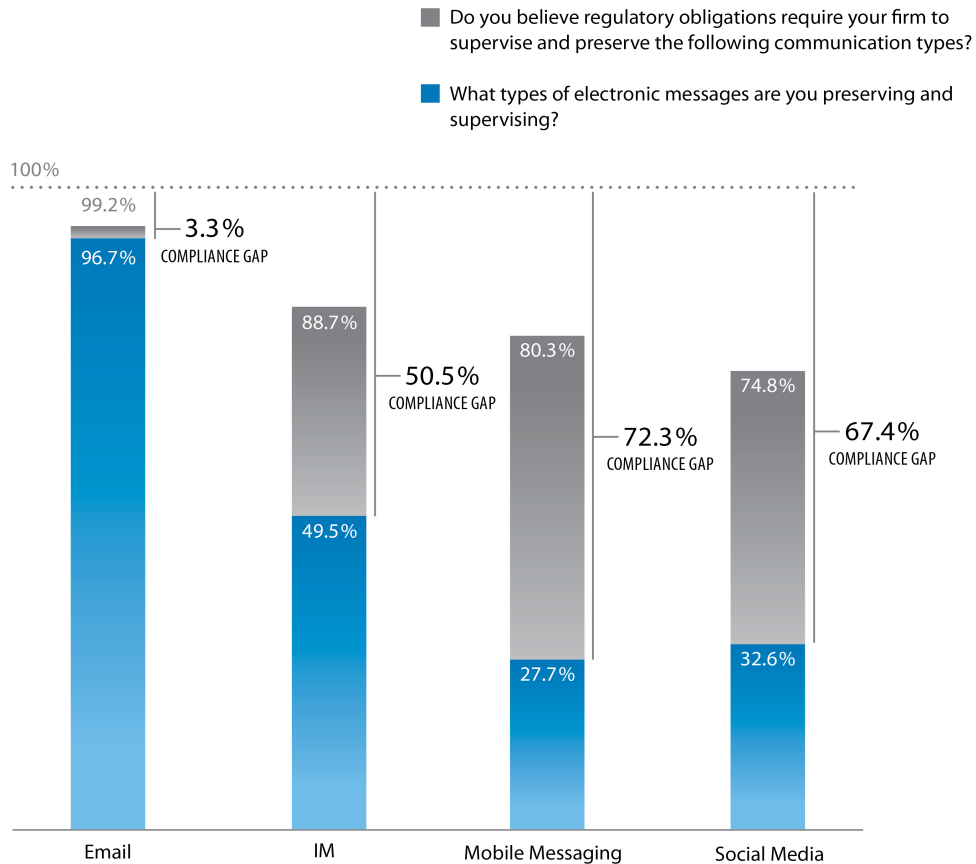
The compliance gap varies by communication type. For example, looking at email, the compliance gap between the regulatory obligation and enterprise compliance is narrow across the participant base. In fact, there is a keen understanding of preservation and monitoring requirements coupled with a high enforcement threshold associated with

these requirements. By the numbers, 70% of responding firms have an email policy in place, while more than 95% have adopted an archiving solution (defined as a system to retain and supervise) and are confident that their preservation and monitoring practices generally meet regulatory obligations.

You can see in the chart on the following page that this is not the case with instant messages, mobile messages, and social media, where the gaps between regulatory obligation and the state of compliance are very wide. In the case of mobile messages and social media, 60% of respondents do not have compliance policies in place and 70% are not archiving these media, yet the vast majority believes they have a regulatory obligation to preserve and monitor these communications. By the way, it is important to highlight the fact that archival does not necessarily mean the enterprise has deployed a purpose-built solution. Again, it is defined as a system to retain and supervise and could simply mean printing out email and social media profiles and storing them in a box.



Compliance practices across communication types



Source: Smarsh 2011 Electronic Communications Compliance Survey

Obviously, much of the survey data is quantitative in nature. Did you capture any subjective feedback along the way as to the mindset of compliance professionals?

Yes, for most of the survey questions, we gave respondents an opportunity to add comments or supplementary information. Several firms who identified a compliance gap for mobile messages and social media said they were in the process of developing policies or implementing solutions to meet

their obligations.

Smarsh has been in the archiving and compliance business for ten years, and this feedback reminds us of the trends we witnessed five or six years ago when we introduced an instant message archiving solution. At that time, firms knew they needed to take compliance action, but were often reluctant to embrace a solution. They may have simply chosen to ignore the inevitable, delayed taking action until

larger firms decided to take the lead, or waited for the regulators to sanction companies for failure to become compliant. In essence, firms were taking time to truly understand the ramifications of this new form of communication. Today, we see similar patterns emerging with mobile messaging and social media, and many firms are again leaving themselves vulnerable to compliance risk.

Did you get a sense in the research that recent regulatory actions and guidance have impacted the CCO's decision to act or not act relative to developing and enforcing a policy response for e-communications?

Yes, we found that some firms are going with an outright ban or prohibition on many forms of mobile messaging and social media. Many firms have taken this posture because they do not have the resources and manpower to keep up with this media. In fact, our research shows that 52% of survey respondents reported being challenged by limited human resource and budgetary constraints. Or firms have certainly taken to heart FINRA's Notice to Members 07-59 which states that if firms cannot govern the use of new and evolving forms of electronic communications, they should not be using them.

But in reality, even in a "ban" situation, firms must still prove that prohibition is working. For example, a ban on social media can be a very difficult policy to enforce, and more importantly, to provide



proof to regulators that it is working. One broker-dealer learned this lesson the hard way - during a recent FINRA examination. This particular firm's policy at the time was to ban social media. It was not until a simple Google search led the examiner to a publically viewable LinkedIn profile of the firm's CEO that a need to change policy and oversight systems became apparent to the firm. Fortunately for the CCO and the firm, this lesson turned out to be a call to action rather than grounds for a penalty. But it reinforces a fundamental compliance challenge with e-communications - to enforce, and even in the case of prohibited activity, to prove compliance with policy.

By its nature, social media is very difficult to ban altogether. The enterprise social media footprint is created not only by current employees but by former and future employees as well. Of course, the balance between personal and professional communications in the workplace will drive the footprint too. So this digital organism exists, ban or no ban.

So, for mobile communications and social media, what will be the catalyst for firms to close the gap between regulatory requirements and enterprise compliance?

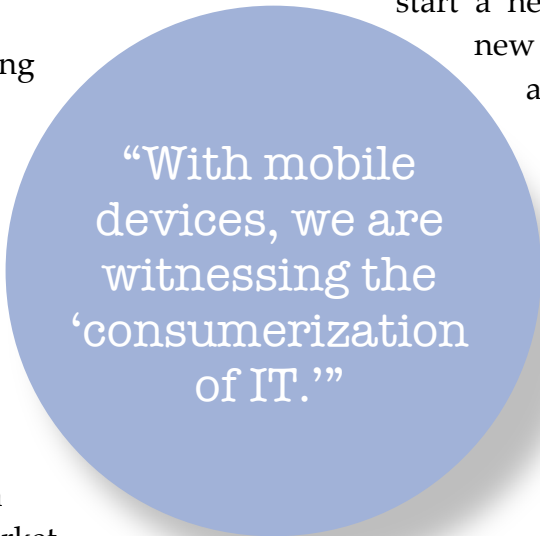
Let's focus on social media. First and foremost, related punitive action from a regulatory body will provide ample motivation, and FINRA, in particular, has made it quite clear that social media will be a priority for regulatory examinations this year.

Right now we are beginning to see large firms, like Morgan Stanley Smith Barney and LPL Financial announce their social media programs. So, the market tides are beginning to change. History has shown that when larger firms make a move, the rest of the market takes notice. Therefore, the visible actions of key market players will be a catalyst.

Mobile communication already has a widespread, grassroots grip on the enterprise. With mobile devices, we are witnessing the "consumerization of IT." This means that unlike other business initiatives that are pushed down to employees through IT, the interest in using these devices for productivity and efficiency stems from their use in employees' personal lives, and the demand

emerges from the ground up. IT is faced with pressure to integrate these devices into its governance policies, while compliance has a burden to make sure the enterprise can balance these new technologies with its regulatory obligations. Compliance must help the enterprise strike the right balance between what is possible and where the limits should be.

It is not a matter of evaluating whether to start a new product or go after a new client segment but rather a question of how the firm will manage the compliance risk inherent in activities that have already been embraced.



Where should the enterprise begin the work of closing the compliance gap?

The first step, I think, is for firms to gain a solid understanding of this evolving medium. And it may not be the compliance officer who is driving the program. Obviously the IT department or consultants will have a critical role in the process. Firms also need to talk to the people internally who are active users of social media and mobile messaging and find out how they are using them. Find out what is effective. Talk to your peers in other firms.

Understand where the business success associated with social media is coming from. I would say that as a precursor to developing a policy response, it is important to understand how it is being used and then to ascertain how it can be used. The formation of a cross-discipline, internal advisory team to assist the enterprise in developing a working business strategy may be part of this first step.

Secondly, it's important to recognize where your customers are. If your customers are communicating through social media, then consider how you will meet them there. If your customers are not actively using social media, maybe your initiatives don't need to be overly aggressive. Sometimes there is a perception that a firm has to embrace all the latest technologies and media because "everyone else is." This is not necessarily informed strategic thinking. The focus should be on customers and where the firm is converting client touches to new business. This can be overlooked at times in the rush to embrace new trends.

Armed with an understanding of the enterprise digital footprint, business opportunities, and customer utilization, the compliance officer will be better positioned to put into place reasonably designed policies to guide the business and ensure compliance with securities laws. In our experience, to make e-communications strategies work effectively for the business, firms should think about:

- 1) Educating users about the rules of engagement associated with electronic communications.
- 2) Deputizing and training those who supervise and manage the attendant risks.
- 3) Evaluating the effectiveness of policies on a regular basis.
- 4) Consistently enforcing policies.

Getting all stakeholders – not just the compliance department – involved in the strategic effort is critical.

Ken, what were the key research observations in terms of the compliance oversight side of the equation?

How firms monitor electronic communications is of great interest to us at Smarsh. How much of the average compliance officer's day is devoted to email and messaging surveillance? The recordkeeping piece is certainly vital, and presents a vulnerability to the enterprise if it is not handled correctly. But beyond



retention, the supervisory aspects of the e-communications challenge are equally important.

A majority of our respondents indicated that one-fifth or less of their time is actually dedicated to the oversight of electronic communications. With the regulatory environment growing in complexity and new mobile devices and platforms to govern, this mission-critical responsibility threatens to rapidly escalate in terms of CCO mindshare. More than 90% of compliance professionals surveyed expect the time spent on electronic communications-related compliance to stay the same or increase in the next 12 months.

With the amount of responsibilities already on the compliance department's plate, the real question becomes: How can you manage these responsibilities more efficiently and effectively? The 30,000-foot answer to that question is with a healthy dose of knowledge, policy, training, and technology. Of course, this is easier said than done.

The survey highlighted firms who are “highly confident” about their capability to manage social media and mobile data. What sets these firms apart from the rest and what can other firms learn from their experience?

Part of the answer comes from having a solution in place which gives CCOs a level of confidence they are at least making a good faith effort to manage the risk. As we

are seeing on the regulatory front, there is a learning curve involved in getting up to speed on communication technologies, risk management issues, and the full range of solutions. So, as long as the CCO is putting forth a good faith effort with “reasonably designed policies” (which is the actual terminology used in FINRA NTM 10-06), there appears to be a fairly high level of confidence.

The one area that our 2011 research initiative did not explore is whether or not that confidence is justified. We have earmarked the confidence factor for our 2012 survey and look forward to delving into that issue a bit deeper next year.

Were there any surprises in your research findings?

Definitely! One surprise is the sheer amount of data requested by examiners from firms that have recently been subject to examination. Although social media inquiries are rising, the increase in Bloomberg messages and IMs is the big surprise. This may be a reflection of the lag time between adoption of new forms of communication and the regulators' interest in their associated risk sets. The bottom line is that respondents report that examination pressures are mounting as SEC and FINRA examiners ask for a deluge of information.

Please refer to the table on page 11

Requests for new communication types are growing

	Exams before 2010	Exams in 2010	Increase
Email	66.7%	78.0%	16.9%
IM	6.7%	28.0%	317.9%
Text messages	3.3%	18.0%	445.5%
Social media	13.3%	22.0%	65.4%
Bloomberg Messages	3.3%	26.0%	687.9%

There is exponential growth in requests for IMs, text messages, and Bloomberg Messages.

Source: Smarsh 2011 Electronic Communications Compliance Survey

Make no mistake - email remains a very high priority, as 78% of respondents reported email requests during 2010 examinations. The risk for registrants remains quite high for all forms of messaging as they represent the proverbial smoking gun when it comes to employees engaging in any number of non-compliant behaviors.

Ken, you have mentioned the growing pressure on firms during the examination process. Do your clients seek assistance from Smarsh as a direct result of an examination?

Yes, and in all fairness, that is part of what we do. We routinely have clients under audit that we help if they are unable to do it on their own or require special assistance. It is not uncommon for us to produce the information for firms under that scenario.

We often hear the question from our clients, "How can we better leverage our technology?" In response, we share best practices gleaned from our ten-year history in the communications compliance space. Keep in mind though that each client situation is different. Technology

applications and service must be customized to meet the unique needs of each enterprise and of course the specific regulatory request if our input is requested during an examination. The integration of our product is a direct function of the business model of the firm, i.e., its products, clients, and attendant risks.

Speaking to the regulatory side of the equation, we have certainly seen a shift over the past ten years in how the examiners are operating relative to electronic communications. In recent years, regulatory authorities have been able to leverage technology solutions to expand the parameters of data requests. So in some ways, the technology has pushed the evolution of the robustness of the examination process. To meet rising regulatory expectations, we frequently share with our clients best practices related to keyword lists, and procedural documentation associated with email searches, among other resources. Our clients also have a series of analytics reports that enable them to document their procedures and evaluate whether these procedures are working to identify and address high-risk behavior.

As you look ahead, where do you see the greatest compliance risk in the communications arena and how will the technology evolve to meet this risk? Do you expect the innovation to come from users or technology solution providers?

Mobile devices, new platforms that are

enabling firms to work more efficiently and productively in the field, social networks and other evolving messaging media will drive demand for compliance solutions in the e-communications arena. Much of our effort is focused in these areas with the goal of supporting clients as they adopt new technologies to improve employee productivity and their competitive stature in the marketplace. Smarsh will continue to innovate and deliver products that provide clients with the peace of mind that they are equipped to meet user needs and capable of developing robust policy responses to meet evolving regulatory standards.

In terms of whether the solutions will be pushed into the marketplace by providers or “pulled” by the users, I think the answer lies in what I mentioned before – the consumerization of IT. It is users who embrace the iPad, mobile phones, and social networks in their everyday lives and recognize all the benefits they can enjoy who are driving these efficiencies into their business lives. So we see this phenomenon as starting in a very grassroots way out in the marketplace by users and working its way back to the enterprise.

Who do you see emerging inside regulated firms to lead digital communications innovation?

Each of the 223 survey respondents had some compliance oversight responsibilities with regard to communications within the enterprise. There were a large segment of

CCOs, but also compliance department staff members, branch managers, and others. However you slice the demographics, though, we see a great opportunity for new leaders to emerge in this area, particularly young people. This is a very exciting time for young people to find a voice in their organizations by extolling the benefits of new technologies and new mediums. CCOs can serve their firms well by tapping the right people in the enterprise to identify opportunities and trends, and leverage culture shifts to benefit the business in a risk appropriate manner. Compliance must be part of the conversation, but they have so much to gain by engaging knowledgeable and tech-savvy stakeholders throughout the enterprise in both strategic and tactical decisions.

It is also very important to stress the role of IT personnel in understanding the full array of technology and networking configurations. The IT voice is critical in formulating an enterprise strategy for e-communications.

What can we expect next from Smarsh in terms of research and reporting?

We gathered a lot of data during this research initiative that we intend to share in coming months. Our next report will more explicitly convey what is being requested by regulators in the examination process. For example, our research uncovered valuable information about the details of examination requests as experienced by

research participants. We have also collected information about peripheral requests by examiners related to electronic communications that we believe can benefit regulated firms.

In closing, we found the insights gleaned from compliance professionals to be very important. Smarsh plans to conduct additional research studies in the future in the area of electronic communications and social media given their significance in the business and compliance equation, and to respond to the market's need to benchmark confidence levels. We welcome compliance practitioner feedback about areas of interest, and will consider thoughtful suggestions as we formulate future research initiatives. To share ideas, readers can contact me directly at kanderson@smarsh.com. For a complete, complimentary copy of the report, go to: <http://www.smarsh.com/compliancesurvey>.

Thanks Ken, for taking the time to share your insight about this important compliance area. We look forward to hearing more about the Smarsh 2011 Electronic Communications Compliance Survey findings in coming months.

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Final Words from Horrigan Resources: Closing the Compliance Gap with Social Media

How can the enterprise leverage the benefits of social media yet avoid rule violations? How can the CCO close the gap between regulatory obligations and compliance policies and internal controls?

To echo Ken Anderson's advice – tap the early adopters and tech-savvy employees in the firm. They can offer an informed opinion about how social media works and the risks that the business should look out for. Once the risk set is identified, the CCO is well positioned to design policies and controls to address the following issues:

- ◆ Site selection – Limit employee use to sites that compliance can monitor.
- ◆ Content – Clearly specify permissible and prohibited content, using examples that will resonate with employees.
- ◆ Related policies – Remind employees of related enterprise policies
 - Code of Ethics
 - Insider trading
 - Advertising
 - Privacy
 - Human Resources
- ◆ Rules of engagement – Articulate activities that are clearly prohibited – such as testimonials (e.g., “likes” on Facebook and “reference requests” on LinkedIn).
- ◆ Blocking – Where possible, turn off privileges that present high risk, such as using email, invitation, and chat features on social media sites.
- ◆ Separate business and personal use – Firms should strongly encourage employees to separate business and personal social media use.
- ◆ Opinions – Employees should be directed to refrain from giving opinions about markets, securities, sectors, products, etc.
- ◆ Property rights – Employees should be instructed to expect the firm to monitor their social media activity.
- ◆ Train and communicate – Ongoing discussion of social media policies and tangible examples of what is permissible and prohibited will help keep the firm in compliance.

FINRA Sanction – Twitter

FINRA suspended and penalized one registered representative for non-compliant behavior through a Twitter account. Among other charges, the rep was sanctioned for failure to disclose to her employer that she maintained a Twitter account. Further, she was found in violation of FINRA rules* for initiating “unbalanced tweets” about the stock Advanced Micro Devices (AMD). From April through December 2009, the rep maintained a Twitter account with more than 1,400 followers. She posted at least 372 tweets, 32 of which related to AMD. Her communications were considered “overwhelmingly positive” as she frequently predicted an imminent price rise. Perhaps most egregiously, the rep’s tweets failed to disclose that she and her family members held more than 100,000 shares of AMD.

*FINRA Conduct Rule 2210 (Communications with the Public); FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); IM-2210 (Guidelines to ensure that Communications with the Public are not misleading)

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