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ELECTRONIC DISCOVERY EMERGES AS KEY CORPORATE COMPLIANCE ISSUE

by

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The potentially significant impact of electronic document discovery, especially internal e-mails, on the outcome of a legal proceeding was well-publicized in the Microsoft antitrust litigation, where company Chairman Bill Gates' e-mails were used by the government as a centerpiece of its case. Since then, numerous other litigants have dealt with the use and abuse of electronic discovery. More recently, the use of electronic discovery to drive the outcome of high-stakes, high-profile litigation has been illustrated in the securities and brokerage industry. Electronic discovery issues are particularly acute for firms in those industries because the preparation, retention and preservation of documents, including electronic communications, is extensively regulated. That regulatory framework poses unique challenges for industry defendants and provides ample opportunities for their adversaries to conduct wide-ranging and intrusive electronic discovery.

On May 21, 2002, New York Attorney General Elliott Spitzer and Merrill Lynch announced the settlement of a civil enforcement proceeding commenced by Mr. Spitzer a few short weeks before. In those weeks, Mr. Spitzer publicized on television and in the front pages of leading newspapers — complete with blown-up visual aids — various damaging electronic communications his office had obtained in the course of its investigation of Merrill Lynch.

Based almost exclusively on those internal e-mail communications, Mr. Spitzer charged Merrill Lynch with violations of New York's Martin Act, a broad-ranging securities anti-fraud statute.[1] In particular, Mr. Spitzer relied on internal e-mails to support allegations of providing misleading publicly-announced ratings that were contrary to contemporaneous internal comments by Merrill Lynch's analysts. Mr. Spitzer also employed those internal electronic documents to support the allegation that the securities analysts were not independent of the investment banking arm of the firm. Ultimately, in order to settle the matter, Merrill Lynch agreed to pay $100 million and to make structural changes.

Merrill Lynch's troubles were just beginning, however. Mr. Spitzer's inquiry, and the trail of e-mails his office uncovered, have formed the basis for dozens of class action lawsuits filed by investors who purchased stocks touted by Merrill Lynch's analysts. The lawsuits borrow generously from Mr. Spitzer's court filings and the e-mails quoted at length therein.[2] The investigation by the New York Attorney General and the subsequent raft of piggy-back private class action lawsuits, all premised on internal electronic communications, illustrate

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[1] *See Spitzer v. Merrill Lynch & Co., Inc. et al.*, Index No. 02-401522, (N.Y. Sup. Ct., N.Y. Cty.), Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, dated April 8, 2002, *reproduced at* http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html.

[2] *See, e.g.*, Class Action for Violation of Federal Securities Laws, *Willcuts v. Merrill, Lynch & Co., Inc. et ano.*, No. 02 CV 4415 (S.D.N.Y.) (filed June 11, 2002); Class Action Complaint, *Myers v. Merrill Lynch & Co., Inc. et ano.*, No. 02 CV 4240 (S.D.N.Y.) (filed June 5, 2002).

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the risks of electronic discovery facing broker-dealers, investment bankers, and their counsel.[3]

RELEVANT SEC RULES AND REGULATIONS

Securities firms operate in a highly-regulated industry, subject to extensive rules, regulations, and directives of the federal and state regulatory authorities, as well as the self-regulatory organizations (SROs) of which they are members and with whom their employees are required to be registered. It is not surprising then, that broker-dealers and their registered representatives face various layers of rules and regulations pertaining to the preparation, dissemination, and preservation of documents and records, including those in electronic form.

The principal rules that regulate document retention and preservation for brokers, dealers, and SRO members are Rules 240.17a-3 and 240.17a-4, promulgated by the Securities and Exchange Commission ("SEC"), pursuant to the Securities Exchange Act of 1934. 15 C.F.R. §§ 240.17a-3, 240.17a-4. Rule 17a-4 provides preservation requirements for those records that must be produced by exchange members, brokers, and dealers pursuant to Rule 17a-3 of the 1934 Act.

Rules of the SROs overlay these rules, and direct members of the SROs to comply with the requirements of Rules 17a-3 and 17a-4 of the 1934 Act. For example, National Association of Securities Dealers (NASD) Rule 3110(a) requires each NASD member to, "make and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws, rules, regulations, and statement of policy promulgated thereunder and with the Rules of [the NASD] and as prescribed by SEC Rule 17a-3. The record keeping format, medium, and retention period shall comply with SEC Rule 17a-4." *See* Release No. 39510 (Dec. 31, 1997), *amending* NASD Rule 3110(a). Likewise, the New York Stock Exchange (NYSE) Rules direct that "every member not associated with a member association and every member association shall make and preserve books and records as the Exchange may prescribe and as prescribed by Rule 17a-3 [under the Securities Exchange Act of 1934]. The recordkeeping format, medium and retention period shall comply with Rule 17a-4 under the Securities Exchange Act of 1934." *See* Release No. 34-39511 (Dec. 31, 1997), *amending* NYSE Rule 440.

Documents Required To Be Retained Under 17a-4. Rule 17a-4(b)(4) requires retention of, "originals of all communications received and copies of all communications sent by [each] member, broker or dealer (including inter-office memoranda and communications) *relating to his business as such*." 17 C.F.R. § 240.17a-4(b)(4) (emphasis added). In 1997, aware of the rising concern over the application of Rule 17a-4(b)(4) to e-mail communications, the SEC attempted to provide guidance on the issue in Release No. 34-38245 (Feb. 5, 1997). The SEC determined the supervisory and retention requirements for electronic communications, "should be based on the content and audience of the message and not merely the electronic form of communication." *See* Reporting Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-38245, [1997 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 85,902, at 89,207 (Feb. 5, 1997). Thus, consistent with Rule 17a-4, broker-dealers are required to retain, "only those email and Internet communications (including inter-office communications) which relate to the broker-dealer's 'business as such.'" *Id.* at 89,208. Thus, internal or external e-mails concerning stock valuation by analysts must be retained, but not personal e-mails with no relation to the broker-dealer's business as such.

Required Medium Or Format For Retention. Rule 17a-4 does not specify what electronic storage media would be acceptable to the SEC, but outlines minimum standards for an approved recordkeeping technology. *Id.* at 89,209. As amended in 1997, Rule 17a-4(f) requires that "[t]he records required to be maintained and preserved pursuant to §§ 240.17a-3 and 240.17a-4 may be immediately produced or reproduced on 'micrographic media' or by means of 'electronic storage media' (as defined in [section 17a-4(f)]) *that meet the conditions set forth in this section* and be maintained and preserved for the required time in that form." *Id.* (emphasis added). The electronic storage media must:

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[3]Not to be left out, the SEC has commenced its own investigation of industry practices as they relate to analysts reports and entanglement between the brokerage and investment banking arms of Wall Street firms.

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•Preserve records in a non-rewriteable, non-erasable format (which can use "write once, read many" technology ("WORM"));

•Automatically verify the quality and accuracy of the storage media recording process;

•Serialize the original and, if applicable, duplicate units of storage media, and time-date for the required period of retention the information placed on [the] electronic storage media; and

•Have the capacity to readily download indexes and records preserved on the electronic storage media to any medium as required by the Securities Exchange Commission or the self-regulatory organizations. *Id.* at 89,210.

Broker-dealers who employ electronic storage media, "must have in place an audit system providing for accountability regarding inputting of records required to be maintained and preserved." *Id.* at 89,210. These auditing standards, added to Rule 17a-4 by the Commission, increase the likelihood that records retained will meet certain minimum accuracy, searchability, and reproducibility requirements. Prior to employing an electronic storage media to satisfy the record retention requirements under Rule 17a-4, a broker-dealer must notify its designated examining authority. *Id.* at 89,209. If the broker-dealer uses a media other than optical disk technology (including CD-ROM), the broker-dealer must notify its designated examining authority at least 90 days prior to employing such storage media.

Required Time That Records Are To Be Retained. There are varying required retention times under Rule 17a-4 depending on the content of the record. For the purposes of e-mail retention, Rule 17a-4(b)(4) requires that broker-dealers preserve for three years, the first two in an easily accessible place, originals of all communications sent by a broker-dealer that relate to his business as such (including qualifying e-mail). 17 C.F.R. § 240.17a-4(b)(4).

Sarbanes-Oxley Act of 2002. In response to the recent wave of corporate scandals and charges of accounting irregularities, President Bush signed the Sarbanes-Oxley Act of 2002 into law on July 30, 2002. Among the many provisions of the new law is Title VIII - Corporate and Criminal Fraud. Section 802 is entitled “Criminal Penalties for Altering Documents,” and adds 18 U.S.C. § 1519 to the U.S. Code:

> Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under Title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title imprisoned not more than 20 years, or both.

Section 802 also adds 18 U.S.C. § 1520, which applies to the retention of corporate audit records, directs the SEC to promulgate, within 180 days, appropriate rules to implement the law, and establishes penalties for violations of the law. Electronic records are expressly included in this mandate. The section also makes clear that these retention obligations are in addition to, and do not supplant, any other duty or obligation imposed by Federal or State law or regulation to maintain, or refrain from destroying any document.

ELECTRONIC DOCUMENTS IN DISCOVERY AND BEYOND

Beyond the SEC specific requirements, the importance of understanding the implications of electronic document retention, deletion, and production requirements has never been more salient. For financial firms, the reality that accompanies the boom economy going bust is more scrutiny from investors, regulators, and plaintiff's lawyers for any companies (and likely their auditors and the related financial community) that have allegedly engaged in fraudulent or improper activities. Beyond the Enron and Anderson situations that have

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been given much ink since last fall, the events of late June 2002 involving MCI WorldCom present another situation where investigators and lawyers will soon been rifling through electronic documents to understand the full picture in order to determine the legal consequences, if any, of the recently alleged conduct. Indeed, the MCI WorldCom scenario is likely to involve a significant investment into electronic discovery. Consider the statement of SEC Chairman Harvey Pitt after the initial disclosures: "If there's even an iota of false statement in there, people will pay heavily." Quote from Sunday, June 30 broadcast of ABC's "This Week" as reported in AP wire story *WorldCom Stock Drops to 6 Cents*" by Marcy Gordon (July 1, 2002 12:58 p.m.).

President Bush even went on the record on the matter, pledging that the Justice Department will "hold people accountable" for mismanaging their companies through "deceit and corruption." *Id*. The July 31 indictment of two former WorldCom's executives leaves little doubt that enforcement efforts are increasing. With such scrutiny and the government's efforts to reassure the investing public, it is beyond question that e-mails and other electronic documents will be sources of evidence for all sides of the dispute. In fact, Judge Jed Rakoff in the Southern District of New York entered a broad preservation order on Friday, June 28, 2002 that covers electronic as well as paper documents in the SEC's civil suit filed against WorldCom. Such orders can be and are entered by courts concerned about evidence preservation and the edicts of such orders can be very broad in an understandable attempt to preclude the improper destruction of relevant information.

Unfortunately, even a clear command to "save all relevant documents" is difficult to implement in an electronic world where much data is never seen by the user, where databases are dynamic (*i.e.*, changing all the time) and, even when files are properly deleted in the ordinary course of business, remnants of such files may remain that could be recovered, in whole or in part, given sufficient time and resources. Worse, although e-commerce and electronic document creation have been expanding exponentially for many years now, the judicial systems move much more slowly, resulting in a legal world without many established boundaries in those areas where there are no regulations on point: what needs to be kept?; what needs to be restored?; what needs to be searched?; what needs to be produced?; in what form should it be produced?; what are the burdens and costs?; and, who should bear the costs?

The uncertainty concerning the practical implications of evidence preservation and production reinforces some of the key considerations for corporate America today: Do you have a good electronic documents (including e-mail) retention policy, is it in good working order, and is there a litigation contingency that can be implemented and enforced to negate any charges of document spoliation that can completely reverse the course of any litigation? More fundamentally, this same uncertainty underscores the critical need for the establishment of best practices guidelines that could be followed as norms by corporations and courts concerning acceptable practices as to what should be done and when.

CONCLUSION

Given the political and legal forces at work today, as well as the potential consequences of evidence spoliation charges, there is certainly "no time like the present" for financial firms and other corporations to focus on electronic document retention policies as one of the significant corporate management issues that must be thoroughly reviewed. In this process, due consideration must be given to the fact that a significant investment today in proper systems and policies can ensure compliance with applicable regulations and also prevent much greater costs (and problems) in the future in the event of litigation or government investigation.

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