



## Risk Management Update July 2010

### **ELECTRONIC COMMUNICATIONS AND SOCIAL MEDIA: FIRMS THAT TWEET, TWITTER AND FACEBOOK—PART II**

According to studies conducted in 2009, 46% percent of American adults who utilize the Internet log onto social networking sites. This is an 8% increase from studies conducted in 2005.<sup>1</sup> Social media site usage by businesses as a method of communicating with customers also is growing significantly. Sites such as Twitter and Facebook provide an inexpensive platform for businesses to communicate and advertise to a vast number of clients and prospective customers. However, with great power comes great responsibility.

In last month's Risk Management Update ("RMU") we discussed general principles recommended by FINRA for how firms may address the various supervisory and compliance challenges faced when utilizing social networking sites and other forms of electronic communication ("e-coms"). In addition, we discussed the types of e-coms that require supervision and several ways firms can review and supervise the use of such communications.

Part II of this series focuses on ways firms can implement effective policies and procedures that take into consideration the use of e-coms and social media sites which serve as powerful business tools and the regulatory compliance requirements firms must consider for permitting such use. In addition, CCLS will provide guidance on best practices to consider for developing internal controls, including the frequency of reviewing e-coms.

#### **Implementing Effective Policies and Procedures**

A successful supervisory system for electronic communications must start with effective policies and procedures. Generally such policies should be reasonably designed to protect against violations of securities rules and regulations, which provide for certain customer protections. The development of strong internal controls will help provide safeguards for clients and address or mitigate systemic risks for the firm and its personnel. Importantly, such policies and procedures should be customized and tailored in accordance with the firm's business model and those needs and potential risks faced by the firm.

In developing effective policies for social media and e-com usage, there are certain basic items that firms should consider:

1. Implement a policy that enhances existing policies in the firm's Compliance Manual.
2. Address supervision of site usage and who will conduct the supervision.

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<sup>1</sup> *Social Media Web Sites*, FINRA REGULATORY NOTICE 10-06, JANUARY 2010, at 1.

3. Include recordkeeping practices in accordance with applicable regulations.
4. Establish firm-wide education and training on social media and e-com usage.
5. Educate personnel on consequences and disciplinary measures for violation of social media and e-com policies.
6. Update policies and keep pace with new technologies to mitigate new risks.

### **Best Practices for Developing Social Media and E-Com Policies and Internal Controls**

Based upon the above list, the following best practices for developing social media and e-com policies are provided.

#### *Identify a Qualified Supervisor*

An important factor to any policy is to identify the person responsible for supervising and reviewing an area, such as social media use and e-coms. FINRA has provided helpful guidance on methods for documenting such reviews and suggests that the review can be satisfied by use of a log or other record that identifies the reviewers and the date of the review.<sup>2</sup> Importantly, the designated reviewer should be able to demonstrate that he or she is familiar with regulatory requirements and has sufficient knowledge, experience and training to perform the reviews. This experience may include<sup>3</sup>:

- Prior supervisory experience;
- Years of service in the industry;
- Professional licenses;
- Completion of a regulatory training course;
- Familiarity with the firm's systems and products; and
- Length of service of employment with the firm.<sup>4</sup>

The ability to identify risks, adequately document issues presented and effectively implement policies and procedures to prevent future issues is paramount for the reviewer.

#### *Enhance Existing Policies and Procedures*

As technology has significantly changed the modes of communication from more personal instant messages to further reaching chat rooms, it is important to recognize that generally such e-coms are classified as correspondence and advertising. Thus, as your firm may have working policies already relating to correspondence and advertising, it is important to categorize social media and e-coms into the appropriate policy area. For example, according to FINRA, publicly available websites such as Twitter are generally considered advertisements and are subject to those regulations governing

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<sup>2</sup> *Supervision of Electronic Communications*, FINRA REGULATORY NOTICE 07-59, December 2007, at 10. In addition, such evidence must comply with NASD Rule 3010(d)(1), 2210 and 2211.

<sup>3</sup> *Social Media Web Sites*, FINRA REGULATORY NOTICE 10-06, JANUARY 2010, at 7.

<sup>4</sup> *Supervision of Electronic Communications*, FINRA REGULATORY NOTICE 07-59, December 2007, at 11

advertisements.<sup>5</sup> On the other hand, e-mail and instant messages are generally categorized as correspondence, which are subject to other regulatory requirements.<sup>6</sup>

Consequently, when enhancing existing policies and expanding upon the permitted use of social media and e-coms, it is essential to also keep in mind those regulatory requirements for advertisements and correspondence, including the need for client disclosures<sup>7</sup>, maintenance of books and records,<sup>8</sup> and supervisory controls for ensuring compliance with the firm's new policies.

### *Frequency of Review*

Generally, the required frequency of reviewing e-coms as well as social media site usage will vary depending on the firm's business model.<sup>9</sup> Factors to consider when determining the frequency of review include<sup>10</sup>:

- The market sensitivity to the activity;
- The type of customers involved;
- The scope of the activities;
- The geographical location of the activities; and
- The volume of correspondence subject to review.

For example, FINRA recommends that firms designate reasonable timeframes within which supervisors are required to complete correspondence reviews.<sup>11</sup> When establishing such review period designations, consideration should be given to the type of business being conducted and the degree of risk which may accumulate by the passage of time. For example, a firm with a retail customer base (compared to institutional clientele) may need to increase its frequency of review as communications may be more widely transmitted to a less sophisticated audience.

### **Final Thoughts**

As the number of businesses and firms utilizing e-coms and social media outlets continues to increase, the importance of implementing effective policies and procedures to mitigate potential risks is essential. Through its Regulatory Notices, FINRA provides a broad foundation for its members, as well as non-members to follow, particularly when establishing supervisory controls and compliance procedures. As we move into a rapidly evolving electronic age of communications, firms should ensure that safeguards and

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<sup>5</sup> FINRA, Guide to the Internet for Registered Representatives, *available at* <http://www.finra.org/Industry/Issues/Advertising/p006118> (last visited July 20, 2010).

<sup>6</sup> *Id.*

<sup>7</sup> FINRA, Guide to the Internet for Registered Representatives, *available at* <http://www.finra.org/Industry/Issues/Advertising/p006118> (last visited July 26, 2010).

<sup>8</sup> *Id.*

<sup>9</sup> *See Supervision of Electronic Communications*, FINRA REGULATORY NOTICE 07-59, December 2007, at 5.

<sup>10</sup> *Id.*, at 5.

<sup>11</sup> *Id.*

protocols are established and disseminated through firm-wide training to instill knowledge of all personnel. For more information, please do not hesitate to contact CCLS at (619) 278-0020. Thank you.

For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

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