INDUSTRY BRIEF

What Does the SEC 17a-4 Regulatory Recordkeeping Update Mean for You?

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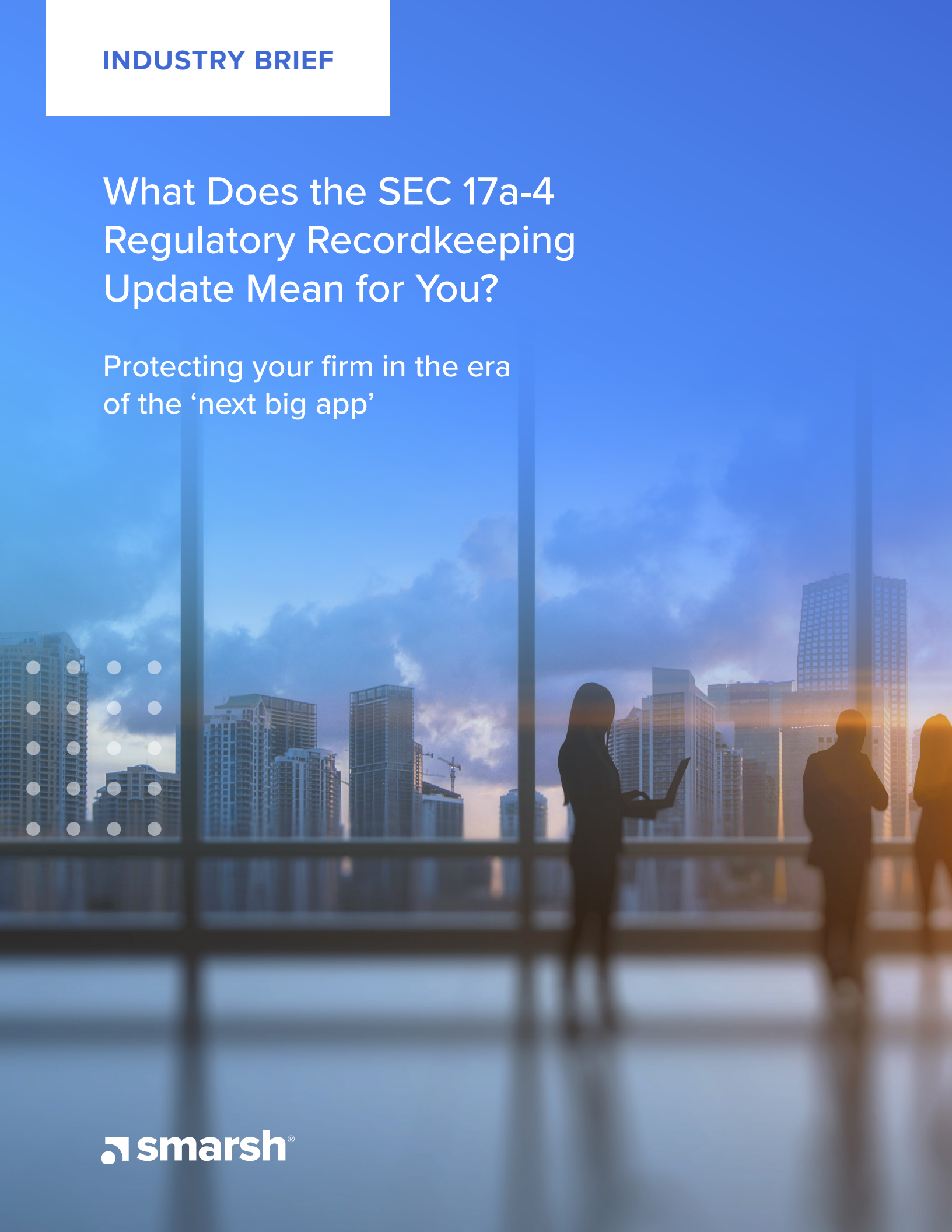

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Today, hybrid workforces are working from everywhere, using a variety of social and mobile applications that are more easily accessible than ever.

For financial services firms, this means that risk lives everywhere and can happen at any time. Hybrid and remote work complicate a firm's ability to meet recordkeeping and supervisory obligations defined in a bygone era of communications technology. This was the case for SEC Rule 17a-4 (written in 1997) to define recordkeeping obligations using WORM (write once, read many) storage technologies.

But recordkeeping rules are being rewritten — or in this case, updated.

SEC 17a-4 was recently modernized to focus less on "electronic storage media" and more on the firm's systems and controls that make up an "electronic recordkeeping system." But what does this mean to firms?

In this industry brief, we explore the reasons behind the SEC 17a-4 update and what firms need to do to stay compliant in the face of evolving communication trends, habits and technologies.

What changed and why

The revised rule emphasizes the responsibility for firms to have the expertise — and/or to work with appropriate third parties — to fulfill the requirements.

Allowing audit trail

The most significant change is that firms can now use an audit trail to satisfy recordkeeping requirements as an alternative to traditional 'WORM' storage approaches.

Objective: Preserve complete and accurate records

WORM

- Content stored in an immutable, contextually specific system for recordkeeping
- Limited ability of users to access, tamper with or override business records

Audit Trail

- Reassembly required of all edits, changes and deletions from an audited change log from all sources daily
- Data stored in multiple locations, increasing the risk of user error and errors produced from changes in source content systems

The addition of the audit trail approach gives firms the option of "recreating" records if they can demonstrate that the records:

- Are complete and time-stamped
- Reflect any modifications, interim iterations or deletions

In theory, this alternative gives firms more flexibility and potential cost savings, especially for smaller firms that may have only infrequently accessed a standalone third-party compliance archive.

Other changes

Beyond the audit trail addition, the update also addresses the following:

Inclusion of securities-based swap dealers and participants

Firms not registered as broker-dealers but regulated under SEC 18a-6 are now — for the first time — also subject to SEC 17a-4.

Elimination of the 90-day notification requirement

While this removes a relatively minor administrative obligation, its removal makes it implicit that firms select storage vendors or third parties "with appropriate expertise" to meet regulatory obligations, as had been stated in the earlier rule.

Modification of the third-party downloader requirement

Firms now have the choice to either:

- Engage a third party to fulfill requests from regulators that they cannot or will not fulfill; or
- Appoint a Designated Executive Officer and the Officers' designees to provide electronic records

While this continues an existing obligation for those who choose to use a third-party downloader, it creates an additional client obligation for those who choose to designate an executive officer.

Reference to cloud service providers

The update acknowledges that many firms leverage recordkeeping systems owned or operated by a third party, such as cloud-based service infrastructure providers. The new language adds the requirement that firms must have "independent access" to records, meaning that firms can access the records "without the need of any intervention of the third party."

Expansion of backup / redundant recordkeeping requirement

While the earlier rule required that firms maintain a separate system to store records, the revised language expands the requirement to a manner that "will serve as a redundant set of records … that is at least equal to the level achieved through using a backup recordkeeping system."

The market impact

We spoke to customers, former industry regulators and advisory partners regarding what impact the SEC 17a-4 modernization will have on the industry.

Potential benefits

The consensus at this early stage was that the change may benefit:

- Smaller firms that infrequently use their archive
- Newly regulated entities, such as swaps participants
- Those who attempt to address challenges with transactional data systems

Supporting that conclusion are the following dynamics:

FINRA-regulated firms with less than $10 million in assets represent over 80% of the securities industry. Some of those smaller firms are not heavy users of their archiving system, which is reflected in SIFMA's submitted comments that indicate that those firms may see WORM archives as an 'unnecessary burden.'

For the industry overall, the update notes that only 500 of 3,500+ firms are currently leveraging cloud services platforms as their recordkeeping system. This implies that the majority continue to use older, on-premise technologies that can easily fall into the 'expensive to build and maintain' category noted in the update.

The update notes a significant cost difference between audit trail and WORM recordkeeping options. However, pursuing a check-the-box solution for recordkeeping simply because it is purported to be cheaper doesn't necessarily align with recent SEC recordkeeping enforcement actions that guide firms to treat "recordkeeping as sacrosanct."

However, one large Smarsh customer noted that they see the update as entailing "too much risk without a clear business benefit, even for swaps."

What financial services experts say about the update

"I think it's positive that it does remove some of the administrative headaches that are a carryover from the pre-electronic days, loosening the designated third-party provider requirement, removing the notification of electronic storage requirements and the third-party record holder acknowledgment."

- Therese Craparo, Partner at Reed Smith, LLP

"In the short term, I don't think there's going to be much of an impact. They didn't say you don't have to do WORM. Everybody who has solutions in place already [comply] with these recordkeeping requirements. There's no immediate need to say, 'Oh, we can't use this anymore.' And then I think everyone's going to try to digest what exactly this new audit trail requirement actually means. [It'll require] testing and really analyzing whatever system they have to see if it actually meets the audit trail requirements, which will take time."

- Anthony Diana, Partner at Reed Smith, LLP

"The audit trail alternative proposed by the SEC is not 'technology neutral' and mandates specific technology requirements and electronic formats for broker-dealers, which reduce the ability for firms to implement future technological innovations or advancements."

- Melissa MacGregor, AGC, SIFMA

The feasibility of audit trail for modern electronic communications

The original SEC 17a-4 was written when firms moved from paper to email. The industry now operates on various collaborative platforms that include persistent chats, voice, video, bots, and collaborative authoring. Determining the most effective approach to preserving and producing a complete record of today's communications requires careful analysis of the following:

What communications tools do you support beyond email?

Today, most businesses run on Microsoft Teams, Slack, and Zoom and are under constant pressure to support the next social or mobile applications to reach new investors. Unlike email, there's complexity when accounting for all modifications, interim iterations, or deletions to an individual record – much less across multiple, constantly evolving products throughout the firm.

The requirement to account for all activities that have impacted a record can significantly understate the time and effort to meet the requirement. Not only should records be completely and accurately preserved, but they must also be delivered to regulators in human- and machine-readable formats and within compressed timeframes to allow regulators to carry out their oversight responsibilities.

"Simply trying to keep up with the changes in individual tools like Microsoft Teams is already more than enough for most firms to handle," notes Anthony Diana, Partner at Reed Smith.

What other compliance processes rely upon electronic communications?

For every financial services firm, recordkeeping is only the beginning of their oversight obligations related to electronic communications. Their responsibilities also include:

- Supervising obligations for regulated users
- Identifying other forms of risk, such as internal policy infractions or possible loss of intellectual property
- Managing or investigating ongoing regulatory inquiries or litigation

As information governance strategist Matthew Bernstein noted:
“Maintaining a separate audit trail system for records will not work if you can’t use the data for other purposes.”

“For e-discovery, it will become a question of how you preserve and produce the audit trail when you produce records. If implementing the audit trail requirement means less centralization for some types of data, you’ll need to ensure all those sources are incorporated into the e-discovery process.”

How often do you access your WORM archive today?

For very small firms with basic requirements (e.g., approved use of email only, infrequent access to their WORM archive, and/or rudimentary supervisory policies), audit trail may enable them to check the box at a lower cost. However, getting to audit trail may not be as simple as it sounds.

“The update makes the most sense for firms who haven’t done something before,” says a principal at Ernst & Young. “Changing from WORM will entail risk.”

How do you work with cloud providers?

As more firms leverage public cloud infrastructure, the rule update can potentially impact their choice of service providers as the requirement indicates that the third party “will not impede or prevent the examination, access, download, or transfer of records by a regulator.”

The update can also be noteworthy if firms currently use backup and redundant storage that do not provide equivalent capabilities, such as operation-only in an active/passive configuration. The ability to provide self-service on highly available infrastructure is now the standard that firms will need from their cloud service providers.

Choosing between WORM and audit trail

The following table summarizes five key considerations when evaluating the audit trail alternative.

Consider:	WORM	Audit Trail
1. **Firm size**	Mid- to large-size, dually registered and/or multiple products	SMB, solely focused broker-dealer or swaps participant
2. **Content Sources**	All content, including collaborative sources	Primarily email
3. **Archive Usage**	Frequent with archive supporting multiple use cases	Infrequent, with archive primarily used to satisfy a regulatory obligation
4. **Supervisory policies**	Complex policies using the archive as system of record	Rudimentary, random sampling that can be pulled from production system
5. **E-discovery demands**	Frequent and/or larger volume across multiple content sources extracted from archive as system of record	Infrequent and smaller volume and can be reactively collected from the production system

Moving forward with the new SEC Rule 17a-4

There's consensus among Smarsh customers, partners and external experts that the SEC 17a-4 update provides some long overdue alignment of recordkeeping requirements with today's technology and changes the emphasis of the rule from storage media to good data and information governance practices. In the short term, this is likely to benefit some firms in their management of more problematic structured data systems, as well as very small firms that do not frequently use their WORM archives.

More broadly, the update raises reoccurring questions that financial services firms struggle with, including:

- What exactly constitutes a record?
- What are the recordkeeping requirements for voice recordings, whiteboards and activities within persistent chats?

Simply “guesstimating” that one method is significantly lower cost than the other is easy enough to state; the reality is that the practical implications of attempting to piece together an audit trail of a series of interactive communications are yet to be tested.

The longer-term impact of the rule remains to be seen. As new communication technologies emerge, or as upgrades to existing systems are made, how do they – or will they – adapt to the audit trail requirement? And, as these communications and recordkeeping changes happen, how will supervisory, discovery and risk management workflows need to adjust to minimize even more copies being produced from multiple disparate content sources?

And finally, for multi-nationals, how will other financial regulators around the world follow these changes?

At the bare minimum, the SEC 17a-4 update is a step forward in modernizing the rules. It shows that regulators acknowledge that the financial industry must be allowed to fully leverage new technologies and keep pace with innovation in the market. Managing that against obligations to treat proactive recordkeeping as “sacrosanct” is now the balancing act that electronic communications require.

Smarsh enables companies to transform oversight into foresight by surfacing business-critical signals in more than 100 digital communications channels. Regulated organizations of all sizes rely upon the Smarsh portfolio of cloud-native digital communications capture, retention and oversight solutions to help them identify regulatory and reputational risks within their communications data before those risks become fines or headlines.

Smarsh serves a global client base spanning the top banks in North America, Europe and Asia, along with leading brokerage firms, insurers, and registered investment advisors and U.S. state and local government agencies. To discover more about the future of communications capture, archiving and oversight, visit www.smarsh.com.

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