Morgan Lewis | Report

SEC ADOPTS RULE AMENDMENTS TO ELECTRONIC RECORDKEEPING REQUIREMENTS

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On October 12, 2022, the US Securities and Exchange Commission (SEC or Commission) adopted amendments (Final Rules) to the electronic recordkeeping requirements applicable to broker-dealers, security-based swap dealers (SBSDs), and major security-based swap participants (MSBSPs) under the Securities Exchange Act of 1934 (Exchange Act).[1] The Final Rules are largely consistent with the Proposed Amendments with some modifications.

The Final Rules are effective 60 days after publication in the *Federal Register*. The compliance dates for the new requirements will be six months after publication in the *Federal Register* for broker-dealers and 12 months after publication in the *Federal Register* for SBS Entities.

The SEC addressed several concerns raised by the commenters when adopting the Final Rules. Although the Final Rules do not have the flexibility that a principles-based approach might offer, they strike a balance between what the SEC described as setting forth a specific and testable outcome (i.e., the ability to access and produce modified or deleted records in their original form) and technology-neutral terminology that should bring the electronic recordkeeping requirements in line with technological innovation for the foreseeable future.

OVERVIEW OF CHANGES

The following charts reflect the amendments to the Final Rules that (1) are *consistent with* the Proposed Amendments, (2) were adopted but *with modifications from* the Proposed Amendments, and (3) were *not originally considered in* the Proposed Amendments.

Amendments Adopted *Consistent with* the Proposed Amendments		
	Rule 17a-4 (Broker-Dealers[2])	**Rule 18a-6 (SBS Entities[3])**
New "Electronic Recordkeeping System" Definition	Replaces the phrase "electronic storage media" with "electronic recordkeeping system" (and makes conforming amendments throughout the rule)[4]	Replaces the phrase "electronic storage system" with "electronic recordkeeping system" (and makes conforming amendments throughout the rule)

[1] *See* Electronic Recordkeeping Requirements for Broker-Dealers, Security-Based Swap Dealers, and Major Security-Based Swap Participants, Exchange Act Release No. 96034 (Oct. 12, 2022). The SEC issued the Final Rules after publishing proposed rule amendments (Proposed Amendments) on November 18, 2021, and considering 57 comment letters. *See* Electronic Recordkeeping Requirements for Broker-Dealers, Security-Based Swap Dealers, and Major Security-Based Swap Participants, Exchange Act Release No. 93614 (Nov. 21, 2021).

[2] As used in the Final Rules and this report, the term "broker-dealer" includes a broker-dealer that is also registered as an SBSD or MSBSP.

[3] As used in the Final Rules and this report, the term "SBS Entity" refers to an SBSD or MSBSP that is not also registered as a broker-dealer.

[4] "Electronic recordkeeping system" is defined in both Rule 17a-4(f)(ii) and Rule 18a-6(e)(i) as "a system that preserves records in a digital format in a manner that permits the records to be viewed and

Elimination of Notice and Representation Requirements	Eliminates the requirements that a broker-dealer (1) notify its designated examining authority (DEA) before employing an electronic recordkeeping system and (2) provide a representation, or a representation from the storage medium vendor or other appropriate third party, that the selected electronic storage medium meets specified conditions	N/A
New "Audit-Trail Alternative" to WORM	Adds an audit-trail alternative to the current requirement that electronic records be preserved exclusively in a non-rewriteable, non-erasable—also known as a "write once, read many" (WORM)—format; the audit-trail alternative will require that firms preserve electronic records in a manner that permits the recreation of an original record if it is altered, overwritten, or erased	Provides that electronic records can be preserved (1) exclusively in a WORM format or (2) in a manner that permits the recreation of an original record if it is altered, overwritten, or erased *Only applies to SBS Entities without a prudential regulator (non-bank SBS Entities)*[5]
Modified Automatic Verification Requirement	Modifies the requirement that electronic storage media verify automatically the quality and accuracy of the recording process to require that an electronic recordkeeping system verify automatically the completeness and accuracy of the process for storing and retaining records electronically	Same *Only applies to non-bank SBS Entities*
Serializing and Time-Dating Only Required for WORM Media	Applies the requirement to (1) serialize the original and, if applicable, duplicate units of storage media and (2) time-date for the required period of retention the information placed on such electronic storage media, only if a broker-dealer uses optical disks (defined below) as the storage media to meet the WORM requirement	Requirement already exists under Rule 18a-6(e)(2) *Only applies to non-bank SBS Entities*

downloaded." Notably, this definition was modified to replace the phrase "and that requires a computer to access the records" with "in a manner that permits the records to be viewed and downloaded" so that the Final Rules are more technology neutral.

[5] Unlike non-bank SBS Entities, bank SBS Entities are subject to oversight and supervision by the banking agencies with respect to record preservation. The SEC explained that this oversight and supervision may now or in the future include regulations or guidance with respect to requirements for electronic recordkeeping systems that differ from the requirements for electronic recordkeeping systems in the Final Rules.

Elimination of the Indexing Capacity Requirement; New "Human Readable Format" and "Reasonably Usable Electronic Format"	Eliminates the requirement that electronic storage media have the capacity to readily download indexes and records preserved on the media to any medium acceptable under Rule 17a-4, and instead requires an electronic recordkeeping system to have the capacity to (1) readily download and transfer copies of a record and its audit trail (if applicable) in both a human readable format and in a reasonably usable electronic format, and (2) download and transfer the information needed to locate electronic records; this furnishing requirement means the record needs to be produced in an electronic format that is compatible with commonly used systems for accessing and reading electronic records and in a form that an individual can naturally read	Same *Only applies to non-bank SBS Entities*
Modified Production "Facilities" Language	Replaces terms that are tied to micrographic media and optical disks	Replaces terms that are tied to optical disks
Elimination of the Indexing Requirement	Eliminates the mandate to use indexes to organize and locate records stored on the systems, and instead requires a broker-dealer to organize and maintain information necessary to locate records stored on its electronic recordkeeping systems	Same
Elimination of the Escrow Account Option Relating to Recordkeeping Files and Formats	Eliminates the option for a broker-dealer to place in escrow and keep current a copy of the physical and logical file format of its electronic storage media, the field format of all different information types written on the electronic storage media, and the source code, together with the appropriate documentation and information necessary to access records and indexes	Same
Preserving the Option to Use Micrographic Media	Retains the option for broker-dealers to use micrographic media	N/A

Amendments Adopted *with Modifications from* the Proposed Amendments		
	Rule 17a-4 (Broker-Dealers)	**Rule 18a-6 (SBS Entities)**
Added Record Production Requirement	The Proposed Amendments proposed to replace the facsimile enlargement production requirement (except where a broker-dealer uses a micrographic media system) to require a broker-dealer to "be ready at all times to provide, and immediately provide, any record or information needed to locate records stored by means of the electronic recordkeeping system" that regulators may request The Final Rules eliminate the alternative means of satisfying the record production requirement where broker-dealers could have instead provided "information needed to locate records," as this is duplicative of a requirement in paragraph (f)(3)(iv) of Rule 17a-4, as amended	Adds the same requirement for SBS Entities to be ready at all times to provide, and immediately provide, "any record stored by means of the electronic recordkeeping system" The Final Rules eliminate the alternative means of satisfying the record production requirement where SBS Entities could have instead provided "information needed to locate records," as this is duplicative of a requirement in paragraph (e)(3)(ii) of Rule 18a-6, as amended
Modified Duplicate Record Requirement, Including New "Other Redundancy Capabilities" Alternative	Replaces the current requirement that a broker-dealer store separately from the original a duplicate copy of a record for the requisite time period, with a requirement to have a backup electronic recordkeeping system or other redundancy capabilities that are designed to ensure access to required records if the primary electronic recordkeeping system is disrupted, malfunctions, or otherwise becomes inaccessible The Final Rules include the option to use "other redundancy capabilities" as an alternative to the backup recordkeeping system, but the SEC clarified that any such redundancy capabilities must have a level of redundancy "that is at least equal to the level that is achieved through using a backup recordkeeping system"	Same *Only applies to non-bank SBS Entities*

Modified Third-Party Access and Undertakings Requirements	Adds an alternative to the existing requirement that the firm engage a third party who has access to and the ability to download the firm's electronic records, and who must provide an undertaking to the firm's DEA (Third-Party Downloader requirement) with an alternative that a "designated executive officer"[6] of the firm can undertake this responsibility For firms that use the designated executive officer approach, the Final Rules offer the further flexibility that the designated executive officer may appoint in writing up to two "designated officers"[7] who will take the steps necessary to fulfill the obligations of the designated executive officer set forth in the undertakings in the event the designated executive officer is unable to fulfill those obligations Moreover, the Final Rules permit the appointment of up to three "designated specialists," over whom the designated executive officer and the designated officers have authority, to take the steps necessary to access the records[8] The Final Rules have been modified from the Proposed Amendments because the Third-Party Downloader requirement, which was proposed to be eliminated in the Proposed Amendments, has instead been retained as an alternative means of compliance	Adds a requirement that a third party or designated executive officer of the SBS Entity, who has independent access to and the ability to provide the records, execute the undertakings and provide the access For firms that use the designated executive officer approach, the Final Rules offer the additional flexibility that the designated executive officer may appoint in writing up to two designated officers who will take the steps necessary to fulfill the obligations of the designated executive officer set forth in the undertakings in the event the designated executive officer is unable to fulfill those obligations Moreover, the Final Rules permit the appointment of up to three designated specialists to take the steps necessary to access the records The Final Rules have been modified from the Proposed Amendments because the Final Rules add the Third-Party Downloader option as an alternative means of compliance

[6] A "designated executive officer" is "a member of senior management of" the broker-dealer or SBS Entity "who has access to and the ability to provide records maintained and preserved on the electronic recordkeeping system either directly or through a designated specialist who reports directly or indirectly to the designated executive officer."

[7] A "designated officer" is "an employee of" the broker-dealer or SBS Entity "who reports directly or indirectly to the designated executive officer and who has access to and the ability to provide records maintained and preserved on the electronic recordkeeping system either directly or through a designated specialist who reports directly or indirectly to the designated officer."

Amendments *Not Originally Considered in* the Proposed Amendments		
	Rule 17a-4 (Broker-Dealers)	**Rule 18a-6 (SBS Entities)**
Alternative Undertaking for Cloud Service Providers	Adds an alternative to the existing third-party recordkeeping service undertaking under Rule 17a-4(i) to accommodate the practice of using a cloud service provider	Same

FROM 'WORM' TO 'AUDIT TRAILS'

As discussed in our prior LawFlash on the Proposed Amendments, the current electronic record preservation requirements for broker-dealers under Exchange Act Rule 17a-4(f) date back to 1997, and, although intended to be technology neutral, were then guided by the predominant electronic storage method at the time: optical platters, CD-ROMs, or DVDs (collectively, optical disks) (i.e., hardware solutions that permanently "burned" records onto optical disks). The original requirements, and the WORM format requirement, in particular, have thus been subject to SEC interpretation over the years to account for changing system norms.

The Commission, once again, sought to adopt "technology neutral" terminology in the Final Rules. Commenters noted, and the Commission recognized, that an electronic recordkeeping system may not always require a computer, for example, and thus should not be limited in that way. In addition, commenters stated that WORM systems often are costly, outmoded, and inefficient and, rather than being dynamic and easily updated, provide a more static storage process.

The Final Rules add the audit-trail alternative under which electronic records can be preserved in a manner that permits the recreation of an original record if it is altered, overwritten, or erased. The audit-trail alternative is designed to provide broker-dealers with greater flexibility in configuring their electronic recordkeeping systems so they more closely align with current electronic recordkeeping practices while also protecting the authenticity and reliability of original records. The Final Rules apply the same requirements to non-bank SBS Entities. Thus, under the amendments to Rules 17a-4 and 18a-6, a broker-dealer or non-bank SBS Entity that elects to use an electronic recordkeeping system will need to ensure that such electronic recordkeeping system meets either the WORM requirement or the audit-trail alternative.

As a result of the Final Rules, firms may maintain the current WORM requirement or transition to the audit-trail alternative. Although firms will not be required to notify the Commission if they intend to switch from WORM-compliant electronic recordkeeping systems to audit-trail alternatives, firms will still be required to make certain conforming changes. For example, a firm will need to file a new undertaking with its DEA regardless of whether it switches to using a designated executive officer, switches to using a different designated third party, or continues to use its existing designated third party. In the new undertakings, firms may indicate that they are replacing the previously filed undertakings.

[8] A "designated specialist" is "an employee of" the broker-dealer or SBS Entity "who has access to, and the ability to provide records maintained and preserved on, the electronic recordkeeping system." Notably, the definitions used in the Final Rules for designated officer and designated specialist hinge on the individual being "an employee of" the relevant firm, possibly borrowing from the same interpretive history associated with Rule 17f-2 relating to fingerprinting requirements.

NOTABLE OBSERVATIONS

Cloud-Based Storage

Despite the fact that cloud-based storage solutions have proliferated over the years, the Proposed Amendments did not explicitly affirm the permissibility of using cloud-based storage to comply with firms' recordkeeping and retention obligations. However, after commenters requested clarity relating to the use of cloud-based storage, the SEC ultimately amended Rules 17a-4 and 18a-6 to explicitly identify entities that provide cloud services as permissible third-party custodians of records.

Under the Final Rules, a cloud-based storage provider may provide an alternative undertaking, in lieu of the traditional third-party recordkeeping service provider undertaking, that is tailored to how cloud-based storage providers hold electronic records for broker-dealers and SBS Entities. The alternative undertaking may be filed in lieu of the traditional undertaking if the broker-dealer's or SBS Entity's required records are maintained and preserved by means of an electronic recordkeeping system utilizing servers or other storage devices that are owned or operated by a third party (including an affiliate) and the broker-dealer or SBS Entity has "independent access" to the records, meaning, among other things, the broker-dealer or SBS Entity can unilaterally access the records without the need of any intervention of the third party.

Consequently, the alternative undertaking cannot be used if the broker-dealer or SBS Entity must rely on the third party to take an intervening step to make the records available to the broker-dealer or SBS Entity (e.g., it cannot be used if the broker-dealer or SBS Entity must ask the third party to transfer copies of the records to the broker-dealer or SBS Entity or must ask the third party to first decrypt the records before they can be accessed). Notably, as part of the alternative undertaking, the third party must specifically acknowledge that the broker-dealer or SBS Entity has made specific representations to the third party (e.g., in a service contract with the third party or an addendum to an existing service contract).

The SEC also repeated its familiar warning that broker-dealers should not enter into contracts with third-party recordkeeping service providers that permit the service providers to withhold, delete, or discard the broker-dealers' records in response to nonpayment by the broker-dealers for fees due, as such contractual provisions are inconsistent with the retention requirements of Rule 17a-4 and the undertaking requirements of Rule 17a-4(i). Any such impermissible withholding, deletion, or discardment would constitute a primary violation of the rule by the broker-dealer and may subject the service provider to secondary liability for causing or aiding and abetting the violation.

Distributed Ledger Technology

The Final Rules are silent on whether blockchain or other distributed ledger technology may be used in furtherance of a firm's compliance measures. Rather than provide clarity, the Final Rules likely will result in firms seeking guidance from the SEC and the Financial Industry Regulatory Authority (FINRA) on whether a particular type of technology or provider is acceptable.

Of course, firms would be obligated to determine for themselves whether a particular technology complies, but it would help the industry for the SEC to provide more specific guidance regarding whether—and the specific circumstances under which—distributed ledger technology can comply with the Final Rules. Given the growing importance and focus on distributed ledger technology across the financial services industry, it would be appropriate for the SEC to acknowledge the technology in order to give the industry comfort that its use could be compliant as it matures.

Outsourcing

While the Final Rules generally add little novelty to the regulatory principles associated with outsourcing to third-party service providers and vendors, firms should take heed that outsourcing continues to be a focus of regulators, as evidenced by FINRA Regulatory Notice 21-29 (RN 21-29) and the SEC's proposal, published October 26, 2022, on outsourcing by investment advisers.[9]

As we discussed in a prior LawFlash, FINRA published RN 21-29 to "remind" broker-dealers of the various obligations to which they are subject when outsourcing functions to third-party vendors. As FINRA noted, since publication of Notice to Members 05-48 on outsourcing, including during the COVID-19 pandemic, member firms have continued to expand the scope and depth of their use of technology and have increasingly leveraged vendors in many facets of their businesses. Firms that outsource have a variety of obligations, including, among others, in relation to supervision; associated person status, fingerprinting, and registration; cybersecurity; and business continuity planning. RN 21-29 came just one month after the federal banking agencies[10] published a request for comment on proposed risk management guidance for third-party relationships.[11]

As a result of this regulatory focus, firms should consider refreshing themselves on regulatory considerations relevant to outsourcing as they consider how to best take advantage of the Final Rules.

Business Continuity Planning

As noted above, the Final Rules replace the current requirement that a broker-dealer store separately from the original a duplicate copy of a record for the requisite time period, with a requirement to have a backup electronic recordkeeping system or "other redundancy capabilities" that are designed to ensure access to required records if the primary electronic recordkeeping system is disrupted, malfunctions, or otherwise becomes inaccessible.

This optionality is a welcome development, and firms wishing to avail themselves of the additional flexibility will want to dive deep into the interplay between existing business continuity plans (BCPs) and the new requirements in the Final Rules. For example, for firms with robust BCPs, can the technological infrastructure supporting the BCPs satisfy the "other redundancy capabilities"? Firms will likely need to evaluate such questions in consultation with the business, compliance, legal, and appropriately qualified IT personnel.

Technology-Neutral and Principles(ish)-Based Approach

The Final Rules are intended to align the Exchange Act's electronic recordkeeping requirements with technological innovation and to be more "technology neutral" so as to preserve the flexibility to maintain relevance for continued innovation. Although the technology-neutral goal has been well received by commenters and SEC commissioners alike, several commenters (and at least one commissioner, Hester Peirce) have recommended that the Commission adopt a more principles-based approach in order to get ahead of future technological advancements.

In response, in adopting the Final Rules the SEC noted that the "principles-based approach advocated by the [commenters] would not ensure the authenticity or reliability of electronic records with the same testable and specific outcomes as the existing WORM requirement or the [audit-trail alternative] the

[9] *See* Outsourcing by Investment Advisers, Advisers Act Release No. 6176 (Oct. 26, 2022).

[10] That is, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

[11] For more information about that proposal, please see our *All Things FinReg* blog post.

Commission is adopting." The SEC further argued that the audit-trail alternative is more likely to achieve its objectives because it sets forth a "specific and testable outcome."

As a result of this approach, the Commission is likely to continue to receive inquiries requesting guidance on the acceptability of new technological advancements—like it did for cloud-based storage and likely will with respect to distributed ledger technology.

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