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Legal Update

SEC Adopts Amendments to Electronic Recordkeeping Requirements for Broker-Dealers and Security-Based Swap Entities

The Amended Rules are Intended to be "More Technology Neutral" and Specifically Address Cloud Storage

On October 12, 2022, the US Securities and Exchange Commission ("SEC") adopted amendments to the electronic recordkeeping requirements under Rule 17a-4 under the Securities Exchange Act of 1934 (the "Exchange Act"), applicable to broker-dealers, as well as Rule 18a-6 under the Exchange Act, applicable to security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs") that are not registered as broker-dealers (collectively, "SBS Entities").[1]

The amendments modify requirements regarding the maintenance and preservation of electronic records, the use of third-party recordkeeping services, and the prompt production of records. Most notably, the amendments provide for an audit-trail alternative to the current requirement for broker-dealers to maintain and preserve electronic records exclusively in a non-rewriteable, non-erasable format (*i.e.*, "write once/read many" or "WORM" format). According to the SEC, the amendments are designed to modernize the SEC's recordkeeping requirements given technological changes over the last two decades and to make the rules "more technology neutral." We provide an overview of the key aspects of the amendments below.

The amendments to SEC Rules 17a-4 and 18a-6 become effective 60 days after publication in the Federal Register, which has not yet occurred as of the date of this Legal Update. The compliance date for the amendments is, with respect to SEC Rule 17a-4, six (6) months after publication in the Federal Register, and, with respect to SEC Rule 18a-6, twelve (12) months after publication in the Federal Register. Importantly, the amendments require updates to (and re-filing of) certain written undertakings previously filed under the rules and potential amendments to existing service provider agreements, as further described herein.

Amendments

ELIMINATION OF NOTICE AND REPRESENTATION REQUIREMENTS FOR BROKER-DEALERS UNDER SEC RULE 17A-4(f)(2)(i)

The amendments eliminate, from SEC Rule 17a-4(f)(2), the requirement for a broker-dealer to notify its designated examining authority ("DEA") before employing electronic storage media, including the 90-day notice if the broker-dealer intends to employ electronic storage media other than optical disk technology.[2] The amendments also eliminate from SEC Rule 17a-4(f)(2) the requirement that the broker-dealer provide a representation (or one from the storage medium vendor or other third party with appropriate expertise) that the selected electronic storage medium meets the conditions set forth in SEC Rule 17a-4(f)(2).[3]

ADDING AN AUDIT TRAIL ALTERNATIVE TO THE WORM REQUIREMENT

Currently, broker-dealers are required to maintain and preserve electronic records exclusively in WORM format.[4] The amendments add an audit-trail alternative to the WORM requirement, which allows broker-dealers to use an electronic recordkeeping system that maintains and preserves electronic records in a manner that permits the recreation of an original record if it is modified or deleted.[5]

For the audit-trail alternative to be available, the electronic recordkeeping system must maintain and preserve the records for the duration of their applicable retention periods in a manner that maintains a complete time-stamped audit trail that includes:

- All modifications to and deletions of the record or any part thereof;
- The date and time of actions that create, modify, or delete the record;
- If applicable, the identity of the individual creating, modifying, or deleting the record; and
- Any other information needed to maintain an audit trail of the record in a way that maintains security, signatures, and data to ensure the authenticity and reliability of the record and will permit re-creation of the original record if it is modified or deleted.[6]

Amended SEC Rule 18a-6(e) requires that SBS Entities without a prudential regulator ("non-bank SBS Entities") maintain and preserve electronic records using an electronic recordkeeping system that meets either the WORM requirement or the new audit-trail requirement, as described above.[7]

Accordingly, as a result of the amendments, a broker-dealer or non-bank SBS Entity that elects to use an electronic recordkeeping system must ensure such system meets either the WORM requirement or the audit-trail alternative.

ADDING A "DESIGNATED EXECUTIVE OFFICER" ALTERNATIVE TO THE THIRD-PARTY UNDERTAKING REGARDING ELECTRONIC RECORDS

Currently, SEC Rule 17a-4(f)(3)(vii) requires a broker-dealer using electronic storage media to engage a third-party who has access to and the ability to download information from the broker-dealer's electronic storage media to any acceptable medium, and provide certain written undertakings to the broker-dealer's DEA.

The amendments to SEC Rule 17a-4 add an alternative approach in which a broker-dealer may designate an executive officer ("Designated Executive Officer") to execute the required undertakings so long as the Designated Executive Officer has access to and the ability to provide records maintained and preserved on the

broker-dealer's electronic recordkeeping system, either directly or through a specialist who reports directly or indirectly to the Designated Executive Officer.[8] The Designated Executive Officer can appoint in writing up to two (2) designated officers to help fulfill the obligations of the Designated Executive Officer set forth in the undertakings in the event that such executive officer is unable to fulfill those obligations.[9] Importantly, the Designated Executive Officer's appointment of, or reliance on, a designated officer or designated specialist does not relieve the Designated Executive Officer of the obligations set forth in the undertakings.[10]

SEC Rule 18a-6 currently does not have either a third-party or executive officer undertakings requirement. The amendments to SEC Rule 18a-6 add the third-party and alternative executive officer undertakings provisions to the rule and require those undertakings to be filed with the SEC.[11]

Accordingly, as a result of the amendments, broker-dealers and SBS Entities must designate either an executive officer of the firm or an unaffiliated third party to make the required undertakings. We note that even broker-dealers that elect to continue using the designated third party option will need to file updated undertakings with their DEAs because the amendments modify the form of the undertakings.[12] However, the SEC has confirmed that a broker-dealer need not notify the SEC if it is switching from a WORM-compliant electronic recordkeeping system to an audit trail-compliant electronic recordkeeping service.[13]

ADDRESSING ELECTRONIC RECORDKEEPING THROUGH CLOUD SERVICE PROVIDERS

Under current SEC Rules 17a-4(i) and 18a-6(f), a third party who prepares and stores electronic records for a broker-dealer or SBS Entity is required to file a written undertaking with the SEC stating, among other things, that the third party agrees to permit examination of the records by representatives or designees of the SEC, as well as to promptly furnish to the SEC or its designee true, correct, complete, and current hard copies of any or all or any part of such books and records.[14] However, cloud service providers may not have the ability to submit such an undertaking, because, although cloud service providers give their clients the ability to remotely access the records and to encrypt the record, cloud service providers may not be able to access these records themselves.[15]

The amendments address the use of third-party cloud service providers to store electronic records, wherein the broker-dealer or SBS Entity maintains its electronic recordkeeping systems and associated electronic records on servers or other storage devices that are owned or operated by the cloud service provider. Specifically, the amendments permit a cloud service provider to make an alternative undertaking that is tailored to how cloud service providers maintain records for broker-dealers and SBS Entities. For this alternative undertaking to be available, the records must be maintained on an electronic recordkeeping system *and* the broker-dealer or SBS Entity must have independent access to the records.[16] In other words, this alternative undertaking is not available 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, such as, for example, if the broker-dealer or SBS Entity must ask the third party to transfer copies of the records, or to first decrypt the records, before they can be accessed by the broker-dealer or SBS Entity.[17]

Additionally, under the alternative undertaking, the third party must acknowledge that: (a) the records are the property of the broker-dealer or SBS Entity (the current ("traditional") undertaking under SEC Rules 17a4(i)(1) and 18a-6(f)(1) has a similar requirement); and (b) the broker-dealer or SBS Entity has represented to the third party that the broker-dealer or SBS Entity:

- Is subject to rules of the SEC governing the maintenance and preservation of certain records;

- Has independent access to the records maintained by the third party; and
- Consents to the third party fulfilling the obligations set forth in the undertaking.

The third party must undertake to facilitate within its ability, and not impede or prevent, the examination, access, download, or transfer of the records by a representative or designee of the SEC as permitted under the law and, in the case of a broker-dealer, a trustee appointed under the Securities Investor Protection Act of 1970 to liquidate the broker-dealer in accessing, downloading, or transferring the records as permitted under the law.[18]

Finally, we note that if broker-dealers or SBS Entities currently use a cloud service provider and a "traditional" undertaking from the provider has *not* been filed with the SEC, either a "traditional" or alternative undertaking will need to be filed. Moreover, service provider agreements may need to be amended to reflect the new requirements.

NEW FORMAT STANDARD FOR THE PRODUCTION OF ELECTRONIC RECORDS

SEC Rules 17a-4(j) and 18a-6(g) currently require that a broker-dealer or SBS Entity furnish promptly to a representative of the SEC legible, true, complete and current copies of the records required to be maintained and preserved under the rules and any other records subject to examination.[19] The amendments require the broker-dealer or SBS Entity to furnish a record, and its audit trail (if applicable), preserved on an electronic recordkeeping system in a "reasonably usable electronic format," if requested by a representative of the SEC.[20] According to the SEC, this requires that the record be produced in an electronic format that is compatible with commonly used systems for accessing and reading electronic records.[21] Moreover, the SEC stated that the request of the SEC representative will govern whether the broker-dealer or SBS Entity must produce the record, the audit trail of the record, or both the record and its audit trail.[22]

Conclusion

The SEC's long-awaited amendments to its electronic recordkeeping requirements for broker-dealers, as well as electronic recordkeeping requirements for SBS Entities, are expected to reduce firms' compliance costs and operational burdens by, among other things, enabling broker-dealers and SBS Entities to satisfy their regulatory recordkeeping requirements using the same electronic recordkeeping system they use for business purposes, rather than separately maintaining a WORM-compliant recordkeeping system solely for the purpose of meeting the WORM requirement. Firms should ensure that required updates to (and re-filing of) certain existing undertakings and potential amendments to existing service provider agreements are made in a timley fashion.

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Endnotes

[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 "Adopting Release").

[2] *Id*. at 15.

[3] *Id.* at 15-16. SEC Rule 18a-6 does not contain parallel notice and representation requirements.

[4] *See* SEC Rule 17a-4(f)(2)(ii)(A).

[5] *See* amended SEC Rule 17a-4(f)(2)(i)(A).

[6] *See id*.

[7] *See* amended SEC Rule 18a-6(e)(2)(i)(A)-(B). SBS Entities with a prudential regulator ("bank SBS Entities") are not subject to the technical requirements for electronic recordkeeping systems set forth in SEC Rule 18a-6(e)(2). *See* Adopting Release at 16 (explaining the SEC's intent to "avoid imposing requirements [on bank SBS Entities] that could potentially conflict with regulations and guidance of the prudential regulators….").

[8] *See* amended SEC Rule 17a-4(f)(3)(v)(A). The Designated Executive Officer must be a member of senior management of the broker-dealer and either have the knowledge, credentials, and information necessary to access and provide the records without having to rely on other individuals at the firm, or have appointed in writing up to three (3) designated specialists who have such knowledge, credentials, and information and that are direct or indirect reports to the officer. *See* amended SEC Rule 17a-4(f)(1)(iii) (defining "designated executive officer"); *see also* amended SEC Rule 17a-4(f)(3)(v)(B)(2).

[9] *See* amended SEC Rule 17a-4(f)(1)(iv) (defining "designated officer"); *see also* amended SEC Rule 17a-4(f)(3)(v)(B)(1). Any such designated officer(s) must be an employee of the broker-dealer 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. The designated officer either must have the knowledge, credentials, and information necessary to access and provide the records without having to rely on other individuals at the firm or be able to direct a designated specialist who has such knowledge, credentials, and information. *See* Adopting Release at 52-53.

[10] *See* amended SEC Rule 17a-4(f)(3)(v)(C).

[11] *See* amended SEC Rule 18a-6(e)(3)(v). Amended SEC Rule 18a-6 defines the terms "designated executive officer" and "designated officer" in the same manner as amended SEC Rule 17a-4, as discussed above in footnotes 8 and 9. *See* amended SEC Rule 18a-6(e)(1)(ii)-(iii).

[12] *See* Adopting Release at 55.

[13] *See id.*

[14] *See id.* at 56.

[15] *See id.* at 56-57.

[16] *See* amended SEC Rule 17a-4(i)(1)(ii)(A) and amended SEC Rule 18a-6(f)(1)(ii)(A).

[17] *See* Adopting Release at 78.

[18] For a broker-dealer, such designee is the broker-dealer's examining authorities.

[19] *See also*, amended SEC Rules 17a-4(j) and 18a-6(g).

[20] *See id.*

[21] *See* Adopting Release at 67-68.

[22] *See id.* at 68.