



# THE DESIGNATED THIRD PARTY(D3P) REQUIREMENT

ENSURE COMPLIANCE WITH SEC AND  
CFTC REQUIREMENTS



## INTRODUCTION:

In 1997, the Securities and Exchange Commission (SEC) issued Rule 17a-4(f), which authorized broker-dealers to store their required books and records in electronic format. Broker-dealers who elected to store records electronically were required by the rule to retain a third party (Designated Third Party or D3P) who had the ability to independently download electronically- store information to another acceptable medium for the SEC's review (the D3P Requirement). The purpose of this provision was to ensure that, in the event a broker-dealer went out of business or refused to cooperate with the SEC, an independent third party could assist the SEC in retrieving information stored on electronic media.

The rule originally envisioned a D3P who would be able to independently download and convert information stored on portable media such as optical platters without having access to the broker-dealer's computers systems. As such, the rule expected that D3ps would have their own systems to download and convert information on media to it by the regulators.

Since 1997, the securities industry standard for electronic storage has shifted from portable media to hard-drive storage systems located onsite at the broker-dealer. As a result, the focus of D3Ps has shifted from so-called "independent access"- the ability to independently download data from portable media at the D3p's own facility, to "onsite" or "online" access- the ability retrieve data from the broker-dealer's storage system at the broker-dealer's facility (onsite) or through secure remote access or a VPN solution (online). D3Ps must now have expertise in retrieving data via all three access protocols.

Despite this changing technological landscape, during the first ten years of the D3P Requirement the SEC and other securities regulators did not meaningfully scrutinize broker-dealers' compliance with the requirement. Certain broker-dealers therefore paid minimal attention to the requirement, confident in their belief that their non-compliance with the requirement would stay under the regulatory radar.

The regulatory environment changed in 2007, which the Financial Institution Regulatory Authority (FINRA), the primary self-regulatory organization (SRO) for broker-dealers decided to make D3P compliance a greater priority. FINRA examiners, in routine examinations of broker-dealers started requesting copies of the D3P's required "Letter of Undertaking," along with the service agreement between the broker-dealer and the D3P, and any documentation verifying that D3Ps were complying with the terms of agreement, including test reports of the D3P's ability to actually access and download random required books and records from storage. It is but a matter of time before we will see FINRA enforcement actions charging broker-dealers with violations of Rule 7a-4(f)'s D3P Requirements.

Broker-dealers therefore can no longer afford to ignore or back-burner compliance with the D3P Requirement. But fear of an enforcement action should not be the sole motivating factor for a broker-dealer to achieve compliance with the D3P Requirement. The D3P Requirement serves the beneficial purpose of forcing broker-dealers to collect, document, and analyze all systems setups and configurations concerning electronic recordkeeping, so that it can impart this knowledge to a D3P. By virtue of this exercise, broker-dealers become better organized, and in the process can discover and fill gaps in their general compliance with Rule 17a-4. Further, D3Ps become indispensable resources to broker-dealers in the case of personnel changes in IT; corporate combinations with other broker-deals using different systems; destruction or loss of systems; and inability to access data stored through legacy systems (after firms have upgraded or purchased new and different storage technologies).

Also, certain D3P vendors now offer a complete set of third party services to broker-dealers under 17a-4(f), including serving as custodian of required duplicate set of electronic media, serving as required escrow agent for systems information, and serving as required D3P- thereby providing substantial efficiency, cost reduction, and a comprehensive compliance solution with respect to Rule 17a-3(f).

This whitepaper will explore the background and purpose of the D3P Requirement, discuss the current and future regulatory environment, describe the collateral benefits of compliance with the rule, and offer suggestions to broker-dealers on how they choose the right D3P for their business needs.

# FINRA MADE D3P COMPLIANCE A GREATER PRIORITY

# BACKGROUND

## The 1993 No Action Letter

Prior to 1993, broker-dealers could maintain required records pursuant to SEC Rules 17a-3 and 17a-4 only in the following formats: paper copies, microfilm, or microfiche. In 1992, the Securities Industry Association (SIA) proposed to the SEC's Division of Market Regulation that it recommend no enforcement action be taken against broker-dealers if they utilized "optical storage technology" to maintain required books and records, in lieu of paper or micrographics.

The SIA explained to the SEC that optical storage technology allowed for data to be recorded in a hardware controlled, non-rewriteable format, such as write-once, read-many (WORM), which provided a non-alterable, permanent record storage medium. The SIA stated that this storage medium provided economic as well as timesaving advantages for broker-dealers, including speedier and higher quality access to preserved records than those kept on microfilm, microfiche or physical format.

The SIA argued that optical disk storage of required books and records was good for SEC too:

- According to the SIA, optical storage technology would enhance the process of providing information more readily to Commission. The SIA states that these benefits also would accrue to the benefit of the Commission in any record analysis done, because the Commission's staff would have the same ready, rapid access to the stored information, thus increasing the efficiency of the review process.

The Division of Market Regulation granted the SIA's request for a no-action position in 1993, but with a caveat. The SEC staff noted:

- The SIA recognizes, however, that industry standards for the development of optical storage technology are currently being set, and that there are suit and examination concerns. Because the technology is new, optical storage systems are not always compatible (i.e information stored on an optical disk of one manufacturer may not be read by the technology developed by a second manufacturer). As a result of this lack of industry standards, the Commission or a self-regulatory organization (SRO) inspecting a broker-dealer may encounter difficulty examining the information on an optical disk, because the technology owned by the inspecting SRO may not be compatible with the optical storage technology used by the broker-dealer to store the information. Accordingly, the Committee recommends that, upon compliance with conditions similar to those set forth below, broker-dealers be allowed to preserve records by employing optical storage technology.

## RULE 17A-4(F)

Almost simultaneously with the issuance of the No-Action Letter, the SEC published for comment a rulemaking proposal to codify the No-Action Letter with respect to broker-dealers' use of optical disk storage to maintain records.

# PROVIDE ACCESS TO INFORMATION STORED ELECTRONICALLY

The SEC's proposed language for the escrow and Third Party Download requirements of the new Rule 17a-4(f) was lifted virtually unchanged from the No-Action Letter. In that regard, the SEC noted:

- The proposed conditions are designed to provide access to information stored electronically when the broker-dealer is no longer operational, when the broker-dealer refuses to cooperate with the investigative efforts of the Commission or the SROs, or when the system has not been properly indexed as to its entire contents.

Four years after the rulemaking proposal, the SEC finally issued new Rule 17a-4(f). The final rule expanded the universe of acceptable storage media beyond optical disks. Rule 17a-4 allowed broker-dealers to utilize any electronic storage media that recorded data in a non-rewritable, non-erasable format such as WORM. According to the SEC, acceptable electronic storage media (in 1997) included optical disk, optical tape, and CD-ROM. In the final rule, the SEC also adopted the D3P Requirement (Rule 17a-4(f)(3)(vii)) "substantially as proposed," as well as the accompanying escrow provision. The full text of the D3P Requirement is as follows:

- For every member, broker, or dealer exclusively using electronic storage media for some or all of its record preservation under this section, at least one third party (the undersigned), who has access to and the ability to download information from the member's, broker's, or dealer's electronic storage media to any acceptable medium under this section, shall file with the designated examining authority for the member, broker, or dealer the following undertakings with respect to such records.

- Furthermore, the undersigned hereby undertakes to take reasonable steps to provide access to information contained on the brokers or dealers electronic storage media, including, as appropriate, arrangements for the downloading of any record required to be maintained and preserved by the broker or dealer pursuant to Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 in a format acceptable to the staffs of the Commission, any self regulator having jurisdiction over the member, broker or dealer. Such arrangements will provide specifically that in event of a failure on the part of a broker or dealer to download the record into a readable format and after reasonable notice to the broker or dealer, upon being provided with the appropriate electronic storage medium, the undersigned will undertake to do so, as the Commission's staff or its designee may request.

In May 2003, the SEC issued an interpretive release stating that rule 17a-4(f)'s requirements that the storage format be non-rewritable and non-erasable did not limit broker-dealers to using optical platters, CD-ROMs, DVDs or similar physical mediums. In 2001, the SEC amended Rule 17a-4(f) to specially allow SROs and State Securities Regulators to have access to a D3P for purposes of their inspections, to the extent they have jurisdiction over the broker-dealer serviced by the D3P.

In May 2003, the SEC issued an interpretive release stating that Rule 17a-4(f)'s requirement that the storage format be non-rewritable and non-erasable did not limit broker-dealers to using optical platters, CD-ROMs, DVDs, or similar physical mediums. In particular, the SEC approved the use of a new storage technology system.

That prevents the records from being overwritten, erased or otherwise altered without relying solely on the system's hardware features. Specifically, these systems use integrated hardware and software codes that are intrinsic to the systems to prevent the overwriting, erasure or alteration of the records. Thus, while the hardware storage medium used by these systems (e.g., magnetic disk) is inherently rewritable, the integrated codes intrinsic to the system prevent anyone from overwriting the records.

The archiving system described in the release above will be referred to hereafter as the "WORM-like Devices." A WORM-like Device essentially stores the data on a hard drive contained in a cabinet-sized tower (Box) which can hold several terabytes of data. Therefore, unlike WORM-compliant optical disks, optical tapes, and CD-ROMs referenced in the SEC's 1997 rulemaking release for Rule 17a-4(f), a WORM-like Device Box is not portable. Because the SEC did not focus on the non-portability of WORM-like Device Boxes in the 2003 Interpretive Release, it did not address what role a D3P should play in assisting the regulators in accessing information stored on WORM-like Device of a broker-dealer that has gone out of business or refused to cooperate with the regulators. Further, the SEC's release did not address what role a D3P should play in assisting regulators in accessing information made available "online" to the D3P.

# REGULATORY INTERPRETATIONS OF THE D3P REQUIREMENTS

Since the adoption of the D3P Requirement in 1997, the NASD staff has published two interpretations of the requirement. First, NASD staff stated that if a broker-dealer uses optical storage technology exclusively for only one category of records required to be preserved under SEC rule 17a-4, then it becomes subject to the third party download provider requirement of the rule with respect to that category of records. Second, according to the NASD staff, the SECs Division of Market Division of Market Regulation informed the NASD staff that a "third-party vendor required under Rule 17a-4(f)(3)(vii) must be a party independent of the broker-dealer. An affiliate or parent of the broker/dealer is not independent."

## **Requirement To Electronically File Letters Of Undertaking**

Starting January 1, 2007, NASD member firms were required to electronically file a pdf copy of their D3P's Letter of Undertaking through the NASD's regulatory filing system. In a February 3, 2007 letter to broker-dealers, NASD Regulation Staff stated that the D3P's Letter of Undertaking was among the "most important topics in NASD's examination that you may want to consider when assessing your operations."

## **Recent FINRA Examination Requests For D3P Documentation**

In May 2007, the NASD announced that its examiners were focusing on broker-dealers' compliance with the more technical provisions of SEC Rule 17a-4, including the D3P Requirement. FINRA examiners now have been asking broker-dealers in routine examinations for a copy of their D3P's Letter of Undertaking, the service agreement between the D3P and the broker-dealer, and for verification that the D3P and the broker have been complying with the terms of the service agreement, including proof that the D3P has the actual ability to perform its undertakings. This verification may include, depending on the service agreement, a D3P's initial or periodic test report showing whether it was able to access and download randomly chosen books and records stored electronically on the broker-dealer's systems. D3P test reports have now become a vital broker-dealer compliance record.

## **The Current State Of Affairs And Future Prospects**

Enforcement actions, or the fear of enforcement actions, have forced most broker-dealers to institute Rule 17a-4(f) compliant archiving procedures. Most particularly, broker-dealers have moved away from



utilizing disaster recovery backup tapes as the sole storage mechanism for required records, and instead are storing emails on Rule 17a-4(f) compliant media such as optical disks, WORM-like Devices, and in the cloud with complaint storage options. To streamline their businesses, many broker-dealers have implemented cloud-based applications to help manage their day-to-day operations, which means critical data is not held with the broker-dealer onsite, but with the cloud application provider. Knowing what data exists, where it is stored, how to retrieve it, and securing long-term access rights to the data is critical to ensuring 17a-4(f) compliance.

Despite the enormous attention given by the securities industry to Rule 17a-4(f) compliance with respect to the proper electronic format to store records, compliance with the D3P Requirement has been of the lowest priority of broker-dealers in connection with Rule 17a-4(f). The lack of interest in complying with the provision is not surprising. The D3P Requirement literally is the final subsection of Rule 17a-4(f), and is intended as a backup to a backup- a fail safe mechanism to allow regulators to review the electronically stored records of broker-dealers who go out of business or refuse to cooperate, where such broker-dealers did not escrow its systems configuration and passwords.

No broker-dealer actively contemplates its own demise; indeed, most firms feel secure in their belief that the firm's operations will continue profitably for generations to come, and that they will maintain reasonably good relationships with the regulators. As such, broker-dealers believe they cannot be faulted for failing to comply with the D3P Requirement, because the requirement provides for a worst-case scenario that never will become applicable to them. Certain broker-dealers therefore have viewed the D3P Requirement as an unnecessary and burdensome rule that accrued only to the benefit of the regulators, and otherwise was no intrinsic compliance value to the firm.

The SEC has done little to discourage this type of thinking. For instance, even though the SEC insisted on

the D3P Requirement in the No-Actions Letter and in Rule 17a-4(f) to protect itself and other regulators, the SEC to date has not meaningfully scrutinized broker-dealers' compliance with the D3P requirement. The SEC apparently has been relying on the integrity of D3P undertakings, and has not been testing the D3P's actual abilities to fulfill their undertakings and perform their regulatory tasks.

FINRA's recent initiatives, however, should give broker-dealers some pause. As stated above, FINRA has been asking for more detail regarding the D3P lately. In addition to the Letter of Undertaking, FINRA

## THE BENEFITS OF D3P COMPLIANCE

Compliance with the D3P Requirement has benefits beyond merely providing comfort to the firm that it is not violating a regulatory rule. In general, it is a beneficial and useful exercise, in and of itself, for a broker-dealer to undertake to collect and distill its tribal IT knowledge and impart it to a trusted third party not only for safekeeping, but also for outside validation of the firm and the D3P will compile a comprehensive reference book detailing the firm's system configurations, hardware, software, illustrative rights, passwords, and encryption keys. In so doing, this analysis necessarily will uncover audit and preservation requirement gaps in a firm's storage and archival systems, which can be filled and corrected by the firm. Implementation of the D3P Requirement gives firm's compliance department a great snapshot where the organization stands with respect to its overall compliance.

Review of systems and record types by a broker-dealer as part of the contracting process with a D3P can lead to discoveries of duplicated data, redundant work, and applications that can be phased out. As a result of this information, the broker-dealer may be able to save on costs related to hardware, software, development, support, operations, manpower and data storage. Other benefits to compliance with the D3P Requirement are less immediate, but are nonetheless important. In all

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DISTILL ITS  
TRIBAL IT  
KNOWLEDGE**

has asked about frequency of testing to ensure access, the process, and proof of compliance. Given the relative ease with which broker-dealers can become fully compliant with the D3P Requirement, it makes little to no sense for broker-dealers to place themselves at risk of being the subject of embarrassing enforcement actions by continuing to ignore the requirement. Enforcement actions, or the fear of enforcement actions, have forced most broker-dealers to institute rule 17a-4(f) compliant archiving procedures.

## UNLOCK THE SECRETS OF THE TECHNOLOGY.

organizations, key IT personnel retire or leave, taking with them when they go their unique or peculiar knowledge of the firm's systems. When they leave, they do not always ensure that the information they possess is passed down to remaining personnel.

In their absence, the only person associated with the organization who may aware of certain material systems information be the D3P. Thus, is the D3P becomes part of the compliance audit process of the organization, then the "knowledge" is contained within the organization.

This problem may be particularly acute in situations where the broker-dealer merges with, has been acquired by, or acquires, another company that utilizes different or conflicting systems, and the original IT personnel of the firm are laid off or reassigned. Also, if the firm switches to the systems utilized by the company with which it is combining, the original systems are scrapped and become "legacy" systems, and institutional knowledge concerning how to access information stored on media generated from the legacy systems slowly dissipates and becomes forever lost. Here again, the D3P will retain the information necessary to unlock the secrets of the old technology.

# CHOOSING THE RIGHT D3P

A D3P MUST HAVE A SOPHISTICATED TECHNOLOGY TEAM THAT CAN ASK THE RIGHT QUESTIONS AND DRILL DOWN INTO A BROKER-DEALER'S SYSTEM INFRASTRUCTURE TO ENSURE THAT IT HAS A FULL PICTURE OF THE FIRM'S OPERATING SYSTEMS...

In finding an appropriate D3P, broker-dealers should keep several things in mind:

## FIRST

As discussed above, Rule 17a-4(f)(3)(vii) originally envisioned a D3P who would be able to independently download and convert information stored on portable media such as optical platters without having access to the broker-dealer's computer systems. The rule expected D3Ps to have their own systems to download and convert information on media supplied to it by the regulators. As technology has progressed, and as data security and protection have become greater concerns, there has been a shift from storage on removable media to hard-drive storage systems kept onsite at the broker-dealer, or to online archiving systems. Fewer and fewer broker-dealers now archive their electronic records on portable media. As a result, there has been a shift in focus for D3Ps from so-called independent access (ability to independently download information from a broker-dealer's removable media on systems at the D3P's office) to onsite access, where the D3P must access records stored on the broker-dealer's electronic storage system at the broker-dealer's facility through the other appropriate application interface, to online access of the same system via VPN or remote access. A qualified D3P must be versed in retrieving records kept through all three access methods.

## SECOND

A D3P must have a sophisticated technology team that can ask the right questions and drill down into a broker-dealer's system infrastructure to ensure that it has a full picture of the firm's operating systems, and understand which information is being electronically stored under Rule 17a-4(f), in which media formats the information is being stored, how to retrieve the information from the media, including knowledge of system configurations, passwords, and encryption keys, and understands who are the key personnel at the firm's systems. The D3P should distill this information into a written system configuration plan that can be audited and updated as needed. Such a plan should contain information concerning (1) the administrative environment for a broker-dealer's storage system, (2) key personnel in compliance, IT operations, securities and facilities, (3) the technical nature of the system, hardware requirements, software, versions, media requirements, network configurations and encryption, (4) location of primary and secondary copies of electronic records, and primary and backup data sets, (5) the procedural steps to retrieve and view electronic records, how to retrieve media indices, how to retrieve electronic records and how to operate the retrieval and viewing software and (6) the regulatory organizations that require a Letter of Undertaking. Therefore, broker-dealers should look for a D3P with significant experience as a D3P and who has dealt with and possesses knowledge and understanding of a wide range of systems.

## THIRD

A D3P should perform an initial test of its ability to access a set of random records, pursuant to the broker-dealer's system configuration plan, before the D3P files its Letter of Undertaking with FINRA. The proposed D3P should conduct such testing under the observation and supervision of the broker-dealer, and provide the broker-dealer with a test report. Broker-dealers should be wary of any D3P that is willing to file a Letter of Undertaking with FINRA without first confirming its ability to adhere to the undertaking.

## FOURTH

The D3P also should offer the capacity to regularly audit the broker-dealer to ensure that the D3P is up-to-date with all changes in the technology utilized by the firm, and such revised information is reflected in a system configuration plan. The D3Ps also should regularly test its ability to download and convert data stored on current representative samples of all storage media utilized by the broker-dealer, and issue reports of its results to the broker-dealer client and request follow-up and feedback. Such protocol will provide ongoing validation that the D3P is accountable for its undertaking. Therefore, broker-dealers should look for a D3P that has in place established procedures to ensure ongoing compliance with the D3P Requirement.

## FIFTH

Where broker-dealers utilize WORM-like Devices to store required records, the D3P should have the capacity to routinely perform a test of its current capabilities to retrieve information from the broker-dealer's storage system, in case the regulators ever call upon the D3P to access data without assistance from the broker-dealers or the regulators. Therefore, broker-dealers should look for a D3P with significant experience across multiple systems, applications, and storage media.

## SIXTH

A team effort is required for a company to operate as a successful D3P provider. A D3P provider should be able to offer broker-dealer clients more than a single human resource to fill the role as third party downloader under the SEC rule. Broker-dealers should be wary of fly-by-night solo D3Ps or "mom and pop" D3P shops who are without a deep bench of qualified and seasoned information technology professionals running its operations.

## FINALLY

Broker-dealers should look to vendors who can provide a suite of third party services under Rule 17a-4(f), including acting as storage facility for the broker-dealer's duplicate copy of the media under 17a-4(f)(3)(iii), acting as escrow agent for current copies of the physical and logical file format of electronic storage media and other systems information under 17a-4(f)(3)(vi), as well as acting as the D3P under 17a-4(f)(3)(vii). Obviously, a vendor that can offer all these services can provide substantial cost efficiencies to broker-dealers, reduce their compliance headaches.

PROVIDE  
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## THE DELIVERABLES: **ANALYSIS, VALIDATION, AND PEACE OF MIND**

GLOBANET'S DESIGNATED THIRD PARTY (D3P) COMPLIANCE SERVICE ASSISTS FINANCIAL INSTITUTIONS IN MEETING THE SEC AND CFTC REQUIREMENTS.

Our methodology involves assessing the eDiscovery infrastructure and analyzing the environment so we can demonstrate an institution's compliance to the SEC, FINRA and/or CFTC. The result of our solution is peace of mind and assurance that your company has satisfied your designated third-party requirement.

### **SECURITY**

We understand that some organizations are still wary about cloud computing; keeping data confidential is essential for any organization. That's why we have **partnered with Microsoft** who has made an industry-leading commitment to the protection and privacy of your data. Microsoft was the first cloud provider recognized by the European Union's data protection authorities for their commitment to rigorous EU privacy laws. Microsoft was also the first major cloud provider to adopt the new international cloud privacy standard, ISO 27018.

Azure safeguards customer data in the cloud and provides support for companies that are bound by extensive regulations regarding the use, transmission, and storage of customer data.

# **KEEP DATA CONFIDENTIAL**



### **DELIVERABLES**

As part of our D3P Compliance Service, we work with your IT staff either onsite or remotely to:

- LETTER OF INTENT TO REGULATORS FOR EACH SYSTEM INFORMING THEM THAT YOU CONTRACTED A DESIGNATED THIRD PARTY PROVIDER
- SYSTEM CONFIGURATION PLAN (SCP) EXPLAINING ACCESS TO RECORDS
- TWO D3P STATUS REVIEWS EACH YEAR TO VALIDATE D3P ACCOUNTABILITY
- ANNUAL TEST AND TEST REPORT TO SHOW COMPLIANCE
- LETTER OF UNDERTAKING FOR FILING WITH SEC AND SELF-REGULATING ORGANIZATIONS
- UP TO 2 DAYS FOR AN SEC AUDITOR AT D3P FACILITY

#### **Fees and Payment Schedule**

Fees are determined on a per system basis.