

Electronic Delivery Fundamentals and Gaps: Broker-Dealers on the “Frontier”

Christopher Gilkerson

Christopher Gilkerson is VP and Associate General Counsel for Charles Schwab & Co., Inc., member NYSE/SIPC. Before joining Schwab, Mr. Gilkerson was Assistant General Counsel for Market Regulation at the Securities and Exchange Commission. © Copyright 2004. All rights reserved.

Electronic delivery of records has the potential to advance important disclosure purposes of the Federal securities laws by providing information to investors, such as trade confirmations and mutual fund prospectuses, on a nearly real-time basis. But advancing technology, helpful but incomplete guidance from the Securities and Exchange Commission, the enabling yet in some ways burdensome Electronic Signatures in Global and National Commerce Act (“ESIGN”), and inconsistencies between SEC guidance and ESIGN make electronic delivery a challenging area for broker-dealers to navigate. This outline reviews the SEC’s electronic delivery interpretive guidance, the ESIGN consumer consent provisions, and the resulting open issues and inconsistencies that broker-dealers must deal with and the SEC could address with updated guidance.

I. Electronic Delivery of Regulatory Disclosures - Overview

1. SEC Electronic Media Releases.

- a. *1995 and 1996 Releases.* The original guidance from 1995 and 1996 was significant because, at that time, it demonstrated the SEC’s technological lead as an administrative agency and because it primarily consists of principles and standards illustrated through hypothetical examples, instead of “command and control” inflexible rules. Below is a summary of the key elements of the 1995 and 1996 Electronic Media Releases Release No. 33-7856 (April 28, 1995) and Release No. 34-37182 (May 9, 1996). All quotes are from the 1996 release.
 - i. *Scope:* Applies to most all required disclosure documents, including trade confirmations, account statements, prospectuses, annual reports, proxy statements, consents, annual statements, and other required notices.
 - ii. *Technology neutrality:* The SEC did not specify a required electronic medium or source of delivery.
 - iii. *Equivalence:* Electronically delivered documents must contain the same required information in substantially the same order as paper documents.

iv. *Right to paper*: “As a matter of policy,” a person should be provided with the paper document whenever specifically requesting paper, whether or not she has revoked consent to electronic delivery.

v. *Reliability, integrity, security*: Broker-dealers should have “reason to believe” that any electronic means they select will result in satisfaction of the delivery obligations under the Federal securities laws, and should take reasonable precautions to ensure the integrity and security of the information.

vi. *Notice*: Electronic communication should provide adequate and timely notice that the required information is available electronically. E-communication such as email itself provides sufficient notice. With delivery through a Web site, however, “separate notice would be necessary to satisfy the delivery requirements unless the broker-dealer ... can otherwise evidence that delivery to the customer has been satisfied.”

vii. *Evidence to show delivery*: Evidence of satisfaction of delivery obligations may be shown by (1) obtaining the recipient’s prior informed consent and “ensuring that the recipient has appropriate notice and access,” or (2) obtaining evidence that the intended recipient actually received the information (e.g., email return receipt).

viii. *Informed consent*: Includes specification of the electronic medium, the period for which consent will be effective (e.g., one-time or continuing), description of the information that will be delivered, and any potential costs. Consents may be obtained manually or electronically, and “[i]n most cases in which a request for information is made through an electronic medium, consent to receive the requested information by means of electronic delivery may be presumed.”

ix. *Additional requirements of personal financial information*: For e-delivery of personal information such as appears in account statements or trade confirmations, the following also apply: (a) *Reasonably secure*: Broker-dealers should take “reasonable precautions to ensure the integrity, confidentiality, and security” of the information, and tailor their precautions to the medium to “ensure that the information is reasonably secure from tampering or alteration”; (b) *Informed consent*: For e-delivery of personal information such as appears in account statements or trade confirmations Broker-dealers should obtain the recipient’s prior informed consent to assure that the recipient is willing to accept delivery of confidential information and has actual notice that e-delivery will occur.

- b. *2000 Release*. The SEC clarified and dealt with certain discrete electronic media issues in its 2000 interpretive guidance (Release No. 33-7233, May 4, 2000). Although the update was welcomed in the industry, and the SEC for the most part continued its path of regulation through announcement of principles and standards clarified by hypothetical examples, the scope of the release was limited. The Securities Industry Association stated in its comment letter: “[T]he SEC has not met the challenge of the bold advances in technology and communication with a bold response.” A large part of the release deals with prospectus delivery, online offerings, and other

1933 Securities Act (15 U.S.C. §77a et seq.) issues that are outside the scope of this outline. (In fact, the release focuses primarily on the securities offering process and not other broker-dealer activities.) With this caveat, below is a summary of some of the key elements of the 2000 release:

i. *Telephonic consent.* In reaffirming that consent = evidence of delivery, the SEC clarified that consent may be obtained through telephonic means, provided that a record of the consent is maintained. Thus, consent to e-delivery under the SEC's guidance may be obtained through paper, an electronic medium, or over the telephone. *But see* ESIGN discussion below.

ii. *Global consent.* Global consent to e-delivery relating to all documents of any issuer, whether the consent is obtained by a broker-dealer or other intermediary is permissible, provided that it is informed and the consent disclosure describes all methods and media of delivery for each type of disclosure or document. However, the SEC also stated that, although broker-dealers may obtain consent in a separate section of an account-opening agreement, it “would not be an informed consent if the opening of a brokerage account were conditioned upon providing the consent.”

iii. *PDF format can meet requirement of “effective access.”* Broker-dealers may use PDF format to meet delivery obligations, provided they inform investors of the requirements necessary to download PDF when obtaining consent, and provide investors with any necessary software and technical assistance at no cost. A link to Adobe's Web site to download the free Acrobat software permitting PDF viewing, and a toll-free number to contact the broker-dealer for assistance, would be sufficient.

iv. *Access = delivery?* The SEC declined to formulate principles or conditions under which investor access to electronic media alone would be sufficient to satisfy a delivery obligation, the SEC made the following points. First, even investors with Internet access are unlikely to rely on the Internet as the sole means of obtaining information. Second, some investors decline e-delivery because they prefer paper delivery. Third, an access equals delivery model could create a system that “requires ownership of a late-model, sophisticated computer to participate in the securities markets.”

v. *Electronic notice.* The SEC stated: “We continue to believe that direct notice of the availability of electronic disclosure documents is necessary unless an issuer or market intermediary can otherwise establish that delivery has been made.” For example, messages posted on a Web site are not sufficient standing alone.

vi. *Implied consent.* As a general matter, the SEC expressed concern that implied consent, when “an issuer could rely on electronic delivery if investors do not affirmatively object when notified of” the firm's intention to begin e-delivery, would adversely impact investors through their “inadvertent failure to object.”

vii. *Electronic-only offerings.* The SEC reaffirmed the validity of “electronic-only” offerings in which investors may participate only if they agree to accept e-delivery of all documents. But there is a substantial condition: the right of an investor to always receive paper, even if she has provided consent and whether or not she has revoked consent.

c. *SEC Action in American Life Insurance.* In October 2001, the SEC broke new ground in the area of electronic delivery and electronic offerings. By a 2-1 vote, the SEC declared a registration statement for an all-electronic, variable annuity, separate account product effective under section 8 of the Securities Act of 1933., 15 U.S.C. §77h; *American Life Insurance Co. of New York*, Release No. 33-8027 (Oct. 25, 2001). The registration statement requires that all contract purchasers consent to electronic delivery of all documents and reports relating to the contract. This includes transaction confirms, proxy statements, account statements, and any personal correspondence, all of which will be made available through a password protected Web site in each purchaser’s own “personal file.”

i. *Key points:* The registration statement appears to be contrary to the SEC’s interpretive guidance from 1995, 1996, and 2000 in two key respects. First, the registration statement makes clear that there is no right to paper and that the effect of withdrawing consent to electronic delivery is that the investor surrenders or (if the investor instructs) exchanges the contract. Second, there is no actual notice (for example, by email) of delivery when a statement, confirmation, disclosure or other required information is posted to the Web site. Thus, Web site access = delivery, at least in this case.

ii. In the SEC’s order, and in their separate statement, Chairman Pitt and Commissioner Unger indicated that their decision was based on the particular facts and circumstances of this matter, but also that the SEC was going to revisit its electronic media releases in light of ESIGN.

2. *Application of the ESIGN Act—Overview.*

a. *Key principles.* There are four key principles embodied in ESIGN: market-driven, not regulatory solutions (because excessive regulation could negatively impact the growth of e-commerce); (ii) media neutrality (between paper and electronic records and signatures); (iii) party autonomy (parties to a transaction should be allowed maximum flexibility in choosing the technology that best meets their needs); and (iv) technology neutrality (regulations should not favor one form of electronic method or solution over another).

b. *Key enabling provision:* Section 101(a) of ESIGN, 15 U.S.C. §7001(a), provides that, “notwithstanding any other statute, regulation, or other rule of law,” and for “any transaction”:

“(1) a signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form; and

(2) a contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation.”

- c. *Broad definitions:* The definitions of “record” and “transaction” are extremely broad, indicating that the Act’s enabling provisions and their requirements apply to broker-dealer records, as well as to agreements and disclosure communications between broker-dealers and their clients relating to securities transactions.
- d. *Inconsistencies, and unclear meaning of some provisions.* Although ESIGN was a major accomplishment and step forward for financial services and their clients in terms of uniform enabling legislation, the meaning of some of the provisions is not clear on their face. Compounding the difficulty is the fact that there is no official legislative history to turn to for guidance, as no report accompanies the final bill. The only legislative history consists of floor statements of “pro-consumer protection” and “pro e-commerce” legislators making competing and conflicting points. Moreover, firms face a number of uncertainties in trying to comply with the SEC’s guidance and requirements on the one hand, and ESIGN’s requirements on the other. In many instances the two sets of requirements are compatible; in other instances it is unclear.
- e. *Regulatory authority to bring consistency and clarity.* Recognizing a need for more clarity for certain industries, ESIGN granted the SEC (and other Federal regulatory agencies) interpretive, rulemaking, and exemptive authority to resolve ambiguities and tailor requirements to fit the industry. *See* §§104(b) and (d), 15 U.S.C. §7004(b) and (d). To date, the SEC has used this authority sparingly.
- f. *A fundamental question for broker-dealers:* Did ESIGN change the application of SEC guidance on e-delivery and, if so, in what ways?

3. *ESIGN’s Consumer Consent Provisions.*

ESIGN §101(c), 15 U.S.C. §7001(c), provides that “if a statute, regulation, or other rule of law requires that information relating to a transaction . . . be provided or made available,” delivery of an electronic record can satisfy the requirement that such information be in writing provided that certain conditions (outlined below) are met. The scope of the consumer consent provision is broad. It covers disclosures on Web sites, in account applications or agreements, and other electronic disclosures, whether governed by state law, SEC, or SRO requirements. The three principal conditions are:

- a. *Consumer must “affirmatively consent” and not withdraw consent:* “Affirmative consent” means that opt-out schemes may not be permissible. However, firms should be able to imply consent from facts and circumstances. For example, if a client makes an electronic request for a prospectus, providing that prospectus through the same electronic means should be deemed to satisfy “affirmative consent.” Moreover, consent need not be provided electronically (but see the “reasonable demonstration” requirement below). Although consent need not be evidenced by an electronic signature, the act of consent could be demonstrated with an electronic signature on an agreement that includes the required disclosures.

- b. *Firms must provide a “clear and conspicuous statement” of six required disclosures:* (1) The right or option to receive the information on paper, if any; (2) The right, and procedures, to withdraw consent and any conditions, consequences, or fees for withdrawing; (3) The procedures to update customer electronic contact information (i.e., change of e-mail address); (4) Whether the consent applies to one transaction or identified categories of records; (5) Whether the customer can request a paper copy of the electronic record and whether a fee will be charged; and (6) The hardware and software requirements for accessing and retaining the electronic record. Although the consumer consent provision requires notice of a right to paper and how to obtain paper, it doesn’t mandate that right. The provision also allows global consent. “Clear and conspicuous” does not mean boilerplate language or all capital letters, for example. Instead, what is clear and conspicuous depends on the electronic record and where and when a firm is requesting consent. For example, informed consent for trade confirmations or account statements may be quite lengthy because of SEC requirements of full disclosure when obtaining informed consent. ESIGN disclosures should be logically integrated with SEC disclosures.
- c. *Consumer consent must meet the “reasonable demonstration” requirement:* Section 101(c)(1)(C), 15 U.S.C. §7001(c)(1)(C), requires that “the consumer consents electronically, or confirms his or her consent electronically, in a manner that reasonably demonstrates that the consumer can access information in the electronic form that will be used to provide the information that is the subject of the consent.” The so-called “reasonable demonstration” requirement has been among the most controversial aspects of ESIGN for several reasons.
- i. “Reasonable demonstration” has been interpreted to prevent paper or telephonic consent to electronic delivery, unless firms use a “double consent.” *See* Federal Trade Commission & Department of Commerce, Report to Congress: Electronic Signatures in Global and National Commerce Act, The Consumer Consent Provision in §101(c)(1)(C)(ii) (June 2001) at 9-10. For example, if a paper account application clearly discloses that clients will be agreeing to electronic delivery of information that will arrive by email, the paper consent would need to be followed by an email from the client confirming consent.
- ii. The requirement shows distrust of e-commerce in that it imposes consent burdens not applied to the paper world. A technical violation of this difficult-to-interpret and implement language conceivably could be raised in an arbitration proceeding challenging the effect or validity of an electronic disclosure, even if there is no factual dispute that the client received the disclosure document. (Note, however, that section 101(c)(3), 15 U.S.C. §7001(c)(3), expressly states that the validity of a contract may not be denied solely because of a failure to follow the “reasonable demonstration” requirement.)
- iii. Compliance with “reasonable demonstration,” and official interpretations of the requirement, should be based on common sense depending on the particular facts and circumstances. For example, the following circumstances should be sufficient if applied under a common sense standard of reasonableness: (1) The electronic format of the form or disclosure delivery is HTML, and the client accesses the Web site and clicks on an “I consent” button after reading the informed consent information; (2) The electronic format is an email, and the client

communicates consent by email; (3) The electronic format is an email, and part of the manner in which the client provides consent is to provide an email address; (4) The electronic format is PDF, and the consent form on the Web clearly explains that Adobe Acrobat Reader is required and includes a method for the customer to download it.

II. Open Issues Appropriate for Additional Guidance.

1. ***Updating the SEC's Interpretive Guidance in Light of ESIGN.*** Following the SEC's statements and actions in 2001, the industry is still hoping for "round four" in the SEC's electronic media releases. Given that guidance governing broker-dealer communications outside of the offering context was not the focus of the 2000 electronic media release, it would be unfortunate for this next round not to speak broadly to all broker-dealer e-delivery areas and issues. Below is a short list of key issues:
 - a. *Reevaluate policy regarding the absolute right to paper.* Five years ago the SEC expressed understandable reluctance to completely let go of paper delivery, requiring firms to provide paper copies upon request in all cases. Today, as a majority of the SEC determined in *American Life Insurance*, requiring a paper back-up when an investor has consented to electronic delivery through email or a Web site imposes an unnecessary cost on firms. It is also contrary to ESIGN's technology neutrality requirements and the prohibition that agencies may not impose or retain a paper record requirement. *See* ESIGN §104(c), 15 U.S.C. §7004(c). Even without requiring paper back-up, many firms will choose to provide paper copies on request as a client courtesy. The firms that choose not to have a paper back-up would need to disclose that fact up front (and likely would pass along the cost savings to the clients who opt-in for an all-electronic service or offering).
 - b. *Make clear that firms can charge for paper delivery.* A number of firms have already begun charging for paper confirmations and statements. It is one "carrot and stick" method to move as many clients as possible for whom it is appropriate to cheaper and more effective methods of e-delivery. Charging certain clients for paper service is part of the continued process of unbundling expenses, services, and fees within the securities industry. ESIGN contemplates that firms may charge for paper duplicates, provided this is disclosed as part of informed consent. *See* ESIGN §101(c)(1)(B)(iv), 15 U.S.C. §7001(c)(1)(B)(iv). However, the SEC's electronic media release statements about the right to paper has created some uncertainty whether charging for paper in some circumstances would be contrary to the SEC's right to paper requirement. SEC guidance could clarify that, subject to appropriate notice, charging clients for paper service if, for example, they do not elect e-delivery, is permissible.
 - c. *Access = delivery.* A majority of the SEC in *American Life Insurance* made clear that they did not believe actual notice of electronic delivery—outside of the informed consent—is required for investor protection under the circumstances of an all-electronic offer and contract. The SEC is now in the process of taking the next step. On November 3, 2004 as part of a broader securities

offering reform proposal, the SEC proposed a new rule that would adopt an access = delivery approach to the final prospectus delivery obligation, provided that the final prospectus is on file (electronically) with the Commission. This would mean that under certain circumstances and with certain exceptions a broker-dealer would not have to deliver a physical prospectus with the trade confirmation. The SEC stated: “We believe that Internet usage has increased sufficiently to allow us to propose a prospectus delivery model for issuers and their intermediaries that relies on timely access to filed information and documents.” Release No. 33-8501 (Nov. 3, 2004). The SEC should now consider whether and how to implement this approach to other broker-dealer communications. For example, after full disclosure, if an investor indicates consent on a Web site to electronic delivery to that Web site, actual notice by US mail or email that a trade confirmation, account statement, proxy statement, registration statement amendment, etc. is available should not be required.

- d. *Global consent.* In light of *American Life Insurance*, the SEC should also revisit its statement in the 2000 electronic media release that informed consent is not valid if the opening of an account is conditioned on an investor giving global consent to subsequent electronic delivery of documents relating to the account.

2. ***Clarifying the Inconsistencies between ESIGN and SEC Guidance.*** On occasion, SEC staffers have stated that broker-dealers should follow both ESIGN’s requirements and the SEC’s guidance on electronic delivery. These statements fall short of the SEC’s traditional role as a technology leader among regulatory agencies and ignore the authority ESIGN grants the SEC to interpret and apply ESIGN in a way that both protects investors and best serves the industry. ESIGN need not preempt SEC guidance in areas that appear inconsistent. The SEC has authority to adopt rules, interpretations, exemptions, or guidance to amend or harmonize ESIGN, or to show how the SEC’s existing guidance is consistent with ESIGN or permissibly deviates from ESIGN. For example, the SEC used this authority in 2001 to reaffirm the broker-dealer electronic records “write-once-read-many” or WORM requirement. See Release No. 34-44238 (May 1, 2001). Below are the issues appropriate for SEC clarification:

- a. *Cross-channel consent.* Beginning with its initial guidance in 1995, the SEC allowed paper consent to e-delivery. The May 2000 release further clarified that investors may consent telephonically to e-delivery. But the “reasonable demonstration” requirement under ESIGN §101(c)(1)(C)(ii), 15 U.S.C. §7001(c)(1)(C)(ii), may be interpreted not to allow paper consent for e-delivery unless the client later “confirms her consent electronically.” The SEC could use its interpretive, rulemaking, or exemptive power to make clear that cross-channel consent (e.g., paper consent to electronic delivery) is permissible. Such SEC action could be based on the fact that there do not appear to have been any customer complaints relating to firms following the SEC’s guidance on obtaining consent to e-delivery.
- b. *Reaffirmation of PDF as permissible e-delivery format.* The May 2000 release stated that PDF is an acceptable form of delivery if firms or issuers inform investors of the requirements necessary

to download PDF when obtaining consent to electronic delivery. Because PDF is an effective way of delivering high-quality readable electronic documents, the industry applauded this clarification. But how should firms and issuers meet ESIGN's "reasonable demonstration" requirement when the documents are in PDF? The May 2000 release contains the right answer: firms should inform investors of the requirements necessary to download PDF when obtaining their consent, and provide them with the necessary software and technical assistance at no cost. The SEC could make clear that following its guidance satisfies ESIGN's requirements.

- c. *Effect of technical violation in terms of SEC compliance.* It is unclear how the SEC would consider the following situation: a broker-dealer meets the SEC's own disclosure and electronic delivery requirements, but commits a technical violation of ESIGN. Has the firm committed a regulatory violation? Any SEC interpretive release could deal with this issue to give the industry appropriate notice.