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Client Alert

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SEC Settlement Highlights Continued Scrutiny of Off-Channel Communications

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On April 3, 2024, the U.S. Securities and Exchange Commission (SEC) announced yet another settlement regarding "off-channel communications."[1] As we have previously written about,[2] settlements of this type have become increasingly common in recent years, have resulted in large-scale fines across the industry,[3] and continue to be a focus of the SEC.[4] We examine this settlement below.

Background

Advisers Act Rule 204-2 (Recordkeeping Rule) requires that registered investment advisers make and keep records of all written communications on a wide array of enumerated topics, and specifically includes Rule 204-2(a)(7), which requires advisers to keep records of investment advice given as well as other communications involving securities. Advisers Act Rule 206(4)-7 requires registered investment advisers to implement written policies and procedures to ensure compliance with the Advisers Act. The SEC regularly enforces these sections of the Advisers Act against firms that do not keep proper records or employ proper compliance procedures.[5] Of note is that while many of the recent settlements were against solely registered broker dealers, dually registered broker dealers/investment advisers, or registered broker dealers and their affiliated registered investment advisers, this settlement was with just a registered investment adviser.

Recent Case

Adviser's Policies and Procedures

In the settlement noted above, a registered investment adviser (Adviser) had policies and procedures in place to help comply with the Recordkeeping Rule. Among other things, the policies and procedures specified approved communication platforms and prohibited the use of non-approved platforms for business purposes (although employees were permitted to use "off-channel communications" in emergencies, provided they reported such use and provided a copy of the communication to the Adviser for archiving). Furthermore, the policies and procedures noted the Adviser would "retain all electronic communications that it sends and receives."

In furtherance of these policies and procedures, Adviser employees were required to annually acknowledge in writing that they "read, understood, and abided by" the Adviser's compliance manual. Moreover, the Adviser was permitted "to access employees' personal devices to review for any off-channel communications." The Adviser's policies and procedures required that all employees attend annual compliance trainings and be made aware that electronic communications were subject to surveillance and required to be retained.
In addition, the Adviser's Code of Ethics required employees to obtain pre-clearance for all personal securities transactions.

Adviser's Recordkeeping Failures

In its settlement, the SEC determined that the Adviser "failed to implement procedures to monitor whether its employees were following the firm's policies concerning work-related communications." During the course of its investigation, the SEC found that thousands of off-channel communications were sent during the applicable period. More specifically, "[the Adviser] did not access employees' personal devices to determine whether they were complying with the firm's communication policies. Because [the Adviser] did not monitor or collect off-channel communications, it failed to keep these messages as its policies and procedures required."

Furthermore, the SEC notes that none of the employees who engaged in off-channel communications "took steps to copy their business messages for retention by" the Adviser as was required by its policies and procedures. Lastly, certain senior employees' personal devices had auto-delete functions enabled. The use of the auto-delete function prevented the Adviser not only from complying with its own "off-channel communication" policies but also from complying with the Recordkeeping Rule.

Adviser's Pre-Clearance Policy Violations

The settlement also states that the Adviser "failed to ensure that certain personal-trading reviews were timely conducted in compliance with the firm's pre-clearance policy."

SEC Findings

As a result of the conduct described above, the SEC found that the Adviser had willfully violated Rules 204A-1, 204-2(a)(7), and 206(4)-7 of the Advisers Act. The Adviser was also found to have failed to reasonably supervise its employees in a way that prevented them from aiding and abetting violations of the Advisers Act. We note that the Code of Ethics violation was likely relevant to the penalty overall and potentially relevant as to the scope of the entire inquiry.

The Adviser, before the settlement became effective, revised its policies and procedures to better ensure compliance with the Recordkeeping Rule and associated rules. The settlement further required the Adviser to engage a compliance consultant and implement an overhaul of its compliance program based on the compliance consultant's report. The Adviser was censured and fined $6.5 million for its actions.

Remedial Efforts

In the settlement, the SEC acknowledged certain remedial efforts taken by the Adviser prior to the settlement, which included (a) revising its policies and procedures and (b) providing "employees with firm-issued cell phones to reduce opportunities for off-channel communications." Of further note is that these devices were set to automatically upload communications into the Adviser's archiving system for retention.

SEC Speaks 2024

In a speech released the same day as the settlement,[6] SEC Deputy Director Sanjay Wadhwa briefly discussed the recent recordkeeping violations and settlements and addressed certain considerations that the SEC took into account when determining penalties with respect to recordkeeping-related violations. These included, but were not limited to:

1. Size of the firm "to ensure that the penalties are adequate to serve as a deterrent against future violations"
2. Number of registered professionals at the firm
3. Scope of the violation
4. The firm's efforts to (a) comply with its own recordkeeping obligations and (b) prevent off-channel communications
5. Whether the firm self-reported or not[7]
6. The firm's cooperation during its investigation

Takeaways

Consequently, advisers should carefully examine their policies and procedures regarding recordkeeping and off-channel communications (and the employee trainings associated therewith) to help ensure they are both compliant with relevant laws and properly tailored to the adviser's business. Advisers should continuously train their employees on the current recordkeeping requirements and acceptable means of communication for business purposes and consider adding the topic to existing year-end training sessions. In addition, advisers may also consider having their chief compliance officers circulate memoranda outlining acceptable means of communication as memorialized in applicable compliance policies and procedures.

In that vein, many financial firms have been and will continue to look at new products that can help capture off-channel communications (such as texting, WhatsApp, etc.) and store them in archiving platforms. However, we acknowledge there may be a practical difficulty in doing so when such products are used on a personal phone (i.e., separating personal nonbusiness communications from business communications). Furthermore, while a firm-provided separate phone for business purposes can be helpful, this can be a material expense for firms and can raise expense allocation issues (e.g., if such firm tries to allocate such expenses to its clients).

Although not necessarily fully dispositive of a "suitable" compliance program with respect to the Recordkeeping Rule and off-channel communications, the undertakings agreed to by the Adviser, which we summarize in part below, provide some insight and guidance to what *might* be helpful additions to the compliance programs and policies of advisers as they relate to the Recordkeeping Rule and off-channel communications:

1. A review of policies and procedures related to the Recordkeeping Rule and off-channel communications
2. A review of trainings conducted to help ensure compliance with the Recordkeeping Rule and associated policies and procedures related to off-channel communications, including quarterly written certifications by personnel that they are complying with the applicable policies and procedures

3. An assessment of surveillance programs implemented to help ensure compliance with the Recordkeeping Rule and associated policies and procedures related to off-channel communications
4. An assessment of technological solutions implemented to help ensure compliance with the Recordkeeping Rule, including an assessment of whether employees actually utilize such solutions
5. An assessment of measures used to help prevent the use of off-channel communications, which include "a review of . . . policies and procedures to ascertain if they provide for any significant technology and/or behavioral restrictions that help prevent the risk of the use of unapproved communications methods on off-channel communication devices"

Next Steps

For further information, guidance, and clarity on how advisers can approach and tailor their policies and procedures (and testing thereof) and associated trainings related to the Recordkeeping Rule and off-channel communications, please reach out to the authors of this article or to your regular Lowenstein Sandler contact directly.

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[1] https://www.sec.gov/files/litigation/admin/2024/ia-6581.pdf.
[2] *See* e.g., "Regulators Crack Down on the Use of Messaging Apps as Wall Street Banks and Investment Advisers Hit With $1.8 Billion in Fines"
[3] *See* e.g., https://www.sec.gov/news/speech/grewal-remarks-nyc-bar-association-compliance-institute-102423. According to Director Gurbir Grewal, "[s]ince December 2021, [the off-channel communications sweep] has resulted in charges against 40 firms and over $1.5 billion in civil penalties for failures to maintain and preserve electronic communications."
[4] The SEC Director quoted in the press release for the settlement noted, "The Commission continues to focus on regulated entities' compliance with the recordkeeping requirements. Adherence to these requirements is essential for the Commission to effectively exercise its regulatory oversight and enforce the federal securities laws." https://www.sec.gov/news/press-release/2024-44.
[5] *See* e.g., https://www.sec.gov/news/press-release/2024-18 (SEC settlement on February 9, 2024 of $81 million against several financial firms for recordkeeping failures), https://www.sec.gov/news/press-release/2023-212 (SEC settlement on September 29, 2023 of $79 million against several financial firms for recordkeeping failures), https://www.sec.gov/news/press-release/2023-149 (SEC settlement on August 8, 2023 of $289 million against several financial firms for recordkeeping failures), and https://www.sec.gov/news/press-release/2022-174 (SEC settlement on September 27, 2022 of $1.1 billion against several financial firms for recordkeeping failures).
[6] https://www.sec.gov/news/speech/sanjay-wadhwa-sec-speaks-2024-04032024.
[7] The Deputy Director cites a firm that previously self-reported, which resulted in a substantially lower fine than for other similarly situated firms.