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Client Alert

Investment Management

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Another Wave of SEC Settlements Underscore the Continued Priority of Record Retention Communication Compliance

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On August 14, 2024, the U.S. Securities and Exchange Commission (SEC) announced another series of settlements regarding "off-channel communications."[1] As part of its Off-Channel Communications Initiative,[2] the SEC settled with 11 broker-dealers, three investment advisers, and 11 dual-registered broker-dealers and investment advisers (collectively, the Firms) for a combined $392.75 million in fees related to widespread recordkeeping failures by such firms. As we have previously written,[3] settlements of this nature continue to be a focus of the SEC.[4] We examine these settlements below.

Background

The SEC adopted Rule 17a-4 pursuant to Section 17(a)(1) of the Securities Exchange Act of 1934 (Exchange Act), which mandates that broker-dealers maintain and preserve certain records, including communications and business transactions, for specific periods and produce these records upon an SEC regulatory inspection (Broker-Dealer Recordkeeping Rule). Similar to Rule 17a-4 of the Exchange Act, Rule 204-2 promulgated under the Investment Advisers Act of 1940 (Advisers Act) requires investment advisers to make and keep records of all written communications on a wide array of enumerated topics for specific periods and to produce such communications upon the SEC's request (Investment Adviser Recordkeeping Rule, and collectively with the Broker-Dealer Recordkeeping Rule, the Recordkeeping Rule). 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 Exchange Act and the Advisers Act against firms that do not maintain proper records or adequate compliance procedures.[5]

As previously written,[6] the SEC continues to focus on off-channel communications and has brought several waves of settlements against financial firms for running afoul of the Recordkeeping Rule. This recent wave of settlements is no different. It included broker-dealers, dually registered broker-dealers/investment advisers, and registered investment advisers. Over the past year, firms have paid more than $2.5 billion in penalties for failures to maintain and preserve electronic communications.[7]

Recent Case

The Firm's Recordkeeping Failures

In this most recent settlement, the SEC issued separate orders against the Firms for failure "to keep for prescribed period, and furnish copies of, such business-related records as necessary or appropriate in the public interest or for the protection of investors." During the course of its investigation, the SEC found a widespread and long-standing failure across the Firms' personnel, including at senior levels, to adhere to their own policies and procedures designed to ensure the supervision of personnel training in the Firms' communication policies and adherence to the Firms' retention of business-related records requirements, including electronic communications and the use of unapproved electronic communication methods. More specifically, the Firms' personnel used their personal devices to communicate both internally and externally by text message and/or other unapproved written communications platforms, such as WhatsApp. Across the various orders, the SEC stated that the Firms' failure to maintain or preserve the substantial majority of the off-channel communications led to a widespread failure to implement and comply with their own policies and procedures, including supervising junior personnel who routinely communicated off-channel with their personal devices.

SEC Findings

As a result of the conduct described above, the SEC found that the dual-registered and broker-dealer firms had willfully violated Section 17(a) of the Exchange Act and Section 203(e) and Section 203(k) of the Advisers Act. Further, the dual-registered and investment adviser firms had willfully violated Rule 17a-4(b)(4) as well as Rules 204A-1, 204-2(a)(7), and 206(4)-7 of the Advisers Act. The settlements will require the dual-registered entities and broker-dealers to cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Exchange Act and Rule 17a-4 and require the dual-registered entities and investment advisers to cease and desist from committing or causing any violations and any future violations of Section 204 of the Advisers Act and Rule 204-2. Moreover, the settlements require the Firms to, among other things, undertake to retain a compliance consultant to conduct a comprehensive review of their supervisory, compliance, and other policies and procedures designed to ensure that all relevant electronic communications are preserved in accordance with the requirements of the federal securities laws. The SEC also stated that the settlement orders will trigger certain disqualifications from exemptions from registration available under the Securities Act for the Firms.

Remedial Efforts and Self-Reporting

In the settlement, the SEC acknowledged certain remedial efforts taken by three of the Fims prior to the settlement, which included (a) conducting internal investigations and self-reporting, (b) issuing firm-owned devices on which only firm-approved platforms were permitted for customer-facing communications, (c) strengthening its self-policing procedures to improve surveillance efforts and enhancing internal certification, and (d) conducting trainings that emphasized the importance of complying with recordkeeping obligations.

The SEC also acknowledged the proactive steps taken by at least three firms to collect and preserve off-channel communications. As a result of the Firms' self-reporting, they faced significantly lower penalties than they otherwise would have. Gurbir Grewal, director of the SEC's Division of Enforcement, stated that these firms differentiated themselves by self-reporting prior to the investigation, demonstrating "once again the real benefits of proactive cooperation."

Takeaways

Consequently, investment advisers and broker-dealers should carefully examine their policies and procedures to ensure they address record retention and destruction and compliance with relevant laws, and to ensure their compliance policies are properly tailored to their business. Broker-dealers and investment 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. Firms can also consider leveraging technology solutions to enhance their surveillance programs to include texting and other, similar means of communication within the scope of their surveillance efforts. In addition, investment advisers may also consider having their chief compliance officers circulate memoranda outlining acceptable means of communication as memorialized in applicable compliance policies and procedures.

Many financial firms have been and will continue to be looking at new products that can help capture electronic communications (such as texting, WhatsApp, etc.) and store them in archiving platforms. While there may be barriers to providing employees with firm-issued devices (which can raise expense allocation issues if a firm tries to allocate such expenses to its clients) and practical issues in segregating communications when products are used on a personal phone, firms can consider testing regimes that are regularly deployed to ensure compliance with prohibited off-channel communications.

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

1. A comprehensive 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 personal electronic devices, are preserved in accordance with the federal securities laws

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 the likelihood that employees will utilize such solutions
5. An assessment of measures used to help prevent the use of off-channel communications, which includes "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 personal devices"
6. A comprehensive review of the framework adopted to address instances of noncompliance by personnel with the associated policies and procedures concerning off-channel communications, which should include "a survey of how personnel failed to comply with the associated policies and procedures, the corrective action carried out, an evaluation of who violated the policies, and why, what penalties were imposed, and whether penalties were handed out consistently across business lines and seniority levels"

Next Steps

For further information, guidance, and clarity on how broker-dealers and/or investment 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/newsroom/press-releases/2024-98.
[2] https://www.sec.gov/files/rules/other/2024/33-11298.pdf.
[3] *See* https://www.lowenstein.com/news-insights/publications/client-alerts/sec-settlement-highlights-continued-scrutiny-of-off-channel-communications-im.
[4] The SEC Director quoted in the press release for the settlement noted, "As today's enforcement actions against more than two dozen firms reflect, we remain committed to ensuring compliance with the books and records requirements of the federal securities laws, which are essential to investor protection and well-functioning markets[.]" https://www.sec.gov/newsroom/press-releases/2024-98.
[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] *See* https://www.lowenstein.com/news-insights/publications/client-alerts/sec-settlement-highlights-continued-scrutiny-of-off-channel-communications-im.
[7] *See e.g.*, https://www.sec.gov/newsroom/press-releases/2023-212.

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