Articles + Publications | February 14, 2024

How to Avoid a Similar Fate? SEC Charges Firms With Record-Keeping Violations for Off-Channel Communications

WRITTEN BY

Stephanie Pindyck Costantino | Jay A. Dubow | Theodore D. Edwards

RELATED PROFESSIONALS

Julia D. Corelli | Stephanie Pindyck Costantino | John M. Ford | Genna Garver | Paul A. Steffens

On February 9, the Securities and Exchange Commission (SEC) announced settlements with 16 firms relating to record-keeping violations stemming from off-channel communications totaling $81 million. The 16 firms were five broker-dealers (BD firms), seven dually registered broker-dealers and investment advisers, and four affiliated investment advisers (IA firms). Off-channel communications are unapproved methods of communication used for business-related communications.

The settlements were a result of the SEC Division of Enforcement's "Off-Channel Communication Initiative." Off-channel communications can include communications conducted on widely used messaging platforms or texting platforms. The BD firms violated Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-4(b)(4) and affiliated IA firms violated Section 204 of the Investment Advisers Act of 1940 and Rule 204-2(a)(7). Broadly, these statutes and rules require that broker-dealers keep certain books and records relating to their businesses, and investment advisers keep certain books and records relating to investment advice provided to clients.

These settlements are the latest batch of settlements in the SEC's ongoing focus on off-channel communications, such as text messages, WhatsApp, Discord, and other third-party applications, by personnel of regulated firms. Employees of the BD firms communicated through personal text messages about the business of their employers, and employees of IA firms sent and received off-channel communications related to recommendations made or proposed to be made, and advice given or proposed to be given. None of the firms maintained or preserved the substantial majority of these off-channel communications. As a result, the off-channel communications could not be captured and maintained as required by the books and records rules applicable to the firms.

Examples of off-channel communications from the orders include:

1. A vice president of a BD firm exchanging numerous off-channel messages with at least six colleagues, including junior employees under their supervision. These messages related to the broker-dealer's business.

2. A BD firm vice president exchanging numerous off-channel messages with at least three colleagues and at least one external contact in the securities industry, relating to the BD firm's business.

3. A senior managing director of a BD firm exchanging numerous off-channel business-related messages with at

least 10 colleagues, more than 50 customers, investors, or other market participants, and with six individuals at other financial firms.

4. A managing partner of an IA firm exchanging off-channel messages with colleagues and other external contacts in the securities industry. These messages related to investment advice proposed to be given to advisory clients.

5. IA firm personnel exchanging off-channel messages discussing an investment trading strategy for an advisory client's account.

Consistent with prior enforcement actions, these latest actions emphasize off-channel communications by senior personnel of regulated firms, and the use of off-channel communications that appeared regular in frequency and widespread in reach. The actions against IA firms are notable because they provide some insight into the substance of off-channel communications viewed as problematic. The record-keeping requirements applicable to investment advisers are generally narrower than those applicable to broker-dealers. Whereas broker-dealers are required to maintain records of any written communication relating to their business as such, investment advisers are only required to maintain records of written communications relating to "[a]ny recommendation made or proposed to be made and any advice given or proposed to be given," among other limited categories. The enforcement actions against IA firms illustrate that the enforcement staff appreciates this difference, but is nonetheless prepared to levy charges where investment advisers do not capture written communications related to client investment advice.

As a result of their failure to provide required books and records, the firms were fined a total of $81 million, in addition to receiving censures and cease and desist orders. Notably, a BD firm, which self-reported their violations received a fine substantially less than that received by the others, which underscores the importance and value of self-reporting in appropriate circumstances.

Compliance officers face the difficult challenge of crafting and implementing effective policies aimed at capturing and preserving business related communications of broker-dealers, and communications of investment advisers related to investment advice. The evolving nature and means of communication notwithstanding, it remains essential for regulated firms to capture and maintain relevant written communications, lest they be deemed to have committed record-keeping violations.

RELATED INDUSTRIES + PRACTICES

- Consumer Financial Services
- Corporate
- Financial Services
- Investment Funds + Investment Management Services
- Private Equity
- White Collar Litigation + Investigations