The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 31, NO. 8 • AUGUST 2024

Next Up: US Securities and Exchange Commission Zooms in on Investment Adviser as Part of Ongoing Off-Channel Communication Sweep

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On April 3, 2024, the US Securities and Exchange Commission (the SEC) announced the first settlement with a stand-alone registered investment adviser in *In re Senvest Management, LLC*, for, among other things, alleged failures to maintain and preserve certain electronic communications (the Order).[1] While the Order was similar to dozens of other settlements the SEC has entered into since December 2021 as part of the SEC's ongoing sweep into the use of unapproved messaging applications for business-related communication (known as off-channel communications), it marked the first off-channel communications settlement with an adviser who was not otherwise affiliated with a broker-dealer.[2] The Order showed that not only is the SEC's sweep continuing, but it appears to be widening in scope to stand-alone investment advisers.

Recordkeeping Requirements

The SEC finds support for its focus on off-channel communication of broker-dealers in Section 17 and Rule 17a-4 of the Exchange Act, which require broker-dealers to preserve communication "relating to business as such." The SEC has applied this broadly to business communication.

Section 204 of the Investment Advisers Act of 1940, as amended (the Advisers Act), provides the recordkeeping requirements applicable to investment advisers. The regulation for advisers is arguably narrower; rather than broadly requiring retention of items related to "business as such," Rule 204-2(a)(7) requires registered investment advisers to preserve original communications received and copies of all written communications sent relating to, among other things, "recommendations made or proposed to be made and any advice given or proposed to be given."

Themes from Recent Enforcement Matters

In orders relating to off-channel communication, the SEC has zeroed in on both recordkeeping failures and failures to develop and enforce internal policies and procedures regarding recordkeeping.

In every order, the SEC has pointed to "widespread and pervasive" use of unrecorded business-related communication conducted through numerous off-channel platforms. The orders have called out text messages, WhatsApp, Signal, and personal email as mediums where business messages were exchanged but where records were not retained

as part of the firm's record retention practices. The SEC has highlighted in every order that materials that should have been retained were deleted, either through regular data clean-up, device failures, or auto-deletion settings. As personal devices are not subject to regular record retention, once the SEC finds communication on an unapproved medium, it appears to be easy to identify deletion and lost messages.

In *Senvest,* for example, the SEC identified the use of personal texting platforms and other nonapproved platforms for both internal and external communication about adviser-related business. Auto-deletion settings enabled on some employee devices led the SEC to infer those records had been deleted.

Where the SEC has found widespread off-channel communication, the SEC also has pointed to internal policy failures. In most instances, firms had existing policies prohibiting the use of personal devices for business-related communication. Yet, the SEC determined that management did not adequately supervise or enforce the policies. In many cases, the orders highlight where management and supervisors themselves were engaged in off-channel communication. Failures to adequately supervise and prevent or detect policy violations can not only cause the SEC to assert a violation of the underlying regulation but can also result in additional violations.

Takeaways from the Adviser-Focused Enforcement Action

While echoing prior orders in the ongoing sweep, the *Senvest* Order provides new insight into how the SEC views the narrower recordkeeping obligations for advisers as compared to broker-dealers.

Order Provides Minimal Information As to the Types of Communications That Are "Business-Related" and Fall within Rule 204-2(A)(7) of The Advisers Act

Although the Order states that some of the communications at issue were related to recommendations made or proposed to be made and advice given or proposed to be given, as with prior orders related to off-channel communication, the Order lacks explicit descriptions or examples of the types of communications the SEC found to fall within those categories. How broadly the SEC applies the Advisers Act recordkeeping requirement remains an open question.

Given the reference to "thousands" of business-related communications, the SEC may be taking an expansive view of the types of communications that are subject to the recordkeeping requirement under Rule 204-2(a)(7). This approach may clash with advisers' existing policies. For example, advisers may maintain policies that do not explicitly bar business-related communication from personal devices, or they may have trained employees on what type of material needs to be preserved pursuant to a narrower interpretation of Rule 204-2(a)(7). It is possible that the SEC may consider an exchange about the volatility of the market as falling under Rule 204-2, but an adviser may see this as not covered by Rule 204-2 unless the exchange specifically contains or references advice or recommendations.

Advisers also should be aware that in practice business communication is a slippery slope. Even scheduling discussions on personal devices could turn into sharing of materials, notes, or commentary on the discussion, which the SEC is likely to see as a violation.

Order Emphasizes Senvest's Failure to Implement Policies and Procedures to Retain All Business-Related Communications, Including Off-Channel Communications

The Order notes that the adviser's policies and procedures strictly prohibited its personnel from using non-firm electronic communication services for any business purpose and that, per the policies and procedures, employees' personal devices were subject to surveillance by the firm. The Order states that the firm failed to implement procedures to monitor whether its employees were complying with these communication policies and specifically

notes that the firm did not access employee personal devices to determine whether they were complying.

As a showing of the failure to implement policies, the Order specifically mentions senior officers' use of personal devices to send and receive text messages related to firm business, including communication concerning recommendations made or proposed to be made and advice given or proposed to be given about securities, and that at least three senior officers had their personal devices set to automatically delete messages after 30 days. The Order noted that following its review the SEC determined that required records had been deleted as a result of the automatic deletion settings.

Importantly, the emphasis in the Order on these points relates to both a failure to implement a sufficient compliance program and the resulting failure to preserve required records. This underscores that advisers should be certain their compliance programs are tailored to their regulatory obligations and that they are implementing and monitoring the effectiveness of these programs on an ongoing basis.

Sanctions Imposed Include Substantial Undertakings to Retain Independent Compliance Consultants

Consistent with the SEC's prior off-channel communication settlements, the Order requires the firm to retain an independent compliance consultant, at the firm's expense. The consultant is charged with reviewing firm policies, procedures, and training materials and preparing an assessment of the firm's surveillance programs, technological solutions, and measures used to prevent unauthorized communication.

Best Practices and Procedures Moving Forward

It is clear that the SEC remains focused on enforcing recordkeeping requirements among registrants of all sizes and types. The substantial penalties and settlements appear intended to send a message to market participants. There are a number of practices and procedures registered investment advisers may wish to consider including in their practices.

Institute and Evaluate Current and Prior Policies Pertaining to Electronic Records Preservation and the Use of Communication Channels

Among other things, such policies should address permitted (and prohibited) communication channels, types of communications permitted on approved channels, record retention requirements, and supervision. Policies should be clear that any business-related communications through employees' personal devices, if permitted, are subject to firm policies, and firm policies should require that any communications subject to the recordkeeping requirements of the Advisers Act are conducted only on firm systems or otherwise subject to the firm's recordkeeping program. Policies should be periodically analyzed to confirm they are being followed, enforced, and are effective. Firms should also consider requiring their employees to certify compliance with such policies quarterly.

Conduct Routine Employee Trainings, Including Initial and Annual Training, Regarding the Firm's Policies and Procedures with Respect to Proper Use of Electronic Communications

These trainings should include proper practices for electronic communication preservation and the use of personal text and email, WhatsApp, Signal, and other off-channel mediums to discuss business-related matters. Firms should consider making these trainings mandatory for all employees.

Institute Technological Measures That Preserve and Flag Off-Channel Communication or Prohibit the Download or Use of Certain Applications Where Message Retention Is Not Possible

Such measures may include surveillance of tracked communications, such as firm email

accounts, for indications that employees may be taking business-related communications into an unmonitored medium. Consider if existing retention methods should be extended to certain platforms that employees are most likely to use.

Conduct Periodic Audits of Electronic Communication Storage and Usage

Firms should continuously assess whether existing measures to maintain and preserve off-channel communications are sufficient in light of the ever-evolving technology and how employees use that technology. It is critical that a firm is prepared to identify, address, and monitor new or changing methods of communication. The SEC emphasized the importance of ongoing monitoring in the Order by requiring the compliance consultant to conduct an assessment of the firm's measures to track employee usage of new technological solutions to meet recordkeeping requirements under federal securities laws.

Respond When Off-Channel Communications Are Detected

Firm policies should clearly state that violation of the policy can result in serious disciplinary actions, including fines and termination of employment. Violations of policies should be addressed and remediated consistent with the written firm policy. Such discipline can both deter future violations and demonstrate to the SEC the firm is serious about recordkeeping.

At a minimum, advisers should be cautious that the existence of *any* firm-related business off-channel communications, including clerical communications about setting up meetings, could result in a close review by the SEC staff in an examination. That risk is enhanced where the number of off-channel communications about firm-related business is in the thousands.

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NOTES

1 *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Advisory Firm Senvest Management with Recordkeeping and Other Failures (Apr. 3, 2024), available at *https://www.sec.gov/newsroom/press-releases/2024-44#:~:text=The%20Securities%20and%20Exchange%20Commission,enforce%20its%20code%20of%20ethics*. The Order also charged the adviser with failure to supervise certain of its employees and failure to enforce its code of ethics. For example, according to the Order, a managing director effected numerous securities transactions in a personal account without preclearance, including transactions in a security owned by a fund managed by the firm.

2 On September 27, 2022, the SEC entered into a settlement with DWS Investment Management Americas, Inc., along with its affiliated broker-dealer, Deutsche Bank Securities Inc., for, among other things, alleged off-channel communications violations. *See* In re Deutsche Bank Sec. Inc., DWS Inv. Mgmt. Ams., Inc., & DWS Distributors, Inc., SEC Release No. 34-95928 (Sept. 27, 2022), available at*https://www.sec.gov/files/litigation/admin/2022/34-95928.pdf*.