SEC Off-Channel Comms Action Hints At Future Enforcement

By **Ranah Esmaili, Lara Shalov Mehraban and David Petron** (April 26, 2024)

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On April 3, the U.S. Securities and Exchange Commission announced an off-channel communications enforcement action that was the first such action against a private fund adviser and the first off-channel case against a standalone investment adviser since the SEC launched investigative sweeps focused on off-channel communications in 2022.[1]

The matter marks the latest in a series of enforcement actions for communications-related recordkeeping failures.

Since the SEC commenced its off-channel investigative sweeps, it has brought a steady stream of enforcement actions against broker-dealers and dually registered firms for off-channel communications.

But the SEC has been slower to bring enforcement actions against standalone investment advisers, likely due to disagreements over the appropriate scope of recordkeeping obligations under, and interpretation of, the Investment Advisers Act of 1940.

Specifically, while the books and records rule applicable to broker-dealers requires all communications relating to the firm's "business as such" to be preserved, Advisers Act Recordkeeping Rule 204-2(a)(7) requires investment advisers to maintain only four narrower enumerated categories of written communications relating to:

- Recommendations made or proposed to be made and advice given or proposed to be given;
- Receipt, disbursement, or delivery of funds or securities;
- Placing or execution of orders to purchase or sell securities; and
- Predecessor performance.

The industry has been waiting for clarity on how the SEC will interpret the Advisers Act recordkeeping rule and for a better understanding of how the SEC will calibrate penalties for investment advisers related to off-channel communications violations.

Although this recent enforcement action does not provide that clarity, it does suggest that we may see more cases against standalone investment advisers.

The SEC's Enforcement Action

Senvest Management LLC is a New York-based private fund manager.

According to the SEC's settled order, from at least January 2019 through December 2021,

Senvest employees at various levels of the organization, including supervisors, communicated about firm-related business internally and externally using personal texting platforms and other nonretained nonfirm electronic communication services.

According to the SEC, the off-channel communications by Senvest employees violated both the Advisers Act recordkeeping rule and the firm's policies and procedures.

Specifically, the SEC noted that Senvest's policies prohibited employees from using nonretained electronic communications services for business communications except during emergencies or technological disruptions, in which case the communications were required to be reported and copied to business email accounts for proper archival.

Further, while the firm's policies permitted the firm to access employees' personal devices to review for any off-channel communications, the SEC found that Senvest failed to implement procedures to monitor whether its employees were following the firm's policies concerning work-related communications and also failed to access its employees' personal devices to determine whether they were complying.

As a result, the SEC found that Senvest did not retain the substantial majority of the off-channel communications and charged the firm with violating Sections 204 and 206(4) of the Advisers Act and Rules 204-2(a)(7) and 206(4)-7 thereunder.

Unrelated to the off-channel communications, the SEC also found that Senvest failed to maintain and enforce its written code of ethics.

The SEC found that certain Senvest employees failed to adhere to provisions of the firm's code of ethics requiring them to obtain preclearance for all securities transactions in their personal accounts, and its supervisors failed to conduct timely personal-trading reviews in compliance with the firm's preclearance policy.

As a result, the SEC also charged the firm with violating Section 204A of the Advisers Act and Rule 204A-1 thereunder.

Finally, the SEC charged Senvest for failing to supervise employees with respect to all of the above requirements, in violation of Section 203(e)(6) of the Advisers Act.

To settle the matter, Senvest agreed to a $6.5 million penalty as well as undertakings, including the now-routine retention of a compliance consultant.

In accepting the settlement, the SEC noted its consideration of remedial acts promptly undertaken by Senvest, including revising its policies and procedures and cooperation afforded to the commission staff.

Our Take

In prior enforcement actions against dually registered or affiliated investment adviser firms, the SEC found that off-channel communications satisfied the broader recordkeeping standards for broker-dealers as well as the narrower Advisers Act recordkeeping rule, without grappling with the differences between the rules.

Unfortunately, the SEC's most recent order does not provide additional clarity on the SEC's interpretation of the Advisers Act recordkeeping rule for electronic communications.

Instead, it simply states that employees had off-channel communications that violated the rule, recites the language of the rule, and declines to characterize the nature or scope of its considerations for the deemed violative communications.

The order does, however, confirm that the SEC is taking the position that internal communications are among the records required to be kept under the Advisers Act recordkeeping rule — which also has been a point of interpretive dispute.[2]

The SEC's order also does not provide any explanation into how the SEC is calculating civil penalties for standalone investment adviser off-channel settlements.

In a recent speech, Division of Enforcement Deputy Director Sanjay Wadhwa outlined factors the SEC considers when determining penalties in off-channel matters, which include the size of the firm based on firm revenues and number of registered representatives, scope of violations, efforts to comply with recordkeeping obligations, precedent, self-reporting and cooperation.[3]

The SEC's order makes clear, however, that the SEC will continue to order settling firms to retain compliance consultants as part of its undertakings, will require firms to admit liability, and will acknowledge firms' preemptive remedial acts and cooperation with the staff in its investigation.

It is also clear that the SEC will fault firms for failing to implement policies and procedures reasonably designed to prevent violations of the Advisers Act recordkeeping rule.

In particular, the SEC's order noted that Senvest did not access its employees' personal devices to determine whether they were complying with the firm's communication policies, despite its policies and procedures permitting the firm to access and review employees' personal devices for any off-channel communications.

In light of this, firms should consider whether they are adequately implementing and enforcing all aspects of existing off-channel communication policies and procedures.

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[1] https://www.sec.gov/files/litigation/admin/2024/ia-6581.pdf.

[2] For a further discussion of the interpretive issues around the Advisers Act Recordkeeping Rule, please see a January 31, 2023 letter submitted by certain trade associations to the SEC concerning its scope and application, available at https://www.sifma.org/wp-content/uploads/2023/02/Investment-Adviser-Recordkeeping-Requirements.pdf.

[3] See Sanjay Wadhwa, Deputy Director, SEC Division of Enforcement, Remarks at SEC

Speaks 2024 (April 3, 2024), available at https://www.sec.gov/news/speech/sanjay-wadhwa-sec-speaks-2024-04032024.