SEC Investigating Investment Advisers' Compliance with Recordkeeping Rules

I. Introduction

Recently, reports emerged that several investment advisers received requests from the U.S. Securities and Exchange Commission ("SEC") for information regarding their policies and procedures related to so-called "off-channel" communications.[1] The requests represent the latest probe by the SEC into how financial institutions preserve electronic communications received and sent by employees on personal devices and via third-party messaging services (e.g., WhatsApp, Telegram, iMessage), and signal that the SEC is expanding its focus to include investment advisers.

Less than a month ago, on September 27, 2022, the SEC announced that a compliance sweep of broker-dealers' electronic communications resulted in 11 administrative actions against 15 broker-dealers and one related investment adviser.[2] The SEC charged the financial institutions with failing to maintain and preserve electronic communications sent and received by employees through unauthorized methods of communication and on personal devices in violation of the federal securities laws.[3] In total, the financial institutions paid more than $1.1 billion in fines.[4]

As night follows day, it is not surprising that the SEC has now broadened its focus to include registered investment advisers. On October 11, 2022, news outlets began reporting that multiple investment funds and advisers received requests from the SEC seeking information regarding their policies and procedures related to "off-channel" communications.[5] Investment advisers and the funds they manage should anticipate increased scrutiny of policies and procedures related to electronic communications in the coming months, and review their policies and procedures accordingly.

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1 *SEC Scrutiny into Wall Street Communications Shifts to Investments Funds – Sources*, REUTERS (Oct. 11, 2022), https://www.reuters.com/business/sec-scrutiny-into-wall-street-communications-widens-investment-funds-sources-2022-10-11/; *EXCLUSIVE U.S. SEC Opens Inquiry into Wall Street Banks' Staff Communications – sources*, REUTERS (Oct. 12, 2022), https://www.reuters.com/legal/litigation/exclusive-us-sec-opens-inquiry-into-wall-street-banks-staff-communications-2021-10-12/; *SEC WhatsApp Probe Digs Deeper Into Asset Managers' Personnel*, BLOOMBERG (Oct. 13, 2022), https://www.yahoo.com/now/sec-whatsapp-probe-digs-deeper-203324816.html?guccounter=1.

2 *SEC Charges 16 Wall Street Firms with Widespread Recordkeeping Failures*, U.S. SECURITIES AND EXCHANGE COMMISSION (Sept. 27, 2022), https://www.sec.gov/news/press-release/2022-174.

3 *Id.*

4 *Id.*

5 *SEC Scrutiny into Wall Street Communications Shifts to Investments Funds – Sources*, REUTERS (Oct. 11, 2022), https://www.reuters.com/business/sec-scrutiny-into-wall-street-communications-widens-investment-funds-sources-2022-10-11/; *SEC WhatsApp Probe Digs Deeper Into Asset Managers' Personnel*, BLOOMBERG (Oct. 13, 2022), https://www.yahoo.com/now/sec-whatsapp-probe-digs-deeper-203324816.html?guccounter=1.

II. Broker-Dealer Charges

In the last year, the SEC has made the proper retention of off-channel communications an enforcement priority. On December 17, 2021, the SEC announced the first major charges against a broker-dealer for failing to retain such communications.[6] The charges related to "widespread and longstanding failures" by the broker-dealer to maintain and preserve electronic communications, including WhatsApp messages, text messages, and emails, in violation of Section 17(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act"), as amended, and Rule 17a-4(b)(4) thereunder.[7] The SEC found that employees across all seniority levels engaged in off-channel communications related to the broker-dealer's business, and that the broker-dealer failed to appropriately retain those communications. The broker-dealer ultimately agreed to pay $125 million to resolve the charges.

In the fall of 2021, the SEC also launched a broad compliance sweep to investigate broker-dealers' policies and procedures for retaining business-related messages sent and received by employees on personal devices.[8] Under Section 17(a)(1) of the Exchange Act and Rule 17a-4(b)(4) thereunder, broker-dealers are required to preserve all communications received and copies of all communications sent relating to the broker-dealers' business for at least three years.[9] This includes all electronic communications, whether sent via email, text message, or a third-party messaging application. To evaluate compliance with these requirements, the SEC collected and evaluated electronic communications from a sampling of employees at numerous broker-dealers.[10]

On September 27, 2022, the SEC reported it had "uncovered pervasive off-channel communications" by the broker-dealers' employees, including the use of text messages and third-party messaging applications, such as WhatsApp, on personal devices.[11] The substantial majority of these off-channel communications were not maintained or preserved by the financial institutions. Fifteen broker-dealers ultimately were charged with violations of the Exchange Act and the rules thereunder as a result of the compliance sweep.

The SEC reported that though the broker-dealers had policies and procedures in place to ensure compliance with Section 17(a)(1) of the Exchange Act and Rule 17a-4(b)(4)—including advising employees that use of unauthorized methods of communication, such as personal devices and WhatsApp, were prohibited—the broker-dealers failed to reasonably supervise their employees to ensure compliance with the procedures.[12] The use of off-channel communications was found across multiple levels of seniority at the broker-dealers, including by supervisors and senior executives.[13] For example, the SEC found that senior managing directors at several of the broker-

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6 *JPMorgan Admits to Widespread Recordkeeping Failures and Agrees to Pay $125 Million Penalty to Resolve SEC Charges,* UNITED STATES SECURITIES AND EXCHANGE COMMISSION (Dec. 17, 2021), https://www.sec.gov/news/press-release/2021-262.

7 *Id.*

8 *See, e.g.*, Exchange Act Release No. 95924, at ¶ 18 (Sept. 27, 2022), https://www.sec.gov/litigation/admin/2022/34-95924.pdf; Exchange Act Release No. 95922, at ¶ 17 (Sept. 27, 2022), https://www.sec.gov/litigation/admin/2022/34-95922.pdf; Exchange Act Release No. 95925, at ¶ 17 (Sept. 27, 2022), https://www.sec.gov/litigation/admin/2022/34-95925.pdf.

9 17 C.F.R. § 240.17a-4(b)(4).

10 *See, e.g.*, Exchange Act Release No. 95922, at ¶ 19 (Sept. 27, 2022), https://www.sec.gov/litigation/admin/2022/34-95922.pdf; Exchange Act Release No. 95925, at ¶ 19 (Sept. 27, 2022), https://www.sec.gov/litigation/admin/2022/34-95925.pdf.

11 *SEC Charges 16 Wall Street Firms with Widespread Recordkeeping Failures*, U.S. SECURITIES AND EXCHANGE COMMISSION (Sept. 27, 2022), https://www.sec.gov/news/press-release/2022-174.

12 *Id.*

13 *Id.*

dealers exchanged thousands of off-channel business-related messages with colleagues, clients, and personnel at other financial services firms.[14] Most of those communications were not preserved by the broker-dealers.

As a result of the investigation, the financial institutions paid more than $1.1 billion collectively in fines, and agreed to undertake various remedial and disciplinary efforts.

III. Recordkeeping Requirements for Investment Advisers

Just weeks after the announcement of the broker-dealer charges, the SEC reportedly sent letters to several investment advisers requesting information regarding their policies and procedures related to electronic communications. Under Section 204 of the Investment Advisers Act of 1940 ("Advisers Act") and Rule 204-2 thereunder, investment advisers are obligated to maintain and preserve certain business-related communications. Specifically, under Advisers Act Rule 204-2(a)(7), investment advisers are required to preserve all communications received and copies of all communications sent by the investment adviser related to:

- any recommendation made or proposed to be made and any advice given or proposed to be given;
- any receipt, disbursement, or delivery of funders or securities;
- the placing or execution of any order to purchase or sell any security; and
- predecessor performance and the performance or rate of return of any or all managed accounts, portfolios, or securities recommendations, subject to certain limitations.[15]

Investment advisers are required to preserve such communications in an easily accessible location for at least five years.[16] As with broker-dealers, these preservation requirements apply to electronic communications, whether sent via email, text message, or a third-party messaging application.

Additionally, Advisers Act Rule 206(4)-7 requires that investment advisers adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.[17] Investment advisers must undertake a review of the adequacy of such policies and procedures and the effectiveness of their implementation on at least an annual basis.[18]

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[14] *See, e.g.*, Exchange Act Release No. 95924, at ¶ 20 (Sept. 27, 2022), https://www.sec.gov/litigation/admin/2022/34-95924.pdf; Exchange Act Release No. 95925, at ¶ 20 (Sept. 27, 2022), https://www.sec.gov/litigation/admin/2022/34-95925.pdf.

[15] 17 C.F.R. § 275.204-2(a)(7).

[16] 17 C.F.R. § 275.204-2(e)(1).

[17] 17 C.F.R. § 275.206(4)-7.

[18] *Id.*

IV. Prior Actions Based on Books and Records Violations

The recent sweep marks a departure from prior SEC enforcement of the recordkeeping requirements under the Advisers Act and rules thereunder. Previously, the SEC has primarily charged violations of Section 204 of the Advisers Act and Rule 204-2 thereunder where they were ancillary to other violations of the federal securities laws. For example:

- In January 2022, the SEC announced that it settled charges against an investment adviser related to the adviser issuing false and misleading advertisements.[19] The SEC also charged the investment adviser with failing to preserve copies of those false and misleading advertisements in violation of Section 204(a) of the Advisers Act and Rule 204-2(a)(11) thereunder. As a result, the investment adviser was censured and ordered to pay a $70,000 fine.

- Also in January 2022, the SEC settled charges against an investment adviser related to a variety of misconduct, including misrepresenting fee-related information and failing to disclose conflicts of interest in its Forms ADV Part 2A.[20] In addition to those violations, the SEC also charged the adviser with failing to maintain accurate records of its discretionary accounts. The investment adviser was ordered to pay a $300,000 fine to the SEC and disgorgement and prejudgment interest totaling $75,654.04 to affected investors.

- In December 2018, the SEC announced that it settled charges against two robo-advisers for making false statements about investment products and publishing misleading advertising.[21] The robo-advisers were also charged with failing to properly retain business-related communications and advertisements sent on social media, such as Twitter, in violation of Rule 204-2(a)(7) and Rule 204-2(a)(11).[22]

- In September 2015, the SEC settled charges against investment advisers for misrepresenting the valuation of certain funds and overcharging clients as a result.[23] In the course of the investigation, the SEC also found that an individual used his personal email account for communications with clients, and failed to preserve all such emails as required under Section 204 of the Advisers Act and Rule 204-2(a)(7)(i) thereunder. The advisers were ordered to pay various penalties as a result of the violations, including disgorgement and civil money penalties.

Recent events signal a change in the SEC's approach to the enforcement of Section 204 of the Advisers Act and Rule 204-2 thereunder. With the proliferation of third-party messaging apps and work from home arrangements, the SEC is now squarely focused on how financial institutions monitor and preserve employees' electronic communications.

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19 *SEC Charges Investment Adviser with Compliance and Books and Records Failures,* U.S. SECURITIES AND EXCHANGE COMMISSION (Jan. 13, 2022), https://www.sec.gov/enforce/ia-5945-s.

20 *SEC Charges NJ-Based Investment Adviser with Hedge Clause Violations, Overcharging Clients*, U.S. SECURITIES AND EXCHANGE COMMISSION (Jan. 11, 2022), https://www.sec.gov/enforce/ia-5943-s.

21 *SEC Charges Two Robo-Advisers with False Disclosures*, U.S. SECURITIES AND EXCHANGE COMMISSION (Dec. 21, 2018), https://www.sec.gov/news/press-release/2018-300.

22 Advisers Act Release No. 5086 (Dec. 21, 2018), https://www.sec.gov/litigation/admin/2018/ia-5086.pdf.

23 Exchange Act Release No. 76218 – Advisers Act Release No. 4237 (Oct. 21, 2015), https://www.sec.gov/litigation/admin/2015/34-76218.pdf.

The recent letters sent by the SEC seek a variety of information related to the regulation and retention of electronic communications. As one might expect, the SEC is seeking information regarding the advisers' respective policies and procedures regarding the devices and platforms employees are authorized to use for business-related communications, and the retention of any such communications by the advisers, as well as records documenting the advisers' annual review of those policies and procedures. But the letters also seek more granular information regarding the investment advisers' compliance with the Advisers Act. Notably, the SEC reportedly is asking investment advisers to identify the specific individuals responsible for overseeing the relevant policies and procedures, and to provide documents sufficient to identify individuals by business unit who are responsible for, among other things, communicating with investors or potential investors. The breadth of these requests signal that the SEC's Enforcement Division is honed in on this issue. Investment advisers should expect to see increased scrutiny of policies and procedures related to electronic communications in the coming months, particularly as they relate to off-channel communications.

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If you receive a request from the SEC's Division of Enforcement for information regarding your policies and procedures related to electronic communications, it is important to consult with counsel right away. The SEC's approach with the large broker-dealer investment banks shows that the Enforcement Division may seek outsized penalties for what were previously regarded as relatively minor violations. We also expect that routine inspections by the Division of Examination will ask about off-channel communications, and will be looking to refer findings to Enforcement. Even if the SEC is not knocking at your door, now is good time to review not only your policies and procedures but also your supervision and ability to enforce those policies on your workforce. Critical short-term steps to take include: renewed training for all employees on the adviser's policies for off-channel communications; review mobile device management policies and implementation; consider requiring self-reporting and/or self-certification by employees for compliance with the adviser's policies and procedures. For further information on best practices for preserving electronic communications in compliance with the Advisers Act and preparing for SEC attention to this area, please contact one of the following Quinn Emanuel lawyers:

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