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Key Takeaways From SEC's First "Off-Channel Communications" Settlement With Stand-Alone Registered Investment Adviser

The SEC's enforcement action sends a clear message that the Commission intends to enforce "off-channel communication" violations against private fund advisers that are not affiliated with a broker-dealer.

Key Points:

- The settlement sheds additional light on how the SEC interprets firms' off-channel communications recordkeeping, policies and procedures, and code of ethics obligations under the Advisers Act.
- The settlement also highlights the SEC's evolving expectations around off-channel communications compliance and indicates the Commission's views on off-channel communications monitoring, the use of auto-delete functions, and firm-issued devices.
- The SEC is continuing to aggressively pursue off-channel communications enforcement actions against firms, demanding admissions as a condition of settlement.

On April 3, 2024, the US Securities and Exchange Commission (SEC or Commission) announced that it had reached a $6.5 million settlement with registered investment adviser (RIA) Senvest Management, LLC (Senvest) on charges related to the firm's "widespread and longstanding failures to maintain and preserve certain electronic communications."

This Client Alert analyzes potential lessons learned from this latest off-channel communications SEC enforcement action, which focuses on a stand-alone RIA that is not affiliated with a broker-dealer (BD).

Background

It is no secret that the SEC, the Commodity Futures Trading Commission (CFTC), and the Financial Industry Regulatory Authority (FINRA) have been cracking down on BDs and dually registered (or affiliated) BD/RIAs based on alleged non-compliance with recordkeeping requirements relating to off-channel communications (i.e., communications on non-company platforms, such as text messages and other instant messaging platforms). To date, firms have paid more than $1.7 billion in penalties to resolve off-channel communications matters.

Investment advisers, too, have been under scrutiny regarding their use of off-channel communications — but until now it was unclear how an SEC enforcement action would play out for a stand-alone RIA. Press reporting around an RIA off-channel communications "sweep" dates back as far as October 2022. And RIA trade associations and others in the industry have raised concerns about how the SEC may interpret the scope and application of the Investment Advisers Act of 1940 (the Advisers Act) in the context of off-channel communications.

With the Senvest settlement, RIAs now have a case study to help evaluate how the SEC may approach off-channel communications enforcement actions against RIAs that are not affiliated with, or related to, BDs, including against RIAs that primarily advise private funds.

The Enforcement Action

Senvest, a Delaware LLC that has been registered with the Commission since 2012, was charged with multiple violations of the Advisers Act, specifically: (1) failure to preserve electronic communications relating to actual or proposed investment advice or recommendations or to the placement or execution of any order to purchase or sell any security; (2) failure to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder; (3) failure to establish, maintain, and enforce a written code of ethics that meets the minimum standards set forth in Rule 204A-1 of the Advisers Act; and (4) failure to reasonably supervise certain employees with a view to prevent them from aiding and abetting violations of the SEC's off-channel communications rules and regulations.[1]

According to the Order, the violations occurred "[f]rom at least January 2019 through December 2021," and included participation by three senior officers and a managing director, who "used personal devices to send and receive thousands of text messages related to firm business, including communications concerning recommendations made or proposed to be made and advice given or proposed to be given about securities."[2]

Takeaways

1. The Order offers limited clarity on how the SEC interprets the scope of off-channel communications recordkeeping obligations under the Advisers Act

As a threshold matter, the scope of the Advisers Act's recordkeeping obligations differ from those that apply to BDs. Rule 17a-4(b)(4) of the Securities Exchange Act of 1934 (the Exchange Act) requires a BD to retain "all communications … relating to its business as such." On the other hand, the recordkeeping requirements under the Advisers Act are narrower and only cover records or communications that fall into certain prescribed categories pursuant to Rule 204-2 of the Advisers Act.

The Order points out three specific categories of communications that are required to be maintained by RIAs under Rule 204-2(a)(7): originals of all communications sent or received relating to (1) recommendations made or proposed to be made and any advice given or proposed to be given; (2) any receipt, disbursement, or delivery of funds or securities; or (3) the placing or execution of orders to purchase or sell any security. Prior "off-channel" communications settlements focused on the first of these three categories. However, the Order offers little insight into how the SEC interprets the scope of those three categories of communications.

The Order does indicate that the SEC accepts the differences between the Advisers Act and the Exchange Act records rules. The Order states that Senvest employees sent and received "thousands of

business-related messages" on off-channel communications platforms. But, distinct from these thousands of business-related messages, the Order also identifies "[n]umerous messages related to matters within the scope of Advisers Act Rule 204-2(a)(7) and thus were required to be preserved by Senvest."

In so doing, the Order seems to acknowledge that despite thousands of business-related communications, only the "numerous" communications within the scope of the Advisers Act were required to be preserved. The Order does not provide further clarity as to what specific communications fell within scope of the Advisers Act. The only example in the Order simply parrots certain requirements from Rule 204-2(a)(2).

Further, the Order suggests that off-channel communications can trigger violations of an RIA's obligations to adopt and implement written policies and procedures under Rule 206(4)-7 of the Advisers Act (the Compliance Rule). In particular, the firm failed to implement procedures to monitor whether its employees were following the firm's communications policies.

2. The Order raises questions about the SEC's evolving expectations for controls around the use and preservation of off-channel communications

In the Order, the SEC states that Senvest did not monitor off-channel communications. The Order notes that "[d]espite [known] unapproved use of off-channel communication, Senvest did not access employees' personal devices to determine whether they were complying with the firm's communication policies."[3] This portion of the Order could suggest that the SEC now expects firms to proactively access their employees' personal devices to prove a negative as part of their regulatory monitoring efforts. If the SEC is signaling an expectation that firms regularly access personal devices to search for evidence of off-channel communications, this would raise a host of complex considerations, including whether such steps are even possible in all jurisdictions (e.g., certain countries or states' privacy statutes may impact an employer's ability to access an employee's personal device).

Three other observations offer additional insights into the SEC's evolving compliance views in the off-channel communications space:

- The Order notes Senvest's remedial effort of amending its policy to have the firm provide employees with "firm-issued cell phones to reduce opportunities for off-channel communications."[4] At a minimum, this suggests that the SEC views firm-issued mobile devices as a compliance uplift.

- The Order takes issue with the fact that "at least three senior Senvest officers had their personal devices set to automatically delete messages after 30 days." The Order notes that the SEC was able to retrieve the auto-deleted messages from other devices, which is how the SEC knew the auto-deletion was resulting in deletion of records subject to the Advisers Act recordkeeping requirements. As such, the Order suggests that the auto-delete setting is an aggravating factor beyond simply using off-channel communications platforms.

- The Order notes that, after engaging in off-channel communications, no Senvest employee took steps to copy their business messages for retention by Senvest. This suggests that, in certain instances, the use of off-channel communications could potentially be cured by taking steps to preserve such communications contemporaneously or after-the-fact, if consistent with the firm's compliance policies and procedures.

3. RIAs can still look to BD resolutions as relevant precedent, since the Order contains several common elements from BD precedent matters

As with the BD enforcement actions, the Order calls out "tone at the top" behavior of senior leaders and focuses on alleged supervisor misconduct.[5] And, consistent with resolutions in the BD space, Senvest was required to admit the facts alleged in the Order and acknowledge that its conduct violated federal securities laws.[6] The Order also imposes on the firm a compliance consultant with a mandate similar to those set out in BD off-channel communications resolutions.[7]

4. The case highlights that all investment advisers must be attentive to potential off-channel communications enforcement, regardless of the adviser's size or strategy

Senvest is an investment adviser that reports $3.67 billion in assets under management.[8] The firm advises pooled investment vehicles that offer securities to investors.[9] The SEC continues to investigate advisers ranging from large private equity firms to smaller retail advisers for off-channel communications in violation of the Advisers Act recordkeeping rules.

Conclusion

This enforcement action and others like it coming out of the SEC and FINRA may help provide additional clarity to RIAs regarding the scope of the Advisers Act as it relates to off-channel communications (including recordkeeping, policies and procedures, and code of ethics requirements). Pronouncements from the CFTC and the Department of Justice in this area also reflect the agencies' evolving views on compliance controls and the potential consequences of non-compliance.

If you have questions about this Client Alert, please contact a member of our White Collar Defense & Investigations and Investment Funds Practices or the Latham lawyer with whom you normally consult.

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Endnotes

1 The Order also includes a charge against Senvest for allowing its employees, including a managing director, to trade securities using their personal accounts without obtaining pre-clearance.

2 Senvest Mgmt., LLC, Advisers Act Release No. 6581 (Apr. 3, 2024) ("Order") at 2, 4.

3 *Id.* at 4.

4 *Id.* at 5.

5 *See generally id.* at 2-5.

6 *Id.*at 1.

7 *See id.* at 6-7.

8 Senvest Mgmt., LLC, Form ADV (March 29, 2024).

9 Form ADV, Part 2A Brochure at 4.