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Family Office Insights

The Securities and Exchange Commission's Scrutiny of Investment Advisers "Off-Channel Communications" – What Family Offices Need to Know

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Family offices and their investment teams should be aware that a recent area of compliance emphasis for the Securities and Exchange Commission (SEC) relating to registered investment advisers (RIAs) is the requirement that RIAs retain and store all "off-channel communications." On April 3, 2024, the SEC brought its first enforcement action against a standalone investment adviser (that is, an investment adviser that is not affiliated with a bank or broker-dealer) for off-channel communication recordkeeping failures.

What are "Off-Channel Communications"?

The SEC uses the term "off-channel communications" to refer to communications sent by text, WhatsApp or other electronic messaging systems on personal platforms or devices that are not maintained by the related RIA or broker-dealer. It was the failure by an RIA to retain and store these communications that gave rise to the enforcement action discussed here.

Federal securities laws impose recordkeeping requirements on registered investment advisers and broker-dealers. Advisers Act Rule 204-2(a)(7), enacted under Section 204 of the Investment Advisers Act of 1940, as amended (Advisers Act), requires RIAs to "preserve in an easily accessible place originals of all 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; any receipt, disbursement or delivery of funds or securities; or the placing or execution of any order to purchase or sell any security."[1] Broker-dealer communications, regulated under Rule 17a-4, issued pursuant to Section 17(a)(1) of the Securities Exchange Act of 1934, as amended (Exchange Act), are subject to a broader requirement to retain originals of all communications received and copies of all communications sent relating to the firm's business.[2]

SEC Enforcement Emphasis

Beginning in late 2022, the SEC has brought charges against more than 30 broker-dealers, dually registered broker-dealers and investment advisers and broker-dealer affiliated investment advisers for failure to comply with the recordkeeping requirements under the Exchange Act and Advisers Act as part of the SEC's "Broker-Dealer Off-Channel Communications Initiative."[3] The charges have resulted in combined penalties in excess of US$1 billion, with particularly egregious violations resulting in US$125 million fines against some large firms.

The SEC consistently refers to two major issues in its off-channel communications enforcement proceedings: the failure to retain messages exchanged via off-channel communications and the failure to implement or enforce adequate policies and procedures to ensure the retention of necessary records (as required under Advisers Act Rule 206(4)). Policy and procedural failures can include not having a system to follow-up with and review employee actions to confirm compliance with existing firm policies that would otherwise be sufficient.[4]

In 2018, as a precursor to these actions, the Office of Compliance, Inspections and Examinations at the SEC issued a risk alert notifying advisers of their record retention obligations regarding off-channel communications,[5] but, until now, the SEC had not brought an enforcement action against a standalone investment adviser.

What Happened Here

Senvest Management LLC (Senvest), a New York–based private fund manager, faced charges that it failed to maintain records of communications as required by the Advisers Act and failed to implement the firm's internal policies and procedures around recordkeeping.

According to the SEC, Senvest's employees sent thousands of internal and external messages using off-channel communications. The firm did not monitor or inspect the employees' messages and did not take any steps to collect and retain the communications. Multiple employees' personal devices were set to automatically delete messages, preventing Senvest and the SEC from being able to quantify the number and subject matter of the off-channel communications.

The SEC, perhaps intentionally, was vague as to what messages were actually covered by the scope of Advisers Act Rule 204-2(a)(7). In its published order, the SEC states that thousands of business-related messages were sent off-channel, and that "[n]umerous messages related to matters within the scope" of the rule.[6] The SEC's description does not provide any insight as to the SEC's view of the actual scope of the rule and which messages in particular violated it.

In addition to the recordkeeping violations, the SEC charged Senvest with failing to adopt and implement required written policies and procedures designed to prevent violations of the Advisers Act. Senvest had a record retention policy that only allowed off-channel communications in limited circumstances, and required that the communications be saved to internal systems as soon as possible, but it did not monitor or enforce compliance with the policy. As a result, the SEC found that Senvest violated Rule 206(4).

Under its settlement agreement with the SEC, Senvest was fined US$6.5 million, had to hire a compliance consultant and had to submit to evaluations and oversight. The SEC noted that Senvest had taken remedial efforts, including providing its employees with firm-issued cell phones that automatically upload data to the firm's archiving system.

1 SEC Order Instituting Cease and Desist Proceedings Against Senvest

2 SEC Order Instituting Cease and Desist Proceedings Against BofA Securities

3 2022 SEC Press Release for Recordkeeping Failures; 2024 SEC Press Release for Recordkeeping Failures

4 Order Instituting Cease and Desist Proceedings Against BofA Securities

5 OCIE Risk Alert- Electronic Messaging (2018)

6 SEC Order Instituting Cease and Desist Proceedings Against Senvest

What Family Offices Should Consider When Interacting with Investment Advisers

The SEC is showing no signs of de-emphasizing its enforcement of off-channel recordkeeping violations, and this enforcement action targeting a standalone RIA is a notable expansion to its prior enforcement practices. While the compliance obligation under the Advisers Act rests with the RIAs, and not their clients, family offices should be aware of this "hot button" compliance issue and should take steps to help protect themselves from being swept up in an SEC enforcement proceeding:

- Review current communication processes and practices to identify family office employees, family members or other family representatives who have direct contact with RIA or broker-dealer personnel
- Consider adopting guidelines or protocols for communications between family office employees, family members or other representatives and the family office's RIAs, so that lines of communication are understood by all parties
- Make certain that all family office employees, family members and other representatives are aware of the regulatory issues surrounding off-channel communications and, if appropriate, have a resource (within the family office or an external resource) to review any concerns or issues that may arise from communications with RIAs and broker-dealers.

Our Family Office Team will be monitoring the regulatory and enforcement developments in this space and regarding securities law compliance matters for family offices in general.

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