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SEC and CFTC Send $2 Billion Message Regarding Monitoring and Preserving Employee Electronic Communications

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If there is one thing the Securities and Exchange Commission (SEC) does well, it's identifying a discrete – and potentially common – violation of the federal securities laws and leveraging it into an enforcement sweep. On September 27, 2022 – just three days before the end of the agency's fiscal year – the SEC stamped out nearly identical settled orders against 15 Wall Street broker-dealers (and one affiliated investment adviser), imposing civil penalties totaling more than $1.1 billion stemming from the firms' failures to monitor and preserve employees' electronic communications. When combined with the Commodity Futures Trading Commission (CFTC)'s same-day announcement of parallel actions against 11 financial institutions with aggregate penalties of more than $700 million, and a similar action by both agencies in December 2021 against another global financial firm, financial regulators have now imposed more than $2 billion in penalties relating to failures to monitor and preserve electronic communications.

This client alert takes a deeper look at the SEC's recent recordkeeping sweep and offers practical tips for broker-dealers and asset managers to help minimize their exposure.

The Statutory Framework for Recordkeeping and Supervision

Section 17(a)(1) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 17a-4(b)(4) require broker-dealers to preserve originals of all communications received and copies of all communications sent relating to the firm's business. Lapses in monitoring, reviewing, and preserving business-related electronic communications also may subject broker-dealers to sanctions for failing reasonably to supervise their employees with a view to preventing or detecting employees' misconduct under Section 15(b)(4)(E) of the Exchange Act.

The recordkeeping requirements applicable to investment advisers are narrower in some respects, but still quite significant. Section 204 of the Investment Advisers Act of 1940 (Advisers Act) and Rule 204-2(a)(7) require investment advisers to preserve originals of all communications received and copies of all written communications sent relating to, among other things, any recommendation made or proposed to be made and any advice given or proposed to be given. Investment advisers that fail to monitor, review, and preserve electronic communications regarding investment advice also may face sanctions for failing reasonably to supervise employees with a view to preventing or detecting employees' violative conduct under Section 203(e)(6) of the Advisers Act.

Summary of the SEC's September 2022 Enforcement Sweep

The SEC's settled enforcement actions against 16 of the largest Wall Street firms can be analyzed and cited collectively because, except for minor fill-in-the-blank details alleged against each firm, the orders are nearly identical.[1]

The Likely Origin of the Enforcement Sweep and the SEC's Investigative Methodology

The orders made public what had been rumored for months -- "[i]n September 2021, the Commission staff commenced a risk-based initiative to investigate whether broker-dealers were properly retaining business-related messages sent and received on personal devices." The initiative appears to have originated after SEC enforcement staff learned that one or more firms had not produced all subpoenaed communications in

[1] https://www.sec.gov/news/press-release/2022-174

numerous investigations due to the failure to capture and preserve communications sent from personal devices.

This initiative was not likely labor-intensive for the SEC staff. The orders note that from each firm, the SEC staff simply "requested off-channel communications data from a sampling of approximately 30 broker-dealer personnel" at various levels of seniority over an almost four-year period from January 2018 through September 2021. By extrapolating data from this sampling, the SEC found that "nearly all of the individuals had engaged in at least some level of off-channel communications," and that in the aggregate, the sampled personnel had sent or received "thousands" or "tens of thousands" of off-channel or unapproved communications (including personal emails, chats, and other messages through text-messaging applications such as WhatsApp). Each of the orders cited at least two examples of pervasive off-channel business-related electronic communications by senior personnel (typically Managing Directors or higher) in investment banking and trading. The orders further emphasized off-channel communications between senior personnel and their subordinates, but also described communications with peers and personnel at other firms.

Firms Apparently Had Effective Policies and Procedures, But Failed to Implement Them

Each firm included in the SEC sweep appears to have had appropriate electronic communications policies and procedures, but the SEC alleged the firms failed to implement or enforce those policies in a meaningful way. The orders summarized the breakdowns as follows:

- "[E]mployees were advised that the use of unapproved electronic communications methods, including on their personal devices, was not permitted, and they should not use personal email, chats or text-messaging applications for business purposes, or forward work-related communications to their personal devices."
- "[Firm]-approved communications methods were monitored, subject to review, and when appropriate, archived," however, "[m]essages sent through unapproved communications methods, such as WhatsApp and those sent from unapproved applications on personal devices, were not monitored, subject to review, or archived."
- Each firm had employee and supervisory training regarding approved and unapproved communications channels, and required that employees periodically self-attest to having reviewed and/or complied with the firm's recordkeeping requirements.
- However, the orders find that each of the firms "failed to implement sufficient monitoring to assure that its recordkeeping and communications policies were being followed," resulting in the tens of thousands of off-channel communications described above, and the firms' failure to monitor or preserve those electronic communications.

The SEC and CFTC Imposed Severe Sanctions

Through the severe sanctions imposed in the orders and the press release announcing the sweep, the SEC sent a clear message regarding the importance of preserving business-related electronic communications and the agency's lack of tolerance for the pervasive violations that it found at the largest Wall Street firms. The settled orders included the following relief:

- **More than $2 billion in civil penalties**: the SEC imposed penalties of $125 million against nine firms (and five affiliates); two firms were fined $50 million; and one firm was fined $10 million. The CFTC imposed a $100 million penalty against one firm; $75 million dollar penalties against 7 firms; and penalties ranging from $6 million to $50 million against three firms.
- **Admissions**: in an unusual departure from most SEC "no-admit no-deny" settlements, each firm admitted the predicate facts set forth in their respective orders and that their conduct violated the federal securities laws.

- **Cease-and-Desist Orders and Censures**: the SEC ordered each broker-dealer to cease-and-desist from committing or causing violations of Section 17(a) of the Exchange Act and Rule 17a-4 and imposed censures. Also, one affiliated investment adviser was ordered to cease-and-desist from committing or causing violations of Section 204 of the Advisers Act and Rule 204-2.[2]
- **Independent Compliance Consultants**: each firm agreed to retain an ICC within 90 days to conduct comprehensive compliance reviews concerning the firm's electronic communications preservation policies and procedures, and subject to certain caveats, to adopt those recommendations within 90 days. Specifically, the ICCs are to assess and make recommendations regarding:
    - Comprehensive policies and procedures to ensure the review and preservation of business-related electronic communications;
    - Employee training, including *quarterly* personal certifications of compliance;
    - Enhancement of electronic communications surveillance measures;
    - The acquisition and implementation of additional technological solutions to meet the electronic communications recordkeeping requirements, including tracking employee usage of these technologies/platforms going forward;
    - Enhancement of measures to prevent the use of unauthorized communications channels by employees, including technological and/or behavioral restrictions; and
    - Frameworks for handling employees' non-compliance with electronic communications usage and preservation policies, including corrective actions, disciplinary measures, and ensuring consistent application of discipline across business lines and seniority levels.
- **Cooperation and Prompt Remediation:** the sanctions set forth in the orders also are notable because, in agreeing to accept the settlements, the SEC purportedly took into account the firms' prompt remediation and cooperation during the respective investigations. Two of the orders went beyond the one-sentence boilerplate language regarding remediation and cooperation often seen in SEC orders and described specific remedial or past disciplinary efforts by the firms,[3] including:
    - Clarification of the firm's application of relevant policies and widely providing *specifically-focused training*;
    - Clear messaging from senior management regarding the use of unauthorized communication channels;
    - Enhancement of surveillance protocols regarding potential off-channel communications, and the regular communication of surveillance findings to supervisors and business units;
    - Prompt disciplinary actions taken against employees for violations of off-channel communications policies, including compensation and promotion impacts, and termination; and
    - Significant investments in new technologies to facilitate compliant communications.

Key Takeaways

In the SEC's September 2022 press release announcing the sweep, Gurbir Grewal, the SEC's Director of

[2] https://www.sec.gov/litigation/admin/2022/34-95928.pdf

[3] https://www.sec.gov/litigation/admin/2022/34-95928.pdf; https://www.sec.gov/litigation/admin/2022/34-95924.pdf

Enforcement, predicted the likelihood of additional enforcement actions in this area by calling the recordkeeping requirements "sacrosanct," and warning that "broker-dealers and asset managers who are subject to similar requirements under the federal securities laws would be well-served to self-report and self-remediate any deficiencies." We understand that the SEC's examination staff recently requested that numerous investment advisers produce policies, procedures, and other information reflecting their retention of electronic communications, including potential "off-channel" communications.

It remains to be seen whether SEC enforcement will initiate a self-reporting initiative regarding electronic communications recordkeeping, and registrants should consult with counsel and carefully weigh their unique facts and circumstances before self-reporting any potential violations to the SEC staff. That said, remediation of problems regarding electronic communication preservation brings to mind a popular Chinese proverb: "The best time to plant a tree was 20 years ago. The second best time is now."

To minimize exposure, the undertakings and remedial measures summarized above set forth a basic roadmap of how the SEC envisions that firms can remediate perceived recordkeeping and supervisory failures going forward. Because many of these remediation efforts are more easily said than done, we offer some additional practical tips:

- Given the pervasive use of personal devices by employees of all ages and levels of seniority, it's important to have a candid internal sampling to determine the extent to which firm personnel have used WhatsApp, personal emails, chats, or text-messaging applications for business-related communications. While it may be difficult to achieve 100% compliance with these policies, given the SEC's emphasis on tone at the top and lapses by senior personnel, compliance by senior personnel is particularly important.
- The SEC appears willing to give some credit for direct compliance messaging by registrants' senior leadership. The SEC's recent enforcement sweep provides a good opportunity for senior management to reiterate and reinforce electronic communications policies and procedures to all employees.
- Consider conducting training specifically devoted to existing (and possibly enhanced) electronic communications review and preservation policies and procedures. Also consider requiring quarterly certifications of compliance by all employees.
- The surveillance of possible unauthorized electronic communications channels presents extraordinary practical challenges and requires careful balancing of employees' expectations of privacy regarding their personal devices. Outside counsel and consultants may be valuable in helping navigate these issues.
- Where financially feasible, firms should explore technological solutions to meet the electronic communications recordkeeping requirements, including tracking employee usage of these technologies/platforms going forward. Again, this is easier said than done. However, requiring employees to use specific technology solutions/platforms is critical to maintaining effective surveillance and reducing compliance costs and enforcement risk going forward.

The collection, review and preservation of electronic communications presents daunting challenges for all legal and compliance practitioners. However, in light of the SEC's recent enforcement sweep, we expect continued examination and enforcement scrutiny of broker-dealers and investment advisers for potential recordkeeping and supervisory violations. If your firm is facing an inquiry in this area, or you would like more information on how to minimize your firm's exposure, please contact one of the following Haynes Boone lawyers.

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