Financial Cos. At Risk In Feds' Off-Channel Messaging Sweep

By **Michael Gilbert, Kate Rumsey and Christopher Bosch** (June 28, 2023)

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Over the last several years, the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission have been laser-focused on the use of so-called off-channel communications in the financial services industry.

On the theory that employees' use of personal devices to communicate about business matters violates the books and records rules, as these communications are not saved in company systems, regulators have conducted intrusive and extensive investigations, requiring employees to turn over their personal devices for review.

SEC Chair Gary Gensler recently stated that "bookkeeping sweeps are ongoing," having resulted in well over $1 billion in fines so far. While the first round of investigations focused on the large banks, this sweep has since spread to hedge funds, credit rating agencies, online banking platforms and regional banks.

Any entity regulated by the SEC or CFTC should be prepared for the significant possibility that regulators will inquire about employees' use of off-channel communications to conduct business. For entities that have not already reviewed their policies and procedures related to communications, they should do so immediately.

This article analyzes the pertinent rules and history of the off-channel communications sweep, and reviews best practices.

The Rules

Broker-Dealers

The rules adopted under Section 17(a)(1) of the Exchange Act, including Rule 17a-4(b)(4), require that broker-dealers preserve in an easily accessible place originals of all communications received and copies of all communications sent relating to the firm's "business as such."

Investment Advisers

The rules adopted under Section 204 of the Advisers Act, including Advisers Act Rule 204-2(a)(7), require that investment advisers preserve in an easily accessible place originals of all communications received and copies of all written communications sent relating to, among other specified categories, "any recommendation made or proposed to be made and any advice given or proposed to be given" and the "placing or execution of any order to purchase or sell any security."

Swap Dealers and CFTC Registrants

Sections 4g and 4s of the Commodity Exchange Act, and the regulations implemented thereunder, require that swap dealers and other CFTC registrants retain comprehensive

records of their business-related communication.

Electronic communications include, but are not limited to, email, text messages, messaging apps, instant messages, Bloomberg messaging and private messaging on social media sites.

History of Regulatory Action on Off-Channel Communications

The first major regulatory action based on off-channel communications was announced in December 2021, when the SEC and CFTC fined JPMorgan Chase & Co. $200 million for widespread off-channel communications.

In September 2022, the SEC and CFTC fined 11 investment banks, which collectively paid $1.8 billion in fines, and which each agreed to certain compliance requirements. Those requirements include hiring a compliance consultant; submitting to a one-year compliance evaluation; a comprehensive review of policies and training; assessing a surveillance program; and considering technology solutions for surveillance.

It has been publicly reported that, as part of these investigations, regulators have required a review of the personal devices for a sample pool of employees, the results of which showed that certain employees were engaging in off-channel business communications.

At some investment banks, the SEC found that the violations were firmwide, that supervisors used their personal devices to discuss business with subordinates and clients, and that there was a culture of noncompliance. The SEC also found, in some cases, that while banks had policies on record retention, there was a failure to implement systems of followup and review.

In the context of large fines and regulatory focus, some entities have chosen to voluntarily report violations, instead of waiting to hear from the regulators, in the hope of more lenient treatment. But the benefits of self-reporting to the SEC and CFTC prior to being caught up in this sweep remain to be seen.

For example, in May 2023, the SEC settled with two broker-dealers who apparently self-reported off-channel violations.[1] The agency found that supervisors engaged in off-channel communications with subordinates and that there was widespread failure to implement policies that prohibit such communications. The entities paid $15 million and $7.5 million, respectively, in fines.

The SEC touted that this self-reporting prior to SEC contact led to reduced fines. But the self-reporting broker-dealers were also required to engage a compliance consultant, conduct a one-year evaluation and report for two years to the SEC.

The SEC's emphasis on compliance is consistent with the U.S. Department of Justice's latest corporate prosecution policies, which promise fewer fines and avoiding prosecution in exchange for cooperation, compliance and self-reporting.[2] The DOJ has also created a clawback pilot program to tie compliance with compensation, and to claw back compensation from corporate wrongdoers.[3]

Takeaways

Following the settlement with the large banks, the regulators have moved to hedge funds, private equity firms, ratings agencies, online banks and regional banks.

This off-channel sweep is a novel regulatory investigation for which there is little guidance. The process inevitably involves the highly sensitive process of obtaining personal cell phones from employees, and reviewing their private communications to identify those that fall within the scope of the regulators' requests.

Companies regulated by the SEC or CFTC that have not yet been subject to the off-channel sweep should review their policies and conduct training. When violations occur, business-related messages should be immediately preserved on the business's system.

No company can monitor all communications on employees' personal devices. But, companies can ensure that they have robust policies in place, and take steps to ensure compliance. Managing this risk — given the robust regulatory interest — is critical.

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[1] https://www.sec.gov/news/press-release/2023-91.

[2] https://www.justice.gov/usao-edny/press-release/file/1569406/download.

[3] https://www.justice.gov/opa/speech/file/1571906/download.