

THE OFF-CHANNEL COMMUNICATIONS SWEEP MAY BE GOING OFFLINE

By Brian Briz & Allison Kernisky*

The U.S. Securities and Exchange Commission (“SEC”)’s and U.S. Commodities Future Trading Commission (“CFTC”)’s recent wave of enforcement actions concerning so-called “off-channel communications” appears to be coming to an end.

Background

The SEC and CFTC impose recordkeeping requirements over entities and individuals they regulate.

Rule 17a-4(b)(4) of the Securities Exchange Act of 1934 (“Exchange Act”) generally obligates exchange members and registered broker dealers to maintain originals of all communications received and copies of all communications sent by them in an easily accessible format. Registered investment advisors are subject to similar, albeit narrower, record retention requirements under Rule 204-2(a)(7) of the Investment Advisors Act of 1940 (“Advisers Act”).

Similarly, commission merchants, retail foreign exchange dealers, introducing brokers, and members of a designated contract market or of a swap execution facility are required to keep records of their business of dealing in

commodity interest transactions and related cash or forward transactions in a reliable manner under Commission Regulations 1.31(c) and 1.35(a). Swap dealers are subject to similar requirements under Commission Regulations 23.201(a) and 23.202(a)(1) and (b)(1).

In 2021, the SEC and the CFTC began investigating financial institutions’ off-channel communications, and specifically, text and instant messages sent and received by employees on their personal devices. Since then, over 100 entities—including broker dealers, investment advisors, introducing brokers, swap dealers, futures commission merchant affiliates, municipal advisors, and credit rating agencies—have been charged with violations of the aforementioned recordkeeping requirements, and have paid collectively over \$3 billion in civil penalties.

Civil Penalties Continued to Rack Up in 2024

The SEC and CFTC did not slow down with their investigations in 2024, with the SEC announcing that it remains committed to ensuring compliance with the recordkeeping requirements under the federal securities laws, which are “essential to investor protection and well-functioning markets.”¹ In 2024, the SEC charged over 60 firms with recordkeeping violations and obtained civil penalties totaling over \$560 million combined.

The range of civil penalties assessed in 2024 varied greatly, from \$50 million on the high end to less than \$50,000 on the low end, but in all,

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were generally lower than in prior years, when the largest penalties reached \$200 million. In one instance last year, no civil penalty was assessed (as described in further detail below).

The agencies assessed the largest penalties against firms that acknowledged that their personnel—including supervisors and senior managers—sent and received off-channel communications that were required to be maintained, but that were not maintained or preserved, depriving the SEC of its ability to review the communications in its investigations. In some instances, the SEC also charged certain firms with failing to reasonably supervise with a view of preventing and detecting recordkeeping violations. The SEC explained that “widespread and longstanding” noncompliance, especially failures that potentially hindered the SEC’s investor protection function by compromising a firm’s response to SEC subpoenas, may result in “robust” civil penalties.²

On the other hand, firms that self-reported and cooperated with the SEC’s investigations generally received significantly reduced penalties. For example, according to the SEC, the firm that received a no-penalty resolution took “substantial steps to comply” with the recordkeeping requirements, and perhaps most importantly self-reported, cooperated, and remediated its violations.³

At the Securities Enforcement Forum held on November 6, 2024, the Acting Director of Enforcement, Sanjay Wadhwa, touted the success of what he dubbed the “WhatsApp initiative” and explained some of the factors that Enforcement considers when assessing what penalties to recommend, if any, including: the size of the firm, the scope and scale of the violations, precedent, compliance efforts, self-reporting and other remedial measures.⁴ As Wadhwa explained, from his perspective, the initiative “shone a light on how widespread noncompliance was” and that “the best measure of success of the initiative is how it has changed industry behavior and spurred proactive compliance by market participants.”

What’s in Store for 2025?

On January 13, 2025, the SEC announced charges against nine investment advisors and three broker-dealers for violating the recordkeeping provisions of the federal securities laws, and the firms agreed to pay a collective \$63.1 million and implement improvements to address the violations. This may be one of the final set of settlements announced involving these types of violations. For many, the expectation is that the SEC may greatly reduce, if not end entirely, its investigations into off-channel communications following the new administration taking office on January 20, 2025.

Indeed, two of the SEC Commissioners at the time, Hester Peirce and Mark Uyeda (he has since been named Acting SEC Chair), issued a statement on September 24, 2024, urging their colleagues to “reconsider our current approach to the off-channel communications use” because the use of such communications is prevalent and thus “even well-intentioned firms could find themselves in the Commission’s queue time and time again.”⁵ Accordingly, they have called for the SEC to work with the industry and the public to develop a “pragmatic and privacy-respecting approach” that allows the SEC and firms to maintain the records that they need “at a reasonable cost in both financial and privacy terms.”⁶

Additionally, Paul Atkins, the nominee for SEC Chair who is awaiting confirmation to replace former Chair Gary Gensler, has generally called for an overhaul of the SEC’s enforcement approach, and has specifically identified the off-channel communications investigations as an area where the SEC has pushed the envelope.⁷

On the CFTC front, the newly appointed Acting Chairman of the CFTC, Caroline D. Pham, has also been critical of the CFTC’s off-channel communications cases and issued dissenting statements in two of them. In her first dissenting statement, she noted that in the three cases brought against introducing brokers, two of the introducing brokers had since de-registered

with CFTC and she questioned whether that was coincidental.⁸ Pham concluded that the “CFTC should be promoting greater access to markets—not limiting access.”⁹ In the second dissent, Pham opined that the CFTC was piggybacking off of the SEC’s investigations and “swerve[ing] out of the CFTC’s lane into the securities markets.”¹⁰

Given the above, it appears that the SEC’s and CFTC’s ongoing off-channel communications sweep is likely wrapping up, along with the hefty civil penalties that came with it.

ENDNOTES:

¹SEC Release 2024-98.

²SEC Release 2024-144.

³*Id.*

⁴Wadhwa’s full remarks are available at: https://www.sec.gov/newsroom/speeches-statements/wadhwa-remarks-securities-enforcement-forum-110624#_ftnref4.

⁵*See* A Catalyst: Statement on Qatalyst Partners LP, Commissioner Hester M. Peirce and Commissioner Mark T. Uyeda (Sept. 24, 2024), <https://www.sec.gov/newsroom/speeches-statements/statement-peirce-uyeda-qatalyst-09242024>.

⁶*Id.*

⁷Atkins’ remarks were made at a panel discussion held at the Federalist Society’s Annual Executive Branch Review Conference held on April 16, 2024. A transcript of the panel discussion can be found at: <https://fedsoc.org/conferences/twelfth-annual-executive-branch-review-conference-ebxii#agenda-item-luncheon-panel-u-s-financial-regulation-principles-opportunities-and-challenges>.

⁸*See* Dissenting Statement of Commissioner Caroline D. Pham on Off-Channel Communications Matter (Aug. 14, 2024), <https://www.cftc.gov/PressRoom/SpeechesTestimony/phamstatement081424>.

⁹*Id.*

¹⁰*See* Dissenting Statement of Commissioner Caroline D. Pham on Off-Channel Communications Enforcement Action (Sept. 23, 2024), <https://www.cftc.gov/PressRoom/SpeechesTestimony/phamstatement092324>.

