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SEC Penalties for Off-Channel Communications: Still Blowing in the Wind

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The SEC has increased its enforcement efforts against firms that are registered as broker-dealers and/or investment advisers for alleged violations of federal securities laws involving “off-channel communications.” Such communications generally include those made by firm personnel through means other than official firm accounts or firm-approved platforms and include communications via firm employees’ personal accounts or devices. Generally, the SEC prohibits broker-dealers from engaging in such communications through broad record-keeping requirements imposed pursuant to Rule 17a-4 under the Securities Exchange Act of 1934. Registered investment advisers are subject to more narrow record retention requirements pursuant to four categories enumerated in Rule 204-2(a)(7) under the Investment Advisers Act of 1940. Since 2021, the SEC has charged approximately 60 firms with off-channel record-keeping violations and imposed approximately $2.7 billion in fines and penalties against such firms. The amount of these fines and penalties, however, does not appear to reliably follow any statutory guideline or consistent method of analysis and application. At the SEC Speaks Conference in June 2024, Deputy Director of Enforcement Sanjay Wadhwa stated that the staff assesses the facts and circumstances on a case-by-case basis to determine a penalty to recommend to the commission. Wadhwa provided the following six factors the Enforcement Division generally considers: (1) self-reporting, which is “the most significant factor in terms of moving the needle on penalties”; (2) cooperation — a firm that cooperates during the investigation “can still receive credit,” even if it does not self-report; (3) size of the firm — the SEC assesses a firm’s revenue and its number of registered professionals to ensure that the penalties are large enough to serve as an adequate deterrent against future violations; (4) scope of the violations, including how many individuals communicated off-channel and the total number of off-channel communications; (5) a firm’s efforts to comply with record-keeping obligations and its remedial efforts; and (6) precedent established by the SEC’s orders on these matters, which serve as a “guide,” though they are “not determinative.” Despite these guidelines, fines for off-channel communications appear inconsistent and surprisingly high, especially because the SEC has not alleged any actual fraud, customer harm, or ill-gotten gains by the firm or its personnel in connection

with these violations. Such an allegation could justify the imposition of significant penalties under the various statutes that set forth the maximum penalties that the SEC may impose in administrative proceedings based on "each act or omission" violating the securities laws. The penalty statutes set forth three enumerated tiers the SEC must observe in recommending penalties, although the SEC is not necessarily wed to complying with this tier structure in settlement negotiations. Tier 1, being the least severe, applies to any violation; Tier 2 applies to violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of regulatory requirements; and Tier 3 applies to violations that also involve a substantial risk of loss to others or gain to the violator. Given the apparent absence of such fraud or substantial risk, the violations alleged in the settled off-channel communication cases should constitute Tier 1 violations, for which the maximum penalty is $111,614 per violation. Yet, a study sampling 16 settlements of such record-keeping violations reveals a range of penalties from $10 million to $125 million. Accordingly, the study suggested, the dollar amount of these penalties would imply that the SEC has identified 89 to 1,110 Tier 1 violations in connection with the settlements — though no official statement indicates as much. Compounding the ambiguity of the SEC's decision-making process in imposing penalties for such record-keeping violations is the lack of transparency on (a) how the SEC weighs and applies the six factors the Enforcement Division considers and (b) what the commission considers to be "each act or omission." Unless and until the commission or its staff provides more clarity on such matters, firms may have an understandable concern that, like the wind, the SEC's imposition of penalties for alleged off-channel communication violations is unfortunately inconsistent and unpredictable.

Authored By

Natalie A. Napierala

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