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Insights

REGULATORS IMPOSE EXTRAORDINARY FINE AMOUNTS IN RECENT OFF-CHANNEL COMMUNICATIONS ENFORCEMENT ACTIONS

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The Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA") have, in two separate recent settled enforcement actions involving off-channel communications ("OCC"), imposed fine amounts that are extraordinary and border on the punitive. One of these matters involved a first-of-its-kind OCC case against a stand-alone investment adviser ("IA"). The other matter involved a small broker-dealer with apparently modest financial resources. Both of these cases are reminders that regulators continue to vigorously investigate, and pursue enforcement actions against, financial firms in the OCC area.

The SEC's Order against the stand-alone IA, Senvest Management LLC ("Senvest"), was issued on April 3, 2024. The SEC imposed a financial penalty of $6.5 million against Senvest. Around the same time, Senvest filed its Form ADV, Part 2A annual update, and identified that it had nearly $3.7 billion in assets under management. While Senvest's annual revenue and income figures are not readily ascertainable, such a fine on a firm with modest AUM figures is breathtaking. To put these figures in perspective, a similar ratio between fine and AUM would result in a fine of nearly $88 million for a firm with $50 billion in AUM.

The SEC's factual findings in Senvest should also give compliance professional pause. Most disturbingly, the SEC noted that "Senvest's policies and procedures also permitted the firm to access employees' personal devices to review for any off-channel communications". However, Senvest's failure to "access employees' personal devices to determine whether they were complying with the firm's communications policies" was itself found to be a record-keeping failure under the Investment Advisers Act of 1940 ("the Advisers Act"). This finding should cause firms to evaluate (and perhaps re-assess) their policies-and-procedures in this area.

Equally troubling is the SEC's finding that "three senior Senvest officers had their personal devices set to automatically delete messages after 30 days". Many people use such a mechanism, to help manage their electronic communications. However, the SEC implied (without making an explicit finding) that use of such a mechanism impeded the SEC's investigation of Senvest.

The SEC also declined to articulate differences (subtle or otherwise) between the record-keeping obligations under the Advisers Act and those under the 1934 Exchange Act ("the Exchange Act") applicable to broker-dealers. The Exchange Act's record-keeping requirements on broker-dealers applies to communications pertaining to the firm's "business as such" – regulators have interpreted this to cover all business communications. The Advisers Act requirements are narrower and more prescriptive, applying principally to: (1) recommendations or advice, (2) receipt or disbursement of funds or securities, and (3) placing or execution of orders. Given that this was the first case against a stand-alone IA, the SEC could have provided examples of the types of written communications found violative in Senvest, or identified in general terms the types of written communications IAs are required to capture, retain and review. Instead, the SEC in Senvest simply found that "Senvest employees sent and received thousands of business-related messages using off-channel communications".

In the end, the Senvest Order provides more questions than answers. One thing is clear though – the SEC is going to bring record-keeping cases against stand-alone IAs.

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Two days after the SEC issued the Senvest order FINRA, not to be outdone, released its own enforcement action containing arguably punitive outcomes. In the Dawson James Letter of Acceptance, Waiver and Consent ("AWC"), FINRA fined the broker-dealer $500,000, and noted that it "imposed a lower fine in this case after it considered, among other things, Dawson James' revenues and financial resources." FINRA's opening demand in the matter was reportedly over $1.5 million. Further, FINRA suspended the Chief Executive Officer (CEO) for one month in all capacities and fined him $10,000.

Such sanctions are deeply concerning, given the size of the firm and scant information regarding the alleged underlying misconduct. The AWC recites that the firm has 35 registered representatives and three branch offices. The AWC further recites no prior disciplinary matters, against the firm or CEO, that were considered in assessing sanctions. This background information, indicating a small firm, suggests a fine of perhaps $50,000-$75,000 would have been appropriately remedial. *See* FINRA By-Laws, Article I ("(ww) "Small Firm" means any broker or dealer admitted to membership in the Corporation which, at the time of determination, has at least 1 and no more than 150 registered persons…").

The underlying facts in the Dawson James AWC similarly do not recite egregious underlying misconduct justifying the fine level and suspension of the CEO. The crux of the case involved Dawson James' failure to "capture, retain and review over 10,900 business-related text messages sent or received by at least 27 associated persons." However, this was over a period of approximately 112 months – or roughly 100 texts per month, hardly an eye-popping number. More importantly, no context is given to the 10,900 texts. While the AWC recites that the messages included communications about: (1) the firm's net capital computations, (2) customer complaints,

and (3) certain securities transactions, no additional information is provided regarding whether these examples were the typical business-related communication or instead a rarity. Consequently, it is hard to know whether firm personnel were frequently texting about topics that were unquestionably the firm's "business as such," or instead topics that fell into gray areas like location for a meeting or discussions about potential recruits.

Likewise, the AWC contains scant information regarding the CEO's alleged misconduct. All that can be gleaned is that he "used his firm-issued mobile phone to send and receive approximately 4,400 businenss-related text messages." It is quite possible that, by using his firm-issued mobile phone for communications, the CEO believed (at least for part of the 10-year period at issue) that the communications were being properly captured. Moreover, and again, no additional information or context is given regarding the nature or type of these "business-related text messages."

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These recent cases serve as a reminder that regulators have imposed, and will continue to impose, stiff sanctions in the OCC space. We anticipate similar future cases in which arguably punitive fines are imposed and executives named in the enforcement actions, with little background or contextual information about the underlying communications, actors or facts.

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