SULLIVAN & CROMWELL LLP

S&C memo

September 26, 2024

SEC Resolution Spotlights Implications of Self-Reporting and Violations of Firm Communications Policies

In an Order Imposing No Monetary Penalty, the SEC Censured a Broker-Dealer for Failing to Implement Sufficient Monitoring to Ensure Policies Were "Always" Being Followed

SUMMARY

On September 24, 2024, the Securities and Exchange Commission ("SEC") announced charges against 12 broker-dealer and investment advisor firms for the alleged failure to preserve electronic communications on mobile devices that were required to be preserved under SEC recordkeeping regulations, including an order censuring but declining to impose a penalty on one firm, Qatalyst Partners LP ("Qatalyst").[1] The charges are the latest in a series of SEC resolutions relating to employee usage of unapproved platforms for business communications, including on personal mobile devices. The SEC imposed civil penalties on 11 other firms for a total of $88,225,000. Consistent with many of the prior resolutions in this space, 11 resolving firms admitted to "widespread" non-compliance, undertook to retain an independent compliance consultant, and committed to certain other undertakings.[2]

The resolution with Qatalyst is of particular interest. According to the allegations in the order, Qatalyst began implementing measures to support compliance with communications recordkeeping requirements as early as 2008, and was an early adopter of technology to support the use and preservation of text messages for business communications—years before the SEC's first enforcement action in this area.[3] Qatalyst voluntarily initiated an investigation, self-reported its findings to the SEC, disciplined relevant personnel, and proactively identified key documents and facts to the SEC.[4] Qatalyst's investigation allegedly identified only that a "small number" of employees had off-platform communications, in contrast to the "widespread"

non-compliance alleged in the other SEC orders announced at the same time.[5] The SEC did not impose a penalty or require any undertakings by Qatalyst. Nevertheless, the SEC brought recordkeeping and supervision charges against Qatalyst, and the firm was censured. Despite finding that Qatalyst had policies and procedures designed to support compliance with recordkeeping requirements, the SEC concluded that the firm "failed to implement sufficient monitoring to ensure that its recordkeeping and communications policies and procedures were *always* being followed."[6] The action prompted a critical statement from Commissioners Hester M. Pierce and Mark T. Uyeda,[7] and indicates that the risk of SEC enforcement exists even where firms take proactive measures, identify discrete non-compliance, and self-report to the SEC.

BACKGROUND

The charges announced on September 24, 2024 are the latest among a series of recordkeeping enforcement actions brought by the SEC since December 2021.[8] These resolutions have involved "off-platform" or "off-channel" communications on mobile devices by employees, which refer to methods of communication that are *not* approved by firm policy (*e.g.*, texting, WhatsApp, or other messaging applications) for use in connection with firm business. In contrast to communications occurring on approved platforms, off-platform communications are unable to be preserved or surveilled according to firms' typical retention practices.

The SEC has brought enforcement actions in this space against different types of registrants, including broker-dealers,[9] investment advisors,[10] municipal advisors,[11] and ratings agencies.[12] The SEC orders charge violations of the applicable recordkeeping provision, as well as the failure to reasonably supervise personnel.

To date, the SEC has imposed at least $2.25 billion on 116 firms, including the 12 firms and $88,220,000 in penalties on September 24, 2024. The largest penalty has been $125 million. The SEC Division of Enforcement Staff has repeatedly stated that firms who self-report violations may receive a reduced penalty, and the SEC has expressly credited self-reporting as the reason for lower penalties for certain firms.[13]

In addition to penalties, the SEC has required resolving firms to undertake certain reporting and remediation measures. Specifically, the SEC has required most broker-dealer and investment advisor firms to retain an independent compliance consultant to perform a "comprehensive compliance review" of the firm's program with respect to the preservation of electronic communications; this review must cover, among other things, the firm's (i) policies and procedures, (ii) training, (iii) surveillance program measures and communications surveillance routines, (iv) technological solutions, (v) measures to prevent the use of unapproved communications methods, and (vi) disciplinary framework for addressing instances of non-compliance.[14] The consultant must submit a written report of its findings to the SEC, and conduct a further assessment one year after the initial written report. Firms have also been required to report to the SEC each instance

of discipline imposed for violations of policies and procedures concerning the preservation of electronic communications, and to conduct an internal audit of relevant compliance matters, among other things.[15]

The Commodity Futures Trading Commission ("CFTC") has also brought charges against swap dealers, futures commission merchants, and other entities for violations of the CFTC's recordkeeping and supervision requirements in connection with the failure to preserve certain written communications. In many cases firms have resolved recordkeeping and other related charges with the SEC and the CFTC in parallel.

SEPTEMBER 24, 2024 SEC ORDERS

On September 24, 2024, the SEC announced 10 orders against 12 firms (some of which were affiliates covered by the same order). Nine of the orders involved similar charges, allegations, and undertakings as prior SEC orders in this space. These firms acknowledged that their recordkeeping failures were "widespread."[16] The penalties imposed varied significantly, ranging from $35 million to $325,000.[17] Two firms that self-reported violations to the SEC received "significantly lower civil penalties than they would have otherwise."[18] The undertakings were similar as previous SEC orders, including the retention of the independent compliance consultant. One of the firms entered into a separate recordkeeping and supervision resolution with the CFTC, in which it agreed to pay a $30 million penalty.[19]

The resolution with Qatalyst is distinct in several respects. Although Qatalyst was censured, it is just the second firm to resolve recordkeeping and supervision charges for off-platform communications with the SEC to date without being required to pay any penalty, retain a consultant, or commit to any other undertakings (following an order against Atom Investors LP ("Atom") one day earlier on September 23, 2024).[20] According to the order, Qatalyst self-initiated an internal investigation into communications practices, imposed discipline on relevant personnel, self-reported its findings to the SEC, and proactively identified key documents and facts for the SEC.[21] Whereas the SEC alleged "widespread" recordkeeping failures for the other firms,[22] Qatalyst's investigation identified that only "a small number" of personnel had off-platform communications relating to broker-dealer business.[23] The order also described Qatalyst's early steps to support compliance, which included (i) advising personnel on the prohibition against off-platform business communications as early as 2008, (ii) being an early adopter of technology to support compliant text messaging in 2017, (iii) requiring all personnel to use a firm-issued device for all work communications beginning in 2020, (iv) reinforcing the consequences of non-compliance with firm communications requirements, (v) trainings, and (vi) mandatory attestations of compliance with firm policy.[24] The order further noted that Qatalyst had issued discipline to at least 17 employees "at all levels of seniority" for violations of communications-related policy requirements.[25]

Although the SEC declined to impose a penalty based on Qatalyst's "self-policing, self-report, prompt remediation, and cooperation,"[26] the SEC nonetheless ordered Qatalyst to cease and desist from violations and censured the firm. The SEC found that, notwithstanding the proactive measures described in the order,

Qatalyst "failed to implement a system reasonably expected to determine whether *all* personnel, including supervisors, were following Qatalyst's policies and procedures."[27] The SEC further found that Qatalyst "failed to implement sufficient monitoring to ensure that its recordkeeping and communications policies and procedures were *always* being followed."[28]

IMPLICATIONS OF QATALYST RESOLUTION

The Qatalyst resolution provides insight into the SEC's approach to enforcement of recordkeeping requirements in the context of off-platform communications. On the one hand, the resolution confirms that, in certain circumstances, the SEC may consider resolving violations without a penalty or other undertakings. On the other hand, it also indicates that the SEC may consider taking enforcement action against and censuring firms who self-report relatively discrete violations of SEC recordkeeping requirements, even where significant compliance measures and/or remediation has already been adopted. Even where there is no penalty, charged violations of the securities law may still trigger collateral consequences in some circumstances (*e.g.*, statutory disqualification), and the effect of any such consequences must be considered. In addition, censure may form part of a firm's record considered in the context of future enforcement proceedings. The basis for liability alleged in the order includes the failure to implement monitoring that could ensure relevant policies and procedures were "*always*" being followed,[29] which presents a very challenging standard.

Two SEC Commissioners, Hester M. Pierce and Mark T. Uyeda, released a statement confirming that they voted against the Qatalyst order, and raising concerns with the SEC's approach to off-platform communications matters.[30] Commissioners Pierce and Uyeda contrasted the widespread scope of non-compliance that resulted in prior SEC orders with the allegations against Qatalyst, and stated that "[u]nder the standard applied in this case, even well-intentioned firms could find themselves in the Commission's enforcement queue time and time again."[31] They criticized the Qatalyst order for "equat[ing] reasonableness with perfection," and added that firms "will never escape our enforcement net" if the SEC "assess[es] reasonableness based on whether policies and procedures always are being followed."[32] Commissioners Pierce and Uyeda identified several points for further consideration, including (i) clarifying requirements under the existing rules, (ii) modernizing recordkeeping rules to reflect new technologies and habits, (iii) excluding from requirements the types of conversations that would previously have occurred in oral form, (iv) the need to accommodate client communication preferences, (v) clarifying best practices for training and monitoring of communications, including in ways that respect employment and privacy laws, and (vi) the value of a Chief Compliance Officer Advisory Committee at the SEC.[33]

While the statement from Commissioners Pierce and Uyeda identifies areas of disagreement, firms should nonetheless bear the Qatalyst precedent in mind when assessing their compliance risk and potential employee communications practices. The Qatalyst order provides further evidence supporting the SEC's

position that self-reporting is a means for reducing or eliminating a potential penalty, but reemphasizes that the risk of an enforcement action cannot be eliminated even when such measures are taken.

* * *

ENDNOTES

1 "Eleven Firms to Pay More Than $88 Million Combined to Settle SEC's Charges for Widespread Recordkeeping Failures," Sept. 24, 2024, SEC Press Release No. 2024-144, *available at* https://www.sec.gov/newsroom/press-releases/2024-144 ("Sept. 24 Press Release"); *In the Matter of Qatalyst Partners LP*, SEC No. 3-22167, Sept. 24, 2024 ("Qatalyst Order").

2 *See, e.g.*, *In the Matter of Invesco Distributors, Inc. and Invesco Advisors, Inc.*, SEC No. 3-22165, Sept. 24, 2024, at ¶¶ 2, 5, 35-41 ("Invesco Order"); *In the Matter of CIBC World Markets Corp. and CIBC Private Wealth Advisors, Inc.*, SEC No. 3-22160, Sept. 24, 2024, at ¶¶ 2, 5, 33-39 ("CIBC Order").

3 Qatalyst Order, at ¶¶ 12-21.

4 Qatalyst Order, at ¶ 3.

5 Qatalyst Order, at ¶ 4.

6 Qatalyst Order, at ¶¶ 12, 22 (emphasis added).

7 Commissioner Hester M. Pierce & Commissioner Mark T. Uyeda, "A Catalyst: Statement of Qatalyst Partners LP," Sept. 24, 2024, *available at* https://www.sec.gov/newsroom/speeches-statements/statement-peirce-uyeda-qatalyst-09242024?utm_medium=email&utm_source=govdelivery ("Pierce & Uyeda Statement").

8 *See, e.g.*, "JPMorgan Admits to Widespread Recordkeeping Failures and Agrees to Pay $125 Million Penalty to Resolve SEC Charges," Dec. 17, 2021, SEC Press Release No. 2021-262, *available at* https://www.sec.gov/newsroom/press-releases/2021-262; "SEC Charges 16 Wall Street Firms with Widespread Recordkeeping Failures," Sept. 27, 2022, SEC Press Release No. 2022-174, *available at* https://www.sec.gov/newsroom/press-releases/2022-174; "Twenty-Six Firms to Pay More than $390 Million Combined to Settle SEC's Charges for Widespread Recordkeeping Failures," Aug. 14, 2024, SEC Press Release No. 2024-92, *available at* https://www.sec.gov/newsroom/press-releases/2024-98; "SEC Charges 12 Municipal Advisors with Recordkeeping Violations," Sept. 17, 2024, SEC Press Release No. 2024-132, *available at* https://www.sec.gov/newsroom/press-releases/2024-132.

9 Under the Exchange Act and SEC Rule 17a-4, broker-dealers are required to preserve all written communications relating to the broker-dealer's "business as such." 17 C.F.R. § 240.17a-4.

10 Under the Investment Advisors Act of 1940 and SEC Rule 204-2, investment advisors are required to preserve all written communications relating to certain topics, including, among other things, (i) "any recommendation made or proposed to be made and any advice given or proposed to be given," (ii) "any receipt, disbursement or delivery of funds or securities," (iii) "the placing or execution of any order to purchase or sell any security," or (iv) "predecessor performance and the performance or rate of return of any or all managed accounts, portfolios, or securities recommendations." 17 C.F.R. § 275.204-2.

11 Under the Exchange Act and rules issued by the Municipal Securities Rulemaking Board, municipal advisors are required to preserve all written communications relating to municipal advisory activities. MSRB Rule G-8(h)(i).

12 Under the Exchange Act and SEC Rule 17g-2, nationally recognized statistical rating organizations are required to preserve internal and external communications, including electronic communications, received and sent by the organization or its employees that relate to credit rating activities. 17 C.F.R. § 240.17g-2.

13 *See, e.g.*, "SEC Charges HSBC and Scotia Capital with Widespread Recordkeeping Failures," May 11, 2023, SEC Press Release No. 2023-91, *available at* https://www.sec.gov/newsroom/press-releases/2023-91; "Twenty-Six Firms to Pay More than $390 Million Combined to Settle SEC's

ENDNOTES (CONTINUED)

Charges for Widespread Recordkeeping Failures," Aug. 14, 2024, SEC Press Release No. 2024-92, *available at* https://www.sec.gov/newsroom/press-releases/2024-98.

14 *See, e.g.*, Invesco Order, at ¶ 35.

15 *See, e.g.*, Invesco Order, at ¶¶ 35-38.

16 *See, e.g.*, Invesco Order, at ¶¶ 2, 5; CIBC Order, at ¶¶ 2, 5; *In the Matter of Glazer Capital, LLC*, SEC No. 3-22164, Sept. 24, 2024, at ¶¶ 2, 5 ("Glazer Order").

17 Sept. 24 Press Release.

18 Sept. 24 Press Release.

19 *In the Matter of Canadian Imperial Bank of Commerce*, CFTC No. 24-28, Sept. 24, 2024.

20 Unlike the Catalyst Order, the Atom order included only a limited reference to "remedial actions" and training for personnel. *In the Matter of Atom Investors LP*, SEC No. 3-22155, Sept. 23, 2024, at ¶ 10. The Atom order states that the SEC did not impose a penalty "because Atom self-reported [its] conduct, took prompt steps to remediate the violations and cooperated with the Commission staff with respect to its investigation of another entity." *Id.* at ¶ 3. Cooperation appears to have been a key consideration, as Atom "undertook efforts to retrieve, analyze, and organize trading data to match orders directed by [another] entity to execution data." *Id.* at ¶ 11.

21 Qatalyst Order, at ¶ 3.

22 Sept. 24 Press Release; Invesco Order, at ¶¶ 2, 5; CIBC Order, at ¶¶ 2, 5; Glazer Order, at ¶¶ 2, 5.

23 Qatalyst Order, at ¶ 4.

24 Qatalyst Order, at ¶¶ 13-20.

25 Qatalyst Order, at ¶ 21.

26 Qatalyst Order, at § IV(C).

27 Qatalyst Order, at ¶ 22 (emphasis added).

28 Qatalyst Order, at ¶ 22 (emphasis added).

29 Qatalyst Order, at ¶ 22 (emphasis added).

30 Pierce & Uyeda Statement.

31 *Id.*

32 *Id.*

33 *Id.*

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.