

Client Alert

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Division of Investment Management: References by Advisers to Public Commentary on Social Media Sites Don't Invoke "Testimonial Rule" if They Satisfy "Independence" and "No Material Connection" Tests

By Jay G. Baris

Acknowledging the growing demand by consumers for information through social media, the Division of Investment Management set some ground rules on how investment advisers can use social media and publish advertisements that feature public commentary about them that appears on social media sites.

Generally, advisers may refer to commentary published in social media without violating the rule prohibiting publication of client "testimonials" if the content is independently produced and the adviser has no "material connection" with the independent social media site. While not a bright line in the sand, the distinction goes a long way to clear up this murky area.

BACKGROUND

The growing use of social media by consumers has created challenges for federal securities regulators, who must enforce antifraud rules that were written at a time when the prevailing technology was the newspaper.

Section 206 of the Investment Advisers Act of 1940 contains broad antifraud provisions that apply to advisers. Rule 206(4)-1(a)(1) under the Advisers Act defines fraud to include "any advertisement which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service" provided by the adviser. This is the so-called "testimonial rule." In a 1985 no-action letter, the staff said that the basis of the prohibition is that a "testimonial may give rise to a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the adviser's clients."

While the SEC's rules do not define the term "testimonial," the SEC's staff has indicated that public commentary made by a client endorsing an investment adviser, or a statement made by a third party about a client's experience with the adviser, may be a testimonial for this purpose. And, as the guidance notes, whether public commentary on a social media site constitutes a testimonial depends on the facts and circumstances relating to the statement.

In the age of social media, this decades-old rule presents enormous compliance challenges for advisers whose clients rely on social media.

Over the years, the staff, through the "no-action" process, has provided limited guidance on what constitutes a testimonial. For example, the staff has said that publication of an article by an unbiased third party regarding an

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adviser's performance, unless it includes a statement of a client's experience with the adviser, or an endorsement of the adviser, would not violate the testimonial rule. The staff has used this concept as the basis for its current guidance.

GUIDANCE

Third-party commentary. The staff attempted to draw a line between endorsements and legitimate third-party commentary:

- Advisers may not publish public commentary on their website that is an explicit or implicit statement of a client's experience with the adviser.
 - Commentary posted directly on the adviser's website, blog, or social media site that touts the adviser's services are prohibited testimonials.
- Advisers won't necessarily violate the testimonial rule if they publish commentary originating from an independent social media site on their own websites or social media sites, provided:
 - The independent social media site provides content that is *independent of the investment adviser or its representative*;
 - There is no *material connection* between the independent social media site and the investment adviser or its representative that would "call into question the independence" of the independent social media site or its commentary; and
 - The investment adviser or representative *publishes all of the unedited comments* appearing on the independent social media site regarding the adviser or representative.
- Content is not "independent" if the adviser or its representative had a hand in authoring the commentary, directly or indirectly. For example, paying a client (or offering a discount to a client) for saying nice things would implicate the testimonial rule.
- Advisers may not use testimonials from independent social media sites that directly or indirectly emphasize commentary favorable to the adviser, or downplay unfavorable commentary.
- Advisers may publish commentary from an independent social media site that includes a mathematical average of the public commentary—for example, based on a ratings system that is not pre-ordained to benefit the adviser.

Investment adviser advertisements on independent social media sites.

- Investment advisers may advertise on an independent social media site, provided that it is readily apparent that the advertisement is separate from the public commentary, and that the receipt of advertising did not influence the selection of public commentary for publication.

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Reference to independent social media site commentary in non-social media advertisements.

- In print, TV, and radio ads, advisers *may* refer to the fact that third-party social media sites feature public commentary about the adviser, but they *may not* publish any actual testimonials without implicating the testimonial rule.

Client lists on social media sites.

- Simply identifying contacts or friends on a social media site by itself does not implicate the testimonial rule, as long as they are not grouped in a way that suggests that they endorse the investment adviser.

Fan and community pages.

- A third party's creation and operation of unconnected community or fan pages generally would not implicate the testimonial rule. However, the staff *strongly cautions* advisers and their employees that publishing content from those sites or directing user traffic to those sites if they do not meet the *no material connection* and *independence* conditions described above may implicate the testimonial rule.

OUR TAKE

The Division of Investment Management's approach to regulating the use of social media by advisers differs markedly from the approach adopted by FINRA for broker-dealers. While both regulators focus on the substance of the communication, rather than the format, the differences arise primarily from the nature of the regulated entity and the starting point of regulation.

For example, the Division of Investment Management focuses almost exclusively on adequacy of compliance programs, and whether a particular use of social media involves a prohibited "testimonial," a concept largely absent from regulation of broker-dealers. On the other hand, FINRA focuses on suitability of a recommendation and whether a particular communication requires advance compliance approval. Both approaches require caution when a regulated entity publishes or relies on third-party content.

The Division of Investment Management's guidance moves the ball forward, and will provide a starting point for chief compliance officers who are struggling to get their arms around advisers' use of social media. It may also provide an opportunity for advisers to revisit their procedures for monitoring advertising. While the guidance provides some relief for advisers who now have a better idea of the limitations to which they are subject, it also provides some compliance challenges, especially when advisers and their representatives make use of fast-paced social media to advertise.

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