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# How to Navigate the Testimonial Rule in the Age of Social Media: Handling Clients' Online Reviews

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On July 10, 2018, the SEC announced that it had settled five separate proceedings against registered investment advisers and investment adviser representatives as well as a marketing consultant for violating Rule 206(4)-1(a)(1) (the Testimonial Rule) under the Investment Advisers Act of 1940 (Advisers Act) through their use of social media and the internet. The published testimonials, which included website posts and videos, all contained information about the firms or representatives, along with the advice and services they provided to their clients.

The SEC has focused on the misuse of testimonials for some time. For example, in 2016, the SEC's Office of Compliance Inspections and Examinations (OCIE) launched a "touting initiative" in which it conducted focused reviews of advisers' promotion of industry awards, testimonials, professional certifications and ranking lists. Among the deficiencies that OCIE staff found during that initiative was the use of client statements on social media and websites. See "HFLR Program Parses OCIE's Recent Advertising Risk Alert: Misleading Claims of GIPS Compliance, Past Specific Investment Recommendations and Results of SEC's Touting Initiative (Part Two of Two)" (Jan. 11, 2018).

These enforcement actions serve as a warning to investment advisers that the SEC continues to scrutinize their advertising practices, including the use of testimonials. This article examines the mistakes made by the respondents in these cases, discusses the key takeaways elucidated by an industry expert and considers the future of the Testimonial Rule.

See our three-part advertising compliance series: "Ten Best Practices for a Fund Manager to Streamline Its Compliance Review" (Sep. 14, 2017); "Five High-Risk Areas for a Fund Manager to Focus on When Reviewing Marketing Materials" (Sep. 21, 2017); and "Six Methods for a Fund Manager to Test Its Advertising Review Procedures" (Sep. 28, 2017).

## The Testimonial Rule

Under the Testimonial Rule, it is a fraudulent, deceptive or manipulative act, practice or course of business for any registered investment adviser (or one required to be registered), directly or indirectly, to publish, circulate or distribute any advertisement that refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or any advice, analysis, report or other service rendered by that adviser.

"Advertisement" is defined broadly and has been interpreted to include postings on social media or the internet, as well as written communications in any publication and announcements on radio or television. The Testimonial Rule does not define "testimonial," but a statement is typically considered to be a testimonial if it describes a client's experience with, or endorsement of, an investment adviser or the adviser's services.

The rationale for this rule is that testimonials are almost inherently misleading, as they provide only positive feedback on an investment adviser without the balance of any negative feedback. In that respect, the ban on testimonials in advertising is akin to the ban on "cherry picking," which prevents an adviser from including in its marketing materials only investments that performed well, while excluding those that performed poorly. See our two-part series "How Can Hedge Fund Managers Market Their Funds Using Case Studies Without Violating the Cherry Picking Rule?": Part One (Dec. 5, 2013); and Part Two (Dec. 12, 2013).

What constitutes a testimonial can get complicated when the Testimonial Rule is applied to social media. As a National Examination Risk Alert issued by the SEC in 2012 explained, depending on the facts and circumstances, certain third-party postings on an adviser's social media sites – such as a client's posts on a Facebook page – could be viewed as testimonials. See "SEC Risk Alert Discusses When Social Media Interactions May Constitute Prohibited Hedge Fund Client Testimonials" (Apr. 5, 2012).

In response to questions regarding the scope of the Testimonial Rule and the use of social media, the SEC issued a Guidance Update in 2014 to address how this rule applies to statements about an investment adviser on social media.

For example, the Guidance Update explains that it is impermissible for an investment adviser or investment adviser representative (IAR) to invite clients to post public commentary directly on the investment adviser's or IAR's own website, blog or social media site that serves as an advertisement for the investment adviser's or IAR's advisory services.

An investment adviser or IAR may, however, publish public commentary from an independent social media site such as Yelp on its own website or social media site if:

- the independent social media site provides content that is independent of the investment adviser or IAR;
- there is no material connection between the independent social media site and the investment adviser or IAR that would call into question the independence of the independent social media site or commentary; and
- the investment adviser or IAR publishes all of the unedited comments appearing on the independent social media site.

See "Risk Alert Highlights Six Most Frequent Advertising Rule Compliance Issues" (Oct. 19, 2017); and "SEC Issues Guidance for Investment Advisers on the Interplay of the Testimonial Rule and Social Media" (Apr. 18, 2014).

# Relevant Facts of the Enforcement Actions

Two of the respondents in the five recent enforcement actions were SEC-registered investment advisers, while three were IARs. In three of the five cases, the violations were caused by a marketing consultant hired by the investment advisers or IARs. The marketing consultant was charged as well.

The following table summarizes the relevant details of the violations and sanctions, and contains links to the individual settlement orders:

| Respondent | Violations | Fine |
|---|---|---|
| Romano Brothers & Co. | • Published anniversary video containing client testimonials to its public website and YouTube.<br>• Published shorter version of the above video to its public website and YouTube. | $15,000 |
| Leonard Schwartz | • Owned and operated companies that solicited testimonials from the clients of investment advisers and IARs and posted them online.<br>• As a result of the above, caused these investment advisers and IARs to violate the Testimonial Rule. | $35,000 |
| HBA Advisers, LLC<br>Jaime Biel | • Maintained a page on Yelp that allowed members of the public to post testimonials.<br>• Responded to testimonials on its Yelp page.<br>• Hired Schwartz to solicit testimonials from its clients.<br>• Orally and through emails from Schwartz solicited testimonials from clients, who posted them to its Yelp page.<br>• Purchased ads on Yelp, which linked to its Yelp page containing client testimonials. | $15,000 (HBA);<br>$10,000 (Biel) |
| William Greenfield | • Hired Schwartz to solicit testimonials from his clients.<br>• Allowed Schwartz to post client testimonials to pages he created on Facebook and Google. | $10,000 |

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|---|---|---|
| Brian Eyster | • Maintained a public website with a "Testimonials" section, which contained testimonials from five clients.<br>• Hired Schwartz to solicit testimonials from his clients, one of which was posted to Yelp.<br>• Allowed Schwartz to create three videos containing client testimonials and publish them on YouTube and Google. | $10,000 |

The testimonials in these actions featured laudatory statements by clients, including comments indicating that the investment advisers or IARs:

- provided certain investment advisory services;
- were knowledgeable and trustworthy;
- generated investment returns for the clients;
- provided a high level of service;
- made the clients feel more secure about retirement; and
- gave the clients income, security and peace of mind.

# The Marketing Consultant

As Schwartz was the cause of the violations by most of the respondents, it is worth examining his actions in more detail.

Schwartz's company provided a service called "Squeaky Clean Reputation," in which he solicited testimonials on behalf of professionals, such as investment advisers and broker-dealers, and posted them to various websites, including YouTube, Facebook, Twitter and Yelp. The company's own website claimed that the service was "100% compliant for investment advisers." As part of this service, Schwartz created videos of client testimonials, which were captioned "Five Star Reviews."

An unnamed investment adviser – Adviser A – had hired Schwartz for this service but later sent him an email informing him that the Testimonial Rule barred registered advisers from distributing advertisements containing testimonials. The email included the text of the rule and a link to guidance on the SEC's website regarding the rule. Adviser A also asked Schwartz to remove the testimonials and videos he had published on its behalf from the internet.

Despite Adviser A's warning and request, Schwartz neither sought legal advice or other guidance about the Testimonial Rule's application to the services he provided, nor did he remove the postings made on Adviser A's behalf.

# Key Takeaways

"The biggest mistake that all of the investment advisers and IARs appeared to make was either not being aware of or not following the guidance issued by the SEC staff in 2014 regarding the use of social media by investment advisers," said Michael W. McGrath, partner at K&L Gates. "All of the allegations in the actions brought against both advisers and representatives were addressed in the guidance, and it is fair to say that these allegations are inconsistent with that guidance."

## Policies and Procedures

"Investment advisers certainly should have policies regarding the use of social media if they are going to either use social media directly or maintain sites that third parties can post on," explained McGrath. "Advisers should ensure that those policies are consistent with available SEC guidance and are followed in a consistent fashion."

"First and foremost, an adviser's policies and procedures should educate the adviser's personnel on which social media communications would be attributed to the adviser and which are entirely personal in nature," noted McGrath. "A well-written social media policy will distinguish between those activities that are permissible when an adviser's staff are engaged in entirely personal communications and those activities that are permissible when the adviser's personnel are engaged in communications that would be attributable to the adviser."

"Once that hurdle is crossed, advisers have a lot of different ways to craft procedures to ensure that any posting made on the adviser's behalf or that could be attributed to the adviser is subject to a reasonable degree of supervision," observed McGrath. Noting that an adviser could require prior approval or after-the-fact approval of all postings, he said that he tended to recommend prior approval but added there are certainly circumstances where that would not be necessary. "The real key is educating

personnel and distinguishing between purely personal communications and communications that would be attributed to the adviser," he noted.

To ensure compliance with social media policies and procedures, McGrath recommended that advisers provide their personnel with appropriate training regarding the use of social media to ensure they understand the policies and know what the policies are. "In addition, advisers typically will ask their personnel who are actively involved either in posting on or otherwise interacting with social media to certify their compliance with these policies," he added.

Certification alone may not be enough, however. "The SEC and its staff have noted on many occasions that compliance policies can and should be tailored to the risks of the investment adviser," explained McGrath. "Monitoring may not be necessary in all cases. An adviser that encourages its personnel to use social media sites to discuss firm business, however, may have a tough time showing that it engaged in adequate supervision without some sort of ongoing or periodic monitoring."

"Advisers can also surveil any mention of their organizations online through relatively low-impact services such as Google alerts. Many advisers receive an alert any time they are mentioned in a website that is picked up by Google," noted McGrath. "That's one way to get a good sense for what is being said about the firm – both by its own personnel and by third parties – without requiring any sort of intrusive supervision of individuals' personal social media activities."

As to compliance's role in the adviser's social media policies and procedures, McGrath said that compliance will generally approve postings either before or after the fact, and to the extent that the adviser determines that some sort of ongoing or periodic surveillance is appropriate, compliance would do that, too. "It's also important for the compliance department to provide or at least to be involved in training an adviser's personnel on these topics because compliance is ultimately going to be responsible for collecting certifications, reviewing certifications, reviewing postings and maintaining whatever control procedures the adviser chooses to put in place," he noted.

See "The SEC's Recent Revisions to Form ADV and the Recordkeeping Rule: What Investment Advisers Need to Know About Retaining Performance Records and Disclosing Social Media Use, Office Locations and Assets Under Management (Part Two of Two)" (Nov. 17, 2016).

## Soliciting Client Feedback

"An adviser can solicit testimonials from clients. Problems arise when the adviser either republishes those testimonials or solicits clients to provide testimonials in a public sphere," explained McGrath. "For example, it would be fine for an adviser to solicit feedback from its clients in an effort to provide better client service, and as long as the adviser does not republish that information, it would not violate the Testimonial Rule."

"To the extent that an adviser invites or solicits its clients to publish testimonials on third-party websites, it calls into question the independence of the commentary on those websites," observed McGrath. "Inviting or soliciting testimonials is just one of the actions that an adviser could undertake that would undermine the independence of that commentary – and could represent a violation of the Testimonial Rule. Other actions that could raise similar concerns are described in the 2014 guidance."

## Definition of Advertisement

"Many investment advisers do not understand the breadth of the definition of 'advertisement' as it exists in the rule," observed McGrath. "The SEC has consistently taken the position that an advertisement includes all modes of electronic communication such as websites, emails, videos, podcasts or social media postings that reach more than one person." He recommended that "advisers not lose track of the fact that any media that they make available to the general public will be considered an advertisement, regardless of its form."

## Repurposing Content

The Romano Brothers case illustrates how an investment adviser can run afoul of the advertising rule when repurposing content.

"According to the order, the anniversary video was originally created for internal purposes, but it was transformed into an advertisement when it was put to a different use. That could be true for other communications that originally had a different purpose," noted McGrath. "If an adviser shares a model client statement or model market commentary prepared for clients with prospective clients, that is another example of how materials that are originally created for one use can become advertisements when they are repurposed for another use."

See "Best Practices for Investment Advisers Using Social Media to Mitigate Advertising Rule Violations and Other Risks" (Mar. 23, 2017).

## Service Providers

"An adviser should have a good sense of all the services that are going to be performed by any person that the adviser hires to perform services on its behalf," suggested McGrath. "In a situation such as this – where the agent is publishing public statements that would be attributed to the adviser – the adviser should certainly have ongoing supervision over the content of those statements."

"The enforcement actions did not suggest that the advisers and representatives that engaged Schwartz misunderstood the services he would be providing. If we take the settlement orders at face value, this was less a failure of supervision and more a failure to understand what the repercussions of those services would be," remarked McGrath. "It seems the issue wasn't that the advisers weren't looking closely enough. Rather, they engaged a person whose services were fundamentally at odds with the SEC's prior guidance."

See "Fund Managers Must Supervise Third-Party Service Providers or Risk Regulatory Action" (Nov. 16, 2017).

# Future of the Testimonial Rule

Although the SEC is actively enforcing the Testimonial Rule, there are indications that this rule – and other advertising rules – may soon change.

On April 12, 2018, in a panel discussion on program priorities at the National Compliance Outreach Seminar for Investment Companies and Investment Advisers,[1] Paul Cellupica, Deputy Director of the Division of Investment Management, said that revision to investment adviser marketing and solicitation rules is on the medium- to long-term agenda.[2] He noted that the advertising rules, including the Testimonial Rule, were adopted in 1961, when social media did not exist.

"The Testimonial Rule was probably a very good idea in 1961," observed Cellupica. Now, however, many people "do not make reservations for things like vacations or restaurants without first going onto social media and researching reviews and seeing what other people had to say," he remarked. "It's not surprising that many people would like to do the same when it comes to researching and selecting investment advisers." The Testimonial Rule makes it very hard for them to do that, so the SEC is looking at updating this rule for "the age of social media" and in light of other developments in technology, he explained.

"A lot of commentators in the market think that the advertising rules are overdue for some amendments. Some advocate for a more principles-based rule rather than a rule that contains absolute prohibitions on certain activities, such as client testimonials and references to past specific recommendations that were profitable," observed McGrath. "Of course, we will have to wait and see what the proposed amendments are and the extent to which they adapt the rule to the realities of modern communications."

These enforcement actions, however, are the best evidence that, despite indications that the Testimonial Rule may change in the near future, the SEC remains committed to enforcing the current advertising rules.

"These enforcement actions are a warning to advisers who think that they can play fast and loose with the rules as they exist now," said McGrath. "It would be unwise to think that, because the SEC has put the advertising rules on its regulatory agenda, advisers have a free pass to begin to reinterpret the rules in whatever fashion is favorable to them."

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[1] A recording of the National Compliance Outreach Seminar for Investment Company and Investment Advisers is available on the SEC's website here: https://www.sec.gov/video/webcast-archive-player.shtml?document_id=041218ccoiciapart1.

[2] According to Reginfo.gov, amendments to the marketing rules under the Advisers Act, including the Testimonial Rule specifically, are at the "Proposed Rule Stage" as of spring 2018.



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