Client Alert

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SEC Issues Guidance on Investment Adviser Use of Social Media

The Office of Compliance Inspections and Examinations of the Securities and Exchange Commission ("SEC") recently issued a National Examination Risk Alert (the "Risk Alert") on the use of social media by investment advisers. The Risk Alert provides guidance on the application of the Investment Advisers Act of 1940 (the "Advisers Act") and its rules to the use of social media technologies. As described below, the Risk Alert discusses several factors that an investment adviser may want to consider when evaluating its social media compliance program, particularly with regard to third-party consents. The SEC seeks comments and suggestions about how its examination program can better fulfill its mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. The SEC Risk Alert is available at: http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf.

Investment advisers registered as broker-dealers are also subject to existing FINRA guidance on social media. For additional information, please refer to our September 9, 2011, Client Alert available at: http://www.chapman.com/media/news/media.1066.pdf.

Background

SEC-registered investment advisers which use social media are required to adopt, and periodically review the effectiveness of, policies and procedures regarding social media pursuant to Advisers Act Rule 206(4)-7. Use of social media must comply with the antifraud provisions of the securities laws as well as the compliance and recordkeeping provisions of the Advisers Act. The SEC staff has recently completed a review of several registered investment advisers of varying sizes and strategies which use social media, and issued the Risk Alert to highlight certain observations and suggestions.

Suggestions for Social Media Compliance Programs

The SEC noted variation in the form and substance of firms' policies and procedures. For example, many firms had multiple overlapping procedures applicable to advertising, client communications, or electronic communications generally, which may or may not specifically include the use of social media. The lack of specificity, the SEC noted, could cause confusion as to which procedures apply. Other observed procedures were not specific as to which types of social networking activity were permitted or prohibited by the firm. Many policies and procedures did not address the use of social media by solicitors.

The SEC notes that when firms evaluate their controls and compliance programs, firms should first identify conflicts and other compliance factors which create risk exposure in light of the particular firm's operations, and then test whether existing policies and procedures effectively address such risks. The Risk Alert includes a non-exhaustive list of factors that investment advisers may want to consider when evaluating the effectiveness of compliance programs with respect to the use of social media. The SEC cautions that compliance with such guidelines is not a "safe harbor" and should be tailored to

best protect a particular firm's clients. The list of factors suggested by the SEC staff includes the following:

- *Usage Guidelines*—Consider whether to create usage guidelines that provide guidance to investment advisory representatives and solicitors on the appropriate use of social media. Consider also addressing appropriate restrictions on the use of social media based on the firm's analysis of risk to the firm and its clients. A firm may choose, for example, to provide an exclusive list of approved social media sites or prohibit the use of specific functionalities on a site.

- *Content Standards*—Consider the risks that content created by the firm, its investment advisory representatives, or solicitors implicates fiduciary duty or other regulatory issues (such as content that contains investment recommendations, information on specific investment services, or investment performance). Also consider issuing clear guidelines with respect to such content and whether certain content prohibitions or restrictions are appropriate.

- *Monitoring*—Consider how to effectively monitor the firm's social media sites, accounting for the reality that many third-party sites may not provide complete access to compliance personnel.

- *Frequency of Monitoring*—Using a risk-based approach, a firm may determine that periodic, daily, or real-time monitoring of the use of social media is appropriate. The frequency might depend on the volume and pace of such communications or the nature of the subject matter of a particular social media conversation. Retroactive review of content may not be reasonable in certain circumstances, particularly where social media content is able to be rapidly and broadly disseminated to investors and the markets.

- *Approval of Content*—Broker-dealers are required to obtain pre-approval before posting to social media sites in certain circumstances pursuant to NASD Rule 2210. Firms may also want to consider the appropriateness of pre-approval for non-broker-dealers.

- *Firm Resources*—Consider whether sufficient compliance resources have been dedicated to adequately monitor investment advisory representative or solicitor activity on social media sites. Also consider employing conversation monitoring or similar services from outside vendors, if, for example, the firm has many persons to monitor. A firm may consider using sampling, spot checking, or lexicon-based or other search methodologies, or a combination of methodologies, to monitor social media use and content.

- *Criteria for Approving Participation*—In analyzing risk exposure, consider the reputation of a social media site, its privacy policy, the ability to remove third-party posts, controls on anonymous posting, and the advertising practices of any social media site that the firm or its investment advisory representatives or solicitors use to conduct business.

- *Training*—Consider implementing training related to social media that seeks to promote compliance and to prevent potential violations of the federal securities laws and the firm's internal policies.

- *Certification*—Consider whether to require a certification by investment advisory representatives and advisory solicitors confirming that those individuals understand and are complying with the firm's social media policies and procedures.

- *Functionality*—Consider the functionality of each social media site approved for use, including the continuing obligation to address any upgrades or modifications to the functionality that affect the risk exposure for the firm or its clients. The rapidly evolving nature of this new media makes such consideration particularly significant. For example, a firm that chooses to host social media on a site that includes a functionality or engages in a practice that exposes a client-user's privacy, which practice or policy cannot be disabled or modified, may need to consider whether the firm's participation is appropriate.

- *Personal/Professional Sites*—Consider whether to adopt policies and procedures to address the conducting of firm business on personal (non-business) or third-party social media sites. A firm may choose to specify what types of firm communications or content are permitted on a site that is not operated, supervised, or sponsored by the firm. A firm might determine that it is appropriate to permit business card information on a specific site, for example, yet may choose to prohibit conducting firm business on that site.

- *Information Security*—Consider whether permitting investment advisory representatives to have access

to social media sites poses any information security risks. Use of social media, especially third party social media sites, may pose elevated risks. Firms may consider adopting compliance policies and procedures to create appropriate firewalls between sensitive customer information, as well as the firm's own proprietary information, and any social media site to the extent that the firm permits access to such sites.

- *Enterprise-Wide Sites*—A registered investment adviser that is part of a larger financial services or other corporate enterprise may consider whether to create usage guidelines reasonably designed to prevent the advertising practices of a firm-wide social media site from violations of the Advisers Act.

Third-Party Content

Most firms allow third parties to make postings on their social media sites, but the policies and procedures governing such third-party postings vary in what types of postings are permissible. Some firms allow third parties to post messages, forward links, and post articles while other firms have explicit policies limiting third-party use to "one way postings" where the firms' investment advisory representatives or solicitors may make postings but do not interact with third parties or respond to third-party postings. More conservatively, some firms limit third-party postings to authorized users and prohibit postings by the general public. Many firms post disclaimers directly on their site stating that they do not approve or endorse any third-party communications posted on their site.

The SEC suggests that those firms that allow third-party postings on their social media sites consider having applicable policies and procedures, including the posting of testimonials about the firm or its investment advisory representatives as well as reasonable safeguards in place to avoid any violation of the federal securities laws.

The SEC consistently interprets a third-party statement as a "testimonial" for purposes of Advisers Act Rule 206 if it includes a statement of a client's experience with, or endorsement of, an investment adviser. The SEC notes, therefore, depending on the facts and circumstances, the use of social plug-ins such as a "like" button could be a testimonial under the Advisers Act. Third-party use of the "like" feature on an investment adviser's social media site could be deemed to be a testimonial if it is an explicit or implicit statement of a client's experience. For example, if the public is invited to "like" an investment advisory representative's biography posted on a social media site, that election could be viewed as a type of testimonial prohibited by the rule.

Recordkeeping Obligations

Advisers Act Rule 204-2 requires investment advisers to keep certain books and records relating to their advisory business and to retain them for a specified period of time. The recordkeeping obligation does not differentiate between various media, including paper and electronic communications, that relate to an adviser's recommendations or advice. Registered investment advisers that communicate through social media must therefore retain records of those communications if they contain information pertaining to an investment adviser's recordkeeping obligations under the Advisers Act. The SEC notes that the content of the communication is determinative. A firm that intends to communicate, or permit its investment advisory representatives to communicate, through social media sites may wish to determine that it can retain all required records related to social media communications and make them available for inspection. The SEC suggests that firms consider reviewing their document retention policies to ensure that any required records generated by social media communications are retained in compliance with the federal securities laws, including in a manner that is easily accessible for a period not less than five years.

The SEC notes that firms may consider adopting compliance policies and procedures that address (if relevant) the following factors, among others, relating to the recordkeeping and production requirements of required records generated by social media communications:

- Determining, among other things, (1) whether each social media communication used is a required record, and, if so, (2) the applicable retention period, and (3) the accessibility of the records.
- Maintaining social media communications in electronic or paper format.
- Conducting employee training programs to educate advisory personnel about recordkeeping provisions.
- Arranging and indexing social media communications that are required records and kept in an electronic

format to promote easy location, access, and retrieval of a particular record.

- Periodic test checking (using key word searches or otherwise) to ascertain whether employees are complying with the compliance policies and procedures (e.g., whether employees are improperly destroying required records).
- Using third parties to keep records consistent with the recordkeeping requirements.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.