The Social Media Experiment: Challenges for Broker-Dealers and Investment Advisers

By Jay Baris and John Delaney on July 10th, 2012

The announcement by a Wall Street firm that it plans to give its financial advisers limited access to social media websites has been viewed by many as inevitable. Morgan Stanley's foray into the fast-changing world of social media highlights the difficulties faced by broker-dealers and investment advisers and the regulators who oversee them. As more financial firms follow suit, regulators will struggle to enforce securities laws that were written when the telephone and the telegraph were the prevailing social media.
Federal securities laws require broker-dealers and investment advisers to comply with a panoply of detailed rules designed to ensure that customers and clients are not misled. The rules require them to keep records of every paragraph, sentence, and word – and now, every tweet.
The challenge: how can financial firms comply with these strict rules while satisfying the market's growing passion for communicating by texts and tweets? And how can regulators enforce two-dimensional securities laws in the new three-dimensional world?
The exponential jump in social media usage has attracted the attention of federal securities regulators, who have responded with additional guidance and enforcement actions.
The Financial Industry Regulatory Authority (FINRA), which regulates broker-dealers, published guidance on blogs and social networking websites in January 2010. This was followed by guidance on social networking websites and business communications, posted in August 2011.

In January 2012, the U.S. Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) published a National Examination Risk Alert called Investment Adviser Use of Social Media, which outlines in stark terms the SEC staff's compliance concerns on the use of social media by registered investment advisers.
While investors typically do not distinguish between broker-dealers, on one hand, and registered investment advisers, on the other hand, these two types of financial institutions are regulated under similar, but very different, sets of rules. Social media use by investment advisers that are

dually registered with the SEC and with FINRA is subject to both sets of rules and interpretations.

Investment advisers. The SEC has recognized that social media is "landscape-shifting" and that its use by the financial services industry is rapidly accelerating.

The SEC staff has stated its view that use of social media to communicate with clients and prospective clients may implicate Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (Advisers Act), which governs advertisements by investment advisers.
This rule, in relevant part, provides that an investment adviser will violate the Advisers Act's anti-fraud provisions if it publishes, circulates, or distributes "any advertisement" that:

- Refers, directly or indirectly, to "testimonials of any kind concerning the investment adviser" or the investment advice it provides;
- Refers, directly or indirectly, to past specific recommendations it provides (e.g., "cherry picking"), unless the adviser discloses a list of all recommendations, subject to certain requirements;
- Represents that a graph, chart, or formula, by itself, can be used to determine which securities to buy, without prescribed disclosures;
- Contains a statement to the effect that a report, analysis, or other service will be furnished free of charge, unless it is actually provided entirely free of charge without condition; or
- Contains any untrue statement of a material fact, or that is otherwise false or misleading.

The SEC defines "advertisement" very broadly. "Advertisements" include, in relevant part, any notice, circular, letter, or other written communication addressed to more than one person, or any notice or announcement in any publication or by radio or television, that (1) offers analysis, report, or publication concerning securities, or that is to be used in making any determination as to when to buy or sell any security, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or (3) any other investment advisory service with regard to securities.

While this regulatory definition reflects technological advancements through and including the cathode ray tube television set, we can reasonably conclude that it applies to all kinds of social media communications, including blogs, wikis, photo and video sharing, podcasts, social networking, and virtual worlds.

OCIE's regulatory concerns can be categorized into three broad categories: compliance policies and procedures, third-party content, and record keeping.

Compliance programs. First, the SEC staff is concerned that investment adviser compliance programs may include overlapping procedures that apply to advertisements and communications but do not specifically include social media. The staff urges investment advisers to evaluate the effectiveness of their compliance programs with respect to the use of social media by the firms themselves, their representatives, or solicitors, including the following hot buttons:

- *Usage guidelines.* Compliance procedures should address appropriate usage and restrictions on use of social media, based on potential risks.

- *Content standards.* Content may implicate fiduciary duty duties or other regulatory issues, which compliance procedures should address.
- *Monitoring.* Advisers should consider how to monitor use of social media by employees, representatives, and solicitors, and should take into consideration the lack of ability to monitor third-party sites.
- *Frequency of monitoring.* The staff suggests a risk-based approach for frequency of monitoring of social media communications.
- *Approval of content.* Advisers should consider pre-approval of communications, rather than after-the-fact reviews.
- *Firm resources.* Advisers should evaluate their resources to ensure that they are sufficient to adequately monitor personnel and archive communications.
- *Criteria for approving participation.* Compliance procedures should assess risks to the adviser, including operational, reputational, privacy, and other regulatory issues.
- *Training.* Advisers should consider implementing a training program related to social media, with a view toward promoting compliance.
- *Certification.* Consider procedures that require personnel to certify that they understand and will comply with social media policies.
- *Functionality.* Advisers should consider the functionality of social media sites approved for use, including the continuing obligation to address any upgrades or modifications.
- *Personal/professional sites.* Advisers should consider whether to adopt policies to address business conducted on personal or third-party media sites.
- *Information security.* Advisers should consider whether permitting representatives to have access to social media sites poses information security risks, and how to protect information.
- *Enterprisewide sites.* Advisers that are part of a larger financial services or corporate enterprise may consider creation of usage guidelines designed to prevent the advertising practices of a firmwide social media site from violating the Advisers Act.

Third-party content. Second, the staff has indicated that third-party content on social media sites presents special compliance challenges. These issues arise when third parties post messages, forward links, or post articles to an adviser's website or in social media sites. Adviser representatives and solicitors generally do not interact with these third parties or respond to their postings.

The staff noted its concern about direct or indirect testimonials "of any kind." The SEC's rules do not define the term "testimonial," but the SEC's staff broadly interprets the term to include a statement of a client's experience with, or endorsement of, an investment adviser. Therefore, the use of "social plug-ins," *even when a third party hits the "Like" button on an adviser's Facebook page* could be a "testimonial" under the Advisers Act if the "Like" represents an explicit or implicit statement of a client's experience with an investment adviser or its representative.

The staff's concerns underscore the challenges that investment advisers face when the use of freewheeling, interactive social media collides with requirements to comply with pre-Internet regulations that were designed to regulate newspaper and magazine advertisements.
Record keeping. The SEC's third area of concern is recordkeeping obligations of advisers. OCIE noted that the recordkeeping rules do not differentiate between traditional paper communications, like snail mail, and electronic communications, such as e-mails, instant

messages, and other ways that investment advisers provide advisory services. In other words, the federal regulators focus on the *content* of the communication, rather than its *form*. OCIE urges investment advisers to ensure that their recordkeeping policies and procedures allow advisers that use social media to comply with the recordkeeping requirements.
In January 2012, the SEC published an Investor Alert, Social Media and Investing: Avoiding Fraud, designed to make investors aware of fraudulent investment schemes that use social media. It also provides tips for checking the backgrounds of investment advisers and brokers. An Investor Bulletin, Social Media and Investing, Understanding Your Accounts provides tips for investors who use social media about privacy settings, security, and password selection. Also in January 2012, the Enforcement Division announced that the SEC charged an Illinois-based investment adviser with offering to sell fictitious securities on LinkedIn. Among other things, the Division alleged that the adviser used LinkedIn discussions to promote fictitious "bank guarantees" and "medium term notes," which generated interest from potential investors. The adviser failed to comply with recordkeeping requirements or maintain a required Code of Ethics.

The SEC's Enforcement Division noted that fraudsters are quick to adapt to new technologies to exploit them for unlawful purposes. This case suggests that the federal regulators are determined to adapt to new technologies to follow the fraud.

Broker-dealers. As long ago as 1999, FINRA recognized the potential compliance issues posed by use of social media when it stated that a registered representative's participation in an Internet chat room is subject to the same requirements as a presentation in person before a group of investors. FINRA codified this guidance in 2003, when it defined the term "public appearance" to include participation in an interactive electronic forum.

FINRA published its Guide to the Internet for Registered Representatives, and in September 2011, it released a three-part series of podcasts on these issues to educate broker-dealers and their representatives.

FINRA is not so much concerned about the form of a communication from a registered representative; rather, it is concerned about the content of the communication and whether the registered representative obtained prior supervisory approval for sending the communication. FINRA penalized a registered representative who posted 32 tweets touting a particular security without prior principal approval, among other alleged violations.

For a summary of recent FINRA concerns about social networking, see our August 3, 2011 News Bulletin, FINRA to Issue More Guidance on Social Media.

The Morgan Stanley initiative. The New York Times DealB%k reported on June 25, 2012 that, after a yearlong trial program, Morgan Stanley planned to give about 17,000 financial advisers "partial access" to Twitter and LinkedIn. But don't expect their registered representatives to get carried away with a flurry of on-the-fly stock picks. The representatives draw posts "from a prewritten library" of Twitter messages and submit all LinkedIn postings for approval, using advanced software designed for this purpose. Other firms likely will follow suit and devote more resources to developing this latest frontier of communications with customers.

Not only did Morgan Stanley give the green light to its financial advisers to post limited tweets. Last week, on the firm's official Twitter account, senior Morgan Stanley economists tweeted their analysis of the U.S. jobs report and the European Central Bank's decision to lower interest rates.

This initiative signals a trajectory and confirms that the financial services industry's use of social media is here to stay. And it is a somber reminder that, notwithstanding advances in communications technology, firms must still comply with pre-Internet federal securities laws covering anti-fraud, advertising, and record-keeping.

Conclusion. The exponential growth of the use of social media presents compliance and operational challenges for investment advisers and broker-dealers. Regulators are devoting more and more resources as they scramble to stay current with technological advances in this area. Financial services firms are well advised to assess how their customers and employees use social media, to evaluate the potential risks, and to ensure that their policies and procedures adequately address the increasingly complex compliance and operational issues arising from the soaring popularity of social media.