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Keeping FINRA And The SEC From De-Friending You

Law360, New York (September 03, 2010) -- Have you recently poked a friend or updated your status (e.g., "Michael is working the phones and selling some serious bonds!!!")? Even if you haven't spring-cleaned your Friend List or untagged yourself from an embarrassing photo, you would be living under a rock not to recognize the societal impact of social networking sites like Facebook, LinkedIn and Twitter, among a myriad of others.

With a social network developed especially for financial planners, where you can, "Find IFAs and Financial Advisers at the financial social network," firms take notice.[1] In fact, in January 2010, the Financial Industry Regulatory Authority recognized the broker-dealer industry's use or potential use of social networking sites and issued Notice to Members 10-06, Guidance on Blogs and Social Networking Web Sites.

The use of social networking is rife with compliance issues that broker-dealers and investment advisers should consider when drafting and implementing policies and procedures. Compliance issues are not limited to scenarios where registered persons are seeking to build their business; firms engaged in online recruiting and marketing are also exposed to regulatory hurdles.

Even if a firm bans outright the use of social networking, firms may have obligations to ensure through monitoring and testing that improprieties are not taking place in their employees' personal digital realms. Since 46 percent of American adults who use the Internet logged onto social networking in 2009,[2] compliance in the age of social networking is no small task.

Due to the functionality of social networks, content posted on a social network can be considered one or more forms of advertisement, sales literature, correspondence, institutional sales material, public appearances, or independently prepared reprints;[3] thus, depending on the circumstances, the content may need to be filed with FINRA, maintained in accordance with the Advisers Act, approved by a principal, or otherwise analyzed in light of the regulations governing its content.

Also, FINRA considers banner advertisements, blogs, bulletin boards and static postings, like profile information or other non-interactive information, to be "advertisements" under FINRA Rule 2210, which requires pre-approval by a registered principal. Interactive content, like real-time communications such as chat rooms, does not require principal pre-approval, but firms remain obligated to supervise the content of the communication. Registered investment advisers should also consider the rules governing advertising and the retention of records, among others.

Compliance Issues for Broker-Dealers and Registered Representatives

In January 2010, FINRA released guidance on the use of social media websites by its members. The following is an overview of compliance concerns facing broker-dealers in the age of social networking.

Supervision — Social Media Requires Supervision

Firms should supervise electronic communications sent through social media sites.[4] Accordingly, firms should consider adopting supervisory procedures comparable to their review of electronic correspondence.[5]

Because service providers are still developing platforms for archiving and performing supervisory review, firms now using social networking sites may initially struggle with ensuring appropriate pre- and post-review. Until more robust and user-friendly systems are developed, significant restrictions on account usage and access are advised.

Like with other areas of supervision, firms should develop policies and procedures directly applicable to social networking, in which the firm limits access to authorized personnel who have proper training and oversight.

Like with e-mail correspondence, the firm should have policies prohibiting the use of social networking related to the business representations conducted outside the firm's supervision.

Similarly, because firms continue to face liability for securities-related activities performed outside a firm's oversight, firms should consider implementing procedures to verify that personal accounts are not improperly used for business purposes. For example, firms may consider requiring that registered persons disclose all personal social networking accounts, and in cases of heightened supervision, require monitoring of personal accounts.

Importantly, firms should ensure that associated persons are complying with policies and procedures. Firms should provide training to ensure representatives know what is permitted and what is not. Whatever policies are implemented, given the technical challenges and the novel issues, FINRA may take issue if firms fail to include procedures testing to ensure policies are being followed.

Suitability—Recommendations Must Be Suitable

As a fundamental, any recommendation to buy or sell a security should be suitable for every investor to whom it is made.[6] Because social networks can disperse communications widely, a recommendation intended for a single individual may be broadcast to hundreds, if not thousands, of additional unintended (and potentially unsuitable) recipients.

Consequently, social networking sites pose risks. For example, social networking allows members to communicate with one another while permitting others in the network to view the discussion chain. Where a recommendation was intended for one individual, representatives and firms may face charges when the recommendation was conveyed to many, or at least made accessible to many.

Firms should consider banning all social networking communications recommending a specific investment product or alternatively limiting postings to pre-approved templates concerning products. Even if the communication is not considered a "recommendation," policies and procedures should be set forth limiting the extent to which specific products or transactions may be discussed.

Record Keeping—Social Networking Content Must Be Archived

Like other business records, firms are required to maintain business content made available through social media, including but not limited to, wall postings, comments on blogs, and personal messages exchanged with "friends" or the public. As a result of FINRA Rule 3010, Exchange Act Rules 17a-1, 17a-3, and Rule 204-2 of the Advisers Act, electronic archiving services are being developed for archiving Twitter accounts and other social media content.

Due to the varied social network outlets and different media formats (e.g., messaging, instant chat, wall posting, friend networks, recommendations, etc.), firms should work with archiving vendors to ensure compliance with all rules and regulations.

For firms that permit social networking, FINRA and the U.S. Securities and Exchange Commission will look to the firm's written supervisory procedures (WSPs) to ensure that policies and procedures are documented and implemented governing both archiving and associated quality checking. This archiving requirement is another reason why representatives and advisers should not use personal social networking for business purposes.

Third-Party Postings — Content Posted By Others May Injure the Firm

Although statements made by third parties usually don't qualify as the firm's communications with the public subject to Rule 2210, social networking provides fertile ground for these statements to be imputed to the firm.

For example, assume a customer posts on the firm's wall, "Thanks so much for recommending the XYZ Fund — it is outperforming all my other investments. You guys are great." Then an associated person replies, "No problem, Mr. Smith. Glad it is working out for you. Give me a call; I have other high-quality investments."

By implicitly endorsing the content, the exchange may be considered a statement of the firm and may create a supervisory liability or a suitability issue to the extent that other investors make purchases based on the statements.

Further, to the extent that a third party posts a complaint on a social networking website (e.g., posting on a wall or twittering about a problem), a firm should comply with its policies and procedures and any rules regarding the treatment of customer complaints, such as FINRA Rule 3070.

Compliance Issues for Investment Advisers

The SEC has not yet provided significant guidance on the use of social media by registered investment advisers; however, investment advisers registered with the SEC who utilize social networking sites have unique considerations due to the SEC's prohibitions against false and misleading advertising.

Investment Advisers Act, Rule 206(4)-1, Advertisements by Investment Advisers, prohibits advertisements that, among other things, refer to testimonials. Testimonials include a statement of the client's positive experience with the adviser or an endorsement.

Thus, an adviser's LinkedIn profile may violate the Advisers Act if a recommendation is provided or accepted regarding the adviser. Facebook's "like" feature may also be violative. Additionally, advisers should be mindful of postings that contain misleading information, discuss prior recommendations, or contain partial client lists.

Like FINRA members, registered investment advisers should also follow document retention requirements that apply to social networking. Rule 204-2 of the Advisers Act, which sets forth specific requirements covering the retention of advertisements and other documents, should be considered prior to engaging in social networking.

Other Considerations for Broker-Dealers and Investment Advisers

In addition to the compliance concerns noted above, both FINRA members and registered investment advisers should be aware of the following:

1) Social networking may result in the unintended disclosure of nonpublic customer information. In an effort to protect consumer information, the SEC enacted Regulation S-P, which prohibits financial institutions from disclosing nonpublic personal information about customers.

Nonpublic information includes a list, description or other grouping of individuals (and publicly available information pertaining to them) that is derived from nonpublic personal information.

If an associated person utilizes client email addresses to create a network or friend list on a social networking site, the associated person may identify part of the client list to the public, which can result in a Reg S-P violation.

2) Rules governing private securities offerings often contain a variety of restrictions relating to the number and qualification of investors and persons authorized to solicit sales.

If capital is raised through a private placement, both customers and brokerage firms should be mindful not to publish information concerning the offering on a social networking site. Public disclosure that amounts to an advertisement or an offer may destroy an exemption from registration.

While regulatory guidance covering social networking is still developing, existing rules governing FINRA members and registered investment advisers cover this new paradigm of social connectivity. Regulated entities and persons are justified for wanting to take advantage of business opportunities surrounding social networking; however, remain alert — the regulators are watching.

--By Cheryl L. Haas-Goldstein (pictured) and Michael K. Freedman, Sutherland Asbill & Brennan LLP

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[1] IFA Life — the Social Network for IFAs and Financial Planners, www.ifalife.com.

[2] See FINRA Regulatory Notice 10-06, Social Media Web Sites: Guidance on Blogs and Social Networking Web Sites, www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120779.pdf Notice to Members 10-06.

[3] See FINRA Rule 2210 (a) 2008, Communications with the Public; SEC Rules Under the Investment Advisor Act of 1940, Rule 206(4)-1 www.sec.gov/rules/extra/iarules.htm#20641Advisers Act Rule 206(4)-1.

[4] NTM 10-06 at 6. See supra note 2 at 6.

[5] See NTM 07-59. FINRA Regulatory Notice 07-59, Supervision of Electronic Communications, www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p037553.pdf

[6] FINRA Rule 2310(a) 2008, Recommendations to Customers (Suitability).