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Advertising, Pay-To-Play Lessons From New SEC Settlements

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On July 10, 2018, the U.S. Securities and Exchange Commission announced five settlements in connection with violations of Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-1(a)(1) thereunder.[1] Each of these settlements involves the improper use of testimonials on social media.

Section 206(4) generally prohibits investment advisers from engaging in fraudulent, deceptive or manipulative conduct, and Rule 206(4)-1, or the "Advertising Rule," prohibits registered investment advisers from using false or misleading advertisements. Testimonials in advertisements are deemed per se misleading and the Advertising Rule prohibits registered investment advisers from including them in advertisements.[2] The term "testimonial" is not defined in the Advertising Rule, but the staff has consistently interpreted that term to include a "statement of a client's experience with, or endorsement of, an investment adviser."[3]

In March 2014, the Division of Investment Management published a guidance update on the application of the Advertising Rule to the use of social media by investment advisers and investment adviser representatives, or IARs.[4] Among other things, the guidance update clarified that it is not permissible for an investment adviser or an IAR to invite clients to post public commentary directly on their internet site, blog or social media site that serves as an advertisement. In addition, in a September 2017 risk alert, the Office of Compliance Inspections and Examinations, or OCIE, noted that it had observed advisers that had published statements of clients attesting to their services or otherwise endorsing the adviser that may be prohibited testimonials (e.g., client endorsements published on firm websites and social media pages, and in pitch books and reprints of third-party articles).[5] The limit on testimonials is designed to address the SEC's concerns that investment advisers might mislead investors by "cherry-picking" the information that portrays them favorably while ignoring the information that portrays them unfavorably.

Four of the Advertising Rule settlements announced last week[6] involve a registered investment adviser or an IAR hiring marketing consultant Create Your Fate LLC to contact their advisory clients and solicit testimonials for publication on their

websites, Google and social media sites, including Yelp, Facebook and YouTube. In addition to hiring Create Your Fate to solicit client testimonials, one of the settled parties, HBA Advisors LLC, orally solicited clients and other individuals to post testimonials on Yelp. The testimonials posted by HBA's clients on Yelp included statements that HBA had enabled clients to purchase unique investments, protected clients' investments from risk, helped clients generate significant investment returns, made clients feel more secure about retirement, and provided a high level of service. The HBA settlement order states that several professionals also published testimonials on HBA's Yelp page, stating that they were comfortable referring clients to HBA because, among other things, HBA was trustworthy and had helped them increase the value of their investments.[7] Certain of the testimonials with respect to the IARs were captioned as "Five Star Reviews," and other testimonials indicated that the IARs were knowledgeable, trustworthy, provided a high level of service, and helped clients generate investment returns. The SEC separately settled with the owner of Create Your Fate for causing the violations of the Advertising Rule described above.[8]

In the fifth Advertising Rule settlement, the SEC found that dually registered investment adviser and broker-dealer Romano Brothers & Co. violated the Advertising Rule by publishing videos on its website and on YouTube that contained statements by its advisory clients about their experiences with the firm. The videos included statements that clients had profited from Romano Brothers' services and that Romano Brothers' services had provided them with income, security and peace of mind. The settlement order indicates that in determining to accept the Romano Brothers' offer of settlement, the SEC considered remedial acts promptly undertaken by the Romano Brothers, including hiring a new chief compliance officer and updating its compliance manual and training program.

Registered investment advisers should keep in mind that in addition to their pitchbooks and other traditional marketing materials, their social media sites, if used to offer their investment advisory services, can also be subject to the Advertising Rule. Investment advisers should ensure that their policies and procedures are reasonably designed to comply with the Advertising Rule, and that all adviser personnel are aware of the restrictions on their use of social media under the Advertising Rule.

Additionally, on July 10, the SEC also announced settlements with two registered investment advisers and one exempt reporting adviser relying on the venture capital adviser exemption for violations of Advisers Act Rule 206(4)-5, or the "pay-to-play" rule.[9] The rule prohibits investment advisers (including exempt reporting advisers) from receiving compensation for providing investment advisory services to a government entity[10] for two years after the adviser, or certain of its executives or employees (covered associates), makes a campaign contribution to certain elected officials or candidates who can influence the selection of that government entity's investment advisers (officials). The pay-to-play rule includes an exception for certain returned contributions made by a covered associate that do not exceed $350. The contribution must be discovered within four months of the contribution date and returned to the contributor within 60 days after the discovery. The pay-to-play rule limits an adviser's reliance on this exception to no more than two or three times per calendar year (based on the size of the adviser), and no more than once for each covered associate.

All three of the pay-to-play settlements describe the pay-to-play rule as a "prophylactic rule," and emphasize that the rule "does not require a showing of quid pro quo or actual intent to influence an elected official or candidate." Each pay-to-play settlement involved contributions to officials of government entities that were already invested with the relevant adviser. In two of the pay-to-play settlements,[11] the covered associates sought and obtained the return of the contribution, but the amount of the contribution exceeded the limit required for the return contribution exception.

The pay-to-play settlements are the second wave of SEC settlements based on violations of the pay-to-play rule. In January 2017, the SEC settled with 10 investment advisers (five of which were exempt reporting advisers) for pay-to-play rule violations.[12] These settlements demonstrate the SEC's continued focus on pay-to-play enforcement cases and serve as a reminder that exempt reporting advisers are not exempt from SEC enforcement. Investment advisers should conduct regular employee training and ensure that their compliance policies and procedures include monitoring and testing functions reasonably designed to detect and prevent violations of the pay-to-play rule.

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[1] In the Matter of Brian S. Eyster, Release No. IA-4962 (July 10, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4962.pdf (the "Eyster Settlement"); In the Matter of William M. Greenfield, Release No. IA-4961 (July 10, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4961.pdf (the "Greenfield Settlement"); In the Matter of HBA Advisors LLC and Jaime Enrique Biel, Release No. IA-4963 (July 10, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4963.pdf (the "HBA Settlement"); In the Matter of Romano Brothers & Co., Release No. IA-4965 (July 10, 2018), available at https://www.sec.gov/litigation/admin/2018/34-83613.pdf (the "Romano Brothers Settlement"); and In the Matter of Leonard S. Schwartz, Release No. IA-4964 (July 10, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4964.pdf (the "Schwartz Settlement").

[2] Rule 206(4)-1(a)(1) states: "it shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business for any investment adviser registered or required to be registered under the Advisers Act, directly or indirectly, to publish, circulate, or distribute 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 rendered by such investment adviser."

[3] See Cambiar Investors Inc., SEC Staff No-Action Letter (pub. avail. Aug. 28, 1997).

[4] IM Guidance Update No. 2014-04, Guidance on the Testimonial Rule and Social Media (Mar. 2014), available at https://www.sec.gov/investment/im-guidance-2014-04.pdf.

[5] National Exam Program Risk Alert, Volume VI, Issue 6, The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers (Sep. 14, 2017), available at https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf.

[6] Eyster Settlement; Greenfield Settlement; HBA Settlement; Schwartz Settlement.

[7] This is a reminder that a statement can be made by someone other than a client and still be deemed a testimonial prohibited by the advertising rule.

[8] Schwartz Settlement.

[9] In the Matter of EnCap Investments LP, Release No. IA-4959 (July 10, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4959.pdf; In the Matter of Oaktree Capital Management LP, Release No. IA-4960 (July 10, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4960.pdf; and In the Matter of Sofinnova Ventures Inc., Release No. IA-4958 (July 10, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4958.pdf.

[10] "Government entity" is defined in the pay-to-play rule to include a state or a political subdivision of a state, and any agency, authority or instrumentality of the state or political subdivision.

[11] Sofinnova Ventures Inc.; Oaktree Capital Management LP.

[12] Press Release, U.S. Sec. & Exch. Comm'n, 10 Firms Violated Pay-to-Play Rule By Accepting Pension Fund Fees Following Campaign Contributions (Jan. 17, 2017), available at https://www.sec.gov/news/pressrelease/2017-15.html.