Official Newsletter of Gordian Compliance Solutions, LLC.

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INVESTMENT ADVISER NEWS UPDATES

SEC Releases Overview of ADV Changes

The United States Securities & Exchange Commission ("SEC") has provided a redlined document describing the upcoming changes to the Form ADV Part 1 that will go into effect later this year. The SEC's redlined document can be accessed here.

SEC and State-Registered investment advisers will begin to see updated Form ADVs on October 1, 2017.[1] As noted in SEC Release IA-4509, the updated Form ADV will require investment advisers to provide additional "information about their separately managed account business, [and] incorporate[s] a method for private fund adviser entities operating a single advisory business to register using a single Form ADV…"[2] among other clarifying and technical amendments. Given the timing of the SEC's rollout, it is likely that many advisers will be reviewing these changes as part of their annual amendment in March 2018.

The SEC has also updated its FAQ page to include the recent Form ADV Part 1 changes as of June 20, 2017. Investment advisers should review both the new FAQs and the SEC's redlined document to see what, if any, impact the updated Form ADV Part 1 will have on their internal reporting processes.

For questions about your firm's Form ADV responsibilities in light of these changes, please contact your Gordian consultant.

[1]*Release IA-4509*, United States Securities & Exchange Commission (August 25, 2016)
[2] *Id.*

Jay Clayton Sworn in as SEC Chairman

On May 4, 2017, Jay Clayton was sworn into office as the 32nd Chairman of the SEC.[1] Supreme Court Justice Anthony Kennedy swore in Mr. Clayton after his May 2nd Senate confirmation.[2] Prior to his appointment, Mr. Clayton served as a partner at Sullivan & Cromwell LLP for over 20 years, providing legal counsel in the areas of securities offerings, corporate governances, and regulatory/enforcement proceedings.[3]

Mr. Clayton's critics are apprehensive that his past experience defending large Wall Street players (Goldman Sachs and Bear Stearns to name a few) may soften the SEC's enforcement program and result in fewer investor protections. While difficult to forecast Clayton's vision for the SEC at this time, his appointment, at a minimum, looks to provide more active rulemaking after the SEC's slow administrative start in 2017.

[1] Jay Clayton Sworn in as Chairman of SEC, United States Securities & Exchange Commission (May 4, 2017)
[2]Id.
[3]Id.

Compliance in Advertising: Testimonials

Gordian's Compliance in Advertising series takes a look at specific marketing and advertising issues that arise under Rule 206(4)-1 and other relevant SEC guidance. We hope our in-depth look at specific advertising issues can assist investment advisers and financial industry professionals in developing informative marketing materials and practices that withstand regulatory scrutiny.

This current installment focuses on the SEC's prohibition against the use of testimonials, as discussed below.

Prohibition on Testimonials: Rule 206(4)-1(a)(1)
Under Rule 206(4)-1(a)(1) the SEC will consider the use of any communication that "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"[1] to be a fraudulent or manipulative act. Although the term "testimonial" is not defined within the scope of Rule 206(4) -1, the SEC has consistently "interpreted that term to include a statement of a client's experience with, or endorsement of, an investment adviser."[2]

The SEC's concern surrounding testimonials is well-warranted. Endorsements regarding an investment adviser's services can mislead potential clients about the success or skill of an investment adviser. Testimonials by their very nature "emphasize the comments and activities favorable to the investment adviser and ignore those which are unfavorable."[3] Therefore, testimonials or endorsements are likely to mislead clients by virtue of the fact that they provide a limited point of view regarding an adviser's skill or success.

While the need for a prohibition against testimonials is clear, the issue is complicated when considering content that is created by unaffiliated third-parties, as well as the use of social media. In these instances, the SEC has provided limited guidance to assist investment advisers in navigating the Rule 206(4)-1(a)(1) prohibition.

Partial Client Lists

Use of any client list that puts forth a direct or indirect endorsement of an investment adviser is a per se violation of Rule 206(4)-1(a)(1).

Notwithstanding, partial client lists that do "no more than identify certain clients of an adviser" would not be deemed a testimonial under the rule. The SEC in its No-Action letter to Denver Investment Adviser's Inc. allowed for such partial client lists where the following criteria was met:[4]

- The adviser does not use performance-based criteria in determining which clients to include in the partial list;
- The partial client list is accompanied by a disclaimer stating "[i]t is not known whether the listed clients approve or disapprove of [the investment adviser] or the advisory services provided;"
- The partial client list would include a statement describing the objective criteria used to determine which clients to include in the list.

The Denver letter highlights what is most problematic about client lists as testimonials—the ability for an adviser to cherry-pick positive client experiences with the adviser, creating an inference that the adviser is always successful in achieving its investment objectives. Partial client lists that adhere to the disclosures and processes outlined in the Denver letter mitigate these problems by ensuring there is no endorsement and that the adviser's selection criteria is applied neutrally across its clients.

Third-Party Articles or Reprints

Testimonials may be further implicated when the investment adviser is re-publishing content from an unaffiliated third-party. While an investment adviser has less control over third-party content, the use or reproduction of that content may implicate Rule 206(4)-1(a)(1).

The SEC took this issue up within the DALBAR, Inc. No-Action letter,[5] in which an investment adviser re-published articles showing third-party ratings of the subject adviser. Noting that such reproductions would function as endorsements under Rule 206(4)-1(a)(1), the SEC provided that reprinting third-party ratings may be allowable where the following criteria is met:[6]

- Disclosing the criteria on which the adviser rating was based;
- Confirming the accuracy of the third-party rating or the appropriateness of advertising the rating prior to re-publication;
- Avoiding reprints of favorable rating without also disclosing any unfavorable rating (subject to the availability public ratings);
- The adviser does not state or imply that an adviser was the top-rated adviser in a category when it was not rated first in that category;
- Advertising materials clearly and prominently disclose the category for which the rating was calculated or designation determined, the number of advisers surveyed in that category, and the percentage of advisers that received that rating or designation;
- Advertising materials disclose that the rating may not be representative of any one client's experience because the rating reflects an average of all, or a sample of all, of the experiences of the adviser's clients;
- Advertising materials disclose that the rating is not indicative of the adviser's future performance; and
- Advertising materials prominently disclose who created and conducted the survey, and whether the adviser paid a fee to participate in the survey.

While the DALBAR letter focuses on a particular kind of content (adviser ratings), it's useful to see the SEC's thought process. The factors outlined above allow an

adviser to qualify the re-published, third-party adviser rating, while providing notice to recipients on the article's potential limitations. In essence, the SEC is focusing on advisers providing appropriate context for an article reprint, while maintaining the clear independence between the third-party content creator and the adviser's re-publication.

Social Media Issues

Advisers re-publishing independent websites and leveraging social media platforms (including but not limited to Facebook, Twitter, or LinkedIn) run into similar content issues regarding the potential re-publication of testimonials. Due to the ubiquity of social media platforms, the SEC issued guidance [7] that focuses on how Rule 206(4)-1(a)(1) may be implicated within the context of social media use.

Where an investment adviser or their representative re-publishes public commentary from independent media sites, the SEC noted the prohibition on testimonials would not necessarily be implicated where the adviser has "no ability to affect which public commentary is included or how the public commentary is presented on an independent social media site; where the commenter's ability to include the public commentary is unrestricted; and where the independent social media site allows for the viewing of all public commentary and updating of new commentary on a real-time basis."[8]

The SEC further clarified that re-publication of public commentary would not create the same kind of misleading communications under Rule 206(4)-1(a)(1) where:[9]

- The independent social media site provides content that is independent of the investment adviser or their representatives;
- There is no material connection between the independent social medial site and the investment adviser or their representatives that would call into question the independence of the social media site or commentary; and
- The investment adviser or their representative publishes all the unedited comments appearing on the independent social media site relating to the adviser.

Further, compliance professionals should carefully assess an adviser's independence from, or material connection to, potential third-party content. The SEC noted that commentary would be considered "independent" if it was not authored by the adviser or their representatives, including through an alias.[10] Additionally, the adviser would not be deemed to have a material connection to the content where it did not 1) compensate a social media user for their commentary, and 2) the adviser did not prioritize, remove, or edit the commentary.[11] For platforms that provide a means to leave comments, the SEC expressly states that an adviser may not highlight emphasize, or alter comments, and must display all public comments in a neutral or equally prominent manner.[12]

In short, there are some key takeaways for advisers interested in leveraging social media:

- Use of social media platforms to publish third-party commentary do not automatically run counter to the prohibition on testimonials. However, careful thought should be given to the adviser's independence or connection to the content and the platform used to re-publish any commentary.
- Platforms that allow for user comments on third-party posts should be referenced by the adviser in a way to make recipients aware of all user comments. An adviser using a platform like Facebook or LinkedIn could not

remove, edit, or rearrange certain user comments on its page without violating SEC guidance.

- To that end, advisers should consider what kinds of messages they will disseminate and how they will engage with these platforms. For example, directing Facebook users to a New York Times article about the adviser is lower risk than using the adviser's Facebook to "Like" or "Favorite" posts from public users.
- Where an investment adviser has created an advertisement for posting on social media, the testimonial rule may not be implicated where 1) it would be readily apparent to a reader that the adviser or representative's advertisement is separate from the platform or social media site and 2) receipt or non-receipt of advertising revenue did not influence what commentary is included.[13]
- Any communications through social media would be subject to the other provisions of Rule 206(4)-1, as well as related SEC guidance.

The component that complicates the testimonial issue within social media use is the ability to quickly share across multiple platforms. While the SEC's guidance provides some concrete examples to guide advisers in this space, the considerations are largely fact specific and likely unique to each adviser's methods of social media engagement.

Final Thoughts

Rule 206(4)-1(a)(1) provides a very specific prohibition against the use of testimonials. As such, adviser endorsements from outside parties or clients almost always provide some level of advertising risk to investment advisers, despite their potential utility to describe an adviser's strengths. Advisers that wish to mitigate the risk of misleading testimonials must pay careful attention to the content they are working with, and their methods of publication, to avoid violations of the Advisers Act.

For questions regarding the potential use or evaluation of testimonials, please contact your Gordian consultant.

[1]Rule 206(4)-1(a)(1)

[2] *Cambiar Investors, Inc.*, United States Securities & Exchange Commission (August 28, 1997)

[3] *IM Guidance Update No. 2014-04*, Division of Investment Management (March 2014)

[4] *Denver Investment Advisors, Inc.*, United States Securities & Exchange Commission (July 30, 1993)

[5] *DALBAR, Inc.*, United States Securities & Exchange Commission (March 24, 1998)

[6] *Id.*

[7] *IM Guidance Update No. 2014-04*, United States Securities & Exchange Commission, Division of Investment Management (March 2014)

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *IM Guidance Update No. 2014-04*, United States Securities & Exchange Commission, Division of Investment Management (March 2014)

[12] *Id.*

[13] *Id.*

Enforcement Actions

Several high-profile enforcement actions made the headlines this past quarter:

- **Alpine Securities:**[1] The SEC charged Salt-Lake City brokerage firm Alpine Securities ("Alpine") with violations under Section 17(a) of the Securities and Exchange act of 1934 ("Exchange Act") and Rule 17a-8. The charges stem from Alpine's allegedly manipulative trading practices, coupled with the firm's inadequate Suspicious Activity Reports ("SARs" Reports), which masked their microcap scheme. Alpine is facing thousands of violations under the Exchange Act.

- **David Humphrey (ex-SEC):**[2] Former SEC employee David Humphrey was charged with violations under Sections 17(a) and 10(b) of the Exchange Act for failing to seek pre-approval for prohibited options trades during his employment. When questioned on his personal trading, Humphrey falsely misrepresented his activities to the SEC Office of Inspector General. "Humphrey has agreed to settle the charges and pay $51,917 in disgorgement of profits made in the improper trades plus $4,774 in interest and a $51,917 penalty."[3] The settlement is subject to court approval.

- **Expansive Stock Promotion Scheme**: [4] The SEC brought enforcement actions against 27 individuals and entities involved in stock promotion schemes that mislead investors into thinking these communications were pieces of unbiased stock analysis. Public companies hired writers to allegedly post "bullish articles about the companies on the internet under the guise of impartiality when in reality they were nothing more than paid advertisements."[5] It's unsurprising to see the SEC take such an aggressive stance on these paid efforts, especially given the Rule 206(4)-1(a)(5) prohibition against false and misleading statements. Nonetheless, this case provides an important reminder for advisers to ensure all advertising communications are unbiased, transparent, and accurate.

[1] *SEC Charges Brokerage Firm with Failing to Comply with Anti-Money Laundering Laws*, United States Securities & Exchange Commission (June 5, 2017)
[2] *SEC Charges Former Staffer with Securities Fraud Violations*, United States Securities & Exchange Commission (May 9, 2017)
[3] *Id.*
[4] *SEC: Payments for Bullish Articles on Stocks Must be Disclosed to Investors*, United States Securities & Exchange Commission (April 10, 2017)
[5] *Id.*

NFA AND CFTC NEWS UPDATES

NFA Compliance Rule 2-46 and Additional Reporting on Forms PQR and PR

Starting June 30, 2017, new amendments to NFA Compliance Rule 2-46 will take effect that require Form PQR and PR filers to report information regarding the following two ratios:[1]

- Current Assets/Current Liabilities (CA/CL) Ratio—This ratio divides a firm's current assets by its current liabilities, providing a measure of a firm's liquidity. This ratio is based on a firm's current asset and current liability balances at the reporting quarter end.

- Total Revenue/Total Expenses (TR/TE) Ratio—This ratio divides a firm's total revenue by its total expenses, measuring a firm's operating margin. Although a firm will report this ratio each quarter, the ratio must reflect the total revenue earned and total expenses incurred during the prior 12 months.

The NFA issued a notice back on December 19, 2016, noting that these data points would help identify CPOs and CTAs that potentially face financial difficulties, and thus, may be impaired in their ability to act in the best interests of their clients.[2] Enhanced ratio reporting on Forms PQR and PR would also require member firms to maintain records substantiating the reported figures pursuant to NFA Compliance Rule 2-10. [3]

The NFA has also provided additional materials and resources regarding this enhanced ratio reporting, accessible here.

[1] *Notice I-16-31 – Effective Date of Interpretive Notice to NFA Compliance Rule 2-46: Reporting Financial Information on NFA Forms PQR and PR*, National Futures Association (December 19, 2016)

[2] *Id.*

[3] *Id.*

Website

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