

# Testimonials and Endorsements: Lessons to be Learned for Implementing Effective Policies and Procedures

2023 ANNUAL COMPLIANCE CONFERENCE

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[ContEd@ria-compliance-consultants.com](mailto:ContEd@ria-compliance-consultants.com)

# Your Instructors

▶ Jarrold James, Senior Vice President

▶ Jarrod has spent his entire career (twenty-two years) working with investment advisers as a compliance professional. His current compliance consulting practice focuses on helping SEC and state-registered firms of all business types and models.

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▶ Teresa O'Grady, Senior Compliance Consultant

▶ Teresa began her career in the financial services industry in 1989, when she joined Ameritrade, Inc. Throughout her career, she worked for several other local firms gaining experience in almost every facet of the broker dealer and investment adviser industry. Teresa joined RCC in 2016 and enjoys helping investment adviser firms meet their regulatory and compliance obligations.

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# Course Overview

- Regulatory Resources
- Introduction
- Understanding Testimonials and Endorsements
  - SEC Definitions, Differences and Changes from Former Rules
  - Updating Compliance Program for New Rule
    - Are Testimonials and Endorsement Allowed
    - Is Compensation Permitted
    - Required Disclosures
    - Pre-Approval Process
    - Is Agreement Required
  - Required Disclosures if Allow Testimonials and Endorsements
  - Updating ADV Documents
  - Prohibitions

# Course Overview

- Developing Effective Policies and Procedures
  - Benefits, Risks and Challenges When Allowing Testimonials and Endorsements
    - Firm Must Ensure All Testimonials and Endorsements are Reviewed and Documented
    - Process for Handling Negative Reviews
    - Identify Who Can Post and Where Posts are Allowed
      - Website
      - Social Media
    - Ensure Compliance With Prohibitions
    - Ensure Supervision and Auditing Practices Comply with Rule
    - Record Keeping
- Questions

# Regulatory Resources



Final Rule Release for SEC's New Marketing Rule:

<https://www.sec.gov/rules/final/2020/ia-5653.pdf>



SEC's Marketing Compliance Frequently Asked Questions:

<https://www.sec.gov/investment/marketing-faq>



SEC Risk Alert –Examinations Focused on New Investment Adviser Marketing Rule (9/19/22):

<https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf>



# Understanding Testimonials and Endorsements

## ➤ Definition of Testimonial

- ▶ *Testimonial means any statement by a current client or investor in a private fund advised by the investment adviser:*
  - ▶ *(i) About the client or investor's experience with the investment adviser or its supervised persons;*
  - ▶ *(ii) That directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or*
  - ▶ *(iii) That refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.*



# Understanding Testimonials and Endorsements

- **Definition of Endorsement**
- *Endorsement means any statement by a person other than a current client or investor in a private fund advised by the investment adviser that:*
  - (i) Indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment adviser or its supervised persons;*
  - (i) Directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or*
  - (i) Refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.*

# Understanding Testimonials and Endorsements

## Rule Includes:

### Investment Advisers Registered with SEC

- Includes SEC RIAs to Private Funds & Investors in Such Funds
- Investment Adviser Required to Be Registered with SEC

## Rule Excludes:

### Exempt Reporting Advisers

### State Registered Investment Advisers

- Check with State Regulator



# Understanding Testimonials and Endorsements

Rule 206(4)-3 Rescinded

Key Requirements of old Rule 206(4)-3 are now included within the requirements of Rule 206(4)-1

# Understanding Testimonials and Endorsements

- Description of Changes From Former Rule
  - Allows Testimonials and Endorsements
  - Allows Advertisement of Third-Party Ratings
  - Replaces the Former Solicitor Rule – Solicitors Now Called “Promoters”
  - Includes All Forms of Compensation – Not Just Cash Compensation
  - Includes Current and Prospective Investors in Private Fund
  - Eliminates Certain Requirements Such as Separate Disclosure Document and Delivery of ADV Part 2A
  - Requires Oversight and Compliance of Testimonials and Endorsements



# Understanding Testimonials and Endorsements

## ➤ EXAMPLES

- May include a lawyer or other service provider that refers an investor to an adviser, even infrequently, depending upon the facts and circumstances
- May include lead-generation firms and referral networks if tout adviser or match client with adviser and receives compensation from the adviser
- May include blogger website review because it indicates approval, support, or a recommendation of the adviser, or because it describes its experience with the adviser and receives compensation from the adviser
- However, hiring a third-party marketing service to prepare a communication generally wouldn't be an endorsement
- Likewise, a non-investor selling an adviser a list containing the names and contact information of prospective investors typically would not, without more, meet the definition of endorsement



# Understanding Testimonials and Endorsements

## 1) Updating the Firm's Compliance Manual to Allow for Testimonials and Endorsements

- Questions Each Investment Adviser Must Answer:
  - Will Testimonials and Endorsements Be Allowed By the Firm?
  - Will Compensation Be Permitted?
  - What Disclosures are Required and Necessary?
  - Will there be a Pre-Approval Process?
  - Is an Agreement Required?

# Understanding Testimonials and Endorsements

## 2) **Maintaining the Files**

- Testimonials and Endorsements May be Considered Advertisements and Investment Adviser Must Ensure the Review of Each

## 3) **Updating ADV Documents**

- ADV Part 1, Item 5.L – Questions Must be Answered
- ADV Part 1, Item 8.H.(1) & ADV Part 2A, Item 14 – Compensate any person that is not an employee for client referrals

## 4) **Training Supervised Persons of the Firm**

- No Engagement with Individual or Posting Prior to Firm Review

# Understanding Testimonials and Endorsements

## ➤ **Required Disclosures That Must be Clear & Prominent**

- The Investment Adviser Discloses, or Reasonably Believes that the Person Giving the Testimonial or Endorsement Discloses the Following at the Time the Testimonial or Endorsement is Disseminated:
  - (A) That the testimonial was given by a current client or investor, and the endorsement was given by a person other than a current client or investor, as applicable;
  - (B) That cash or non-cash compensation was provided for the testimonial or endorsement, if applicable;
  - (C) A brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person.

\* If the Disclosures are not Provided at the Time the Testimonial or Endorsement is Disseminated, Many of the Disclosures May Not Have the Same Impact on Investors.



# Understanding Testimonials and Endorsements

## ➤ **Clear & Prominent Disclosures:**

1) Disclosures Must be Included Within the Testimonial or Endorsement to be Read at the Same Time;

2) Cannot Refer Reader to Somewhere Else for Disclosures;

3) Oral Testimonials and Endorsement are Allowed and Disclosures Must be Provided at the Same Time.

# Understanding Testimonials and Endorsements

## Other Required Disclosures Not Necessarily Clear & Prominent

- The material terms of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the person for the testimonial or endorsement.
- A detailed description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person and/or any compensation arrangement.
- Other disclosures (not required to be clear and prominent), which can provide useful information but are not integral to the SEC's concerns about testimonials and endorsements, can be provided via paper, electronically or orally by separate disclosure. If delivered orally, Firm must have a recording.

# Understanding Testimonials and Endorsements

## Conflicts of Interest Disclosures

- There should be explicit disclosure that the promoter, due to such compensation, has an incentive to recommend the adviser, resulting in a material conflict of interest.
- A promoter could have other material conflicts of interest based on a relationship with the investment adviser that could affect the credibility of the testimonial or endorsement.



# Understanding Testimonials and Endorsements

- **Written Agreements**
  - Written Agreement Required for Compensated Testimonials and Endorsements Over \$1,000 in the previous 12-month Period.
  - Written Agreement Must Describe the Scope of the Activities and the Terms of Compensation for the Activities.
  - No Written Agreement Required for Related Persons.



# Understanding Testimonials and Endorsements

## ➤ **Types of Compensation**

- Cash Compensation Includes Fees Based on a Percentage of Assets Under Management or Amounts Invested, Flat Fees, Retainers, Hourly Fees, Reduced Advisory Fees, Fee Waivers, and Any Other Methods of Cash Compensation.
- Non-Cash Compensation Incentivizes Persons to Provide a Positive Statement About an Adviser or Makes a Referral or Solicitation on an Adviser's Behalf and Thus Must be Disclosed. Examples Include Entertainment, Tours, Outings, Sales Awards and Gifts.
- No Compensation Can be Paid for a Testimonial or Endorsement to an Ineligible Person.

# Understanding Testimonials and Endorsements

- **Partial Exemption for Related Persons of Firm**

Testimonial or Endorsement by Related Persons of Firm Are Not Required to Comply with Disclosure and Agreement Requirements as Long as Affiliation is Readily Apparent or Disclosed to Client or Investor at the Time the Testimonial or Endorsement is Made.



# Understanding Testimonials and Endorsements

- **Partial Exemption for De Minimus Compensation**

A Testimonial or Endorsement Disseminated For No Compensation or De minimus Compensation (\$1,000 or Less or Equivalent in Non-Cash Compensation During Preceding 12 Months) is Not Required to Comply With the Written Agreement and/or Disqualification Requirements.

# Understanding Testimonials and Endorsements

- **Some Prohibitions of Testimonials and Endorsements**
  - Making an untrue statement of a material fact, or omitting a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;
  - Making a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;
  - Including information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser;

# Understanding Testimonials and Endorsements

- **Some Prohibitions of Testimonials and Endorsements - Continued**
  - Discussing any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;
  - Including information that is otherwise materially misleading;
  - Statements are inconsistent with the experience of other individuals;
  - Disclosures are not in accordance with proximity and timing requirements;
  - Disclosures given orally are not recorded and preserved; and
  - Written Agreements are Not Signed.



# Developing Effective Policies & Procedures

If Firm Determines It Will Allow Testimonials and Endorsements:

- **1) Firm Must Determine the Benefits, Risks and Challenges When Allowing Testimonials and Endorsements**
  - Firm Must Ensure All Testimonials and Endorsements Are Reviewed and Documented.
  - Firm Must Ensure Supervised Persons Are Not Posting Testimonials and Endorsements without Approval or Required Disclosures.
  - Do the Benefits of Allowing Testimonials and Endorsements Outweigh the Risks?
  - What if There is a Negative Review? Does the Firm Have a Process For Handling?
    - Firm Does Not Need Equal Number of Negative Testimonials or Endorsement Alongside Positive Testimonials or Endorsements in an Advertisement for Balance.
  - Firm Must Identify Who Can Post Testimonials and Endorsements and Where.
  - An Annual Review by the Supervisor That the Individual Giving the Testimonial or Endorsement is not Disqualified from Providing Such Service.

# Developing Effective Policies & Procedures

If Firm Determines It Will Allow Testimonials and Endorsements:

## **2) Firm Must Ensure Compliance With Prohibitions.**

Examples:

- ▶ It would be misleading for an adviser to compensate a person to refer investors to the adviser by stating that the person had a “positive experience” with the adviser when such person is not an advisory client but an insurance client.
- ▶ An adviser may not provide a testimonial on its website where a client falsely claims that the client has worked with the Adviser for over 20 years when the Adviser has only been in business for five years.
- ▶ It would be misleading if a prospective client gave a positive endorsement in expectation of getting a discounted fee from Advisor for advisory services.

# Developing Effective Policies & Procedures

As a best practice, due diligence of an individual (Promoter) giving a testimonial or endorsement who eligible to receive more than \$1,000 during the next 12 months or an existing Promoter who has received more than \$1,000, at a minimum, should include at a minimum:

A background check;

A review of professional licenses;

Confirmation that the individual (Promoter) is not prohibited from entering into an arrangement with the investment adviser;

A review of state licensing rules to ensure individual (Promoter) is not required to be registered.



# Developing Effective Policies & Procedures

If Firm Determines It Will Allow Testimonials and Endorsements:

### **3) Firm Must Have Supervision and Auditing Practices to Ensure Compliance With the Rule.**

- Determine if Pre-Approval Is Required
- Implement Daily Internal Review Process
  - Check Websites and Social Media Sites for New Testimonials and Endorsements
  - Ensure All Testimonials and Endorsements Were Approved if Pre-Approval Required
  - Ensure the Testimonials and Endorsements Posted Are the Approved Version
  - Ensure All Required Disclosures Are Present
  - Have a Disciplinary Escalation Policy for Those Who Violate the Policy
- ▶ Implement Annual Audit Review Process
  - ▶ Review Sampling of Testimonials and Endorsements Approved as Part of Annual Compliance Review
  - ▶ Add Use of Testimonials and Endorsements to Firm's Risk Inventory

# Developing Effective Policies & Procedures

If Firm Determines It Will Allow Testimonials and Endorsements:

## 4) Record Keeping

- Rule requires the Adviser to maintain and preserve these records “in an easily accessible place for a period of not less than five years, the first two years in an appropriate office of the Investment Adviser, from the end of the fiscal year during which the investment adviser last published or otherwise disseminated, directly or indirectly, the advertisement.
- Investment Adviser is required to keep a copy of the advertisement (as defined in Rule 206(4)-1(e)(1)) that the Investment Adviser disseminates, directly or indirectly.
  - Exception: For compensated oral testimonials and endorsements (as defined in Rule 206(4)-1(e)(17) and (5)), the adviser may instead make and keep a record of the disclosures provided to clients or investors pursuant to Rule 206(4)-1(b)(1) of this chapter.

# Developing Effective Policies & Procedures

If Firm Determines It Will Allow Testimonials and Endorsements:

## **4) Record Keeping - Continued**

- If not included in the advertisement, a record of the required Testimonial and Endorsement disclosures provided to clients or investors.
- Documentation substantiating the adviser's reasonable basis for believing that a testimonial or endorsement complies with Rule 206(4)-1.
- A record of the names of all persons who are an Investment Adviser's partners, officers, directors, or employees, or a person that controls, is controlled by, or is under common control with the Investment Adviser, or is a partner, officer, director or employee of such a person pursuant to Rule 206(4)-1
  - (i.e., Endorsement by a Related Person)



# Developing Effective Policies & Procedures

**A Testimonial and Endorsement that did not go through the firm's stated review process should be:**

1) Taken Down Immediately;

2) Reviewed by the Supervisor for Compliance with the Rule;

3) Documented on a Non-Compliance Log as a Violation;

4) Take Steps to Reprimand the Supervised Person Responsible for the Post.

# Developing Effective Policies & Procedures



If Firm Does **NOT** Allow Testimonials and Endorsements



Part of an effective procedure is reviewing advertisements to ensure the firm and its supervised persons are not posting Testimonials and Endorsements on any form of communication.

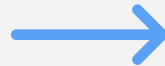
# Sample Testimonial



"ABC Investments has been my investment adviser for 10 years. They are transparent and always willing to answer my questions. They do a great job of explaining complicated issues in an easy-to-understand manner".



"I recommend you call them to learn how they can help you!"



Disclosure: The preceding is a non-paid testimonial from a current client of ABC Investments. The client was solicited by ABC Investments to provide the testimonial.



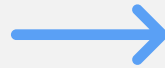
# Sample Endorsement



“ABC Investments has helped me with all my insurance needs. I heard their advisory services are also stellar.”



“Call ABC Investments for all your financial needs.”



Disclosure: The preceding is an endorsement from a non-client.

# Questions

Please submit any question online or email with any questions about the content of this course.

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Thank You

