Legal and Regulatory Compliance Considerations for Business Transitions

By Michelle L. Jacko

Introduction & Background

Ever since the financial crisis of 2008, we have witnessed an increase in registered investment advisory business growth. Traditional brokers are "breaking away" to form their own independent businesses and existing registered investment advisers are joining forces with other advisers in order to accelerate growth opportunities in the marketplace. Also, mergers and acquisitions are becoming more and more common place as a result of strategic transition planning. Each of these scenarios has a series of regulatory compliance considerations the business must face, whether on the breakaway path or on the merger and acquisition side. This article will discuss the labyrinth of regulatory compliance issues involved in breaking away and either starting an independent advisory business or joining forces with an existing adviser. We will use case scenarios in order to articulate a variety of considerations that must be evaluated.

Breakaway Considerations that Representatives Face

Case Study #1: Joe and Jean are affiliated with a nationally well-known broker-dealer and investment adviser (the "employer"). After much contemplation and discussions with their team about the firm's business model and clients' needs, Joe and Jean have decided that they would like to break away and form a new registered investment adviser to be named *J&J Independent Advisors*. They contact their professional advisors, including a securities attorney and a compliance consultant, for guidance on what they need to consider from a regulatory standpoint. To their surprise, there was a lot more to this process than merely forming a new corporate entity and registering with the SEC. Here is what they learned.

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Formulate a Strategic Plan

The key to beginning any successful business lift-out is to formulate a strategic plan. There are many facets to owning and operating an independent business. While historically Joe and Jean simply utilized the back office of and followed instructions from their employer, now they have to make those critical decisions. From products and service offerings to research, trading platforms, fee assessments and invoicing clients, Joe and Jean need to determine how to best structure the business. Building a strategic plan helps to chart this vision and plan for how things will be done, which will eventually be disclosed on Forms ADV. The strategic plan should outline, among other things:

- The types of products or services that will be offered;
- Business goals and objectives;
- A marketing plan to target new clients and service existing clients;
- Management and organizational structure;
- Staff and recruiting needs;
- Internal controls and resources necessary to comply with complex regulations;
- Financial goals, budget considerations and earnings projections; and
- Operational systems and outsourcing necessary for the business.

Hire Strategic Business Advisors

Once Joe and Jean formulate their strategic plan, the next step is to secure legal counsel, if they have not already done so. Many types of attorneys are available; however, a specialist in one area may not necessarily be experienced in another. Therefore, Joe and Jean take time to research, interview and assess the skills and competence of the legal counsel they ultimately select.

Joe's and Jean's legal engagement commenced while they still were associated with their employer. Among other things, they requested that legal counsel perform many different tasks, including the review and assessment of their:

- Current employment agreement and any restrictive covenants;
- Client contracts for notification and assignment provisions;
- Business plan to see if any material provisions were not included and need to be addressed;
- Custodial relationships, considering the best techniques for transitioning clients; and
- Current payout and other compensation arrangements with the employer, including terms relating to any commission or bonus schedules, promissory notes and payback provisions relating thereto.

Legal counsel serves as a mentor to guide Joe and Jean through the breakaway process. Counsel is involved in the preparation, development and execution phases for each step, and serves as a strategic advisor for addressing certain challenges during the transition. Here are some of the most common areas that counsel analyzes.

1. Key Employment Contract Provisions – In reviewing Joe's and Jean's respective employment agreements, counsel found very specific language relating to non-competition, non-solicitation and trade secrets, with detailed provisions relating to final payouts and transference of client accounts and records to an outside entity.

While some states uphold noncompetition agreements if they are subject to reasonable time and geographic constraints, other states view noncompetition agreements as a barrier to the right to engage in lawful employment. Accordingly, such courts find noncompetition agreements void and contrary to public policy.

Similarly, non-solicitation provisions, in which an employee agrees not to solicit the firm's clients for his or her own benefit or for the benefit of a competitor after leaving the company, are viewed by some states as void and unenforceable because of constraints placed on the marketplace. To be enforceable, the non-solicitation provision must:

- Have a valid business reason (such as protecting a client list or trade secret);
- The "protected information" must have a value (*e.g.,* a proprietary method and not the internet was used to create a client list); and
- The client is not prohibited from moving its account elsewhere.

On the other hand, a trade secret generally is protected. Suppose that Joe's and Jean's principal place of business is based in California. Considering the laws within that jurisdiction, California defines trade secrets as "information that (a) derives independent economic value, actual or potential, from

not being generally known to the public […]; and (b) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."[1]

Joe and Jean are concerned that their respective client lists could be viewed as a "trade secret" and ask counsel to investigate. Counsel explains that in order to be a trade secret, the client list must have an "economic value." California courts have interpreted this to mean that the secrecy of this information provides a business with a "substantial business advantage."[2]

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Logically, a client list can be found to have economic value because its disclosure would allow a competitor to direct its sales efforts to those clients who have already shown a willingness to use a unique type of service or product as opposed to a list of people who only *might* be interested. In other words, the use of a misappropriated client list enables an advisor to solicit potential clients more selectively and more effectively.

To satisfy the requirement that efforts were made to "reasonably" protect the trade secret, counsel explains that more is needed than simply labeling the client list as "confidential." Counsel asks the following to assist in the assessment:

- Is the information on the client list readily derivable from publicly-available sources;
- Does the firm have policies about the use of confidential business information;
- Is the client list labeled as a "trade secret" or "confidential information";
- Who was the source of the client list – the employer or Joe and Jean;
- Have Joe and Jean signed a trade secret or employee proprietary information and assignment of inventions agreement with the employer; and
- Have steps been taken by the employer to limit accessibility of the client list, such as restricting access and/or password protecting the list?

Dependent upon the answers, such actions will help in determining whether it was the intent of the employer to protect the client list as a trade secret.

Joe and Jean also are concerned about their final payout. They want to know whether the employer can withhold their commissions and advisory fees after they provide a notice of termination. The answer: it depends.

Counsel reviews their employment contract to determine whether there are any conditions set forth for final payout. Often employers stipulate that the advisor must wait 30 to 60 days after quarter end for all final fees to be debited from his or her payout. This would include fees for Errors and Omissions (E&O) insurance coverage, repayment of promissory notes or loans due to employer, registration and licensing fees and overrides. If there are no compliance or regulatory concerns and fees are reconciled and paid in full prior to the stipulated time period, the employer typically releases the payout as soon as practical. However, if the employer commences an internal review for investigating potential compliance infractions, if there is a dispute about a fee owed to the employer or an outstanding fee owed to the employer or one that has not yet been reconciled (for example, an invoice due but not yet received), the payout may be delayed – but will occur eventually once the parties come to a resolution.

Finally, Joe and Jean are concerned about their historical client records. Ideally, they would like to make copies and transfer all records to their new firm but are concerned that there may be ramifications for doing so. And they are right to be concerned.

Most employers have very specific provisions relating to an advisor's ability to take any books and records with him or her to an outside independent firm. This is because the employer is bound by certain regulatory provisions, such as Regulation S-P, and internal protocols to protect proprietary information of the firm.

Regulation S-P[3] is aimed at preventing financial institutions from disclosing various types of non-public personal information gathered from individual clients to certain unaffiliated entities. It covers information that is not already publicly available, and is provided by a customer to obtain a service. Examples include age, telephone number as well as social security number and date of birth. Thus, at the

very least, the employer will be concerned about protecting and safeguarding certain customer information obtained by employer as a result of the customer's request to open a brokerage account and/or enter into an advisory contract.[4] To provide for such protections, financial firms adopt certain policies and procedures to safeguard and protect confidential non-public information, with which Joe and Jean must comply. Counsel therefore requests to review the employer's policies and procedures manual for these provisions to provide guidance as to the regulatory compliance considerations for Joe's and Jean's ability to remove any files, books or records that contain this customer information. Their greatest concern is to have the ability to contact their existing clients once they leave their employer.

One solution that could be available to Joe and Jean is reliance on the "Broker Protocol."[5] Adopted in August 2004, the Broker Protocol was constructed to allow advisors leaving one Protocol firm to join another Protocol firm to maintain a list of their clients for solicitation purposes without fear of litigation. Notably, both investment advisers and broker-dealers can become members of the protocol.

After further research, Joe and Jean are happy to discover that their employer is a member of the Broker Protocol. Furthermore, they are not opposed to having *J&J Independent Advisors* apply for membership to become a Protocol firm. If both firms are signatories to this protocol at the time of Joe's and Jean's termination, Joe and Jean may take limited account information with them: client name, address, phone number, email address, and account title of the clients that they serviced while at the employer (the "Client Information"). However, they are prohibited from taking any other documents or information until they receive a written request from the client authorizing the release of the client's account information to Joe and Jean at their new firm. Once the written request is received by employer, the employer will forward the client's recent statements and other records concerning the client's positions to the former advisor.

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Importantly, to satisfy the protocol's requirements, both Joe and Jean must provide a written resignation to their branch manager. The resignation letter must include a list of the Client Information that the advisor is taking with him or her, which also must include the account numbers associated with those clients' accounts. Should they comply with these provisions, Joe and Jean are able to solicit customers that they serviced while at their former employer after they join their new firm without fear of litigation.[6]

2. Transitioning to the New Firm – Joe and Jean are concerned about the transitioning process. They ask counsel to outline what they will need to do in order to make *J&J Independent Advisors* fully operational. The following are those areas that need to be addressed:

- Complete all filings and corporate resolutions for formation of the entity (LLC, S-Corp, Partnership, etc.)
- File Forms ADV to apply for registration with the state(s) or SEC
- Complete Forms U4 (as required) and Form ADV Part 2B for those professionals who will provide advisory services
- Engage counsel to draft client agreements, employee and independent contractor agreements and other business contracts
- Develop operational documents, including privacy notices, written policies and procedures, business continuity plans, code of ethics and marketing collateral[7]
- Identify and engage key vendors to support the business (including custodial arrangements, electronic record maintenance, E&O insurance carriers, information technology (IT), etc.)
- Secure appropriate insurance coverage for the new business

From a timing standpoint, review and approval of the application for investment adviser registration differs. The registration process for state-registered advisers typically takes 30 to 90 days from the initial date of the filing. SEC filings generally take less time. Formulation of the internal control processes for the new advisory firm generally can be done within two to three months, or shorter with the assistance of professional advisors.

3. Exit Strategy from the Employer – One of the most difficult things facing Joe and Jean is informing their employer about their impending departure. When they depart and how they provide notice is critical.

The timing of the departure should be based on several factors, including, among other things:

- Whether the new firm's application is ready to be approved by the regulator(s);
- Ability and preparedness to open the new firm;
- Whether *J&J Independent Advisors* has completed the necessary steps to become a member of the Broker Protocol; and
- Ability to pay back any promissory note owed to the employer.

RISK MANAGEMENT TIP: After submission of the application, have counsel contact the regulators to request a specific date that you desire the application to be approved, which will synch with departure of the employee to avoid problems with potential violations involving Outside Business Activity reporting. Per FINRA Rule 3270, no registered person may be compensated from any other person outside of the member firm unless he or she has provided written notice and received approval from the broker-dealer.

Assuming that Joe and Jean are on target with completing these items, they now are ready to prepare their notice of resignation. Counsel advises them to include the following within their notice letter:

- Effective date of termination;
- List of any files/records in their possession (including the Broker Protocol client list);
- Inventory of all items being returned to the employer; and
- If applicable, a check for repayment of the promissory note.[8]

Where possible, it is important to deliver the termination notice in person so that the employees can address their understanding of what books and records they can and cannot take. Dependent upon the employer, the employee may be entitled to receive certain copies of client records, particularly in the independent broker-dealer / investment adviser business models.

Having a candid, open discussion with the employer about the termination will help to avoid potential concerns from the employer's perspective and may help to expedite the employer's submission of the employee's Form U5.

III. Onboarding New Advisors: Considerations for the Hiring Firm

As Joe's and Jean's practice begins to thrive, they consider bringing on a new team of advisors to join their wealth management practice. They are excited about the potential synergies that this brings, including a new portfolio management team and expansion of service offerings they can make available to their clients. They contact counsel for guidance on what due diligence steps they should take when evaluating the new advisors, including potential impacts that onboarding a new team will have to their business.

1. Impact to the Firm

First, Joe and Jean need to consider whether the new team will be provided with equity ownership. They ask for counsel's guidance on what, if any, impact this may have on the firm, other than dilution of potential profits from the current owners.

From a regulatory perspective, counsel explains that certain regulatory filings may be necessary. If there is a material change in ownership (for example, a non-registered company will now own a substantial amount of assets and liabilities of the advisory business), then a succession by application is required. This means that within 30 days of the succession, Joe and Jean will need to file a new Form ADV application for registration with the SEC or state(s). If, on the other hand, there is no change in management or control,[9] but a new advisory entity is formed for purposes of this merger, then a succession by amendment filing is required for the SEC or state(s), which is completed by updating the current adviser's Form ADV Part 1. Finally, if there is no change in management or control and no new advisory entity formed, then Joe and Jean would complete an "other than annual amendment" by updating and adding disclosures about the new team members and related products, service offerings, fees and conflicts on the current adviser's Forms ADV.

From an operational and compliance risk management perspective, Joe and Jean must evaluate the current internal controls of *J&J Independent Advisors* to determine what will be needed in order to supervise and oversee new products and service areas. For example:

- Is anyone at the firm experienced in the new area and thus qualified to "supervise" related activities?

- Does the firm have technology to surveil the activities?
- If the new advisors wish to market their historic track record, do they have requisite books and records and conditions required for portability of performance?
- Does the new team require technologies that might not yet be used by *J&J Independent Advisors?*
- Are new client disclosures required based on the new products and services being offered?
- Will policies and procedures need to be developed to cover the new area(s)?
- Are new conflicts now apparent that need to be mitigated or eliminated?
- Will marketing collateral, including websites, social media, pitch books and firm overview material require updating and additional disclosures?

Finally, counsel asks Joe and Jean how they have conducted and documented due diligence on the new potential team members. While the prospect for potential upside in the venture weighs heavily on Joe's and Jean's excitement for moving forward, they soon realize that they should be more methodical and thoroughly conduct pre-hire background checks for the onboarding team. Specifically, with the guidance of counsel, Joe and Jean:

- Conduct a criminal and credit background on all potential onboarding team members;
- Use BrokerCheck[10] to see if there have been any previous disciplinary reporting pages (DRPs) completed on the advisor;
- Ask the onboarding team members to:
  - Complete Form U4, with focus on all disciplinary reporting disclosures;
  - Provide a copy of their current employment or independent contractor agreement, which will be provided to counsel for review of restrictive covenants;
  - Provide information[11] relating to the practicality of bringing over assets;
  - Provide a list of all political contributions that the advisor may have made over the past two years, particularly if JJ Independent Advisors has advisory service agreements with the government or transacts in municipal securities;
  - Disclose all outside business activities currently performed by the advisor so as to understand potential conflicts;
  - Complete a new-hire questionnaire, which includes information as to whether there are any current or pending customer complaints or regulatory inquiries; where personal outside brokerage accounts are held, how they currently market to prospects, and strategies used for managing assets;
  - Provide any information relating to concerns for departing the current employer (e.g., substantial debt repayment, compliance concerns that could impact Form U5 filings, inadvertent possession of an employer record on personal laptop, etc.);
  - Deliver a copy of the advisory client agreements that currently are in place to determine if positive or negative consent notifications are required; and
  - In the case of portability, request affirmation that the team members, pursuant to their current agreement with their employer, have obtained or can obtain all requisite records to support the portability of their performance track record;
- Request that all potential onboarding team members meet with various members of the senior management team to evaluate whether there is a "cultural fit."

Joe and Jean have learned through the years that good compliance means good business and less administration. It is important for them to onboard a team that has a similar philosophy and ethical standards as they have carefully set forth for *J&J Independent Advisors.* Taking time now to help identify potential issues will help provide for a smooth transition and set expectations for the future.

2. Compliance Program Requirements: Considerations for Hybrid Advisors

Through their due diligence, Joe and Jean learn that one of the potential onboarding advisors currently is registered with a broker-dealer in order to sell certain brokerage products to her legacy customers (the "hybrid advisor"). From a compliance perspective, this presents certain challenges.

Pursuant to FINRA Notice to Members 94-44 and 96-33,[12] broker-dealers are required to supervise their registered representatives' outside business activities, including advisory activities. In particular, 96-33 suggests that the broker-dealer:

- Maintain a supervisory recordkeeping system that captures all securities transactions of the hybrid advisor; and

- Supervise the advisory activities conducted by the hybrid advisor, which may require the broker-dealer to obtain copies of:
  - All advisory client contracts;
  - A list of all advisory client new business for those who also are clients of the broker-dealer (hereinafter "dual clients");
  - Duplicate confirmations and advisory client account statements;
  - Correspondence files for dual clients;
  - Suitability reviews for dual clients; and
  - Advertising files.

While Joe and Jean appreciate the hybrid advisor's desire to service legacy brokerage clients, Joe and Jean need to weigh the administrative and regulatory challenges that this arrangement brings to *J&J Independent Advisors* and determine if they wish to permit this outside business activity.

Importantly, if this activity is allowed, *J&J Independent Advisors* will be impacted by the fact that the hybrid advisor is subject to a second regulator—FINRA—and oversight by the broker-dealer. Furthermore, *J&J Independent Advisors* will be faced with the challenge of new supervisory obligations to become familiar with the products and services being offered by the hybrid advisor and, from an internal control standpoint, should adopt written policies and procedures that closely align with the broker-dealer's requirements for certain sales transactions and outside business activities, as applicable.

IV. Concluding Thoughts – Compliance Risk Management Checklist

Many times the role of compliance is that of a business advisor. Based on the above hypothetical, we cannot tell if Joe or Jean was designated as the firm's Chief Compliance Officer ("CCO"), or if another individual within the organization was appointed that role. Regardless of the answer, the CCO plays a critical role here in providing guidance to the business and liaising with the firm's professional advisors as to what regulatory compliance requirements *J&J Independent Advisors* must consider if they are to go independent and/or bring on new advisors.

The purpose of this article was to provide guidance on various considerations the business will face in either scenario.

Compliance Risk Management Checklist for Business Transition Planning

- ☐ Formulate the strategic business plan
- ☐ Assemble your list of professional advisors
- ☐ Evaluate current employment and independent contractor agreements for restrictive covenants on non-competition, non-solicitation and trade secrets and other terms relating to termination
- ☐ Commence application for registering as an independent investment adviser
- ☐ Discuss with counsel options for pay back terms for existing promissory notes with the employer
- ☐ Create client disclosure documents, including Forms ADV, privacy notices, offering memoranda and marketing disclosures, as applicable
- ☐ Prepare client agreements for all services to be provided by the adviser
- ☐ Have counsel author agreements and letters, as necessary, for all employees and independent contractors
- ☐ Conduct background and compliance checks on all new hires
- ☐ Prepare or update written compliance policies and procedures
- ☐ Confer with your insurance carrier to purchase E&O, Directors and Officers (D&O) and other forms of insurance
- ☐ Assess all compliance and operational requirements and develop a project manager for implementation
- ☐ Select broker/custodian or prime broker as needed
- ☐ Prepare communications for announcing the launch of the new firm, service area or team and work with counsel to understand the boundaries involving solicitation

In preparation for meeting with senior management, the CCO should consider the following checklist to help navigate through the complex compliance requirements involving the transition to a new business model due to breaking away or merging and acquiring a new team.

ENDNOTES

1 *See* generally, *Gordon v. Landau,* 49 Cal.2d 690 (1958); *Gordon v. Schwartz,* 147 Cal.App.2d 213(1956); *Gordon v. Wasserman,* 153 Cal.App.2d 328 (1957).

2 Klamath–Orleans Lumber, Inc. v. Miller, 87 Cal. App.3d 458 (1978).

3 Section 248.10 of Regulation S-P provides the limits on disclosure of nonpublic information to nonaffiliated third parties. Specifically, it prohibits a financial institution, directly or through its affiliates, from sharing nonpublic information about a consumer with a nonaffiliated third party unless the institution:
- provides the consumer with notice of the institution's privacy policies;
- provides the consumer with a clear and conspicuous notice that the consumer's nonpublic personal information may be disclosed to nonaffiliated third parties;
- gives the consumer a reasonable opportunity to opt-out of that disclosure prior to the institution disclosing that information; and
- informs the consumer how to opt-out (such as by mailing a form, calling a toll-free number or other reasonable method within 30-days after the date the opt out notice was mailed).

4 For more information, see 17 C.F.R. § 248.3(k)(2)(i)(A).

5 For more information, please visit http://www.bressler.com/broker-protocol.

6 Note, however, that certain claims that are excepted from the Protocol, including, among other things, solicitation of customers prior to resignation, retention of customer records or other information outside of the Protocol, soliciting employees to resign from the former employer, and collection of monies due under promissory notes.

7 Depending upon whether the adviser is a state or SEC registrant, requirements differ and may not be mandated. Advisers are strongly advised to confer with professional advisors to find out more information for their specific situation.

8 It is strongly advised to work with counsel regarding the terms of the promissory note. Often counsel contacts the employer's legal department following the employee's departure to discuss repayment options.

9 In accordance with the instructions for submitting Form ADV Part 1, for Corporations, a person (which includes corporate entities) is presumed to control a corporation if the person: (i) directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or (ii) has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities. For limited liability companies ("LLCs"), a person is presumed to control a LLC if the person: (i) directly or indirectly has the right to vote 25 percent or more of a class of the interests of the LLC; (ii) has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the LLC; or (iii) is an elected manager of the LLC.

10 BrokerCheck can be accessed by going to http://www.finra.org/.

11 Be sure that such information does not include client account information, which could be in violation of Regulation S-P and client contracts.

12 For additional information, see also FINRA Rule 3270.