

**Legal Risk Management Tip**  
**April 2016**

**BREAKING AWAY: VITAL CONSIDERATIONS FOR THE TRANSITIONING ADVISOR**

There are many reasons why an investment adviser representative (“IAR”) or registered representative (“RR”) might decide to change companies or "break away" from a registered investment adviser or broker-dealer. Even when an individual has a strong relationship with his or her current employer, there may be a variety of compelling motivations to make a change. Jacko Law Group, PC (“JLG”) has seen an increase in activity where IARs and RRs are forming their own independent businesses or combining with other existing investment advisers and broker-dealers.

Regardless of whether one is seeking more independence and greater potential financial rewards by forming a new entity or simply looking for changes and opportunities at a new shop, the regulatory and legal considerations that may arise during the process of moving to a different company need careful attention in order to mitigate risk and ensure the smoothest transition possible.

This month’s legal tip will focus on a few primary considerations to consider when “breaking away.”

**Which Way to Go? - Entity Structure, Management Roles and Responsibilities**

*Entity Structure*

For those advisors who leave a company to start their own business, in addition to having a strategic plan, immediate operational decisions will need to occur to properly establish the new entity. Each corporate form carries with it certain advantages and drawbacks depending on the goals of the founders and expected needs of the organization. Many prefer the flexibility of a limited liability company (“LLC”) to the more formal corporation structure, but the most suitable entity type for any business will vary depending on a wide variety of factors.<sup>1</sup> Some of the primary considerations may include:

- How many individuals will be owners of the new entity?
- What is the likelihood of bringing on new owners or partners after formation?
- Will all types of owners have the same voting rights?
- How many individuals will be involved in the day-to-day management of the company?
- Does the entity expect to raise capital from third party investors in the near term to fund operations after launch?

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<sup>1</sup> For example, JLG has previously written about forming and operating a limited liability company. See <http://www.jackolg.com/Part-1-Considerations-for-Forming-and-Operating-a-California-LLC-Oct-2015.pdf> and <http://www.jackolg.com/Part-2-Considerations-for-Forming-and-Operating-a-California-LLC-Nov-2015.pdf>.

### Management Roles and Responsibilities

A group of IARs or RRs whom breaks away from their former employer will need to decide which individuals will hold certain responsibilities at the new organization. It is common for the roles relating to investment services to be clearly defined; however, depending on the experience of the individuals making a transition, how to divide up the operational and governance duties may require some deliberation. A few primary issues to consider here include:

- Who will participate in material decisions and day-to-day supervision?
- Who is responsible for operations, HR, compliance and risk management?
- What will you outsource (if anything) versus keep in-house?
- Will the organization have a Board of Directors or Advisory Board?

### Chief Compliance Officer

The importance of the role of a new company's Chief Compliance Officer ("CCO") should not be overlooked. The CCO has responsibility for overseeing the organization's regulatory compliance with applicable statutes, communicating with personnel about the firm's compliance program and related protocols to stay in compliance, and serving as the primary point of contact during a regulatory examination.<sup>2</sup>

For investment companies and investment advisers, pursuant to the compliance program rule, the Securities and Exchange Commission ("SEC") has provided guidance that the CCO should be "competent and knowledgeable regarding the [Investment Advisers / Investment Company] Act[s] and . . . empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm [and] have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures."<sup>3</sup>

For those entities considering whether to outsource the CCO function, the SEC's November 2015 National Examination Program Risk Alert addressed the various issues that should be considered and evaluated to understand risks involved with this approach to a firm's CCO, and provided information about recent SEC examination findings particular to this topic.<sup>4</sup>

### What Do the Documents Say? – Contracts and Promissory Note Considerations

A variety of agreements between IARs and RRs and their respective prior employers may set forth rights that are particularly relevant when that individual changes firms. The discussion below focuses on two such documents.<sup>5</sup>

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<sup>2</sup> For additional information relating to compliance considerations for CCOs and risk management see JLG's September 2015 Legal Tip at <http://www.jackolg.com/The-Importance-of-Strategic-Transition-and-Business-Succession-Planning-Sept-2015.pdf>.

<sup>3</sup> See SEC, Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204 and IC-26299 (December 17, 2003).

<sup>4</sup> See National Examination Program Risk Alert, *Examinations of Advisers and Funds that Outsource Their Chief Compliance Officers*, (November 9, 2015).

<sup>5</sup> Another critically important issue to consider is how an IA's or RR's separation will be reported on a Form U5. See JLG's March 2015 Legal Tip for discussion of important considerations relating to U5 reporting at [http://www.jackolg.com/JLG-Legal-Risk-Management-Tip-Form-U5-Reporting-and-Beyond\\_03-2015-00088039xD690E.pdf](http://www.jackolg.com/JLG-Legal-Risk-Management-Tip-Form-U5-Reporting-and-Beyond_03-2015-00088039xD690E.pdf).

### Contract Considerations

Once an IAR or RR decides to make a transition, an inventory of the legal agreements that might affect the individual involved is mandatory to understand obligations owed to the former employer and any restrictions that may apply to business operations going forward. It is common for employment contracts or independent contractor agreements to contain provisions that place limitations on the activities an IA or RR may conduct after leaving his or her current company. Some focus areas include:

- Does the former company or IA/ RR own the client relationships?
- Do the contracts contain any non-compete provisions that proscribe certain activities or otherwise restrict competing with the former company?<sup>6</sup>
- Do agreements contain confidentiality protections that prohibit use of data available through the former employer?
- What information, if any, may the transitioning individual take to the new company?
- Is the former company a member of Broker Protocol?<sup>7</sup>

### Promissory Note Considerations

Many advisors, especially those at larger companies, enter into promissory note agreements (“Notes”) with their firm. The amount of such Notes is often significant, with regular payments under the Notes covered by the production of the advisor during the time of employment. So long as an advisor’s book of business generates revenue in excess of the periodic Note payments, these types of agreements are beneficial to both the issuing firm and advisor alike.

When an advisor elects to transition to a new company, meaningful attention should be paid to the terms of the Notes. Many Notes call for an acceleration of all amounts due and unpaid if the advisor leaves his or her firm for any reason. As a result, an individual may be obligated to make a huge (re)payment in a lump sum when changing companies.

Depending on an advisor’s particular situation, there are a variety of strategies and approaches to navigating the repayment of Notes strategically so that this type of agreement does cause extraordinary hardship or chill transition to a new organization. JLG strongly advises speaking with counsel throughout the process.

### **Dangerous Waters or Smooth Sailing? - Client Communications**

One of the most challenging topics that an IAR or RR will face after arriving at a new company is the issue of client communications. Most individuals will be eager to inform all former clients and prospects about the transition and will invite them to transfer their accounts to the new shop.

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<sup>6</sup> While in California, traditional non-compete provisions that restrict an individual from going to work for a competitor are generally unenforceable, many jurisdictions do allow and require adherence to non-compete provisions so long as they are reasonable in scope and duration. Analysis of applicable state law, which is outside the scope of this Legal Tip, is required to gain a specific understanding of this issue for the transitioning IAR or RR.

<sup>7</sup> The Broker Protocol (also referred to as the Protocol for Broker Recruiting) is an agreement among participants in the securities industry that governs the use of client data when advisors move between firms that are signatories to the Broker Protocol. The stated goal of the Broker Protocol is to further clients' interests of privacy and freedom of choice in connection with the movement of their registered representatives. The Protocol contains specific procedures for transitioning among its signatory firms and, sets forth limits on the client information that can be taken by the departing advisor to a new employer.

Making a mass announcement or allowing ad hoc communications relating to transferring business to the advisor's new firm often can create legal problems for the transitioning advisor and the company.

The last thing a new employer or advisor wants is a lawsuit from a former employer. In addition to those focus areas outlined under "Contract Considerations" above, the transitioning advisor and his or her new firm should consider the type of non-solicitation provisions which may be included in any contracts that will be breached if communications about the employee's new role are not thoughtful, deliberate and compliant with provisions of documents and applicable statutes.

JLG assists firms and individuals through the complicated and numerous considerations relating to investment adviser or registered representative transitions. For more information on this topic, please contact us at (619) 298-2880 or at [info@jackolg.com](mailto:info@jackolg.com).

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