JACKO LAW GROUP, PC

Legal Risk Management Tip
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WHAT TO CONSIDER WHEN ONBOARDING NEW ADVISORS

Over the past several years, Jacko Law Group, PC ("JLG") has seen an increase in the number of financial advisors transitioning from one broker-dealer or registered investment advisory firm to another. Making this type of change in the financial industry requires the navigation of federal and state laws, as well as an understanding of the contractual requirements that may guide the process. Regardless of the reasons for such a change, it is critical for both the onboarding firm as well as the transitioning advisor[1] to pay close attention to laws that govern this area as well as any additional restrictions to mitigate risks and potential liability.

This month's legal risk management tip focuses on several important onboarding considerations from the firm's perspective, with particular focus on regulatory and legal considerations for assisting with advisor transitions.

Step 1: Evaluate Whether It Is a Broker Protocol Transition

The Protocol for Broker Recruiting ("Broker Protocol") is an agreement among participants in the securities industry that permits the taking and use of certain confidential client information when an advisor moves between firms that are both signatories to the Broker Protocol. The initial intent of the Broker Protocol was to help reduce the likelihood for litigation between the firms, assist in the facilitation of advisors moving from one firm to another and minimize the impact to the client. To that end, the Broker Protocol specifies the type of client information that can be taken by the departing advisor to a new firm, so long as the advisor adheres to the express requirements of the Broker Protocol.[2]

If the onboarding firm and the advisor's former employer are both members of the Broker Protocol at the time of a breakaway, the risks associated with the transition are minimized by adhering to the conditions set forth in the Broker Protocol. .

After a successful "Protocol Transition," the advisor and the onboarding firm should have a clear understanding of what information can be used to communicate with the clients from the advisor's former company. Note that the protections offered under the Broker Protocol do not eliminate all issues, including privacy issues discussed below, from a transition event.

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[1] The term "advisor" used in this article refers to a transitioning registered representative or investment adviser representative.
[2] The criteria of the Broker Protocol are outlined in a recent JLG Legal Risk Management Tip, *available at*: https://www.jackolg.com/News-Room/OCT2018RMT.pdf.

Step 2: Assess Contractual Provisions and Restrictions

Regardless of whether the Broker Protocol applies, it is always prudent for the onboarding firm to consider any limitations an advisor may face as part of his/her transition to a new firm. Contractual restrictions in particular can influence an advisor's transition steps.

The employment contract[3] between and advisor and the advisor's prior company typically contains rights triggered upon termination of the relationship. For example, non-solicit and non-compete provisions are common in advisor contracts and directly impact how an adviser may seek to bring clients to a new firm. To illustrate, commonly we see non-compete provisions that prohibit an advisor from engaging in the same business as the advisor's former employer, usually with a geographic restriction (*e.g.,* within 50 miles of the office location). Similarly, non-solicit provisions prohibit the advisor from encouraging clients, employees and/or vendors from ceasing to do business with the advisor's prior company, and instead, come to the advisor's new firm. While non-competition clauses are not universally enforceable in all jurisdictions, non-solicitation clauses typically are valid.[4] Importantly, some advisor contracts allocate "ownership" of client accounts and carve those accounts out of non-solicit restrictions.[5]

Both the advisor and the onboarding firm should consider the following:

- Does the advisor's contract contain enforceable non-compete and/or non-solicit provisions?
- Does the advisor's contract assign "ownership" of the client relationships to the advisor's former firm?
- Does the contract contain a confidentiality clause or other protections that would proscribe the use of any information of the former employer?
- Has the advisor complied with all applicable contract restrictions and can the adviser continue to do so as the transition moves forward?
- Does the former firm have trade secret considerations that impact the advisor's transition?

Depending on the details, there are approaches to navigating the contract limits strategically and in a manner that reduces the difficulty of the transition process.

Step 3: Assess Privacy Considerations and Determine What Information the Onboarding Firm Can Receive

As a value added service, many Transition Teams at financial firms assist transitioning advisors with completing the onboarding firm's new client paperwork to make the process as easy as

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[3] Many advisers from larger organizations have promissory notes that also require attention at the time of a transition. Discussion of Promissory Notes is outside the scope of this article.

[4] This paragraph scratches the surface of this complicated area of employment and contract law that varies across the United States, and is for discussion purposes only. Detailed legal analysis is required to determine whether the laws in an advisor's jurisdiction will support these types of contractual provisions.

5 Additionally, although outside the scope of this Risk Management Tip, the protection of a firm's trade secrets is another critical area that may bear on how an advisor transitions to an onboarding firm. Trade secrets are governed at the federal level by the Defend Trade Secrets Act of 2016, and by state laws (see, e.g. the California Uniform Trade Secrets Act, Cal. Civil Code § 3426 et seq.).

possible for both the advisor and clients alike. While this step may seem straightforward from an operational perspective, it is fraught with regulatory peril.

Whether it is Regulation S-P[6] or a state law, there are numerous rules and regulations that govern whether and when a third-party can receive information about an advisor's clients. Regulation S-P requires financial institutions to safeguard consumer information, and, among other things, provide such consumers a notice describing the conditions under which they may disclose the consumer's information to nonaffiliated third parties. In addition, Regulation S-P requires a company to provide a method for consumers to prevent such disclosure by "opting out" of that disclosure.[7]

In the context of adviser recruiting, when a transitioning adviser delivers client information to a New Firm, the potential for impact under Regulation S-P cannot be overlooked. Regardless of whether the client feels that the individual, not the firm, is the client's advisor, the law does not accommodate that belief. This scenario was apparent *In the Matter of NEXT Financial Group*[8] where, among other things, NEXT Financial Group ("NEXT"), the onboarding firm, encouraged advisor recruits to provide nonpublic customer information to NEXT so that NEXT could assist with the completion of new account transfer paperwork prior to the advisor recruit's breakaway from his or her former firm. Thus, consumer information was disclosed to NEXT even though the customers had not consented to the disclosure nor to the transfer of their account(s). In the enforcement action relating to this matter, the SEC found that NEXT had both violated and aided and abetted violations of Regulation S-P.

In addition to Regulation S-P, state laws can impose obligations in addition to or greater than federal law on a transitioning advisor and the onboarding firm. For example, the State of California requires a client to "opt-in" prior to sharing certain information with third parties.[9] Depending on where a client is located, a transitioning advisor and the onboarding firm should consider whether extra steps are necessary in order to ensure that state-level privacy considerations are followed in connection with a transition event.

Step 4: Engage Professional Advisors to Assist with the Onboarding Process

One way many major financial services firms seek to mitigate the risks related to recruiting and onboarding a new adviser is to ensure that they have the opportunity to work with qualified professionals, including counsel and valuation firms (when necessary) to assist with the transition. Like so many things in the regulatory environment, the rules and regulations that apply to a transition scenario can be complex and nuanced. As a result, it is easy for both advisors and/or the onboarding firm to step over the line during the stages leading up to

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[6] Pursuant to the mandate in the Gramm-Leach Bliley Act, the SEC promulgated Privacy of Consumer Financial Information (Regulation S-P) ("Regulation S-P"), which governs the treatment of nonpublic personal information about consumers by brokers, dealers, investment companies and SEC registered investment advisers.

[7] *See* 17 C.F.R. § 248. As noted below, some states, such as California, have more stringent regulations and require an "opt-in" by the consumer; see Cal. Fin. Code §§ 4050-4060 for more information relating to the California Financial Information Privacy Act, commonly referred to as SB-1.

[8] In re NEXT Financial Group, Inc., File No. 3-12738 (Aug. 24 2007), available at: https://www.sec.gov/litigation/admin/2007/34-56316-o.pdf.

[9] *See* California Fin. Code §§ 4050-4060

transition, during the transition and thereafter, particularly in relation to communications and new account paperwork. It is strongly recommended for advisor recruits to obtain legal counsel about how to properly leave one firm and join another; the engagement also may serve to significantly lower the risks of the onboarding firm through the transition process. Regardless of the risk mitigation steps taken, many former employers send a strongly worded letter as a matter of course, "reminding" the adviser of his or her obligations to the prior company. If an advisor breaches a contract or an applicable protocol, the onboarding firm should expect a "cease and desist" communication from the prior company, especially if an advisor is too aggressive – or uniformed – about how to transition and seek the transfer of client relationships. If handled properly, that strongly worded letter communication may be the last from the advisor's prior firm.

Conclusion

If your firm is considering onboarding a new advisor, it is imperative to understand your firm's rights and where potential areas of exposure lie. Coordination of your company's Legal, Compliance and Transition Teams is paramount in order to identify and address issues relating to a transition where there may be legal or regulatory exposure. After the initial rush to get an individual or team in the door based on successful recruiting efforts, revisit the issues discussed above that may have been moved lower on the priority spectrum so that there are no surprises once a new advisor's Form U4 is filed and they officially join the team.

JLG assists firms and individuals through the numerous complicated and nuanced 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.

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