JACKO LAW GROUP, PC

Legal Risk Management Tip
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STRATEGIC CONSIDERATIONS FOR THE TRANSITIONING ADVISOR

Investment adviser representatives and registered representatives (together, "Advisors") face numerous issues when making a move to a different financial services company. Even the strongest relationship with an employer can be strained when a departure occurs as the Advisor is generally attempting to transfer client relationships (and corresponding revenue) to the new company. Jacko Law Group, PC ("JLG") continues to see an increase in this activity, sometimes called "breakaways," where Advisors are forming their own independent businesses or combining with other existing investment advisers and broker-dealers.

Regardless of whether one is seeking more autonomy, better economics or improved service offerings at a new firm, the legal and regulatory considerations that arise during a move to a different company need careful attention in order to manage risk and ensure a smooth transition.

This month's Risk Management Tip focuses on certain important considerations relating to Advisor transitions.

1. **Does the Broker Protocol Apply?**

The Protocol for Broker Recruiting ("Broker Protocol") was put into place in 2004 by Citigroup (then Smith Barney), Merrill Lynch and UBS to enable more efficient transitions of Advisors. The Broker Protocol 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 Advisors. It contains specific procedures for transitioning among its member firms and, sets forth limits on the client information that can be taken by the departing Advisor to a new employer. Firms that become members of the Broker Protocol permit a transitioning Advisor to take certain types of information relating to clients without facing the threat of litigation from the Advisor's former company.

Of course, certain criteria must be met to perform a valid transition under the Broker Protocol, including (i) the Advisor's former and new firms need to be members of the Broker Protocol at the time of transition, (ii) the Advisor provides detailed notice in accordance with the Broker Protocol, and (iii) the Advisor (and the new firm) strictly adheres to the Broker Protocol's restriction about use of client information. Failure to satisfy the requirements can lead the Advisor and the Advisor's new company directly into a litigation scenario.

To complicate matters, firms actively depart as members of the Broker Protocol on a regular basis. Notably, recent high-profile withdrawals by founding firms Morgan Stanley and UBS have raised concerns in the industry about the continued efficacy of the Broker Protocol over the long term. However, there are over 1,700 current members (as of September 2018) with additions occurring frequently. The fluidity of Broker Protocol membership adds a relatively new challenge to the transition process. If the Broker Protocol applies, an Advisor's move to a new firm will be more defined (but, of course, not without risk). If not, the Advisor will not enjoy the protections of the Broker Protocol when seeking his or her next opportunity and the range of important legal considerations expands.

2. The Advisor's Contracts Add Challenges to the Transition Process

The contracts between the Advisor and the Advisor's firm will govern what activities are and are not permitted with respect to a transition. Advisors may enter a variety of agreements with their employers that are relevant when an Advisor changes firms. The discussion below focuses on two common types of contracts.[1]

Employment Agreement or Independent Contractor Agreement
Firms require (at least, they should require) Advisors to sign a contract that governs the terms of the Advisor's employment or contractor relationship with the Firm. It is typical for those employment or independent contractor agreements to have provisions which place restrictions on an Advisor after leaving his or her current company. Some focus areas may include:

- Does the contract state whether the company or Advisor owns client relationships?
- Does the contract have a non-solicitation provision that limits the type of contact the Advisor may have with clients and personnel?
- Does the contract have a non-compete provision that validly restricts the Advisor form competing?[2]
- Does the contract contain confidentiality or other protections that limit or proscribe use of information from the former employer?
- What information, if any, may the Advisor transport to the new firm?

Promissory Note Considerations
Many Advisors at larger institutions enter 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 employment term. So long as an Advisor generates enough revenue to cover a periodic Note payment, these types of agreements can be beneficial to both the issuing firm and Advisor alike.

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[1] Another critically important issue to consider is how an Advisor's separation will be reported on 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.

[2] Note that, in California, non-compete provisions that restrict an individual from going to work for a competitor are generally unenforceable. However, many jurisdictions do allow and enforce 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 RMT, needs to be performed in order to obtain a detailed understanding of this issue for the transitioning Advisor.

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When an Advisor elects to transition to a new company, careful attention should be paid to any Notes that have an outstanding balance. Most Notes will have an acceleration clause, calling for immediate repayment of any unpaid balance upon the Advisor's departure. As a result, an Advisor may be contractually obligated to make a large payment in a lump sum when a transition occurs.

Depending on an Advisor's details, there are approaches to navigating the repayment of Notes strategically so that this type of agreement does cause extraordinary hardship or chill the transition process.

3. **Post-Transition Client Communications**

One of the most challenging areas an Advisor will encounter after arriving at a new firm is the issue of post-transition client communications. Most Advisors are keen to inform all former clients and prospects about a transition and enthusiastic about asking them to transfer their accounts to the new shop. This subject is complicated and nuanced, and naturally requires adherence to both Federal and state privacy laws. Making a broad announcement (like an email "blast") or allowing ad hoc messaging relating to transferring client business to the Advisor's new firm can create significant legal problems for both the Advisor and the new company.

To mitigate the issues that may arise, the Advisor and the new firm need to consider the Advisor's contractual restrictions (see discussion above) and the type of communications that will not violate any limitations that may apply. All such communications, regardless of how they are delivered, need to be carefully conducted to be compliant with contract provisions and relevant rules and statutes.

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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