Opinion

Cover Your Legal Bases When Breaking Away

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There are many reasons why a financial advisor might change companies or break away from their RIA or broker-dealer. Even when an individual has a strong relationship with their current employer, there can still be compelling motivations to make a change. The industry has seen a significant increase in advisors forming their own independent businesses or combining their practices with other existing advisers.

Regardless of whether one is seeking more independence, greater potential financial rewards or simply looking for opportunities with a new shop, the regulatory and legal considerations that can arise when individuals or firms move need careful attention in order to mitigate risk and ensure the smoothest transition possible.

Here are a few primary considerations for breaking away.

Which way to go?

For advisors starting their own business, immediate operational decisions will need to be made to properly establish the new entity. Each corporate form carries certain advantages and drawbacks, depending on the goals of the founders and 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 a business will vary. Key considerations include: How many individuals will be owners of the new entity? What is the likelihood of bringing on new owners 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?

A group of advisors that leaves their former employer will need to decide who will hold certain responsibilities at the new organization. Depending on the experience of the transitioning individuals, deciding on how to divide the operational and governance duties may require deliberation. You'll want to include the following in that discussion: 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 versus what you will keep in-house? Will the organization have a Board of Directors or Advisory Board?

What do the documents say?

Written agreements between advisors and their prior employers may set forth rights that are particularly relevant when that individual changes firms.

Firstly, there are contract considerations. Once an advisor decides to make a transition, a review of legal agreements is mandatory to understand obligations owed by the advisor to the former employer. Some focus areas include: Does the former company or advisor own the client relationships? Do contract provisions restrict certain activities or competing with the former company? Do confidentiality protections prohibit use of data available through the former employer? What information (if any) may be taken to the new company? Is the former company a member of Broker Protocol?

Then there are promissory note considerations. Many advisors – especially those at larger companies – enter into promissory 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.

When an advisor transitions to a new company, attention should be paid to the terms of the notes. Many call for an acceleration of unpaid amounts upon an advisor's departure. As a result, an individual may be obligated to make a payment in a lump sum when changing companies.

There are a variety of strategies and approaches to repay notes strategically so that such agreements do not chill transition to a new organization.

Client Communications … Danger Ahead?

One of the most challenging issues an advisor will face after arriving at a new company is client communications. Most individuals will be eager to inform former clients and prospects about the transition and invite them to transfer accounts to the new shop. Making a blast announcement or allowing ad hoc communications in this area can often create legal problems for the transitioning advisor and the new company.

The last thing a new employer or advisor wants is a lawsuit from a former employer. The transitioning advisor and new firm should consider whether non-solicitation provisions will be breached if communications about the employee's new role are not thoughtful, deliberate and compliant with agreements and applicable statutes.

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