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Advocate's View

Special considerations for recruiting financial advisers

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Advisers in the financial industry often leave their employers to pursue new opportunities on their own or with new companies. An adviser's ability to take clients and materials is subject to the typical contractual and common law restrictions commonly addressed by New York courts. Beyond these restrictions, however, are important additional considerations that apply to financial advisers and their firms that are subject to supervision by the Financial Industry Regulatory Authority, or FINRA. This article discusses some considerations specific to financial advisers who seek to change employers.

Many, but not all, financial advisers are licensed registered representatives of a broker-dealer firm, which is a member of FINRA. The financial advisers pass certain tests and hold licenses. However, the FINRA member firms "hold" these licenses and are responsible for supervision of the adviser's activities. Financial advisers who are not employed by a member firm, with limited exceptions, cannot utilize their personal licenses to work in the securities field. Therefore, in most cases, advisers who leave an employer to move elsewhere must be immediately employed by another FINRA member firm.

Financial advisers often wish to have clients follow them to a new firm. This situation raises familiar questions: Is there an agreement that contains a restrictive covenant against competition or solicitation? Are the restrictions enforceable? Should there be full, partial, or no enforcement? In the case of financial advisers, the decision on the merits is made by a panel of arbitrators (with injunctive relief available through the courts).

While typical enforceability questions are by no means unique to the financial industry, there are aspects to the movement of financial advisers between firms that are different and noteworthy. First, practitioners should be aware of the Protocol on Broker Recruitment ("Protocol"), which is an agreement between various (but not all) financial firms concerning how recruitment of brokers is to be conducted. The Protocol was formed in 2004 after the member firms had spent years suing each other over commonplace conduct and recruitment practices. Signatory firms to the Protocol agreed not to sue one another for recruiting financial advisers if specific steps were followed during the process of recruitment and transfer. The Protocol allows a financial advisers to take with them certain account information, which is designed to allow advisers to solicit, sign, and begin the transfer process for clients, while protecting the confidentiality of customer information. When advising a financial adviser who is considering a move, it is important to know whether the present and future employer of the adviser are both Protocol signatories.

Second, in considering a possible change of firms, a financial adviser must ensure compliance with applicable FINRA rules or risk administrative sanctions. A recent Securities and Exchange Commission administrative ruling involving an upstate New York financial adviser serves as a reminder that the Protocol does not lessen an adviser's duties to refrain from taking confidential customer information during a move. In addition to the possible civil liability that attaches to the misappropriation of customer information, financial advisers face potentially career-ending administrative sanctions.

In the case of In re Tomlinson, Exchange Act Release No. 73825, the SEC considered the case of a financial adviser who took a flash drive with information relating to 2,000 customers when leaving his employment with a FINRA firm to begin working for another FINRA member firm. The adviser then shared the flash drive with his new firm and used the files on the flash drive to communicate with 160 of those customers. When the adviser received questions concerning his possession of the customer information, he began deleting files in a futile attempt to cover his tracks. After an evidentiary hearing before a FINRA disciplinary panel and subsequent administrative appeals, the commission rendered its decision suspending the adviser from working in the industry for a period of 90 days.

Despite the admitted "absence of demonstrable harm to customers," the commission found that the adviser's actions had violated FINRA Rule 2110, which requires that advisers adhere to "high standards of commercial honor and just and equitable principles of trade." The commission found that the adviser had acted carelessly in disclosing the confidential customer information to the new firm and that aggravating factors included the facts that the adviser acted in a "surreptitious manner" and had deleted files after questions were raised.

The adviser argued unsuccessfully to the commission that a 90-day suspension would effectively end his career in the securities industry. There is good reason to believe that may be so. A suspension is a serious matter. Advisers with disciplinary records often have difficulty keeping their jobs with FINRA firms and finding new

Continued on next page

Continued from previous page

positions. Further, a 90-day suspension is likely to cause an adviser's client base to substantially deteriorate. If the adviser had sought and obtained good advice before changing firms, the chances of a successful move without jeopardizing his career would have been much improved.

FINRA has also recently proposed new Rule 2273, which is presently under review by the SEC for comment and adoption. If adopted, Rule 2273 would require that the member firms who receive new clients as a result of the hiring of a financial adviser provide an "educational" FINRA communication to the new clients about matters relating to costs and service at the new firm. This form communication, which is prepared by FINRA, must be delivered to the client at the time when contact is first made by the financial adviser in writing. If the first contact is oral, the adviser must inform the client of the FINRA communication and provide it in written form promptly thereafter. If the client attempts to transfer accounts without individualized contact or inducement, then the notice is given at the time the firm approves the transfer of the account.

While the providing a FINRA communication to clients during the transfer process may seem insignificant, it is another time-consuming task that must be planned, done properly, and coordinated with the member firm. Financial advisers who move to so-called "independent" firms may find that they have to shoulder more of the logistics associated with the delivery and documentation of the FINRA communication during a stressful time.

It is important to be aware of the special issues raised by the recruitment of financial advisers. Advisers and their counsel should consider those cited above, among others, in charting the path to be followed during the transition process.

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