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Client Alert

Changing Firms? Five Issues to Consider

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There are a myriad of reasons why registered representatives and investment advisor representatives elect to change firms. These include product offerings, technology platforms, compensation, cultural fit, or particular practice goals. Most often, new business opportunities following a transition pay off, but failing to consider key issues in advance may result in a very bumpy transition, expensive litigation and E&O insurance coverage issues. Many departing representatives assume that there is an inherent right to take clients and their financial information if he or she established the client relationships or acted as the primary servicing representative. While the client relationship is fundamentally important, there are significant contractual and regulatory issues to consider. With advance planning and by consulting with qualified legal counsel many pitfalls can be avoided or at least mitigated.

1. Restrictive Covenants

The first question I ask a representative is: "Are you subject to a non-solicitation or non-competition agreement?" Frequently, wire house brokers know the answer (almost always YES) while brokers and investment advisor representatives who are part of a team at an independent broker dealer or investment advisory firm do not know the answer. Determining the answer to this question is step #1 for any transition. If a restrictive covenant exists, almost every aspect of the transition will be impacted. Don't guess, don't speculate, get out your contracts and review them, preferably with an attorney familiar with the securities industry. Careful advance planning is necessary to create an action plan designed to avoid violating restrictive covenants. Rest assured, if you violate the

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restrictive covenants, your former employer is likely to seek an immediate injunction to stop your transition in its tracks. Transitioning your book is stressful and expensive enough without redirecting your time and resources to litigation.

If you are not subject to a restrictive covenant, congratulations! Unfortunately, you are not out of the woods quite yet.

2. Promissory Notes, Advances and Claw backs

Representatives often accept recruiting compensation packages without understanding the repayment terms for loans, commission advances or the claw back of advisory fees paid in advance by clients. In most promissory notes the termination of employment automatically triggers a "default" provision making the note immediately due and payable. Similarly, commission advances and fees that must be refunded to clients who transfer to your new firm may become due and payable. Even if you do not breach a restrictive covenant, it is highly likely that a substantial debit balance will trigger a FINRA arbitration or a lawsuit in state court. It is very important to understand your rights and obligations under these agreements and you should review existing agreements with qualified counsel before resigning.

3. Restrictions on Client Data Transfers

The SEC's Regulation S.P. (Privacy of Consumer Financial Information) requires financial services entities and professionals to protect consumers' personally identifiable financial information from disclosure to non-affiliated third-parties. The financial services firm must first obtain the consumer's consent or provide the consumer with an opportunity to "opt out" of the information transfer. What does this mean? Essentially two things: (i) the days of moving a client book using "block transfers," "negative consent letters" and completing pre-filled account applications in the weeks before your departure are long gone; and (ii) all of your clients' financial data, including account numbers, account holdings and historical data must be protected by your employer, and you are not allowed to take it to your new firm without the clients' prior written consent. Don't think for a second that emailing spreadsheets, making copies of client documents or downloading the data to a flash drive will be an easy end-around Reg. S.P. or firm privacy policies. An IT technician will be able to easily find emails, images in copy machine memory caches and track downloads and exports of data. It is equally important to review your employer's technology and privacy policies. Frequently, these policies provide the firm with the right to

wipe your computer hard drives and portable devices. Again, talk to an experienced securities attorney before taking any data. Brokerage firms, RIAs the SEC and FINRA all take Reg. S.P. violations very seriously.

4. The Broker-Dealer Recruiting Protocol

The Broker Protocol is basically a truce between brokerage firms and investment advisory firms to avoid costly litigation over representatives moving between firms. Under the Protocol, transferring brokers are permitted to take the name, address, phone number, email address, and account title for each client that the advisor has personally serviced at the firm. *Nothing more*. The restrictions dovetail with the limitations in Reg. S.P. and most firms' privacy policies. In sum, account numbers, social security numbers, account values, positions and historical performance data may not be taken.

It is important to note that many broker-dealers and investment advisors are not Protocol members. The Protocol protections only apply if both the delivering firm and the receiving firm are current participants. In addition, even if both firms are Protocol members, other restrictions may apply. For example, if you are subject to a restrictive covenant, the terms of that agreement may override Protocol and limit the ability to solicit clients using Protocol data. The Protocol protections may not apply to individuals who are part of a group/practice, who solicit clients prior to departure or who solicit other employees. Navigating the Protocol may involve a complex analysis and counsel should be consulted.

5. Will you have E&O Insurance Coverage for Transactions at Your Old Firm?

Errors & Omissions insurance is written on a "claims made" basis, meaning that coverage must be in place on the date that the claim is made. In other words, the policy in place when the claim is filed rather than the policy that was in place when the security was sold will be reviewed for coverage. Continuity of coverage from policy year to policy year is necessary to avoid a lapse in coverage or a loss of coverage for acts in prior years. As a result, when transferring to a new firm, it is important to find out if the new firm's E&O policy includes "prior acts coverage" or "retroactive date of inception" coverage that will extend coverage for acts under other E&O policies you have had. To obtain prior acts coverage you must be able to demonstrate that you had continuous coverage in place over the entire time frame for which you want coverage. So, before

departing your firm, dig through your records and locate the coverage certificates provided by your firm.

In sum, transitioning to a new firm can bring many opportunities. Proper planning increases the odds that the transition will be smooth and the opportunities will come to fruition.

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