# *A GUIDE TO SECURITIES ARBITRATION FOR THE NEW YORK PRACTITIONER*

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## *The Protocol for Broker Recruiting* and Restrictive Covenant Cases

One of the effects of the market meltdown was the migration of brokers from one firm to another, either before their firms went out of business or merged or after they had an opportunity to experience their new employers' manner of doing business and, disappointed with the mindset of that firm, looked around for new homes. What makes these individuals attractive to potential employers are their "assets under management," which can range from the low millions to the hundreds of millions. Despite the world's economy, large brokerage firms have paid exorbitant sums to these individuals in the form of "signing bonuses" to gather those assets, contractually obligating them to work off "forgivable loans" over seven to nine years, thereby allowing the new firms to recoup their investments in the individuals.

Until a few years ago, when brokers left a firm to go to another one, they were not permitted to bring *any* customer information with them, especially if these employees-at-will had signed employment related agreements that contained non-solicitation clauses and other restrictive covenants. The firms they were leaving would go to court and seek injunctions against the brokers and their new firms who attempted to contact "former" clients and solicit their business. These court battles were expensive and often frustrating for the firms seeking to restrain their former brokers from taking accounts with them to other firms.

In 2004, a relatively small number of the largest firms entered into *The Protocol For Broker Recruiting*, which permits brokers who move from one "signatory firm" to another "signatory firm" to solicit their former clients if certain specific conditions, or protocols, are followed by the departing broker. Today, the number of Protocol signatory firms has grown appreciably. This has not resulted in the end of litigation, however, especially when the new firm is not a signatory to The Protocol. In those instances, some courts have been guided by the conditions of The Protocol even when a broker leaves a signatory firm and goes to one that has not agreed to its terms.

*What does The Protocol permit and how have the courts interpreted its application?* The answers to these questions are important for practitioners retained by brokers or money managers who are thinking of leaving one firm (along with their assets under management) and going to a new firm.

## The Protocol For Broker Recruiting

What follows, in question and answer format, is The Protocol:

- *What is its principal goal?*

  To further the clients' interest of privacy and freedom of choice in connection with the movement of their Registered Representative ("RRs") between firms.

- *If complied with, what benefit does it confer?*

  If departing RRs and their new firm follow the Protocol, neither the departing RR nor the firm that he or she joins will have any monetary or other liability to the firm that the RR left by reason of the RR taking the information identified below or the solicitation of the clients serviced by the RR.

- *Does The Protocol insulate a firm from liability if "raiding" takes place?*

  No. The Protocol does not bar or otherwise affect the ability of the prior firm to bring an action against the new firm for "raiding." The signatories to the Protocol agree to implement and adhere to it in good faith.[1]

- *When RRs move from one firm to another and both firms are signatories to The Protocol, what may the RRs take?*

  Only the following account information [known as "Client Information"]:

  1. Client name.
  2. Address.
  3. Phone number.
  4. E-mail address.
  5. Account title of the clients that they serviced while at the firm

- *Are they prohibited from taking anything else?*

  Yes. RRs are prohibited from taking any other documents or information.

- *When RRs resign, what must they do?*

  Resignations to be in writing delivered to local branch management and shall include a copy of the "Client Information" that the RR is taking with him or her.

- *Must the RRs' list of clients provided to the manager <u>differ</u> from what they can take with them?*

  Yes. The RRs' list delivered to the branch *also* shall include the account numbers for the clients serviced by the RR. The local branch management will send the information to the firm's back office.

- *What if the departing firm does not agree with the RRs' list of clients?*

  The RR will nonetheless be deemed in compliance with the Protocol as long as the RR exercised good faith in assembling the list and substantially complied with the requirement that only Client Information related to clients he or she serviced while at the firm be taken.

- *What is the new firm permitted to do with the Client Information brought over by its new employee?*

  The new firm will limit the use of the Client Information to the solicitation by the RR of his or her former clients and will not permit the use of the Client Information by any other RR or for any other purpose. If a former client indicates to the new firm that he/she would like the prior firm to provide account numbers and/or account information to the new firm, the former client will be asked to sign a standardized form authorizing the release of the account numbers and/or account information to the new firm before any such account numbers or account information are provided.

- *What information (and how soon) will the prior firm be required to provide the new firm if The Protocol is complied with?*

  The prior firm will forward to the new firm the client's account numbers and/or most recent account statements or information concerning the account's current positions *within one business day*, if possible, but, in any event, within two business days of its receipt of the signed authorization.

  This information will be transmitted electronically or by fax and the requests will be processed by the central back office rather than the branch where the RR was employed.

  A client who wants to transfer her/her account need only sign an ACAT form.

- *If RRs comply with The Protocol, what can they do with their clients?*

  They are free to solicit customers who they serviced while at their former firms,

but only *after* they have joined their new firms. A firm would continue to be free to enforce whatever contractual, statutory or common law restrictions exist on the solicitation of customers to move their accounts by a departing RR *before* he or she has left the firm.

I have observed that an RR's departure and new employment is tightly choreographed by the new firm so that the RR submits a letter of resignation at around 11:00 am; the RR walks over to the new firm that morning and signs employment-related documents at that time (not generally before); the new firm submits the RR's application for registration with FINRA and the states; a team of support staff at the new firm begins to address FedEx envelopes, enclosing account transfer forms, to the RR's "former clients"; and, the RR calls those clients to advise them of his new employment and his desire that they transfer, or ACAT, their accounts.

RRs who have built client loyalty usually transfer over 90% of the accounts, sometimes 100%. Some brokerage firms provide a contractual incentive bonus for doing so, granting the RR not only a "signing bonus," but a second bonus for assets under management and a third for revenue generated by the RRs' accounts. These bonuses are often in the multi-million dollar range. (They have been in the news as a result of large firms being "bailed out" by the federal government.)

- *Is there any customer information that the departing RR can provide his or her new potential employer before resigning?*

  Yes. It shall not be a violation of the Protocol for an RR, prior to his or her resignation, to provide another firm with information related to the RR's business, other than account statements, so long as that information does not reveal client identity.

- *What if, as is often the case at large firms, the RR is a member of a team or a partnership? How does that affect the implementation of The Protocol?*

  If an RR is a member of a team or partnership and *the entire team/partnership does not move together to another firm*, the terms of the team/partnership agreement will govern: (a) the taking of Client Information and (b) which clients the departing team members or partners can solicit.

  In no event, however, shall a team/partnership agreement be construed or enforced to preclude an RR from taking the Client Information for those clients whom he or she introduced to the team or partnership or from soliciting such clients.

  In the absence of a team or partnership written agreement on this point, the following terms shall govern *where the entire team is not moving*:

  (1) If the departing team member or partner has been a member of the team or partnership in a producing capacity for <u>four years or more</u>, the departing team member or partner may take the Client Information for all clients serviced by the team or partnership and may solicit those clients to move

their accounts to the new firm without fear of litigation from the RR's former firm with respect to such information and solicitations.

(2) If the departing team member or partner has been a member of the team or partnership in a producing capacity for less than four years, the departing team member or partner will be free from litigation from the RR's former firm with respect to client solicitations and the Client Information only for those clients who he or she introduced to the team or partnership.

- *Once a firm becomes a signatory to The Protocol, can it withdraw from its enforcement?*

  Yes. A signatory to the Protocol may withdraw from it at any time and shall endeavor to provide 10 days prior written notice of its withdrawal to all the other signatories. A signatory which has withdrawn from the Protocol shall cease to be bound by it and it shall be of no further force or effect with respect to that signatory. The Protocol will remain in full force and effect with respect to those signatories who have not withdrawn.

## How Courts Have Applied the Protocol

In *Smith Barney v. Griffin,*[2] a state court in Massachusetts refused to impose an injunction against a broker who left a firm and solicited her former clients, despite agreeing that, "If I leave Shearson Lehman Brothers for any reason I will not, within six months of my leaving, solicit any of the clients I serviced at Shearson Lehman Brothers or any clients I learned of during my employment at Shearson Lehman Brothers."[3] While the firm where the broker went, in this case, was not a signatory to The Protocol, the fact that Shearson was greatly influenced this court:

> Smith Barney is a signatory to the Protocol, an agreement that, according to Smith Barney's counsel, has now been entered into by 39 financial institutions (but not by N.Y. Life). Under the Protocol … these financial institutions agreed that, if a financial advisor leaves one signatory financial institution to join another signatory institution, the latter will have no monetary or other liability to the former if the departing financial advisor follows the terms of the Protocol and the new firm does not engage in raiding. According to the Protocol, when a financial advisor leaves one firm to join another, she may take with her the following account information of the clients she had serviced: name, address, telephone number, email address and account title ("Client Information"). She may not take any account numbers or other account information. She may not solicit her clients to join her at her new firm until she leaves her old firm but, once she joins her new firm, she is free to solicit her former clients and to use the Client Information to do so.[4]

In *Griffin,* the firm where the broker went to work was not a party to the Protocol. The court nevertheless held that a preliminary injunction was unnecessary to prevent a risk of irreparable harm because, "If there truly was a significant risk of substantial irreparable harm from departed financial advisors soliciting their former clients, one would not expect Smith Barney to have entered into a Protocol permitting precisely that.[5]"By 2008, there were 54 brokerage and advisory firms who were signatories to The Protocol.[6]

In *Wachovia Securities v. Stanton,*[7] a federal district court in Iowa stated that The Protocol provides that where both the former firm and the new firm are signatories a departing registered representative may solicit his or her clients to move to the registered representative's new firm. The Protocol applies, said the court, "When RRs move from one firm to another and both firms are signatories to this protocol," and "RRs that comply with this protocol would be free to solicit customers that they serviced while at their former firms, but only after they have joined their new firms."[8]But when the new firm is not a signatory, the old firm has no reciprocal benefit to look forward to, and a prohibition on solicitation of clients by a departing registered representative is still reasonably necessary to protect the former firm's client base from "poaching" by the new, non-Protocol firm.[9]

In *Smith Barney v. Darling,*[10] a federal district court held that as a matter of public policy, the interests of customers in being advised of their brokers' move to a new firm weighs against the issuance of an injunction enforcing the brokers' non-solicitation covenants. Here, the brokers went from a Protocol firm to a non-Protocol firm, but the non-Protocol new firm argued that the court should take cognizance of the fact that Smith Barney had agreed to the terms of the Protocol.[11]

Thus, while the courts do not consistently apply the Protocol to non-Protocol member firms, it continues to have an influence in litigated transitions. The impact of the Protocol generally depends upon the courts' view of the Protocol's impact on customers and the intent of signatories to it.

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[1] For an appreciation of so-called "raiding cases," see Chapter 15, Section 15-7 of *Securities Arbitration Procedure Manual* , D. Robbins, Lexis Publishing - Matthew Bender (5th Edition, 2009).
[2] 2008 WL 325269 (Mass. Super.).
[3] *Id.*, 2008 WL 325269*1
[4] *Id.*, 2008 WL 325269*5
[5] *Id.*, 2008 WL 325269*7
[6] *Investment News*, May 2008.
[7] 571 F. Supp. 2d 1014, 2008 U.S. Dist. LEXIS 63320.
[8] *Id.*, 571 F. Supp. at 1029, 2008 U.S. Dist. LEXIS 63320**31
[9] *Contra Merrill Lynch, Pierce, Fenner& Smith v. Brennan,* 2007 U.S. Dist. LEXIS 34501, 2007 WL 632904 (N.D. Ohio Feb. 23, 2007); *Smith Barney Div. of Citigroup Global Mkts., Inc. v. Griffin,* 23 Mass. L. Rptr. 457, 2008 WL 325269 (Mass. Super. 2008).
[10] 2009 U.S. Dist. LEXIS 46515(E.D. Wis., June 3, 2009).
[11] For a similar ruling, see, *Merrill Lynch v. Baxter,* 2009 WL 960773 (D. Utah, April 4, 2009). where brokers resigned from Merrill Lynch, a Protocol signatory, to join a non-Protocol member.