Volume

1

Law Offices of Patrick J. Burns, Jr., PC

Industry White Paper Series

Opening the Floodgates to Independence:

The Brief History and Impact of The Protocol for Broker Recruiting

Table of Contents

Introduction

As part of our ongoing commitment to provide the financial services industry with innovative educational content, *The Law Offices of Patrick J. Burns, Jr.* is pleased to introduce the first in a series of industry white papers that have been specifically developed for financial advisors.

This paper provides a detailed analysis of the Protocol for Broker Recruiting (Protocol), its brief history, along with the impact that the Protocol is having on Wall Street and the independent Registered Investment Advisor (RIA) industry.

Developed in partnership with Nexus Strategy, LLC, a leading consulting firm to the wealth management industry, this report will highlight the current industry issues impacting the Protocol, provide insight on how RIAs can take advantage, as well as inform employee-based advisors in major financial institutions on their options for going independent.

We invite you to learn more about the industry's important legal, compliance and regulatory issues by logging on to our web site at www.pjblawoffice.com or that of our affiliated company, Advanced Regulatory Compliance at www.advreg.com.

Executive Summary

"The Protocol, while an excellent recruiting tool, can also provide a backdoor through which advisors can easily depart a firm."

The Protocol for Broker Recruiting (Protocol) originated in 2004 between three wirehouse firms designed to stop the rash of litigation that typically happened after a departing broker would leave to join another competing wirehouse firm.

Effectively, the Protocol has become an industry standard, open to all broker-dealer and independent firms and now numbers over 650 members. According to Discovery Database, roughly 12% of financial advisors change firms each year and the Protocol has streamlined this process by removing a majority of the uncertainty, costs and fear from both advisors and member firms.

The Protocol, while an excellent recruiting tool, can also provide a backdoor through which advisors can easily depart a firm. It is this ability to "breakaway," that has Wall Street more than concerned, with several hundred Independent RIAs and numerous independent broker-dealers now part of their once exclusive club.

The Protocol also creates an interesting and unintended dynamic for the independent advisor marketplace, as independent advisors continue to grow faster than any other segment in the financial services industry, brought on by the financial crisis of 2008-2009 and the many product failures and "brand damage" Wall Street firms created.

Ultimately, Wall Street needs the Protocol to keep their recruiting engine functional, yet how can they plug the leak to the independent channel that the Protocol has created? In a sense, how can they close the floodgates?

In response, some Protocol members have qualified their membership status by establishing provisions designed to weaken the Protocol and tilt the playing field back into their favor. We believe that these actions are shortsighted and will limit their ability to recruit in the future, and will be addressed by market forces.

The path to independence has never been more achievable, rewarding and an excellent destination where financial advisors can best serve their clients, free from the conflicts of Wall Street.

Thus, now is the time for advisors considering breaking away and forming their own independent advisory firm or joining an existing one, to take action, learn about the nuances of the Protocol and consider their best options for the future.

Background and Brief History of the Protocol

"Effectively, the Protocol has become an industry standard, open to all broker-dealer and independent firms."

The Protocol for Broker Recruiting (Protocol) originated in 2004 between Citigroup Global Markets, Inc. ("Smith Barney"), Merrill Lynch, and UBS Financial Services.

The Protocol was designed as a "cease fire" among the major wirehouses to stop the rash of litigation and rush to file Temporary Restraining Orders (TRO) that typically happened after a departing broker would leave to join another competing wirehouse firm. An additional reason for the Protocol was to respect clients' privacy and allow for freedom of choice to follow their advisor to his/her new firm – a consideration that was most likely to be imposed on the industry anyway due to complaints from clients and pressure from regulators and congress.

Despite originating from Wall Street, better known for creating complexity and opacity in its products and services, the Protocol is surprisingly simple and effective.

Generally, the Protocol supersedes the broker's employment contract, however, this is only the case if the firm being left and the firm being joined are both members at the time of the move. If a departing broker follows the Protocol and joins a Protocol member firm, neither the advisor nor the new firm has any monetary or legal liability.

A departing broker can take with him/her certain information such as client names, addresses, phone numbers, email addresses, fax numbers and account names. The broker cannot take specific customer information such as account numbers, social security numbers, copies of statements, or other financial documents.

Effectively, the Protocol has become an industry standard, open to all broker-dealer and independent firms. According to Discovery Database, roughly 12% of financial advisors change firms each year and the Protocol has streamlined this process by removing a majority of the uncertainty, costs and fear from both advisors and member firms.

Over time, the Protocol has served the industry well, reflected by the fact that it has grown from 3 original firms to now over 650 firms.
http://www.riabiz.com/protocol_members

The vast majority of firms recently joining the Protocol, however, coincide with the growth of the independent Registered Investment Advisor (RIA) and independent Broker-Dealer industries and the financial meltdowns at wirehouse firms during 2008-2009. Something the original Protocol founders most likely never envisioned when they set about to create this landmark industry agreement.

And therein lies the rub.

The Impact of the Protocol on Wall Street

"The rise of the independent advisor industry has created "leakage" in the system, with the Protocol now being used against wirehouses more often than for them."

At its very essence, the Protocol is a double-edged sword. It works fantastically from a recruiting point of view, however it can also provide a backdoor through which advisors can easily depart a firm.

As the movement among financial advisors to go independent has accelerated over the last decade, the Protocol has become a lightning rod for industry attention, especially among wirehouse member firms that are now suddenly worried that their brave experiment is no longer a closed ecosystem where advisors and assets are cycling amongst themselves.

The rise of the independent advisor industry has created "leakage" in the system, with the Protocol now being used against wirehouses more often than for them. Further, the process of advisors leaving wirehouses to go independent is truly a one way street – industry data shows that there are virtually no independent advisors going the other way to join a wirehouse firm.

It is no secret that traditional wirehouses have been losing market share of high net worth investors and advisors to the independent advisor industry for years. Recent Cerulli and AITE Group estimates show that assets overseen by RIAs has tripled over the last decade to over $1.7 Trillion, while assets overseen by the four major wirehouses have recently declined 17% from 2007-2009.

Additionally, with the vast brand damage that has occurred to the major wirehouses from their own actions during the financial crisis and the many product failures they were responsible for that subjected millions of investors to billions of dollars in losses, many financial advisors are looking for greener pastures where they can run their practices in a different way.

By establishing a new independent RIA firm or joining an existing RIA or independent broker-dealer, brokers are able to easily set up their own business that is free from the conflicts of Wall Street, offer unbiased and objective advice, have access to the highest quality, lowest cost investment products, all while building business value that they can monetize upon their retirement.

It is this ability to breakaway easily, facilitated by the Protocol that has Wall Street more than concerned, with several hundred Independent RIAs and numerous independent broker-dealers now part of their once exclusive club.

In response, some Protocol members have qualified their membership status by establishing self-created "carve outs" designed to weaken the Protocol and tilt the playing field back into their favor. Some of these actions have dubious legal merit, and need to be addressed, however, there are no procedures spelled out for amending the Protocol.

"The question now is, do other Wall Street firms follow suit and continue to attempt to weaken the Protocol or ultimately exit?"

Recent high profile examples such as the U.S. Trust unit of Bank of America creating a "Garden Leave" policy that would require departing advisors to provide 60 days notice before leaving have made headlines. U.S. Trust is not a member of the Protocol, however many of their advisors maintain their securities license through Merrill Lynch, which is a member.

During this Garden Leave period, contact with clients must be consistent with the firm's policies and most likely would hinder the departing advisor's ability to convince his/her clients to join them at their new firm, due to the length of time between transition and the uncertainty that will arise in the client's mind. Many observers believe that this policy was instituted in direct response to a recent very high profile, multi-billion dollar broker defection to an independent RIA firm.

The question now is, do other Wall Street firms follow suit and continue to attempt to weaken the Protocol or ultimately exit?

The answer is no.

Wall Street firms all have extremely high goals and objectives for advisor recruiting to ensure their continued profitability. As a competitive result, they continue to offer stratospheric deals to steal advisors from each other, creating a vicious circle they cannot escape from. Additionally, placing onerous provisions, such as Garden Leave policies, on their brokers or attempting to create self-dealing carve outs, will extremely limit their ability to recruit new advisors in the future.

Ultimately, Wall Street needs the Protocol to keep their recruiting engine functional. No one wants to return to the days of out of control litigation and TRO's that slow down the process and create new costs, yet how can Wall Street plug the leak to the independent channel that the Protocol has created? In a sense, the question is how can they put the genie back into the bottle?

Many experts and industry observers believe that they will not be able to do so, due to Anti-Trust laws that will prohibit these firms from colluding and attempting to muscle the Protocol in their favor.

Potentially Violative Anti-Trust Activities

Large Wall Street firms were experiencing a multitude of financial, regulatory and reputational problems in 2008 and 2009. Many of their brokers got tired of explaining to clients why they should have their financial affairs managed by firms who could not manage their own. As such, a wave of brokers departed during this time and many established their own RIAs and joined the Protocol. Several Protocol members expressed great displeasure with this and threatened legal action based on the premise that Protocol membership was only meant to include large Wall Street firms.

"Many brokers got tired of explaining to clients why they should have their financial affairs managed by firms who could not manage their own."

On the surface, this approach seemed to provide the leverage necessary to fix the problem of leakage; however, it would not stand up under the scrutiny of anti-trust laws.

In fact, none of the firms, which took this position, followed through with their threats of legal action once they studied the issue more closely and realized that U.S. Antitrust laws were clearly at odds with their arguments. Antitrust law violations can result in criminal and civil penalties. For a complete overview, please see the Appendix.

Implications for Independent RIA Firms

One of the fastest ways to grow an advisory firm is to bring on new advisors who have already have built a book of business.

For many existing RIA firms, this has become a very real option brought on by the flight away from the wirehouses during the financial crisis of 2008-2009. Additionally, with many of the retention packages offered to the top brokers to stay during the crisis set to expire over the next several years, many noted consultants and experts believe that the floodgates are about to become open. Accordingly, this creates a tremendous time in the industry for RIAs to start planning to recruit many of these brokers and put in place a process to smoothly on-board them.

In order to make that transition predictable, the Protocol has been a tremendous help. All that an existing RIA firm needs to do is simply join the Protocol prior to recruiting Protocol members to take advantage of the protections available.

For brokers who are currently employed by a Protocol member firm and are interested in transitioning to their own, new, startup RIA firm, the Protocol provides similar protections. All the breakaway broker needs to do is work with knowledgeable legal counsel familiar in Protocol and RIA startup matters to have their new firm join the Protocol prior to their departure. (see section on Joining the Protocol)

"Once these issues have been completed, the departing advisor can easily resign and join his/her new firm…"

Once these issues have been completed, the departing advisor can easily resign and join his/her new firm, provided they abide by the following guidelines:

Take only the following client information regarding the accounts they serviced at their old firm:

Client name
Address
Phone number
Email address
Account title

Don't take any other client information, especially confidential information such as social security numbers, account numbers or copies of any statements or financial documents. Additionally, don't pre-solicit accounts before resigning. When the time to leave has come, resign in writing to local branch management and provide a copy of the client information the advisors is taking at the same time, including account numbers. Note: do not take those account numbers with you, however.

Another caveat for independent RIAs is that if someone is leaving a Protocol member firm and going the hybrid route, they need to make sure they join an RIA and BD, which are both Protocol members. The Protocol only applies if someone is leaving a member firm and joining one or more member firms.

Joining the Protocol

Joining the Protocol is quite simple. Firms need to first notify the Securities Industry and Financial Markets Association ("SIFMA") that they wish to be added to the Protocol. Then firms need to complete a joinder form. The timing of their joinder is important because updated membership lists are circulated quite often by SIFMA to the other members. A legal entity must be in existence at the time a firm joins the Protocol. There is no cost for joining and no known formal review process for new members.

Protocol membership must be effective prior to the time a broker resigns a Protocol member firm and joins another.

Case Studies

"By…strictly adhering to the provisions of the Protocol, these advisors were able to facilitate their transition and escape any legal or financial exposure."

The following real case studies are provided as examples of how advisors can use the Protocol to simplify and streamline their breakaway from their previous wirehouse employer. By following advice of counsel and strictly adhering to the provisions of the Protocol, these advisors were able to facilitate their transition and escape any legal or financial exposure. Generic names are used in order to protect advisor confidentiality.

Example 1 – RIA Start up

An Investment Management firm was formed by two wirehouse representatives seeking to break away and run their own independent RIA with assets custodied at a major custodian.

The brokers were leaving a Protocol member firm and had restrictive employment agreements in place with non-compete and non-solicitation provisions. In order to allay their concerns about their employment agreements, their new RIA joined the Protocol. This allowed the brokers to safely depart without fear of having legal action instituted against them for violating their employment agreements. The vast majority of their client relationships transitioned with the brokers to their new RIA and they now run a very successful independent RIA practice.

Example 2 – Joining an existing RIA

A Financial Advisory firm was looking to recruit a wirehouse broker who was looking for higher payout and better working conditions, but not interested in running their own practice.

The firm found someone who was a good fit from a business and personal standpoint. XYZ Financial Advisors joined the Protocol prior to the wirehouse broker departing and only allowed the broker to bring with him the allowed for information under the Protocol. The on-boarding of the broker was successful and has served as a success story the firm can use when recruiting additional brokers.

Conclusion

The Protocol for Broker Recruiting has been an effective tool that has simplified the process for financial advisors transitioning firms. In it's roughly 7 years of existence, it has served the industry well, reducing costs, uncertainties and facilitating investor choice to follow their advisor to their new home whether that be with another financial institution or an independent advisory firm.

While there are signs of unrest and competitive threats from legacy Protocol member financial institutions, the prevalence and growth of the Protocol can serve as a counter-balance to maintain an agreement that ultimately has the best interests of investors at its core.

Those employee advisors considering breaking away and joining the fast growing ranks of the independent advisory industry can benefit greatly from the Protocol and should learn more about the process involved.

Advisors owe it to themselves and their clients to find the most open, conflict free and supported environment to best serve their collective needs.

Appendix - The Antitrust Laws

Congress passed the first antitrust law, the Sherman Act, in 1890 as a "comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade." In 1914, Congress passed two additional antitrust laws: the Federal Trade Commission Act, which created the FTC, and the Clayton Act. With some revisions, these are the three core federal antitrust laws still in effect today.

The antitrust laws proscribe unlawful mergers and business practices in general terms, leaving courts to decide which ones are illegal based on the facts of each case. Courts have applied the antitrust laws to changing markets, from a time of horse and buggies to the present digital age. Yet for over 100 years, the antitrust laws have had the same basic objective: to protect the process of competition for the benefit of consumers, making sure there are strong incentives for businesses to operate efficiently, keep prices down, and keep quality up.

Here is an overview of the three core federal antitrust laws.

The Sherman Act outlaws "every contract, combination, or conspiracy in restraint of trade," and any "monopolization, attempted monopolization, or conspiracy or combination to monopolize." Long ago, the Supreme Court decided that the Sherman Act does not prohibit *every* restraint of trade, only those that are *unreasonable*. For instance, in some sense, an agreement between two individuals to form a partnership restrains trade, but may not do so unreasonably, and thus may be lawful under the antitrust laws. On the other hand, certain acts are considered so harmful to competition that they are almost always illegal. These include plain arrangements among competing individuals or businesses to fix prices, divide markets, or rig bids. These acts are "*per se*" violations of the Sherman Act; in other words, no defense or justification is allowed.

The penalties for violating the Sherman Act can be severe. Although most enforcement actions are civil, the Sherman Act is also a criminal law, and individuals and businesses that violate it may be prosecuted by the Department of Justice. Criminal prosecutions are typically limited to intentional and clear violations such as when competitors fix prices or rig bids. The Sherman Act imposes criminal penalties of up to $100 million for a corporation and $1 million for an individual, along with up to 10 years in prison. Under federal law, the maximum fine may be increased to twice the amount the conspirators gained from the illegal acts or twice the money lost by the victims of the crime, if either of those amounts is over $100 million.

The Federal Trade Commission Act bans "unfair methods of competition" and "unfair or deceptive acts or practices." The Supreme Court has said that all violations of the Sherman Act also violate the FTC Act. Thus, although the FTC does not technically enforce the Sherman Act, it can bring cases under the FTC Act against the same kinds of activities that violate the Sherman Act. The FTC Act also reaches other practices that harm competition, but that may not fit neatly into categories of conduct formally prohibited by the Sherman Act. Only the FTC brings cases under the FTC Act.

The Clayton Act addresses specific practices that the Sherman Act does not clearly prohibit. As amended by the Robinson-Patman Act of 1936, the Clayton Act bans certain discriminatory prices, services, and allowances in dealings between merchants. The Clayton Act also authorizes private parties to sue for triple damages when they have been harmed by conduct that violates either the Sherman or Clayton Act and to obtain a court order prohibiting the anticompetitive practice in the future.

In addition to these federal statutes, most states have antitrust laws that are enforced by state attorneys general or private plaintiffs. Many of these statutes are based on the federal antitrust laws.

About the Law Offices of Patrick J. Burns, Jr.

Patrick J. Burns, Jr., Esq., is the managing attorney with *The Law Offices of Patrick J. Burns, Jr., P.C.,* and also the President of *Advanced Regulatory Compliance, Inc.* He is a member of the California, New York and New Jersey Bars, and received his Juris Doctorate degree from Southwestern University School of Law in Los Angeles, California and Bachelor of Business Administration degree from Pace University's Lubin School of Business in Pleasantville, New York. Mr. Burns began his professional career with a New Jersey based law firm and then worked in a legal/compliance capacity for several financial services firms located in New York City and Los Angeles. During his financial services career, he acquired numerous FINRA and insurance licenses. Mr. Burns is a frequent industry speaker and a member of the Financial Planning Association and the Southern California Compliance Group.

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