FINRA Sends Transition Bonus Disclosure Rule to SEC

By Ben Coulter and Al Teel

In a move designed to increase transparency between its member firms' registered persons ("representatives") and their former clients when they move from one firm to another, the Financial Industry Regulatory Authority ("FINRA") recently submitted FINRA Rule 2243 to the U.S. Securities Exchange Commission for approval. The rule would require representatives who have or will receive "upfront payments" or "potential future payments" exceeding $100,000 to disclose to former customers considering transferring their accounts, within ranges, incentives that the representative is receiving from the representative's new firm and the basis for those incentives. The rule also requires that representatives disclose "costs, fees or product portability issues, including taxes if some assets must be liquidated prior to transfer, that will result if the former customer decides to transfer assets to the recruiting firm." The disclosures would be oral if the first contact between the representative and the former customer is oral (to be followed in writing within 10 days) and in writing if the first contact between the representative and the former customer is in writing. In addition, the proposed rule would require members to report "information related to significant increases in total compensation over the representative's prior year compensation that would be paid to the representative during the first year at the recruiting firm" to FINRA to allow FINRA to "assess the impact of these arrangements on a member's and representative's obligations to customers and detect potential sales practices abuses." FINRA's overarching goal for the new disclosure requirements is to alert clients to any possible conflicts of interest that may arise from representatives changing firms in order to receive enhanced compensation.

Critics of FINRA's new rule point to two issues. First, the financial dealings between registered representatives and their employing firm are private. Second, the rule may result in chilling of recruitment. In addition, the rule is arguably unnecessary because there are already regulations in place aimed at preventing the exact behavior that the new rule is supposedly meant to stop. Supporters, on the other hand, argue that the new rule will increase transparency and communication between advisors and their clients – a "dialogue" – and will prevent conflicts of interest.

POTENTIAL PROBLEMS WITH THE NEW DISCLOSURE RULE

The two main concerns about Rule 2243 are concerns about protecting the representative's financial privacy and the potential for chilling recruiting. First, the financial dealings between a firm and a representative generally do not concern the client. Indeed, most sophisticated clients understand that a representative often has a financial reason for changing firms. Moreover, the fact that a representative is rewarded for his success by an increase in compensation does not mean that the representative will put his personal interests over those of the client's or that performance for the client will decline. In fact, most of the time professionals are recruited and offered more compensation because they have been successful in their practice. Those representatives should be rewarded without being subjected to a burdensome disclosure requirement that can cause a rift between the representative and his clients.

A person's compensation is personal information and professionals should not be forced to divulge that private information. No other professional industry requires professionals to disclose the details of their compensation to their clients before a change in firms or offices. Doctors, attorneys, and CPAs, just to name a few, are not required to disclose the details or amount of their compensation to clients.

In addition, the new rule may result in chilling recruiting.[1] Representatives may naturally be reluctant to change firms if it means revealing their compensation to their clients, and that may limit moves which could in fact benefit clients. There are, of course, many reasons why a representative may decide to change firms. The representative may change firms to have better resources or services at a new firm, to avoid a bad situation that has arisen at her previous firm, out of a desire to change locations, or a host of other reasons. Singling out compensation might give clients the impression that their advisor changed firms solely for financial reasons when that is not necessarily the case. Consequently, the disclosure requirement could have the undesirable effect of keeping some advisors at a firm that they desire to leave for reasons other than personal compensation out of fear of compromising their relationship with clients.

Furthermore, professionals are already obligated to act in their client's best interest regardless of their personal compensation. One representative who submitted a comment to the proposed rule change stated that SEC Chairwoman Mary Shapiro "had it right when she said that the concern with transition bonuses is that supervisors must be on the lookout for advisors who begin churning accounts or moving clients into higher fee products to boost their trailing 12-month production."[2] The argument "was and is that brokers might be tempted to do one or both of those things in an effort to either qualify for, or be awarded, a higher transition package."[3] The representative correctly pointed out that supervisors are already charged with looking out for both of those activities, and both are already violations under the current code. The few unethical representatives in the industry who may choose to place their own interests above those of their clients' in direct violation of existing regulations will continue to do so despite the adoption of another rule.

POTENTIAL BENEFITS OF THE NEW RULE

The obvious benefit of Rule 2243 would be an increase in transparency, and all that could come from it. First, some proponents of FINRA's disclosure rule argue that clients should be made aware of any enhanced compensation received by advisors when switching firms so that the client may protect themselves from an advisor who is not acting in their best interests.

Second, supporters of the new disclosure rule believe the industry should embrace increased transparency because it as an opportunity for advisors to have "frank conversations" with their clients. Of course, recruited representatives will usually have significant books of business, and forcing those representatives to have a "frank conversation" with every client may consume time and effort better used performing her job for the client.

Finally, supporters of the new rule point out that many of the criticisms asserted against the rule can be easily cured. Proponents argue that the “frank conversation” with the client can alleviate most, if not all of the problems associated with clients not fully understanding the disclosure. For example, representatives might explain that they have been recruited by another firm who has better resources for both the advisor and the client.[4]

CONCLUSION

FINRA's proposed Rule 2243 has already drawn the ire of many, including the insurance industry (because representatives often receive some of their compensation from related financial service entities which partner to offer other financial products), and the support of others.[5] If approved by the SEC, it has the potential to radically alter recruitment of representatives and transitions from one firm to another.

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[1] In the interim, before the ruling, some have seen an increase in aggressive recruiting. *See*, *e.g.*, Megan Leonhardt, *Recruiters Leveraging Broker Fear Over FINRA Disclosure Rule*, May 8, 2014, available at http://wealthmanagement.com/industry/recruiters-leveraging-broker-fear-over-finra-disclosure-rule. Moreover, the proposed rule excludes retention bonuses, which would further encourage representatives to stay with their firms.

[2] Comment by William Edde to FINRA, January 7, 2013 at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p197638.pdf.

[3] Melanie Waddell, *Brokers Angered Over FINRA's Bonus Disclosure Plan* (January 11, 2013), http://www.advisorone.com/2013/01/11/brokers-angered-over-finras-bonus-disclosure-plan?t=legal-compliance&page=2.

[4] Corrie Driebusch, *Wirehouses Back FINRA Bonus Disclosure Proposal*, THE WALL STREET JOURNAL (March 11, 2013, 3:22 PM) WSJ.com at http://online.wsj.com/article/SB10001424127887324735304578354562153474302.html.

[5] *See* http://www.sec.gov/comments/sr-finra-2014-010/finra2014010.shtml.