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FINRA Proposes Disclosure of Recruitment Practices

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On January 4, 2013, FINRA published Regulatory Notice 13-02, proposing a new FINRA rule (the “proposed rule”) in connection with the recruitment compensation practices of member firms.¹

Introduction

In short, the proposed rule would:

- Require a member to disclose the details of any “enhanced compensation”² provided to any registered person recruited from another “financial services industry”³ firm for one year following the date of engagement to any former customer with an account assigned to the registered person at the previous firm that:
- is individually contracted by the recruiting member or registered person, either orally or in writing, regarding the transfer of the employment (or association) of the registered person to the recruiting member; or

¹ See FINRA Regulatory Notice 13-02, “Recruitment Compensation Practices” (January 2013) (the “Release”). FINRA Regulatory Notices are available on FINRA’s Internet website: www.finra.org.

² For purposes of the proposed rule, the term “enhanced compensation” means compensation paid in connection with the transfer of securities employment (or association) to the recruiting member other than the compensation normally paid by the recruiting member to its established registered persons. Enhanced compensation includes (is not limited to) signing bonuses, upfront or back-end bonuses, loans, accelerated payouts, transition assistance and similar arrangements paid in connection with the transfer of securities employment (or association) to the recruiting member.

³ For purposes of the proposed rule, the term “financial services industry” means any industry regulated by the SEC, Commodity Futures Trading Commission, state securities authorities, federal or state banking authorities, state insurance authorities or substantially equivalent foreign regulatory authorities.

- seeks to transfer an account from the previous firm to a broker-dealer account assigned to the registered person with the recruiting member.
- Require disclosure of the details of any enhanced compensation to be made orally or in writing at the time of first individualized contact by the recruiting member or registered person with the former customer after the registered person has terminated his or her association with the previous firm.

The text of the proposed rule can be found at Appendix A. The comment period terminates on March 5, 2013.

Summary of Proposed Rule

As part of its hiring of registered representatives, member firms will often recruit certain registered representatives from other member firms or from the financial services industry. As part of the recruitment process, member firms will, among other things, offer upfront bonuses, forgivable loans, transition assistance and back-end production bonuses. As part of structuring recruitment compensation packages, member firms will often look at the registered representative's most recent 12-month gross production or revenue.

FINRA believes that (a) these recruitment compensation programs raise conflicts of interest that often are not disclosed when registered representatives encourage former customers to move to their new firm; and (b) customers would benefit from knowing the incentives that may have led their representative to change firms before they transfer an account to a new firm. As a result, the proposed rule would require disclosure of the compensation paid to a registered representative recruited by a member firm from a financial services industry firm.

Specifically, under the proposed rule, FINRA would require a member firm (the "recruiting member") that provides, or has agreed to provide, to a registered person enhanced compensation in connection with the transfer to the recruiting member of the securities employment (or association) of the registered person from another financial services industry firm (the "previous firm") to disclose, for one year following the date the registered person associates with the recruiting member, the details of such enhanced compensation to any former customer with an account assigned to the registered person at the previous firm that (1) is individually contacted by the recruiting member or registered person, either orally or in writing, regarding the transfer of the securities employment (or association) of the registered person to the recruiting member; or (2) seeks to transfer an account from the previous firm to a broker-dealer account assigned to the registered person with the recruiting member.

The proposal would require disclosure of the details of enhanced compensation to be made orally or in writing at the time of first individualized contact by the recruiting member or registered person with the former customer after the registered person has terminated his or her association with the previous firm.

If such disclosure is made orally, or if the customer seeks to transfer an account from the previous firm to a broker-dealer account assigned to the registered person with the recruiting member and no individualized contact with that customer has occurred (e.g., the customer learns of the registered person's move from a general announcement or other sources), then the recruiting member would be required to provide written disclosure to the customer with the account transfer approval documentation. The written disclosure must be clear and prominent, and must include information with respect to the timing, amount and nature of the enhanced compensation arrangement. For example, a general disclosure in small type that a registered person received an unspecified bonus in connection with his or her employment at a new firm would not be sufficient under the proposal.

Exclusion Under the Proposed Rule

The proposed rule will not apply to enhanced compensation in an amount less than \$50,000 or require disclosure to a customer account that meets the definition of an institutional account pursuant to FINRA Rule 4512(c),⁴ except any natural person or a natural person advised by a registered investment adviser.

Conclusion

The proposed rule is part of a number of recent rulemaking activities of FINRA that impacts the retail securities business. These rulemaking initiatives include, among others, new FINRA rules regarding suitability, private placements,⁵ and fixed-income research.⁶ If adopted, the proposed rule will impact the methods by which representatives are recruited. It could also impact merger and acquisition activities of broker-dealers and, where applicable, their parent companies, as purchases of retail wealth management business will need to factor in the disclosure of retention packages to the acquisition processes and costs.

⁴ FINRA Rule 4512(c) defines institutional account to mean the account of (1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

⁵ For more information regarding the new private placement rule, you may refer to “Private Placement Update: SEC Approves FINRA Private Placement Rule” (June 2012), available at <http://www.shearman.com/private-placement-update-sec-approves-finra-private-placement-rule-06-28-2012/>.

⁶ For more information regarding the proposed fixed-income research rule, you may refer to “FINRA Releases Revised Proposal on Fixed-Income Research Reports” (March 2012), available at <http://www.shearman.com/finra-releases-revised-proposal-on-fixed-income-research-reports-03-15-2012/>.

APPENDIX A

Text of Proposed New FINRA Rule

Enhanced Compensation

- A member (“recruiting member”) that provides, or has agreed to provide, to a registered person enhanced compensation in connection with the transfer to the recruiting member of the securities employment (or association) of the registered person from another financial services industry firm (“previous firm”) must disclose, for one year following the date the registered person associates with the recruiting member, the details of such enhanced compensation to any former customer with an account assigned to the registered person at the previous firm who:
 - is individually contacted by the recruiting member or registered person, either orally or in writing, regarding the transfer of the securities employment (or association) of the registered person to the recruiting member; or
 - seeks to transfer an account from the previous firm to a broker-dealer account assigned to the registered person with the recruiting member.
- The disclosure of the details of the enhanced compensation must be made orally or in writing at the time of first individualized contact by the recruiting member or registered person with the former customer after the registered person has terminated his or her association with the previous firm. If such disclosure is made orally, the recruiting member also must provide the disclosure in writing to the former customer with the account transfer approval documentation.
- Where a former customer seeks to transfer an account from the previous firm to a broker-dealer account assigned to the registered person with the recruiting member, and no individualized contact with that customer has occurred requiring disclosure of the enhanced compensation under paragraph (b) above, the recruiting member must provide the disclosure in writing to the former customer with the account transfer approval documentation.
- Written disclosure must be clear and prominent.
- This Rule shall not apply to enhanced compensation in an amount less than \$50,000 or require disclosure to a customer account that meets the definition of an institutional account pursuant to FINRA Rule 4512(c), except any natural person or a natural person advised by a registered investment adviser.
- For purposes of this Rule:
 - The term “enhanced compensation” means compensation paid in connection with the transfer of securities employment (or association) to the recruiting member other than the compensation normally paid by the recruiting member to its established registered persons. Enhanced compensation includes but is not limited to signing bonuses, upfront or back-end bonuses, loans, accelerated payouts, transition assistance, and similar arrangements, paid in connection with the transfer of securities employment (or association) to the recruiting member; and
 - The term “financial services industry” means any industry regulated by the SEC, Commodity Futures Trading Commission, state securities authorities, federal or state banking authorities, state insurance authorities, or substantially equivalent foreign regulatory authorities.