FINANCIAL SERVICES & REGULATORY

FINRA Warns Firms Not to Lie or "Obfuscate" When Clients Ask About a Departed Rep

By John S. Monical

INTRODUCTION

When a registered representative ("Rep") with a large book of customers voluntarily resigns from one firm to join another, the Rep's old firm immediately assigns a replacement. Excited about the potential to keep the book, the replacement Rep frequently races to contact the customers and secure their business. And when some of those customers question what happened, the replacement Rep – perhaps out of youthful enthusiasm – might "play dumb" by pretending not to know why the departing Rep left the firm, or worse, may imply that the departed Rep retired, was fired, or left because of customer complaints, poor investment recommendations, or some cloud of suspicion.

On April 5, 2019, FINRA issued Regulatory Notice 19-10, which clarifies the old firm's disclosure obligations to customers relating to a departing Rep. Firms and Reps alike should consider the impact and pitfalls of Notice 19-10.

BACKGROUND OF NOTICE 19-10

FINRA (and its predecessor, the NASD) has long sought to ensure that customers have the ability to make a timely and informed choice about where to maintain their assets when their Rep moves from one firm to another. In 1979, NASD Notice to Members 79-7 alerted members that unnecessary delays in transferring customer accounts, including delays accompanied by attempts to persuade customers *not* to transfer their accounts, are inconsistent with just and equitable principles of trade. The NASD and FINRA later codified obligations into what is now FINRA Rule 2140, which prohibits any interference with a customer's request to transfer his or her account in connection with a change in employment. Rule 2140 expressly prohibits a firm from seeking a temporary or permanent injunction prohibiting the processing of a customer's request to transfer. *Id.*

Notice 19-10 takes this concept one step further by imposing an affirmative obligation upon FINRA members to provide information to customers and to have policies and procedures in place relating to the departure of an adviser.

Notice 19-10 states:

> … In the event of a registered representative's departure, FINRA expects that the member firm will have policies and procedures reasonably designed to assure that the customers serviced by that registered representative are aware of how the customers' account will be serviced at the member firm, including how and to whom the customer may direct questions and trade instructions following the representative's departure and, if and when assigned, the representative to whom the customer is now assigned at the member firm.
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> In addition, a member firm should communicate clearly, and without obfuscation, when asked questions by customers about the departing registered representative. Consistent with privacy and other legal requirements, these communications may include, when asked by a customer:
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> 1. clarifying that the customer has the choice to retain his or her assets at the current firm and be serviced by the newly-assigned registered representative or a different registered representative or transfer the assets to another firm; and
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> 2. provided that the registered representative has consented to disclosure of his or her contact information to customers, providing reasonable contact information, such as phone number, email address or mailing address, of the departing representative.

WHAT IT MEANS FOR FIRMS AND REPS

Notice 19-10 raises questions for both firms and Reps, including the following:

1. <u>What Contact Information Should a Firm Share With Customers About a Departing Rep?</u>

Notice 19-10 warns firms to provide customers with "timely and complete answers, if known, when the customer asks questions about a departing registered representative" and to "communicate clearly and without obfuscation, when asked questions by customers about the departing registered representative." *Id.* Notice 19-10 goes on to clarify that, when asked by a customer, a firm's communications "may include" a statement that the customer has the choice to move his or her assets and – provided the Rep has consented – share the Rep's new contact information. *Id.*

When read as a whole, Notice 19-10 appears to require firms to honestly and fully answer questions about how to contact a departed Rep. Under Notice 19-10, if a customer asks how to contact a departing Rep, and that Rep has given permission for his or her contact information to be shared, a firm that lies or pretends not to know the answer might be violating an obligation to the client. Notwithstanding the permissive "may include" language, a firm that does not share a departed Rep's contact information when a client requests it may be risking regulatory scrutiny.

2. <u>What if the Contact Information is Unknown or a Rep Has Not Given Consent to Share His or Her Contact Information?</u>

Notice 19-10 imposes no obligation upon a firm to obtain the departing Rep's contact information and only requires the firm to share that information with a customer who asks if the Rep has "consented to the disclosure." *Id.*

Most departing Reps want customers to have their contact information. Accordingly, when resigning, Reps should consider including their contact information and specific consent to the departed firm to share that contact information with customers.

The extent to which a firm could rely upon the lack of express written consent as a basis for withholding a Rep's new contact information from a customer may depend upon the circumstances. If the firm knows that the Rep is actively notifying customers of his or her new contact information or knows that the new contact information is publically available, it may be disingenuous for the firm to refuse to respond to a client request for it because the Rep has not expressly consented to its disclosure. However, if the only contact information available to the firm is a home address or personal email, the firm may have legitimate concerns that, without additional consent, the Rep would not want that information shared.

3. What Information Should a Firm Share About the Reasons for a Rep's Departure?

Notice 19-10 states that a firm should provide "timely and complete answers, if known, to all customer questions resulting from a departed representative, so that customers may make informed decisions about their accounts." The language of Notice 19-10 is not limited to contact information, and may require a firm to answer customer questions about the reasons for a Rep's departure.

The type and amount of information shared presents a delicate balance between the obligations to the customer, the rights of privacy of the Rep, and the rights of the firm. What information, for example, should be shared when the Rep's departure involves personal health issues? Can a firm disclose that a Rep failed to meet minimum production or left to receive a large signing bonus from another firm? Does Notice 19-10 require a firm to answer customer inquiries about whether the departure is related to confidential internal investigations or customer complaints? If the Rep left over unresolved complaints about the firm, and the customer asks the reasons why the Rep departed, doe the firm have to share the Rep's grievances?

4. How Will Notice 19-10 Affect Disputes Between Firms and Reps?

Firms and Reps should expect Notice 19-10 to affect arguments in restrictive covenant and defamation cases. Some firms may rely upon the full disclosure policy of Notice 19-10 as a basis for disparaging departed Reps. Citing the policy of helping a customer "make an informed decision about their accounts," these firms may tell customers that a departed Rep was terminated for lack of production, failure to follow internal rules, or based upon unproven internal or customer complaints.

Reps, on the other hand, may rely upon Notice 19-10: (i) to bolster arguments that customers have the right to know the Rep's new contact information; (ii) to attack the enforceability of restrictive covenants as overly broad and as violating the public policy basis for Notice 19-10; and (iii) to accuse firms of bad faith and unclean hands for 'obfuscating' in response to customer questions about a Rep's departure.

Notice 19-10 does not depend upon the firm's contract with the Rep. It applies equally to independent model and wirehouse broker-dealers, to signatories and non-signatories to the protocol for broker recruiting, and to firms with and without strong non-solicitation. It appears to apply even to Reps with

garden-leave provisions. Thus, Courts and arbitration panels will have to sort out the balance struck by Notice 19-10 in a myriad of circumstances.

5. Does Notice 19-10 Require Amendments to a Firm's Policies and Procedures?

Notice 19-10 clarifies the obligation of a firm during the transition of a Rep, and also expressly states that "FINRA expects that the member firm will have policies and procedures reasonably designed" to meet those obligations. Those policies and procedures are expected to address: (i) notice to customers of how customer's accounts will be serviced after departure of a Rep; (ii) how and to whom a customer may direct questions and trade instructions following the departure. Firms should review their policies and procedures to ensure compliance with Notice 19-10.

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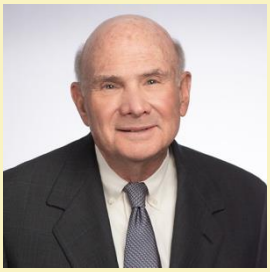

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