

## Recruitment Compensation Practices

### FINRA Requests Comment on a Proposed Rule to Require Disclosure of Conflicts of Interest Relating to Recruitment Compensation Practices

Comment Period Expires: March 5, 2013

#### Executive Summary

Many member firms offer significant financial incentives to recruit registered representatives to join their firms, yet these compensation arrangements are not disclosed to customers when they are asked to transfer their accounts to a representative's new firm. To address conflicts of interest relating to recruitment compensation practices, FINRA seeks comment on a proposed rule that would require specific disclosure by the recruiting member firm of the financial incentives a representative receives as part of his or her relationship with the new firm. The recruiting member firm would be required to provide the disclosure before a former retail customer of the representative makes a final determination to transfer an account to the new firm.

The text of the proposed rule can be found at [www.finra.org/notices/13-02](http://www.finra.org/notices/13-02).

Questions concerning this *Notice* should be directed to:

- ▶ Philip Shaikun, Associate Vice President, Office of General Counsel (OGC), at (202) 728-8451; and
- ▶ Erika Lazar, Assistant General Counsel, OGC, at (202) 728-8013.

January 2013

#### Notice Type

- ▶ Request for Comment

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Senior Management

#### Key Topics

- ▶ Compensation
- ▶ Conflicts of Interest
- ▶ Customer Account Transfers
- ▶ Disclosure

#### Referenced Rules & Notices

- ▶ FINRA Rule 4512

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 5, 2013.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:  
Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.<sup>1</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).<sup>2</sup>

## Background & Discussion

A number of securities firms offer enhanced compensation packages to induce registered representatives to move from one firm to another. These inducements typically take the form of some combination of upfront bonuses, forgivable loans, transition assistance and back-end production bonuses. Such financial incentives may amount to as much as two to three times the commissions and fees produced by a representative in the previous year.<sup>3</sup> FINRA understands that currently the prominent factor in structuring recruitment compensation packages or transition assistance is the representative's "trailing twelve," *i.e.*, the most recent 12-month gross production or revenue.

These recruitment programs raise conflicts of interest that often are not disclosed when registered representatives encourage former customers to move to their new firm. Instead, many representatives typically address only the platform, products and services of the new firm. To inform customers of the conflicts raised by recruitment packages, FINRA is requesting comment on a proposed rule to require detailed disclosure of the recruitment incentives provided to a registered representative in conjunction with a move to a new firm.

## Enhanced Compensation Packages

In general, enhanced compensation packages offered to recruit a representative to leave one firm and join another provide an additional and significant layer of compensation on top of the commission payout grid compensation that the representative receives based on production at the new firm. The disclosure proposal applies only to that additional layer of compensation. The amount and structure of these additional arrangements depend on multiple factors, including the firm from which the representative is transferring, the representative's book of business, and the representative's years of service. Most recruitment compensation is calculated based on the representative's trailing production at the previous firm. Recruitment compensation packages also may depend on the business model of the firm offering the package.

Incentives at some firms appear to tend toward transition assistance, which may include moving expenses, leasing space, furniture, staff and termination fees associated with moving accounts. Other firms offer an upfront bonus that takes the form of a one-time signing bonus or a forgivable loan, based on a percentage of the representative's trailing twelve. To encourage an extended commitment to the new firm, some firms offer representatives a combination of a forgivable loan and an annual bonus in which the representative signs a promissory note for an upfront loan and receives an annual bonus that equals the annual installment due on the loan at the time the loan payment is due.<sup>4</sup> Firms also may offer a bonus based on a percentage of assets brought over from the representative's former firm, or bonuses (or bonus and loan combination packages) based on the representative's production of new business at the new firm, which are known as "back-end" or "production" bonuses, structured to encourage a representative to remain at the new firm.

## Concerns Regarding Enhanced Compensation Packages

Enhanced compensation packages offered to recruit representatives have been the subject of regulatory concern in the past. SEC Chairman Schapiro identified potential conflicts raised by recruitment compensation practices in 2009 in an open letter to broker-dealer CEOs.<sup>5</sup> The letter noted that:

Some types of enhanced compensation practices may lead registered representatives to believe that they must sell securities at a sufficiently high level to justify special arrangements that they have been given. Those pressures may in turn create incentives to engage in conduct that may violate obligations to investors. For example, if a registered representative is aware that he or she will receive enhanced compensation for hitting increased commission targets, the registered representative could be motivated to churn customer accounts, recommend unsuitable investment products or otherwise engage in activity that generates commission revenue but is not in investors' interest.

FINRA understands that in response to the 2009 letter, for a time many firms restructured recruitment compensation arrangements to avoid incentivizing such activities. While there may be legitimate business rationales for offering enhanced compensation and transition assistance to registered persons, these practices continue to raise conflicts of interest.<sup>6</sup> The proposed rule focuses on the undisclosed conflict that representatives have received lucrative financial incentives, often based on trailing production, to move firms, and customers that are solicited to follow their representatives are not directly notified of these practices. FINRA believes that 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. Therefore, the proposed rule would provide transparency to customers at the previous firm before they contract to transfer their accounts to the representative's new firm.

## Proposal

FINRA believes that customers would benefit from being told the material conflicts arising from a registered person being paid recruiting incentives to change firms. To that end, FINRA requests comment on a proposed rule that would require a member firm (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) 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 who (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), 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.

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 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. It would not include, for example, the receipt of a higher payout at the recruiting member that was not otherwise related to the transfer of securities employment (or association). In addition, 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.

The proposed rule would exclude disclosure to customer accounts that meet 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.<sup>7</sup> Furthermore, a member would not be required to disclose enhanced compensation in an amount less than \$50,000. The *de minimis* exception for enhanced compensation under \$50,000 is intended to allow firms to offset a registered person’s ordinary costs in the transition process, since such compensation does not raise the same degree of conflicts of interest as more lucrative enhanced compensation arrangements.

## Request for Comment

In addition to generally requesting comments, FINRA specifically requests comment regarding whether the proposed rule should:

- ▶ require written disclosure at first individualized contact in all instances, rather than allowing oral disclosure at this point;
- ▶ apply to all customers recruited by the transferring registered person during the year after transfer;
- ▶ apply to any new broker-dealer account assigned to the registered person with the recruiting member opened by a former customer of the registered person in addition to accounts transferring from the previous firm;
- ▶ require the registered person to disclose the details of any enhanced compensation to be received in connection with a transfer of securities employment (or association) to a recruiting member to any customer individually contacted by the registered person regarding such transfer *while the registered person is still at the previous firm*;

- ▶ include a requirement that a customer affirm receipt of the disclosure at or before account opening at the new firm. FINRA is interested, in particular, in the potential for such a requirement to delay the account opening process in a manner that could disadvantage customers;
- ▶ apply to a time period different from the proposed one year following the date the registered person associates with the recruiting member;
- ▶ establish an amount different from the proposed \$50,000 for a *de minimis* exception; or
- ▶ apply an alternative approach that would require a general upfront disclosure by the recruiting member or registered person that the registered person is receiving, or will receive, material enhanced compensation in connection with the transfer of securities employment (or association) to the recruiting member and that additional specific information regarding the details of such compensation is available at a specified location on its website or upon request.

FINRA also specifically requests comments on the economic impact and expected beneficial results of the proposed rule.

- ▶ What direct costs for the recruiting member will result from the rule?
- ▶ What indirect costs will arise for the recruiting member or its transferring persons?
- ▶ What benefits would result for individual investors and their agents? How extensive are these benefits?
- ▶ Are the costs imposed by the rule warranted by the potential harm to customers arising from the payment by member firms of recruitment compensation to incentivize representatives to change firms without disclosure of such incentives to transferring customers?
- ▶ Is the proposed rule well designed to reduce conflicts related to recruitment compensation practices?
- ▶ How will the rule change business practices and competition among firms with respect to recruiting and compensation practices? Will these impacts differentially affect small or specialized broker-dealers?
- ▶ What second order impacts could result?

We request quantified comments where possible.

## Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See [Notice to Members 03-73](#) (November 2003) (NASD Announces Online Availability of Comments) for more information.
2. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the [Federal Register](#). Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
3. See, e.g., J. Horowitz, [What Meltdown? Broker Bidding Wars Are Back](#), Reuters, April 11, 2012.
4. For example, a recruiting member may offer a representative a combination loan and bonus agreement where the representative signs a promissory note for \$900,000 with a term of nine years. The representative receives the loan up front and is expected to pay nine annual installments of \$100,000 plus interest until maturity. On the date the annual installment is due on the loan, the member firm pays the representative a bonus in the exact amount of the loan payment due, including principal and interest.
5. See [Open Letter to Broker-Dealer CEOs from SEC Chairman Mary L. Schapiro](#), dated August 31, 2009.
6. FINRA notes that we are currently discussing with several major firms how they identify and manage conflicts of interest. See [Targeted Examination Letters Re: Conflicts of Interest](#) (July 2012).
7. 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.

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