

# Unintended Consequence: The Protocol That Binds

By James J. Eccleston

## Introduction

In 2004, three financial services firms devised a way to ease the transition of financial advisers from one firm to another. The three firms – Citigroup Global Markets (Smith Barney), Merrill Lynch, and UBS Financial Services – signed an agreement called the Protocol for Broker Recruiting (the “Protocol”). Since then, at least 153 financial services firms have signed the Protocol. The result has been a profound increase in the number of transitions and an equally profound decrease in the number of litigation filings in which firms have sought to obtain Temporary Restraining Orders (TROs) or other injunctive relief against their departing employees!

By its express language, the Protocol protects transitioning financial advisers only when they comply with the terms of the Protocol in transitioning from one Protocol signatory firm to another. If one firm (or both firms) is not a Protocol signatory firm, then temporary restraining orders and other injunctive relief, as well as monetary damages for loss of business, continue to be remedies available to firms who elect to pursue their departing advisers. That said, recently several courts of equity have refused to grant injunctive relief to financial services firms that are Protocol signatories. That trend perhaps best is characterized as an unintended consequence of the Protocol that binds.



**James J. Eccleston** heads the securities practice at Shaheen Novoselsky Staat Filipowski and Eccleston, P.C. where he also serves as the Chairman of the Board of Directors. He has extensive experience representing financial services professionals in SEC, FINRA, and state disciplinary matters, employment termination cases, non-compete and non-solicitation cases, promissory note collection cases, and SEC compliance matters.

## Protocol Basics

When the three original signatory firms created the Protocol, there was a great deal of speculation as to whether it would last. The thinking, at the time, was that each firm would need to reflect on whether, in the months and years ahead, it would be a “net hirer” or a “net target” of employee defections. A “net target” firm would not accept the deal because the Protocol, in effect, was a litigation forbearance agreement. Giving up the right to enjoin transitioning

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financial advisers leaving with “the firm’s customers” and to seek damages was not a decision to be made lightly. Nonetheless, and despite some early delays in signing on, most major financial services firms, including all of the “wirehouse” firms (such as Merrill Lynch and Morgan Stanley), signed the Protocol. Since then, several (but clearly not all) other firms of all sizes have signed on.

The result has been an employment transition expressway! Why? The principal goal of the Protocol, as noted in the opinions of numerous courts, is client choice. The Protocol expressly provides:

The principal goal of the following protocol is to further the clients’ interests of privacy and freedom of choice in connection with the movement of their Registered Representatives (“RRs”) between firms. If departing RRs and their new firm follow this Protocol, neither the departing RR nor the firm that he or she joins would have any monetary or other liability to the firm that the RR left by reason of the RR taking the information identified below or the solicitation of the clients serviced by the RR at his or her prior firm.

When RRs move from one firm to another and both firms are signatories to this protocol, they may take only the following account information: client name, address, phone number, email address, and account title of the clients that they serviced while at the firm (the “Client Information”) and are prohibited from taking any other documents or information. Resignations will be in writing and delivered to local branch management and shall include a copy of the Client Information that the RR is taking with him or her. The RR list delivered to the branch also shall include the account numbers for the clients serviced by the RR....

As stated, transitioning financial advisers may take their client names, addresses, telephone numbers, email addresses and client account names/titles. Likewise, transitioning financial advisers may share their personal sales production information with their new firm. On the other hand, transitioning financial advisers may not take other account data, such as client account numbers, account statements or tax identification

numbers. Similarly, financial advisers may not share with their new firms any client information prior to resignation. Of course, it is worth noting that nothing in the Protocol alters the common law duty of loyalty as it relates to prohibiting a financial adviser from soliciting clients (to move their accounts) and staff (to join the new firm) before the adviser resigns. Financial advisers must resign in writing and attach copies of any client information that they are taking. While the financial adviser can and will bring a list of client account names/titles, he or she also will provide that list to the former employer but will add to it the client account numbers.<sup>1</sup>

### Protocol Litigation Surrounding Non-Compliance

As one would expect, there has been litigation addressing whether transitioning financial advisers have complied with the Protocol, and what the consequences should be in the event that they have not so complied. Courts indeed have issued injunctive relief under these circumstances. *E.g., A.G. Edwards & Sons, Inc. v. McCreanor*, 2007 WL 2696570 (M.D. Florida) (temporary restraining order issued against advisers transitioning to Morgan Stanley). However, the terms of the Protocol deem advisers to be in compliance with the Protocol so long as the adviser “exercised good faith in assembling the list” of customers delivered to branch office management, and “substantially complied” with the requirement that only certain customer information be taken.

Accordingly, other courts have not granted such relief – even in situations where, perhaps, it would have been warranted. For instance, in *Merrill Lynch v. Reidy*, 477 F.Supp.2d 472 (D.Connecticut 2007) the court was faced with deciding whether financial adviser Brendan Reidy and his team should be enjoined in transitioning from Merrill Lynch to Morgan Stanley. Merrill Lynch cried foul and sued Reidy and his team, arguing that because they had not followed the Protocol, they were exposed to liability for breach of contract, as well as statutory and common law obligations. Merrill Lynch requested that the court issue a temporary restraining order and preliminary injunction. The court noted that

such equitable relief is an “extraordinary and drastic remedy, one that should not be granted unless the movant, by a clear showing, carries the burden of persuasion.”

Turning to the facts, Merrill Lynch argued that Reidy and his team had breached the Protocol by failing to provide adequate customer information to it upon resigning, by taking more client information than permitted, including account numbers, and by accessing and/or taking prohibited documents with them upon resignation, pointing to computer access records and printing histories. For example, one set of documents at issue included annual performance reviews. Reidy and his team had prepared them for 50 clients in the month prior to their resignation, without Merrill Lynch compliance approval as client correspondence.

The court addressed each of the purported Protocol deficiencies. The court determined that Reidy and his team substantially had complied with the Protocol. Additionally, the court concluded that there was a “legitimate dispute” about the scope of the client information that Reidy and his team had retained upon resignation. Notably, with respect to the annual performance reviews, the court stated that while such activity might have violated Merrill Lynch’s compliance policies, it did not rise to the level of a Protocol violation. Finally, the court found Merrill Lynch’s claim that Reidy and his team had retained client account numbers as “largely speculative.” Accordingly, the court held that Merrill Lynch had failed to meet its burden of proof for injunctive relief.

Similarly, the court in *A.G. Edwards v. Martin*, 2007 WL 4180943 (N.D.Florida), based its decision to deny a request for a preliminary injunction on the fact that the document and information taking was “inadvertent” and quickly remedied by its return. In that case, adviser Frank Martin and his team transitioned to Raymond James & Associates. In doing so, they unquestionably took records and impermissible client information not permitted under the Protocol. However, the court stated:

Here, the Defendants moved from one firm to another, both of which are signatories to the Broker Protocol. Thus, the Broker Protocol governs and Defendants are allowed

to take certain account information. The Defendants admit to inadvertently taking documents that contain additional information, but have returned all documents containing the additional information. The Plaintiff has not shown that the Defendants still have in their possession any additional information. The Defendants have substantially complied with the Broker Protocol. Thus, the Plaintiff has not shown there is a substantial likelihood that the Plaintiff will prevail on the merits.

Although the court opinion does not address it, presumably A.G. Edwards retained the right to seek damages (in arbitration).

### **Creative Applications of the Protocol Agreement**

As one may expect, parties in litigation have argued that the Protocol effectively has become an industry standard. Consequently, parties argue that transitions in accordance with the Protocol should not be subject to injunctive relief, regardless of whether the parties’ contractual agreements provide for injunctive relief – and, more significantly, even where both of the parties involved are not signatories to the Protocol. This creative argument has had moderate success.

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In *Merrill Lynch v. Brennan*, 2007 WL 632904 (N.D. Ohio), financial advisers transitioned from Merrill Lynch (a signatory firm) to Bear Stearns (a non-signatory firm). Merrill Lynch sought a temporary restraining order for breach of contract, misappropriation and misuse of trade secrets, conversion of confidential business information, breach of the duty of loyalty, and unfair competition. Merrill Lynch cited to its Financial Consultant Training Agreement with the defendants, in which

they agreed, among other things, to document confidentiality, non-solicitation and the issuance of a TRO or a preliminary or permanent injunction.

To justify a temporary restraining order, the court stated that Merrill Lynch had to demonstrate: (1) a likelihood of success on the merits; (2) that it would be irreparably harmed in the absence of injunctive relief; (3) that greater harm would result to Merrill Lynch from the denial of injunctive relief than to the defendants where injunctive relief is granted; and (4) that the

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public interest would be better served by issuing a preliminary injunction. Merrill Lynch argued that it met each of those four elements.

The court, however, found that Merrill Lynch could not demonstrate irreparable harm.<sup>2</sup> Damages are calculable, the court concluded, reasoning:

Although this court found such arguments persuasive in 1998, the changed circumstances in the securities industry convinces the court that such arguments no longer merit such weight. *Merrill Lynch v. Martin*, No. 98 CV 1408 (N.D. Ohio 1998). To wit, in 2001 [sic 2004], Merrill, along with industry peers, signed the Protocol For Broker Recruiting ("the Protocol"). In essence, the Protocol allows brokers, under certain conditions, to bring client lists with them when transferring firms. Although Bear Stearns is not a signatory to this agreement, Merrill's signature indicates that they understand the fluid nature of the industry; brokers routinely switch firms and take their client lists with them. By setting up such a procedure for departing brokers to take client lists, Merrill tacitly accepts that such an occurrence does not cause irreparable harm.

Merrill Lynch also argued that the loss of goodwill was a source of irreparable harm; specifically, "allegedly suffering a loss of customer trust and goodwill once it becomes clear that such confidential information was given to others (i.e. Bear Stearns)." Nonetheless, the court rejected that argument, commenting that the existence of the Protocol "significantly undercuts the notion that such behavior destroys customer goodwill." The court ordered the matter to proceed in arbitration where, if appropriate, Merrill Lynch could seek monetary damages for its alleged loss of business.

Likewise, the court rejected Merrill Lynch's effort to obtain a temporary restraining order in *Merrill Lynch v. Brinkman*, 2008 WL 4534299 (D.Arizona). There defendants had transitioned to a non-Protocol firm, Robert W. Baird & Co. Merrill Lynch contended that it simply wanted to enforce its contractual agreement with the defendants, and that the Protocol was irrelevant.

In an interesting twist, the court observed that even though Robert W. Baird was not a signatory to the Protocol, the defendants "would have been wise to have followed it and taken with them only the information allowed under the protocol." In view of the fact that the defendants did more than what the Protocol allowed, among other reasons, the court found that Merrill Lynch indeed had shown the first element of a temporary restraining order, probable success on the merits ("or at least that serious questions are raised").

Still, the court denied the issuance of a TRO, determining that Merrill Lynch had failed to show two other elements -- irreparable harm as well as balance of hardship -- notably without reference to the Protocol. As to irreparable harm, the court believed that "the identification of lost clients and the determination of associated damages would not be difficult within the scope of the parties' arbitration agreement. As to balance of hardship, the court noted that the loss of Merrill Lynch's customers (the harm) already had occurred, whereas, "the harm to the defendants is that they likely would not be able to earn a living in their chosen field for up to a year." Observing that covenants not to compete are frowned upon, the court found that the balance of hardship did not "tip sharply" in Merrill Lynch's favor.

In *Smith Barney v. Griffin*, 2008 WL 325269 (Mass.Super.), the court again was faced with a

situation where a financial advisor had transitioned from a signatory firm, Smith Barney, to a non-signatory firm, N.Y. Life. The court was faced with the usual arguments and responded that it had “struggled for many years with various motions, such as this, brought by financial services companies seeking preliminary injunctions that would prohibit their departing financial advisors from taking any client information with them and from soliciting their former clients to transfer their accounts to the new firm.” The court described five reasons for this difficulty.

First, the enforcement of the confidentiality and non-solicitation provisions “punishes the clients of the departing financial advisors” as the clients’ financial advisor “one day simply disappears without warning.” Second, citing the movie “Casablanca”, firms seeking injunctive relief simply are “shocked, shocked” that another firm would induce their new financial advisor to breach his or her agreements with the former firm, yet “they are themselves engaged in precisely the same ‘shocking’ conduct.” Third, the non-solicitation agreements typically have been presented to financial advisors when they first commence employment, without separate consideration beyond continued employment, and without any choice apart from termination. Fourth, the legal justification for such restrictions is to preserve the company’s goodwill, yet a company is not entitled to preserve the goodwill earned by its employee that fairly belongs to the employee. Fifth, and finally, there is a real question as to whether clients’ names, addresses and telephone numbers are confidential.

In addition to those five generic reasons, the court wrote that in the case before it, another, sixth reason was present: Smith Barney was a signatory to the Protocol. While Smith Barney argued that the Protocol was “irrelevant to this motion for preliminary injunction because it is simply a forbearance agreement that does not apply here, since N.Y. Life is not a signatory”, the court nonetheless states that it does not agree that the Protocol is “inconsequential to the decision of whether preliminary injunctive relief equitably is warranted.”

In fact, the *Griffin* court found that New York law (which governed the parties’ contract), like Massachusetts law, recognizes that a non-solicitation agreement is an “ancillary employee anti-competitive agreement that will be carefully

scrutinized by the courts.” As such, the court stated that – in determining whether to grant Smith Barney’s request for a preliminary injunction – it must examine not only whether the non-solicitation provision of the adviser’s employment contract was a reasonable restraint on the adviser’s ability to compete with Smith Barney,

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but also whether the court’s equitable power should be used to preliminarily enjoin violation of the adviser’s employment contract.

In rejecting Smith Barney’s request for a preliminary injunction, the *Griffin* court found that the Protocol indeed did shed light on three critically important questions: (1) Does Smith Barney regard Client Information, as defined in the Protocol, truly to be confidential? (2) Is the non-solicitation agreement in the [employment] Contract truly necessary to protect the goodwill of Smith Barney? and (3) Is a preliminary injunction truly necessary to prevent a substantial risk of irreparable harm?

Significantly, the *Griffin* court held that, in view of the Protocol, the answer to each of the aforementioned questions is a “no.” For example, with respect to Question No. 1, the court found that, by allowing its departing financial advisers to leave freely with client information (pursuant to the Protocol), Smith Barney effectively has declared that it does not consider this client information to be “nonpublic personal information.” Hence, such client information cannot be characterized as “confidential.” In sum, the court found that Smith Barney cannot have it both ways – declaring this information to be confidential and, at the same time, permitting it freely to be taken to other financial institutions by advisers departing for Protocol signatory firms.

In *Smith Barney v. Burrow*, 558 F.Supp.2d 1066 (E.D. California 2008), the defendants resigned from

Smith Barney (a Protocol signatory firm) on March 7, 2008 to become SEC-registered investment advisers doing business as Valley Wealth Incorporated (“Valley Wealth”). In arguing against the motion for preliminary injunction, defendants claimed that the Protocol was an “industry standard collective bargaining agreement” to govern “financial firms in dealing with the modern trends of financial advisors who change financial firms and bring with them their clients.” Indeed, on the day that defendants had resigned from Smith Barney they had signed a Joinder Agreement to the Protocol for Broker Recruiting.

Whether or not the defendants were signatories to the Protocol, Smith Barney argued that the defendants failed to abide by the terms of the Protocol. Nonetheless, the court found that Smith Barney failed to demonstrate sufficient successes on the merits to satisfy that element for a preliminary injunction.

First, citing *Smith Barney v. Griffin, supra*, the court rejected Smith Barney’s argument that defendants had removed confidential trade secrets. The court stated, “Given the Protocol, Smith Barney is hard pressed to convince this Court that information regarding clients whom [defendants] serviced qualify as Smith Barney’s confidential trade secrets.” Elaborating, the court observed that defendants built up their clientele through their efforts, and that one of the defendants brought (and was encouraged to bring) his clients with them initially when he transitioned to Smith Barney. The court also noted that Smith Barney had failed to pinpoint that it had spent substantial sums of money to develop defendants’ clients and, in any event, noted that Smith Barney had acknowledged that it purchases mailing lists – “i.e., public information to develop clientele.”

Additionally, relying on the Protocol, the court determined that Smith Barney had failed to prove its claims of unfair competition as well as breach of fiduciary duty. Regarding unfair competition, the court states:

The record before us indicates that [defendants] pursued clients whom they had serviced and developed while at Smith Barney. Smith Barney’s signing the Protocol indicates that it expected outgoing financial advisors to continue to service their clients and that such continuing service is not unfair competition. Smith Barney overplays its claims of deception.

Regarding breach of fiduciary duty, the court wrote:

Smith Barney’s participation in the Protocol diminishes its claims that [defendants] breached duties of loyalty, especially given that Smith Barney presumably benefitted from [one of defendant’s] transfer of his Morgan Stanley clients to Smith Barney. At most, defendants and Smith Barney compete on a limited scale in a limited market. Defendants do not compete with Smith Barney in the national market to which it is privy. Clients are free to come and go among defendants, Smith Barney, and a myriad of other financial advisors.

Likewise, the court relied upon the Protocol to find that there was no irreparable harm. Citing *Merrill Lynch v. Brennan, supra*, the court commented that, “Courts have become disinclined to find irreparable, incalculable harm from financial advisors’ departures.” In lieu of an injunction, the court offered Smith Barney “to seek compensation for proven economic harm” – in arbitration.

### Strict Interpretations of the Protocol Agreement

Not all courts are so willing to overlook the contractual agreements between the firms and their financial advisors, however. For example, in *Hilliard-Lyons v. Clark*, 2007 WL 2589956 (W.D. Michigan), the plaintiff seeking injunctive relief, Hilliard-Lyons, was not a signatory to the Protocol. Defendants transitioned from Hilliard-Lyons to Raymond James & Associates, a signatory firm.

Arguing against the issuance of an injunction, including the enforceability of non-solicitation provisions in trainee agreements, defendants contended that the Protocol was signed by a majority of firms and such non-solicitation provisions were inconsistent with the Protocol. The court disagreed. The court stated that the Protocol applies, by its own terms, only when both firms are Protocol signatories. Distinguishing *Merrill Lynch v. Brennan, supra*, the court concluded that, unlike Merrill Lynch, Hilliard-Lyons did not “tacitly accept” the terms of the Protocol because it never had signed it. The Protocol, the court wrote, “is not intended to bind those firms who opt not to sign it.”

Moreover, in *Wachovia Securities v. Stanton*, 571 F.Supp.2d 1014 (N.D.Iowa 2008), the court found the Protocol arguments unpersuasive even though the plaintiff, Wachovia Securities, was a Protocol signatory. Recognizing that the ruling was contrary to the ruling in *Merrill Lynch v. Brennan*, *supra*, the court wrote:

Where both parties are signatories, they have essentially agreed to reciprocal “poaching” of registered representatives and the registered representative’s clients from the former firm, apparently on the assumption that they will gain as much as they lose in the exchange. On the other hand, where the new firm is not a signatory, the old firm has no reciprocal benefit to look forward to, and a prohibition on solicitation of clients by a departing registered representative is still reasonably necessary to protect the former firm’s client base from “poaching” by the new, non-Protocol firm.<sup>3</sup>

The court did, however, find that the Protocol was relevant to its finding with regard to prejudice to the public interest. The court highlighted the fact that the Protocol “does recognize that its ‘principal goal’ is ‘to further the clients’ interests of privacy and freedom of choice in connection with the movement of their Registered Representatives (‘RRs’) between firms.” This and other facts, the court

said, were “sufficient to call into serious question the enforceability of those covenants.”<sup>4</sup>

## Conclusion

While we cannot be certain what the future holds (or even whether the Protocol will exist ten years from now), there can be no doubt that the Protocol has been nothing less than a “sea change” for the financial advisers who seek to transition their books of business from one firm to another, and the securities broker-dealers and investment advisory firms that employ them. The ease with which departing advisers can transition their books of business – and the eagerness of firms to race to the courthouse for a TRO – greatly have been impacted by this so-called “forebearance agreement.”

One thing is clear, based on the foregoing review of court opinions from throughout the country: the Protocol indeed has caused unintended consequences. While several courts have sought to protect the interests of non-signatories seeking to enforce their rights as against departing advisers, a significant number of courts have relied upon the Protocol to deny injunctive relief – even where one (or both) of the parties at issue is a non-signatory to the Protocol. Whether that trend will continue remains to be seen, but the existing case law, discussed above, no doubt will continue to shape this debate in the years ahead.

## ENDNOTES

<sup>1</sup> The Protocol expressly does not protect against injunctive relief and damages for what the securities industry calls “raiding” cases. These cases are not easily defined, but normally “you know ‘em when you see ‘em.” They occur when a financial services firm loses so many of its advisers to a competitor that a “severe economic impact” results. That impact has been

quantified as approximately 40% of a business unit’s production, but the percentage varies and the determination depends upon what kind of “improper means” was employed and/or the degree of “malice/predation” that existed.

<sup>2</sup> Because Merrill Lynch’s motion failed on that prong, the court did not address the other three remaining TRO prongs.

<sup>3</sup> That said, independent of the Protocol the court expressed concerns that the employment restrictions were unreasonably restrictive, and it sought a fuller record.

<sup>4</sup> Ultimately, the court denied the request for a temporary restraining order but granted the request for expedited discovery in preparation for the application for a preliminary injunction.

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