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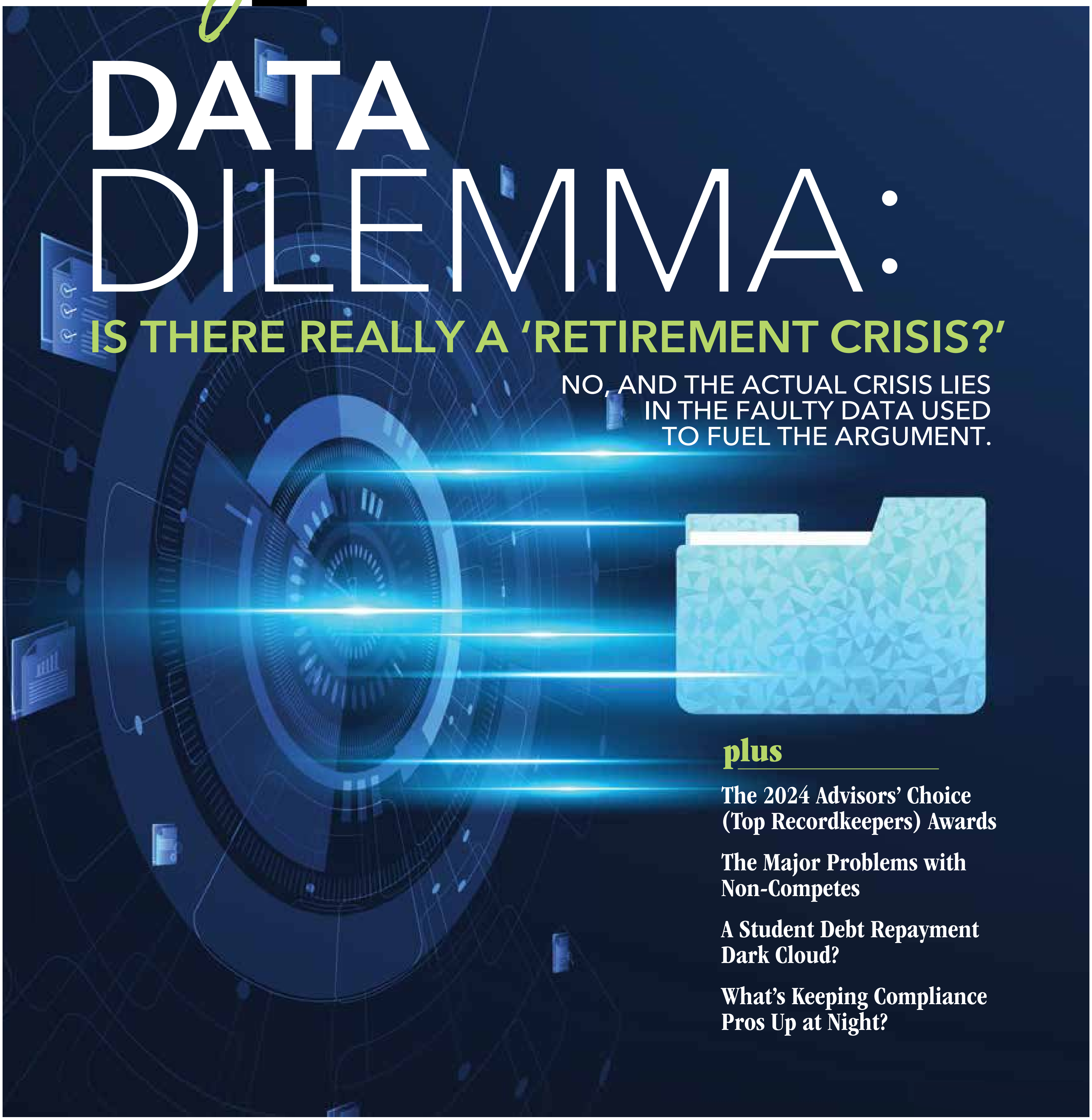


DATA DILEMMA:

IS THERE REALLY A 'RETIREMENT CRISIS?'

NO, AND THE ACTUAL CRISIS LIES IN THE FAULTY DATA USED TO FUEL THE ARGUMENT.

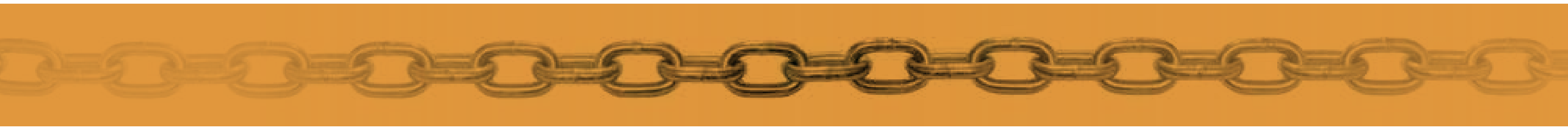
plus

The 2024 Advisors' Choice (Top Recordkeepers) Awards

The Major Problems with Non-Competes

A Student Debt Repayment Dark Cloud?

What's Keeping Compliance Pros Up at Night?



For 401(k) and financial advisors,

transitioning to a new firm is often the single biggest move they make in their career,

and they typically only do it once, said Brian Hamburger, chief counsel at New York-based Hamburger Law Firm LLC.

His years of experience working with advisors switching firms has shown him that they shouldn't underestimate the ramifications of a non-compete or non-solicit agreement they previously signed at the employer they're leaving.

"What's important is that they understand the gravity of that situation, and they don't try to 'Web MD' it," Hamburger said of not seeking personalized, expert guidance on how to do a transition effectively. "In making that transition, we want to make sure that they don't step into a treacherous area and put themselves and their career in danger and that they optimize the chances of success at their new firm."

Non-compete agreements have been in the news lately. The Federal Trade Commission (FTC) issued a final rule in April that imposed a nationwide ban on employers enforcing non-competes with current and former employees who have left the employer.

Then, in August, the U.S. District Court for the Northern District of Texas issued a nationwide injunction to prevent the FTC from enforcing the rule, which it planned to do starting September 4.

The FTC said in late August that it might appeal the decision, and other lawsuits have been filed over the non-compete ban, so the ban's ultimate fate remained unclear. If the rule is upheld by the courts, it could make it simpler for some advisors to switch firms. Even if courts block its implementation, there's a larger, emerging trend away from allowing enforcement of a non-compete.

"I'm telling advisors I talk to, 'Don't jump for joy yet because we don't know what's going to happen,'" said Louis Diamond, president of Morristown, New Jersey-based Diamond Advisors, which works as a consultant to financial advisors making or contemplating a transition. "But even if this FTC decision doesn't survive the legal challenges, the decision may be a sign of things to come."

Drawing Attention

When asked about the reasoning behind the FTC's decision to issue a ban, Hamburger pointed to the general overuse of non-competes by American businesses. These days, someone who makes sandwiches at a sandwich chain may be required to sign a non-compete that prevents him or her from leaving to work for another sandwich chain. In the eyes of some, the overuse of non-competes adversely affected the U.S. labor market by limiting workers' mobility.

Diamond said that non-compete agreements have been a less widely used restrictive covenant by companies employing financial advisors.

But some firms employing advisors do require them to sign a non-compete as part of their employment contract, and private equity firms and RIAs commonly utilize non-competes when acquiring an advisory practice in which the business owner also serves as the underlying advisor to clients, he said.

Diamond said a client non-solicitation agreement has been the most common restrictive covenant for financial advisors. He added that a non-solicit often covers a 12-month period after an advisor departs an employer. The recent FTC ban did not prohibit non-solicitation agreements.

In some cases, advisors are also required to sign a "garden leave" agreement, which says that if they decide to leave their current firm for a stipulated timeframe (usually 30, 60, or 90 days) after they resign, they technically are still employees of the firm they're leaving, and they are paid to not work. That includes the advisor not working to attract existing clients to move with them to a new firm.

Some—but certainly not all—financial advisors are currently covered by The Protocol for Broker Recruiting, originally put together in 2004 by Merrill Lynch, Citigroup Global Markets (Smith Barney), and UBS Financial Services. The Broker Protocol governs how registered representatives can utilize client information when they move between firms that have signed it.

Before that, there had been a lot of litigation over registered reps switching firms, said Laurence Landsman, a partner at law firm Landsman Saldinger Carroll, PLLC in Chicago.

More than 2,000 firms have signed

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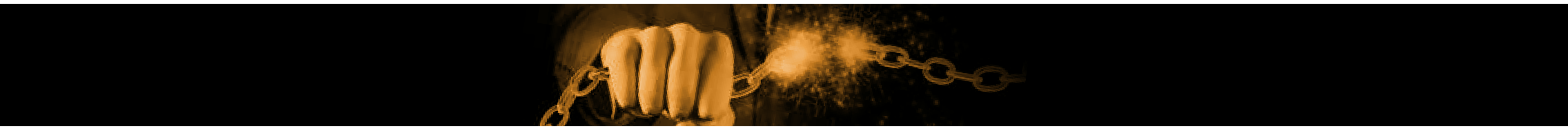

on and are current members of the Broker Protocol, which allows registered reps more ability to move from one firm to another as long as they follow the protocol's standards.

They can leave and take certain specific, limited information about customers with them, and they're required to tell the firm they're departing what information they've taken.

Landsman said the protocol has significantly reduced the amount of non-compete litigation, although registered reps covered by the protocol can still be sued by their former employer if they fail to follow it when switching firms.

"The protocol is far from perfect, but at least it was a step in the right direction," Landsman said. "It really has helped ease the way for people to move from one firm to another." If the FTC ban ultimately gets upheld by the courts, it could make it easier for financial advisors not covered by the Broker Protocol to move from one firm to another, he added.

There is a lot of tension between employers who want to protect confidential information and their client relationships, versus someone's ability to change employers as they progress in their career, Landsman said. It seems like the balance tilted too much toward employers' concerns, and some rebalancing would be appropriate, he added.

Even if the FTC's non-compete ban holds up in court, it includes a carve-out allowing the use of non-competes as part of a business sale. Hamburger said that it makes sense still to allow non-competes for the sale of a business. It would drastically lower the market value of an advisory practice being acquired, for example, if the acquirer couldn't get assurances about the potential future competition that the principal advisors pose.

In Peter Campagna's experience, buyers always require owners selling an advisory practice to sign a non-compete as part of their new employment agreement. Often, other producers on staff also are required to sign as part of their new employment agreement, said Campagna, Incline Village, Nevada-based managing partner of Wise Rhino Group, an M&A advisory firm focused on the wealth and retirement industry. The non-competes typically run for three to five years, and he added that the employment agreements usually also include a client non-solicitation agreement that often runs for two years.

Hamburger discouraged advisors from seeing a client's non-solicitation agreement as falling into a gray area that would be hard to enforce if an advisor who came over as part of an acquisition then departed the acquirer company and tried to take clients with him or her.

"Even if an advisor goes door to door to speak with clients, so there's no electronic footprint, the firm impacted will interview those clients about what happened. If you start to get enough clients that have transitioned to the advisor who has left, the circumstantial evidence can become strong."

"In the world we live in, it is not a gray area at all because everything we do leaves behind an electronic footprint," Hamburger said. "Advisors often proceed in these cases with an idea of, 'How am I going to get caught?' But then they find out it's a lot easier than anticipated to follow their tracks.

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Still, Campagna said it's not the legal ties of a non-compete and non-solicitation agreement that primarily keep advisors at acquirer firms. He said that the economics of the acquisition deal really bind advisors tighter to an acquirer.

Part of what holds advisors who sell their practice to an acquiring company has been the earn-out structure typically included in these deals, Campagna said. For a time period that usually ranges from two to four years after they sell, if the advisor's practice grows at certain specified rates—perhaps average annual growth of anywhere from 5% to 25% of revenues or EBITDA (earnings before interest, taxes, depreciation, and amortization)—then the advisor gets a substantial payout that could exceed the advisor's base compensation, he added.

For example, an advisor with $250,000 in base pay might make millions more with the earn-out.

Campagna said advisors who've sold to a private equity-backed acquirer often receive private equity stock as part of their deal. That stock's initial value to the advisor may range from perhaps 15% to 50% of the deal's overall financial value, but its value may then grow rapidly.

And advisors have to keep working for the acquirer company to continue holding the private equity stock, so they usually have a strong financial incentive to stay.

"That stock has been 'gold' in recent years: The expectation is that it triples in value every three to five years, and that has been a key factor with people staying," Campagna said. "The challenge is that some of these firms have now gone public, or they have been purchased by publicly held companies. In those cases, all of a sudden, the private equity stock is not a reason for the advisors to stay. So, the question is, what will emerge now to get those advisors to stay?"

Moving the Needle

Hamburger explained that the legal challenges filed against the non-compete ban argue that the FTC overstepped its authority by essentially enacting a new law that it was not entitled to enact. If the new rule is ultimately challenged successfully in the courts, that would be consistent with a broader trend emerging.

"There is a real push by the courts right now, to limit the options for federal agencies to take action to those that have been enumerated by Congress, and not use their judgement to expand their options," Hamburger said. "It's certainly a trend we're seeing to limit agencies' ability to unilaterally come up with new policies that may be outside the scope of what Congress intended. The courts recently have been pretty reticent to allow agencies to act on their own."

It's widely expected that the FTC's non-compete ban ultimately will not survive judicial scrutiny, said Matthew Prewitt, a partner at law firm ArentFox Schiff LLP in Chicago. That has less to do with the ban itself than with broader legal developments involving the powers of federal government regulators. Most notably, in June the U.S. Supreme Court overturned the so-called Chevron doctrine, named after the lawsuit *Chevron U.S.A., Inc. vs. Natural Resources Defense Council*. The 1984 precedent said that courts should defer to a federal agency's reasonable interpretation of federal law in cases when aspects of the law are unclear. The Supreme Court's decision was seen as shifting power away from the federal government's executive branch agencies and potentially resulting in significant changes in how agencies such as the FTC work.

"The long-term trend with the current Supreme Court is to curtail the power of executive branch agencies to enact the type of rulemaking that is happening with the FTC's decision," Prewitt said. "This is a very bold step that the FTC took with its ban, and it is hard to take seriously the idea that the FTC thought this would actually survive judicial challenges in the courts. It was more, 'Hey, isn't this an interesting thought exercise?' I think it's really an effort by the FTC to draw attention to this issue and use their 'bully pulpit' to make a policy statement. I think this is the most significant development in non-competes in the past 20 or 30 years."

Prewitt said the FTC's decision does move the needle and prompt more discussion about whether non-compete agreements should be enforceable or not. Whether it moves the needle with state legislatures enough to pass their own non-compete bans covering employers operating in their state or impacts how state supreme courts or federal courts interpret state and federal laws addressing non-competes remains to be seen.

"The FTC's decision puts the issue front and center for state regulators, and maybe it will focus some state regulators to define where they stand on this issue," Diamond said. "This might embolden other states to follow suit, and that's where we may see a potential impact of the FTC's decision, for states to issue new regulations or rules to curtail the ability of employers to have restrictive covenants."

California already mostly prohibited the enforcement of anti-compete agreements for employers operating in that state, but effective January 1 of this year, Senate Bill 699 and Assembly Bill 1076 became law and strengthened the state's anti-compete stance. The legislation adds new requirements for employers, imposes penalties for those who don't follow the new rules, and makes it easier for employees to challenge anti-compete provisions.

Diamond said that California has long been very employee-friendly, and this new law extends that. He hasn't seen data on the mobility rates for financial advisors working in California, but in Diamond Advisors' experience, advisors there believe they have less to worry about in making a change, and they feel much freer to move to another firm.

There's an emerging state-level trend to place a greater value on employee mobility as a stimulus to the economy, as opposed to allowing employers to enforce restrictive covenants such as a non-compete agreement, Prewitt said.

In January 2022, the Illinois Freedom to Work Act took effect, limiting the ability of employers operating in that state to utilize restrictive covenants with employees, including non-compete and non-solicit provisions.

Then, in July 2023, Minnesota's SF 3035 bill took effect, mostly prohibiting non-compete agreements.

And New York State got very close to enacting similar legislation. In June 2023, The New York State Legislature passed a very broad prohibition on non-compete agreements, but New York Governor Kathy Hochul vetoed the legislation in December 2023. Hochul indicated her willingness to sign a narrower bill, but the discussions broke down, Prewitt said.

"In some states, I think we will see bans, and in some states, you won't," Landsman said. "It would be hard to do in some states, because it's very political. There is a lot of money and a lot of interest among employers."

Landsman said that if the FTC's federal ban is ultimately upheld in the courts, it would presumably take legal precedence over less-inclusive state bans. He added that it's hard to imagine more-inclusive state bans than the FTC's federal ban. And if the FTC ban is struck down in court, he expects to see legal challenges in any state that has passed its own ban.

In anticipation of the possibility that non-compete bans could survive legal challenges, Prewitt suggested that employers review their current steps to preserve their client base and protect their business's confidential information when employees leave.

It means that employers need to have a robust non-solicitation agreement that applies to former employees potentially taking customers with them, and possibly even taking other important commercial relationships that can include vendors. Additionally, employers need a strong employee confidentiality agreement and data security agreement that will also apply if employees depart.

"What we're advising our clients to do is to imagine a world where non-compete agreements are going to be struck down," Prewitt said. "Whatever happens with the FTC's new rule, I think we still have to assume that employers are going to have significant headwinds enforcing non-competes in the years ahead." NNTM

Judy Ward is a freelance writer specializing in retirement plan-related subjects.