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# Contractual and Compensation Issues for Financial Services Executives

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The financial services industry is highly specialized, highly regulated and highly scrutinized. The products which financial services firms market are often abstract and opaque. The issues that arise between employer and executive in other sectors of the economy have heightened consequences for financial services executives, because what is at stake concerning an executive's compensation and professional reputation can be so great. At the same time, both sides have to be conscious of the layers of regulatory requirements that govern their relationship.

This paper highlights some of the unique executive employment issues that arise in the financial services industry and how they can be practically addressed.

## I. Licensing and registration

Most financial services professionals cannot be employed unless they first comply with the licensing and registration requirements of the major self-regulatory organization governing the industry, the Financial Industry Regulatory Authority, referred to as FINRA.

FINRA was formed in 2007, the result of a merger between the enforcement authorities of the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD). FINRA licenses financial services professionals, regulates their activities, provides a mechanism for public disclosure when the employment relationship ends, and provides a forum for the arbitration of employment-related (and customer-related) disputes. It oversees more than 4,000 brokerage firms and 600,000 investment professionals.

FINRA is comprised of “member” firms, which are bound by its rules. FINRA requires that financial services professionals – dubbed “associated persons” in the FINRA lexicon -- obtain specific licenses and register with FINRA. Without the applicable license and registration, they cannot be employed with a FINRA member.

FINRA is the largest of a number of “self regulatory organizations” (SROs) that supervise the financial services industry. The other SROs cover more specialized financial markets.

**A. Licensing**

To qualify for a license, a prospective associated person much pass the exam FINRA administers, which is specific to the individual’s job function. The exams are highly specialized, corresponding to the investment products the individual will handle. There are exams for “registered representatives” and “registered principals.” Registered representatives engage in a member’s securities or investment banking business, or supervise or train those who do that. Registered principals manage the member’s securities or investment banking business, supervise, solicit or conduct that business, or train people who perform any of those functions; they include sole proprietors, directors, partners, officers and mangers of supervisory offices. An individual seeking to supervise employees handling a particular investment product must pass both the exam for that investment product and for the specific principal role.

Common FINRA exams for Registered Representative include the Series 7 (General Securities Representative; this allows the candidate to solicit, purchase or sell all securities products); Series 79 (Limited Representative – Investment Banking) (allowing the candidate to advise on or facilitate debt or equity offerings through private placement or public offerings, or advise or facilitate mergers or acquisitions and other corporate restructurings); Series 86 and 87 (Research analyst); Series 55 (Equity Trader); Series 62 (Corporate Securities Limited Representative); Series 52 (Municipal Securities); Series 72 (Government Securities Limited Representative (for Treasury, government agency and mortgage-backed securities); and Series 42 (Registered Options Representative). Some exams (for example, the Series 7) are prerequisites for a number of others.

For Principals, there are exams for, among others, General Securities Principal (Series 23, required for management or supervision of a member's investment banking or securities business.); General Securities Sales Supervisor (Series 9 and 10); Registered Options Principal (Series 4); and Municipal Fund Securities Principal (Series 51).

In most states, individuals must also pass the FINRA-administered exam required by the state law.

### B. Registration

Once the individual passes the qualifying exams, he must still register with FINRA, as a registered representative and/or registered principal. For all associated persons, the registration requirement applies regardless of whether the individual provides or supervises investment or securities services on a retail basis, or to institutions. Also subject to the registration requirement are compliance officers, and general counsels, unless their work is limited to solely providing legal services.

To register, the individual submits a FINRA "U-4" form -- "Uniform Application for Securities Industry Registration or Transfer" -- to both FINRA and the applicable state jurisdiction. The form requires the disclosure of extensive information about the individual, the exams the individual has passed, prior employers for the previous ten years, the circumstances under which the individual left those employers, previous customer complaints, regulatory actions or investigations, civil actions, bankruptcies, judgments or liens, and criminal records. An individual is required to continually amend and update his U-4 disclosures as circumstances change. The U-4 form is available to the public on FINRA's website, at http://www.finra.org/Investors/ToolsCalculators/BrokerCheck.[1]

## II. Contractual issues

Let's say the employee has taken and passed his exams, and submitted his U-4 form. The employer and the executive still need to memorialize the terms of employment. How should they do that?

The contractual issues that would commonly arise between executives and employers are particularly critical in the financial services industry, simply because there

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[1] Certain investment advisors are required to file a form with the SEC, the Form ADV, which is available on the SEC's website at http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx.

is so much at stake.  An executive's base salary may be high, but it may pale in comparison to the equity or cash bonus compensation the executive can (or would like) to expect.  The consequences of a dispute are high for both parties.   For the executive, if the employment relationship founders and is severed, there is the potential for a huge loss of compensation.  For the employer, there is both the risk that despite a termination of employment, it might be required to make payments it does not believe should be made. There is also the possible business and cultural cost of making significant payments to an executive the employer views as disloyal, a poor performer, or superfluous.

The more senior the employee, the more likely it is that the contractual relationship will be seriously negotiated.  Stock brokers and traders may have barely-negotiable form agreements, amounting to at will arrangements, with a provision describing how their compensation is determined in a formula tied to their production. Often these employees are provided, at the start, with a substantial loan, designed to make up for compensation lost by leaving the previous employer.  The loan is forgiven or repaid in installments (typically, monthly, over several years).  The rub for the employee is that the loan can be accelerated and called if the employee resigns or is terminated before it is extinguished (in some cases, for cause, and in others, for any reason.) Therefore, for the employee, the loan is both a benefit and a great handicap to mobility.

Senior executives will commonly negotiate a detailed employment contract.  Both sides must pay careful attention to issues of compensation, "cause," good reason resignation, and severance.  If the relationship becomes troubled, these terms will determine how the parties will seek to characterize the grounds for termination, which will in turn determine what compensation the departing will receive. A full discussion of these issues, along with common provisions addressing them, can be found in my paper, Negotiating Executive Employment Contracts to Anticipate Disputes (Employment Rights and Responsibilities Committee 2011 MidWinter Meeting, www.americanbar.org/groups/labor_law/committees/errcom/err_archive/2011.html.)

**A. Compensation**

Compensation for these executives is normally comprised of base salary, an initial equity award, continuing equity awards, and a bonus comprised of cash, equity, or both. For many financial industry professionals, the base salary will be a fraction of the potential bonus and equity awards. The more senior and potentially profitable the executive, the more likely it is that the relationship between base salary and the other elements of compensation will be highly skewed.

**1. Equity**

The initial equity award is often calculated to at least make up for equity which an executive has lost by leaving the prior employer. Executives may also seek to negotiate an additional sign-on award, regardless of what the executive has forfeited from the previous employer.

For both sides, the way that the employment contract structures future equity is critical. Employers will want to use equity awards as a performance incentive, and as a tie to continued employment. They will also want to exercise maximum discretion in awarding equity. Therefore, it is common for employers to seek to provide that an award of future equity is either entirely discretionary, or based in whole or in part on the performance of the company, or the executive's business unit. The executive will seek guaranteed awards over the term of the contract, or at the very least, to tie equity awards to the executive's individual performance in a manner based on agreed-upon metrics. (In some situations, though, it may be better for the executive's equity award to be tied to company performance.)

Equity awards are normally made pursuant to a pre-existing equity plan, and an equity agreement signed by the employer and the executive. Financial industry employers' equity plans determine the form of the equity award (stock, stock option, Restricted Stock Unit, Stock Appreciation Rights, Phantom Shares, etc.) The plan will set the number of years it will take for an award to vest (commonly four or five), and whether the vesting is "cliff" vesting (none of the award vests until the last year of the vesting period) or incremental (for example, 25% per year, over four years.)

Equally critical are the plan's provisions for the consequences of various events in the employment relationship, such as termination without Cause, termination for Cause, the executive's resignation for Good Reason, or resignation without Good Reason. It is common for plans to provide that if an executive is terminated without Cause or resigns for Good Reason, the executive will continue to vest in the tranches of equity which have previously been awarded but which are unvested at the time of termination. When a termination is for Cause, or a resignation is not for Good Reason, plans commonly provide for vesting to cease. The more draconian plans require a forfeiture of vested equity.

Many equity plans also contain restrictions on competition, solicitation of clients, solicitation of employees and the use of confidential and proprietary information. The plans commonly provide that if the employee breaches these restrictions, vesting of all awards will cease; some plans provide for a forfeiture of the equity which has already vested.

If the parties want to vary those terms for the executive, that must be addressed in the employment contract and the equity agreement the executive signs. What happens here will largely be governed by who has the most leverage in negotiating the executive's hiring. In these negotiations, employers commonly argue that equity arrangements are governed by the terms of the plan, which they cannot vary. However most equity plans provide that the plan's administrator (commonly, the employer's compensation committee) has the discretion to vary or waive a plan term.

**2. Bonus arrangements**

Bonuses in the financial services industry are often termed discretionary, although to entice a much-courted executive to join a firm, an employer may include a minimum bonus for the first year or two. Nonetheless, executives know that while the employer reserves its discretion, in fact business generators are well rewarded. Executives may want to bargain for a bonus that is tied to a pre-determined metric, related to their own performance or the performance of their group. A bonus may consist of cash, equity, or both. Executives confident in the future of the company, and their own contribution, may seek to maximize the equity portion of the bonus.

## III. Dodd-Frank's requirements for shareholder "say on pay" and golden parachutes

While the Dodd-Frank Act tremendously broadened federal oversight of the financial services industry, Congress essentially punted in deferring to employers on the issues of senior executive compensation and golden parachute payments in connection with corporate acquisitions. Dodd-Frank requires SEC-registered issuers to give their shareholders at least a voice on decisions concerning senior executive pay, and lucrative severance arrangements in connection with a change in control. The vote, though, is purely advisory, and has had little impact on compensation arrangements.

### A. Say on Pay

Dodd-Frank required that the shareholders of an SEC-registered issuer vote at least once every three years to approve or disapprove the compensation of the company's named executive officers, CEO, CFO, and three other most highly compensated officers. Dodd-Frank Sec. 951, creating new Sec. 14A of the Securities Exchange Act, 15 USC 78n-1. The shareholder vote is not binding. Instead, the company must describe in its proxy statement whether and how it has taken the shareholder vote into account in setting compensation. Making clear that companies covered by Sec. 951 really had nothing to be worried, about, Congress provided in Dodd-Frank that the shareholder vote was not to be construed as overriding any decision of the Company or its Board of Directors or creating any fiduciary duty of the company or its Board. Exchange Act, Sec. 14A(c).

In January, 2011 the SEC adopted final regulations implementing "say on pay." http://www.sec.gov/rules/final/2011/33-9178.pdf. The regulations require that the shareholder vote occur at least once every three years, beginning with the first shareholder meeting after January 21, 2011. The company must disclose the vote (and whether it is binding) in its annual proxy statement, and note in its Compensation Discussion and Analysis whether and how it has taken the vote into account. In addition, once every six years, shareholders must vote on how frequently the "say on pay" vote should take place (annually, every other year, or every three years.) The company must disclose that vote in an 8K filing. [2]

The impact of these votes on employers' compensation decisions has been minimal. In 2012, less than two per cent of shareholder votes resulted in disapproval of a compensation decision (57 out of 2,215). . In the financial services industry, shareholder support has been higher than in most others sectors, with approved compensation proposals receiving 70% of shareholder support. Russell 3000, 2012 Say on Pay Results Year End Report, www.Semlerbrossysayonpay.com. (The Russell 3000 report is comprehensive and detailed, describing each shareholder vote and analyzing the overall results.)

**B. Golden Parachutes**

Dodd-Frank Sec. 951 also mandates the disclosure to shareholders of compensation arrangements executive officers have in connection with a potential change

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[2] Companies with publicly available shares of less than $75 million were exempt from the say on pay requirements until their first shareholder meeting after January 21, 2013.

in control, whether the arrangement is with the target company or the acquiring company. The requirement applies to mergers, acquisitions, consolidations and sales, and includes disclosure of current, deferred and contingent compensation. Exchange Act. Sec. 14A(b)(1). Shareholders must be permitted to vote on the arrangements, but, again, the vote is non-binding. 14A(b)(2); 14A(c).

## IV. Termination of Employment and the U-5

If the parties have protectively negotiated what will happen if the employment relationship ends, each side should know what the consequences may be. As described above, from the executive's point of view, the employment contract would ideally provide that a termination which is not for Cause (or a resignation which is for Good Reason) will be cushioned by an acceleration of outstanding equity, or continued vesting in equity; a bonus payment for the year of termination, or at least a pro rata payment; continued base salary payments; and arrangements concerning continued coverage under the employer's benefit plans. The employer would have sought to minimize these awards and payments.

Most financial services employers terminating an executive without Cause under a contract will make a severance offer in exchange for a release of claims, and the parties will then negotiate concerning those terms. Employers terminating for Cause may not seek a release, not wanting to give the executive a bargaining chip.

In addition to financial issues, a terminated executive has to be concerned with the disclosures the employer must make on the form it must file within thirty days with

FINRA, the Uniform Termination Notice for Securities Industry Registration, known as the U-5. The U-5 is publicly available on FINRA's website. A critical disclosure the employer must make is in response to Question 3, "Reason for Termination." The possible answers are Discharged, Permitted to Resign, Voluntary, and Other. [3] The employer must provide an explanation if the response is Discharged, Permitted to Resign and Other.

The U-5 also requires the employer to disclose whether the employee was under internal investigation for fraud, violating investment-related statutes, regulations or standards of conduct; was the subject of a governmental regulatory investigation; was involved in any disciplinary action by an SRO or governmental body; was the subject of a customer complaint or customer-initiated arbitration (with exceptions for certain arbitrations settled below certain ceilings); or was discharged or permitted to resign after allegations of violations of investment-related statutes, regulations, rules or industry standards, or allegations of fraud or theft, or because of a failure to supervise in connection with investment-related statutes, regulations, rules or industry standards. If the answer to any of these questions is positive, the employer must provide an explanation.

Whether the executive can negotiate these disclosures with the employer will depend on the allegations involved, the employer's culture, and the attitudes and skill of counsel. Employers do not want to be viewed as exchanging U-5 disclosures for a release of claims.

[3] There is also an option for noting the employee's death.

The potentially damage flowing from an adverse U-5 disclosure has spawned many claims by aggrieved former employees, frequently for defamation. Most courts have held that an employer's statements on a U-5 are subject to only a qualified privilege, allowing claims to proceed if the privilege can be overcome. See, e.g., *Dawson v. New York Life Ins. Co.,* 135 F. 3d 1158 (7th Cir. 1998); *Weitecha v. Ameritas Life Ins. Corp*., 2006 U.S. Dist. LEXIS 70320 at *33-34 (D. Az. 2006); *Eaton Vance Distributors v. Ulrich*, 692 So.2d 915 (Ct. App. Fl. 2d Dist. 1997); *Moreland v. Perkin, Smart & Boyd*, 240 P.3d 601 (Ct. App. Kan. 2010); *Shanklin v. Columbia Management Advisors, Inc*. 2008 U.S. Dist. LEXIS 91797 (S.D. Tx 2008). However, in New York -- the center of the financial services industry -- since 2007, defamation claims based on statements in a U-5 form have been barred, based on the absolute privilege afforded those statements. *Rosenberg v. Met Life, Inc*., 493 F.3d 290 (2007); *Krolick v. Netixis Securities North America Inc*., 2011 N.Y. Misc. LEXIS 6188 at *4 - 5 (Sup. Ct. 2011).

Where U-5 defamation claims are actionable, employees have been able to recover substantial damages in FINRA arbitrations, as well as an order that defamatory statements on a U-5 be expunged. See., e.g., *Kipple v. Wells Fargo*, Case No. 10-02871, July 6, 2011 ($1 million**);** *Leahy v. Charles Schwab,* FINRA Case No. 09-00260, February 26, 2010 ($1.5 million in punitive damages, $279,000 in compensatory damages); *Olson v. World Equity Group, Inc.*, FINRA Case No. 10-01803, June 7, 2011 (more than $7.5 million in compensatory and punitive damages awarded, although the decision is not clear as to which of the claimant's claims corresponded to which portion of the award). [4]

## V. Arbitration of Employment Claims at FINRA

When a prospective associated person signs his U-4 form, he agrees to submit all disputes with the member firm to binding arbitration before FINRA. FINRA U-4 form, page 15, Sec. 15A, Par. 5.

However, statutory claims of employment discrimination, and whistleblowing claims based on a statute which bars arbitration, are not within that waiver, and can only be required to be arbitrated if the employee specifically agrees to arbitrate such a claim before or after it arises. FINRA Rule 13201. As a result, financial services employers commonly include arbitration clauses in their employment contracts. Note that the Dodd-Frank Act prohibits the enforcement of mandatory arbitration agreements concerning claims under the Sarbanes-Oxley Act. Dodd-Frank Sec. 922(c)(2).

Except for statutory claims of employment discrimination, claims for more than $100,000 in damages, and claims that do not seek damages, are heard by a panel of three arbitrators. FINRA Rule 13401. Otherwise, one arbitrator is appointed. FINRA Rule 13401. In a tripartite panel, two members are "public" members (that is, not associated with the securities industry) and one is "non-public" (associated with the security

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[4] FINRA arbitration decisions are easily available at finraawardsonline.finra.org.

industry). When the case is heard by a single arbitrator, that arbitrator must be a public one. See FINRA Rule 13402, and definitions in FINRA Rule 13100(p) and (u).

The parties may seek the production of documents, but the rules state that depositions are strongly discouraged, and may be taken only on a party's motion, in exceptional circumstances FINRA Rule 13510. Statutory claims of employment discrimination are governed by a separate set of rules. While they are subject to the same financial thresholds for single and tri-partite arbitration, a tripartite panel will be composed of all public members. In these cases, single arbitrators and the chairpersons of tripartite panels are required to have specific experience in employment discrimination matters. FINRA Rule 13802(c). The member employer pays all arbitration fees, except for a $200 filing fee borne by the claimant. Rule 13802(d). The rules governing a party's ability to take depositions are more liberal than in other cases. Rule 13510. The arbitrator has authority to award any relief the claimant could obtain in court, including attorney's fees. Rule 13802(e) and (f).

FINRA arbitrators are not paid handsomely. They receive $200 per hearing session, with some additional compensation for deciding motions, acting as chair, or writing the decision. Potential claimants should keep this in mind when filing their claims, making motions, and planning hearing strategy.