BUSINESS SUCCESSION PLANNING

Unlock the Value of Your Investment Advisory Business

U/S/C/C U.S. COMPLIANCE CONSULTANTS

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Introduction

"Sometimes a piano does fall from the sky."

As much as we don't like to contemplate our own mortality, as a fiduciary, an investment adviser has a responsibility to their clients to do just that. It is well-settled law and indeed, the basis of the entire advisory profession, that investment advisers have a fundamental obligation to always act in the best interest of their clients.[1] A significant part of this fiduciary obligation is to minimize client harm in the absence of key advisory personnel.

While this responsibility weighs heavily on all investment advisers, it is especially problematic for advisory firms which are owned and operated by a single individual who is both the sole client contact and client service representative. With no internal successor readily available in the event they are suddenly unable to provide advisory services, these advisors must look outside their own business structure to satisfy their fiduciary and regulatory responsibilities.

Succession planning can be a daunting task for an investment adviser that is required by law to protect their clients' privacy and reluctant to share information with potential competitors about their advisory business. It is also often looked upon by advisors already beleaguered by onerous compliance obligations, as just "one more thing" that

[1] In 1963, the United States Supreme Court held in *SEC v. Capital Gains Research Bureau, Inc.*, that Section 206 of the Investment Advisers Act of 1940 imposes a fiduciary duty on investment advisors by operation of law. Section 206 of the Act (generally referred to as the "anti-fraud" provision) makes it unlawful for an investment advisor to engage in fraudulent, deceptive, or manipulative conduct.

they "eventually" will address. However, both the advisor's duty to his or her own clients, as well as the advisor's own pecuniary interests, requires planning for the continuity of their advisory practice in the event that the proverbial piano does falls from the sky.

This white paper is designed to help advisers understand succession planning, familiarize them with the business succession process and educate them as to the potential it brings for financial benefit. It also explores the current regulatory landscape, as well as the key compliance issues that arise when planning for the succession of an investment advisory business. Finally, it helps investment advisers assess their advisory business and offers guidance on finding a successor advisor.

An investment adviser has a fiduciary and regulatory obligation to its clients to implement a business succession plan.

The Risks

"What happens to my investments if something happens to you?"

Advisers that cannot satisfactorily answer this increasingly common client question are not only risking the growth of their business, but are also violating their regulatory and fiduciary responsibilities. No longer are clients satisfied with being told that they can "just" contact their custodian if they need access to their accounts. Nor do clients want to hear that given the nature of your advisory services (i.e., periodic rebalancing of mutual fund portfolios), that having a succession plan in place is not that imperative. Clients demand to know what safeguards an advisor has put in place to protect their interests in the event the advisor is either permanently or temporarily unavailable to provide advisory services.

A summary of the risks associated with the failure of an advisor to adopt a business succession plan reads like a "who's who" of all the negative things that could happen to an advisory business:

1. Disruption to client services;
2. Diminished client-base;
3. Exposure to regulatory sanctions;
4. Potential for private litigation;
5. Reputational harm;
6. Complete loss of the advisory firm's value.

It is important to understand that it is not as though these risks are independent - chances are that if an advisor fails to plan for an unexpected interruption in client services, that each of them will be triggered sequentially.

When an emergency suddenly makes an advisor unavailable to their clients, time is of the essence. Unfortunately, the middle of a crisis is not the most efficacious time to try and resolve that crisis. That is why we don't wait to plan our family's fire escape route until the smoke alarm starts ringing. Accordingly, the failure to properly anticipate the needs of the advisory business at the time of an advisor's absence makes it all the more likely that each of the above listed risks will indeed come to fruition.

Prior planning the only way to avoid the multitude of risks associated with an advisor's unexpected absence.

Your Financial Best Interest

"If you don't value your business, who will?"

Rather than see this particular fiduciary obligation as yet another compliance and regulatory burden, investment advisers should welcome the opportunity succession planning affords them to both *monetize* the business they have labored so hard to build and to *protect* the clients for whom they have served as trusted advisers. Rarely in the financial industry does one see such a confluence of regulatory requirements, fiduciary responsibilities and financial self-interest as is present with business succession planning.

Unfortunately, business succession planning has not been a high priority for investment advisers. With so many compliance and regulatory obligations competing for limited resources, advisors have been hesitant to take on business succession planning as yet another project. Moreover, the perceived "over-the-horizon" nature of succession planning can make it seem less important than the immediacy of more day-to-day business and compliance matters.

However, this attitude is, from a both a practical and business perspective, short-sighted. As a practical matter, few individuals will have advanced notice of the proverbial piano falling from the sky. This, in and of itself, should make succession planning no less pressing than other matters. But when combined with the fiduciary and financial imperatives highlighted throughout this white paper, it should be on the very top of every investment adviser's "to do" list.

From a strictly business standpoint, either the investment adviser can be the one to value their advisory business (*i.e.*, through succession planning) or it can be left up to the whims of the marketplace. Though exceptions may exist, the consensus among valuation experts is that the market will never place as high a value on a business - especially a business that is in distress because it has lost its most valuable asset - as does the business owner.

A business succession agreement allows an investment adviser to monetize the value of their advisory business on their own terms.

The Regulatory Landscape

"The penalties for violations have become more severe."

Federal Regulations

At present, there is no specific federal rule or regulation requiring investment advisers to have a business succession plan in place. In 2016, the SEC issued a proposed rule that required registered investment advisers to adopt and implement both business continuity plans and business transition (*i.e.*, succession) plans.[2] The rule as proposed requires investment advisers to create and implement its policies for a plan of transition, which must include:

- Policies and procedures intended to safeguard, transfer and/or distribute client assets during transition;
- Policies and procedures facilitating the prompt generation of any client-specific information necessary to transition each client account;
- Information regarding the corporate governance structure of the advisor;
- The identification of any material financial resources available to the advisor; and
- An assessment of the applicable law and contractual obligations governing the advisor and its clients, including pooled investment vehicles, implicated by the advisor's transition.

[2] Release No. IA-4439, File No. S7-13-16, *Adviser Business Continuity and Transition Plans* (June 28, 2016).

Though not yet having the status of law, the accompanying rule release offers valuable insight as to risks an investment adviser bears for failing to adopt a succession plan, including reputational damage, deterioration in client relationships, a shrinking client-base and financial loss.

As if these are not motivation enough, investment advisers should be forewarned that even though the proposed rule has yet to be adopted, the SEC has been aggressively sanctioning advisory firms for failing to implement written business succession plans. Basing its actions on the anti-fraud provisions of Section 206 of the Investment Advisers Act, the SEC has taken the position that it would be "fraudulent and deceptive" for an investment adviser to hold itself out as providing advisory services *unless the adviser had taken the steps necessary to ensure a transition process for its clients in the event of the loss of key personnel*.

As a general rule, when the SEC uses terms like "fraudulent and deceptive," they are accompanied by monetary penalties and harsh regulatory sanctions. Rarely are they treated as mere deficiencies.

State Regulations

While a state-by-state survey is beyond the scope of this white paper, it is evident that state securities authorities are following the lead of the SEC when it comes to succession planning. This is not surprising as over the past dozen or so years the trend has been for the states to either expressly or implicitly adopt recently enacted SEC rules. Much in the same way the majority of states now have adopted rules governing custody, cybersecurity, compliance and ethics that are virtually identical to the SEC rules, state

securities authorities are now approaching business succession planning with the same rigor as their SEC counterparts.

In an attempt to codify this approach on the state level, the North American Securities Administrators Association adopted a Model Rule on Business Continuity and Succession Planning.[3] Applicable to state-registered advisors, the succession planning portion of the Model Rule requires *an assignment of duties to qualified responsible persons in the event of the death or unavailability of key personnel*.

Whether an advisor is registered with the SEC or with one or more states, they should be on notice that all regulators have a keen interest in the status of their business succession planning. From all indications, anything less than entering into a comprehensive business succession relationship with a successor advisory firm, with all key terms and conditions memorialized in writing, will simply not pass regulatory scrutiny.

Compliance Considerations

Beyond the issue of whether regulators require advisors to have a business succession plan (they do), there are compliance considerations that must be taken into account when developing and implementing a succession plan. Chief among these are (1) limitations on the assignment of advisory contracts and (ii) state and Federal privacy regulations promulgated under the Gramm-Leach-Bliley Act (GLBA).

[3] *Model Rule on Business Continuity and Succession Planning*, NASAA Model Rule 203(a)-1A or 2002 Rule 411(c)-1A (adopted April 13, 2015).

Assignment of Advisory Contracts

To the extent the implementation of your succession plan involves the assignment of advisory contracts, there are certain regulatory issues governing the transfer of investment advisory agreements.[4] Section 205(a)(2) of the Investment Advisors Act of 1940 (and similar state laws) imposes restrictions on the transfer of advisory contracts to other advisors. Specifically, Section 205(a)(2) requires advisory contracts to provide that "no assignment of [the contract] shall be made by the investment advisor without the consent of the other party to the contract." Accordingly, if it is anticipated by the succession plan that the advisor transfers advisory contracts to the successor advisor (as opposed to having clients sign all new agreements), the advisor would need prior client consent.

Privacy

The GLBA limits the instances in which an investment adviser may disclose nonpublic personal information about a client to nonaffiliated third parties, and requires the advisor to disclose to all of its clients the advisory firm's privacy policies and practices with respect to information sharing with both affiliates and nonaffiliated third parties. This creates a challenge for an investment adviser that needs to reveal information about their client base to the successor adviser (*i.e.*, a nonaffiliated third party).

To avoid violating the rules and regulations under the GLBA, an investment adviser can obtain written permission from their clients to discuss their accounts with the potential successor adviser. Usually, however, this is a non-starter for an advisor who either does

[4] A succession plan may contemplate that clients are going to sign new advisory contracts with the successor advisor.

not want clients to question why they do not already have a succession plan in place or is reluctant to raise additional privacy concerns in today's environment. An alternative strategy is for an advisor to discuss their client base, investments, investing strategies, portfolio management, brokerage, fee structure, etc. only in more general terms.

An investment adviser that fails to recognize the aggressive regulatory stance towards business succession planning does so at their own peril.

Assessing Your Advisory Business

"A little self-analysis is essential."

The driving force behind the planning process is finding a successor advisor that is the best match for your clients. This necessitates an in-depth assessment of an investment adviser's current advisory business. Attached as Appendix I to this white paper is a helpful assessment questionnaire that covers the following key areas:

- Advisory Firm
- Advisory Services
- Client Base
- Portfolio Management
- Brokerage/Custodial Relationships
- Fee Structure

Once an investment adviser has worked through the questionnaire, they will be in a much better position to find a suitable successor advisor.

Determine what traits make your clients' experience with your advisory firm unique.

Finding a Successor Advisor

"Rarely is it love at first sight."

Once an investment adviser has completed an assessment of their advisory business, it is time to search for a successor advisor or advisors (based on how diverse an investment adviser's client base is, an investment adviser may need to find more than one successor).

It is recommended that an investment adviser rank, in order of importance to both their advisory firm and its clients, the results of all the information gathered during the assessment process. Next, the advisor must determine which of that information is non-negotiable (*i.e*., the successor must offer a certain service, charge a certain type of fee, work with a certain custodian, etc.). Finally, an investment adviser needs to network - ask for referrals, attend conferences and participate in seminars that specifically target the business of providing advisory services.

Once a potential successor advisor is identified, an investment adviser needs to conduct preliminary due diligence on the successor's advisory business to determine if the successor is a suitable match. Part of this preliminary due diligence should include a review of the disciplinary history of the successor advisor, its principals and its investment adviser representatives. An investment adviser should also review the successor firm's primary disclosure documents (Form ADV Parts 1 and 2A) as well as the disclosure brochure of their investment adviser representatives (Form ADV Part 2B).

Once the parties begin serious discussions about entering into an actual business succession agreement, an investment adviser can ask the successor adviser to provide more detailed information about their regulatory exam history, client base and financial history. The advisor must determine whether there are any potential conflicts of interest between the advisor's clients and the successor's client-base. The parties can sign a non-disclosure agreement to protect the confidentiality of sensitive firm information. An investment adviser should also inquire as to the successor firm's compliance program, including cybersecurity, ethics and privacy.

The business succession agreement, which serves to memorialize the succession plan, has two distinct characteristics:

1. The agreement lies dormant until some triggering event (*i.e.*, death, incapacity or permanent disability) sets the plan in motion. If the triggering event never occurs, the advisor is free to sell or transfer the advisory business to whomever they want and whenever they see fit.

2. There is a potentially long expanse of time between entering into the agreement and the actual triggering event.

Accordingly, a well-drafted business succession agreement must:

- Be detailed enough to allow the person or persons administering the succession plan to follow the agreed-upon procedure for the transfer of the business . . . yet flexible enough to be implemented many years after it was originally drafted.
- Plan for the transfer of sensitive client information . . . without violating the privacy laws governing the operation of all investment advisory firms.

- Allow sufficient business information to be communicated to the successor adviser prior to the triggering event . . . while preserving the advisory firm's trade secrets and confidential information in case the triggering event never happens.
- Afford the successor advisor enough of an economic incentive to take on the transitioning clients . . . while still allowing the advisory firm the opportunity to realize a fair portion of the value of the business being transferred.

Once an investment adviser determines what traits make their clients' experience unique, find a successor adviser that embodies as many of those traits as possible.

Summary

"There's no time like the present to unlock the value of your advisory business."

Business succession planning is an onerous chore and a business succession agreement not inexpensive for a professional to draft. But the potential costs of not having a plan/agreement in place are extremely high - regulatory sanctions, a shrinking pool of new clients, violating the trust of existing clients and the failure to realize the financial benefits that have accrued to the advisory business over the course of its existence.

Whether one views succession planning as a fiduciary obligation, a regulatory requirement or strictly as a business issue, the prudent move for an investment adviser is to marshal the resources necessary to put a succession plan in place as soon as feasible.

A business succession plan allows an investment adviser to unlock the value of their advisory business while satisfying their fiduciary and regulatory obligations.

Important Information

This white paper has been developed to provide the user with general compliance information. It has not been developed to address the business, financial, regulatory or estate planning requirements applicable to any one particular individual or investment advisory firm. No representation is made that it is applicable to the reader's investment advisory business or individual business, financial, regulatory or estate planning needs. Accordingly, the information contained herein is not intended to constitute legal, financial, tax, estate planning or compliance/regulatory consulting advice. Any such advice should be sought from an appropriately qualified and/or authorized professional. Like most tools of a generic nature, this white paper has inherent limitations – unforeseen regulatory changes, the unique financial, tax or estate planning situation of the reader, the difficulty with factoring in all existing types of advisory business models and the impossibility of anticipating all types of business, financial, tax, regulatory and/or estate planning issues that may be applicable to any one particular individual or investment adviser.

About U.S. Compliance Consultants

Established in 2004, U.S. Compliance Consultants is a full-service consulting firm that specializes in registration and compliance support services for investment advisers. U.S. Compliance Consultants is a preferred compliance service provider for Charles Schwab & Co., TD Ameritrade, Raymond James and Scottrade.

U.S. Compliance Consultants' services include business succession planning, annual registration renewal, investment adviser registration, compliance program development, compliance support, compliance training, annual compliance reviews and mock compliance audits. U.S. Compliance Consultants can customize a compliance solution to fit the exact needs of your advisory firm.

For more information,

- please visit our **website**
- read our **blog**

Appendix I - Assessment Questionnaire

Question	Response	Importance	Non-Negotiable
Advisory Firm			
Are you registered with one or more states or with the SEC?			
Are you a registered representative of a broker dealer?			
Do you have any financial industry affiliations?			
Do you have any professional certifications (CFP, CFA, etc.)?			
Do you have custody of client assets?			
Do you serve as a trustee on any client accounts?			
What types of client-oriented service providers (i.e., account aggregation, statement production, etc.) do you use?			
What is your approach to client service?			
Do all clients have signed advisory agreements?			
Advisory Services			
What types of services do you provide?			
Do you limit your advisory service to one particular type of service?			
If you provide investment management services, does it include financial planning?			
If you provide financial planning services do you also implement plan recommendations?			
Client Base			
How many clients do you have?			

Question	Response	Importance	Non-Negotiable
What is the percentage breakdown in terms of types of clients?			
What are the demographics (age, income, gender) of your client base?			
Do you specialize in any one particular type of client?			
Are your clients local or dispersed throughout the state, region, country?			
Do your clients appreciate a hands-on or hands-off approach?			
Are your clients technologically savvy?			
Do your clients prefer to be contacted by phone, email or via client portal?			
How often do you meet with your clients			
Portfolio Management			
Do you have discretion to buy or sell securities?			
Do you have discretion as to the amount of securities to buy or sell?			
Do you have your clients complete a risk tolerance questionnaire?			
Do you use an investment policy statement?			
How often do you update clients' information?			
Do you use a portfolio management system?			
What methods of analysis do you use?			
What investment strategies do you employ?			
What types of investments do you make?			
What are your cash management practices?			

Question	Response	Importance	Non-Negotiable
Do you offer wrap fee accounts?			
Do manage private funds (i.e., hedge funds)?			
Brokerage & Custodial Relationships			
Do you maintain client accounts with a single broker-dealer/custodian?			
Do you require clients to maintain accounts at a particular custodian?			
Do you have discretion to select the broker-dealer/custodian used?			
Do you have discretion to determine commission rates?			
Do you allow clients to direct brokerage?			
Do you aggregate client trades?			
Do you maintain client accounts with a single broker/custodian?			
Fee Structure			
How are you compensated?			
Are you fee only?			
If not fee only, what other types of compensation do you receive?			
Do you charge fees in advance or arrears?			
How are fees paid (direct deduction or invoice)?			
Are your fees negotiable?			

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