Navigating Compliance When Buying or Selling a Client List or Investment Adviser Entity

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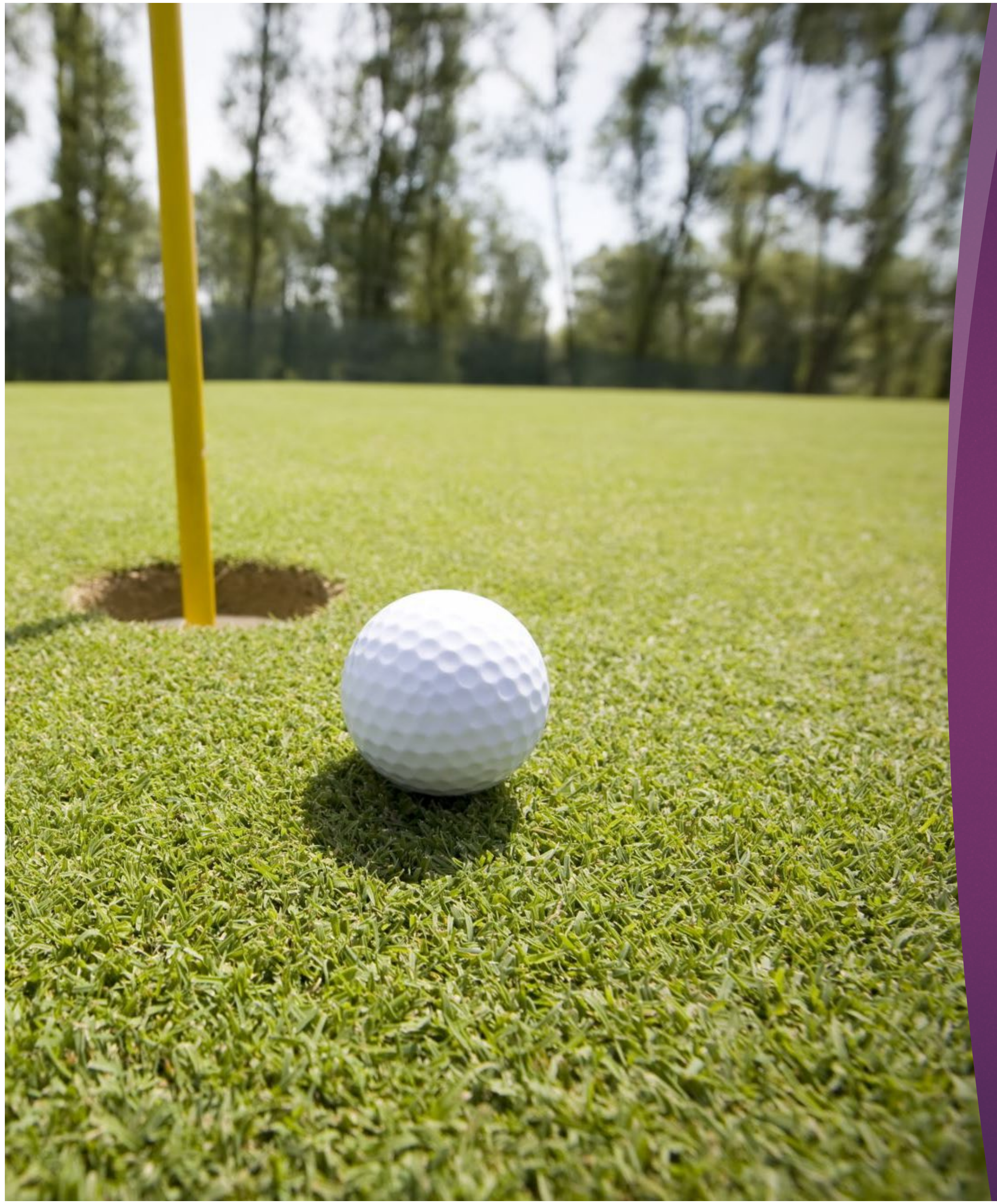

Investment Adviser Rep Continuing Education

This Course Has Been Approved by NASAA For 1 Hour of IAR CE Under the Ethics & Professional Responsibility Category

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Content Questions & Technical Help

If you have questions about the content of this course or need technical help, please contact us via the email address below:

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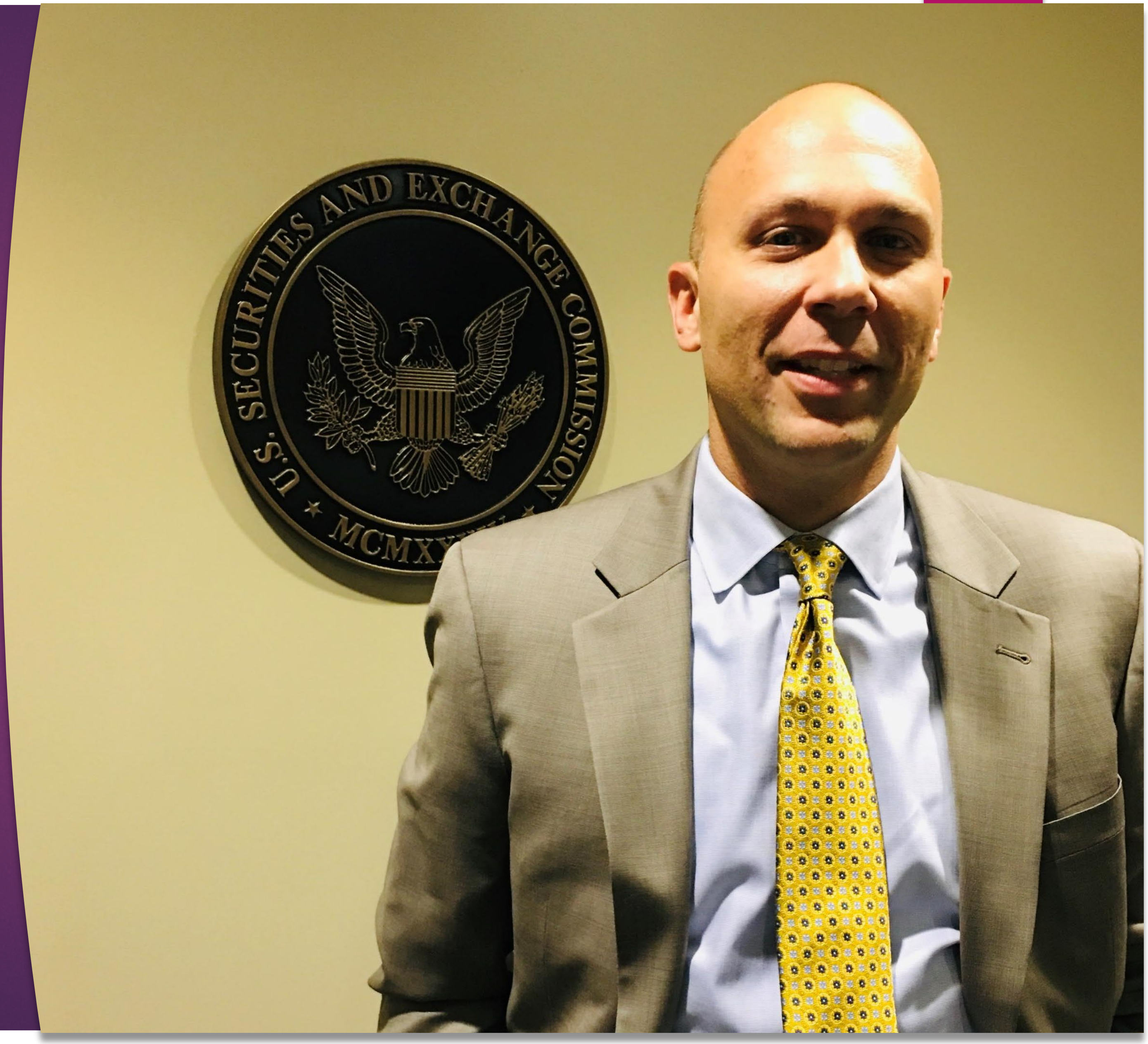


Course Overview

- Team of Professionals
- Key Laws & Rules
- Types of Transactions
- Due Diligence
- Questions & Answers

Resources

- Section 205 of the Investment Advisers Act of 1940

  https://www.law.cornell.edu/uscode/text/15/80b-5
- SEC No-Action Letter: Jennison Assoc. Cap. Corp.,1985 WL 55687 (12/02/1985)
- SEC Enforcement Action: SEC v. Jared D. Eakes et al., Jury Demand

  https://www.sec.gov/litigation/complaints/2022/comp25533.pdf

Limitations

- This Presentation Is Limited To A Sampling of Compliance Issues
- There Are Numerous Compliance, Due Diligence, Legal, Accounting and Valuation Issues Not Discussed In This Presentation
- This Presentation Is Educational and Should Not Be Considered Advice
- This Presentation Is Not Substitute From Getting Assistance and Specific Advice From Professionals Such Lawyer, Accountant, Valuation Expert and Compliance Professional

Need To Work With Team Of Professionals

Each Party Should Retain Own Team Of Professionals Experienced In Acquisitions Of Investment Advisers:

- Investment Banker/M&A Consultant
- Business Acquisition Attorney
- Certified Public Accountant
- Appraiser/Business Valuation Consultant
- Compliance Professional

Due Diligence: Investment Banker/M&A Consultant

Licensing & Registration

- Confirm The Professional Is Properly **Licensed And Registered.**

Conflicts of Interest & Compensation Structures

- Determine **Who Is Paying**.
- Examine How Compensation May Influence Advice:
  - 💼 **Retainer-based**: May Reduce Pressure To Close Quickly But Could Weaken Incentive To Drive Toward A Result.
  - 💰 **Success/Sales-based**: Intermediary May Push For *Any* Closeable Deal Rather Than *Best* Deal.

Buyer Sourcing Process (for Sellers)

- Ask How Potential Buyers Are Identified.
- Request Expected Number Of Inquiries.
- Understand Whether Process Will Include **Broad Market Outreach** Or Be Limited To **Known Closeable Buyers**.

Review Engagement Terms Carefully

- Request Clear Explanation Of **Entire Process**, From Valuation To Outreach To Deal Close.
- Review All Documents & Proposals Thoroughly.
- **Engage Legal Counsel** To Review Engagement Agreement Before Signing.

Involvement of CCO

Engage Chief Compliance Officer At Earliest Stages Of Due Diligence — Not After Terms Are Finalized. CCO Is Essential To

- Identify Compliance Risks,
- Evaluate Disclosure Requirements,
- Coordinate Client Communication Strategies, And
- Ensure A Smooth Regulatory Transition.

Fiduciary Duty

- Under Federal And State Laws, An Investment Adviser Must Disclose/Mitigate Conflicts Of Interest & Act In A Client's Best Interest
- No Carve Out When Selling Client List, Recommending Another Investment Adviser Firm Or Changing Ownership/Control
- Must Notify Clients About Any Material Changes In Their Advisory Relationship Including Change Of Majority Ownership Or Control
- Transition Should Be Planned To Minimize Disruptions To Clients & Ensure Clients Continue To Receive The Same Level Of Care During The Transition Period

Privacy

GLBA – Requires Advisers To Safeguard Non-public Personal Information (NPI) Even During A Sale Or Transfer.

Does Privacy Policy Permit Sharing Client Data?

Enter Into Confidentiality Agreement

Should Partially Redact NPI of Clients

Use Secure Data Room

Post Transaction: Ensure NPI of Clients Destroyed or Returned

SEC Anti-Assignment Rule

- Section 205(a)(2) of Investment Advisers Act Prohibits Assignment Without Consent of Client
- Definition of Assignment:
  - SEC Broadly Defines "Assignment" To Include Any Transfer Of The Advisory Contract Or Transfer Of A Controlling Block Of The Adviser's Voting Stock; And
  - A Transfer Of Stock Or Control, Directly Or Indirectly, Can Be Considered An Assignment If Results In A Change Of Control Of The Adviser.
- If Term "Written Consent" Or Something Similar Is Used In Agreement, Cannot Use No-Response Letter.
- Obtaining Consent (If "Written" Is Not Required by Agreement):
  - Affirm In Writing;
  - No Response Letter: Must Send 1st Letter 60 Days Before Closing and Then Send 2nd Letter Immediately After Closing Providing Additional 45 Days To Cancel Without Any Fees Due For Period After Closing; or
  - Sign New Agreement with New Owner.

State Firms Navigating Assignment

Some States Require Adviser To Notify Client Of Any Change In Partners Or LLC Members Within A Reasonable Time After Such Change.

Many States Prohibit Assignment Without Written Consent Of Client.

Recommend Contacting State Securities Regulator For Guidance.

Types of Transactions & Compliance Implications

Asset Purchase (Client List Only):

- Buyer Acquires Specific Assets (Client List & Good Will) & Excludes Liabilities.
  - Practice Tip: Buyer Should Avoid Taking Seller's Trade Name – Risk of Successor Liability Due to Apparent Continuity
- Either (1) Existing Advisory Agreements Are Assigned To Buyer or (2) New Advisory Agreements with Buyer Are Executed By Clients
- If Advisory Agreements Are To Be Assigned, Must Obtain Client Consent
- Tax Planning Consideration: Goodwill Treated As Capital Gain & Services Subject To Restrictive Covenant Treated As Ordinary Income

Types of Transactions & Compliance Issues (Cont.)

Equity Purchase (Entire Advisory Entity):

When Purchasing Entire Entity, Buyer Assumes Responsibility For Client Contracts, Liabilities, And Existing Compliance Programs.

- Requires Extensive Due Diligence of All Aspects of Business – Not Practical For Small Firms
- Requires Client Consent
- Requires ADV Filing

Types of Transactions & Compliance Issues (Cont.)

Mergers and Consolidations:

Merger Could Trigger Assignment & Require Client Consent If

- Person Who Had Control Of Adviser Prior To Merger Does Not Have Control Of Surviving Entity;
- Person Who Did Not Have Control Of Adviser Prior To Merger Gains Control Of Surviving Entity; Or
- Adviser Is Merged Out Of Existence As A Result Of Transaction.

May Require Filing of Succession By by Application Depending Upon Situation.

Combining Compliance Programs of Both Firms Including Merging Written Supervisory Procedures, Codes Of Ethics, And Internal Audits To Ensure Regulatory Compliance.

Due Diligence – Critical for Both Parties

Allows Buyer To Verify The Value And Risk Profile Of The Business Being Acquired

Enables Seller To Evaluate Risks Of Buyer And Minimize Post-closing Disputes

Due Diligence: Character & Culture Fit

Character & Integrity

- Assess Whether **Personal And Professional Values** Of The Buyer And Seller Align—especially Around Fiduciary Duty, Ethics & Transparency.

Cultural Alignment

- Explore What **Motivates Each Party's Relationships** With Clients, Team Members & Business Partners. Are Their Service Philosophies And Leadership Styles Compatible?

Shared Vision & Drive

- Evaluate What **Each Party Is Striving To Accomplish** With The Firm Post-transaction. Does The Buyer Aim To Grow Aggressively? Does The Seller Prefer Stability?

Passion For The Business

- Understand What The Seller **Loves Most About Being An Adviser** And Whether That Passion Can Still Be Expressed Or Honored Under New Ownership.

Leadership & Control Expectations

- Clarify How Much **Control Or Influence The Seller Wants Post-closing**—full Exit, Advisory Role, Or Co-leadership—and Whether Buyer Supports This Vision.

Creditworthy Considerations

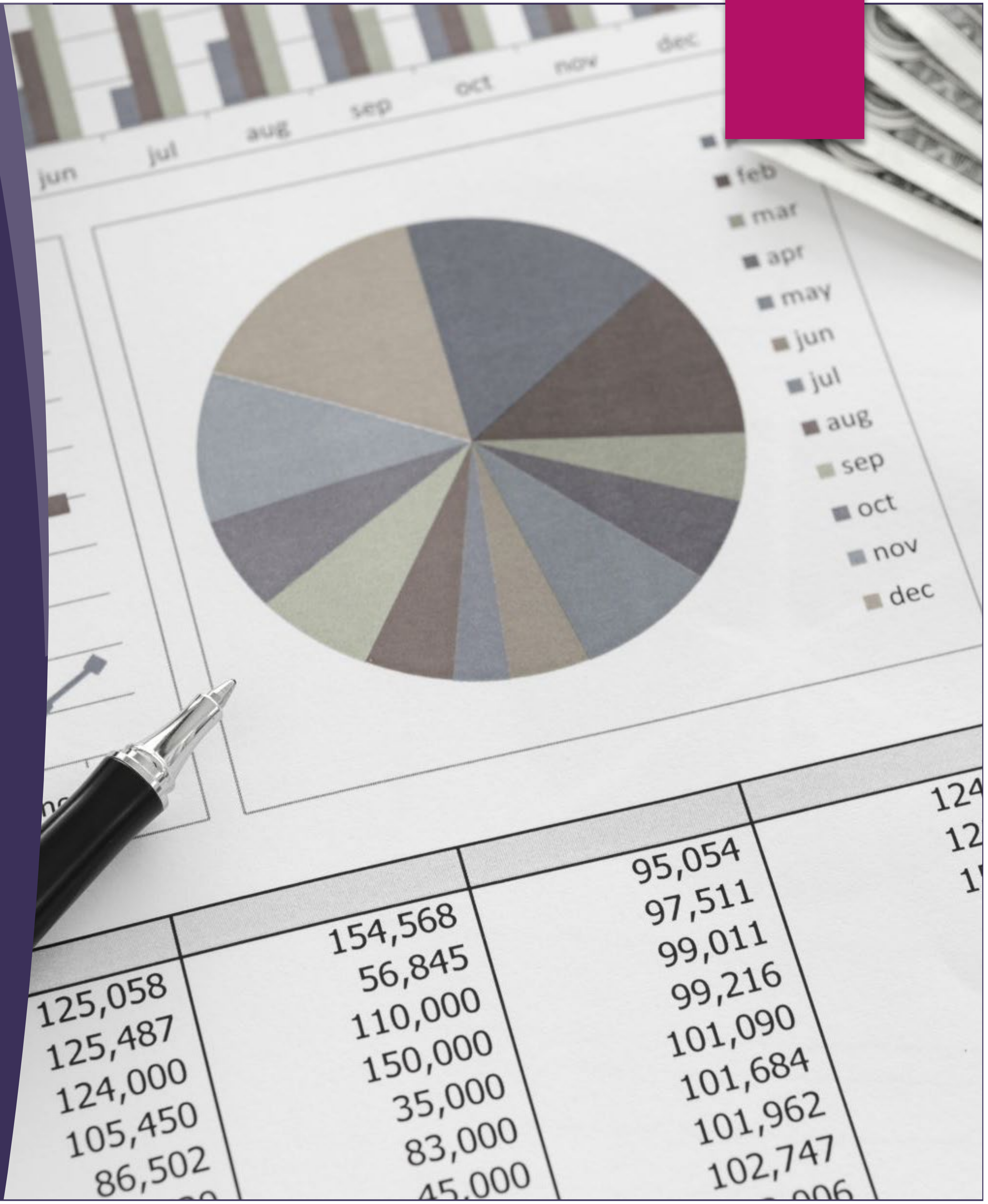
1. **Credit Report & Payment History:** Run a credit check to identify delinquencies, defaults, or negative credit events that could indicate financial instability.

2. **Debt Load & Financial Ratios:** Evaluate debt-to-income and other financial ratios to assess whether the buyer or seller is overleveraged or at risk of default.

3. **Income & Asset Verification:** Review balance sheets, income statements, and prior W-2s/1099s/tax returns. Confirm revenue through third-party sources (e.g., custodial fee reports).

4. **Bankruptcy & Creditor Issues:** Investigate prior bankruptcies, creditor settlements, and other financial compromises that may affect creditworthiness or legal standing.

5. **Existing Liens & Encumbrances:** Search for UCC liens or other encumbrances on key assets (e.g., client lists, goodwill, trade names).



Background Check Of Key Parties

Independent Public Records Check: Conduct a thorough background check covering the **last 10 years** in **all counties** where the individual has lived or worked—beyond what's listed in the IAPD report.

Comprehensive Internet Search: Perform a detailed online search using the buyer/seller's **name, address, affiliated business entities**, and any **trade names** to uncover reputational concerns or undisclosed activities.

Review of Website & Online Materials: Analyze the buyer/seller's **business website** for marketing representations, ownership disclosures, bios, and any potential red flags or inconsistencies.

Secretary of State Business Filings: Search **Secretary of State entity databases** for business registrations, name usage, and potential unreported or conflicting entities.

Legal or Criminal Issues: Determine whether the background check reveals **arrests, civil litigation, or regulatory actions** that could impact credibility, client trust, or deal viability.

Licensing & Registration

Verify Current Licenses And Registrations: Confirm That Buyer And Seller Are Properly Registered With SEC Or Appropriate State Securities Regulators As Investment Advisers Or Investment Adviser Representatives.

Assess State-specific Requirements: Licensing Standards And Definitions Of "Investment Adviser Representative" Vary By State—Do Not Assume SEC Registration Exempts You From State Requirements For Individuals Involved.

Review Impact Of Contingent Purchase Price Structures: If Any Portion Of The Seller’s Compensation Is Contingent On Future Advisory Fees, This May Trigger Post-closing Licensing Obligations For The Seller Under Certain State Laws.

Consult State Regulators On Grey Areas: Where Payments Resemble Ongoing Revenue Sharing, Or Where The Seller Stays Involved With Clients Post-closing, Confirm With State Regulators Whether A License Or Registration Is Required.

Document Licensing Compliance: Maintain Written Evidence To Support Your Firm’s Position On Whether Licensing Was Required And How It Was Addressed.

Regulatory Due Diligence

- Review Last Regulatory Examination Findings & Corrective Actions For Last 6 Years
- Review Any Regulatory Orders & Inquiries For Last 6 Years
- Review Any Disciplinary "Yes" Answers on Form ADV & Form U4 of Current Reps
- Review Annual Compliance Review Report & Any Internal Audits For Last 6 Years

Due Diligence: Customer Complaints & Litigation

- List of Customer Complaints During Past 6 Years and Copies of Each Letter of Complaint and Response
- List of All Lawsuits or Arbitrations Filed Against Firm and/or Rep During Past 6 Years, Copy of Pleadings and Description of Current Status
- Copy of Current Errors and Omissions Professional Liability Insurance Policy

Impact of Conflicts of Interest on Retention

New Conflicts Introduced By Buyer: Does Buyer Have Conflicts Seller's Clients Have Not Previously Faced?

Effect On Client Retention: Could Buyer's Business Model Jeopardize Client Trust Or Retention?

Seller's Role Post-Closing: Will Seller Accept Working Within A Model That Includes These Conflicts?

Retention Of Key Staff: Will Seller's Team Be Comfortable With Buyer's Compensation, Product Mix, Or Affiliations?

Disclosure And Mitigation Strategy: How Will New Conflicts Be Disclosed And Managed To Preserve Client Confidence?

Client List: Verification And Risk Review

Verify Accuracy Of Client List: Confirm That All Listed Clients Are Active, Paying Clients With Supporting Documentation (Agreements, Custodian Reports, Fee Records).

Obtain Third-Party Validation Of AUM And Fees: Require Independent Reports (From Custodian Or Admin Firm) Verifying Assets Under Advisement And Advisory Fees Over The Past 12 Months.

Assess Demographics And Longevity Risk: Evaluate Client Age Distribution. Are Clients Nearing Retirement Or Withdrawal Phase? Will Assets Likely Grow Or Decline?

Evaluate Retention Risk Of Certain Client Types: Identify Clients (e.g., Family Members, Legacy Friends, Special Service Clients) Unlikely To Transition Or Remain Post-Sale.

Exclude High-Risk Or Undesirable Clients: Consider Excluding Clients With Poor-Performing Accounts, Complex Needs No Longer Serviced, Or Where Transition Risk Is Too High.

Due Diligence: Succession Planning

Ensure That Buyer Has A Robust Succession Plan In Place, Particularly For Adviser & Key Personnel.

Consider Need For Life Insurance Or Disability Insurance As Part Of The Transaction To Mitigate The Risk Of Unexpected Departures Of Key Individuals.

Explore Whether To Require Buyer To Pay Any Remaining Amount Owed on Earn Out Before Selling Firm or Client List

Post-Sale Client Recommendations And Fiduciary Duty

- **Recommendations Must Reflect Fiduciary Duty**
  - Any Encouragement To Use Buyer's Or Third-Party Adviser's Services Must Be Consistent With Fiduciary Obligations To Clients.
- **Conduct Thorough Due Diligence On Buyer Or Successor Firm**
  - Seller Should Not Recommend A Firm Unless Due Diligence Has Been Completed On The Background And Capabilities Of That Firm.
  - If Adverse Information Is Discovered, It Must Be Disclosed To Clients.
- **Disclose If Due Diligence Has Not Been Performed**
  - If Seller Has Not Conducted Extensive Due Diligence, They Must Refrain From Recommending The Buyer's Services Or Clearly Disclose Lack Of Review.
- **Disclose Conflicts Related To Earn-Outs Or Retention-Based Compensation**
  - If The Seller Is Compensated Based On Client Retention, Or Is Required To Encourage Client Transitions, This Must Be Disclosed As A Conflict Of Interest.
- **Avoid Misleading Clients About Ongoing Involvement**
  - If Seller Is No Longer Involved In Investment Decisions Or Reviews Post-Sale, Clients Must Be Promptly Informed To Avoid Misrepresentation.

Questions

Please submit any question online or email with any questions about the content of this course.

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Thank You