JACKO LAW GROUP, PC

Legal Risk Management Tip
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Succession Planning 101: FAQs to Consider

What is Succession Planning? Succession planning is a process for determining how one will transfer a business ownership interest when a "succession event" occurs (*e.g.*, upon the death, disability or retirement of a founder or a monetization event).

Why is Succession Planning important? While every firm is unique in ownership and framework, certain similarities exist across such spectrums. Specifically, if a "succession event" occurs, each firm must: (1) ensure that the business operations continue unabated; and (2) properly compensate business owners for the fruits of their efforts in the event of "succession event."

In this month's Risk Management Tip, we will discuss some of the most frequently asked questions posed by advisory firms related to Succession Planning. While not an exhaustive list, the following should provide a solid foundation for exploring the topic.

1. Why is Succession Planning Important?

A cultural age shift is occurring in the US. As the baby boomer generation is entering retirement, the need for proper planning has increased. Per recent statistics[1]:

- 43% of advisers are over age 55
- 33% of advisers are between ages 55-64
- Average age of adviser: 51

As these numbers show, almost half of all advisers are over the age of 55, which traditionally is the age when most people start to consider retirement. Further, the average age of advisers has now eclipsed to 50-years-old. While Succession Planning is important to all age groups, it's obviously that much more important to those who are closer to retirement. General time-frames for creating and implementing a Succession Plan are typically anywhere between two (2) and 10 years depending on the succession methodology employed. As such, it is imperative for advisers in advanced age groups to start putting a plan in place, if they have not already done so. This will affect younger generations of advisers as many of them are likely to be the ones identified as successors in these plans.

2. Is My Firm the Only One Without a Succession Plan Already in Place?

The answer to this question is a resounding "no." According to a 2013 study[2]:

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[1] Cerulli Associates of Boston
[2] *See* https://www.onefpa.org/business-success/ResearchandPracticeInstitute/Documents/RPI%20Initial%20Study%20Release%20-%20121113%20-%20FINAL.pdf

- 75% of advisers say they have no formal succession plan; and
- 59% of advisers over age 65 have no formal succession plan.

Importantly, we recognize that this study is over six (6) years old and current business trends and regulatory focus have likely improved these numbers. Nevertheless, these numbers paint an eye-popping picture. Three out of four advisers do not have a formal[3] succession plan in place. While the numbers get a little bit better for advisers over the age of 65, it's still clear that majority of advisers approaching retirement have not implemented a formal Succession Plan within their firm. These statistics exist despite evidence that most advisory firm clients want their respective adviser to have a clear Succession Plan in place.

3. I Already Have a Business Continuity Plan in Place, Isn't that the Same Thing?

No. While in the same family of "forward planning," Succession Planning is a separate and distinct topic from Business Continuity Planning. In a nutshell, Business Continuity Planning focuses on ensuring business operations, should an external disturbance occur in the processes and/or functions of the business (i.e., a hurricane, fire, cyber-attack or other major event). Conversely, Succession Planning focuses on ensuring business operations following an internal disturbance – such as a succession event of key personnel.

4. What is the Expectation of Regulators Concerning Succession Plans?

Regulators see that for particularly smaller firms with senior executives nearing retirement, succession planning is essential. As discussed, the average age of financial professionals has increased; most advisers do not have a formal Succession Plan in place; and clients must be serviced regardless if a "succession event" is triggered. As such, regulators are pushing to have Succession Plans be a mandatory component of an advisory firm's compliance program.

The first such regulation has been promulgated by the North American Securities Administrators Association ("NASAA") who implemented their "Model Rule on Business Continuity and Succession Planning" (the "Model Rule") in 2015[4], which requires investment advisers to adopt a "Business Continuity and Succession Plan" for their RIA practice. In drafting the Model Rule, NASAA took into consideration that advisory business structures vary greatly in how they are organized and operated. Thus, the Model Rule serves as guidance for states, and by extension, state investment advisers on factors to consider on how to develop a written succession plan, with considerations about how the adviser will handle the transition of his or her business and policies and procedures related thereto. Notably, while the Model Rule doesn't necessarily speak to SEC investment advisers, it does provide strong guidance on Succession Plan considerations.

For SEC registrants, there are early indications that the SEC wants to make sure clients don't wind up at risk if their financial adviser retires, gets sick or dies without a succession plan in

[3] For purposes of this study, "formal" was defined as the advisor not having reduced to a writing what processes will take place should a succession event occur.

[4] *See* https://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Model-Rule-on-Business-Continuity-and-Succession-Planning-with-gu....pdf

place. Speaking before *The New York Times*' DealBook Opportunities for Tomorrow Conference[5], former SEC Chair Mary Jo White stressed the risks associated with such events, and specifically cited the need for succession planning "during an advisor's dissolution or following the departure of key personnel."[6] The SEC also *proposed* Rule 206(4)-4 to the Investment Advisers Act of 1940, as amended (the "Advisers Act") that would require registered advisers to have both a business continuity and succession plan in place (that is reviewed at least annually) prior to providing advisory services to clients. To date, there are no current plans to promulgate the Rule as proposed.

5. What Should my Succession Plan Include?

The Succession Plan itself will vary greatly from firm to firm. However, at a minimum, it is recommended that the Succession Plan identify what party(-ies) will oversee servicing client accounts, should a succession event occur. To get started, it is recommended that advisers consider short-, intermediate, and long-term plans. Generally, a short-term plan is appropriate for key personnel who are only unavailable for a temporary amount of time, such as less than six months or a year. An intermediate succession plan could be triggered if there is a longer-term absence of an employee (such as six to nine-months unavailability). Additional considerations, such as whether the temporary successors will receive additional compensation, whether/how much the key personnel should be paid for the business following a succession event, when/how clients are to be contacted, privacy considerations, etc. may or may not also be included. The NASAA Model Rule[7] includes additional considerations when creating a Succession Plan that includes the following:

- Are the clients' investment advisory contracts with an individual or a legal entity?
- Does an adviser representative's death or unavailability affect the advisory agreements?
- How will the advisory firm ensure continuity of services to the client?
- What will happen in the event of death or incapacity of the manager of discretionary accounts?
- How will the death or unavailability of certain individual owners affect the legal ownership of the firm and the registration status of the entity and/or its new owner(s)?
- Does the advisory firm only have one person with IARD access?
- What will happen if that contact is no longer available?
- Who is responsible for dealing with creditors and vendors?

6. What Are Some Options Available when Determining a Successor?

While there are some succession issues that apply to every business, each adviser must tailor its Succession Plan to the adviser's needs. One example is found in the NASAA Model Rule when discussing sole proprietorships. Specifically:

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[5] *See* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722

[6] Id.

[7] *See* https://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Model-Rule-on-Business-Continuity-and-Succession-Planning-with-gu....pdf

In a sole proprietorship, the client's legal relationship is with the sole proprietor - who is often the only advisory representative of the advisory business. If a succession event occurs, the sole proprietorship will legally terminate, as would any powers of attorney, advisory contracts, and other client agreements. The deceased (or otherwise incapacitated) sole proprietor is likely to be the only regulatory contact and likely, the only person who would be able to access electronic client files or authorize rebates of pre-paid fees. There are many additional issues (such as probate) that are unique to sole proprietorships that may affect the implementation of a Succession Plan.[8]

Conversely, owners of larger firms face different issues in generating their Succession Plan. This includes who is the best the party(-ies) to oversee and own the business; what is the desired successor ownership structure; how will the deceased/departing owners be properly compensated for the business; and over what time period. Numerous options are available in such scenarios:

- Consider Ownership by Employees. In this multigenerational model, firm owners identify and nurture the next generation of owners from internal personnel. Financing for the departing owner's business interests might come in the form of an Employee Stock Ownership Plan ("ESOP"), employees/successors buying ownership interests directly, as well as having the business and/or employees/successors take out "Key Person Insurance"[9] on the current owner(s).
- Consider External Successors. Some advisory firms are not in a position to have a successor from within the firm take over the business and must identify external persons/firms. When doing so, it is important to consider your location, client base and investment methodology(-ies) to find a successor that would best fit with your current operations and culture. Firms should also acknowledge the trade secrets and privacy considerations of the firm and its clients during negotiations to refrain from inadvertently sharing such information.

- Merge or Sell Within an Existing Network. Similar to looking for external successors, an adviser or firm may look to join an existing network, which enables them to continue operating under the "umbrella" registration within that network. The downside of this method is losing the operational independence of serving as your own firm. This option also may have additional compliance, systems and operating benefits or complexities that must be considered. Positively, this structure provides an ongoing a network of potential successors to choose from.

7. How Should I Value My Business?

This is a frequent question for firms during the Succession Planning process. All financial professionals want to ensure they receive adequate compensation for a business that undoubtedly

[8] *See* https://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Model-Rule-on-Business-Continuity-and-Succession-Planning-with-gu....pdf
[9] This is usually structured as term life insurance, and it allows for a successor to buy out a business owner's stake in case of an unforeseen event.

took significant time, money and energy to create. There is no "one" way to value an advisory firm. However, there are several methodologies that are commonly used; and at the end of the day, the value of the business is ultimately determined by the amount another party is willing to pay. With that said, the following are some of the more typical methodologies employed:

- Multiple of Revenues. Whether done on a "net" or "gross" basis, a typical way to value the worth of an advisory firm is to look at the revenues generated by firm (normally over a one-to-five-year period) and apply a multiplier[10] to the revenue number. For example, if the gross revenue of the firm is $100,000, and a multiplier of 2x is agreed upon, the value of the firm would be $200,000. Typically, an advisory firms' revenue (mostly) is derived from ongoing asset-based fees that are expected to continue beyond the time of a succession event.

  A variety of factors often determine the multiplier to be applied, which includes: (i) the "age" of the firms' clients, (ii) whether the majority of revenues are attributable to a relatively small number of clients or are dispersed throughout the client base, (iii) the longevity of the firms' client relationships and the risks associated with attempting to transfer the relationship to a new adviser/firm, (iv) the investment strategy/complexity of the firms' typical investment strategy, (v) payment methodology/terms, and (vi) whether any type of "look-back" or "claw-back" provision is included for the buyer, etc.

- Comparing to Relevant Market Data. As with any "hard-to-value asset," contrasting what similar assets are selling for or have sold for in the marketplace and adjusting for relevant factors of the business is another valuation methodology. The downside to this approach is the availability of locating relevant market data do this comparison. Frequently, this methodology requires the use of third-party vendors as firm sales in the advisory space are non-public information.
- Third-Party Vendors. There are several third-party vendors that range ranging from general accountancy firms to more specialized valuation firms. Within their valuation process they take an outside perspective and evaluate various factors, such are cash flows, market risk, as well as demand. While this method is usually the most-costly in regard to business valuation, it often provides the "independence" that many parties seek in determining a valuation for the business, which aligns with industry standards.

No matter the valuation methodology employed, it is important to remember that the value of the business will change over time. A Succession Plan may not be triggered for several years or decades following its creation (if ever), so routinely examining the contents of the Succession Plan, and determining with the valuation methodology's ongoing applicability to the business, is an important ongoing and evolving factor.

[10] The multiplier typically ranges between 1.5x – 3x revenues in the advisory space but can greatly vary based on varying facts and circumstances.

Conclusion

Creating a Succession Plan is a prudent component of any advisory business. Not only do both clients and regulators expect that such planning has been performed, but advisers and firm owners themselves benefit from developing and implementing comprehensive plans. While the content of any succession plan will vary greatly dependent upon the business model, the central concepts will remain consistent.

There is no one right way to create a Succession Plan, as it mainly depends on the firm's business and people. It's a best practice for advisers, and advisory firms alike, to examine their firm's approach to creating and maintaining a Succession Plan that effectively tracks the risks associated within their respective business model. Working with an attorney and other professionals familiar with these matters, can assist in the planning process.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com/news-room for additional Legal Risk Management Tips.

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