

Legal Risk Management Tip March 2016

Considerations When Purchasing an Investment Advisory Business

For Registered Investment Advisers (“RIAs”), acquiring another investment adviser’s practice can often serve as an efficient means for quickly increasing the assets under management and profitability of the RIA, while also adding scale and efficiency to client services. However, in light of the numerous regulatory and corporate considerations involved in such corporate combinations careful analysis and planning should be conducted prior to entering into a definitive agreement. Not only will the acquiring RIA face legal and compliance obstacles, but the selling RIA often has a personal connection to the business being sold that needs to be considered.

The purpose of this article is to review some of the more prevalent items to consider when acquiring an investment advisory business. This article contemplates the scenario where an acquiring RIA is purchasing the business of the selling RIA outright.¹

Important Aspects to Consider When Purchasing an Advisory Business

A. Performing Due Diligence

As with any business decision, performing proper due diligence is paramount to ensuring a beneficial acquisition. The first question to be answered should be “what exactly is being purchased?” In asset purchases between RIAs, typically the largest “asset” to be acquired is the selling RIA’s “book of business.” The book of business represents those clients for whom the selling RIA performs advisory services and holds exclusive rights to the advisory agreement(s) governing the relationship between the RIA and the clients. As such, a primary focus of the acquiring RIA’s due diligence should be the book of business, and how its acquisition could impact the acquiring firm. For instance, factors to consider during a due diligence review include: the types of clients included in the book of business - their geographic location, net worth and investment profiles; the investment strategies utilized by the selling RIA; the type of billing employed by the selling RIA (i.e., fee based, performance based, etc.), the reason(s) for sale, among others. All of these items can considerably impact the acquiring RIA, and should be thoroughly reviewed at the due diligence stage.

B. Valuations

Attempting to determine the value of a privately held RIA is often extremely difficult, even for the most sophisticated parties. In general, the buyer is trying to determine the future value of the assets, while the seller is more concerned about past results as the driver of RIA value. In addition, both parties need to agree on the value of other assets being purchased. For instance, is the buyer acquiring the selling RIA’s book of business only, or is it also purchasing the RIA entity itself, office space, tangible assets, etc.? Will the selling RIA insist that one or more individuals be retained by the buyer (more on this concept below) and will the acquisition price be reduced accordingly?

¹ Other types of combinations, e.g. a merger of two RIAs, entail additional considerations such as ownership changes, corporate re-organization and tax implications which are outside the scope of this Legal Tip.

Once it is determined what comprises the “assets” being acquired, a dollar amount representing the assets’ worth must be determined. There are several methods that can be employed in determining the value of an advisory business – such as valuation based upon the selling RIA’s assets under management (“AUM”), cash flows or by viewing similar transactions that have occurred recently in the market. Unfortunately there is no one standard method of valuing such assets. It is often beneficial to utilize the services of a third-party to provide an impartial value that can serve as the basis for valuation negotiations.

C. Transferring Assets

Once the parties have decided upon the value of the assets, they must then turn their attention to transferring the assets to the buyer. There are two items of particular concern here: client consents and timing of the transfer.

Client Consents: As mentioned above, the selling RIA’s book of business is often valued based upon the number of clients and cumulative amount of AUM such clients represent. However, while the selling RIA holds the exclusive right to the advisory contract governing the relationships with the selling RIA’s clients, per the Investment Advisers Act of 1940, as amended, that advisory agreement may not be transferred without the client’s consent. As such, the parties to a transaction should specify who is responsible for contacting clients to gain their consent, how such consents will be tracked, and what will occur if a client’s consent cannot be obtained.

Timing of Transfer: The second consideration is the timing of the transfer of client agreements to the acquiring RIA. Not all asset purchases occur at a single point in time. Often, for varying reasons, assets are transferred to the acquiring RIA in different stages or tranches. The longer it takes to transfer assets, the greater the chance a disruption could occur altering the anticipated transaction. For instance, what would happen if the selling RIA were an individual who passed away or became permanently disabled prior to all assets transferring? Would the transfer schedule be accelerated so that all remaining assets automatically transfer to the buyer? Who would be responsible for obtaining any remaining client consents to the transfer? Would the buyer be responsible for continuing to make any payments to the seller’s estate for monies owed? For those transactions where assets are to be transferred over a longer period of time, the parties should consider including terms in the agreement to help govern these and other “what if” scenarios that could arise.

D. Other Important Considerations

While the aspects discussed above cover certain overarching concepts of an RIA asset purchase, there are numerous other considerations that might apply given the specifics of a transaction.

Incumbent Adviser/RIA: Frequently, an individual owner of a selling RIA wishes to sell her book of business, but is not ready retire from the industry. Or, alternatively, the acquiring RIA may condition the sale upon a seller’s agreement to work for the buyer in some capacity in order to help ensure a smooth transition for acquired clients. In these situations, the acquiring RIA must consider whether it makes sense financially and from a regulatory supervisory aspect to take on the individual adviser as part of the overall transaction, and what arrangements need to be made in connection with that relationship.

Financing Options: Just as there are numerous ways to value the assets, there are a variety of ways in which the purchase of those assets can be financed. Typically, the acquiring RIA does not have the entire purchase amount available to pay for an asset purchase at a closing event.

In such a scenario, two ways to spread out payments for the assets are through the combination of a down payment and promissory note, or through revenue sharing arrangements whereby the selling RIA will receive a percentage of revenue generated by the acquired assets for a given period of time (this is especially common where one or more advisers of the selling RIA go to work for the purchasing RIA). There are several additional common methods to finance the purchase of an RIA, and any such financing means should be thoroughly reviewed to ensure they comply with applicable regulations.

Additional Notice Filings/Registrations: Following an RIA asset purchase, the acquiring RIA will need to evaluate whether additional regulatory filings will be required by the acquiring RIA. For example, if as a result of the transaction, the firm's AUM surpasses \$100 million, the firm will need to become SEC registered. Similarly, the onboarding of new clients will likely result in additional "notice filings" or registrations to be performed at the state level for the firm. Additionally, depending upon the types of securities invested in by the acquiring firm, the influx in AUM could result in the firm being deemed a "large trader" requiring the firm to perform 13-H² or similar regulatory filings. Failing to promptly plan for any new regulatory or filing obligations could result in fines, penalties and sanctions being imposed upon the acquiring firm by the respective governing body.

Conclusion

Each RIA acquisition transaction will be different, and depending upon the motivations of the buyer and seller, the importance of the considerations mentioned above and other significant issues will be weighted differently. It is important to remember that not all RIA firms are the same, and as such, not all RIA acquisitions will be the same either. While this article is not designed to serve as an all-inclusive list of the items that should be reviewed, negotiated and memorialized when purchasing an RIA's practice, utilizing the services of experienced legal counsel can help ensure that all relevant factors are considered.

For more information on these and other considerations, please contact us at (619) 298-2880 or at info@jackolg.com.

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² See 17 CFR 240.17a-25.

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