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Ongoing Compliance Updates for Investment Advisors

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An Overview of Internal Succession Planning for the Registered Investment Advisor

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Introduction

Investment advisers who are formulating a succession plan should focus on protecting existing client relationships, planning for business continuity and determining what will happen when advisory firm founders retire, whether that will entail internal succession or an external acquisition or sale. Critical to any successful succession is having the appropriate underlying documents in place, including restrictive covenant agreements protecting the firm's proprietary interests in its client relationships. For an internal succession, advisers will need a well-crafted compensation plan and a well-drafted shareholders' agreement or operating agreement addressing the terms and conditions for the disposition/succession of ownership interests (e.g., stock, membership interests, etc.) upon the occurrence of various events, including admitting new owners, regulatory disqualification, death, disability, retirement and termination of employment. For an external transition, firms should have a well-drafted purchase/sale/merger/joint venture agreement that adequately protects the respective parties' interests before and after the transaction. Regardless of whether an internal or external succession is selected, conducting appropriate due diligence and reviewing the corresponding regulatory issues are critical.

This article provides an overview of each of these important components of effective internal succession planning for registered investment advisers. (It is not intended, however, to provide an exhaustive discussion of all succession planning considerations. Firms should consult with their legal counsel and other professional advisers for specific advice.)

Protecting Client Relationships

Many principals of investment advisory firms think ahead to the day when they may sell their largest asset, their firm. Unfortunately, too many firms do not adequately protect their most important asset—

their client relationships. It is imperative for every firm to make sure that it has taken appropriate steps to protect its client relationships in order to prevent departing firm employees (generally, the firm's investment adviser representatives) from taking those relationships with them. How does the firm avoid the loss of client relationships? By requiring each employee who is responsible for establishing and/or serving clients to execute a restrictive covenant agreement. Although creating and executing a restrictive covenant agreement is a relatively simple process, too many firms have either not done so or have put in place agreements that do not adequately protect the firm.

The Restrictive Covenant Agreement. The purpose of this document is to prohibit or restrict an employee from diverting client accounts from the firm in the event that the employee leaves the firm, either through termination or voluntary departure. Generally, there are two types of restrictive covenant agreements that an investment advisory firm can require its employees to execute:

1. Non-competition—In this type of agreement, the firm generally seeks to prohibit the employee from accepting employment in the investment advisory/financial services industry for a certain period of time. A non-competition covenant can be modified to limit the restriction by geography (e.g., the employee cannot accept employment at a competing firm for a period of two years in a particular state or geographic region, such as within a 100-mile radius of the firm's offices, etc.).
2. Non-solicitation—In this type of agreement, the firm does not seek to prohibit the employee from accepting employment in the same or a similar industry, but rather to prohibit the employee from soliciting to render or from rendering services to firm clients, wherever located, for a certain period of time. The non-solicitation covenant can be modified to limit or expand the client prohibition to past and current clients, and/or to prospective clients who were reasonably identified by the firm prior to the employee's termination.

Both types of restrictive covenants aim to protect the firm's legitimate business interests—most importantly, its client relationships. The primary difference is whether the employee will be prohibited from seeking or accepting gainful employment in the same industry as that of the firm (i.e., non-competition), or the employee will be permitted to become employed in the same industry, but not with the benefit of the firm's clients or employees (i.e., non-solicitation).

A properly drafted non-solicitation agreement should also include a provision restricting the solicitation of firm employees (i.e., making sure that a former employee cannot contact employees for the purpose of inducing them to leave their current employment) during the same time period that the employee is restricted from soliciting clients. The agreement should also contain a confidentiality provision, in which the employee promises to maintain the confidentiality of all firm information (e.g., client information, proprietary investment processes or technology, etc.) and not to use any of the firm's confidential information for any purpose other than for the benefit of the firm. In addition, this provision should also require an employee who maintains or has access to any of the firm's confidential information outside of the firm's offices (whether in hard copy or electronic form) to immediately return that information to the firm.

The authors of this article favor the non-solicitation covenant agreement. Certain states tend to look unfavorably upon or to prohibit non-competition covenant agreements based on the principle that it is not good public policy to prohibit an individual from making a living in his or her chosen profession. Thus, if the enforceability of the non-competition covenant agreement could be challenged, the firm is much better off seeking a reasonable non-solicitation covenant agreement that is generally enforceable. Is the firm still protected? Yes, with two caveats: (1) California's courts have recently called the enforceability of such covenants into question; and (2) laws may vary slightly from state to state (regarding duration, geography, consideration, etc.) and a corresponding review of applicable state law (statutory and case law) is necessary. The firm's primary concern is to maintain its client relationships, employees, and other confidential information and processes. A properly drafted non-solicitation covenant agreement will accomplish that objective. Departing employees will generally be unable to adversely impact the firm if they're restricted from soliciting or working with clients; soliciting, working with or hiring firm employees; or using confidential firm information and/or processes.

However, executing the restrictive covenant agreement does not mean that the departing employee won't seek to violate its terms. If that happens, the advisory firm will need to enforce the agreement. For this reason, the agreement should provide the firm with adequate legal recourse against any employee who violates the non-solicitation covenant agreement or signed confidentiality provisions. Enforcement includes, but is not limited to, the ability to immediately seek injunctive relief by requesting that a court enjoin the former employee from violating the agreement (i.e., through a restraining order) and the ability to recover monetary damages and costs of enforcement (legal fees, etc.). The non-solicitation covenant agreement should contain an acknowledgment by employees that they understand the restrictions to which they are bound, as well as an acknowledgment that the firm reserves the right to notify any prospective employer that departing employees are subject to a restrictive covenant agreement. The following is an example of such an acknowledgment:

> I understand that the above restrictions are not intended to deprive me of an opportunity to earn a living in the same profession as that of the Company. Rather, I agree to abide by the above restrictions in recognition of the Company's legitimate and reasonable objective to protect its business interests. I further understand and agree that upon termination of my employment/association with the Company (for any reason whatsoever), the Company shall have the right to notify my prospective employer of the existence of this Agreement, and I release and hold the Company harmless from any adverse consequences that may result therefrom.

When enforcing such language, the advisory firm will put the new employer on written notice of the restrictive covenant agreement, and advise the new employer that the firm will also seek recourse against it if it assists the former employee with the violation of his or her agreement.

Overbroad Restrictive Periods. Some states are known as "blue-pencil" jurisdictions. This means that if a court of law finds that the restrictions in the covenant agreement are unenforceable because they are overbroad (e.g., the duration of the non-solicitation period is too long), the courts are permitted to modify the covenant agreement to make the restrictions narrower. In states that are not "blue-pencil" jurisdictions, advisory firms run the risk of having an overbroad covenant agreement dismissed in its entirety. For this reason, because laws may vary from state to state, it's always prudent to review state law prior to finalizing the terms and conditions of the agreement.

When to Execute. An employee should execute the restrictive covenant agreement immediately prior to, or upon commencing, employment. What if the new employee will not execute the agreement? Do not hire him or her! A properly prepared agreement with reasonably drafted non-solicitation and confidentiality covenants only asks the new employee, at the inception of the employment relationship, to agree to not “steal” from the firm and to recognize the firm’s legitimate proprietary interest in protecting its client relationships and business operations. For a new employee who brings clients with him or her, it is not unusual to exclude those pre-existing client accounts (as specifically identified on a schedule to the agreement). However, unless there are unusual circumstances, the agreement should also make clear that any new clients (i.e., clients other than the pre-existing clients specifically identified on the schedule) the new employee subsequently brings into the firm are the firm’s clients and are subject to the non-solicitation covenant.

Consideration. Is it too late if you did not have the employee execute the restrictive covenant agreement when he or she first became employed by the firm? No. However, you should not present the agreement to an existing employee without first ascertaining whether the state in which the employee is located is a “consideration state.” In a consideration state, the employer must provide adequate “consideration” to the existing employee in order for the employee’s non-solicitation covenant to be enforceable. In these states, the employee’s continued employment is not adequate consideration. Depending upon the state, adequate consideration could be a raise, bonus and/or promotion. Generally, a one-time execution bonus is favored so that the employee cannot later object to the agreement on the grounds of insufficient consideration by claiming that he or she was due the raise and/or promotion in the ordinary course of his or her employment. Even in states where continued employment is deemed adequate compensation, it is generally recommended that the firm consider providing the existing employee with some type of additional consideration.

Liquidated Damages. Liquidated damages are sometimes referred to as “transition compensation.” In some restrictive covenant agreements, the firm may want to consider a provision that requires the departing employee to compensate the firm in the event that clients terminate their relationship with the firm and engage the departing employee and his or her new employer. This type of provision must be carefully drafted so as not to permit the employee to violate his or her restrictive covenant agreement obligations and/or to negate the firm’s legal remedies, including its ability to seek injunctive relief.

What to Do. If you do not have a restrictive covenant agreement in place, get one. If you do, but are concerned about its enforceability, have it reviewed. If you accomplish this relatively simple task, you will be in a much better position to ensure that your employees will not leave the firm with your most important asset—your client relationships.

The Internal Succession Process

Many investment advisory firm owners prefer to pass ownership of the business to their chosen successors, as opposed to simply merging with or being acquired by the highest bidder. During an internal succession, existing firm employees become owners of the firm. Most firms are able to identify those employees who may eventually become owners, and who will be able to sustain the firm following the retirement of the existing principal owners. When a firm cultivates new ownership from within, it can establish the framework for an initial (and continuous) exit plan that allows for continued growth, while compensating retiring owners for their contribution to the firm.

Basic Agreements. The following is an overview of some of the basic documents, in chronological order of execution, that can be vital to establishing a reliable internal succession plan.

1. Restrictive Covenant agreement—This is the critical initial document discussed above (preferably executed when an Investment Adviser Representative [IAR] begins his or her employment/association with the firm).
2. Investment Adviser Representative agreement—This is an additional agreement between the firm and the IAR (preferably executed when the IAR begins employment/association with the firm), in which the IAR acknowledges the terms and conditions of his or her employment/association with the firm.
3. Purchase agreement—An agreement between the firm and the IAR, this document sets forth the terms and conditions of the IAR's purchase of an ownership interest in the firm (e.g., as a shareholder, member or partner). Part of this document will require the employee to become a party to the firm's existing shareholder/operating agreement. In the event that the firm has not previously established such an agreement, it should contemporaneously establish one (see below). In addition, if the prospective employee/owner is a new lateral hire with an established book of business, the purchase agreement should include indemnification and set-off provisions in the event that either party becomes involved in a lawsuit or claim resulting from the new hire's actual or alleged actions and/or omissions prior to joining the firm.
4. Shareholder/operating agreement (the buy/sell agreement)—Executed by the firm and each of its owners, the buy/sell agreement sets forth, among other substantive provisions, the terms and conditions for the disposition of each owner's interest upon the occurrence of various events, including retirement, death, disability, statutory disqualification and employment termination. This document may include the establishment of insurance trusts, which would require a firm or its owners to purchase insurance on the lives of the firm owners (the amount of which would be routinely evaluated). The proceeds of these life insurance policies would be used by the firm (or its owners) to fund the purchase of the ownership interest from the deceased owner's estate.

Alternative Structures. Whether the chosen successor is a trusted employee or a family member, the transition from the founding generation to the successor generation requires thorough planning and thoughtful consideration of many factors, including the firm's compensation arrangements and the structure of the buy/sell agreement.

1. Compensation planning—The most critical element in any internal succession plan is an obvious one, but often difficult to accomplish—namely, identifying and cultivating appropriate successors. An effective succession plan includes a compensation arrangement that will serve to retain, motivate and attract competent employees so that a firm can transfer ownership to the next generation. If employees feel as if they have been overlooked or unfairly treated during the succession planning process—especially if those unhappy employees are key members of the firm's sales and operations staffs—the firm risks the loss of their skills and seniority precisely at the time when they're most needed. Therefore, key employees should be identified and given some level of participation in the succession process through a well-crafted compensation plan.

   First and foremost, when developing the compensation plan, the owners must understand and consider the goals and expectations of key employees. There are many compensation plan strategies that could balance the owners' objectives with those of the key employees. The following are a few strategies that have been widely used by investment advisory firms:

   a) Nonqualified stock option plan—Stock option programs allow owners to gradually transfer ownership to employees at a specified later date. Basically, employees receive a promise that they will have the option to purchase stock and become equity owners of the firm at a future date. A stock option agreement is a legally binding agreement between owners and employees, and is individualized for each employee.

      The percentage of stock granted to the employee may vary, and so may the vesting and exercise dates. The stock option plan can incorporate a gradual vesting schedule whereby only a certain percentage of the granted stock options vests each year. For instance, an employee could be granted 10% of the stock of the firm today, but only 20% of that stock would vest each year over a five-year period. This structure provides an ongoing incentive for the employee to continue employment during the vesting period, and offers more time for the firm or other grantor-owner to implement and adjust to the gradual change in ownership.

      Alternatively, firms could establish a system in which stock options vest upon the firm or the employee achieving certain business or financial benchmarks, such as revenue goals. The stock option agreement can also specify the time period when vested options need to be exercised, and whether vested options that are not exercised will terminate upon death, disability, retirement, a change in control, or termination of employment.

   b) Phantom stock plan—Phantom stock programs compensate employees for participating in the firm's success and growth without actually transferring any ownership. This type of compensation plan allows the owners to reward key employees who contributed to the financial success of the firm, without all the implications associated with equity ownership. If a phantom stock plan is properly structured and administered, employees should feel like owners. But this type of plan does not transfer ownership of the firm.

      The phantom stock plan structure varies. Typically, a phantom stock plan operates like a stock option plan. Certain employees are granted specified numbers of phantom stock units, and amounts are credited to the employees' accounts based on an agreed-upon formula. These employees receive cash equal to the increase, if any, in the value of the firm's shares (as opposed to receiving the shares themselves) multiplied by the number of phantom stock units. The employees should receive periodic statements that report the number of phantom stock units posted to their accounts and that disclose the current value of the units, just as if they owned actual stock. When certain triggering events occur, the employees receive compensation, generally in the form of cash. Typically, the phantom stock agreement contains a benchmark amount, such as the fair value of the firm's stock. Subsequent increases over the benchmark amount, multiplied by the number of phantom stock units awarded to an employee, are credited to the employee's nonqualified deferred compensation account. The phantom stock agreement defines when the accumulated amounts can be distributed from the account balance to the employee, such as upon death, disability, retirement, change in control of the business, or after a defined period of years. Generally, the employee does not pay any income tax until he or she actually receives the compensation, and the firm does not receive any income tax deduction until the compensation is paid to the employee.

c) Restricted stock bonuses—A restricted stock bonus program allows a firm to provide its key employees with stock bonuses instead of cash compensation. This type of compensation program is another way to gradually transition ownership from one generation to the next. Typically, an employee is awarded restricted shares of the firm's stock as part of an ownership succession plan. The agreement awarding the shares restricts the employee's ability to transfer them until specific conditions, such as a period of continued employment or achievement of financial benchmarks, are met. Further, the agreement requires the employee to return shares to the firm upon some triggering event, such as termination of employment or the end of a specified period of time. A properly structured restricted stock bonus plan allows for the transfer of ownership to employees without producing any current taxable income for the employee. However, when the stock restriction lapses, the employee will be subject to ordinary income tax on the value of the shares as of the date that the restriction is lifted, and the firm would be afforded a corresponding tax deduction.

d) Rabbi trust or nonqualified deferred compensation plan—The rabbi trust is commonly used in structuring nonqualified deferred compensation plans. A rabbi trust is an irrevocable trust established by the firm on behalf of the employees. Firms tend to favor the use of a rabbi trust because it can provide "golden handcuffs" for certain key employees. The rabbi trust could include a requirement that the employee remain employed in a specified capacity for a fixed period of time in order to trigger the benefit. Employees may favor the use of a rabbi trust because the firm is putting cash aside in the trust for the employees' benefit and employees do not have to pay tax on the cash contributed until they withdraw it from the deferred compensation plan.

Another popular use of the rabbi trust is to fund the owner's succession plan. The owner can establish a nonqualified deferred compensation plan for the benefit of the successor-employee. The nonqualified deferred compensation agreement, a legally binding document, allows the firm to defer portions of the successor-employee's salary into the rabbi trust, and the firm can also agree to make contributions to the trust on behalf of that employee as well. The balance in the trust continues to grow without income tax consequences to the successor-employee. When it comes time to transition ownership to the successor-employee, that employee can withdraw the necessary funds from the rabbi trust, pay the associated tax and use the cash to buy the stock from the owner. This type of structure gives assurances to both the successor-employee and the owner that the succession plan will be funded. When you're drafting a nonqualified deferred compensation plan such as the one described above, it is important to ensure that the plan is compliant with the recently enacted Section 409A of the Internal Revenue Code; noncompliance could have severe effects on the employee receiving the deferred compensation payments.

2. Shareholder agreements or buy/sell agreements—A shareholder agreement, or buy/sell agreement, is a legally binding contract among shareholders of a privately held business that establishes a procedure for redeeming or buying out an ownership interest upon the occurrence of a specific event (e.g., death, disability, retirement, divorce, termination of employment, etc.). The buy/sell agreement is the most critical document in any business succession plan. A properly drafted buy/sell agreement protects the owner's interest and ensures that the owner's business legacy continues in accordance with his or her wishes long after the owner has left the firm.

   The three most common types of buy/sell agreements are: (a) cross-purchase agreements; (b) redemption agreements; and (c) hybrid cross-purchase/redemption agreements. The type of buy/sell agreement that should be used in a firm's succession plan depends on a case-by-case analysis of various factors, such as each owner's succession planning objectives, the number of owners, the type of relationship between the owners, and the liquidity of the firm and each of the owners.

   a) Cross-purchase agreements—In a cross-purchase agreement, the remaining owners directly purchase the shares from the selling owner or the selling owner's estate. The owners depend on each other for the payment of the purchase price of the stock. Accordingly, a cross-purchase agreement may require that each of the individual owners maintain liquidity in amounts sufficient to buy out the other owners at any time. Some owners favor the cross-purchase structure because it gives them flexibility in allocating differing percentages of ownership to the remaining owners or other interested parties.

      In a cross-purchase agreement, the surviving owners generally receive a "step-up" in tax basis equal to the purchase price paid for the stock. This means that eventually, when the acquiring owners sell their shares, the capital gain will be less. However, if an acquiring owner plans to retain the stock until death, this step-up in tax basis may not be realized, because his or her heirs who inherit the stock will get the "inheritance step-up" in basis.

      A cross-purchase structure should be used only if the acquiring owners can satisfy the terms of the buyout. Unless the acquiring owners have adequately reserved cash or kept up with insurance premiums, the selling owner may not be able to cash out according to the terms of the buy/sell agreement.

b) Redemption agreements—In a redemption agreement, the firm (as an entity), not the individual owners, buys the stock from the selling owner. In a redemption structure, the firm must have liquidity. The firm has the responsibility to maintain cash reserves and/or insurance policies on each of the owners' lives. For some owners, holding the firm (rather than individual owners) responsible for paying for a buyout makes a redemption agreement preferable.

However, unlike in a cross-purchase agreement, the other owners do not receive any step-up in the tax basis of their stock when the firm redeems the selling owner's stock. The repurchased stock is simply retained in the firm as treasury stock, and each individual owner's stock basis remains unchanged, although the ownership percentage will increase proportionately.

c) Hybrid (or "wait-and-see") cross-purchase/redemption agreements—Of the three types of buy/sell agreements, the hybrid or wait-and-see cross-purchase/redemption agreement provides the greatest flexibility. Generally, in this type of hybrid structure, the remaining owners may "wait and see" and choose to cross-purchase or execute a redemption at the time of the triggering event. The hybrid buy/sell agreement will specifically give either the firm or the remaining individual owners the first option to purchase the exiting owner's stock upon a triggering event. If the remaining party (either the firm or the owners, as the case may be) elects not to purchase the shares, the secondary option to purchase any or all of the remaining stock will go to the other party (either the firm or the owners, as the case may be).

A well-crafted buy/sell agreement should identify not only who the successors of the firm will be, but also how, when and where the succession will take place, as well as the funding method. Specifically, it should address how the purchase price for the stock of the exiting owner will be determined, what method of funding will be used in paying the purchase price, when the purchase price should be paid to the exiting owner, and where the purchase will occur. The answers to these questions are not as simple as they may seem. Each question carries with it a myriad of complex legal and business considerations that need to be incorporated into the buy/sell agreement.

Purchase Price or Buyout Price. There are a lot of different ways to define the buyout price for the exiting owner, and it's vital to address the valuation issue specifically in the buy/sell agreement. The buyout price should be clearly defined and understood by all owners. It is not appropriate for the buy/sell agreement to state the same valuation for all triggering events. Rather, the better method is to formulate a purchase price depending on each of the various triggering events. For example, the buyout price in the event of death should differ from the buyout price in the event that the exiting owner was terminated for cause. In addition, if an employee-owner failed to adequately transition his or her client accounts/relationships to the remaining owners, then that exiting owner's buyout price should be reduced. These are merely a few examples.

The buy/sell agreement will contain the buyout price for each share of stock in the firm. The buyout price will usually be based on a valuation formula that the owners previously agreed to; a capitalization method; or a formula based on a multiple of the firm's cash flow, gross revenue or net operating income. Some agreements require an appraisal by a qualified professional to determine the fair price of the stock. There is no right or wrong method to ascertain the buyout price. However, if the valuation formula for computing the buyout price depends on a moving variable such as the firm's cash flow, gross revenue or operating income, the buy/sell agreement should address the possibility of adjusting the buyout price after the date of purchase to reflect the impact of the selling owner's exit on the firm's business.

For investment advisory firms, the valuation is generally determined by the number of client accounts and assets under management, and the buy/sell agreement should outline a method to recalculate the buyout price within a certain period of time after the selling owner has left the firm. Otherwise, the buyout price does not accurately reflect the value of the ongoing business of the firm.

Funding the Purchase Price or the Buyout Price. In the event of the death or disability of an owner, a practical (and more often implemented) method of funding the buyout is through life and/or disability insurance policies. When an owner dies or becomes disabled, the insurance policy's payout is used to buy the stock from the estate or the selling owner. Generally, the insurance premium payments are not deductible by the firm, and the insurance proceeds are not taxable income for the firm.

When a buyout results from a triggering event other than death or disability, the required cash must come from the remaining owners' personal assets, firm cash reserves or loan proceeds. Otherwise, the buy/sell agreement needs to provide for the remaining owners to purchase the stock under a promissory installment note. The terms of the promissory installment note need to be incorporated into the buy/sell agreement and negotiated prior to the execution of that agreement. Ideally, the buyers fund the installment note obligations from the successful business operations so that outside financing is unnecessary.

Transfer of Ownership Techniques. In an outright sale to the remaining owner(s) or potential owner(s), the sale is generally structured as a stock sale versus an asset sale (the advantages and disadvantages of each sale structure and the associated tax issues are discussed in next month's *Compliance Review*, which covers the external transition process). Generally, the buyer pays the selling owner a lump-sum payment equal to the purchase price for the stock, or a lump-sum payment comprised of a certain percentage of the purchase price plus a short-term or long-term installment note to pay the balance of the purchase price by a certain date.

Depending on whether the stock sale is structured as a redemption or a cross-purchase, the implications vary. As discussed above, in a cross-purchase arrangement, the remaining owners are purchasing the stock from the selling owner, and therefore the individual owners have the payment obligation. However, in a stock redemption arrangement, the firm, as an entity, is redeeming the stock; therefore, the firm, as an entity, has the payment obligation. In a cross-purchase, each buying owner gets a step-up in tax basis of the stock purchased. In the event of death, life insurance proceeds can be used to fund the buyout, and no tax will be imposed on the collection of the proceeds. Also, usually there will be no gain or loss on the sale of stock upon an owner's death. But if ordinary rules don't apply, then any gain that the seller receives will typically be taxed as capital gains and, if the holding period requirements are met, will qualify as long-term capital gains. On the other hand, the buying owner will receive a tax basis that's equal to the purchase price paid for the stock even if the purchase price is paid for with life insurance proceeds that were received tax-free by the buying owner. In addition, in a properly structured cross-purchase, there should be no tax consequences to the firm.

In a stock redemption, the tax implications for the selling owner do not differ largely from those in a cross-purchase arrangement. However, unlike in a cross-purchase, the remaining shareholders will, in most cases, have no change in the basis in their stock. Also, the firm will receive no basis in any of the shares redeemed. If cash is used to pay for the redemption, the firm incurs no gain or loss, and as a general rule, no payments made to the selling owner are deductible. In addition, the collection of life insurance proceeds by the firm will be subject to the alternative minimum tax.

Conducting Appropriate Due Diligence

Regardless of the type of succession, it is critical to allocate sufficient time for appropriate due diligence.

For internal successions, conducting due diligence starts with new employee screening. It should include carrying out a comprehensive Central Registration Depository (CRD) review of all new employees, in addition to obtaining and reviewing a completed IAR questionnaire from them before they are hired and an updated one immediately before they become owners. The IAR questionnaire should require the candidate to answer various background questions regarding his or her relevant experience, designations, disciplinary history, potential conflicts of interest, etc. In addition, if the new owner intends to transfer existing client relationships to the firm, the firm should obtain a list identifying the number of clients that the new employee currently services in each state so that the firm can determine whether additional state notice or registration filings will be required. The questionnaire should be signed by the IAR and should require the IAR to immediately notify the firm of any change in previously provided information.

By obtaining this information, the firm will be able to determine whether the IAR candidate is disqualified from being associated with the firm under provisions of the Investment Advisers Act of 1940 (the "Advisers Act"). This is called statutory disqualification. Disqualifying conduct includes, among other things, committing felonies and other specified crimes and making false or misleading statements to the SEC.

In addition, the firm should obtain a list of all of the employee candidate's outside investment-related and financial services industry activities and affiliations so that the firm can determine if those affiliations and/or services warrant enhanced or ongoing due diligence, raise potential conflicts of interest or disqualify the individual from serving as an IAR of the firm.

Regulatory Considerations

During internal successions, firms must address regulatory considerations related to the Advisers Act and other legal mandates. First, the firm's ADV filing will need to be amended to reflect the changes in its officers, directors, members and/or ownership. Second, the firm must determine whether internal succession will cause an "assignment" (as defined in the Advisers Act) of its advisory agreements with its clients. Will there be a change in firm management or control? To the extent that there is an assignment under the Advisers Act, the firm will need to obtain clients' consent, and negative consent letters may not be appropriate.

Conclusion

The internal succession process involves a number of components. From the outset, it's important to make sure that the firm protects its most important asset—its client relationships. Prudent planning, comprehensive due diligence and the retention of experienced professional advisers (e.g., CPAs, attorneys, management consultants, etc.) to coordinate the process will help ensure a successful internal succession.

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