COMPLIANCE CONSIDERATIONS IN AN RIA MERGER OR ACQUISITION

Mergers and acquisitions of registered investment advisers set new records in 2019 with the number of deals reportedly exceeding 200 for the year. Large-scale moves this past year like Goldman Sachs' acquisition of RIA consolidator United Capital Partners and Oak Hill Capital Partners' acquisition of Mercer Advisors—at substantial multiples—suggests a strong appetite for RIA consolidations by private equity. Charles Schwab's recent purchase of TD Ameritrade will also spur activity as the combined entity's custodial services position in the market may serve to lower costs for RIA clients.

Driving these consolidations is a fragmented industry of over 11,000 RIAs, continuing downward pressure on fees, a demanding regulatory environment that increases compliance costs, and rapid advances in financial technology that offer both great opportunity, but at potential cyber and privacy cost.

The case to consolidate in today's market is strong. Combinations may offer a way for RIAs to expand their client base, mitigate pricing pressures, leverage staff and technology, improve a competitive or geographic position, protect or add talent, and expand products and services. In addition, high valuations are proving a lure to deal making. For the potential buyers who see the benefits of scale and depth, the market is robust.

The backdrop, however, includes changes to the regulatory framework and how best to protect retail investors while ensuring a marketplace that works for advisers and brokers. For those considering a merger or acquisition, failure to account for the practical and future implications of these regulatory changes is a mistake that can impact their best effort.

Considerations in a Changing Regulatory Environment

This year, there were dramatic regulatory adjustments across the adviser spectrum. For example:

To get a handle on a number of evolving complexities brought on, in part, by the rise in FinTech, regulators continued to emphasize a "principles-based" or "risk-based" approach to regulation. This approach focuses on promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy. As a result, longstanding rules and guidance have been amended because the regulators continue to place an emphasis on protecting investors, disclosures of conflicts of interest and hidden fee arrangements.

In 2019, the SEC demonstrated their ability to use data analytics to identify unusual patterns and adviser transactions that can highlight adviser misconduct or regulatory violations. The SEC has indicated that in 2020 they will pay special attention to whether compliance policies and procedures are in place, especially for Regulation Best Interest compliance.

Firms thinking about consolidations, therefore, should be concerned with some of the bigger regulatory changes from the past few years. These include additional requirements and interpretive guidance on conduct standards (SEC Regulation Best Interest), on safeguarding client information, and, on advertising and solicitor compensation. At the same time, the SEC's Office of Compliance

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Inspections and Examinations warned investment advisers to strengthen compliance concerning securing electronic and web-based platforms, conflicts of interest, fee disclosures (particularly on share class and wrap fee programs,) bad actors, senior financial exploitation, anti-money laundering, cybersecurity and digital assets. This is by no means a complete list, but it serves to demonstrate the breadth of regulatory demands placed on all firms, and those that are particularly problematic for small firms trying to stay competitive. Notably, these regulatory trends constitute additional motivation for RIAs to consolidate. The evolving regulatory frameworks work best for firms of size and scale, i.e. those that can best handle the added costs of compliance and supervision.

RIA Merger Due Diligence

The list of factors that make up an adequate merger and acquisition due diligence report must take into consideration these regulatory changes and expectations. Beyond business considerations, including ownership structure, legal and litigation concerns, management challenges, employee matters, revenues and revenue sources, client base makeup, and standard accounting of assets and liabilities, due diligence for RIAs considering a merger requires a serious focus on the kinds of risks regulators will be looking for. The due diligence process not only serves as a way to spot and assess whether issues identified are unacceptable risks that may prevent a deal, but also serves as a way to assess potential deficiencies that could devalue the firm or trigger regulator examination or enforcement. Historically, regulators will hold the acquiring firms accountable for compliance deficiencies that occurred pre-merger at other firms. Such situations, discovered during the due diligence process, not only help the acquirer to assess the nature and size of the risk, but also to factor into the risk into the acquisition value, which will be decreased by the exposure being taken in.

Consequently, for target firms that may already be struggling to keep up with changing compliance obligations, the acquirer must consider the state of the target's policies and procedures, their technology and the adequacy of their supervision.

Based on the regulatory environment, here are a few important considerations:

Policies and Procedures – Firms considering combinations need to dive deep into each other's operations to review policies and procedures concerning existing and anticipated new products and services. In 2019, in part as a result of its Regulation Best Interest standard setting analysis, the SEC focused on adviser conflicts of interest and disclosure. The agency issued new guidance for advisers on (i) general compensation disclosure obligations; (ii) specific instruction on "material facts" that advisers should disclose concerning mutual fund share classes; and (iii) disclosure requirements related to an adviser's receipt of revenue-sharing payments. As firms prepare their due diligence plans, it is important not only to review the status of all policies and procedures, but to ensure that they adequately take into account—and indeed anticipate—the expectations set by regulators in their rules and guidance.

A key takeaway here is that the principles-based approach to regulation is shifting the compliance burden further to firms to self-police. Federal and state regulators are moving past "check-the-box" compliance. They expect firms to spot their own risks and to mitigate them. A comprehensive review of disclosure policies and procedures will be essential to ensure that risks are identified and that they can pass regulatory scrutiny post-combination.

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Supervision – In many cases, where there is an RIA violation found in an enforcement proceeding, a supervisory violation may also be found. RIAs contemplating mergers should be making sure that post-transaction lines of supervision are clear and that supervisors have appropriate training and access to systems and information to seamlessly oversee the activities of advisers and associated persons. If they are not, disclosure and mitigation of these issues is expected.

Systems and Technology – In the M&A scenario, RIAs often employ systems and technology that differ significantly in capability from one another. For M&A purposes, older technology, legacy systems, or unintegrated systems can affect valuation. Sophisticated and integrated client relationship management systems and client portals may do the opposite.

From a regulatory point of view, older systems usually mean greater vulnerability to hacking or breach and, therefore, greater security risk. All systems, from those that ensure compliance with books and records requirements to model based trading systems require evaluation, as they are an increasingly vital part of oversight. This includes physical and virtual security, privacy and data security for desktop, cloud, web, and mobile systems. Compatibility issues aside, assessments of existing systems for compliance purposes are an increasing focus of regulatory scrutiny as they may reveal deep vulnerabilities in the protection of retail investors.

Clients – A deep understanding of the client base is, of course, a requisite for understanding the potential of a merger or acquisition to sustain or grow business. In addition to due diligence factors concerning the transferability of clients, firms need to detail and communicate compliance risks associated with characteristics of clients that may require greater protections, or may be reasonably expected to require such protections in the future. For example, in recent years, regulators launched programs and initiated significant enforcement actions to protect seniors and other vulnerable clients from financial exploitation and to weed out bad actors.

Litigation – All current, pending, or threatened litigation, investigations, or administrative proceedings should be uncovered and disclosed in a potential sale.

Products – Firms should have a solid understanding of the types of strategies and investment products which all clients are invested in. Supervisors should be able to identify and supervise risks associated with products and strategies after the merger occurs.

Cybersecurity and Anti-Money Laundering – Regulators have been increasingly vocal about the rise in volume and sophistication of cybersecurity attacks. As a result, regulators encourage firms to ensure the development and implementation of effective policies and procedures that better protect customer records and information. This year, both state and federal regulators have offered up a diverse—and sometimes conflicting—set of obligations requiring investment advisers to adopt policies and procedures related to the physical and cybersecurity protection of confidential client records, additional recordkeeping, unethical business practices and conduct rules. (See e.g. NASAA's recently adopted model rules.)

While technically the AML rules do not yet apply to advisory firms, in the coming year, regulators will continue to scrutinize financial institutions including RIAs for transactions that may involve money laundering. FinCEN's proposed rule to require RIAs to establish and implement mandatory

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AML compliance programs continues to hover over adviser compliance. RIAs, particularly those that are contemplating scaling up through a merger or acquisition, should anticipate where the regulators are going and prepare accordingly. Regulators are already identifying deficiencies in systems and processes necessary to satisfy AML program requirements of financial institutions, including failures with respect to compliance with the Customer Due Diligence rule obligations, failures to tailor monitoring to address the firm's particular business, failures to detect and report suspicious activity, and failures to detect assorted red flags. Mergers and acquisitions are forward-thinking business strategies. In any combination, compliance with anti-money laundering rules should be factored into the costs and burdens of a potential combination.

Conclusion

The business case for consolidation in the current market is strong and the growing regulatory expectations on firms only adds to that trend. As a business matter, parties considering a merger or acquisition have the opportunity to gain real benefits and better serve their clients. For smaller firms, combinations can expand product offerings, offer greater specialization, harness efficiencies and lower costs. For larger firms, combinations can improve a competitive or geographic position, build talent and add scale. From a regulatory perspective, larger entities may allow for higher investments on compliance infrastructure which may translate into better control over market risk. These considerations come together in a thorough pre-merger due diligence process.

The broader point is that compliance should be at the table in every conversation concerning a potential merger or acquisition. Regulation affects every aspect of the business. Ultimately, addressing regulatory compliance early on can determine the difference between success and failure in a combination.

About Bates Compliance

The Bates Compliance team of senior compliance staff and former regulators brings tailored regulatory compliance services, guidance, and expertise to financial services clients on an as-needed or ongoing basis to meet the evolving requirements and practices of today's global financial services industry. Bates provides a wide range of support to financial institutions of all sizes, structures and business models, working with its clients to review, test, and strengthen their compliance programs. We provide and implement solutions based on regulatory requirements and industry-accepted best practices designed to supplement and enhance compliance and supervisory systems, and to remediate the results of regulatory and internal audit findings.

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