Heir Tight: Who Owns Your Business When You Die or Retire?

BY RICHARD FORD

Advisors who care about their clients need to consider who will care for them after they leave the business.

You help your clients plan for retirement, but have you considered your own retirement options? What will happen to your book of business when you retire? Who will take care of your clients? How can you maintain your income after you retire? If you're asking yourself these questions, you're not alone.

As a growing number of independent commission and fee-based financial advisors contemplate retirement—or their own mortality—they're increasingly likely to strike contracts with broker/dealers to sell the rights to their lucrative trail and advisory fee commissions, and even bequeath them to spouses and children. As the population of financial advisors continues to age, it's becoming ever more apparent that they're moving into the asset-preservation business because there's value in recurring residual revenue.

Business succession planning forces a financial advisor to consider several unpleasant facts: his or her own mortality or disability and the fact that a practice that produces a decent income may not have a substantial value. Succession planning for individuals in the financial services industry is crucial because no one can time his or her death. It's further complicated by the regulatory environment and the third parties involved: custodians, insurance companies, broker/dealers, and clients.

At stake is control of billions of dollars in quarterly asset-based 12(b)1 and advisory fee payments.

WHAT HAPPENS TO MY SECURITIES CLIENTS UPON MY DEATH, DISABILITY, OR RETIREMENT?

Most broker/dealers will assign them to a regional director/office of supervisory jurisdiction to take over on a case-by-case basis. Most broker/dealers have a direct obligation to take care of the client upon the death of one of their representatives and to safeguard the client's securities assets.

FINRA Interpretative Memorandum 2420-2 (Continuing Commissions Policy) offers an exception to paying 12(b)1, advisory fees, or other asset-based compensation to a non-registered entity. Commissions can be paid to an advisor's widow or designated beneficiary(ies) as long as a bona-fide contract exists while the representative was still registered. In particular, the memorandum recognizes the validity of contracts that vest with the financial advisor and the heir's right to receive continuing compensation upon retirement and to designate such payments to the financial advisor's surviving spouse or other beneficiary designation.

Retired financial advisors who are no longer registered (or their unregistered widows or other beneficiaries) can continue to receive what are meant to be "service fees" under the FINRA memorandum, so long as the advisor specifies the details in a contract while he or she is still registered and active. In no event can a non-registered representative receive compensation on new sales activity. This memorandum has existed for years, but has even more importance now as financial advisors are making

the transition from commission-based practices to fee-based practices.

WHAT ASSISTANCE CAN SUCCESSION PLANNING OPTIONS OFFER?

It's no surprise that many firms use former representative or advisor accounts to recruit new representatives or reward star producers. Others will assign them as house accounts, leaving the heir with no remaining split on ongoing advisory or trail commissions.

Few firms will offer any assistance with succession planning options or requirements. It appears that most independent, full-service firms and discount brokerage houses do little to help advisors to retain the value of their practice and what they have worked so hard to create. Most of the big wire house brokerage firms decline to comment on whether they allow a representative to sell the rights to commission and fee income upon retirement or death.

In a recent conversation with a 30-year retiring wire house broker with $230 million under management, he indicated his retirement compensation would be a 3-year continuing residual commission payout of 30 percent, 20 percent, and 10 percent respectively, of what he would have previously received, over a 3-year time period.

With a commission-based practice, there's little lasting value in the long term for the financial advisor. With a fee-based business practice you align your interests with those of your client and create more long-term lasting value. Financial advisors now find themselves with residual asset-based income that creates real value within their book of business, whether it's sold or passed on to a new servicing representative.

DO YOU HAVE A BUY-SELL AGREEMENT IN PLACE? WHAT IS YOUR BUSINESS WORTH?

A $50 million book of business might annually gross $500,000 at 1 percent. Subtract from this $150,000 for replacing the owner with a paid employee and another $100,000 for overhead, and you're looking at an operating income of $250,000. Taxes after deductions might run $75,000, so you'd net $175,000.

Selling your book of business for a one-time, upfront, lump sum payment could net you only a fraction of one year's gross revenue, reducing significantly the true value of your business. With an installment sale, you may be able to sell your practice for one to three times annual gross revenues, depending on how your business practice compensation is structured.

Alternatively, you could vest your business with a firm that can support paying the retiring advisor (W-9) and receive up to 10 to 15 times more income spread out over a 20-year time period.

The best preventative step depends on the way you do business. Independent financial advisors affiliated with a broker/dealer face somewhat different issues. You might look at Oregon-based FP Transitions, a leading provider of equity management, valuation, and succession planning services. Or speak with your broker/dealer to find out about available business succession and vesting options. Alternatively, you might explore Mitch Vigeveno of Turning Point Inc.'s new "Successor Search," a service that assists financial advisors in need of the right successor.

STRATEGIES FOR CONTINUED SUCCESS

Succession planning is a big issue for many advisors, yet 60 percent of advisors surveyed report that they don't have a succession plan. In a very recent study by T.D. Ameritrade, 50 percent of the advisors surveyed stated that they would prefer to pass the practice on to an internal successor (with another 30 percent undecided).

More telling is that 50 percent of the advisors surveyed hadn't identified any clear successor. All this data points to the indisputable fact that most advisors would rather pass their business on to a colleague they know and trust. This allows them to retain better control over the process. They really want to know the person who will be entrusted with taking good care of their clients.

Over the coming years, many financial professionals will be looking to retire or sell their practices. The best way to find someone who can take over when you retire, die, or become disabled is to groom a trusted colleague or individual of