Mergers and Acquisitions of Investment Managers: Fund and Board Consolidation

by Jon S. Rand, J. Stephen King, Jr., and Mary C. Carty
Dechert LLP
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This is Part III in a three-part series addressing selected issues in investment management merger and acquisition transactions. Part I of this series reviewed the situations under which a merger or acquisition involving an investment manager may trigger an assignment of an investment advisory agreement under the Investment Company Act of 1940 as amended (1940 Act), and the Investment Advisers Act of 1940, as amended, giving rise to the necessity for approval by both a fund’s governing board (board) and the fund’s shareholders of a new advisory agreement between the fund and the investment adviser Part II addressed fund governance issues in the context of mergers or acquisitions of investment advisers, specifically the responsibilities and duties of the board with respect to the approval of a new investment advisory agreement and a new underwriting agreement. Part III addresses fund and board consolidation following a fund manager merger or acquisition.

Business Considerations

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und reorganizations frequently follow acquisitions of investment advisers. A variety of business objectives motivate mergers of funds following the acquisition of an investment adviser, most often combining fund complexes and otherwise eliminating duplicative products.

Following the acquisition of one investment adviser by another adviser or a diversified financial services company, the surviving or newly affiliated advisers may manage a number of funds with similar investment objectives or strategies. The enterprise may wish to merge similar funds in an effort to rationalize its products and avoid confusing investors. Merging similar funds also may enable the investment adviser to manage the assets of the funds more efficiently, with the resultant larger asset base permitting greater diversification, more meaningful positions in attractive investments, and greater attention from brokers and underwriters. In addition, the larger asset size of the combined fund may result in a lower expense ratio than the predecessor funds, as fixed expenses are spread over a larger asset base. The combined fund’s expense ratio also may be reduced to the extent that the fund’s agreements with service providers provide for breakpoints in the fee percentage as the fund’s assets increase. In addition to the obvious benefit to the funds, a lower expense ratio also may benefit the investment adviser by improving performance, which may lead to an increase in assets and higher advisory fees, and by minimizing fee waivers or expense reimbursements that may be in effect.

An investment adviser also may wish to merge funds in an effort to eliminate funds with lagging performance records. The Staff of the Securities and Exchange Commission (SEC) has taken the position that, in the context of a fund merger, the surviving fund may carry forward the performance record of the predecessor fund that is the “accounting survivor” of the merger that is, the fund whose financial statements will be carried forward. The accounting survivor of a fund merger is the predecessor fund that most closely resembles the surviving fund. In determining which predecessor fund the surviving fund most closely resembles, the following factors, among others, should be
considered: (1) the identity of their investment
advisers; (2) the similarity of investment
objectives, policies, and restrictions; (3) their
respective net asset levels, expense structures,
and ratios; and (4) their relative portfolio
composition. 2

Prior to proposing a fund reorganization for
the purpose of eliminating a fund with a poor
performance record, the investment adviser
should carefully consider these factors in
consultation with fund auditors and determine
which fund’s financial statements and
performance record will be carried forward.

The SEC has recently adopted amendments to Rule
17a-8 that expand the types of business combinations
that are exempt from Section 17(a)(1) and Section
17(a)(2) of the 1940 Act.

When considering whether to propose the
merger of funds in different fund families, the
investment adviser should consider whether the
funds have compatible channels of distribution
and comparable share classes. For example, a
fund that is primarily sold directly to investors
and has a single class of shares may be difficult
to merge with a fund that is primarily sold
through intermediaries and has multiple classes
of shares. Similarly, the funds may both be sold
through intermediaries but have different classes
of shares with different fee structures. In each of
these situations, the investment adviser will need
to consider which class of the surviving fund is
the most appropriate class into which the classes
of a predecessor fund will be merged. If some
but not all classes of a predecessor fund are
adversely affected by the merger (e.g., if a class
is merging into a class with a higher expense
ratio), the reorganization may require the
approval of the adversely affected classes voting
separately. 3 This effectively gives each
adversely affected class of the predecessor fund
the power to veto the proposed reorganization.

Regulatory Considerations

Fund reorganizations are typically structured
as a purchase of the assets and assumption of the
liabilities of the acquired fund by the acquiring
fund, in exchange for securities of the acquiring
fund. Section 17(a) of the 1940 Act prohibits an
affiliated person of a fund, or an affiliated
person of an affiliated person of a fund, from
selling any security or other property to, or
buying any security or other property from, the
fund. Accordingly, absent an exemption, a fund
reorganization structured as an asset purchase
would constitute a prohibited affiliated
transaction under Section 17(a) of the 1940 Act,
as these reorganizations generally occur between
funds in the same fund complex and therefore
are affiliated by reason of having the same or
related investment advisers. 4

Rule 17a-8 under the 1940 Act excepts a
“merger, consolidation, or purchase or sale of all
or substantially all of the assets” of a fund from
the provisions of Section 17(a) if the funds
would be subject to Section 17(a) only because
they have a common investment adviser,
common directors, and/or common officers. 5
Rule 17a-8 requires the boards of both the
acquiring and the acquired fund, including a
majority of the board members of each fund who
are not “interested persons” of either fund, as
defined in the 1940 Act, to determine that the
acquisition is in the best interests of the
shareholders of the fund and will not dilute the
interests of the shareholders of the fund. The
board’s determinations and the bases for the
determinations must be recorded in the fund’s
minute books.

The SEC has recently adopted amendments
to Rule 17a-8 that expand the types of business
combinations that are exempt from Section
17(a)(1) and Section 17(a)(2) of the 1940 Act. 6
As amended, Rule 17a-8 is available to affiliated
funds regardless of the source of the affiliation.
Amended Rule 17a-8 requires each fund’s
board, in addition to the requirements of Rule
17a-8 discussed previously, to request and
evaluate such information as may reasonably be
necessary to make the determinations discussed
previously and to consider and give appropriate
weight to all pertinent factors. Unlike the
proposed amendments to Rule 17a-8, which
would have required the fund’s board to
consider certain enumerated factors, if relevant,
in determining whether a proposed merger is in the best interests of the fund, amended Rule 17a-8 as adopted references the adopting release for a discussion of factors that may be relevant to a fund’s board in making the required determinations. These factors (which are neither exclusive nor determinative) include: (1) any fees or expenses that will be borne directly or indirectly by the fund in connection with the proposed reorganization; (2) any effect of the proposed reorganization on annual fund operating expenses and shareholder fees and services; (3) any change in investment objectives, restrictions, and policies that will result from the proposed reorganization; and (4) any direct or indirect federal income tax consequences of the proposed reorganization to shareholders of the fund.7

In addition to the factors that are listed in the adopting release, a board should also consider the following: (1) the relative performance records of the acquired and acquiring funds; (2) whether the increase in assets of the acquiring fund will present challenges in the management of that fund’s portfolio; (3) the extent to which the liquidation and reinvestment of portfolio holdings received from the acquired fund will result in taxable gains or losses to the acquiring fund’s pre-merger shareholders; (4) the benefits, as well as disadvantages, to each of the acquired fund and acquiring fund; (5) the benefits to be realized by the investment adviser as a result of the reorganization, including but not limited to reduced personnel and other operating expenses and reduced expense waiver and reimbursement obligations as a result of the elimination of the acquired fund and the increase in the asset base of the acquiring fund; and (6) whether one fund’s portfolio has imbedded tax or other benefits or detriments that should be reflected in the price at which its shares are exchanged for shares of the other fund. The board also must consider whether the board’s legal counsel, if any, is “independent legal counsel.” If not, the board should engage counsel who qualifies as “independent legal counsel.”

Section 15(f)

In a transaction involving the acquisition of an investment adviser to an investment company, the investment adviser being acquired typically relies on the safe harbor provided by Section 15(f) of the 1940 Act. This safe harbor permits the owners of an investment adviser to retain any profit in connection with any acquisition of the investment adviser that results in the assignment of its investment advisory contracts with funds. If the investment adviser to either the acquired fund or the acquiring fund is relying on the Section 15(f) safe harbor, the board should consider whether any of the terms of the proposed fund reorganization would result in the imposition of an “unfair burden” on the fund. Section 15(f)(2)(b) of the 1940 Act defines an “unfair burden” to include:

[A]ny arrangement, during the two-year period after the date on which any such transaction occurs, whereby [either the predecessor or successor adviser] or any interested person of such adviser receives or is entitled to receive any compensation, directly or indirectly (i) from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of [the fund], other than bona fide ordinary compensation as principal underwriter for [the fund], or (ii) from such [fund] or its security holders for other than bona fide investment advisory or other services.

In order to ensure that the fund’s investment adviser will be entitled to rely on the safe harbor, the board should consider whether, during the two-year period after the date on which the predecessor investment adviser was acquired, the fund reorganization will result in an increase in the fund’s advisory fees or other implicated fees (including any expenses of the fund reorganization borne by the fund). Any such increase may constitute the imposition of an unfair burden on the fund. Accordingly, the investment adviser may be required to undertake to waive fees and/or reimburse the fund’s expenses for a period following consummation of the fund reorganization.

Shareholder Approval

If the acquired fund’s organizational documents or the law of the state where the fund is organized requires shareholder approval of mergers or similar reorganizations, the board of
the acquired fund will also need to recommend the approval of the reorganization to the acquired fund’s shareholders, and authorize the holding of a shareholders’ meeting for the purpose of voting on the proposed reorganization. Typically, the law of the state of the acquiring fund’s organization and the fund’s organizational documents do not require shareholders of the acquiring fund to approve a reorganization involving the acquisition of another fund. Accordingly, shareholders of the acquiring fund typically do not vote on the reorganization.

The vote of the shareholders of the acquired fund is generally solicited on Form N-14, a combined registration statement/proxy statement, which also is used to register the shares of the acquiring fund that will be issued to the acquired fund’s shareholders in connection with the reorganization. In fund reorganizations involving the acquisition of a fund by an acquiring fund that is a newly-formed fund, or a newly-formed series of an existing series fund, the reorganization may, in certain instances, be submitted to shareholders on a proxy statement on Schedule 14A. Although much of the disclosure required by Form N-14 will also need to be disclosed in a proxy statement on Schedule 14A, a proxy statement on Schedule 14A is only subject to a 10-day review period by the SEC Staff, while a registration statement/proxy statement on Form N-14 is subject to a 30-day review period. The disclosure in the Form N-14 or proxy statement with respect to the board’s findings and recommendations should be appropriately evidenced by detailed minutes and copies of the materials that were reviewed by the board should be maintained in the fund’s records.

**Board Consolidation**

Consolidating the boards of one or more funds or fund complexes may have the benefit of allowing a board to operate in conformity with the safe harbor of Section 15(f). Section 15(f)(1)(A) requires that at least 75 percent of the members of a fund’s board not be “interested persons,” as defined in the 1940 Act, of either the predecessor or successor investment adviser. In addition to structuring the composition of a board in order to satisfy the safe harbor requirements of Section 15(f), there are often other reasons to consolidate boards when complexes are combined after an acquisition. For example, board consolidation may streamline board operations, including reducing the total number of board meetings per year across a complex, thereby making the fund governance process more efficient and possibly providing cost savings by avoiding duplication of effort involved in the preparation for and conduct of board meetings. In addition, board consolidation may reduce the possibility that separate boards within a fund complex might arrive at conflicting or inconsistent decisions regarding the policies, strategies, operations, and management of funds within the complex. Consolidation of boards also may result in a more effective board as a result of the new perspective brought to the board by new board members.

Confrontational issues can arise, however, as a result of shifts in the power structure upon board consolidation. Although generally when there is a board consolidation within a fund complex the same “insider” will be the chairperson of both boards, under certain circumstances one of the current board chairpersons will have to resign from his or her position, particularly when the chair is an independent board member. Additionally, there may be changes in the chairperson and/or composition of certain committees, such as the audit and nominating committees. Boards may choose to respond to these issues by appointing a chairperson and a vice chairperson of the consolidated board with appropriate additional or special compensation. Similarly, committees may have a chairperson and a vice chairperson with appropriate compensation with members from each predecessor board being given committee leadership positions.

Issues also may arise as to the correct way of doing things. Each board prior to the consolidation will have had its own policies and protocols, which will have to be considered and melded together in appropriate ways upon board consolidation. These may range from the organization of meetings, including their timing...
and frequency, to the imposition (or relaxation) of mandatory board retirement policies.

Shifts in power structure, whether overt as in the appointment of a chairperson, or less apparent as in the forming of certain alliances, will play a part in these determinations.

**Reduction in Size of Consolidated Board**

A combined board may need to be reduced in size, as the aggregate members of two or more boards may prove unwieldy. A board consolidation in connection with a reduction in the original aggregate size of two boards can be fraught with emotional issues, as it means in effect that certain board members (along with their colleagues on the board, with whom they may have worked closely for a number of years) will be voting to terminate their own employment.

Reductions in the size of a board may be accomplished in a number of ways. May boards have adopted mandatory retirement policies, which may reduce the size of the board over time. Of course, the size of the board may also be reduced by the voluntary resignations of board members.

When considering issues of resignations of board members and reorganizations of board and committee structures, funds have adopted various procedures to smooth the transition and/or permit resigning board members a transitional role. Some funds, faced with mandatory retirement policies affecting some of the new members of a consolidated board, have permitted limited waivers that allow the new members to remain on the board for one or two years past the mandatory retirement age. In considering whether to permit a board member to remain on the board past the mandatory retirement age, the board should balance the benefits derived from the board member’s experience against the additional costs and administrative burdens associated with maintaining a large board. In order to ensure that an exemption from a fund’s mandatory retirement age does not continue in perpetuity, a board should limit any waiver to a specified period of time.

To motivate early resignation, funds may institute severance pay packages for retiring board members. To avoid the appearance of manipulation (i.e., elimination of board members who are perceived to be problematic or obstreperous), these packages or other inducements should be offered to all board members. Funds have often structured these packages as a one-time payment to those board members who voluntarily leave the board prior to their normal retirement age. These payments may be borne by the fund, which will benefit from the reduced expenses associated with a smaller board, by the adviser, which will benefit from more efficient fund operations, or in some determined proportion between the fund and the adviser.\(^{13}\)

Some funds have established emeritus programs that permit board members upon retirement to serve for an established period of time as directors emeritus, receiving a reduced level of compensation, or compensation on a declining scale over time, for attending board meetings, but without having voting rights. A variation on the emeritus program has been instituted by some funds that allow retiring board members to serve as consultants to certain board committees with appropriate compensation.

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**Reduction in the size of the board may be accomplished by voluntary resignation of board members, mandatory retirement policies, or emeritus programs.**

The emotional and logistical aspects of completing a board consolidation, including consideration of the policies and issues discussed previously, need to be worked out with subtlety and (to the extent possible) well in advance of the consolidation. It is important to consider that the board is the master of its own fate. Once the process of board consolidation and membership reduction is set in motion by management, that process may take on a life of its own, creating confrontation, discord, and
unintended consequences. Therefore, in proposing a consolidation or reduction in size of a board, management is wisely counseled not to stray far from likely consensus.

Summary

Following the acquisition of an investment manager, it is common for the successor investment manager to propose fund reorganizations to combine funds in the complex having common investment objectives or strategies and to eliminate funds with low asset levels, high expense ratios, or poor performance. Prior to proposing fund reorganizations, however, the investment manager should allow time for approval of the boards of the funds being reorganized and, if necessary, the shareholders of the acquired fund. In addition, if the investment manager wishes to consolidate the funds’ boards, by fund reorganization or otherwise, the investment manager may need to consider whether the board composition following the proposed consolidation would conform with the requirements of Section 15(f).

To the extent that boards are combined, the size of the combined board may prove unwieldy and the board may need to be reduced in size. Reduction in the size of the board may be accomplished by voluntary resignation of board members, mandatory retirement policies, or emeritus programs. As a practical matter, however, reduction in the size of a board should be handled delicately as board members are, in effect, terminating their own, or their colleagues’, employment. Once management proposes a process of board consolidation and reduction, unintended consequences may result.

NOTES

2 See id.
3 See Rule 18f-3 under the 1940 Act (funds may issue multiple classes of shares provided, among other things, that each class has separate voting rights on any matter submitted to shareholders in which the interests of one class differ from the interests of any other).
4 Section 2(a)(3) of the 1940 Act defines an “affiliated person” of a person to include any person controlling, controlled by, or under common control with the person. Funds having a common investment adviser may be deemed to be controlled by the investment adviser. See Mergers and Consolidations Involving Registered Investment Companies, Release No. IC-11053 (February 19, 1980). Accordingly, funds having a common investment adviser may be considered under common control and, therefore, affiliated persons of each other.
5 In addition, a fund may rely on Rule 17a-8 only if: (1) a majority of its board members are independent board members, and the independent board members select and nominate any other independent board members; and (2) any person who acts as legal counsel for the independent board members is “independent legal counsel.” For the definition of “independent legal counsel,” see Rule 0-1(a)(6) under the 1940 Act.
6 See Investment Company Mergers, Release No. IC-25666 (July 18, 2002) (adopting release). The amended rule was effective on July 26, 2002. Funds entering into mergers that occur on or after October 25, 2002, must comply with the conditions of Rule 17a-8 as amended. Funds entering into mergers that occur between July 25, 2002, and October 25, 2002, may rely on Rule 17a-8 as amended or as it existed prior to the amendments.
7 See id.
8 See supra n.5.
9 Section 15(f)(1)(A) provides that an investment adviser or an affiliated person of the adviser may receive “any amount or benefit in connection with a sale of securities of, or a sale of any other interest in, such investment adviser … which results in an assignment” of the advisory agreement, if: (1) for a period of three years after the transaction, at least 75 percent of the board is composed of persons who are not “interested persons” of either the predecessor adviser or the successor adviser; and (2) there is not imposed on the fund an “unfair burden . . . as a result of [the assignment] or any express or implied terms, conditions, or understandings applicable thereto.” For a more complete discussion of the Section 15(f) safe harbor, see Jon S. Rand and Mary C. Carty, “Mergers and Acquisitions of Investment Managers: Fund Governance Issues,” Investment Lawyer, July 2002.
10 Funds organized as business trusts may not be required to obtain shareholder approval of a proposed reorganization. See, e.g., Del. Code Ann. tit. 12 § 3806(b)(3) (2000). If the fund is relying on amended Rule 17a-8 under the 1940 Act, however, shareholder
approval of the proposed reorganization may be required (even if not required by the fund’s organizational documents) if the surviving fund: (1) has materially different fundamental policies than the acquired fund; (2) has a materially different advisory contract than the acquired fund; (3) after the reorganization does not have a majority of its independent directors composed of noninterested directors of the acquired fund who were elected by shareholders of the acquired fund; and (4) after the reorganization will be authorized to pay a higher Rule 12b-1 fee than the acquired fund. See adopting release, supra n.6.

11 The use of a Schedule 14A proxy statement rather than a Form N-14 proxy statement/registration statement is based on Rule l45(a)(2) under the Securities Act of 1933 (Securities Act), which preserves the “no-sale” rule previously embodied in Rule 133 under the Securities Act with respect to transactions the sole purpose of which is to change the issuer’s domicile. The Staff of the SEC has issued a series of no-action letters liberally construing the scope of Rule 145(a)(2) in the context of fund reorganizations to permit, among other things, changes in legal form, capital structure, voting arrangements, and investment policies. See, e.g., CIGNA Aggressive Growth Fund, Inc., SEC No-Action Letter (pub. avail. February 15, 1985). See also Securities Act Release No. 5463 (February 28, 1974) (Illustration II (b)).

12 The SEC has granted exemptive relief from the board composition requirement of Section 15(f) in circumstances in which the surviving fund’s investment adviser has not undergone a change of control. See, e.g., The Hartford Mutual Funds, Inc., et al., Release No. IC-25419 (February 13, 2002) (order), Release No. IC-25372 (notice). If the surviving fund is required to add board members to comply with Section 15(f), consideration should be given to Section 16(b) of the 1940 Act, which requires that these additional board members be elected by shareholders. See Rand and Carty, supra n.9.

13 If the payment is borne by the fund and is made within two years of the acquisition of the fund’s investment adviser, the investment adviser should consider whether the payment would constitute the imposition of an unfair burden on the fund. If an unfair burden is imposed on the fund, the investment adviser would not be entitled to rely on the safe harbor provided by Section 15(f) of the 1940 Act. See infra n.9 and accompanying text.