Report of the
Mutual Fund Directors Forum

Practical Guidance for Fund Directors on Adviser Mergers & Acquisitions

June 2019

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I. Introduction and Summary

Mutual fund investment advisers and their parent companies combine, reorganize and restructure to grow and streamline their businesses or gain access to new markets, technology or expertise. These transactions trigger Securities and Exchange Commission rules and regulations and hold practical and legal considerations for fund independent directors. This paper[1] discusses the responsibilities of fund independent directors with respect to adviser mergers and acquisitions. Adviser mergers and acquisitions can result in the reorganization and mergers of mutual funds. A companion Mutual Fund Directors Forum publication discusses mutual fund mergers and fund directors' related obligations and responsibilities.

Business Considerations: An acquiring adviser may consider a merger or joint venture with another firm to expand its product lineup, enter new markets and distribution platforms, gain technological expertise or brand-name recognition, among other reasons. For a selling adviser, a joint venture or merger may be an attractive option in periods of slow growth, declining assets, and limited resources. While a mutual fund board does not oversee the adviser's operations, both the acquiring and selling firm are obligated to notify their fund boards in advance of the transaction and to provide the board with the information necessary to make certain required determinations. The board, at a minimum, may wish to be assured by the adviser that the transaction will not negatively impact the day-to-day operations of the adviser or the services provided to the funds.

Regulatory Considerations: A merger or acquisition involving a fund adviser may result in the automatic termination, via "assignment," of the fund investment advisory contract and trigger the need for board and shareholder approval of a new advisory contract. Assignment of an advisory contract generally involves a transfer of the contract or a controlling block of stock representing more than 25 percent of the adviser's (or its parent company's) outstanding voting securities.[2] When a change of control and assignment occurs, the adviser must obtain consents from the shareholders of the acquired funds and clients of the adviser that has undergone the change in control.[3] A fund board will need to approve the new advisory agreement, an interim advisory agreement in some cases, authorize a shareholder meeting and, as applicable, approve changes to other fund service providers.

Governance Considerations and Challenges: As a result of certain adviser transactions, two fund boards may be combined, or an existing board may be reduced in size. Early in the process, directors potentially affected by these transactions may wish to consider and discuss transition planning, board composition, and director and officer insurance coverage and indemnification for departing directors, among other issues. From proposal to consummation, adviser transactions may last months, or even years, depending on complexity. For fund directors, important steps could include everything from consideration of the initial proposal from the adviser, requests and supplemental requests for information, negotiation of a new advisory contract, and, if necessary, preparation and review of proxy proposals and filings, and holding shareholder meetings. Boards will need adequate time to gather information from the adviser, conduct due diligence of the materials received, and make the necessary determinations and approvals.

Director Considerations for Adviser Reorganizations

Understand the economic impetus for the reorganization to determine the degree of advisory contract trafficking concerns, if any	Understand the terms and structure of any new investment advisory agreement	Consider the long term effects on the funds
Consider of the nature, quality and extent of services that will be provided to the funds going forward	Confirm that the transaction does not create any independence issues for fund directors or board counsel	

II. Business Considerations

While a fund board has no direct oversight responsibility for the business operations of the fund's adviser, directors should consider their fiduciary duties to the funds when an adviser considers a merger or combination. An adviser merger can result in restructuring of an adviser's fund lineup, including fund mergers, fund liquidations, changes to portfolio managers and fund fees and expenses. While the fund board is not involved in approving the adviser transaction, the transaction's impact on the funds should be top of mind for directors. A fund board can reasonably expect to receive appropriate prior notice of an adviser's plans to merge with, acquire or form a joint venture with another business; information regarding the counterparty business; and all information necessary to facilitate effective due diligence and make regulatory determinations.

An acquiring adviser can begin the adviser merger process informally by simply approaching a target business, or counterparty, with a potential offer. In other cases, a selling firm can seek out a buyer or investor. For any merger or acquisition, the acquiring and selling adviser will consider the legal, regulatory, structural, financial, tax, personnel and management aspects of the transaction. Directors of the affected funds likely will not be involved in these aspects of the transaction, but directors should at least understand the basic structure and terms of transaction, and remain abreast of potential problems that could impact the management of the funds during and after the transaction.

Planning and Due Diligence: An adviser may undertake a lengthy planning process before buying another firm or business line. The selling and acquiring adviser will conduct due diligence of the counterparty's business, the findings of which will inform determinations on price, the form of consideration (e.g., stock, cash), legal and regulatory considerations regarding assignment of the advisory contract and shareholder/client solicitations. An adviser may consult the following during its due diligence of the counterparty business:

Form ADV	Proxy Materials
SEC Filings	Distribution Agreements
Employment Contracts	Rule 12b-1 Plans
Non-Compete Agreements	Custodian, other Service Provider Agreements

Financial Statements	Types of Funds
Litigation, Regulatory Inspections, e.g. SEC deficiency letters	Fund Documents – Articles of Incorporation, Declaration of Trust, Bylaws
SEC Registration statements and Post-Effective Amendments	Types of Shareholder Accounts
Shareholder Reports, Other Communications	Sales Material used by broker dealers

For the fund board's due diligence, independent counsel and/or fund counsel will assist the board in requesting relevant information about the transaction and the counterparty, and the potential impact on the adviser's and the fund's operations. This information would include changes in personnel, compliance, financials and adviser resources.

Transaction Structure: An adviser merger may be structured as an asset acquisition, stock purchase, or a merger. In most acquisitions, the acquiring adviser becomes the adviser of the acquired funds while the selling adviser's role is eliminated. In other transactions, the existing adviser may continue to manage the funds but under the ownership of a new parent company. The legal ramifications of the transaction depend on the structure of the deal. For instance, a new adviser for the funds would require a shareholder vote and board approval of a new advisory contract. Many adviser transactions are two-fold – involving the acquisition of the selling adviser and a reorganization of the funds. Some common scenarios include:[4]

- An adviser acquires a minority, non-controlling stake in another adviser.
- An adviser acquires a majority or controlling stake in another adviser.
- Two firms may jointly launch a fund or series of funds.

Impact on Funds. As a result of an adviser merger, the selling adviser's funds may be liquidated, merged or otherwise reorganized into existing or new funds by the acquiring adviser. The acquiring adviser's assets likely will be increased, possibly with more diversity and complexity in its product lineup. Directors may wish to consult the Forum's white paper Practical Insights for Fund Directors on Mutual Fund Mergers for a deeper discussion on fund mergers. A combination of fund complexes can pose various challenges for an adviser, including navigating the different share class and expense ratio structures and the existence of load vs. no-load funds in each complex. Fund reorganizations as a result of an adviser merger or acquisition can also be very costly, and complications can arise with determining who bears these costs.

The following table summarizes some regulatory and practical considerations for certain types of adviser transactions. The information below is not exhaustive and fund boards wish to engage with independent counsel when considering their role in connection with adviser transactions.

Transaction	Regulatory and Practical Considerations for the Board
An acquiring adviser acquires a minority, non-controlling stake of selling firm.	Because the acquiring adviser is purchasing less than 25% of the target adviser, the 1940 Act provisions on change of control (see Regulatory Considerations) are not applicable. Adviser of each entity must inform fund board of transaction. If funds are merged, liquidated or otherwise reorganized, then both advisers must provide boards with information necessary to make the regulatory determinations on behalf of the funds. The fund boards may need to oversee and approve fund mergers and reorganizations.
An acquiring adviser acquires a majority or controlling stake of selling adviser.	Advisers of each entity must inform their respective fund boards and provide information necessary for regulatory determinations and approvals. The fund board at the selling adviser will approve the new advisory contract and the new fund adviser pursuant to Section 15 of the 1940 Act. A vote of the shareholders of funds advised by the selling adviser is required because the funds' advisory contracts cannot be "assigned." If funds are merged or liquidated as part of the transaction, the boards of the surviving funds and target funds must undertake state law and 1940 Act obligations regarding the approval of fund mergers.
Joint venture – two firms may launch a fund or series of funds. The joint venture may establish a sub-advisory relationship with one firm providing investment management and the other providing fund administration and compliance services.	Funds are typically newly registered under the 1940 Act and the relevant state laws. Directors of the newly launched funds must approve the new advisory contract.

III. Regulatory Considerations

Assignment of Advisory Contracts

What is an assignment? Adviser mergers and acquisitions often result in new management for a complex's mutual funds, which effectively terminates and "assigns" the existing advisory contract. Generally, an advisory contract is assigned when it is transferred to another owner or when a controlling block of the adviser's outstanding voting securities has been purchased by another entity, effecting a "change of control."[5] SEC regulations and a number of no-action letters provide a legal basis to determine whether there has been a change of control of an adviser and hence an assignment of the advisory contract.[6]

Whether an assignment occurs is important because under the 1940 Act,[7] an investment adviser may serve as an investment adviser to a fund only pursuant to a written contract that, among other things, provides for the automatic termination of the contract in the event that it is assigned. Practically, because the advisory contract will automatically terminate, shareholder approval will be required for the adviser to continue to serve as the fund adviser. The funds' board, including a majority of the independent directors, must meet to approve the new advisory agreement to replace the current advisory agreement and must authorize the proxy solicitation process.[8]

Shareholder Approval: Prior to closing a transaction that will end in an assignment, the shareholders of the acquired funds will be asked to vote on the new advisory contract.[9] In nearly all cases, the assignment of an investment advisory agreement will involve a shareholder solicitation.[10] The SEC has indicated that Congress enacted certain regulations to give shareholders a voice in a fund's investment advisory contract and to prevent trafficking in fund advisory contracts, or the sale of investment advisory relationships for profit.[11]

Disinterested directors for three years. For a period of three years after the transaction that triggered the assignment, at least 75% of the board must be composed of directors independent of the acquiring and selling advisers.[12]

No unfair burden for two years. For a period of two years after the transaction, no "unfair burden" can be imposed on the fund due to the transaction. This generally means there can be no increase in the fund's fees or expenses in that two-year period.[13]

Interim Advisory Contract: An exemption under the 1940 Act permits a person to act as an investment adviser to a fund under a written interim advisory contract that has been approved by the fund board, but not by the company's shareholders, for a period of 150 days following the date on which the previous contract terminated, during which time the adviser can obtain shareholder approval of a new contract.[14] The interim advisory contract can minimize adverse consequences to a fund from the automatic termination of the advisory contract while shareholder approval of the new contract is solicited. SEC rules and regulations require the following with regard to interim advisory contracts:[15]

- The board of directors, including a majority of independent directors, must find that the scope and quality of the advisory services to be provided under the interim contract are at least equivalent to the scope and quality of the services provided under the previous contract.
- The board also must approve the interim contract before the previous contract is terminated.
- The interim contract must contain generally the same terms and conditions as the previous contract and provide compensation to the adviser that is no greater than the compensation under the previous contract.
- The interim contract also must provide that the board may terminate the contract with no more than ten days written notice.
- Any fees earned by the adviser during the interim contract must be placed in an interest-bearing escrow account and be paid to the adviser only if shareholders approve the new advisory contract.
- If shareholders do not approve the new contract, the adviser may receive the lesser of the fees provided under the interim contract or the costs of providing services under the interim contract.

The Contract Review Process

When reviewing the new advisory contract, the board's process is held to the same standards as the annual advisory contract review. The same analysis[16] that directors undertake when evaluating whether an advisory fee is fair and reasonable will be applied in considering the new advisory contract. The board should give comprehensive and diligent review to the contract and related materials, as the validity of the board's decision-making and process has often been the focus of litigation.[17] Please see the MFDF's white paper Practical Guidance for Fund Directors on Mutual Fund Mergers for a discussion on board responsibilities regarding fund mergers and board approval of advisory contracts.

Board Duties in Adviser Transactions

- ***Approval of the Advisory Agreement.*** The board, including a majority of the independent directors, must approve any new investment advisory agreement (and/or sub-advisory agreement) for the funds with the new investment adviser resulting from the adviser transaction.

- ***Shareholder Approval.*** Generally, when an adviser acquires another adviser or when a parent company of an adviser is acquired by another institution, the advisory firm's non-fund clients and shareholders will be subject to a proxy or consent solicitation.[18] In addition to approving a new advisory contract, the fund board will need to authorize a shareholder meeting for fund investors and review and approve proxy and SEC registration documents, among other actions.

- ***Approval of Changes to the Fund's Other Service Providers.*** Some adviser mergers may result in the appointment of a new distributor or other fund service providers, and the board will need to consider and/or approve the fund's new service provider agreements.

IV. Governance Considerations

Adviser transactions can raise the question of how much, if any, board oversight of management's business is appropriate. When an adviser begins to seek a merger partner, is targeted by an acquiring adviser or engages in any transaction that significantly affects the management and structure of the fund complex, and the services provided and to be provided to the fund shareholders, directors' fiduciary duties to the funds are implicated. Directors may in their oversight role launch valid inquiries about the viability of the adviser and its ongoing ability to manage and appropriately service the funds.

Considerations during the transaction: In addition to executing its fiduciary duties to the funds and evaluating the adviser's capability to manage the funds, the board may wish to consider how the transaction will impact board operations. Adviser transactions may be complex and have extended durations. The nature and structure of the transaction may change throughout negotiations, and the workload for the board members could increase. Boards may appoint a special committee to interact with the adviser as the transaction progresses. Boards may also wish to enlist other experts as needed.

Considerations after the transaction: After the transaction is consummated, directors solely in their oversight role may wish to monitor the transaction's success and whether the fund's interests are being protected. An adviser can face challenges or even fail after a reorganization because of incompatibility of cultures, software integration problems, diseconomies of scale, and the defection of key personnel,[19] all of which could adversely impact the services provided to a fund. With the help of independent counsel, boards may wish to remain alert for potential pitfalls and keep communication lines open with management on post-merger integration.

Board Consolidation or Reduction: As a result of an adviser merger, two fund boards may be combined, and the board of the acquired funds may cease to exist. Directors who are departing may wish to discuss with independent counsel strategies for ensuring that the acquired funds are managed well by the acquiring adviser and whether some directors should be retained for a period on the new board to lend their expertise.

Directors who are folded into the surviving board will need to become familiar with the acquiring adviser's internal processes, business and culture and any new funds under their oversight. Before and during the adviser merger or acquisition, the fund boards involved may wish to consider and discuss the following:

- ***Board Composition and Characteristics:*** Directors' ages, skillsets and experience with the applicable types of funds, whether the directors meet the statutory independence requirements, and whether new committees are necessary. Who will step off the board and who will remain? Will the new board reflect appropriate diversity categories?
- ***Board Counsel:*** Directors may find that board counsel may not be the same for both boards or new conflicts of interest could arise with existing independent counsel.
- ***Policies and Procedures:*** Retirement policy, the function of the nominating and governance committee, compensation and/or severance for departing directors, policies regarding required skills, committees, and term limits, if necessary.
- ***Insurance and Indemnification:*** Most current D&O policies provide coverage for a fund's past, present and future directors. Directors may wish to review older policies to make sure that there is continuing coverage for directors who are stepping off the board. Directors may consult with independent counsel on issues including whether coverage is available to the non-surviving fund's board to protect it from future claims. The board also may wish to request indemnification from the adviser for various risks.

V. Conclusion

Adviser transactions can last over several months, or even years, depending on complexity, and can involve considerable resources of the adviser. Contract negotiations, review and approval of a new advisory contract, shareholder meetings and the proxy process and registration of added funds may increase board responsibilities. Boards should undertake their responsibilities with diligence and maintain a cooperative and accountable relationship with the adviser, while protecting the interests of the fund.

Appendix

Q&A Below are questions directors may have for management and independent counsel regarding the adviser merger.

Board Discussion Items	Transaction-Specific Questions
♦ What are the adviser's plans for the funds, such as a merger or liquidation of some of the funds? ♦ How will systems be integrated? Are there concerns regarding the quality of fund service providers? ♦ What is the adviser's approach to management? E.g. Oversight of portfolio managers; risk measurement and control systems, compliance infrastructure; compensation and retention of key staff. ♦ How will the merger affect the nature and quality of services provided to the funds? ♦ Does the adviser have any concerning regulatory/legal history (e.g., SEC enforcement actions)? ♦ How will the board be affected by the adviser merger? Who will pay the costs of board consolidation? E.g., retaining consultants, severance for departing directors, if any.	♦ What are the key steps to accomplish the adviser merger, who will execute these steps and what is the timeline? ♦ What has been done to prepare for the conversion of the acquired fund's transfer agent, custody and accounting records as of the exchange date? What are the particular challenges if the acquired and acquiring funds use different platforms? ♦ Have all interested parties/significant shareholders been notified of the transaction? Have the appropriate disclosure and regulatory obligations been addressed? ♦ How will the daily mutual fund business be affected over the duration of the transaction? ♦ Does the acquisition give rise to any new conflicts of interest?

Endnotes

1 This report has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. The Forum's current membership includes over 1075 independent directors, representing 137 fund groups. Each member selects a representative to serve on the Steering Committee. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues related to its individual circumstances.

2 See, e.g. Dean Witter, Discover & Co.; Morgan Stanley Group Inc., 1997 SEC No-Action Letter, LEXIS 548 (April 18, 1997). Accessible at: https://www.sec.gov/divisions/investment/noaction/1997/deanwitter041897.pdf and https://www.sec.gov/divisions/investment/noaction/1997/americancentury122397.pdf

3 See: Mergers and Acquisitions of Investment Managers: Assignment of Investment Advisory Agreements. By Jon S. Rand, J. Stephen King, Jr. and Mary C. Carty. The Investment Lawyer June 2002, Vol. 9, No. 6 edition..

4 Recent M&A Activity in Asset Management. February 2018. Registered Funds Alert. Simpson Thacher & Bartlett LLP.

5 Section 15(a)(4) of the 1940 Act provides that when there is an "assignment" of an investment advisory agreement, the old investment advisory agreement terminates and a new investment advisory agreement must be submitted to both the investment company's board of directors and shareholders for approval. Section 2(a)(4) of the 1940 Act defines "assignment" to include: "any direct or indirect transfer or hypothecation of a contract . . . by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor . . . ." Section 2(a)(9) defines "control" and Rule 2a-6 of the 1940 Act provides that a "transaction that does not result in a change of actual control or management of the fund is not an assignment for purposes of Section 15(a)(4) of the 1940 Act.

6 See Note 2 above.

7 Section 15(a) and related 1940 Act rules effectively prohibit a person from serving as an investment adviser of a fund unless there is a written contract that provides for the contract's automatic termination upon assignment. See also Section 205(a) of The Investment Advisers Act of 1940.

8 Section 15 of the 1940 Act and the rules thereto govern certain adviser transactions and the board's role. Section 15(c) requires, among other things, that the board meet in person to approve the advisory contract and for a majority of the independent directors of the fund to approve the new advisory contract. Section 15(a)(4) of the 1940 Act provides that when there is an "assignment" of an investment advisory agreement, the old investment advisory agreement terminates, and a new investment advisory agreement must be submitted to both the investment company's board of directors and shareholders for approval.

9 See: Mergers and Acquisitions of Investment Managers: Assignment of Investment Advisory Agreements. By Jon S. Rand, J. Stephen King, Jr. and Mary C. Carty. The Investment Lawyer June 2002, Vol. 9, No. 6 edition.

10 In certain instances, a fund may determine not to seek shareholder approval in reliance on an opinion of counsel that there has been no assignment. See for example: See, e.g. Dean Witter, Discover & Co. Accessible at: https://www.sec.gov/divisions/investment/noaction/1997/deanwitter041897.pdf

11 See: ING Investments, LLC, Directed Services LLC, and ING Investment Management Co. LLC, SEC No-Action Letter, Reference Nos. 801-48282; 801-32675; 801-9046 (March 27, 2013). Accessible at: https://www.sec.gov/divisions/investment/noaction/2013/ing-funds-032713-15a.htm

12 Section 15(f)(1)(A) of the 1940 Act.
13 Section 15(f)(1)(B) of the 1940 Act.
14 Rule 15a-4(b)(1). This exemption applies where the previous advisory contract was terminated by either the board or fund shareholders; by a failure to renew the previous advisory contract; or by an assignment of the previous advisory contract. Thus, if an advisory contract terminates as a result of an unforeseeable event, SEC regulations allow the board of directors ten business days to approve an interim contract and to participate in a telephonic meeting to approve the interim contract.. See: Rule 15a-4(b)(1)(ii). See also: Temporary Exemption for Certain Investment Advisers. SEC Release Nos. IC-24177, IA-1846; File No. S7-22-98 Accessible at: https://www.sec.gov/rules/final/ia-1846.htm
15 Rule 15a-4(b)(2). See also: Temporary Exemption for Certain Investment Advisers. SEC Release Nos. IC-24177, IA-1846; File No. S7-22-98 Accessible at: https://www.sec.gov/rules/final/ia-1846.htm
16 The Gartenberg factors cited in the Supreme Court case Jones v. Harris Associates L. P., 559 U.S. 335 (2010) include: The nature and quality of the adviser's services; the performance of the fund and the adviser; the adviser's cost in providing services to the fund; the profitability of the fund to the adviser; the extent to which the adviser realizes economies of scale as the fund grows larger; fee structures for comparable funds; any "fall-out" benefits accruing to the adviser or its affiliates; and the independence, expertise, care, and conscientiousness of the board.
17 See: Mergers and Acquisitions of Investment Companies: Fund Governance Issues. By Jon S. Rand, J. Stephen King, Jr. and Mary C. Carty. The Investment Lawyer, July 2002, Vol. 9, No. 7 edition.
18 See: Mergers and Acquisitions of Investment Mangers: Assignment of Investment Advisory Agreements by Jon S. Rand. J. Stephen King, Jr., and Mary C. Carty. The Investment Lawyer, June 2002, Vol. 9, No. 6 edition.
19 27 Rev. Banking & Fin. L. 509 (2007-2008) The Scope of Investment Advisers' Fiduciary Duties When They Merge. Accessible at: https://heinonline.org/HOL/LandingPage?handle=hein.journals/annrbfl27&div=18&id=&page=

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