MFDF
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The FORUM for FUND INDEPENDENT DIRECTORS

Report of the
Mutual Fund Directors Forum

Practical Guidance for Fund Directors on Mutual Fund Mergers

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I. Introduction and Summary

The upward trend in industry consolidation is expected to continue with increasing mergers of funds and investment adviser acquisitions. Mutual fund mergers have been a time-tested way to manage a complex's fund lineup, and the decision to merge away or acquire a new fund is often a prudent strategic move. These transactions trigger Securities and Exchange Commission ("SEC") rules and regulations and hold practical and legal considerations for fund independent directors. This paper[1] discusses fund independent directors' oversight of fund mergers. A companion Mutual Fund Directors Forum publication will address directors' responsibilities with respect to mergers and acquisitions involving investment advisers.

Business Considerations: Fund mergers can be used to manage a complex's fund lineup. Fund mergers can reduce redundancies in investment objectives across a fund complex's lineup, achieve economies of scale by making funds larger, spin off a poorly performing business line, and expose a fund to greater distribution opportunities. Chief among a board's considerations will be the adviser's analysis of which funds to merge, why the funds are being merged, and the effect of the merger on the funds and fund shareholders.

Regulatory Considerations: The Investment Company Act of 1940 (the "1940 Act") requires fund independent directors to make critical determinations before approving a fund merger or a new advisory contract. The SEC requires that each fund's board (including a majority of disinterested directors) determine that the merger is in the best interests of the fund and will not dilute the interests of shareholders.[2] State laws also impose on directors overall fiduciary duties of care and loyalty toward the fund and shareholders. Additionally, under most states' laws there is a presumption that directors will use their business judgment to determine whether a fund merger is in the fund's best interests.[3]

Governance Considerations and Challenges: Certain merger transactions may call for consolidation of fund boards, which will affect directors on both sides of the transaction. Boards with strong governance and nominating committees and policies and procedures that anticipate oversight of complex transactions, transition, and changes to board makeup and culture will be better equipped to handle the challenges that may arise from fund mergers.

From proposal to consummation, a fund merger may take several months, or even years, depending on complexity. Necessary steps include the initial proposal from the adviser, negotiation of the merger terms, 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 their determinations and approvals.

Board Determinations Before Fund Merger Approval

- The adviser considered alternative actions besides merging the fund
- The merger is in the best interests of the fund and will not dilute existing shareholders' interests
- The adviser has provided enough information to help the board evaluate the transaction and inform its determinations
- Have all tax implications been addressed?
- What are the costs involved and who will bear them?

II. Business Considerations

An adviser may consider a fund merger to address the following issues, particularly if they are sustained over a significant period of time:

- slow asset inflows or increasing outflows;
- short or unimpressive performance track record;
- high loads; and/or
- poor performance.

A fund complex with struggling or inefficient funds is likely to prefer to maintain its assets under management, and a fund merger within the fund family may better accomplish that goal than a fund liquidation, which results in the loss of assets and may be taxable for investors. An adviser will consider the costs and structure of the merger and the expected impact on its business and then evaluate the surviving and target funds considering, among other things:

- Which fund will be the accounting survivor[4] (not necessarily the surviving entity);
- The compatibility of the merging funds' share classes;
- The compatibility of fees among service-providers;
- The similarity of the funds' investment objectives and policies; and
- Distribution channels for the surviving fund.

These considerations bear heavily on the board's determination of whether the proposed merger is in the best interests of a fund, and directors may wish to carefully evaluate the adviser's analysis with guidance from counsel.

Adviser May Seek Alternatives to Merger: A merger is not always an appropriate solution to the issues a fund is facing, and the adviser may present options for the board's consideration. The adviser may seek to replace the fund's portfolio manager or sell the fund to another adviser. The adviser may decide that some low-performing funds may not and should not survive current investor demand for low fees and high performance. A proper evaluation of merger alternatives should be part of board and adviser discussions.

Directors may also wish to keep in mind that each fund complex is different in philosophy and capabilities. Larger fund complexes may have the financial and operational resources to merge low performers into better performing funds within the complex. A smaller complex may have less flexibility and fewer resources to acquire a new fund or find a suitable merger partner for a poor performer. Sometimes, the best way forward is an unaffiliated fund merger.

III. Regulatory Considerations

Affiliated and Unaffiliated Fund Mergers

Generally, affiliated fund mergers[5] are a combination of funds within a complex or fund family or a combination of funds that are otherwise affiliated; while unaffiliated mergers occur between funds belonging to different fund families.

Boards may wish to think of fund mergers within the following framework:

- Affiliated mergers, with no material changes for the funds.
- Affiliated mergers with material changes, such as to the fund fees or fundamental investment policies, which would require a shareholder vote.

- Unaffiliated mergers, which would trigger a 15(c) analysis for the target fund board as well as a shareholder vote.

The table below summarizes each type of merger and relevant regulatory, governance and practical board considerations with more details in the discussion following. The information presented below is not exhaustive, and it is critical for directors to engage independent counsel's guidance as they undertake oversight of these transactions.

Type of Merger	Regulatory Considerations	Governance Considerations	Practical Considerations
Affiliated Mergers	- Board has state law fiduciary duties toward the fund and shareholders. ("state law requirements") - Under the 1940 Act, a majority of the independent directors must make a determination that the merger is in the best interests of the funds and that the interests of the surviving fund's existing shareholders will not be diluted as a result of the merger. - Board must request and evaluate all information reasonably necessary to make their determinations and board must have considered and given appropriate weight to all pertinent factors. - Board deliberations must be documented in minutes. ("1940 Act requirements")	- The same board may oversee both funds, and directors must balance fiduciary duties to both the surviving and target fund and shareholders. - If separate boards are involved, an affiliated merger could result in a board consolidation or board size reduction. - Transition planning for new and departing directors, D&O insurance and indemnification for departing board members.	- Due diligence review: Comparison of each fund's fees, expenses, performance, investment policies and strategies, investment objectives, risks, valuation policies, distribution and fund services, repositioning of securities and direct costs of merger -- who will cover the costs and/or how will costs be allocated between and among the funds, the adviser or both. - Each board must consider and approve the adviser's proposed Agreement and Plan of Merger and relevant regulatory filings.

Type of Merger	Regulatory Considerations	Governance Considerations	Practical Considerations
Affiliated Mergers with material changes: E.g., a change in fundamental investment policies; a materially different advisory contract; a higher distribution fee than before the merger; the post-merger board is not composed of a majority of independent directors of the target fund who were elected by shareholders of the target fund.	- State law requirements and 1940 Act requirements. - A majority vote of the outstanding voting securities of target fund may be required. - Board must authorize meeting of target fund shareholders.	- Boards may be shared by both funds, but directors must evaluate transaction pursuant to state law requirements and 1940 Act requirements. - If separate boards are involved, an affiliated merger could result in a board consolidation or board size reduction. - Transition planning for new and departing directors, D&O insurance and indemnification for departing board members.	- Due diligence review (see above). - Consider and approve Agreement and Plan of Merger, proxy process, authorize shareholder meeting, review regulatory filings. - If there is a new advisory contract involved, then board must undertake the 15(c) contract approval process.
Unaffiliated Mergers	- A majority vote of the outstanding voting securities of target fund may be required. - Board must authorize meeting of target fund shareholders. - Target fund board must undertake a process similar to the 15(c) contract approval process to consider the qualifications and liabilities of the adviser.	- Board consolidation may result from merger. - Transition planning for which directors will remain or depart may be undertaken. - Surviving fund board may consider retaining directors of target fund board to serve because of their knowledge of target fund operations. - D&O insurance and indemnification for departing board members, so-called "tail insurance."	- Boards on both sides of transaction will evaluate terms of the transaction, adviser's business, operations and capabilities to manage the surviving fund, fees and expenses of surviving fund, differences in valuation policies of surviving and target fund, portfolio manager capabilities, adviser personnel, compliance infrastructure, third-party service providers, results of SEC inspections, history of regulatory and legal proceedings, systems integration issues. - Proxy process, shareholder meeting. Review and approval of regulatory filings. Consider and approve Agreement and Plan of Merger.

Board Determinations

The 1940 Act requires fund independent directors to make certain determinations before approving a new advisory contract or a fund merger.[6] Independent counsel will assist the board in drafting an information request letter to the fund adviser seeking information on factors relevant to the board's determinations. On a practical level, directors of both the surviving and target funds will need to commit to overseeing the merger process, which can, at minimum, include extensive due diligence and review and approval of regulatory filings.

A board should address the following determinations required by the 1940 Act before approving a fund merger:

- The adviser considered alternative actions besides merging the fund.
- The merger is in the best interests of the fund.
- The adviser has provided enough information to help the board evaluate the transaction and inform its determinations.
- The merger will not dilute the interests of existing shareholders.

When considering a merger, board discussions typically include a comparison of the merging funds' investment objectives, policies, strategies and risks; fund performance; distribution and other fund services; repositioning of fund securities (i.e. retaining or selling securities); comparison of fund fees and expenses; board composition; respective capabilities and commitments of the advisers involved; director insurance and indemnification; and direct costs of the merger. A thorough record of the board's determinations should be recorded in the board's meeting minutes.

Factors to Inform Board Determinations

The SEC has recommended[7] specific factors boards should consider before approving fund mergers, including:

- ► fees or expenses in connection with the merger that will be borne directly or indirectly by the fund;
- ► the effect of the merger on annual fund operating expenses and shareholder fees and services;
- ► any change in fees or expenses to be paid or borne by shareholders of the fund (directly or indirectly) after the merger; and
- ► any direct or indirect federal income tax consequences of the transaction to fund shareholders.

These recommendations are non-exhaustive and are meant to guide the board's process. A board's considerations will be determined by the characteristics of each merger scenario. For instance, a board's consideration of fees and expenses would focus not only on the total fund operating expenses of the surviving fund but also on each component of the fees and expenses - and how these components compare to the target fund. The board's determinations and the bases for its determinations must be recorded in the board's meeting minutes. In making those determinations, directors may also (as relevant) consider:

- ► any change in services to be provided to shareholders of the fund after the merger;
- ► any change in the fund's investment objectives, policies and restrictions;
- ► any change in investment adviser. If so, consider the new investment adviser's reputation, financial health, track record, compliance resources, etc.;
- ► the net assets and performance record of the acquired and acquiring fund;
- ► whether one fund has certain tax benefits or disadvantages that should be reflected in the price at which its shares are exchanged in the transaction;

- the experience of the portfolio managers who will manage the surviving fund;
- the expected timeline and costs of buying and selling securities to reposition the portfolio and who will bear portfolio repositioning costs;
- the compliance background of the adviser and service providers to the surviving fund;
- the current lineup of funds in the adviser's complex; and
- potential for more efficient cost allocations.

Shareholder Approval

State laws vary on whether shareholders must vote on a fund merger transaction or whether a board alone may approve a merger. For Delaware statutory trusts, for instance, no shareholder vote is required to approve a fund merger or reorganization unless the 1940 Act or the fund's governing documents require such a vote.[8] State law also determines the mechanics of how votes are cast and what vote proportions constitute a majority.[9] As discussed above, a shareholder vote is required for a merger of unaffiliated funds and when there are certain material changes involved in a merger of affiliated funds. The 1940 Act, however, permits mergers to occur without a shareholder vote under certain conditions.[10] Under the 1940 Act, the shareholders of a target fund must vote to approve a fund merger unless: the two funds being merged share the same adviser, investment objectives, principal policies and risks, the same (or lower) distribution fees; and a majority of the disinterested directors of the surviving fund must be composed of persons who were elected disinterested directors of the target fund. For mergers requiring a shareholder vote, the board will need to set a shareholder meeting date and a record date for determining shareholders eligible to vote at the meeting. The board also will need to authorize the preparation of a proxy statement to be filed with the SEC and transmitted to shareholders. Key considerations might include whether the adviser should bear some of the costs of the shareholder meeting. In many cases, the adviser will pay all merger expenses, including proxy costs. The board may wish to consult with independent counsel regarding the appropriateness of allocating merger costs among the target and surviving fund and the adviser.

Regulatory Filings

The boards of the surviving and target funds will be required to take certain actions in connection with the fund merger, including consideration and approval of regulatory filings as relevant.

- ***Form N-14.*** If a shareholder vote is required, a registration statement on Form N-14 will be prepared and filed with the SEC. The board must approve the Form N-14. Once the SEC declares the Form N-14 effective, the target fund's shareholders must be sent a prospectus/proxy statement that: describes the proposed merger; compares the target fund to the acquiring fund in terms of investment objective, policies, risks, fees, expenses, performance, includes financial statements and pro forma financial statements along with other key information; and requests the shareholders' approval of the merger. The disclosures in Form N-14 will include the board's deliberations and the materials the board reviewed to make its determinations and findings. In certain fund reorganizations, including ones involving a new fund, a shareholder vote will be solicited on Schedule 14A, which includes information similar to that in Form N-14.
- ***Agreement and Plan of Merger.*** The board must consider and approve management's proposed Agreement and Plan of Merger.
- ***Prospectus Supplement.*** The prospectus supplement informs shareholders that the board approved the merger and provides general information about the transaction.

IV. Governance Considerations and Challenges

Board Composition and Consolidation. A fund merger may not necessarily result in a board consolidation but if it does, a strong governance and nominating committee, robust policies and procedures that anticipate transition and change can mitigate board disruption and conflict. Board consolidation can mean fewer meetings per year, more efficient governance, added perspective from new directors, and cost savings for the funds.[11] Board consolidation may also result in leadership shifts and changes in board culture. Boards can approach changes in board composition in a number of ways. For example, some boards have adopted mandatory retirement policies or encouraged voluntary resignations when a merger necessitating consolidation or board reduction occurs.

Certain mergers may involve negotiated terms where the directors of a surviving fund seek to retain some or all of the target fund's board members. Other transactions may require that a board member of the target funds serve for a period as consultants or are awarded deferred compensation or severance pay. An adviser of the surviving fund may also seek to place one of its officers on the fund board as an interested person for a time. These initiatives should be undertaken with the guidance of independent counsel.

Considerations for Surviving Fund Board: The surviving directors may wish to become familiar with the target fund's investment objectives, policies, risks, strategies, performance history, fees and expenses. Directors may also wish to explore whether the board has the appropriate skill level to oversee the fund being acquired.

Considerations for the Target Fund Board: Directors of a target fund maintain a fiduciary duty to the fund and should consider the acquiring adviser's capability to manage the fund. Directors may also wish to consider the acquiring adviser's financial health, performance history, compliance record, history with regulators, its operational capabilities, and service provider relationships.

Merger Challenges

Independent counsel and other experts will shepherd the board through the fund merger process. The board meeting minutes should reflect that the board carefully considered the transaction as prescribed by the law. Depending on the complexity of the merger, the board's process will likely constitute robust discussions during one or more meetings once the adviser proposes the merger.

Fund combinations can raise new issues for boards. For instance, differences in valuation policies that may need to be reconciled after the merger. Stalemate can emerge over various issues, including merger costs or whether the merger proposal can gather adequate shareholder support.

Shareholder Support: A merger requiring a majority shareholder vote can be torpedoed if no quorum is achieved. Another round of proxy solicitation may be required if the first solicitation was unsuccessful. Proxy solicitations are costly undertakings that should be carefully considered with independent counsel. Additionally, shareholders may reject a merger proposal for various reasons, most commonly high fund fees.

Non-registered funds: Mutual fund mergers are effected on the basis of each fund's net asset value. However, in certain mergers, there is increased chance for mispricing the transaction. The 1940 Act requires that if a fund is being merged with a non-1940 Act registered entity, the fund's directors must approve procedures for the valuation of assets held by the non-registered fund participating in the merger.[12]

Who Bears the Costs: Fund merger costs quickly climb when proxy solicitation costs, legal, administrative and portfolio transaction expenses are factored in. Cost complications also can arise in the selling and buying of portfolio securities to realign the surviving fund. Directors will want to know who will ultimately bear the costs of the merger and that fund shareholders are not being unduly burdened. The adviser, in many cases, will pay the costs of the merger. However, costs can be split between the adviser and the surviving fund -- for instance, if the fund will achieve economies of scale cost savings as a result of the merger. When a fund is being asked to pay merger costs, directors may wish to carefully evaluate the benefits and costs. The proper allocation of the costs between the adviser and the target and surviving fund can be a major point of negotiation and the assistance of independent counsel and accountants can be critical in this area.

V. Conclusion

Fund mergers are a time-tested way to manage a complex's fund lineup. An adviser's decision to propose to merge away or acquire a new fund is often a prudent strategic move. Fund directors are obligated to determine that the merger is in the fund's best interests and shareholders economic interests are not diluted. Directors can find comfort in the fact that independent counsel, accountants and other experts can guide them during and after the transaction. Boards should seek to undertake their regulatory and business responsibilities with diligence, and maintain a cooperative and accountable relationship with the adviser.

Appendix

Evaluating Whether Merger is in Fund's Best Interests

Q&A Having a roadmap of key topic areas for discussions with management will help directors evaluate whether the merger is in the fund's best interests. The board itself will have robust discussions to properly evaluate the transaction. The following topics can help guide the board's process.

- ***Investment Objectives:*** Directors should ask questions addressing how the fund's investment objectives may change and how will such a shift affect shareholder value. Will the unique objective of the fund be diluted?
- ***Liquidity, Risk Profile:*** Will any reclassification of the portfolio holdings be required and, if so, at what cost? Will it affect the risk profile of the fund? How will the costs associated with portfolio classification be allocated?
- ***Portfolio Management:*** Directors should ask questions regarding the portfolio management of the combined fund. For example: Which of the funds' portfolio managers will manage the combined fund? What is the experience level and prior performance of the portfolio managers who will manage the surviving fund? Will the adviser have the investment personnel and other resources to manage the combined fund? How will a shift in management style affect shareholder value? If there is a new investment advisory firm involved, will a change in the approach to management affect the fund and its shareholders? How will the fund fit in the adviser's complex? Will there be improved distribution opportunities?
- ***Performance:*** Directors should ask how the funds have performed for the past three to five years. What are the typical down periods for the acquired fund?
- ***Distribution, Fund Services:*** How do the nature and quality of distribution and other shareholder services provided to each fund compare? Are there any differences in class structure between the funds? Will there be any barriers to obtaining space on platforms after the merger?
- ***Federal Tax Considerations:*** Will this be a tax free or taxable merger? Is there a final legal opinion concluding that the reorganization will be tax free to shareholders? What representations did outside counsel require from the funds' management to render their opinion? Do other tax advisers agree with this conclusion? Have all required steps been taken for the acquired fund to meet federal tax distribution and dividend requirements prior to the merger date? If the merger is not tax-free, what has been done to prepare for the "step-up" of cost basis and holding period of acquired security positions on the exchange date?

Balancing Fiduciary Duties

Q&A Fund directors on each side of the merger transaction may have slightly different concerns. It is important to show that directors have properly balanced their interests as fiduciaries of each fund. Below are some questions directors may raise with management on behalf of the surviving fund and the target fund that may help in informing a balanced view of the merger from both funds' point of view.

When Fund is the Target	When Fund is the Survivor
♦ Will fund expenses increase? What effect will the merger have on the surviving fund's fees and operating expenses? ♦ Who will manage the portfolio and will the investment philosophy change? ♦ What is the new portfolio manager's track record and qualifications to manage the combined fund? ♦ Will the fund's investment objective change? ♦ Will there be any direct or indirect federal tax consequences to the fund or its shareholders, including the ability to use tax loss carry-forwards? ♦ What steps have been taken to ensure that the target fund meets all of its Subchapter M compliance requirements at the merger date? How have fund management and tax advisers determined that the fund is in compliance with these requirements?	♦ What are the transaction costs to the fund of acquisition and integration of the new fund? ♦ Will the fund's larger size affect its performance and ability to achieve its objectives? ♦ Will there be short or long-term changes to performance? ♦ Will the fund receive substantial unrealized gains? If the acquiring fund has substantial realized gains, have distributions occurred prior to the merger? ♦ What are the expected economies of scale? ♦ If capital losses are carried over to the surviving fund, what are the applicable limits on the ability of the surviving fund to use these capital losses? Have the relevant tax advisers reviewed this analysis?

Overview of Questions to Ask

Q&A Below are questions directors may have for management and independent counsel regarding the merger or the impact of the merger on their funds.

Fund-Specific Questions	Transaction-Specific Questions
♦ Why is this merger in the best interests of the fund? ♦ Do the funds have different valuation methodologies? If so, how are they being resolved to minimize dilution and provide for a fair exchange ratio on the merger date? ♦ What is being done to prevent the dilution of shareholders' interests? ♦ How will the portfolios be aligned prior to the merger to eliminate any concentrations, securities that do not comply with the acquiring fund's investment restrictions or other securities that the continuing portfolio manager would remove from the combined portfolio? ♦ If the surviving fund needs to open new share classes to accommodate the exchange of share classes of the target fund, how is management prepared to introduce multi-class allocations for those new classes (or, if the surviving fund is currently single-class, for the entire fund) after the exchange date? ♦ Does the board have concerns regarding the adviser's regulatory history (e.g., SEC enforcement actions)?	♦ What are the key steps to accomplish the merger, who will execute these steps and what is the timeline? ♦ What has been done to prepare for the conversion of the target fund's transfer agent, custody and accounting records as of the exchange date? What are the particular challenges if the target and surviving funds use different platforms? ♦ Have all interested parties/significant shareholders been identified? How will full and fair disclosure concerning their affiliations/interests be provided? ♦ How will all of the work associated with a fund merger be performed while fund management and other service providers continue to properly run the daily mutual fund business? If there are additional costs incurred, who will bear these costs? ♦ Has management determined that the target fund eliminated accruals for costs which will no longer be borne post-merger (e.g., separate shareholder reports and registration statements), recognized appropriate accruals for merger-related costs, and otherwise reviewed its accounting records to identify and resolve old or unsupported balances? ♦ 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 1100 independent directors, representing 137 fund groups. Each member group 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 Rule 17a-8(a)(2)(i) of the 1940 Act. See: SEC Release No. IC-25666; File No. S7-21-01, July 26, 2002. Accessible at: https://www.sec.gov/rules/final/ic-25666.htm#mergers

3 See for example: MD Corp & Assn Code § 2-405 (2013) and Smith v. Van Gorkum, 488A.2d 858 (Del. 1985).

4 The fund accounting survivor is the entity that survives for accounting purposes and the fund whose historical performance may be used by the combined fund. The determination of which is the fund accounting survivor is analyzed from an accounting and not legal basis. See: North American Security Trust, 1995 SEC No-Act LEXIS 876 (pub. Avail. Aug. 5, 1994). See also: Mergers of Investment Companies, 10th Edition. Stradley Ronon Stevens & Young LLP; Page 43.

5 SEC Release No. IC-25666; File No. S7-21-01, July 26, 2002.

6 Rule 17a-8 of the 1940 Act permits affiliated fund mergers regardless of the reasons for the funds' affiliation. The rule requires that each fund's board (including a majority of disinterested directors) determine that the merger is in the best interests of the fund and will not dilute the interests of shareholders.

7 SEC Release No. IC-25666; File No. S7-21-01, July 26, 2002.

8 See: § 3815(a) Delaware Code. See also: Mergers of Investment Companies, February 2018. 10th Edition. Stradley Ronon Stevens & Young LLP, Page 58-59.

9 Mergers of Investment Companies, February 2018. 10th Edition. Stradley Ronon Stevens & Young LLP; Page 58.

10 Rule 17a-8(3) of the 1940 Act.

11 See: Mergers and Acquisitions of Investment Companies: Fund and Board Consolidation. By Jon S. Rand, J. Stephen King, Jr. and Mary C. Carty. The Investment Lawyer, September 2002, Vol. 9, No. 9 edition.

12 Rule 17a-8(a)(2)(iii) of the 1940 Act.

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