Compliance Corner

Deal or No Deal: Key Considerations for Buying an Investment Management Firm

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The influx of new regulatory requirements in the financial services industry has increased the compliance burdens and costs for many investment managers. Many small-to-mid-size managers may conclude that consolidation is the optimal way to absorb the regulatory costs associated with these requirements and to maintain profitability, thereby increasing mergers and acquisitions activity.[1] The acquisition of any regulated commercial enterprise is a significant undertaking, and transactions in the investment management space present a host of industry-specific legal and business issues. In this article, we highlight some of the principal issues unique to an investment adviser target (a "target") that a buyer should evaluate in connection with an acquisition.

Caveat Emptor: Pre-Acquisition Considerations

The pre-acquisition phase of an investment management firm transaction can involve a laundry list of pivotal activities, including due diligence, deal structuring and addressing other securities law issues. Below we discuss certain key considerations relevant to evaluating risk, creating an accurate closing timeline and sketching out a post-acquisition compliance framework.

Due Diligence. A fulsome due diligence process is critical to developing a comprehensive understanding of the legal and business risks related to a target. In some respects, the due diligence review will resemble that of any acquisition (*i.e.,* an assessment of material business agreements, office leases, tax documentation, *etc.*). However, there also are several diligence items that merit particular attention with respect to advisory targets:

Additional Diligence Documents. In addition to the documents noted above, an acquirer also should consider requesting the following adviser-specific documents to review during its due diligence:

- *Investment management agreements and side letters.* Investment management agreements and side letters can assist with an understanding of any necessary transaction consents, a target's advisory fee structure (including certain fee guarantees or MFN obligations), restrictions on competing investments, the allocation of investment opportunities, restrictions imposed on "affiliates" and current investment decision-making authority for client accounts.
- *SEC and/or state securities authority examination reports and correspondence.* These documents may identify material compliance failures and other deficiencies to address post-acquisition.
- *Form ADV.* Among other things, a target's Form ADV can provide insight into the target's business, disciplinary history and its client/investor disclosure practices.
- *Documentation regarding annual reviews and compliance exceptions.* This documentation should identify historical compliance issues, a target's efforts to remediate such issues, prior waivers of, or exceptions to, existing compliance requirements and potential areas of increased risk in a target's business.
- *Compliance policies and procedures.* Following a review of a target's compliance practices, an acquirer can assess the strength of the target's compliance program and whether and how the acquirer should bolster such program post-transaction.
- *Marketing materials.* Among other things, an acquirer should consider reviewing a target's marketing materials for potentially misleading disclosure, including with respect to prior performance information.
- *Other documents.* Other documents to review may include: (i) personal trading reports, (ii) regulatory filings (*e.g.,* Form PF, Schedules 13D and 13G and any CFTC filings), (iii) investor complaints, (iv) gift and

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entertainment logs, (v) list of political contributions and (vi) custody agreements.

Potential Conflicts of Interest. The due diligence process should endeavor to ferret out potential conflicts between the acquirer and target, including (i) overlapping investment strategies, (ii) conflicting allocations of investment opportunities, (iii) conflicts due to public versus private investment strategies, (iv) allocations of management resources and (v) conflicting client/investor rights pursuant to side letters or other arrangements.

Applicable Regulatory Regimes. An acquirer's due diligence should assess whether the acquisition could subject it to additional regulatory scrutiny, or require particular regulatory consents. For instance, if a target also is a broker-dealer, the transaction may require approval from the Financial Industry Regulatory Authority and state securities authorities.

Valuation Issues. An acquirer should review whether a target has clearly documented and consistently applied its valuation methodologies, policies and procedures.

Background Checks and Disciplinary Reports for Key Employees. An acquirer may seek to obtain background checks and disciplinary reports for key employees to adequately assess any criminal and disciplinary histories.

Registration Exemptions. An acquirer should understand the particular registration exemptions, if any, upon which a target relies in connection with securities transactions (*e.g.,* Section 3(c)(7) or 3(c)(1) of the Investment Company Act of 1940 or Section 4(a)(2) of, or Regulation D under, the Securities Act of 1933) or commodities interest transactions (*e.g.,* Rule 4.13(a)(3) under the Commodity Exchange Act). In connection with a target's marketing practices, an acquirer also likely should analyze the target's reliance, if any, on the so-called "issuer's exemption" from registration as a broker-dealer (*i.e.,* Rule 3a4-1 under the Securities Exchange Act of 1934 (the "Exchange Act")).

Other Potential Legal Issues. An acquirer should carefully consider an acquisition involving plan assets under the Employee Retirement Income Security Act ("ERISA") or a registered investment company. Certain investment advisers whose clients are deemed to hold ERISA plan assets are subject to certain requirements under ERISA.[2] Likewise, registered investment companies must comply with various management restrictions (including with respect to affiliate transactions and deviations from investment mandates), and may present additional business risks for an acquirer.[3]

Assignment of Investment Management Agreements. Section 205(a)(2) of the Investment Advisers Act of 1940 (the "Advisers Act") prohibits federally-registered advisers from executing or performing any contract that fails to include a provision prohibiting an "assignment" without the consent of the other party to the contract. An "assignment" includes any direct or indirect transfer or hypothecation of an advisory contract or of a controlling block of the assignor's outstanding voting securities. Therefore, a target likely must obtain client consent before assigning its investment management agreements to the acquirer at the closing.

The Advisers Act does not specify the mechanism under which a target must obtain client consent to an assignment. One approach is to seek the affirmative consent of every client for which an investment management agreement will be assigned. Alternately, the SEC staff has suggested that an adviser may obtain consent by notifying clients in writing (i) of the adviser's impending assignment, (ii) that advisory services will continue to be provided by the adviser for a specified "reasonable" period of time and (iii) that if the client does not terminate the service by the end of that period, the adviser may assume that the client has consented to the assignment.[4] It is not entirely clear what would constitute a reasonable amount of time for such purposes, but the SEC staff has not objected to a 60-day opt-out period.[5]

If a target manages an entity with which it is affiliated, such as a private fund, there is a question as to whether the adviser should rely solely on the affiliated client fund to provide the requisite consent. In these circumstances, the manager often will obtain the consent of all or a portion of the limited partners or members of the private fund or of an independent body such as the limited partner advisory board, in addition to that of the private fund client.

Section 13 and 16 Issues. If the target invests in public securities, it may have obligations under Sections 13 and 16 of the Exchange Act, in connection with its business operations, including:

- Sections 13(d) and 13(g), which require the beneficial owner of more than 5% of a class of publicly traded equity securities to file with the SEC certain ownership reports;
- Section 13(f), which requires an institutional investment manager that invests for its own account or has investment discretion over $100 million or more of publicly traded equity securities to file with the SEC certain holdings reports;
- Section 13(h), which requires "large traders" to provide certain information to the SEC; and
- Section 16, which, among other things, (i) requires the beneficial owner of more than 10% of a class of publicly traded equity securities to file with the SEC certain reports (*i.e.,* Forms 3, 4, and 5) and

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(ii) provides for disgorgement of profits related to certain purchases and sales of equity securities.

An acquirer (particularly a private fund manager) may need to aggregate and match the securities held in its client accounts with those securities in the accounts of a target.[6] Such matching and aggregation can add a significant degree of complexity to an acquirer's existing reporting obligations. Moreover, it can increase an acquirer's exposure to short-swing trading risk. Consequently, an acquirer may evaluate whether it can avoid aggregation and matching with respect to certain of these provisions by erecting an information barrier between certain of its and a target's personnel.[7]

SEC Consent/Form ADV. Federally-registered advisers need not obtain the SEC's consent prior to engaging in a merger or other change of control transaction.[8] However, amendments to the target's Form ADV should be considered several times during the acquisition process, including after the signing of the definitive acquisition agreement and following the closing. The extent and nature of the changes to the Form ADV will largely depend on the type of transaction effected, whether the acquirer also is a registered entity and how the target will be operated following its integration into the acquirer's structure. Finally, it is possible that the acquirer could elect to withdraw the target's registration as an investment adviser following the closing and, assuming it satisfies the SEC staff's conditions for inclusion, add the target as a "relying adviser" to its existing Form ADV.

Putting it All Together: Post-Acquisition Integration Considerations

After the champagne corks pop, an acquirer must focus on the often challenging exercise of integrating a target into its operations. For instance, the acquirer must consider how a target should fit into its existing corporate structure and whether the target's operations should be consolidated or reorganized. The acquirer also must assess how the newly-acquired entity should be supervised, and whether to incorporate the target and its supervised persons into the adviser's existing compliance architecture or to operate a target with a stand-alone compliance program (potentially, with a separate chief compliance officer). We discuss some of the relevant compliance considerations, including the use of the target's performance information, below.

Compliance. The integration of the acquirer's and the target's compliance needs and processes can be a complicated task. Areas where additional care may be necessary to ensure seamless compliance integration include:

- *Anti-money laundering/know-your-customer ("AML/KYC") procedures.* There can be wide variance in AML/KYC practices among advisers. For example, an adviser may use a third-party service provider for AML/KYC compliance, or it may complete the client or investor review in house. Similarly, an adviser's policies may contemplate an enhanced process requiring it to review extensive investor background and tax documentation, or the adviser may simply check to ensure an investor's name is not on the Office of Foreign Assets Control (OFAC) list. The acquirer's integration plan should consider whether the acquirer and target will be subject to a unified AML/KYC process, or whether business differences warrant separate procedures.
- *Custody.* If a target has custody of client funds or securities, the acquirer must determine (i) whether it can rely upon the private fund audit exception or if a surprise examination is necessary, (ii) who should act as the qualified custodian and (iii) whether to impose additional controls for particular types of assets.
- *Office space.* The decision of whether to share office space or maintain separate offices entails a number of compliance considerations, including (i) whether maintaining multiple locations creates additional regulatory requirements (*e.g.,* state securities authority registrations), (ii) any flow of information concerns for public/private businesses, (iii) the acquirer's ability to adequately supervise remote personnel, (iv) books and records requirements and (v) the acquirer's ability to maintain effective business continuity policies and procedures.
- *Personal trading practices.* There are numerous approaches to addressing personal trading, including outright bans, prescribed holding periods and pre-clearance of all or certain trades. An acquirer may impose more stringent personal trading policies on the target's personnel—which may be met with resistance. Any trading lists of the acquirer and a target also may need to be combined.
- *Flow of information.* The acquirer may consider imposing information barriers between certain of the firms' personnel to (i) separate the public and private sides of the business for insider trading compliance purposes, (ii) avoid aggregation and matching of securities positions, (iii) take advantage of certain exemptions from the requirement to aggregate commodities interest positions[9] or (iv) provide assurance to certain clients that competitively sensitive information will be appropriately safeguarded.

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Portability of Track Record. If the acquirer desires to use the prior performance results of a target in its marketing materials, it must ensure that it can comply with certain disclosure and other portability requirements designed to prevent the use of misleading information by advisers. The SEC staff has taken the position that the use of a target's prior performance results would not, in and of itself, be misleading under the Advisers Act if certain conditions are satisfied.[10] First, the persons who manage the acquirer's clients must primarily be responsible for achieving the prior performance results. There also must be substantial similarity between the accounts or clients managed by the target adviser, including with respect to investment objectives, policies and strategies, and the accounts or clients at the acquirer such that the performance results would provide relevant information. The acquiring adviser cannot cherry-pick the best performance results of the target and instead must include all of the target's accounts or clients managed in a substantially similar manner. Additionally, the acquirer must take care to ensure that the target's prior performance information is not presented in a misleading manner and includes all relevant disclosures, including that the accounts were managed by another firm and the relevant time periods for such information.

The acquiring adviser also must comply with the Advisers Act's books and records requirements with respect to the target's performance results. Accordingly, it is important that the target's back-up information be appropriately vetted as part of the due diligence process.

Conclusion

Before and after the closing, buyers should carefully consider the myriad of issues relating to a target's past practices and its future business objectives. Not every investment management firm target will present thorny or show-stopping compliance risks; however, addressing the items described in this article can help facilitate a successful closing and an effective and efficient integration process.

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1 Indeed, according to Charles Schwab data, the number of M&A transactions among registered investment managers increased in 2013 versus 2012. *See* "RIAs Lead The Way In Advisor M&A Activity," Financial Advisor (March 4, 2014).
2 *See* Sections 404 and 406 of ERISA.
3 *See* Section 17 of the Company Act of 1940.
4 Funds, Inc. (Mar. 3, 1972).
5 Kephart Communications, Inc. (Aug. 14, 1976) and Funds, Inc. (Mar. 3, 1972) (stating that the SEC staff could not determine whether the proposed 30-day termination period would be reasonable in the circumstances).
6 *See e.g.,* Rule 16a-1 under the Exchange Act.
7 *See* Exchange Act Release No. 39538 (Jan. 12, 1998).
8 Consent of a government regulator may be required, however, if the adviser also is registered under state law, or also acts as a broker-dealer or a bank.
9 *See* CFTC Rule 150.3.
10 *See e.g.,* Nicholas-Appelgate Mutual Funds (Feb. 7, 1997); Horizon Asset Management, LLC (Sept. 13, 1996); Bramwell Growth Fund (Aug. 7, 1996); Taurus Advisory Group, Inc. (July 15, 1993); and Great Lake Advisors, Inc. (Apr. 3, 1992).

SEC Chair Mary Jo White Addresses Proxy Advisory Firms, MMF Reform at U.S. Chamber of Commerce

SEC Chair Mary Jo White

On March 19, SEC Chair **Mary Jo White** addressed the Center for Capital Markets Competitiveness (CCMC) Annual Capital Markets Summit at the U.S. Chamber of Commerce in Washington, D.C. White responded to questions on a variety of topics, including the different informational needs of retail and institutional investors, proxy advisory firms, shadow banking, the Treasury Department's Office of Financial Research (OFR) report on the asset management industry, the SEC's money market mutual fund (MMF) rule proposals, and systemic risk regulation.

White expressed the "crying need" for more funding from Congress for the SEC to increase examinations of investment advisory firms. White stated that the agency is significantly under-resourced, especially with regard to its examination program, even though the agency operates on a deficit-neutral basis and cannot rely on self-funding, similar to some banking regulators. Even given these resource constraints, White insisted that the SEC has been a careful steward of taxpayer

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