THE INVESTMENT LAWYER™

covering legal and regulatory issues of asset management

ASPEN PUBLISHERS Vol. 17, No. 10 • October 2010

Buying a Private Fund Manager: An Overview of Legal Issues

By Nathan J. Greene and Kasey Choi

An unprecedented degree of uncertainty has characterized the asset management business environment over the last two years—a period that saw extreme market volatility, threatened changes to key tax structures, a rapidly shifting regulatory environment, and rising expectations from institutional investors. One collateral result is a dramatic fall-off in asset management industry mergers-and-acquisitions (M&A) deal activity relative to 2006 and 2007. But the same forces of change that put dealmakers on the sidelines carry the seeds for a rebound in activity. Moreover, the Volcker Rule and other significant regulatory changes under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)—the import of which are just becoming clear—will themselves prompt new M&A activity.

Indeed, throughout the tumult, hedge fund and private equity fund managers of all shapes and sizes continued to turn to the M&A marketplace. Some sold their businesses outright, although independent firms typically retain a

Mr. Greene (ngreene@shearman.com) is a partner and Mr. Choi (kasey.choi@shearman.com) is an associate in Shearman & Sterling LLP's Asset Management Group.

meaningful stake and role for the principals. Other firms expanded by buying competitors, complementary businesses or stakes in those businesses.

These types of transactions raise traditional M&A concerns, such as valuation, deal structuring, relationships among the parties post-transaction, and so on. But there are also many aspects specific to transactions involving fund managers. This article focuses on those industry-specific issues.[1]

Regulatory Overlay

A private fund—such as a hedge fund or private equity fund—is an investment fund that avoids regulation as a public mutual fund. A fund remains "private" by limiting sales of its shares or partnership interests to qualified investors and avoiding sales efforts that are public in nature.

Management of virtually *any* fund that invests in securities is (assuming the fund manager is either a US business or a non-US business with sufficient US contacts) nonetheless a regulated financial services activity within the jurisdiction of the Securities and Exchange Commission (SEC) and covered by the US Investment Advisers Act of 1940 (Advisers Act). Many managers of private funds are thus registered with the SEC as investment advisers.

There is, however, a large and thriving segment of the fund management business that currently opts out of SEC registration. Yet the relevant exemption from registration on which most have relied will be repealed by provisions of the Dodd-Frank Act in July 2011, at least for larger hedge fund and private equity fund managers. And even unregistered managers remain subject to antifraud and fiduciary principles under the Advisers Act and to inquiries from the SEC.

That overlay presents a variety of questions for the parties to a potential M&A transaction involving the purchase of a private fund manager.

Is SEC approval of the transaction required?

No. While it often comes as a surprise, there are relatively few rules—except for ineligibility of persons or firms with "bad boy" records (for example, various financial related felonies)—that establish who can own or operate a federally regulated investment advisory business. There are also no federal capital, licensing or testing requirements.[2] There are, however, regulatory approvals if a broker-dealer, bank or other more heavily regulated business is involved. Likewise, non-US regulators can require approvals if they have jurisdiction.

Is consent to the transaction by the selling firm's clients required?

Yes, insofar as client contracts often terminate automatically as part of the transaction, so that client consent to continuing the contracts will be needed. The process is described later in this article.

Are there heightened liabilities that attach to owning a regulated business?

Yes. The Advisers Act is less prescriptive relative to rules governing broker-dealers or banks, but still provides for a comprehensive regulatory regime. Compliance failures carry risks of SEC sanctions, private lawsuits (typically under related common law principles) and, in the most extreme circumstances, criminal fraud liability.

Ownership that does not extend to participation in day-to-day operations reduces the risks to the owner, but does not extinguish them. An owner may have liabilities on "inquiry notice," "red flag" or "negligent supervision" theories if the person knew or should have known of problems and did not address them. Accordingly, it is customary to attend closely to regulatory exposure during a potential buyer's due diligence.

Will the fact of the transaction be made public?

Maybe. While a transaction involving two private parties that are not SEC-registered or otherwise regulated may avoid public reporting, SEC registration changes that. If the fund manager being purchased is SEC-registered, there is at least the possibility of drawing public attention when the fund manager's SEC file is updated to reflect its changed ownership. No details of the transaction need be reported, however.

Does the presence of SEC-registered investment funds (for example, public mutual funds) change the regulatory overlay?

Yes. While most private fund managers focus their business on private funds, some also serve as investment advisers or subadvisers to SEC-registered funds, which are regulated under the US Investment Company Act of 1940 (Investment Company Act). That additional layer of regulation affects the answers to each of the questions posed above.

First, while it continues to be the case that no SEC approval of the transaction is required, a change of control of a manager servicing an SEC-registered fund terminates the management agreement with the fund, triggering a mandated process for continuing the agreement. That process is always a two-step, requiring both a vote of the fund's independent board members and a public proxy statement that requires the same level of documentation and care as for any other US public company. Second, the Investment Company Act is more complex and prescriptive than the Advisers Act, so greater institutional infrastructure is required to manage such a fund or own such a manager. The overall effect of these differences is a more public transaction.

Due Diligence

Early in every potential acquisition, the prospective buyer seeks to engage in some level of due diligence, with two primary objectives: (i) verification of the seller's past revenue and future prospects, and (ii) identification of issues that could dissuade the buyer from proceeding.[3] Areas of special diligence interest in the asset management industry include:

- Embedded portfolio risks;
- Ability to replicate positive investment performance going forward;
- Stability of the management team;
- Stability of the customer base;
- Level of difficulty in transitioning customers to the "new" organization (including the client consent issues discussed in this article); and
- Regulatory exposures.

More specifically, topics often covered when conducting due diligence on a fund business include:

- Organization of the Fund Management Firm
    - Organizational and ownership structure (including any strategic investors) and any recent changes;
    - Number of personnel by function, background and employment terms of key personnel, and any recent key personnel departures;
    - Supervisory structure (for example, management committees);
    - Description of the organization's other businesses apart from investment advisory services;
    - Affiliates or subsidiaries that may have dealings with the investment vehicles (for example, broker-dealers, banks);
    - Description of conflicts of interest and how they are addressed;
    - Risk management arrangements; and
    - Financial statements.
- Investment Funds and Accounts Generally
    - Description of each investment vehicle, including any non-fund accounts (with a discussion of new products under development);

— Assets under management (AUM);

— Performance history, generally net of fees;

— Key-person terms and investments by key personnel, including invested amounts;

— Portfolio characteristics (geographic and sector dispersion of investments, number of investments, credit quality, portfolio turnover, etc.);

— Composition of capital and investor base;

— Management fees, performance fees, and other fees and expenses;

— Redemption terms, including applicable fees, lock-ups, gating provisions, etc.;

— Identity of auditors, counsel, administrators, prime brokers, custodians, etc.;

— Offering documents, financial statements, investment management agreements, side letters giving special rights to certain investors, and other key contracts;

— Arrangements for sharing of revenue (for example, guaranteed bonuses or profit-sharing terms, "trail fees" paid for investor referrals, or investment performance guarantees and/or operating expense limitations); and

— "Clawback" provisions under which revenue may be subject to repayment to clients.

- Compliance Information and Legal Proceedings

— Registrations or licenses;

— Compliance policies and procedures;

— Identity and background of chief compliance officer; and

— Legal proceedings and results of recent regulatory examinations.

- Transaction-Specific Matters

— Change of control and related investor or client consent terms (change of control provisions also can appear in credit agreements, ISDAs and the like);

— Systems integration issues to accompany a combination of the buyer's and seller's businesses; and

— Tax structuring needs of the seller.

Client Consents

As a result of obligations under the Advisers Act, SEC-registered investment advisers that are being acquired generally are required to obtain consent for the "assignment" of a client investment fund's advisory contract (with such an "assignment" defined to include a change of control of the manager's business). This obligation may be supplemented by related consent terms in the constituent documents of the seller's funds or in "side letters" or other special arrangements entered into by the seller directly with the seller's clients or fund investors. Note that client contract terms affect the deal regardless of whether an SEC-registered investment adviser is involved.

For SEC-registered firms, the following statutory provisions establish when client consent is required as a matter of law:

- Section 205(a)(2) of the Advisers Act provides that each investment advisory contract between an SEC-registered investment adviser and a client must provide in substance that "no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract."

- Section 202(a)(1) of the Advisers Act defines "assignment" to generally include "any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor. . . ."

- Section 202(a)(12) of the Advisers Act defines "control" as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." Section 2(a)(9) of the Investment Company Act provides a corresponding definition of "control," which presumes that a person holding more than 25 percent of a company's voting securities controls that company. This 25 percent presumption frequently is imported into the Advisers Act.[4]

Under those provisions, a rough rule of thumb is that transactions in which more than 25 percent of the seller's voting securities are transferred to the buyer, or in which the buyer will obtain the rights to more than 25 percent of the seats on the seller's board of directors or equivalent governing body, will be a "change of control." That in turn will require the consent of the seller's clients to continuation of their contracts with the firm, assuming the seller is an SEC-registered investment adviser.

As a result, it is common for strategic investors in a fund manager's business to structure their interest at 24.99 percent or less—or even to avoid taking voting securities at all and holding only what is called a "revenue share" or "revenue strip." The principle that a meaningful economic stake, even substantially in excess of 25 percent, can be taken without triggering a change of control has been recognized by the SEC Staff.[5]

Importance of underlying contract terms

Regardless of whether there is a change of control of the seller for purposes of the Advisers Act (and so regardless of the SEC registration status of the firm), the terms of the seller's contracts must be reviewed. For a fund manager, the most important contracts are typically the management contracts with the funds, the funds' internal governing documents, and side letters with particular fund investors.

When there has been no Advisers Act change of control, the goal in reviewing these documents is identifying any purely contract-specific rights between the seller and its clients. When there has been such a change of control, the goal will be to identify both contract-specific rights *and* any contract-specific mechanics for obtaining the requisite consent.

What the contract says carries great weight, because the manner in which consent is to be obtained is not specified in any SEC regulation. Instead, in a series of positions taken by the SEC Staff addressing whether "negative consent" mechanisms are permissible under Section 205(a)(2), the Staff effectively deferred to the terms of the client contract, establishing in each case that affirmative consent is required when specified by contract and not required when the contract is silent.[6] That guidance suggests that the manner in which consent is to be obtained can, within broad limits, be agreed contractually between the registered investment adviser and its client.

But who "speaks for the fund" when the fund has a consent right?

That is a mixed question of contract and local corporate law that requires referring to both the fund's constituent documents—for example, do the documents specify a consent mechanism, perhaps by establishing a committee of investors?—and the law of the jurisdiction in which the fund entity was formed. When the fund has an "independent" board of directors or an "independent" trustee (meaning independent of the fund management company), as many non-US domiciled funds do, this analysis often results in finding that the board or the trustee has the authority to give the consent on behalf of the fund.

More complicated is the situation of a fund that is a US limited partnership or limited liability company (LLC) when the documents essentially vest all control with the partnership's general partner or the LLC's managing member. Since the general partner/managing member is frequently an affiliate of the fund manager seeking the consent, there is a clear conflict of interest in the general partner or managing member causing the fund to consent.

In that case, a vote of the fund investors may be taken, notice may be given of the pending transaction and an opportunity to redeem from the fund may be provided, or other arrangements may be followed, such as consultation with a third-party expert named to represent investor interests in considering the transaction. These types of approaches also are used occasionally even when an independent board or independent trustee has authority to consent on behalf of the fund. One rationale for doing so is that they can reduce the risk of loss of assets from disgruntled investors redeeming from the funds following a deal.

Special issues for SEC-registered funds

The consent process triggered by a change of control of an investment adviser or sub-adviser to an SEC-registered investment fund is highly regulated. The process will include an early presentation regarding the transaction to the majority-independent board of directors or trustees of the fund, which is empowered under the Investment Company Act to request any information that reasonably bears on the suitability of the investment adviser and its proposed compensation package from the fund. This required review, and the industry customs that surround it, give these boards substantial leverage to extract promises of, for example, continuity of personnel, expense caps, and fee reductions. Fund board approval is required prior to closing and only by action at an in-person meeting of the board.

When registered funds are involved, a sale of the fund manager's business also triggers application of Section 15(f) of the Investment Company Act, which shields the selling manager from claims that it breached its fiduciary duty to the fund simply by the act of the sale. Compliance with Section 15(f) requires that there be a supermajority of 75 percent independent board members, both at the time of the transaction and for three years after, and that no "unfair burden" is imposed on the fund or its shareholders as a result of the transaction for a two year period. The "no unfair burden" test tends to result in scrutiny of affiliated service arrangements generally and an automatic, albeit temporary, cap on investment advisory fees.

The next step of the consent process, assuming satisfaction of the fund board, is a full-blown SEC-regulated proxy statement to solicit fund shareholder consent. In reviewing the proxy statement, the SEC Staff may ask a variety of intrusive questions and often press for more detailed disclosures generally. Once the proxy information has been mailed, inertia among the shareholder base (particularly when a large number of retail shareholders are involved) can be an impediment to obtaining the necessary quorum, so that repeated calls and mailings may be necessary. Broker-dealer rules limiting the ability of financial representatives to vote shares for their clients aggravate this problem.

Finally, in recognition of the burdens under this proxy process, SEC rules permit an "interim" advisory agreement to be approved solely by the fund board that can run for up to 150 days post-closing. During the term of such an interim agreement, fees earned are escrowed and are released only upon shareholder approval of the permanent agreement (if that approval is not obtained, the manager can withdraw monies from the escrow account only to cover its costs of delivering the service, with no profit allowed).

The Human Element—Retaining the Team

It is often said that acquiring an advisory business is acquiring a management team. A primary order of business therefore is to assure continuity of personnel. Key personnel typically include the investment teams, but may also include executive management and individuals having relationships with investors, marketers, lenders, counterparties, and other market participants. Generally, the buyer will seek to enter into employment agreements with the seller's key personnel and require continued employment as a condition to closing.

Looking at the same set of issues from the perspective of the seller, owners of an independent private fund management firm (who are usually involved in the investment process) will not be keen to sell their business without knowing their post-closing compensation and management structure. Hence, questions around the retention and compensation of key personnel are often integral to whether a definitive agreement can even be reached with the seller.

There are generally two types of retention/motivation tools negotiated in employment agreements: (i) incentives that reward effort and success over time and align interests of the seller and buyer going forward, and (ii) disincentives that limit a person's departure options.

Examples of incentives:

- *Earn-Outs*. Due to the uncertainty of future performance and asset levels once a deal has been consummated, the purchase price for private fund manager acquisitions is generally structured with a partial payment upfront and a material portion paid on a deferred basis, contingent (in whole or in part) on the purchased business meeting certain targets subsequent to the date of closing.

- *Bonuses*. Bonuses may be tied to investment performance or to the success of the business and/or a particular fund.

- *Equity Stakes*. To the extent key personnel do not have an ownership interest before the acquisition, the buyer can offer a stake in the acquired business through, for example, options or call rights at the closing (possibly with additional rights to increased ownership vesting over time).

- *Investment in the Business*. Staff members are less likely to leave a robustly supported business. Promises to "seed" new products or capitalize existing products can be a powerful incentive.

- *Investment Discretion/Culture*. A central consideration to key personnel often will be the ability to retain their professional autonomy. For example, a buyer acquiring a majority interest in the seller may establish a management committee to oversee the seller's business as a whole, but may allocate investment discretion to the seller's existing personnel by providing such authority to a separate investment committee.

Examples of disincentives:

- *Non-Compete Agreements*. The enforceability of non-compete agreements will vary from state to state, depending on duration, geographic coverage and professional scope.

- *Non-Solicitation Agreements*. Non-solicitation agreements restrict the solicitation of key employees or clients by persons leaving the firm. These agreements generally do not raise the enforceability issues above to the same extent.

- *Other Employment Terms*. Employment agreements with key personnel may provide for a termination provision for "cause" or without cause, with different rules depending on the manner of termination. Another approach is for employment agreements to have staggered terms, which make it more difficult for a group of employees to leave together.

- *Track Record Controls.* Key personnel of the seller may be prohibited from using performance data or their "track record" upon leaving. In the same vein, SEC-registered investment advisers may only market their performance track records if they have detailed back-up data to support it. A firm can limit the ability of personnel to engage in performance marketing after leaving the firm simply by declining to assist in making the requisite back-up data available.

Planning for Post-Transaction Conflicts of Interest

US fund managers are fiduciaries to the client funds they manage. As a fiduciary, the manager owes a duty of loyalty to clients and must pay special attention to the potential for conflicts of interest. As various types of conflicts can come to the fore during and after a transaction, identifying and appropriately managing conflicts is often part of the deal process.

For example, a selling fund manager may be tempted to commit to send fund brokerage business to a broker-dealer affiliated with the buyer. That may be a sensible business arrangement—and even appear innocuous if the brokerage relationship exists independent of the transaction—but any commitment to use client assets in a manner that may not be related to the client's normal interests presents a conflict. Other examples are the buyer that wishes to provide fund administration services to, or engage in securities lending, derivatives contracts or other dealings with, a purchased fund manager's client funds. In some cases, and again, especially if there is an element of pre-commitment, such arrangements should be avoided. At a minimum, they require analysis, disclosures to the affected clients and, sometimes, client consent to the arrangement.

Because conflicts of interest in this area tend to involve dealings with affiliates, it is important to map out the "web of affiliates" around buyer and seller and, from that, to identify current, planned and even possible instances of dealings that clients of either party might have with these affiliates. Each set of dealings should be reviewed to determine how it might be affected by the transaction.

To the extent a manager's clients include SEC-registered investment funds the conflict of interest rules are even more stringent. The same is true if any of the funds (or other accounts) is subject to the Employee Retirement Income Security Act of 1974 (ERISA). Both of these laws also have more expansive definitions of affiliation than does the Advisers Act, so the web of affiliates to be considered is broader.[7]

The Definitive Agreement

Various parts of the agreement memorializing key terms and conditions of the acquisition are affected by asset management industry-specific considerations.

Closing conditions

To the extent regulatory approvals are required, they typically are included as closing conditions. This can be especially fraught if multiple non-US regulatory approvals are involved.

The client consent process described above, while critical, is documented differently deal to deal in terms of how the consents affect the closing. In many cases, the receipt of client consents attributable to a specified percentage of overall AUM is a required closing condition. In other cases, the parties are prepared to close and obtain consents after closing. Given its importance to the deal, the manner of the client consent process to be followed is typically described in the definitive agreement. At a minimum, the agreement will specify whether positive versus negative consent is required.

Purchase price and payment mechanisms

As already stated, most fund manager M&A transactions include provisions for payment of the purchase price over time, with adjustments depending on the success of the business being purchased. Terms, including percentage paid up-front, length of earn-out period, and benchmarks that determine earn-out amounts, vary deal to deal. Factors in setting future earn-outs are often related to gross or net earnings, AUM levels (sometimes with "credit" for changes in AUM attributable solely to market movements as opposed to client defections) or retention of key clients. Some payment terms provide for clawbacks if specified targets are not met.

Representations and warranties

The seller, in addition to providing standard corporate representations and warranties, generally provides certain representations and warranties that relate to its status as an investment adviser. These representations and warranties include some variation of the following:

- The seller is, and, at all times so required by the Advisers Act to be, has been, duly registered as an investment adviser under the Advisers Act [or was properly excepted from registration].

- The seller is duly registered, licensed or qualified as an investment adviser [again, or properly excepted] or has submitted a notice filing in each state or any other domestic or foreign jurisdiction where the conduct of its business required such registration, licensing, qualification or notice filing.

- None of the investment funds managed by the seller is or has been required to be registered as an "investment company" under the Investment Company Act.

- The seller has been at all times during a specified period in compliance with the Advisers Act, and any affiliated broker-dealer has been at all times during a specified period in compliance with the US Securities and Exchange Act of 1934 and applicable Financial Industry Regulatory Authority rules.

- None of the seller or its directors, officers, or employees is disqualified from acting as such under the Advisers Act or other applicable law.

- The seller and the funds advised by the seller have adopted various policies and procedures, including a code of ethics, required under the Advisers Act, and such policies and procedures are designed to assure compliance with applicable laws.

In the event that the seller or buyer has operations outside of the United States, one or both also may provide similar jurisdiction-specific representations and warranties.

Special issues for SEC-registered funds

Given the broader range of compliance obligations, it is customary for agreements that cover SEC-registered funds to include correspondingly more representations and warranties. It is also typical to describe the more complex client consent process that will apply to these funds.

Other Regulatory Matters at Closing

Other US regulatory matters that may arise are described below:

Form ADV

The seller typically updates its Form ADV—the primary SEC registration document for investment advisers—at least twice in relation to the transaction. First, once a definitive agreement has been reached (but in any event following public announcement), the seller may find it appropriate to update its Form ADV to disclose the possibility of a change in ownership. Second, following closing, the seller must amend its Form ADV "promptly" to reflect changes in its control persons and owners, and this update would address changes required by the addition of new affiliates. The schedules that show the firm's ownership are publicly available online.

Form BD

If the seller or its affiliate is a registered broker-dealer, similar amendments must be made to Form BD—the primary SEC registration document used by broker-dealers—regarding control persons and any additional disciplinary proceedings. Form BD is publicly available online.

CFTC filings

If the seller is registered with the US Commodity Futures Trading Commission as a commodity trading adviser, a commodity pool operator, or a commodity futures commission merchant, the seller must apply for a new registration, or if applicable, submit other required filings following the transaction. These CFTC filings are publicly available, online in some cases.

Exemptive orders/no-action letters

The buyer should consider whether the SEC or another regulator allows the seller to operate under an exemption from some aspect of the regulator's rules (SEC exemptions are typically called either exemptive orders or no-action letters). If yes, the parties should determine whether the relief can be relied on after closing, particularly if the transaction takes the form of a merger or sale of assets. While not always relevant (especially with smaller businesses), "carrying over" regulatory relief can be an important component to a transaction.

Fund registration statements

To the extent SEC-registered investment funds are involved, their registration statements on file with the SEC must be kept current. As with Form ADV, this tends to mean a two-step filing process, with an initial amendment filed at closing or on public announcement of the transaction and another amendment filed on completion of the consent process.

Conclusion

The pace of M&A transactions involving private fund managers may have dipped in recent years, but it seems likely that a return to normalcy in the broader economic and political environments will reveal pent-up demand. In the meanwhile, transactions in this space continue, and each presents a variety of industry-specific issues for dealmakers. Understanding that landscape—ideally before negotiations start—is critical to closing a successful transaction.

Notes

1. The article presumes that the business being sold is located or regulated in the United States, but many of the issues apply regardless of jurisdiction.

2. This is not to say that the SEC is uninterested in a firm's adequacy to operate an advisory business. It certainly is, but it tests for adequacy through periodic inspections of industry participants, not as an upfront gatekeeper. Individual personnel may require state-level licensing, but there is no federal licensing requirement.

3. While this article focuses on buyer-side diligence, the reality is more complex, with a prospective seller actively engaged in diligence of its own. A cautious seller always both (a) conducts its own diligence on potential buyers to assess their fitness as future business partners and (b) shadows the diligence that is being done on it by buyers to understand how it is being perceived and to identify business issues that a buyer might raise.

4. *See, e.g.*, Wellington Management Company, SEC No-Action Letter (Nov. 29, 1979).

5. American Century Companies, Inc./J.P. Morgan & Co., Inc., SEC No-Action Letter (Dec. 23, 1997).

6. *See, e.g.*, Templeton Investment Counsel Limited, SEC No-Action Letter (Dec. 23, 1985); Jennison Associates Capital Corp., SEC No-Action letter (Oct. 31, 1985); Scudder, Stevens & Clark, SEC No-Action Letter (Feb. 15, 1985); Fiduciary Counsel, Inc., SEC No-Action Letter (Jan. 27, 1981); Funds Inc. Investment Advisory Co., SEC No-Action Letter (Feb. 1, 1972).

7. Other issues relating to ERISA are beyond the scope of this article.

Reprinted from *The Investment Lawyer* October 2010, Volume 17, Number 10, pages 1, 10-18,
with permission from Aspen Publishers, Inc., Wolters Kluwer Law & Business, New York, NY,
1-800-638-8437, www.aspenpublishers.com

Wolters Kluwer
Law & Business