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by Jon S. Rand, J. Stephen King, Jr., and Mary C. Carty
Dechert LLP

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by Jon S. Rand and Mary C. Carty

This is Part I of a series addressing the issues arising in these types of transactions. Part II will explore fund governance issues in investment management acquisition transactions.

This article reviews the situations under which a merger or acquisition involving an investment adviser may result in an "assignment" of an investment advisory agreement under the Investment Company Act of 1940 (1940 Act) and the Investment Advisers Act of 1940 (Advisers Act). An assignment of an investment advisory agreement with a registered investment company (fund) under the 1940 Act results in the automatic termination of the agreement, giving rise to the necessity for approval by both the fund's governing board and the fund's shareholders of a new advisory agreement between the fund and the investment adviser. The assignment of an investment advisory agreement with a non-fund client requires the consent of the client. Thus, the determination as to whether a transaction involves an assignment of an investment advisory agreement should be made early in the planning stages of the transaction to allow sufficient time to obtain the necessary approvals.

Assignment under the 1940 Act

Section 15(a) of the 1940 Act states that it shall be unlawful for a person to serve or act as an investment adviser to a fund except pursuant to a written contract that, among other things, provides for its automatic termination in the event of its assignment. Section 2(a)(4) of the 1940 Act defines "assignment" as "any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor . . . ." (Emphasis added.)

The 1940 Act does not define "controlling block." In analyzing situations involving a potential change of control, the Securities and Exchange Commission (SEC) Staff has looked to the definition of control to interpret the term controlling block. "Control" is defined in Section 2(a)(9) of the 1940 Act 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) also contains a rebuttable presumption that:

> Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company.

The SEC Staff has interpreted controlling block to mean a block of stock representing more than 25 percent of the company's outstanding voting securities.[1]

Rule 2a-6 under the 1940 Act provides that a "transaction that does not result in a change of actual control or management of the investment adviser to . . . an investment company is not an assignment for purposes of Section 15(a)(4) . . . of the [Investment Company] Act . . . ." One no-action letter, discussed later in this article,

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Jon S. Rand is a partner in the New York office of Dechert. **Mary C. Carty** is an associate with Willkie Farr & Gallagher. The authors gratefully acknowledge the assistance of J. Stephen King Jr., an associate in the Newport Beach, CA office of Dechert, in the preparation of this article. Portions of this article appeared in conference materials presented at the Investment Company Institute's 2002 Mutual Funds and Investment Management Conference. Copyright ©2002 Jon S. Rand and Mary C. Carty. All rights reserved.

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addresses the application of Rule 2a-6 in the context of mergers and acquisitions involving an investment adviser, or the parent company of the investment adviser, to a fund.

Assignment under the Advisers Act

Section 205(a) of the Advisers Act states, among other things, that no investment adviser, unless exempt from registration under Section 203(b) of the Advisers Act, shall enter into, renew, or extend any investment advisory contract that "fails to 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."

The construction and implications of an assignment under the Advisers Act are highly similar, although not identical, to those under the 1940 Act. Section 202(a) of the Advisers Act defines "assignment" as "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 . . . ." (Emphasis added.)

The Advisers Act does not define controlling block and, as with potential change of control scenarios under the 1940 Act, the SEC Staff has looked to the definition of control in the Advisers Act to interpret the term. As in Section 2(a)(9) of the 1940 Act, 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." Although the Advisers Act definition omits the rebuttable presumptions of control found in the 1940 Act, the 25 percent presumptions may be used as a guide in analyzing change of control scenarios under the Advisers Act.

Rule 202(a)(1)-1 under the Advisers Act, which is analogous to Rule 2a-6 under the 1940 Act, provides that a "transaction that does not result in a change of actual control or management of an investment adviser is not an assignment for purposes of Section 205(a)(2) of the [Advisers] Act."

No-Action Letters Addressing Assignments

Three no-action letters issued by the SEC Staff within the last several years have examined the assignment provisions of the 1940 Act and the Advisers Act in situations involving merger and acquisition transactions.[2] The first letter involved a merger of two publicly held companies with asset management subsidiaries, while the other letters related to an acquisition of a controlling block of stock. Although the facts considered in the first no-action letter state the paradigm case for a transaction that does not involve an assignment, the second letter illustrates the importance of, and to some extent the SEC Staff's flexibility in, examining situations in which a person may be deemed to exercise a controlling influence over a company's management or policies. The third letter, in which the SEC Staff apparently was unwilling to supply assurances with respect to acting without shareholder and client approval, imparts some uncertainty in extending the holdings in the first two letters beyond their strict facts.

Dean Witter, Discover & Co.; Morgan Stanley Group Inc.

In Dean Witter, Discover & Co.; Morgan Stanley Group Inc. (Dean Witter),[3] the Staff agreed that the merger of Dean Witter, Discover & Co. (DWD) and Morgan Stanley Group Inc. (MS) would not result in an assignment under the 1940 Act or the Advisers Act of advisory contracts entered into by wholly-owned asset management subsidiaries of MS and DWD, notwithstanding the fact that DWD would issue stock equal to more than 25 percent of its outstanding common stock to accomplish the merger, and MS would cease to exist after the merger. The applicants represented that DWD and MS were both publicly held corporations and that shares of each corporation were held by a widely-dispersed group of public and institutional investors, none of which held more than 5 percent of the outstanding shares of common stock of either corporation.[4] Moreover, the pre-merger asset management businesses of DWD and MS were expected to be maintained as separate entities after the merger. The SEC Staff summarized its position as follows:

> In our view, the transfer or issuance of a block of stock in connection with a merger involving two issuers generally would not by itself cause an assignment of the advisory contracts of their advisory subsidiaries, for purposes of the [1940 Act] or the Advisers Act, unless (1) a person who had control of either issuer prior to the transaction does not have control of the surviving entity after the transaction, (2) a person who did not have control of either issuer prior to the transaction gains control of the surviving entity, or (3) the transaction results in an advisory subsidiary being merged out of existence.[5]

The SEC Staff also noted that approximately 1,300 MS officers collectively held 32 percent of the outstanding stock of MS pursuant to a series of agreements that restricted voting and disposition of the shares, and that as a result of the merger this block position would be diluted to approximately 14 percent of the stock of the combined company.[6] The applicants expressed the opinion that this dilution would not involve the transfer of a controlling block of stock because the shares were held by individual MS officers and no MS officer individually owned a significant percentage of the stock. The SEC Staff assumed, but expressed no legal conclusion with respect thereto, that the stock subject to these agreements did not constitute a controlling block of MS stock. The authors understand that, perhaps because the SEC Staff declined to express a view as to whether this dilution would involve the transfer of a controlling block of stock, the parties to the transaction determined to solicit the consent of fund shareholders and advisory clients.

American Century Companies, Inc./ J.P. Morgan & Co. Incorporated

Also in 1997, the SEC Staff issued a no-action letter, American Century Companies, Inc./J. P. Morgan & Co. Incorporated,[7] with respect to a transaction contemplated by J. P. Morgan & Co. Incorporated (JPM). JPM proposed to purchase a 45 percent equity interest in American Century Companies, Inc. (ACC) which, due to ACC's dual class structure, entitled JPM to a maximum of 10.83 percent of the voting power in ACC. In addition, JPM would enter into a stockholders' agreement, pursuant to which ACC agreed not to take certain specified actions (relating to transactions that could significantly alter ACC's structure or business as currently conducted) without JPM's prior consent. JPM also had the right, on a 25 percent or greater decline in ACC's assets under management (net of market changes) or extraordinary turnover in ACC's senior management, to replace certain members of ACC's senior management.

The SEC Staff agreed that common stock representing 10.83 percent of the voting securities of ACC is presumptively not a controlling block of voting securities of ACC and, based on this presumption and the other facts presented by the applicants, the acquisition of the stock by JPM would not result in an assignment of investment advisory agreements entered into by ACC. The SEC Staff's position was based on, among other things, the applicant's representation that JPM's rights under the stockholders' agreement: (1) were not intended to, and would not, give JPM the right to direct the day-to-day management of ACC; (2) would apply only in extraordinary situations; and (3) merely provided JPM with limited consent rights, as opposed to the right to direct affirmatively the activities of ACC.

Zurich Insurance Company, Scudder Kemper investments, Inc.

In 1998, the SEC Staff issued a no-action letter[8] to Zurich Insurance Company (Zurich) and its indirect subsidiary, Scudder Kemper Investments, Inc. (Scudder), concerning a complex series of transactions involving the transfer of a block of voting securities of Zurich exceeding 25 percent. Prior to the proposed transactions, Zurich indirectly owned 70 percent of the outstanding voting securities of Scudder. The applicants requested the SEC Staff's concurrence that the safe harbors of Rule 2a-6 under the 1940 Act and Rule 202(a)(1)-1 under the Advisers Act were not limited to nominal reorganizations.[9]

Zurich and B.A.T. Industries p.l.c. (B.A.T.) had entered into an agreement under which B.A.T.'s financial services businesses would be combined with Zurich's businesses. Since, for legal, tax, and accounting reasons it was not possible to structure the transaction as a direct merger between B.A.T. and Zurich, the parties structured the transaction to achieve an

equivalent result in which the former B.A.T. and Zurich shareholders would own the newly-combined company through the mechanism of dual public holding companies.

Zurich established a new holding company, Zurich Allied AG, a Swiss corporation (ZA). The shares of ZA were then exchanged for Zurich shares so that the then-current Zurich shareholders became shareholders of ZA. B.A.T. spun off its tobacco-related subsidiaries and distributed to its shareholders shares of a new holding company, Allied Zurich p.l.c. (AZ), which held its financial services subsidiaries. AZ then transferred these financial services subsidiaries to Zurich Financial Services, a newly formed Swiss corporation, and ZA also contributed all of the shares of Zurich received from the shareholders of Zurich to Zurich Financial Services. Once this transaction was completed, Zurich Financial Services would hold directly or indirectly all the Zurich businesses (including Zurich's 70 percent interest in Scudder) and the former B.A.T. financial services subsidiaries. ZA and AZ then would receive voting securities representing 57 percent and 43 percent, respectively, of the voting capital stock of Zurich Financial Services in exchange for these transfers, based on agreed upon valuations.

The applicants represented that prior to consummation of the proposed transactions, Zurich and B.A.T. were each a publicly held company with no controlling shareholder. In addition, after consummation of the proposed transactions, ZA and AZ were each expected to have no controlling shareholder. Accordingly, the applicants concluded that the proposed transactions satisfied the first two conditions of the SEC Staff's position set forth in the Dean Witter letter (i.e., no person who had control of Scudder before the consummation of the proposed transactions lost control after the consummation of the transactions and no person was expected to gain control of Scudder as a result of the proposed transactions), unless AZ's 43 percent interest in Zurich Financial Services constituted control of Scudder. The applicants also noted that the proposed transactions would not result in Scudder's being merged out of existence.

In support of the position that AZ would not gain control of Scudder as a result of the proposed transactions, the applicants made various representations regarding the continuity of management before and after the transactions, including: (1) steps would be taken to ensure that the membership of the boards of each of ZA, AZ, and Zurich Financial Services would converge as soon as possible; (2) a primary business objective of the transaction was not a combination of the asset management businesses of B.A.T. and Scudder; and (3) it was not expected that the transaction would result in material changes in the investment advisory personnel of Scudder.

The applicants inquired whether the safe harbors of Rule 2a-6 under the 1940 Act and Rule 202(a)(1)-1 under the Advisers Act, which deem an assignment not to occur in connection with transactions that do not result in a change of actual control or management of the investment adviser, would be available in connection with the Zurich-B.A.T. transaction. The applicants had obtained opinions of counsel that the contemplated transactions would not result in a change of actual control or management of Scudder within the meaning of Rule 202(a)(l)-1 under the Advisers Act. The applicants noted that in the proposing release for Rule 2a-6 under the 1940 Act, the analog of Rule 202(a)(1)-1, the no-action letters cited as examples of the types of transactions to which Rule 2a-6 would apply involved internal reorganizations with no change in ultimate ownership at the holding company level. The applicants stated that i Rule 202(a)(1)-i and Rule 2a-6 were interpreted t apply only to the types of transactions noted in the proposing release for Rule 2a-6, and not to transactions involving a change in presumptive control (the investment adviser, the relief provided by the Rules would be largely eviscerated.

The SEC Staff agreed that the Rules need not be limited in their application to nominal reorganizations but, significantly, refused to opine on whether the proposed transactions in fact fell within the ambit of the Rules. The Staff reiterated the SEC's prior statement that the determination as to whether a particular transaction involves a change of actual control or management of an investment adviser is primarily factual in nature and accordingly, the Staff is "not in a position to make the

investigation necessary to ascertain, verify, or evaluate the requisite factual information regarding particular transactions."[10] Scudder ultimately determined to seek the approval of its affiliated fund shareholders and the consent of its private advisory clients in connection with the proposed transactions.

Application to Specific Transactions

The interplay of the three no-action letters discussed previously illustrates that the determination of whether a transaction involves an actual change of control triggering the need for a proxy or consent solicitation involves a fact-intensive analysis that will not receive the benefit of endorsement by the SEC or its Staff. Because of the specter of litigation challenging the conclusion, and since the remedy for failure to sustain the conclusion is the repayment of the advisory fees—counsel and their client companies have been reluctant to stray far from the facts recited in Dean Witter and American Century Companies, Inc./J. P. Morgan & Co. Incorporated. Although it might be suggested that it is possible to structure a transaction purposely to avoid a proxy or consent solicitation, other business considerations often weigh more heavily in arriving at agreed deal terms. Moreover, transactions involving large financial services businesses typically are not simple "dollars for stock" arrangements, but generally involve complex valuation, payment, earn-out, and management rights provisions that vex the analysis. Therefore, it is difficult to generalize in this context about scenarios that either do or do not involve a change of control. Nevertheless, some observations can be made.

It is important to recognize in the first instance, that even when an effective change of control and consequent assignment does arise, consent needs to be solicited only from the shareholders of the funds and clients of the adviser that has undergone a change in control. Thus, in the simplest of circumstances, such as when one adviser acquires another, only the acquired adviser's fund shareholders and clients need to be solicited. Similarly, when one financial institution or its advisory subsidiaries are to be acquired by another financial institution, only the acquired company's affiliated funds and advisory clients would need to be the subject of a proxy or consent solicitation.[11]

> ***Transactions involving large financial services businesses typically are not simple "dollars for stock" arrangements.***

The Dean Witter letter suggests that there is significant latitude to conclude that some transactions—particularly those involving advisory organizations embedded in diversified financial institutions that themselves are publicly traded and widely held—do not involve a change of control triggering the necessity of seeking approval of affected fund shareholders or advisory clients. If one financial services company were to acquire or merge with another whose stock is also widely held, the transaction could be consummated without a shareholder vote by either participant's affiliated funds and without the consent of non-fund advisory clients, provided that the three conditions in the Dean Witter letter were met. That is, it could be concluded that: (1) no person who had control of either company before the merger lost control after the merger; (2) no person who did not have control of either company before the merger gained control of the combined company as a result of the merger; and (3) the merger did not result in an advisory subsidiary's being merged out of existence.

It is interesting to note, however, that notwithstanding the no-action relief granted by the SEC Staff in the Dean Witter letter, approval of fund shareholders and the consent of non-fund advisory clients was obtained in the Dean Witter transaction. Similarly, Scudder ultimately sought the approval of fund shareholders and the consent of non-fund advisory clients. Ironically, the authors are aware that other companies have relied on these precedents to conclude that their transactions did not result in an assignment.

If an advisory unit, rather than an entire publicly traded issuer conducting diversified businesses, is to be acquired or disposed of, a

shareholder vote by the affected funds would likely be required, especially if the unit were to be merged out of existence or otherwise had its management structure changed materially, as would often be the case in an acquisition of a discrete business unit. This result would be even more manifest when business control rights were vested in particular parties and, of course, in a circumstance in which the unit was sold to a company with concentrated ownership.

A joint venture combining the operations of two distinct investment advisory units would likely raise the prospect of a shareholder vote for many of these reasons. Moreover, the outcome in Zurich Insurance Company, Scudder Kemper investments, Inc., has prompted many practitioners to regard a dual holding company structure, which would be a likely feature of a joint venture arrangement, as not susceptible to analysis under the Dean Witter factors. Other counsel, however, adhere strongly to the view that two widely held joint venture partners are for this purpose substantively indistinguishable from a single widely held holding company. There may be some room, therefore, to envision a joint venture structure that does not involve the combination of two investment advisers in a manner that would involve a change of control. This might be the case, for instance, when each adviser manages different asset classes or pursues discrete investment strategies, each maintains separate and unchanged advisory personnel and operations, but both share a common sales apparatus and distribute income jointly to the two parent companies.

Summary

Determining whether a merger with, or acquisition of, an investment management company, or a company with an investment management subsidiary, will result in an assignment of investment advisory agreements between the investment management company and its clients is particularly significant in this period of consolidation in the investment management industry. Given the stakes of the judgment—the effective wagering of the enterprise's advisory fees—prudence would mandate that the analysis should be tested exhaustively and the determination be made at the highest levels. Moreover, to the extent that this determination cannot be made with a high degree of certainty, the best course of action may be to proceed as if the merger or acquisition will result in an assignment of the investment advisory agreements. This determination, and the resultant decision whether to seek approval of shareholders of funds advised by the adviser and the consent of non-fund advisory clients, should be made early in the planning stages of a transaction to allow sufficient time to obtain the necessary approvals.

NOTES

[1] See, e.g., Dean Witter, Discover & Co.; Morgan Stanley Group Inc., 1997 SEC No-Action Letter, LEXIS 548 (April 18, 1997). "Voting Security" is defined in Section 2(a)(42) of the 1940 Act as "any security presently entitling the owner or holder thereof to vote for the election of directors of a company."

[2] For a discussion of "assignments" of investment advisory agreements in situations not involving mergers or acquisitions, see Timothy P. Harris and Marc C. Cozzolino, "Change of Control and Contract Assignment: Ramifications for Investment Advisers and Investment Companies," Investment Lawyer, April 1998.

[3] See Dean Witter supra n.1.

[4] Approximately 12 percent of DWD was held by employees of DWD, and just over five percent of DWD was owned by a group of commonly advised investors. Id. at p.8, n.2.

[5] Id. at p.14, n.14.

[6] The agreements provided that with respect to each matter submitted to a vote of MS stockholders, the holders of the shares subject to the agreement would vote in advance of the vote of all MS stockholders. All shares subject to the agreements would then be voted in accordance with the vote of the majority of the votes cast in the preliminary vote.

[7] 1997 SEC No-Action Letter, LEXIS 1107 (December 23, 1997).

[8] Zurich Insurance Company, Scudder Kemper Investments, Inc. 1998 SEC No-Action Letter, LEXIS 811 (August 31, 1998).

[9] See id. at p.12.

[10] See id. at p.13 (quoting Release No. IC-10809 and Release No. IA-1013).

[11] It should be noted that under Rule 15a-4 under the 1940 Act, subject to certain conditions, consent of

fund shareholders may be obtained within 150 days of the consummation of a change of control transaction.