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## ACQUISITIONS OF INVESTMENT MANAGERS

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In recent times, acquisitions of control and minority stakes in investment managers have become prevalent. In a “people”-based service business such as this, and particularly considering certain regulatory concerns, these transactions raise several issues which should be considered by the participating parties, including those summarized below.

### Motivation for acquisitions

Acquirers of hedge fund and other investment managers may be motivated primarily by higher management and incentive fees, as well as the attributes of particular fund managers, in order to expedite growth of assets under management and spread costs over a larger base. Hedge fund investment managers may seek to be acquired for a number of reasons including:

- diversification of illiquid assets
- support for growth of assets under management such as:
  - marketing resources,
  - new products,
  - better financing terms,
  - raising additional funds,
- expense reduction; and
- improved benefits

### Valuation

Variations in valuation depend largely on the same factors as in conventional acquisition and financing transactions, such as revenue predictability, margins and growth. For investment managers in particular, these factors include:

- quality of investment team<sup>1</sup>
- infrastructure (front office, back office, accounting systems, etc.)
- sustainability of strategy
- stability of revenues, particularly as evidenced by the length of contracts;
- growth rate of assets under management;
- profitability of management and incentive fees/cost of overhead;
- length of track record
- loss carry forwards; and

- anticipated synergies

According to some sources, values typically may range from approximately three to eight times trailing annualized revenues. With respect to valuation methodologies for underlying securities or investments, managers also need to ensure compatibility between the acquired and acquiring firms in order to minimize the risk of post-closing confusion.

### Firm Management

Since most acquirers are buying the performance and track record of the investment managers of the acquired firm, it is common for the sellers to remain in charge of day-to-day operations and investment decisions. Additionally, it is less likely that clients of the acquired investment firm will withdraw their investment if the investment manager remains in charge. In fact, an agreement by the former managers to remain, accompanied by long-term employment and non-competition/non-solicitation agreements, is usually a condition to the transaction. Non-competition provisions may vary but typically will last for the longer of (a) three to five years after closing, or (b) one to two years after termination of employment. Restrictions on soliciting or advising clients may be painstakingly detailed, considering the nature of the industry.

Beyond day-to-day management, governance decisions typically will be delineated as those subject to control by the board, such as budgets and new products, or by the shareholders or the buyer, such as extraordinary transactions. Sometimes these approvals are required to be by super-majority.

### Fiduciary Duties

Investment managers owe a fiduciary duty to the funds they advise, and must act in the best interests of the funds and their non-fund clients. Conflicts of interest may arise between the interests of the funds and the clients, on one hand, and those of the investment adviser or manager, on the other hand, particularly since the economic interests of an investment manager may drive the investment manager to increase assets under management or take risks in its investing, which may not always be in the best interest of the fund or the manager's clients.

Managers considering a sale should consider many factors, including the following:

- likelihood of key management/investment team defections;
- compatibility of cultures with the acquirers, particularly to ensure an investor-oriented culture;
- investment objectives including proposed changes or restrictions;
- software integration;
- valuation;
- economies or diseconomies of scale;
- effect on operating expenses;
- tax consequences; and
- any additional/resulting expenses to be borne by the fund, such as increased costs for portfolio management, research or administration.

### Consents

Non-registered investment managers generally will be required to seek the consent of their fund and non-fund clients to an acquisition in accordance with the terms of their investment management contracts. This will, of course, depend on the nature of the transaction and the terms of the management contracts.

Registered investment advisors are subject to additional restrictions under the Investment Advisers Act of 1940, as amended:

- They are prohibited from profiting on the sale of their business unless:
  - For three years after the acquisition, at least 75% of the board of the registered investment advisor are disinterested; and
  - there is no burden imposed on the investment company and non-fund clients as a result of the transaction.
- Their investment advisory contracts automatically terminate if a change in control occurs, unless the majority of the fund shareholders consent to the assignment of the advisory contract and the fund's disinterested board members approve the new investment advisory agreement. Consent of non-fund clients also must be obtained.

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As the Securities and Exchange Commission recognizes that fund shareholders' consent is difficult to obtain, especially given the passive nature of most investment company shareholders, a negative option procedure generally is permitted.

- under an interim advisory contract, the registered investment advisor may continue the advisory relationship for 150 days after acquisition, if the following conditions are met;
- the fund's board of directors, including a majority of disinterested directors, must approve the interim agreement within 10 days after termination;
- advisor compensation can be no greater than under the terminated agreement;
- a majority of the fund's disinterested directors must determine that the scope and quality of services under the interim contract will be at least equivalent to that provided under the terminated agreement; and
- the disinterested directors' attorneys must also be disinterested.

In several instances, even where parties to an acquisition transaction have concluded that the consent of investment company shareholders would not be required, and even when the SEC has concurred, parties have sought such approval anyway, seemingly in order to eliminate risk from the transaction.

### Conclusion

Acquisitions of investment advisers and managers, whether they manage funds or have non-fund clients, are in many ways similar to acquisitions of any people-based service business. However, additional legal and regulatory requirements introduce complications which the parties must address. Appropriate structures, terms, client relations and other factors should be considered to maximize the likelihood of success of an acquisition of a registered or non-registered investment adviser or manager.



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