

Asset Management M&A: Deal Structuring, Due Diligence, Consent Requirements, and Regulatory Concerns

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Introduction – Types of Transactions and Rationale

- **Control or majority stake by financial buyer** – Acquisition by a financial buyer, such as a PE firm, of a controlling (> 25%) or majority stake
 - Rationale: Target presents attractive investment opportunity. Buyer typically not looking to change day-to-day operations of target
- **Control or majority stake by strategic buyer** – Acquisition by a strategic buyer, such as a PE firm, of a controlling (> 25%) or majority stake
 - Rationale: Buyer gains scale and/or complementary expertise. Buyers making a scale play generally take an active role in day-to-day operations post-closing, existing management more likely to remain in charge when adding complimentary expertise via acquisition that buyer does not currently have
- **Minority stake** – Acquisition of 25% or less of the voting securities of an asset manager
 - Rationale: Can be completed quickly because does not result in a new control person; typically does not require consent from clients or formal action by registered fund board
- **Fund adoption** – Transfer of the management of a fund from one asset manager to another
 - Rationale: Buyer acquires existing AUM; seller exits business line or lessens compliance burden
- **Joint Venture** – Two parties establish a joint venture to launch one or more new funds
 - Rationale: Two parties combine complimentary expertise (i.e., asset manager and distribution channel)
- **Fund Merger** – One or more funds merge into another fund
 - Rationale: Achieve economies of scale by combining funds with similar investment strategies, spin off a poorly performing business line and/or expose a fund to greater distribution opportunities

Transaction Structures for Control Acquisitions

Clients and Team Only

- Limited asset purchase — specific client contracts and key employees
- Buyer has maximum flexibility to acquire only desired assets
- Consideration structure highly flexible – could be revenue share only
- Liabilities are retained by the seller
- “Lift out” of investment teams

Asset Sale/Carve-Out

- Traditional asset purchase—core clients, assets and employees
- Often used to “carve out” business from a larger enterprise
- Consideration structure flexible – upfront payment to contingent
- Transition services and migration considerations
- Liabilities largely retained by seller

Whole Company/Equity Purchase

- Traditional whole company acquisition
- All assets and liabilities retained in acquired entities / indemnity
- Acquired entities include regulated entities and necessary infrastructure
- Consideration typically upfront payment with additional contingent

Public Company

- Public company target
- Deal terms largely dictated by public company “market terms”
- Limited conditionality for client retention
- Limited ability for contingent consideration or price adjustments
- No indemnity

Deal Stages and Key Considerations

- **Auction Process**

- Bid letter / IOI
- Joint transaction considerations in deal structuring
 - Is the fund a party to the deal? Is the fund a party to anything related to the deal? (e.g., buyer investing in the fund at closing)

- **Term Sheet Negotiation**

- ∅ Time spent up-front drafting clear terms will save time and headache down the road

- **Diligence**

- ∅ Scope of review varies deal by deal but focus is typically on reputational risk/red flags. Organization of diligence findings is critical; results of diligence will play a key role in deal documentation and negotiation (e.g., schedules, reps, client consents)
 - Diligence request list and data room review
 - Form ADV; Compliance; Regulatory exams/actions; Client complaints
 - Diligence meetings/calls and memo (e.g., red flags memo)

Legal and Other Due Diligence

- **Fund diligence**
 - Terms of existing funds (partnership agreements, side letters), including economics and liquidity
 - Ability of investors to withdraw (note hedge vs. PE funds; hybrid funds; “side pockets”)
 - No-fault removal or dissolution rights, contractual restrictions on change of control or other sale of business
 - “Carry leakage” / fee sharing obligations; fee discounts
 - Placement agent arrangements
 - Exclusivity and “competing funds” covenants
 - “MFN”; capacity rights in future funds)
 - “Key man” terms
- **Employment “Team” Diligence**
 - Restrictive covenants in existing employment arrangements; use of “track record”
 - Vesting of carried interest

Legal and Other Due Diligence

- **Specific regulatory issues**
 - CFTC registration / exemptions
 - Investment Advisers Act and investor consents (see in more detail below)
 - Registered investment advisers – robustness of compliance procedures and controls
 - Banking regulation / “Volcker Rule”
 - CFIUS
- **Regulatory issues – investor-related**
 - Public pension plan investors: “Pay to play” issues (placement agents, finders)
 - Sovereign wealth funds: FCPA, UK Bribery Act of 2010
 - Foreign individuals / financial institutions: anti-money laundering
- **Recent trends in diligence**
 - ESG
 - Allegations of inappropriate behavior

Deal Stages and Key Considerations (Continued)

- **Documentation**

- What is being bought/sold/left behind

- Defining the purchased assets

- Treatment of existing and future carried interest

- Carving out liabilities/escrows

- ∅ Track record – Confirm seller has support for all performance history; consider portability (e.g, similarity of accounts and continuity of management)

- ∅ Purchase Price

- ∅ Cash

- ∅ Equity

- ∅ Contingent payments/earn-outs

Deal Stages and Key Considerations (Continued)

- **Documentation (continued)**

- Purchase Price Adjustments

- Revenue run-rate at the closing date for clients that have consented to the transaction (“Closing RRR”) is compared to revenue run-rate existing at a fixed point in time (e.g., signing date or a prior date when data are available) (“Base RRR”)
 - A decrease in revenue run-rate from the Base RRR to Closing RRR will generally result in a correlative decrease in purchase price paid to the seller at the closing
 - Typically a one-way adjustment in buyer’s favor
 - Particularly where the minimum revenue run-rate condition is a buyer-only condition, the adjustment is typically subject to a floor
 - Adjustment metric can increase based on the size of the decrease
 - Sellers sometime negotiate a deductible or basket
 - “Deductible” is an amount of revenue run-rate decrease for which no negative price adjustment is made (often 1% to 5% of Base RRR)
 - Alternative is a “tipping basket,” which, if exceeded, results in the purchase price being reduced by the full (or partial) percentage decrease in revenue run-rate (rather than the percentage decrease in excess of the deductible)

Deal Stages and Key Considerations (Continued)

- **Documentation (continued)**

- Calculating revenue run-rate
 - Closing RRR is typically determined on a client-by-client basis by multiplying AUM at the closing by the annual fee rate on AUM at the closing
 - Closing RRR generally excludes increases or decreases due to market movement
 - Appreciation or depreciation of underlying investments is neutralized
 - Only inflows and outflows of AUM are counted
 - Typically inflows attributable to “related clients” (AUM belonging to sellers, employees and owners of the seller or entity being sold) are not counted in closing RRR
 - Outflows from related client accounts may be taken into account even if inflows are not
- Sellers typically deliver a schedule listing AUM and fee rates on a client-by-client basis at signing (for the Base RRR) and shortly prior to closing (for the Closing RRR)
- Post-closing true-up (“Penalty Box”)
 - To the extent there has been a downward revenue run-rate adjustment, seller may receive a subsequent true-up payment for clients that had not consented as of the closing, but that continue to have their assets managed by the seller for an agreed period of time following closing

Deal Stages and Key Considerations (Continued)

- **Documentation (continued)**
 - Contingent payments/earn-outs
 - Performance metrics vary widely and are deal-specific; examples include:
 - EBITDA or other P&L-based metrics
 - AUM or revenue run-rate
 - Limitations on buyer's conduct during the earn-out measurement period
 - Acceleration of earn-out (e.g., change of control or bankruptcy of buyer or sale of the target)
 - Duration of earn-out
 - ∅ Tying the duration and amount of earn-out payable to individual sellers to their continuing employment with the target post-closing may jeopardize the long-term capital gains treatment that those individuals would otherwise receive on such payments

Deal Stages and Key Considerations (Continued)

- **Documentation (continued)**

- Reps

- Revenue Run-Rate Schedule

- Typically sets forth by client, the name, assets under management, management fee and performance fee rates, and revenue run-rate

- Fund-level reps

- Undisclosed liabilities

- Affiliate transactions

- Compliance

- Other general reps usually sufficient; add more detailed/specific reps if buyer has particular diligence concerns

- Covenants

- Interim operating covenants

- Limitations on changes to fee rates

- American Century no-action letter

Deal Stages and Key Considerations (Continued)

- **Documentation (continued)**

- Covenants

- Various efforts standards (i.e., “best efforts,” “substantial efforts,” etc.) vs. “hell-or-high-water” standard (e.g., “all actions necessary”)
 - Compliance in “all material respects” – breach found if the buyer’s knowledge of a covenant breach would “significantly alter” the “total mix of information” when compared to the buyer’s reasonable expectations
 - Board/shareholder approvals
 - Board approval and recommendation; Proxy statement/N-14; Special meeting and shareholder approval
 - Ø Stock exchange rules generally requires shareholder approval before a listed company can issue 20% or more of its outstanding common stock or voting power
 - Private fund/SMA client consents
 - Interim agreements and Rule 15a-4
 - Safe harbor for sellers – Section 15(f)
 - Change in fund directors – Section 16(b)

Deal Stages and Key Considerations (Continued)

- **Documentation (continued)**
 - Closing conditions
 - Client consents
 - Closing RRR (often between 75% and 85%)
 - Consent of certain specified clients
 - Amendments to fund documents
 - Indemnity
 - Special indemnities for identified problems (e.g., regulatory issues or litigation)
 - Use of reps and warranties insurance

Important 1940 Act Provisions

- Section 15(c)
 - A Board has a duty to request, and adviser has a duty to provide, all information reasonably necessary for the board to evaluate the terms of a proposed advisory agreement
 - Boards should carefully consider the Gartenberg factors
- Rule 15a-4
 - Allows for a temporary interim advisory agreement with a duration of up to 150 days after an adviser undergoes a change of control to permit solicitation of shareholder approval
- Section 15(f)
 - Safe harbor to profit from sale of fiduciary office (discussed on next slide)
- Section 16(a)
 - At least two-thirds of the board must have been elected by shareholders (does not apply to BDCs)
- Section 16(b)
 - If directors are asked to resign in connection with an assignment of an advisory agreement or new vacancies are created to expand the board, the new directors may be required to be elected by shareholders if they are new independent directors and needed to satisfy Section 15(f)'s 75% independence requirement (does apply to BDCs)

Section 15(f) of the 1940 Act – Safe Harbor

- Section 15(f)
 - State law may prohibit the sale of a fiduciary office (i.e., an adviser's advisory business)
 - Section 15(f) provides a safe harbor protecting advisers who sell their business (or a controlling portion thereof)
 - An investment adviser to a 1940 Act fund can rely on the safe harbor if two conditions are met:
 - (i) At least 75% of a fund's board is independent of both the pre- and post-closing advisers for a period of three years; and
 - (ii) The transaction does not result in an "unfair burden" on the fund for a period of two years

Important Advisers Act Provisions

- Applies to registered investment advisers only; from March 2012 – essentially all US-based asset managers with more than \$150 million under management
- “Assignment” of advisory contract requires client’s consent
 - Change of control – “deemed assignment”
 - Use of analogies with Investment Company Act of 1940 – presumption of change of control at 25% of voting securities
 - 50%+ of economics, even with less than 25% voting rights, is likely to result in an assignment; also can be a close question for significant minority investments that include governance rights

Signing and Announcement

- Press Releases
 - ∅ Confirm public statements do not conflict with legal analysis (e.g., does not suggest change in day to day control if taking position there is no assignment)
- Employee Communications

Post-signing/pre-closing period

- **Client consent process**

- **1940 Act funds**

- Board approval of new advisory agreement – 15(c) process
 - Board approval of interim advisory agreement – Rule 15a-4
 - Board calls shareholder meeting and authorizes proxy (if needed)

- **Proxy/N-14 considerations**

- Schedule 14A proxy for change of control of adviser or new adviser
 - SEC has 10 days to review preliminary proxy statement
 - N-14 for fund merger
 - Registration statement for shares of the acquiring fund to be issues to shareholders of the target fund (in addition to serving as the proxy statement)
 - SEC has 30 days to review, may involve multiple rounds of comments as SEC must declare the N-14 effective
 - Wording of proposals is important, effectiveness of proposal should be contingent on deal closing in certain types of deals
 - Materials announcing the transaction sometimes need to be filed as solicitation material

- **Private funds/SMAs**

- Advisers Act requires advisory agreements include a provision providing for client consent in the event of an assignment (Section 205)
 - Affirmative consent vs. negative consent

Post-signing/pre-closing period

- **Regulatory process**
 - Antitrust (HSR) – not always required, but always checked
 - FINRA (for deals involving a broker-dealer)
 - Rule 1017
 - Materiality consultation/continuing membership application
 - Stock exchange (for publicly traded advisers or funds)
 - Exchange rules generally require a shareholder vote for a buyer if the buyer is issuing shares equal to 20% or more of its pre-transaction outstanding shares
 - Supplemental listing application or listing of additional shares application

Closing

- **1940 Act fund considerations**
 - NAV determinations for fund mergers
 - Execution of advisory agreement

Post-closing

- **Closing date board meeting**
 - Appointment of officers
 - Compliance manual and other policies, code of ethics
 - Appointment of new directors/officers (Form 3 required)
 - Reliance on exemptive relief (e.g., co-investment relief)
- **Post-closing filings**
 - Deregistration (1934 Act, 1940 Act, Advisers Act)