THE SCOPE OF INVESTMENT ADVISERS’ FIDUCIARY DUTIES WHEN THEY MERGE

Hristiyaniya Atanasova

I. Introduction

Mutual fund shareholders should be wary when investment advisers merge. Moreover, when merging, advisers should be even more concerned because as fiduciaries they must consider the best interests of the funds they manage. There has recently been a spate of mergers between investment advisers within the investment management industry. Some advisers merged to achieve economies of scale, reduce distribution and marketing costs, and to acquire specialized research expertise. But some of these mergers have been unsuccessful due to incompatibility of advisory cultures, software integration problems, diseconomies of scale, and the defection of key personnel. As a result of these unsuccessful transactions, the investors in those mutual funds suffered.

The Investment Company Act of 1940 (the “Investment Company Act” or “ICA”) and the Investment Advisers Act of 1940

1 J.D., Boston University, 2008. I would like to thank Professor Tamar Frankel for her valuable guidance and Professor Robert Volk for his helpful comments. I would also like to thank Bruce Kessler and my family for all of their love and support.
2 A mutual fund as referred to in this Note is an open-end, diversified investment company within the meaning of 15 U.S.C. § 80a-5 (2000). This Note refers to mutual funds and investment companies interchangeably.
3 See infra Part VI.
4 See Lawrence C. Strauss, Quarterly Mutual Funds Review: When Fund Marriages Go Bad, BARRON’S, Oct. 8, 2007, at L5. Most news articles do not distinguish between mergers of advisers and mergers of mutual funds, but use the two interchangeably. Furthermore, some news articles use the terms an investment adviser and a money manager interchangeably. This Note discusses only mergers of investment advisers. An investment adviser as referred to in this Note is defined as an adviser of an investment company within the meaning of 15 U.S.C. § 80a-2(a)(20) (2000).
5 See id.
6 See Strauss, supra note 4.
7 See id.
Investment advisers' fiduciary duties govern the mergers and acquisitions of investment advisers. Subject to certain limited exceptions, the Investment Company Act prohibits the assignment of advisory contracts without the approval of a majority of the investment company's shareholders. A merger or acquisition of investment advisers usually results in the assignment of the investment advisory contracts. Therefore, the adviser cannot provide services to the investment company until the majority of the investment company's shareholders approve the new advisory contract. Furthermore, an investment adviser is a fiduciary of the investment company and, thus, it cannot place its interests before the interests of the investment companies it advises. An investment adviser cannot profit from the sale or change of control of its business if, as a result of such a transaction, the investment company would suffer an "unfair burden."

According to some scholars, despite this apparently broad regulation, investment advisers are not rigorously regulated. Many mergers of investment advisers fail and thereby harm the financial interests of investment companies and their shareholders. This Note examines the scope of investment advisers' fiduciary duties when they want to merge. Part II discusses the statutory and regulatory framework governing investment advisers. Part III discusses the origins of investment advisers' fiduciary duties to their investment companies. In Part IV, this Note examines the current regulation of mergers and acquisitions of investment advisers under the Investment Company Act. In Parts V and VI, respectively, this Note addresses the positive and negative effects of such mergers and acquisitions on investors. Part VII defines the constantly evolving

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12 Herlihy, supra note 10, at 390.
17 See Strauss, supra note 4.
scope of investment advisers’ fiduciary duties to investment companies. This Note argues that an adviser’s fiduciary duties should encompass consideration of the impact of a merger or acquisition on its investment companies prior to entering into a merger or acquisition agreement. These fiduciary duties should focus on the retention of key management, compatibility of the merging advisory cultures, diseconomies of scale, software integration and valuation methods. Many advisers already may consider all or some of the above mentioned factors prior to a merger or an acquisition for business reasons. This Note argues that advisers’ fiduciary duties require consideration of these factors before entering a merger or an acquisition transaction. Finally, Part VIII outlines the process advisers should use to comply with their fiduciary duties in the mergers and acquisitions context prior to entering into such transactions.

II. Regulation of investment advisers

The Securities and Exchange Commission (the “Commission” or “SEC”) has the authority to regulate investment advisers under the Advisers Act.18 Section 202(a)(11) of the Advisers Act defines an investment adviser as:

any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.19

Section 2(a)(20) of the Investment Company Act defines an investment adviser to an investment company as:

(A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or

employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and (B) any other person who pursuant to contract with a person described in clause (A) of this paragraph regularly performs substantially all of the duties undertaken by such person described in said clause (A). 20

Usually, only advisers that have at least $25 million of assets under management or “that provide advice to investment company clients are permitted to register with the Commission.” 21

The Advisers Act assumes that every investment company will be advised by an investment adviser. 22 Rule 204A-1 23 of the Advisers Act requires investment advisers to adopt a code of ethics that requires compliance with the applicable Federal Securities Laws. 24 The code of ethics must prescribe standards of business conduct, which reflect advisers’ fiduciary obligations. 25

III. The origin of advisers’ fiduciary duties

The Advisers Act is “based on the central premise that investment advisers are fiduciaries to their clients.” 26 Section 206 27 of the Advisers Act creates the statutory fiduciary relationship between investment advisers and their client investment companies. 28 Section 206 is an anti-fraud provision that applies to all advisers that meet the statutory definition of an investment adviser under the Advisers Act, regardless of whether or not the advisers is

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21 Regulation of Advisers, supra note 18.
24 Id.
25 Id.
26 FRANKEL, supra note 16.
28 Id.
registered with the Commission.\textsuperscript{29} Section 206 makes it unlawful for an investment adviser to “engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”\textsuperscript{30}

In SEC v. Capital Gains,\textsuperscript{31} the United States Supreme Court considered the scope of the fiduciary duties imposed by Section 206.\textsuperscript{32} In Capital Gains, the Supreme Court had to decide whether the Commission could compel “a registered investment adviser to disclose to his clients a practice of purchasing shares of a security for his own account shortly before recommending that security for long-term investment and then immediately selling the shares at a profit upon the rise in the market price following the recommendation.”\textsuperscript{33} The Court considered whether that practice, known as “scalping,” constituted fraud within the meaning of the Advisers Act.\textsuperscript{34} The Court ruled that it was fraud and thus the Commission could require the adviser to fully disclose the practice to the clients.\textsuperscript{35}

The Court’s decision turned on determining Congress’s intent behind Section 206.\textsuperscript{36} The Capital Gains Court considered the legislative history of the Advisers Act and the developments in common law fraud at the time that the Advisers Act was enacted.\textsuperscript{37} Based on that analysis, the Court stated that the statute clearly recognizes an adviser’s fiduciary relationship to its clients.\textsuperscript{38} The Court stated that the fiduciary has “an affirmative duty of ‘utmost good faith, and full and fair disclosure of all material facts,’ as well as an affirmative obligation ‘to employ reasonable care to avoid misleading’ his clients.”\textsuperscript{39} This duty is consistent with the Commission’s interpretation that the Advisers Act “prohibits misstatements or misleading omissions of material facts and other

\textsuperscript{29} Regulation of Advisers, supra note 18.
\textsuperscript{32} Id. at 191.
\textsuperscript{33} Id. at 181.
\textsuperscript{34} Id.
\textsuperscript{35} Id. at 181-82.
\textsuperscript{36} Id. at 185-86.
\textsuperscript{37} Id. at 186-95.
\textsuperscript{38} Id. at 194.
\textsuperscript{39} Id. (citing PROSSER, LAW OF TORTS (1955), 534-535) (citing HARPER & JAMES, THE LAW OF TORTS 541 (1956)).
fraudulent acts and practices in connection with the conduct of an investment advisory business.”

IV. Mergers and acquisitions of investment advisers and how they are regulated

In 2007, there were 195 mergers and acquisitions of investment advisers, with a total value of approximately $52.8 billion. This represented roughly a 19% increase in deal value compared to 136 deals worth $44.5 billion in 2006. Among the reasons for the rise in the number of mergers are the “[c]ompetitive pressures and the importance of scale, cross-selling opportunities, the desire to expand product offerings, the desire to add to fee based revenues, the desire to expand distribution capabilities, as well as the need to obtain the specialized marketing expertise that many investment advisers have developed.” Another reason to merge investment advisers is to acquire key managerial personnel. Usually, the purchasers of investment advisers are banks, brokerage firms, insurance companies and other investment advisers.

A. Special Considerations in Mergers and Acquisitions of Investment Advisers

Mergers and acquisitions of investment advisers present issues that are unique to the investment company industry. Investment advisers are typically the sponsors or organizers of the investment companies they advise. And investment advisers control the funds’ operations while shareholders of the funds remain

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40 Regulation of Advisers, supra note 18.
42 Id.
43 Id.
44 Herlihy, supra note 10, at 388.
46 Id.
47 John D. Rea, Brian K Reid & Kimberlee W. Millar, Operating Expense Ratios, Assets, and Economies of Scale in Equity Mutual Funds, 5 INVESTMENT COMPANY INST. PERSP. 1, 4 n.10 (1999).
passive. Generally, the only relationship between an investment adviser and mutual fund is the investment contract. Furthermore, when an adviser wants to sell its business, the purchase negotiations are only between the investment adviser and the purchaser and, thus, do not directly involve the shareholders of the investment company.

A purchaser of an investment adviser no doubt realizes that the primary assets of the investment adviser “are its people and its advisory relationships” with the investment companies. These advisory contracts are automatically terminated upon assignment, usually resulting from a sale or merger of the advisory business. Thus, to minimize investment companies’ run-offs, many buyers demand that their acquisition agreements “contain client consent closing conditions expressed in terms of permitted percentage changes in revenue run-rates or assets under management between a pre-signing date and the closing date.” Purchase agreements also may contain a purchase price reduction clause that is triggered upon reduction of the assets under management to a specified threshold. Such clauses balance the “seller’s need for certainty of closing” and the buyer’s level of assumption of risk for loss of certain percentage of client accounts.

B. Regulation of Mergers and Acquisitions of Investment Advisers

The Advisers Act and the Investment Company Act are the federal statutes which govern mergers and acquisitions of investment advisers to investment companies. This section outlines potential conflicts of interest that may arise in merger situations and the corresponding regulatory responses.

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48 Zhou, supra note 44, at 3.
49 See id.
50 Id. at 5.
51 Herlihy, supra note 10, at 388.
53 Herlihy, supra note 10, at 390.
54 Id. at 388-389.
55 Id. at 389.
56 Id.
57 Id.
1. Assignment of Investment Advisory Contracts

Section 15(a)\textsuperscript{58} of the Investment Company Act provides that an investment adviser’s contract with a registered investment company shall provide that “it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered [investment] company . . . on not more than sixty days’ written notice to the investment adviser.”\textsuperscript{59} Furthermore, the advisory contract should provide “for its automatic termination in the event of its assignment.”\textsuperscript{60} The purpose of Section 15(a) is to prevent an investment advisor from selling its fiduciary office.\textsuperscript{61}

The Investment Company Act further defines “assignment” in Section 2(a)(4) to include “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.”\textsuperscript{62} Section 2(a)(9) presumes “control” if a person “owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company.”\textsuperscript{63} Thus, mergers or acquisitions of investment advisers usually result in an assignment of the advisory contracts from the target investment adviser to the acquirer or merger partner.\textsuperscript{64} Even when two equally sized parent companies of investment advisers merge, “a conservative reading of the [Investment Company Act] would suggest that both companies treat the parent merger as a ‘change of control’ under Section 15(a) for their investment adviser subsidiaries.”\textsuperscript{65} However, the Commission has given no-action letters ruling that no assignment of the advisory contracts had occurred in certain stock-for-stock mergers of public parent companies, where the adviser subsidiary continues to exist.\textsuperscript{66}

Moreover, after a change of control, an investment adviser cannot continue its advisory relationship with the funds absent approval of new advisory contracts by the funds’ boards of directors.

\textsuperscript{61} Herlihy, supra note 10, at 390.
\textsuperscript{64} Herlihy, supra note 10, at 390.
\textsuperscript{65} Id. (Emphasis in the original).
\textsuperscript{66} Id. at 390-91.
and shareholders, unless interim advisory contracts exist. Thus, investment advisers “should take special care” when informing investment companies about a pending merger or acquisition and when “seeking their approval of a new investment advisory contract.” In deciding when is the best time to inform investment companies of the pending transaction, investment advisers, together with the purchaser or merging partner, should consider deal-specific factors such as confidentiality, financing availability, and the reputation of the purchaser. Unfortunately, neither the Investment Company Act nor the Advisers Act provides clear guidance on when the advisers should notify investment companies about the pending change of control. Section 15(c) of the Investment Company Act merely imposes on advisers the duty to provide directors of investment companies with any information that may reasonably be necessary to evaluate their advisory contracts.

2. Interim Advisory Contract Exemptions

As mentioned above, a merger or acquisition of an investment adviser usually results in a change of control that leads to an assignment of the advisory contract. An investment company’s shareholders must approve the assignment of the investment advisory contract, unless there is an interim advisory contract. But obtaining shareholder approval of the new contract is a very long process. According to some commentators, obtaining a mutual fund shareholder vote “can be more difficult than obtaining a shareholder vote from public companies” because most investors in mutual funds are very passive.

69 Herlihy, supra note 10, at 391.
70 Id.
71 Id.
73 Herlihy, supra note 10, at 390.
76 Herlihy, supra note 10, at 391.
77 Id.
Rule 15a-4\textsuperscript{78} of the Investment Company Act allows an investment adviser to continue the advisory relationship with its investment company under an interim contract after the termination of the previous contract if the fund shareholder approval cannot be obtained prior to closing the deal.\textsuperscript{79} The fund’s board of directors, including a majority of disinterested directors, must approve the interim contract within ten business days of the termination of the previous contract.\textsuperscript{80} The advisory relationship may continue under an interim advisory contract for 150 days after a change of control transaction as long as the adviser compensation under the interim contract is no greater than the compensation under the previous contract.\textsuperscript{81} In addition, the majority of the fund’s disinterested directors must determine that “the scope and quality of services to be provided to the fund under the interim contract will be at least equivalent to the scope and quality of services provided under the previous contract.”\textsuperscript{82}

3. Section 15(f) Safe Harbor

As mentioned above, an investment adviser is a fiduciary to the investment companies with whom it has advisory contracts.\textsuperscript{83} Thus, as a fiduciary, an investment adviser cannot sell its office for personal gain.\textsuperscript{84} The Second Circuit ruled in Rosenfeld\textsuperscript{85} that “an investment adviser and its shareholders may be liable to an investment company client and its shareholders for any profits arising out of the sale of the adviser.”\textsuperscript{86} However, the decision in Rosenfeld was superseded by the enactment of Section 15(f) of the Investment Company Act.\textsuperscript{87} Section 15(f), also known as the “safe harbor” provision, allows investment advisers to retain profits resulting from an assignment of advisory contracts if certain

\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{82} 17 C.F.R. § 270.15a-4(b)(2)(iii) (2006).
\textsuperscript{84} Herlihy, supra note 10, at 395.
\textsuperscript{85} Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), cert. denied, 409 U.S. 802 (1972).
\textsuperscript{86} Herlihy, supra note 10, at 395.
\textsuperscript{87} Meyer v. Oppenheimer Mgmt. Corp., 895 F.2d 861, 865 (2d Cir. 1990).
conditions are met. First, for a period of at least three years after the change of control, “at least 75 per centum of the members of the board of directors of such registered company” should not be interested. Second, no “unfair burden” should be imposed on the investment company as a result of the transaction resulting in change of control. Section 15(f)(2)(B) defines “unfair burden” as any arrangement, during the two-year period after the closing of such transaction whereby the investment adviser . . . receives . . . any compensation directly or indirectly (i) from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of such company, other than bona fide ordinary compensation as principal underwriter for such company, or (ii) from such company or its security holders for other than bona fide investment advisory or other services.

A purchaser of an investment advisory business thus cannot pay any part of the purchase price from future advisory fee increases. Potential buyers should be careful not to violate the requirements of Section 15(f) safe harbor provision by purporting to raise fees or cut services after the transaction.

V. Positive effects of mergers of advisers on mutual funds’ shareholders

All mutual funds have three major categories of expenses that are paid out of the funds’ assets under management. First, usually the largest fund operating expense is the advisory fee that compensate funds’ investment advisers for portfolio management

88 Herlihy, supra note 10, at 396.
91 Id.
92 See id.
93 Herlihy, supra note 10, at 396.
services such as research and analysis. The second category is operating expenses for administrative services such as legal, regulatory, tax, accounting, and transaction services to shareholders and other administrative matters. The third category, which not is an operating expense, are fees that are used to compensate sales professionals for advertising, marketing and distribution services.

The driving force behind mergers and acquisitions of advisers is the creation of synergies. Synergies result from “the combination of complementary resources or economies of scale.” Economies of scale create the potential for cost savings in operating and distribution expenses. Mergers and acquisitions of investment advisers produce economies of scale because many operational costs of investment management companies such as research and trading technologies are fixed.

Furthermore, many funds employ declining rate schedules in their advisory contracts; these provide for the reduction of the percentage fee rate as assets increase to a certain threshold. Mergers of mutual funds may lead to economies of scale, which reduces the pro rata cost of portfolio management and shareholder servicing. However, if a fund grows by increasing the number of accounts while it holds the accounts’ size constant the economies of scale are much smaller. Thus, in cases of mergers and acquisitions of investment advisers, when advisers merge some of their funds, the benefits of economies of scale will be much smaller than if the funds were to grow by increasing the size of their accounts.

“[T]he average cost curve of a typical mutual fund is downward sloping over the entire range of fund assets.”

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95 Id.
96 Rea, supra note 47, at 4.
97 Id.
98 Zhou, supra note 44, at 4.
99 Id.
100 Id.
102 Rea, supra note 47, at 4.
103 Amel, supra note 101, at 28.
104 Id.
105 See Amel, supra note 101, at 28.
106 Id.
Furthermore, “the ratio of operating expenses to fund assets, a proxy of the managerial and administrative efficiency of a fund, declines steadily as assets grow and reaches a low of 70 basis points for the group of funds with over $5 billion in assets.”107 Thus, by expanding the scale of their operations, advisers achieve efficiency and productivity gains that tend to reduce fund expenses.108

Additionally, mergers of advisers may lead to economies of scope.109 The economies of scope in the investment management context are usually “cost efficiencies arising from advertising and administering multiple funds by the management company.”110 Since all funds in a fund complex share common resources, an individual fund’s expenses may decrease as the overall size of the fund complex increases.111

VI. Negative effects of mergers of advisers on mutual funds’ shareholders

Some investment advisers are motivated to merge or sell their advisory business not only because of the above mentioned synergies, but also because they want to cash out “with a big pay day.”112 Moreover, according to Geoffrey Bobroff, a fund consultant, “[o]rganic growth is hard to come by and people are looking at alternatives”113 and “[t]he cost of acquiring a new customer has gone up.”114 Unfortunately, not all mergers are successful for buyers or the investment companies’ shareholders.115

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107 Rea, supra note 47, at 8.
108 See Amel, supra note 101, at 29.
109 See Rea, supra note 47, at 5 n.15.
110 Id.
111 Id.
112 Strauss, supra note 4.
114 Id.
115 Id.
A. Integration of Advisory Cultures

The firm culture of the investment adviser is very important for the success of the funds they manage. According to Andrew Donahue, Director of the Division of Investment Management of the SEC, a successful fund manager should have an investor-oriented culture rather than a culture that promotes self-interest. Donahue reiterated that fund directors should expect “a fund’s adviser to have a fiduciary mindset.” For example, Laurence Fink, BlackRock’s chief executive, says that successful integration of the advisory cultures of Merrill Lynch and BlackRock may take years. Thus, if the cultures of the merging advisers and their respective clients diverge significantly, certain inefficiencies and costs would result, which in turn would injure the financial interests of the funds’ shareholders.

B. Key Management Changes

Key management defection is one of the most cited reasons for unsuccessful acquisitions of investment advisers. According to commentators, investors should reassess their investment if a new manager is assigned to their fund. In 2001, Marsico Capital Management became a wholly-owned subsidiary of Bank of America. Before the transaction Marsico Funds was an autonomously managed boutique with a stellar track record. According to Neil Donahoe, Chief Investment Officer of SYM Financial Advisors and an investor in funds run by Marsico, “[t]he thing we look for is not so much the name on the door, but who’s

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116 See Andrew Donahue, Director, Division of Investment Management U.S. Securities and Exchange Comm’n, Speech by SEC Staff: Keynote Address at the Mutual Fund Directors Forum Institute (Mar. 1, 2007).
117 Id.
118 Id.
119 Strauss, supra note 4.
120 See id.
121 See id.
123 Id.
124 Id.
managing the fund.” Donahoe stated that he is concerned as an investor only when the merger of advisers results in change of management within two years of the transaction. Donahoe shared that he is loyal to the fund managers rather than the funds they manage.

When AMG acquired Friess Associates, an adviser for the Brandywine funds complex, AMG took special care to assure Brandywine shareholders that the acquisition would not result in any changes the way the funds are run. AMG assured investors that Foster Friess, the founder star manager of the Brandywine funds, along with other senior managers had signed ten-year employment contracts. Investors usually worry when key managers leave as a result of change in ownership. According to Donald Cassidy, Brandywine shareholders had no reason to redeem their shares because the current Friess Associates key managers will continue to run the funds. When key managers leave, investors should evaluate whether the new management can continue that funds’ successful track record.

C. Software Integration

The biggest consolidations in the mutual fund industry in the last couple of years were Legg Mason’s acquisition of Citigroup Asset Management in 2005 and the merger of Merrill Lynch Investment Managers into BlackRock in 2006. Only the BlackRock-Merrill merger resulted in gains for fund investors. The market reacted favorably to the BlackRock-Merrill merger because it “progressed more smoothly in the integration of back-office systems, asset retention and, probably most important,

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125 Id.
126 Id.
127 Id.
128 Paul Katzeff, Foster Friess Sells 51% of Brandywine Funds But Independent-minded Fund Manager’s Role is Not Seen Changing, INVESTOR’S BUS. DAILY, Aug. 30, 2001, at B3.
129 Id.
130 Id.
131 Id.
132 See Merger Effect, supra note 122.
133 Strauss, supra note 4.
134 Id.
in investment performance.” Furthermore, according to one fund manager, one of the reasons that the BlackRock deal was successful, unlike the Legg Mason deal, was because BlackRock is considered more technologically savvy than Legg Mason and “good computer systems are essential for successful integration.” Thus, mergers between advisers with different software platforms may create inefficiencies and cost time and money to investment companies and their shareholders.

D. Diseconomies of Scale

While mergers of smaller funds may produce economies of scale, mergers of larger funds may produce diseconomies of scale. The term diseconomies of scale describes the situation where, as funds grow, they become less liquid and less flexible. Indeed, as assets under management grow, additional expenses are needed for portfolio management, investment research and fund administration. Thus, additional labor and capital may be required to manage the new funds’ size.

Moreover, while the average fund’s expenses “diminish over the full range of fund assets,” for large funds on the other hand, this “rapid decrease in average costs is exhausted by about $3.5 billion in fund assets.” So if mergers and acquisitions of funds result in behemoth funds with more than $3.5 billion of assets under management, there are no economies of scale in terms of reduced expenses. As a result, fund shareholders typically suffer from the reduced flexibility and increased average trade costs. If mergers and acquisitions of advisers are followed by mergers of funds, fund shareholders may suffer financially as a result of diseconomies of scale. Additionally, funds may experience diseconomies of scale

135 Id.
136 Id.
137 See id.
138 See Amel, supra note 101, at 29.
139 Id.
140 Rea, supra note 47, at 4.
141 See id.
142 Latzko, supra note 94.
143 See id.
144 See Amel, supra note 101, at 29.
145 See id.
even if the consolidation is only at the advisers’ level because operating expenses increase as the total assets under management grow.146

E. Valuation Issues

A merger of two significantly different advisers may result in valuation problems post-deal.147 According to Ryan Caldwell, an analyst at Waddell & Reed Financial, Legg Mason “spent three or four quarters getting analysts comfortable with what the numbers were.” This delay in valuation resulted in a loss of Legg’s credibility among analysts and investors.148 Time is of crucial importance in the investment management business and an adviser that fails to quickly announce to the investment community the new financials after a merger or acquisition, is likely to suffer on the market.149

F. Different Investment Strategy

Section 8150 of the Investment Company Act requires that the registration statement of a mutual fund should contain a description of the investment policies of the fund.151 Investors should be concerned when funds with divergent investment strategies and objectives merge.152 Such mergers and acquisitions can upset investment companies’ shareholders’ asset allocations.153 For example, when AIM Investments wanted to merge its Aggressive Growth fund, a small and mid-cap fund, into its Constellation fund, a midsize and large-cap fund, AIM stated in its proxy statement that “[a]ggressive Growth fund shareholders may lose most of their current small-cap exposure.”154 Furthermore, when Columbia

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146 See Rea, supra note 47, at 4.
147 See Strauss, supra note 4.
148 Id.
149 See id.
154 Laise, supra note 152.
Management merged its Newport Tiger fund, an Asian-stock fund, into its Columbia International Stock fund, a general foreign-stock fund, the management tried to justify the loss of exposure to Asian stocks by pointing out that the fund would continue to invest in international stocks, but with reduced expenses. The reduced fees, which should translate into reduced costs, may be good news for some shareholders, but such a merger nevertheless derails the investment objectives of investors who strategically select such a fund with a specific investment strategy in mind.

If a merger of investment advisers is followed by a merger of some of their funds with divergent strategies, shareholders of the investment companies may suffer. And advisers may try to convince funds to change their investment strategies even without encouraging the funds to merge. Funds may change the investment policies contained in their registration statements only with the approval of the majority of voting shareholders. But due to the relationship of power between advisers and their funds, the passive nature of the fund investors, and the fact that it is the adviser-sponsor that initially prescribed the general investment strategies, such shareholder approval might be easily obtained.

VII. Reexamining the scope of advisers’ fiduciary duties in mergers and acquisitions

Investment advisers dominate the relationship with the investment companies they advise, and because of this domination, the Supreme Court in Capital Gains ruled that an investment adviser is a fiduciary to the funds it advises and owes them “an affirmative duty of ‘utmost good faith, and full and fair disclosure of all material facts,’ as well as an affirmative obligation

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155 Id.
156 See id.
157 See id.
159 See Zhou, supra note 44, at 3.
160 Id. at 6-7.
162 See Zhou, supra note 44, at 3.
'to employ reasonable care to avoid misleading’ his clients.” As a fiduciary, the investment adviser must act in the funds’ best interest. An adviser must make the requisite disclosure of all material facts and conflicts of interests. However, no federal statute prevents an adviser from selling its business when the advisor fails to consult the funds it manages.

A problem arises when an adviser decides to go ahead with a merger before consulting the investment companies or giving them short notice. Due to the unique relationship between the investment adviser and the funds it advises, many of the funds may feel locked-up and thus, may approve the new advisory contracts simply because finding a comparable adviser is costly and time consuming. Furthermore, an adviser may be able to persuade its funds to approve the new advisory contracts simply because the new contracts offer the same or lower fees and similar services.

As discussed above, mergers and acquisitions of advisers sometimes injure investors because they produce diseconomies of scale. Further problems arise when the mergers and acquisitions of advisers lead to defection of key management, failure to assimilate culture, problems with software integration and valuation. Moreover, under the current regulations there is no rule requiring investment advisers to consider investment companies’ interests when deciding whether and with whom to merge or sell their advisory business. Although there is no explicit section or rule under the Investment Company or Advisers Act, there is an implicit fiduciary duty that advisers must consider investment companies’ best interests when they merge. The Supreme Court and the Commission long ago decided that investment advisers owe fiduciary duties to the funds they manage. Thus, to achieve the Commission’s goal of placing the funds’ interests first, an

164 Richards, supra note 14.
165 Capital Gains, 375 U.S. at 180.
166 See Herlihy, supra note 10, at 391.
167 Zhou, supra note 44, at 6.
169 See Strauss, supra note 4.
171 See Regulation of Advisers, supra note 18; see Richards, supra note 14.
investment adviser should consider funds’ interests even before an adviser signs a preliminary merger agreement.

A. The Unique Context of the Adviser-Fund Relationship

Two very important factors have the potential to create adviser-fund conflicts of interest. First, if the adviser is the sponsor of the investment company, the adviser is responsible for selecting the fund’s board of directors. Further, the adviser usually “provides personnel to manage and operate the fund, including officers and affiliated directors.” And the adviser-sponsor “identifies affiliated or outside contractors to provide ancillary services to the fund.” The adviser decides the general investment strategies and hires key management.

Second, mutual fund shareholders are usually not active because they are small investors and, thus, it is easier for them to simply redeem their shares than it is to directly exercise their voting power. One of the main reasons for the lack of shareholder activism is that most mutual fund shareholders invest their money with the objective to be passive investors. Most mutual fund shareholders buy into mutual funds because they want to be passive and have someone else actively manage their investments, while they share in the return. So if an adviser wants to proceed with a merger, the fund would probably support the adviser’s decision because it had always followed the adviser’s lead and finding a comparable new adviser may be a costly and timely pursuit.

\[^{172}\text{Zhou, supra note 44, at 6.}\]
\[^{173}\text{Id.}\]
\[^{174}\text{Schonfeld, supra note 161.}\]
\[^{175}\text{Id.}\]
\[^{176}\text{Id.}\]
\[^{177}\text{Zhou, supra note 44, at 6-7.}\]
\[^{178}\text{See id. at 3.}\]
\[^{179}\text{See id.}\]
B. Defining the Scope of Investment Advisers’ Fiduciary Duties to Investment Companies

1. Early Common Law Fiduciary Duties

In *Capital Gains*, the Supreme Court case that announced the existence of fiduciary relationship between an investment adviser and its investment company clients, the Court stated that the fiduciary relationship to another party originates in the common law of fraud.\(^ {180} \) The Supreme Court further ruled that Congress, in enacting the Investment Advisers Act, was aware of the developments in the common law of fraud.\(^ {181} \) Therefore, in examining the scope of investment advisers’ fiduciary duties, it is worth reviewing fiduciary duties existing before the enactment of the Advisers Act. Justice Cardozo described the higher duty of a fiduciary:\(^ {182} \)

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.\(^ {183} \)

According to Ms. Richards, Director of the Office of Compliance Inspections and Examinations of the Securities and Exchange Commission, it can be reasonably inferred from Cardozo’s famous ruling that “[a] fiduciary must act for the benefit of the person to whom he owes fiduciary duties, to the exclusion of any contrary interest.”\(^ {184} \)


\(^{181}\) Id.

\(^{182}\) Meinhard v. Salmon, 249 N.E. 545 (N.Y. 1928).

\(^{183}\) Id. at 546.

\(^{184}\) Richards, *supra* note 14.
2. Common Law Fiduciary Duties Post-Capital Gains

The Supreme Court in *Capital Gains* further stated that common-law fraud, the source of the fiduciary duties established in *Capital Gains*, are not static, and instead evolve with the relationship between the fiduciary and its investment companies.\(^\text{185}\) So we now turn to the case law handed down after the enactment of the Advisers Act. In *Rosenfeld*, the Second Circuit ruled that an adviser “endeavoring to influence the selection of a successor must do so with an eye single to the best interests of the beneficiaries.”\(^\text{186}\) The Court stated that, because the adviser is a fiduciary, the sale of an advisory contract for profit “has some elements of the sale of a fiduciary office [which was] strictly prohibited at common law because of the conflicts of interests which are involved.”\(^\text{187}\) Moreover, investment advisers owe investment companies and their respective shareholders the highest fiduciary duties.\(^\text{188}\)

Furthermore, the Commission has also stated that “as a fiduciary, an investment adviser owes its clients undivided loyalty, and may not engage in activity that conflicts with a client's interest without the client's consent.”\(^\text{189}\) According to Ms. Richards, the first and most important duty an investment adviser has, as a fiduciary, is to consider clients’ interests first.\(^\text{190}\)

At least one Court has recognized that potential conflicts of interests exist when an adviser is selling its business.\(^\text{191}\) Therefore, advisers have fiduciary duties to act in clients’ best interest in the mergers and acquisition context. To comply with these fiduciary duties advisers must consider funds’ best interest in selecting a merger or acquisition partner. Additionally, to properly consider

\(^\text{185}\) *Capital Gains*, 375 U.S. at 193.
\(^\text{187}\) *Id.* at 1347 (citing REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 151 (1966)).
\(^\text{189}\) Regulation of Advisers, *supra* note 18.
\(^\text{190}\) Richards, *supra* note 14.
funds’ best interests, advisers should evaluate the compatibility of the advisers’ cultures, investment objectives, software integration, possibility of diseconomies of scale, key management defection, and valuation methods.

C. Potential Conflicts of Interests between Advisers and Investment Companies in Mergers and Acquisitions of Advisers

The relationship between investment advisers and mutual funds and their respective shareholders is “fraught with potential conflicts of interest.” The SEC, in the wake of numerous recent scandals, has become even more concerned that “the obligations attendant to this duty [of undivided loyalty] [have been] lost on the growing number of advisers.” Thus, the Commission promulgated a rule that required advisers to adopt code of ethics. Unfortunately, nothing in the rule requires advisers to consider their conflicts of interests with the investment companies they advise in the context of mergers and acquisitions with other advisers.

Conflicts of interest between advisers and the funds they manage exist because most advisers are motivated to merge to obtain more assets under management, which translates into more fees generated. Usually an adviser argues that the merger results in economies of scale, which would reduce fees. However, as mentioned above, this does not always happen, and many mergers result in a low return for investors. This is exactly the type of conflict of interest that should be prevented. So as a fiduciary, an investment adviser should make a careful evaluation of the compatibility of the merging partner’s culture, software, valuation methods, management objectives and other considerations that may be of high importance to the particular funds under management.

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192 Burks v. Lasker, 441 U.S. 471, 481 (1979) (citing Galfand v. Chestnutt Corp., 545 F.2d 807, 808 (2d Cir. 1976)).
195 See id.
196 See Zhou, supra note 44, at 5.
197 See Laise, supra note 152.
198 Strauss, supra note 4.
VIII. How can advisers satisfy their fiduciary duties in the mergers and acquisition context?

There are many possible regulatory solutions to ensure that advisers consider their funds’ best interests and comply with their fiduciary duties. The Commission has reiterated on a number of occasions that the scope of adviser fiduciary duties come “not from the SEC, or another regulator, but from common law.” Therefore, the best approach to define the scope of advisers’ fiduciary duties in the mergers and acquisitions context is to refer to the common law fiduciary doctrine.

First, the Commission could require that investment advisers make public disclosure of the anticipated transaction before a merger deal is even signed. Such disclosure would inform fund shareholders of the change of control and would give them an opportunity to redeem their shares before the transaction takes place. However, it seems unlikely that the Commission would promulgate a rule requiring such preliminary disclosure. Mergers often depend on obtaining financing and involve the exchange of confidential information and thus an early disclosure of the merger plans may work against the interests of the merging parties. So such a mandatory disclosure rule could prevent efficient mergers and harm both funds and advisers.

Second, Congress could codify adviser duties in merger transactions as it did for mergers of funds and their affiliates. Section 17 of the Investment Company Act proscribes certain transactions between investment companies and their affiliated persons. The Commission adopted amendments to Rule 17a-8 that permit mergers of mutual funds and some of their affiliates. The Commission requires that “each fund’s board (including a majority of disinterested directors) determine that the merger is in the best interests of the fund and will not dilute the interests of

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199 Richards, supra note 14.
200 Herlihy, supra note 10, at 391.
The Commission further prescribed a list of factors that each board must consider, if relevant:

- Any fees or expenses that will be borne directly or indirectly by the fund in connection with the merger;
- Any effect of the merger on annual fund operating expenses and shareholder fees and services;
- Any change in the fund's investment objectives, restrictions, and policies that will result from the merger; and
- Any direct or indirect federal income tax consequences of the merger to fund shareholders.

The list of relevant factors is not exhaustive and the Commission notes that “[c]onsideration of these specific factors does not relieve a board of the obligation to consider other relevant factors.” However, a similar codification may not be the best solution in mergers and acquisitions of advisers because many of the considerations mentioned in Part VI, above are constantly evolving and are specific to the particular adviser-fund relationship. For example, following the investment objectives may be crucial for certain funds, but software integration might be more significant in another context.

Finally, the best solution is for advisers to promulgate internal rules similar to the requirements of Rule 204A-1. Advisers would be required to adopt internal fiduciary duties guidelines that would be disclosed to the Commission. Advisers would list the relevant factors that may have a material impact on the funds they

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203 Id.  
204 See id.  
205 Id.  
206 Id.  
207 Advisers may adopt the materiality standard as outlined in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976). “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . [T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the
advise in advisers’ mergers or acquisitions. Such factors could include some of the considerations mentioned in Part VI that could potentially harm funds and their shareholders in mergers. For example, advisers may consider advisory cultures, investment objectives, software integration, defection of key personnel, and diseconomies of scale. However, the factors would vary from one adviser fund relationship to another. Furthermore, disclosure to the Commission would encourage advisers to make more extensive analysis of the relevant factors. Failure of advisers to consider the factors that are material to their clients would be a violation of their fiduciary duties. Advisers are in the best position to come up with such a list of factors because they know their business and the funds they manage better than anyone else. Additionally, this approach would provide more transparency to fund shareholders.

Of course, almost no merger or acquisition transaction could likely satisfy all listed material factors. Thus, advisers should consider all relevant factors as a whole rather than any particular factor. For example, an adviser may believe that retention of key managers, culture, and software integration are of material importance to the funds in a merger. However, if a potential merger produces economies of scale, allows retention of key managers and culture, but causes a software integration problem, the adviser may go ahead with the transaction if the benefits outweigh the cost of the software integration problem.

IX. Conclusion

Investment advisers owe fiduciary duties to the funds they advise.\footnote{SEC v. Capital Gains, 375 U.S. 180, 194 (1964).} Investment advisers should act in the best interests of the funds they advise and their shareholders.\footnote{Richards, supra note 14.} When there is a conflict of interest between an adviser and the funds it advises, the conflict should be resolved in favor of the funds.\footnote{See id.} Mergers and acquisitions of investment advisers may present such conflicts of interest because
there is an inherent tension between advisers’ desire to profit and the funds’ best interests. As mentioned above, not all mergers and acquisitions of investment advisers are successful and, as a result, sometimes investment companies and their shareholders suffer. Therefore, advisers’ fiduciary duties should also encompass consideration of the funds’ best interests in the mergers and acquisitions context. An adviser should consider the funds’ best interests when selecting a merger or acquisition partner. The best way to assure consideration of these interests is for the advisers to adopt internal guidelines, disclosed to the Commission, that outline the relevant factors that may have material impact on the funds in an adviser merger. Advisers should consider these relevant factors as a whole. Advisers can satisfy their fiduciary duties if the benefits of a merger outweigh any negative effects of the transaction.

211 See Strauss, supra note 4.