

## In Securities Deals, Plan for the Regulators

**Know the rules and avoid delay.** By John V. Ayanian, Stephen H. Cohen, Monica L. Parry, and Beth D. Kiesewetter

Over the past decade, the securities industry has undergone significant consolidation. Broker-dealers, investment advisers, and registered and unregistered investment funds have sought opportunities to find synergies, create economies of scale, and eliminate redundancies.

As with most business transactions, closing speed is a primary goal for the deal makers. The sooner the transaction closes, the earlier the firms can realize the benefits of the transaction and minimize customer and employee attrition.

Because of the highly regulated nature of the securities industry, however, achieving this important goal (as well as establishing a framework for efficient post-closing integration) requires thinking through from the outset the regulatory issues that may arise in the transaction.

A number of milestones along the path to closing exist where firms should take the opportunity to consider key regulatory issues beyond performing due diligence and negotiating the transaction agreement. Analyzing key regulatory issues early will make the transaction more efficient. The following discussion identifies several of these milestones.

### REGULATORY APPROVALS

At the outset, although any deal has pressing corporate, tax, employment, and antitrust issues related to the structuring of the combination, the regulatory timetable, in both the near and the long term, is critical to determining the appropriate structure for the combination, especially in the securities industry.

Conventional wisdom suggests that buyers typically prefer to structure combinations as asset-purchase transactions, and sellers favor stock deals, for a variety of sound reasons.

In particular, buyers prefer asset purchases because they allow

the buyer to acquire specific assets and business lines of the seller selectively, avoid assuming the seller's liabilities, receive a "stepped-up" tax basis on the assets acquired, obtain the option—but not the obligation—to hire the seller's employees, and choose which of the seller's client and service-provider agreements to maintain.

Conversely, sellers generally favor stock purchases because the buyer typically takes not only the assets, but all of the related liabilities.

But when it comes to transactions involving participants in the securities industry, regulatory issues often drive the decision to select one structure over another.

For example, the buyer of a broker-dealer may prefer structuring the acquisition as a stock transaction to streamline the near-term review-and-consent process for the broker-dealer's primary regulator (such as the National Association of Securities Dealers or the New York Stock Exchange) as well as for the broker-dealer's customers.

In stock deals, few changes (other than potential changes in certain key officers and directors) that would require significant regulatory scrutiny typically occur on the closing date. Broker-dealers typically maintain branch-office structure, branding, employees, clearing arrangements, order-routing methodologies, and other service arrangements until post-closing integration. As such, the NASD, in Membership and Registration Rule 1017, allows a member firm to close a stock transaction upon 30 days' written notice—even if the NASD has not yet formally approved the change of equity ownership. Asset deals not involving two NYSE member firms are subject to the NASD's formal approval process before the transaction can close.

NYSE members, although not subject to a formal application review and approval process similar to NASD Rule 1017, are subject to various posting (vetting before the other NYSE members) requirements for the transaction. This includes the *NYSE Weekly Bulletin* posting (up to two weeks prior) of any new trading-license holders, directors, and principal executive officers; member-firm name changes; and corporate reorganizations involving the member firm.



The NYSE typically requires that before posting these events, all corporate consents (including shareholder votes) must have already been obtained. Like the NASD, the NYSE will review an asset deal more closely if it has a larger number of moving pieces. These include branch-office and personnel changes as well as changes of clearing platforms. Although many of these changes ultimately will occur and require regulatory approvals, companies should remember that the fewer changes to the continuing operations and structure of the broker-dealer at the outset, the more quickly the broker-dealer's primary regulator should be able to approve the initial transaction.

Investment advisers, however, need not wait for approval of a business combination from the Securities and Exchange Commission. Typically, the buyer can rely on the registration of the acquired adviser, so long as that adviser is no longer conducting business.

Registered-fund mergers, on the other hand, require the filing of the SEC's Form N-14 or a proxy statement, which can take weeks or months to clear the SEC's review process. Fund directors also must approve the merger. Early planning is thus critical.

Customer-notification and disclosure requirements for securities-industry combinations in today's market are rarely so straightforward, however. Acquisitions of broker-dealers often involve mixed financial products as well as complex interdependencies upon affiliated or unaffiliated advisers and funds. Although these disclosure issues typically arise when integrating the firms' products and services after the deal closes, it is never too soon to review notices and consents for compliance with the current regulatory guidance. In particular, the following areas warrant evaluation:

- **Brokerage customer agreements**

It is important to review the seller's form of brokerage customer agreements to determine whether an assignment of the agreement is permissible. For a stock deal, this will not be an immediate issue because the deal will not trigger an assignment of the underlying customer agreement. For an asset deal (and for a stock deal in the post-closing integration period), the assignment of customer agreements will require advance written customer notice. For most asset deals, the NYSE or NASD will closely scrutinize these customer notices and related disclosures in the approval process.

- **Investment-advisory contracts**

For a transaction involving advisory agreements, regardless of whether it is structured as a stock deal or an asset purchase, the acquisition of an adviser or its agreements generally triggers an "assignment" under the Investment Advisers Act of 1940 and the Investment Company Act of 1940 (known as the 1940 Act).

The Advisers Act requires nonregistered-fund advisory contracts to require client consent to an assignment, and the 1940 Act provides that the contracts of the fund's adviser and principal underwriter automatically terminate upon their assignment. The Advisers Act and the 1940 Act broadly define an "assignment" to include a transfer of a controlling block (that is, 25 percent or more) of the assignor's outstanding voting securities, and "control" as the power to exercise a controlling influence over the management or policies of a company. As a result, a purchase of an investment adviser or a financial-services company that owns

or controls any investment adviser, or the purchase of the principal underwriter to a registered fund, usually results in an assignment of the contract.

The buyer of a nonregistered-fund adviser should check client contracts to determine if the contract can be assigned through a negative-consent process (that is, failure to object after receiving notice, thus authorizing the assigning firm to continue to manage the client's account). Even if using negative consents, buyers should anticipate that the consent process will typically involve a 45-day period that, if possible, should be completed before closing.

If the consent process straddles the closing date, the purchase agreement should contemplate that some advisory agreements may not transfer, resulting in an accompanying reduction in the assets that will be ultimately transferred. The buyer of a registered-fund adviser should ensure that it has obtained fund board and shareholder approval before the closing—or risk having no advisory or underwriting contracts in place upon closing.

- **Broker-dealer/investment-adviser interrelationships**

Securities-industry combinations involving broker-dealers often reveal interrelationships between broker-dealers and affiliated or unaffiliated investment advisers. For example, a buyer may want to develop or expand its mutual-fund or variable-annuities business and thus wish to acquire not only the broker-dealer acting as the product's underwriter and distributor, but also the adviser to the funds and the fund or contract assets themselves. Each of these acquisitions will trigger additional regulatory notification requirements and issues in valuing the deal, not to mention further review by the primary regulator of the broker-dealer.

- **Cash sweeps**

One of the most common regulatory issues for combinations involving a broker-dealer involves the changes to cash—"sweep" products for brokerage customers. Such sweep products automatically invest idle cash balances in customers' brokerage accounts into money-market mutual funds or bank accounts. These cash-sweep products, and the movement of assets between them, have attracted a tremendous amount of regulatory scrutiny during the past few years, and further regulatory guidance regarding bank-sweep products is expected in the near future.

In connection with these transactions, broker-dealers typically consider bulk transfers from one money-market mutual fund to another, or a so-called drain-and-fill from a money-market mutual-fund-sweep product to an FDIC-insured bank-sweep account. The regulatory scrutiny and consent process will depend largely on the selected approach, the limitations in the seller's form of customer agreements, and the use of appropriate disclosures. Again, to the extent that the buyer learns of this issue at an early stage, the post-closing integration plan can be tailored accordingly.

## REGULATORY DUE DILIGENCE

Securities-industry combinations present complex due-diligence issues that are often overlooked until far too near to closing. Typically, this occurs because the buyer and seller devote their time to the business logistics of the deal rather than the

deal's legal issues. At the end of the process, counsel may discover a lurking issue while reviewing the proposed opinions and their underlying representations.

For example, in a transaction where the buyer intends to acquire both private funds organized as a master-feeder complex (in which feeder funds invest all their assets in a master fund) and the funds' private-placement agent and investment adviser, the seller's counsel will need to opine on whether the funds have a good exemption or exception from registration.

But counsel to the buyer and seller may differ on their interpretation of the law. For example, buyer's counsel may require an opinion on the use of a Section 3(c)(1) feeder fund where the master fund relies on Section 3(c)(7) of the 1940 Act. If seller's counsel for the deal did not organize the funds, neither seller's counsel nor its officers and directors may be comfortable with providing factual representations, much less a legal opinion, on that issue without a backup opinion from the law firm that

formed the funds. The sooner these regulatory issues are flagged, the earlier in the process they can be resolved.

Given regulators' heightened scrutiny of the securities industry during recent years, both buyers and sellers should carefully consider the regulatory aspects of proposed deals from day one. Deciding early about the structure of the deal, the disclosures to customers, the consents from clients, the scope of related legal opinions, and the post-closing integration issues are all critical to avoiding regulatory pitfalls along the path to closing.

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