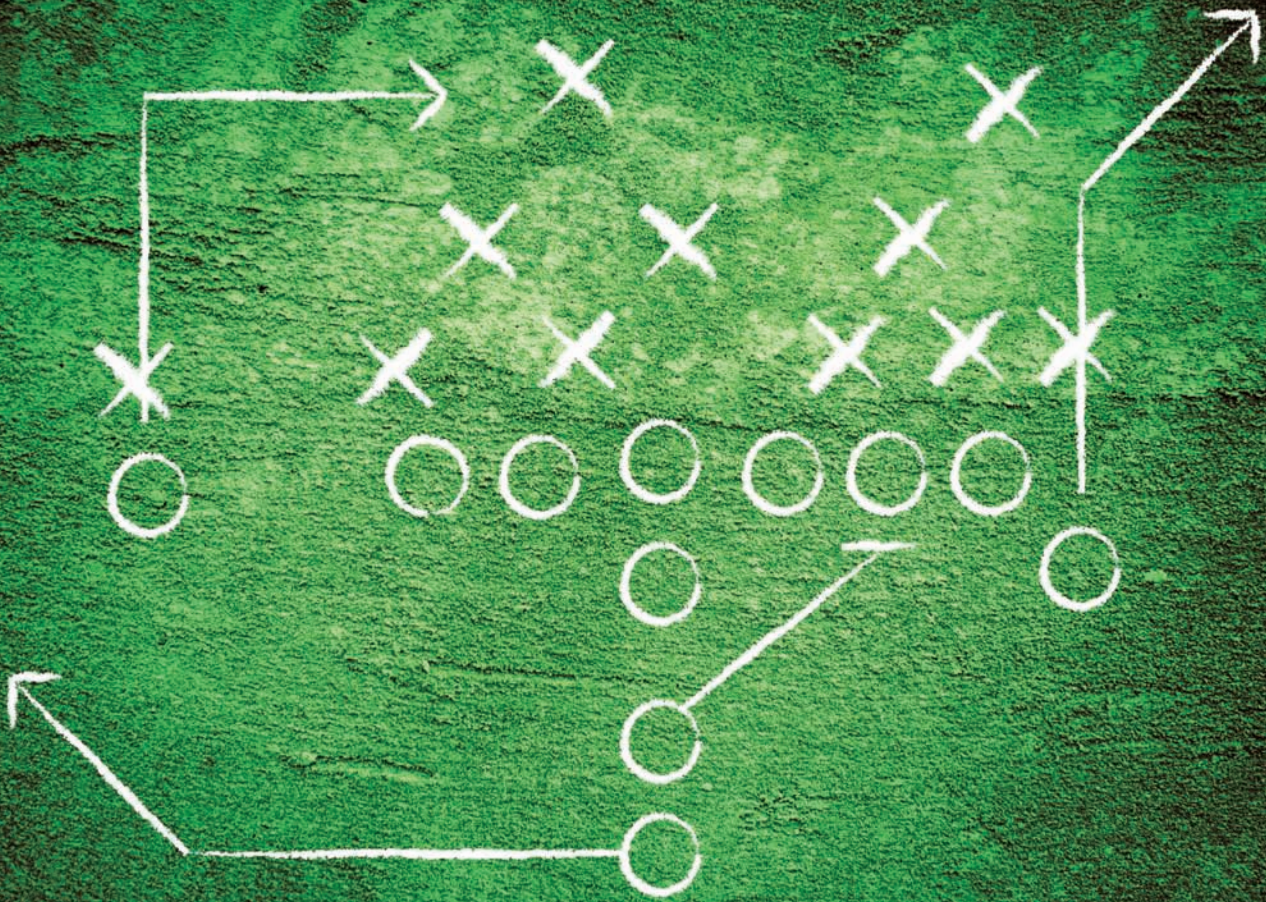

# M&A Transactions in the Investment Management and Securities Industry

## KEY ISSUES AND CONSIDERATIONS

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M&A activity in the investment management and securities industry has recently been on the rise and is expected to continue to gain momentum. This article identifies key issues and considerations for each phase of an M&A transaction in this highly regulated environment.

M&A activity in the investment management and securities industry has been on the rise since the economy started showing signs of recovery in 2010. It is expected to continue to grow due in large part to recent regulatory reforms, including the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and Basel III.

Financial analysts anticipate that both strategic buyers looking to increase earnings and private equity buyers looking to use committed capital will seek to capitalize on favorable market valuations (see *Positioning for Growth, 2011 US Financial Services M&A Insights, PriceWaterhouseCoopers LLC, April 2011*). Broker-dealers, investment advisers, asset managers and other similar financial institutions are likely targets of this increased M&A activity because, among other factors:

- Regulatory reforms will likely increase operating and compliance costs for these companies. This increase may result in large institutions continuing to divest non-core operations and underperforming subsidiaries, and smaller institutions continuing to consolidate to create cost efficiencies and increase product offerings.
- Specific financial reforms, such as the Volcker Rule, will require some companies to divest certain businesses to achieve compliance. The Volcker Rule limits investments of banking organizations in hedge funds and private equity funds and broadly prohibits, subject to limited exceptions, proprietary trading (for more information on the Volcker Rule, search Summary of the Dodd-Frank Act: The Volcker Rule on our website).

>> For a Practice Note that tracks the rules and regulations which implement the Dodd-Frank Act, search Road Map to the Dodd-Frank Act on our website.

>> For an overview of Basel III and more information on how Basel III will impact US banks, search Basel III on our website.

M&A transactions in the investment management and securities industry present many industry-specific issues. M&A practitioners in this space need a thorough understanding of the highly regulated environment in which the industry operates (see *Box, Investment Management and Securities Industry*).

This article identifies key issues and considerations for each phase of the transaction, including:

- How the transaction structure can affect which governmental approvals and third-party consents are required.
- Which areas of due diligence require particular attention.
- Potential issues to take into account when drafting and negotiating the transaction documents.
- Factors to consider when planning for the post-closing integration of the target into the buyer's organization.

## TRANSACTION STRUCTURE AND REQUIRED CONSENTS

Because companies in the investment management and securities industry operate in a highly regulated environment, the transaction structure can significantly impact governmental approvals and third-party consents. In turn, the amount and complexity of the necessary approvals and consents can significantly impact the time that it takes to close the transaction.

### GOVERNMENTAL APPROVALS

The governmental approvals that are needed before closing the transaction (if any) and the amount of time it takes to obtain those approvals depend on, among other things:

- How the transaction is structured.
- Whether the target has any regulated subsidiaries.
- Which governmental entities have authority over the operations of the target.

A company operating in the investment management and securities industry may be regulated by multiple agencies, including:

- The Securities and Exchange Commission (SEC).
- The Commodity Futures Trading Commission (CFTC).
- Self-regulatory organizations (SROs), such as the:
  - Financial Industry Regulatory Authority (FINRA);

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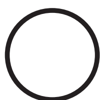

- National Futures Association (NFA); and
- Chicago Mercantile Exchange (CME).

The parties must consider the particular type of company and the regulators involved. For example, if the target is:

- A broker-dealer and a FINRA member, and the transaction is structured as an asset deal (often a buyer-favored structure), the transaction must be approved by FINRA before closing. However, if the transaction is structured as a stock deal, FINRA Rule 1017 allows the parties to close the transaction after a 30-day waiting period, even if FINRA has not yet officially approved the transaction.
- An investment adviser, typically neither a stock nor an asset transaction requires the approval of the SEC because the buyer should be able to rely on the registration of the target as long as (in the case of an asset purchase) the investment adviser whose assets are being sold ceases to conduct business.

In addition, in most M&A transactions there are certain other changes that may trigger regulatory consent issues. For example, if the parties contemplate changing the name of the company or replacing key officers and directors of the target, they may want to make these changes at or immediately after the closing to avoid having to make additional post-closing applications (such as a FINRA continuing membership application).

In other transactions, however, postponing these changes until after the closing may reduce the number of pre-closing required approvals or the level of regulatory scrutiny of the transaction and thereby expedite the closing process.

### THIRD-PARTY CONSENTS

The type and number of necessary third-party consents should also be considered during the structuring stage. The consents required depend on, among other things:

- How the transaction is structured.
- The type of products the target sells, executes, clears, advises or manages.
- The specific assignment, change of control or successor language contained in the target's customer agreements.

For example, if the target is:

- A broker-dealer and the transaction is structured as an asset purchase, depending on the exact assignment or successor language contained in the target's customer agreements, the seller may be able to rely on the negative consent of the target's customers (see *Box, Affirmative or Negative Consent*).
- An investment adviser, a stock transaction involving a change of control of more than 25% of the target's outstanding voting securities is considered an "assignment" under the Investment Advisers Act of 1940 (Advisers Act) and the Investment Company Act of 1940 (1940 Act). Therefore, the transaction may require the affirmative consent of customers and service providers depending on the specific assignment, change of control or successor language contained in the target's customer agreements. The Advisers Act requires affirmative consent for the assignment of a nonregistered-fund advisory contract and the 1940 Act provides for the automatic termination of the fund's advisory contracts and principal underwriter contract on an assignment.
- An adviser to a registered fund, a change of control of the adviser or an assignment of the advisory contract requires the approval of the board of directors of the fund, as well as the consent of all of the fund's shareholders. This is a lengthy process involving the preparation and SEC review of a proxy statement.

## DUE DILIGENCE

In many respects, conducting a due diligence review of a company operating in the investment management and securities industry is similar to typical diligence practices. However, there are several diligence areas that present specific issues, such as:

- Regulatory matters.
- Material contracts.
- The products offered, executed, cleared, advised or managed by the target.
- The compensation structure used by the target for its key employees.

The due diligence findings in these areas can affect all aspects of the transaction, including the structure of the purchase price, the negotiation of representations, warranties and indemnification and the covenants and conditions to closing that will be required to ensure a seamless transition from the seller to the buyer.

### REGULATORY MATTERS

Regulatory due diligence is particularly important. Counsel must:

- Confirm that the target has not committed any material regulatory violations and is not subject to material regulatory investigations or inquiries that could taint the buyer's otherwise clean record.
- Determine whether any restrictions or requirements have been imposed on the target's business by a regulator (for example, limits on the types of products the target is allowed to offer or a requirement that all sales calls be recorded).
- Ensure a smooth and seamless integration of the target company into the buyer's organization after the transaction closes.


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## INVESTMENT MANAGEMENT AND SECURITIES INDUSTRY

The investment management and securities industry covers a broad range of companies, as well as numerous asset classes and types of products. Having the appropriate regulatory experts involved throughout the M&A transaction is critical, but to represent the client effectively, M&A counsel should have an understanding of the type of company the target is and the asset classes and products that it sells, executes, clears, advises or manages.

The various types of companies that operate within the investment management and securities industry include:

- Investment advisers.
- Broker-dealers.
- Asset managers.
- Exchanges or alternative trading systems.
- Non-bank lenders.
- Investment companies.
- Futures commission merchants.
- Commodity trading advisers.

The types of asset classes or products offered by these companies vary depending on the type of company, and can include:

- Stocks.
- Bonds.
- Mutual funds.
- Hedge funds.
- Fund of funds.
- CLO or CDO funds.
- Exchange-traded funds.
- Collective investment vehicles.
- Swaps.
- Commodities.
- Futures.
- Retirement products (such as IRAs and 401(k) plans).
- Asset-backed securities.
- Mortgage-backed securities.
- Loans.
- Treasuries.

A buyer should also understand the target's regulatory capital requirements and how the target calculates the amount of regulatory capital it is required to maintain. Following the closing, the target will be subject to the same regulatory capital requirements. However, because the target (depending on the transaction structure) will potentially have a new parent company with a different capitalization, the amount of regulatory capital that the target company will be required to maintain after the closing may differ from the amount it was required to maintain before the closing.

### MATERIAL CONTRACTS

As discussed above, counsel must be fully aware of all the material contracts to which the target is a party and what third-party consents may be required when determining the transaction structure. In addition, the buyer must have a complete picture of required third-party consents under the material contracts to determine:

- Which consents should be required as conditions to closing.
- Whether affirmative or negative consent is required (see *Box, Affirmative or Negative Consent*).
- Whether customer retention is a concern that should be addressed (for example, if a customer has to affirmatively consent to the transaction, it may be inclined to look at alternative providers).

Counsel should also be aware that any retail customer contracts are usually form contracts that are updated from time to time on a going-forward basis. Therefore, it is important to get copies of all versions of the various form contracts that may still be in effect.

Further, it is essential that all the appropriate subject matter experts review the customer agreements. For example, if the target company is a broker-dealer that introduces or clears retirement products, both a broker-dealer specialist and an ERISA specialist should review the customer agreements to:

- Ensure that the contracts comply with all applicable laws, rules and regulations.

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## AFFIRMATIVE OR NEGATIVE CONSENT

When a company is required to obtain affirmative consent from a customer to something such as a change in control, it can be time consuming and require substantial resources to follow-up with customers who do not respond in a timely fashion.

However, in some cases, a regulated entity is allowed by its primary regulator to send a notice to a customer that describes the transaction and tells the customer that his account will transfer as part of the transaction to the buyer, unless he responds within a certain period of time (typically 30 to 45 days). This is referred to as negative consent. The negative consent process typically takes 45 to 60 days, which includes the time it takes to prepare the notice and, if required, obtain the approval of the consent letter from the target's primary regulator.

The negative consent process is preferred by the transaction parties because it not only reduces the time period between signing and closing, but is also more beneficial for customer retention purposes.

- Determine whether consents will be required in connection with the contemplated transaction.
- Determine whether disclosures must be made to customers (for example, certain customer disclosures are required if the cash sweep option or the investment options will change).

### TARGET COMPANY PRODUCTS

The buyer must have a solid understanding of the products that are offered, executed, cleared, advised or managed by the target company. This is critical for overall integration purposes and necessary to determine whether:

- The buyer will need any transitional services.
- The buyer has comparable product offerings that it would like to integrate with the target's products.
- There will be any issues involved with converting the target's customers over to the buyer's platform.

### COMPENSATION STRUCTURES

The compensation structures for key employees of asset managers, funds and other financial institutions often involve a large deferred compensation or incentive bonus component. This means that a significant portion of compensation for services rendered before the acquisition may be payable by the buyer after the closing. The buyer should understand how this compensation structure works early in the process so that it can determine whether the purchase price should be adjusted or a covenant should be included in the transaction agreement to address deferred compensation payments (see below *Deferred Compensation and Incentive Bonuses*).

## DRAFTING AND NEGOTIATION

In addition to the typical matters that counsel must consider when drafting and negotiating the M&A transaction documents, there are a number of factors and potential issues that are specific to the investment management and securities industry, such as:

- Ensuring that there is an adequate amount of regulatory capital following the closing.
- Accounting for future deferred compensation or incentive bonus payments in the purchase price.
- Setting thresholds that the target must meet following the closing for assets under management or other similar financial indicators.
- Including appropriate, industry-specific representations and warranties, covenants and indemnification provisions in the transaction agreement.

>> For a Standard Document for a long-form agreement for the purchase and sale of a division or line of business of a private US corporation, with explanatory notes and drafting and negotiating tips, search Asset Purchase Agreement (Pro-Buyer Long Form) on our website.

>> For a Standard Document for a long-form agreement for the purchase and sale of all of the outstanding capital stock of a private US corporation, with explanatory notes and drafting and negotiating tips, search Stock Purchase Agreement (Pro-Buyer Long Form) on our website.

### MAINTENANCE OF SUFFICIENT REGULATORY CAPITAL

Continued maintenance of regulatory capital is critical for many companies in the investment management and securities industry (such as broker-dealers and trust companies) and the amount of regulatory capital required to be maintained can change daily. Therefore, a buyer should consider how it will ensure that the target company has the required amount of regulatory capital immediately following the closing. There are two primary ways to do this:

- **The seller leaves cash with the target.** The seller may leave an amount of cash in the target necessary to ensure adequate regulatory capital levels through closing, and the buyer simply pays for this cash through a working capital or similar purchase price adjustment. This guarantees that the target has adequate regulatory capital at all times before, during and after the closing of the transaction. The buyer may prefer this alternative to avoid any issues during the transfer of funds that could cause the target to be out of regulatory compliance for even a short period of



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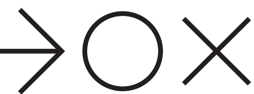

time. However, the parties should make certain that there are no negative tax or regulatory implications related to increasing the purchase price to cover the additional cash.

- **Cash is contributed by the buyer.** Alternatively, the seller could covenant to cause the target to distribute all excess cash (disregarding the regulatory capital requirements for purposes of calculating the amount of excess cash) to its parent immediately before the closing. The buyer would then infuse an amount of capital into the target immediately following the closing to enable the target to meet its regulatory capital requirements. Choosing this alternative requires careful planning of the closing logistics (and sometimes discussions with the target's primary regulator) to ensure that there is no gap period during which the target does not have adequate regulatory capital levels or, if there will be a short gap period, that the regulator has signed off on the process.

### DEFERRED COMPENSATION AND INCENTIVE BONUSES

Deferred compensation or incentive bonuses for key employees are frequently paid one or more years after the services are performed by those employees. Therefore, when structuring the purchase price and purchase price adjustment, the buyer should consider whether and how to address the compensation structure in the transaction agreement so it does not pay for value created during the seller's ownership of the business. The buyer should consider:

- Adjusting the purchase price to account for the future deferred compensation or incentive bonus payments.
- Including a covenant requiring the seller to pay the compensation or bonuses before the closing.
- Using a combination of the above by requiring the seller to covenant to pay the current year's compensation and bonuses before the closing and then deducting an amount equal to the remaining payments from the purchase price.

If the compensation is contingent on certain conditions being met before the payment can be made to the employee, the parties may need to agree on a mechanism whereby the seller either:

- Is reimbursed for any deferred compensation or incentive bonuses that are not paid to one or more employees as a result of those conditions not being met (buyers favor this alternative).
- Pays the buyer the amount of any deferred compensation or incentive bonus paid post-closing to an employee at the time when the conditions are satisfied (sellers favor this alternative).

The mechanism that the parties ultimately agree on depends on the negotiating leverage of the parties and how the deferred compensation or incentive bonuses are structured.

### ASSETS UNDER MANAGEMENT OR OTHER FINANCIAL INDICATORS

If the target is a broker-dealer, investment adviser, fund sponsor or adviser or other similar type of financial institution, the transaction may only be economically beneficial to the buyer if certain thresholds are met following the closing. These thresholds can be implemented either as conditions to closing or as adjustments to the purchase price. The particular threshold that needs to be met depends on the nature of the target's business. For example, if the target is:

- An investment adviser, the buyer may require that the target has a certain level of assets under management at closing or that a certain number of adviser clients have agreed to convert over to the buyer's platform.
- A hedge fund sponsor or adviser, the buyer may want assurance that less than a certain percentage of fund shareholders have made redemption requests.
- A swaps dealer, the buyer may want to know that at least a certain number of counterparties have agreed to accept the buyer's replacement credit assurance.

In these cases, the parties could structure the agreement to include a closing condition stating that the applicable financial measurement (for example, assets under management or redemption requests) is not less than or greater than, as applicable, a certain threshold. Alternatively, if one of these thresholds is not met, the deal may still be economically viable for the buyer, but the purchase price it is willing to pay may be less. In that case, the parties could structure the purchase price to include an adjustment if the applicable threshold is not met.

### REPRESENTATIONS AND WARRANTIES

In addition to typical representations and warranties, a buyer in an M&A transaction in the investment management and securities industry usually asks the seller to make certain other representations and warranties, including the following:

- Representations about the history and eligibility of the target's "associated persons" (or other similar category of employees). The definition of associated persons varies depending on, and as defined in, the rules governing the target.
- Representations about the material filings and communications the target has made or exchanged with a governmental entity or SRO.
- Representations either confirming that the target does not act as a fiduciary, custodian or trustee or relating to the target's performance in its role as a fiduciary, custodian or trustee.
- Representations about the target's books and records. This is important because there are specific rules governing the retention and preservation of books and records in this industry (see below *Retention of Books and Records*).

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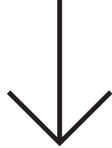

- Depending on the operations of the target, representations relating to transactions (such as trades, swaps and other derivatives) performed by the target on behalf of its customers. If, for example, the target trades or deals in swaps or other derivatives, the buyer may want assurances that the customer transactions:
  - were entered into in the ordinary course of business;
  - were performed according to applicable law and industry practice;
  - are legal, valid and binding;
  - are in full force and effect; and
  - are reflected in the financial statements of the target, in accordance with GAAP.
- If the target is an investment adviser, specific representations regarding the target's clients and its assets under management. The buyer will typically also request representations that the target has received no action letters or exemptive relief orders for certain operations (for example, enabling it to sponsor exchange-traded funds) and specific representations about those letters or orders.
- If the target sponsors a fund, collective investment vehicle or similar product, specific representations regarding the target's third-party service providers, and whether any customer contract contains provisions relating to fee caps, rebates, fee reductions, fee reimbursements and so on.

## COVENANTS

The buyer also typically asks the seller to agree to certain covenants specific to the investment management and securities industry. Further, there are certain covenants that are typically included in M&A transaction agreements, but which are particularly important in this context.

### Conduct of Business

As part of the traditional conduct of business covenant and to avoid additional regulatory approvals, the buyer may require the seller to covenant that it will not take any of the following actions between signing and closing:

- Open a new branch office or close an existing branch office.
- Change its marketing materials from those that have already been approved by its primary regulator.
- Change its incentive compensation program or arrangement from those that have already been approved by its primary regulator.
- Change its supervisory, credit and other policies and procedures from those that have already been approved by its primary regulator.

### Shareholder Approval

If the target is a fund sponsor or adviser, the transaction agreement should contain a covenant related to the proxy process that is necessary to obtain the approval of the fund's shareholders. The covenant should specify:

- Who will prepare the proxy statement.
- The level of involvement and any review rights of the non-preparing party.
- The date by which the proxy statement should be filed.
- Which party bears the costs of the proxy and consent process.

### Guaranty Arrangements

If the target's parent is a party to guaranty arrangements with a counterparty and these arrangements are necessary for the target to conduct its business (for example, the target is a swaps dealer and the counterparties to the swaps transactions require the target's parent to provide credit assurances), the seller should include a covenant for the buyer to enter into a similar guaranty arrangement with those counterparties. These covenants are often heavily negotiated and both parties should consider, early in the process, a number of potential issues related to these counterparty arrangements. Potential issues include:

- How to structure the replacement of the credit assurances.
- Whether the buyer or its parent has the same or a better credit rating as the seller. If it does not, how to resolve this issue since the contracts often contain credit rating termination or similar triggers.
- Whether the buyer will need financial assistance from the seller for a transitional period following the closing. This may be necessary to enable the buyer to replace the target's parent as the guarantor.
- The timeframe required for the buyer to replace the credit assurances.
- Whether the change in guarantor will affect any required regulatory approvals (for example, if the target is a clearing member of the CME, ensuring that the CME will accept the new parent guaranty).

### Retention of Books and Records

Companies in the investment management and securities industry are typically required to retain their books and records for a certain number of years and must be able to easily access them on request by a regulator. The exact period of time that the books and records must be kept depends on which governmental entity or SRO is the target's primary regulator and varies by type of record (for example, voice recordings may only need to be kept for a few months, but e-mails typically need to be kept for six years). The buyer should consider how to handle the storage of and access to the current and historical records relating to the target. Common ways of dealing with the books and records requirements include:

- Transferring all of the books and records to the buyer at closing. This may not be possible if the books and records


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are not in a format that is easily transferable, are not compatible with the buyer's systems or are commingled with other books and records of the seller.

- Leaving most, if not all, of the books and records with the seller and including an access provision in the transaction agreement whereby the buyer and the target would have access to the books and records as necessary. In this case, the parties typically negotiate the access parameters and who bears the cost (if any) of providing copies and storing the records.
- Agreeing to a hybrid of the above alternatives. It is often the case that the parties agree that:
  - those records that are not commingled with the seller's other records and are in a format easily accessible by the buyer are transferred to the buyer at or shortly after the closing; and
  - any remaining records are retained by the seller for an agreed period of time and the seller will provide access to the buyer on request and subject to other agreed terms set forth in the transaction agreement.

If the parties do not transfer all of the books and records of the target to the buyer at closing, they should confirm with the target's primary regulator that it is comfortable with the agreed arrangement regarding access to and storage of the target's books and records.

### Post-closing Integration Matters

Post-closing integration in an M&A transaction in the investment management and securities industry can be highly complex and time consuming (see below *Post-closing Integration Considerations*). Therefore, buyers should take into account the post-closing integration issues that may arise when negotiating the transaction agreement. For example, if the buyer is planning to merge the target with another subsidiary of the buyer after the closing, there may be additional regulatory approvals and third-party consents or notices required. If the buyer has a basic understanding of the necessary post-closing integration steps, it may be able to require that the seller take certain pre-closing actions (such as moving assets among the companies being sold or assigning certain contracts to the buyer immediately before the closing).

The buyer may also want to include a covenant regarding the payment of deferred compensation and incentive bonuses (see above *Deferred Compensation and Incentive Bonuses*).

### Traditional Covenants with Particular Significance

In addition to the covenants detailed above, there are certain covenants that are typically included in M&A transaction agreements, but which are particularly significant in the context of the investment management and securities industry.

PRACTICE NOTES | DOCUMENTS | CLAUSES | CHECKLISTS | ARTICLES

The following related Practice Notes can be found on practicallaw.com

**>> Simply search the title OR resource number**

Road Map to the Dodd-Frank Act or 3-502-8479

Summary of the Dodd-Frank Act: The Volcker Rule or 6-502-7553

Summary of the Dodd-Frank Act: Regulation of Systemically Significant Financial Institutions or 1-502-8437

Basel III: An Overview or 7-504-1959

These covenants include:

- **Required governmental approvals.** This covenant should be expanded to include other governmental and SRO approvals that are required for the transaction. It should also include greater detail regarding which party will take primary responsibility for preparing the applications and the level of involvement and cooperation that is expected of the non-preparing party. This covenant may be drafted to trigger an automatic extension of the drop dead date in the termination section if any of the required governmental approvals have not been received before that date and all of the other conditions to closing have been satisfied or waived.
- **Access.** In light of the heavily regulated environment, the buyer will frequently want to have greater access to and involvement in the target company and its business during the period between signing and closing. As with any M&A transaction, it is important to ensure that an antitrust specialist is involved in any negotiations relating to the buyer's access rights during the period between signing and closing to avoid or minimize any gun-jumping issues that may be implicated.
- **Non-compete.** Companies in the investment management and securities industry are often part of large companies that have various businesses which overlap in many ways. For example, a seller may be selling its correspondent clearing business, but will continue to clear transactions for third parties in other parts of its business. Because of this frequent overlap between businesses, if the seller is a large company that is divesting a non-core business, the non-compete provision is likely to be a heavily negotiated covenant.

## INDEMNIFICATION PROVISIONS

Indemnification provisions in agreements in the investment management and securities industry are substantially the same as those in other industries. However, there are two noteworthy potential differences.

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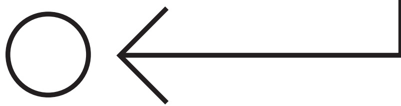

Because these entities are highly regulated and violations of law or regulations can lead to significant adverse consequences, buyers often require (even in a stock purchase transaction) indemnification for all liabilities relating to or arising out of the pre-closing ownership or operation of the target. If a seller agrees to this indemnity, it will likely require a parallel indemnity from the buyer for liabilities relating to or arising out of the post-closing ownership or operation of the target. This "your watch/our watch" indemnity is typically not subject to any limitations (such as caps or baskets) that may be applicable to the indemnity for liabilities resulting from breaches of other representations and warranties.

Buyers may also require that the specific regulatory representations and warranties survive for a longer period than the other representations and warranties. The buyer will likely also seek to carve-out these specific regulatory representations and warranties from any of the limitations on recovery applicable to other representations and warranties.

## POST-CLOSING INTEGRATION

There are certain issues that the parties should take into account when planning for the post-closing integration of the target into the buyer's organization. The two major considerations specific to M&A transactions in the investment management and securities industry are:

- Transitional service arrangements.
- Conversion of customer accounts.

### TRANSITIONAL SERVICE ARRANGEMENTS

If the target is part of a larger company, the seller is often providing a variety of corporate-level services to the target that will need to be provided by the buyer after the closing. However, the buyer is sometimes unable to get all of these services in place in time for the closing. In this case, the parties typically enter into a transition services agreement. Key considerations in negotiating this agreement include:

- **The term of the agreement.** Depending on whether a conversion of customer accounts will need to occur, the term of the transition services agreement can be lengthy and will sometimes continue for multiple years.
- **Indemnity and seller liability.** As with any transition services arrangement, because the seller typically provides the transitional services at cost or a reduced rate and as an accommodation to the buyer, the seller wants to limit its liability. However, given the highly regulated environment, and because failing to provide a service as required under the transition services agreement could cause many customers to incur losses, the buyer will want to be indemnified for any breach of the agreement without being subject to a liability cap. The negotiation of seller liability typically depends on the type of services provided. If the services are more closely related to the target's customers, such as custody services or the execution or clearing of trades, the transition services agreement may even include a specific indemnity from, and reimbursement obligation of, the seller for any losses incurred by the buyer relating to trade processing errors.

### CONVERSION OF CUSTOMER ACCOUNTS

When an M&A transaction involves the transfer of customers' money and asset balances from one custodian's platform to another custodian's platform, the transaction is said to involve a conversion. For example, if the target is:

- An introducing broker-dealer that previously cleared and settled transactions through an affiliated clearing broker-dealer, but the clearing broker-dealer is not acquired by the buyer as part of the transaction, then the target will likely change the broker-dealer through which it clears and settles transactions. In this situation, the money and other assets of the target's customers will transfer from the old clearing broker-dealer to the new clearing broker-dealer in what is referred, to as a back office conversion.
- A family of mutual funds, and the buyer or one of the mutual funds decides to change the custodian that holds its omnibus account(s) through which it clears and settles shareholder transactions, the transfer of each mutual fund's omnibus account from its current custodian's platform to its new custodian's platform is referred to as a mutual fund conversion.

If the transaction involves a conversion, the buyer and the seller must work together to create a conversion or migration plan under which the target business's customers will be converted from the seller's platform to the buyer's platform. Although this conversion or migration plan will be handled largely by the parties' operations and IT teams, counsel must ensure that all of the appropriate notices or consent letters are approved by the applicable regulator(s) and sent to the customers in a timely manner. The notices that will need to be given to the customers depend on several factors, including the:

- Types of accounts that are being converted (for example, conversion of retirement accounts may require specific ERISA disclosures to customers).
- Changes that will be effective on the conversion (such as changing the cash sweep products available to brokerage clients or changing the investment options available to customers).

The parties should also consider incorporating information about the acquisition and, to the extent appropriate, the post-closing integration into a single notice letter to minimize the number of notices that need to be sent to retail customers.



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