Asset Management M&A In The COVID-19 Era: Part 2

By Joe Castelluccio, Adam Kanter and Stephanie Vasconcellos (June 10, 2020)

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In the **first installment** of this three-part article, we described some reasons asset manager M&A activity may recover sooner than M&A in other industries, and some ways to address challenges through deal structure.

In this installment, we will talk about key considerations in the current environment in regulatory compliance and key personnel retention that relate to M&A in this sector.

Elevated Regulatory Concerns in Light of Increasing Compliance Challenges

Even under ideal circumstances, it is essential to conduct thorough due diligence as part of an acquisition to identify any potential regulatory landmines. Depending on the nature of uncovered landmines, they could be a reason to walk away from a deal entirely, or the buyer may want to take them into account in pricing the transaction.

There are numerous examples of enforcement actions by the U.S. Securities and Exchange Commission brought against acquirers arising out of premerger conduct of an acquired company.[1]

The current climate has the potential to exacerbate these risks, as asset managers face increasing compliance challenges related to their investments, their personnel, and their compliance framework.

In this section, we briefly highlight some of the most significant potential regulatory pitfalls and areas of concern that should be a focus of due diligence and seller representations and warranties in connection with any asset management M&A transaction in the current climate.

How Has the Firm Handled COVID-19?

Sellers should expect that buyers will seek information on how the target firm handled, or is handling, complications related to COVID-19. As part of this diligence, buyers may:

- Assess compliance with any stay-at-home and essential-business orders.
- Evaluate the effectiveness of the firm's implementation of its business continuity plans and disaster recovery systems. Many firms conduct annual or biannual testing of these plans, but the current work-from-home environment is a true trial by fire. Going forward, looking at enhancements made to these plans stemming from COVID-19 will provide a stark record of the lessons learned through the process.
- Examine compliance with supervision requirements in light of remote working.

Cybersecurity, Privacy and Data Protection

Sellers should expect that buyers will take an interest in how the firm complied with its privacy obligations and data protection policies. Among other things, adherence to any firm policies restricting the use of personal email, text messages, and similar nonbusiness communications for firm business may be put to the test in the work-from-home environment.

Sloppy handling of client personal information can easily lead to a data breach that could have significant collateral impact on the firm. Moreover, personnel working from home may be using personal devices that are more vulnerable to malicious cybersecurity threats than in-office computers.

Selective Disclosure and Inequitable Treatment of Clients/Investors

In difficult economic times, asset managers may feel the pinch, but so do many of their clients and fund investors, and these clients and investors often have increased questions and requests for their asset managers.

For some managers, in the heat of the moment, when there's a desire to keep a large client/investor satisfied, there's a temptation to provide more information, accommodate more requests, and otherwise provide more special treatment than they would under normal circumstances.

However, this can be a trap for the unwary, as this kind of inequitable treatment, without proper disclosure, could lay the groundwork for a future enforcement action or private litigation.

Sellers should expect that buyers may wish to carefully assess any special accommodations — whether in the form of advance notice of actions the manager may take; selective, supplemental reporting regarding valuations or liquidity; redemption or withdrawal rights from private funds; or other actions — and assess whether they comport with existing disclosures to clients/investors and other obligations under applicable law.

Valuation and Redemption Practices

Given the considerations relating to illiquid assets in some funds and portfolios noted above, where such assets are involved, sellers should expect buyers to evaluate the target's valuation practices to look for material weaknesses in the firm's valuation process, assess compliance with the firm's valuation procedures, and confirm proper authority and disclosures around any use of gates or redemption suspensions for open-end funds.

Retaining Key Individuals in Uncertain Times

In nearly all asset manager acquisitions, it is critical for a buyer to retain executives, relationship and portfolio managers, and other key individuals. These individuals are the foundation of a robust asset management business; they are the key to maintaining and growing existing client relationships, attracting new clients and successfully managing investments.

Ensuring stability in the team provides reassurance to clients of an acquired business that service will remain consistent despite the transaction. This will be particularly important in the coming months as clients' concerns will likely be compounded by the ongoing uncertainty flowing from the COVID-19 crisis.

Buyers typically implement incentives to encourage the retention of key individuals for a period of several years following a transaction, often through a mix of equity or equity-based compensation and time- or performance-based retention bonuses.

Buyers will need to carefully consider the structure of any retention bonuses to ensure that they provide an incentive for key individuals to remain employed following closing and that performance-based bonuses are designed to incentivize desired performance while taking into account the impact of COVID-19 on the business and its investments.

For example, a buyer may consider using relative investment performance, rather than absolute investment performance, as a performance bonus criteria. Buyers may also consider giving more weight to metrics that are less dependent on market performance but still important to the business, such as client retention or assets under management retention.

The use of equity compensation to incentivize key individuals may also change during the COVID-19 crisis. Stock options, in particular, may have greater appeal as a long-term retention tool because the recipients see value from stock options only if the value of the stock increases as compared to the grant price.

Options granted during COVID-19, when the stock values of many companies are depressed, have great upside potential. Recipients who remain with their companies over the long term — as options are often exercisable for a period of up to 10 years — will have tremendous opportunities to create value for the company, the shareholders, and themselves.

Of course, in an asset management business, many of the key individuals also have an equity stake in the business, and these individuals may be asked to roll over a portion of their equity in connection with the transaction.

Even if the deal value is depressed, rollover equity may provide another source of retention value and a way to further align the interests of key individuals with those of the buyer.

While key employees often want to liquidate all or a significant portion of these investments, in a down market, they may welcome the opportunity to remain invested in the business with the hope of selling at a higher price later, when the market improves.

In the last installment of this three-part article, we will describe some of the ways that buyers and sellers can address closing risk in this environment.

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[1] See, e.g., https://www.sec.gov/litigation/admin/2014/34-73183.pdf and https://www.sec.gov/litigation/admin/2019/34-85249.pdf.