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Directors' Considerations of Fund Mergers

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Over the past several years, the number of fund mergers has been on the rise. As this trend continues, it is important for directors to be familiar with their responsibilities when considering a proposed fund merger.

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Some guidance on mergers is provided by state law and, in the case of affiliated fund mergers, Rule 17a-8 of the Investment Company Act of 1940. Both state law requirements and Rule 17a-8 indicate, in brief, that directors must determine that participation in a proposed merger is in the best interests of fund shareholders. Rule 17a-8 also notes that directors must determine that the interests of fund shareholders will not be diluted as a result of the merger.

Directors' considerations must be tailored to the situation in question. Funds might consolidate after a merger of investment advisors, for example, if the combined firm finds that it has overlapping funds. Alternately, two funds within a fund complex might merge in order to achieve economies of scale, enhanced investment management efficiencies, more focused product offerings or greater market leverage and market presence.

In order to determine whether a fund merger is in the best interests of shareholders, directors can rely on information provided by management—but it is the director's responsibility to request whatever information may reasonably be necessary to make that determination.

Investment Objectives, Policies, Strategies, Restrictions and Risks

A comparison of the investment objectives, risks, restrictions and policies of the merging funds is often the first step in a director's consideration of a fund merger. Differences in these policies and strategies can have a significant impact on the investment philosophy and operations of the combined fund, and it is important for directors to consider carefully how any such differences will affect shareholders. In addition, directors should consider the advisor's research and decision-making processes, including methods adopted to ensure compliance with investment objectives, policies and restrictions of the funds. To evaluate the advisor's ability to implement these processes effectively, directors should also discuss the adequacy and sophistication of the advisor's technology and systems with respect to investment and administrative matters.

WHAT TO REQUEST:
Comparative information with respect to investment objectives, risks, restrictions and policies

Performance and Expenses

Other major factors that directors should consider are the performance histories and expense information of each of the merging funds. The combined fund will be allowed to use the financial history of only one of the merging funds—the "accounting survivor"—following the merger. Directors should consider, in consultation with the funds' outside accountants, which fund will be the accounting survivor. With respect to performance history, directors should evaluate short- and long-term performance, including performance volatility, as well as performance comparisons against benchmarks and peer funds.

WHAT TO REQUEST:
Performance history of each fund, including comparative performance information against benchmarks and peers

In addition, directors should consider the fees and expenses of each fund (including voluntary or contractual fee waivers, breakpoints and performance-based fees). In particular, directors should consider the effect of the merger on advisory fees, shareholder servicing fees and total fund operating expenses.

WHAT TO REQUEST:
Comparative fee information and estimated fees of the combined fund

Advisory Personnel

Directors should also consider which of the merging funds' portfolio managers will be managing the combined fund. Particularly if there are substantive differences in the merging funds' investment objectives or philosophies, directors should consider whether the portfolio manager has the experience and qualifications to manage the combined fund. Where both funds do not use the same investment advisory firm, more general information with respect to the post-combination advisor's ability to attract and retain capable research and advisory personnel, including incentive and retirement plans, recent hiring and retention experience and a description of the advisor's policies relating to the assignment of personnel to the combined fund will also assist in making these evaluations.

WHAT TO REQUEST:
Portfolio manager biographies

Direct and Indirect Costs and Tax Consequences

There are a number of direct costs associated with fund mergers, including proxy solicitation expenses, legal and accounting fees and costs related to portfolio repositioning. Directors should consider how these costs will be allocated between the advisor(s) and the merging funds. This will often be related to the reasons for and expected benefits of the merger—if an acquired fund will be paying lower advisory fees after the merger, that fund may bear a larger portion of the expenses; if the acquiring fund will achieve economies of scale as a result of the merger, that fund may bear the greater share of expenses. Directors should also consider whether any of these costs will be borne by the combined fund after the merger is consummated. Expected cost savings for either the acquired or acquiring fund occurring as a result of the merger may take place over an extended period of time, so directors should consider both the expected benefits and timeframe.

WHAT TO REQUEST:
A description of how the costs associated with the merger will be allocated

Portfolio repositioning will often occur following a fund merger, either because the acquired and acquiring fund hold the same securities or because certain securities in one fund may not be consistent with the combined fund's investment objective and philosophy. Directors should consider what costs will be associated with repositioning and who will be bearing those costs.

WHAT TO REQUEST:
A description of the allocation of costs associated with repositioning and an estimated timeline of repositioning

Directors should also consider the tax consequences of the proposed merger. In addition to ensuring that the transaction will not be a taxable event to shareholders, directors must take into account indirect tax consequences, such as whether repositioning will result in capital gains or whether the acquired fund will be able to carry forward capital losses and gains.

WHAT TO REQUEST:
A detailed analysis of tax consequences

Shareholder Services

Because a director's ultimate consideration is whether a merger is in the best interests of shareholders, the effect of the merger on services provided to shareholders is a key factor. Particularly with unaffiliated funds, distribution and other shareholder services may differ following a fund merger. Directors should consider the nature and quality of services that will be provided to shareholders.

WHAT TO REQUEST:
Comparative information regarding shareholder services

Conclusion

The factors and examples discussed above serve as a starting point for directors considering fund mergers. Ultimately, the role of a director is to act as the representative of fund shareholders and to reach reasonable decisions made in their interests. As such, directors must focus their consideration on whatever elements they believe, in their best business judgment, will most affect shareholders.

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