"Orderly Resolution" of Mutual Funds and Their Managers
July 15, 2014

During the global financial crisis, the distress or disorderly failure of certain large, complex and highly leveraged financial institutions—banks, insurance companies and investment banks—required direct intervention by governments, including a number of bailouts, to stem the damage and prevent it from spreading. One focus of post-crisis reform efforts has been to ensure regulators are better equipped to "resolve" a failing institution in a way that minimizes risk to the broader financial system and costs to taxpayers. The new tools provided under the Dodd-Frank Act include requirements for the largest bank holding companies and nonbank SIFIs to engage in comprehensive resolution planning in advance, and a new "orderly resolution" mechanism for financial institutions whose default could threaten financial stability.

These requirements are unnecessary for mutual funds and firms that sponsor or manage them.[1] As a threshold matter, funds do not "fail." Investors are not promised gains on their investment, or even a return of the principal amount they invested. All investment results—gains and losses, no matter how big or small—belong to the fund's investors on a *pro rata* basis. If a fund doubles in value, it is the investors who reap this reward. And if the fund plunges in value, it is the investors who absorb the impact of those losses. This is the expectation shared by all investors in mutual funds and by the broader marketplace.

Moreover, funds and fund managers routinely exit the asset management business. Even when these exits occur during, or are precipitated by, a period of severe market stress, they do not occasion disorder broadly affecting the investing public, market participants or financial markets. This paper provides a summary overview of the reasons why.

We begin by providing data to illustrate that fund and manager exits from the mutual fund business are routine. Next, we explain how fund structure and regulation, as well as competitive dynamics, help to facilitate these regular comings and goings in the fund industry. Finally, we describe the various exit strategies available to funds and managers, all of which can be accomplished within the existing regulatory framework.

[1] Typically, the firm that sponsors a fund also serves as its manager.

Fund and Manager Exits are Routine, Even in Times of Severe Market Stress

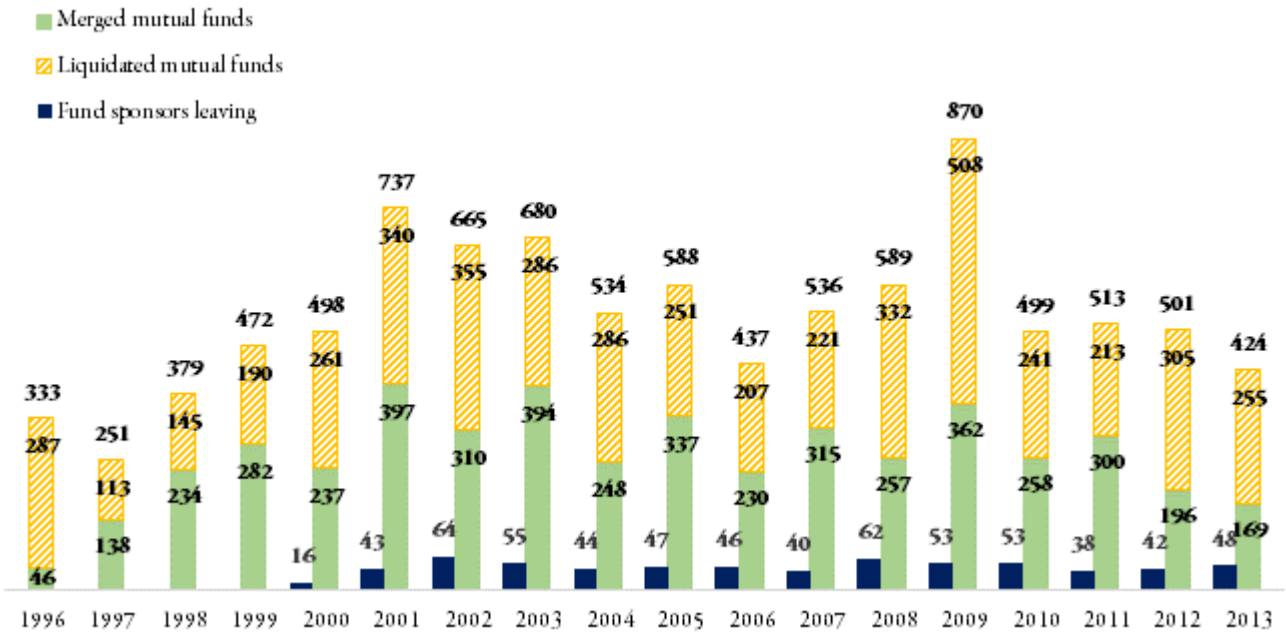
Mutual fund mergers and liquidations occur routinely for a variety of reasons. One common reason for liquidating a fund or merging it with another is the inability of the fund to attract or maintain sufficient assets. Frequently, a fund is launched by a fund manager seeking to offer a new or improved investment strategy, or following the hiring of new portfolio management personnel with expertise in a particular strategy. But if the fund fails to attract sufficient assets over time, and does not attain certain economies of scale, the fund will not ultimately be viable from a business perspective. Furthermore, if the fund does not acquire sufficient assets over time, its expenses will be spread over a smaller asset base, leading to higher expenses for fund shareholders and impairing the fund's ability to compete with similar funds. In such a scenario, the fund manager may and often does recommend liquidation or merger of the fund to the fund's board of directors.

A fund may fail to attract or maintain sufficient assets for a variety of reasons. Poor investment performance—whether or not due to market conditions—is likely the most common reason. Other factors can include difficulties in marketing the fund or gaining access to certain distribution platforms, an inability to distinguish the fund from its competitors, or the departure of key portfolio management personnel.

Likewise, fund managers also exit the business on a routine basis. This may occur where the fund manager itself has failed to attract or maintain sufficient assets under management, or could happen in the event of the bankruptcy of the manager's parent company. It could also occur due to a reputational problem impacting the ability of the manager to retain fund shareholders and other clients, or the retirement or death of the firm's founder.

The figure below shows the number of US mutual funds that have been merged or liquidated in each year since 1996, as well as the number of mutual fund sponsors exiting the business in each year since 2000. The numbers are significant. In 2013 alone, for example, 424 mutual funds were merged or liquidated, and 48 mutual fund sponsors left the business. Outside of press coverage by the media specific to the US fund industry, these 2013 events passed with little notice and certainly did not create distress in the financial markets.

US Mutual Funds and Mutual Fund Sponsors Routinely Exit the US Mutual Fund Market*



Note: Data for number of mutual funds that are merged or liquidated include US mutual funds that are funds-of-funds and those that are not. Excludes ETFs and closed-end funds. Number of fund sponsors leaving is unavailable before 2000.
Source: Investment Company Institute

Fund Structural and Regulatory Features and Industry Competitive Dynamics Facilitate Exits

Several features of the structure and regulation of mutual funds, along with the dynamic and competitive nature of the fund management business, are instrumental in facilitating the "orderly resolution" of funds and their managers.

The most relevant aspects of fund structure and regulation include the following.

Fund structure. Each mutual fund is a separate legal entity, distinct from its manager and from other funds in the same fund complex. A fund typically has no employees of its own; fund operations are carried out by service providers, including the fund manager (also called the "investment adviser").

Separate custody of fund assets. The Investment Company Act of 1940 requires mutual funds to maintain strict custody of fund assets, separate from the assets of the fund manager, using an eligible custodian. Nearly all mutual funds use a US bank custodian.

Role of the fund manager. Acting as an agent, the fund manager manages the fund's portfolio under a written contract with the fund and in accord with the fund's investment objectives and policies as described in the fund's prospectus. The fund manager does not take on the risks inherent in the securities or other assets it manages for a fund; those risks are borne by the fund and its shareholders. Shareholder recourse for losses is limited to the fund and does not extend to the fund's manager (absent breach of a contractual standard of care). The manager does not own fund assets and may not use those assets to benefit itself or any other fund or client. Likewise, creditors of the manager have no claim on fund assets.

Role of the fund board of directors. Mutual funds are required by statute to have a board of directors (or trustees). The board generally must have a proportion of members who are independent of the fund manager, and in practice most fund boards have 75% or more independent members.[2] Fund directors are subject to fiduciary duties of care and loyalty under state law, and the independent directors serve as "watchdogs" for the interests of fund shareholders. In broad terms, the fund board oversees the fund's management, operations, and investment performance. Specific responsibilities include annual review and approval (including by a majority of the independent directors) of the fund's investment advisory contract and overseeing the fund manager's provision of services under that contract.

Fund industry competitive and marketplace dynamics play an important role.

Competition in the mutual fund industry. The mutual fund business is very dynamic. There were more than 800 sponsors of mutual funds in the United States in 2013. Long-run competitive dynamics have prevented any single firm or group of firms from dominating the market. For example, of the largest 25 fund complexes in 2000, only 13 remained in this top group in 2013.

A prominent measure of market concentration is the Herfindahl-Hirschman Index, which weighs both the number and relative size of firms in an industry. Index numbers below 1,000 indicate that an industry is unconcentrated. The U.S. mutual fund industry had a Herfindahl-Hirschman Index number of 481 as of December 2013. This lack of concentration in the industry also demonstrates that fund managers are highly "substitutable" and that there would be no need for government intervention to support the activities or survival of any particular manager.

Individual funds likewise are highly substitutable. Appendix A shows that there are typically well over 100 different mutual funds within each investment category—and, in many cases, several

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[2] As of year-end 2012, independent directors made up three-quarters of boards in 85 percent of fund complexes. *See* Independent Directors Council/Investment Company Institute, *Overview of Fund Governance Practices, 1994–2012*, available at http://www.idc.org/pdf/pub_13_fund_governance.pdf.

hundred funds—available to investors in the market. Fund sponsors generally offer funds in many different categories. Investors can and do move their investments easily from one fund to another without causing market disruption.

An active and robust M&A market. The high degree of competition in the fund industry also suggests that there are many potential bidders for a fund management business should it be put up for sale. Historical experience has borne this out, even during times of severe market stress.[3] Similarly, there is no shortage of firms willing and able to take on additional fund assets under management, for example through fund mergers.

Fund managers have a very strong incentive to acquire assets under management and thereby diversify their offerings to achieve greater economies of scale. Although a fund manager's assets under management can grow organically, acquiring more assets under management through the acquisition of another manager's business is a well-known strategy in the industry. While the manager does not own the assets of its funds and other clients, its contracts to manage those funds and the accounts of other clients are considered to be valuable "assets" of the manager. In any situation in which a fund manager decided or was forced to leave the business, other fund managers (or other financial institutions seeking to enter the fund management business) could be expected to be bidders for that business.[4]

"Orderly Resolutions" of Funds and Managers – The Exit Strategies

<u>Fund Mergers and Liquidations</u>

In the vast majority of cases, a fund merger or liquidation is not compelled by unusual circumstances, so the process can unfold over a time period that the fund manager and fund board deem appropriate. As a result of its oversight functions, a fund board generally will be attuned to any difficulties with the fund, such as lagging performance, failure to attract assets or investor outflows. Tax-free fund mergers or the sale of an advisory business (discussed below) may be preferred options, because they do not involve potential adverse tax consequences (*i.e.*, recognition of capital gains) for shareholders.

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[3] To provide some context, in 2008, the global merger and acquisition activity in the asset management industry totaled $2 trillion. In 2009, the level of such activity reached $4.0 trillion, with nine deals in excess of $100 billion. Source: Grail Partners LLC, Current and Future State of the Asset Management Industry and Implications on Fund Manager Merger and Acquisition Transactions (June 2014).

[4] In 2004, for example, Wells Fargo announced that it was acquiring the mutual fund business of Strong Capital Management. *See* Wells Fargo press release at https://www.wellsfargo.com/press/strong05262004?year=2004. The deal was prompted by an SEC enforcement action (settled just six days prior to the deal announcement) that, among other things, barred Strong's founder from the industry. *See Strong Capital Management and Founder Richard Strong Agree to Pay $140 Million to Settle Fraud Charges Concerning Undisclosed Mutual Fund Trading* (May 20, 2004), available at http://www.sec.gov/news/press/2004-69.htm.

In the face of extreme market conditions or other extraordinary circumstances, these transactions may need to occur on a more expedited basis. The Securities and Exchange Commission also has sufficient authority to provide regulatory relief if necessary to protect the interests of fund shareholders.

Fund mergers. Funds are merged into other funds on a routine basis. A merger could be recommended when a fund fails to attract or maintain sufficient assets, and there is another fund advised by the manager with similar investment objectives and strategies. A merger involving affiliated funds would be conducted in accordance with Rule 17a-8 under the Investment Company Act, which seeks to ensure that the transaction is in the best interests of the shareholders of each fund. Fund mergers are also common following the merger of two fund managers who have similar or overlapping lineups of fund offerings. In this instance, the newly combined manager will frequently rationalize its investment product offerings by merging similar funds.[5] Fund boards play a critical role in evaluating and approving the terms of any merger, consistent with their fiduciary obligations.[6]

Fund liquidation. When a mutual fund does need to liquidate, there is an established and orderly process by which the fund liquidates its assets, distributes the proceeds *pro rata* to investors and winds up its affairs, all without consequence to the financial system at large. This process, which is explained in detail in Appendix B, adheres to requirements in the Investment Company Act and state or other relevant laws based on the domicile of the fund, including consideration and approval by the mutual fund's board of directors. Furthermore, as with fund mergers, all actions by the fund manager and the fund board are undertaken in accordance with their fiduciary obligations to the fund. As the SEC has observed, "liquidations will proceed differently depending on a fund's particular circumstances, and we believe that fund management, under the supervision of the board, is best able to devise and execute a plan of liquidation that is in the best interests of fund shareholders."[7]

Fund liquidations are relatively straightforward because mutual funds have simple capital structures. A fund contracts with a limited number of service providers (in addition to the fund manager, these typically include the custodian, administrator, auditors, transfer agent and distributor) and it pays these service providers through routine asset-based or annual service fees that are accrued in advance on the fund's books. The Investment Company Act strictly regulates and limits the ability of a

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[5] As part of the Wells Fargo acquisition of the Strong funds, as described in footnote 4 above, several Strong funds were merged into similar funds already offered by Wells Fargo, while the remaining Strong funds continued to be offered under a new management contract with Wells Fargo. *See Company News; Wells Fargo Will Merge Some Strong Capital Funds*, New York Times (Sept. 16, 2004), available at http://query.nytimes.com/gst/fullpage.html?res=9F0CE6DA1F30F935A2575AC0A9629C8B63.

[6] *See generally Board Consideration of Fund Mergers*, Independent Directors Council Task Force Report, June 2006, available at http://www.idc.org/pdf/ppr_idc_fund_mergers.pdf.

[7] *See* Money Market Fund Reform, 75 Fed. Reg. 10060, 10089 (Mar. 4, 2010).

fund to borrow or lend money or other assets, and to engage in transactions involving leverage. Accordingly, a primary focus of the liquidation process is the conversion of the fund's portfolio investments to cash or cash equivalents. As noted in Appendix B, how long this process takes will depend upon such factors as portfolio liquidity, the degree of ease in converting portfolio securities to cash or cash equivalents and the fund's investment strategy and objectives.

Extraordinary circumstances. If a particular situation demands an expedited timetable, the fund manager and fund board have the ability to act swiftly. An example from the height of the 2008 financial crisis is instructive. On September 18, 2008, Putnam Investments announced the closing of the Putnam Prime Money Market Fund and the distribution to investors of the fund's assets. The fund had no exposure to Lehman Brothers or other troubled issuers, but had experienced significant redemption pressures from its concentrated institutional investor base. The fund manager and the fund's board of directors determined to close the fund rather than sell portfolio securities into a liquidity constrained market; this action allowed the fund to treat all of its investors fairly. Just six days later, on September 24, the fund merged with Federated Prime Obligations Fund at $1.00 per share and investors did not lose any principal.[8] The transaction required no government intervention.

Even in times of severe market stress, funds—particularly stock and bond funds—are generally able to satisfy investor redemptions without adverse impact on the fund's portfolio and the broader marketplace.[9] Should a fund face a "perfect storm" of unusually heavy redemption pressures and difficult market conditions, however, the SEC has the authority under Section 22(e) of the Investment Company Act to allow a fund to suspend redemptions for such period as the SEC determines necessary to protect the fund's shareholders. The need for such relief is rare. We are aware, however, that during the height of the financial crisis, the SEC invoked this authority to facilitate the orderly liquidation of several money market funds and a short-term bond fund, all of which were managed by Reserve Management Company, Inc. The funds' boards of directors requested the relief "to ensure that each of the funds' shareholders will be treated appropriately in view of the otherwise detrimental effect on each fund of the recent unprecedented illiquidity of the markets and extraordinary levels of redemptions that the funds have experienced." The SEC concluded that the circumstances "require immediate

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[8] *See* "Putnam Fund Shifts Investors to Federated," *New York Times* (September 24, 2008) (citing *Bloomberg News*), available at http://www.nytimes.com/2008/09/25/business/25fund.html.

[9] The reasons for this are outside the scope of this paper. For further discussion, *see, e.g.,* Letter to Secretariat of the Financial Stability Board from Paul Schott Stevens, President & CEO, ICI, dated April 7, 2014 at Appendix F (discussing the historical experience of US stock and bond funds, including modest redemptions by mutual fund investors during periods of financial stress). The letter is available at http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf.

action to protect the funds' security holders" and issued an order allowing each fund to suspend redemptions until it had liquidated.[10]

The SEC is expected to finalize additional reforms designed to enhance further the resiliency of money market funds in the face of difficult market conditions. Recent press reports indicate that the reforms, among other things, will authorize money market funds to suspend redemptions in times of severe market stress.[11]

Sale or Merger of Advisory Businesses

Because of the dynamic nature of the fund industry, as described above, a likely exit strategy for a fund manager would be to find a buyer for its business. A fund board must carefully consider the terms of any proposed transaction. In addition, Section 15(f) of the Investment Company Act addresses circumstances under which a fund manager may receive compensation or other benefits in connection with the sale of its business, consistent with its fiduciary obligations to fund shareholders. Pursuant to Section 15(f), the fund board must maintain a high degree of independence from both the original manager and the acquiring manager for a three-year period, and there can be no "unfair burden" (*e.g.*, fee hikes) on the fund as a result of the transaction for at least two years.

Sale or merger of a fund business may happen for a variety of "routine" business reasons. Such a transaction also may be prompted by financial difficulty of the fund manager, or if there were a problem with an entity affiliated with the fund manager (e.g., the bankruptcy of the manager's parent company), there would likely be a sale or spin-off of the advisory business.

Fund custody arrangements facilitate the movement of an advisory contract to another manager. Because a fund's custody arrangements are governed by a separate contract between the fund and the custodian, there would be no immediate need to alter the fund's custody arrangements. In general, the custodian would simply need instructions from the board on the identity of persons at the new adviser who are authorized to transact on behalf of the fund.

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[10] *See* Reserve Municipal Money-Market Trust *et al.*, SEC Rel. No. IC-28466, File No. 812-13585 (Oct. 24, 2008). We note that the SEC has since adopted a rule allowing a money market fund to suspend redemptions to allow for the orderly liquidation of fund assets, if the fund board (as well as a majority of the independent directors) has determined that the extent of deviation between the fund's amortized cost price per share and its current net asset value per share may result in material dilution or other unfair results to investors or existing shareholders. The rule contains strict conditions designed to limit its use to "extraordinary circumstances," including a vote of the fund's board (including a majority of the independent directors) irrevocably to liquidate the fund and prior notice to the SEC. Rule 22e-3 under the Investment Company Act.

[11] *See, e.g.,* Andrew Ackerman, *SEC to Vote on Money-Fund Reforms July 23*, Wall Street Journal MoneyBeat (July 14, 2014), available at http://blogs.wsj.com/moneybeat/2014/07/11/sec-to-vote-on-money-fund-reforms-july-23/.

Transfer of Fund Management Contract to a New Manager

As noted earlier in the paper, the fund manager serves as manager to the fund pursuant to a contract that must be approved annually by the fund board, including a majority of the independent directors. Typically, any issues relating to the manager's provision of services to the fund are discussed and resolved as a part of the board's regular oversight function and/or as part of the contract renewal process. The fund board has the authority under the Investment Company Act to terminate a fund's contract with its manager and engage a new manager for the fund. If necessary, this can be done quickly on an interim basis, subject to later shareholder approval.[12]

This process can occur without undue disruption to the fund and its shareholders. For example, as is the case with the sale of an advisory business, there would be no immediate need to alter the fund's custody arrangements. The custodian would simply need instructions from the board on the identity of persons at the new manager who are authorized to transact on behalf of the fund. It also bears re-emphasizing that the manager and its creditors would have no claim on the fund's assets.

Resolution of the Fund Manager

We are unaware of any notable fund manager in its own right filing for bankruptcy protection. In the unlikely event of a solvency problem with a fund manager, the fund board could exercise its authority to terminate the fund's contract with the manager, as discussed above.

The resolution of a fund manager would be a very straightforward process. The manager's own assets would typically be limited to, for example, real estate, and telecommunication, computer and office equipment, and possibly some proprietary equity investments in the funds it (previously) managed, that would rank *pari passu* with investments held by other shareholders. Liabilities would typically be limited to, for example, leases and contracts for services used in the asset management business (e.g., investment research, pricing vendors, legal, and accounting) and routine liabilities tied to personnel.

It is worth noting that two of the nonbank financial companies that have been designated as "systemically important" under Title I of the Dodd-Frank Act have asset management subsidiaries that are considered to be "material entities" that must be included in their resolution plans.[13] The plans for

[12] Rule 15a-4 under the Investment Company Act.

[13] Section 165(d)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act; *Resolution Plans Required*, 76 Fed. Reg. 67323 (Nov. 1, 2011) (implementing rules).

both companies contemplate a Chapter 11 bankruptcy proceeding for their asset management subsidiaries. Moreover, one of those plans specifically contemplates the sale of certain businesses from its asset management holding company as part of the Chapter 11 proceeding.[14]

[14] *See* Prudential Financial Inc., 2014 Resolution Plan, Public Section (June 30, 2014), available at http://www.federalreserve.gov/bankinforeg/resolution-plans/prudential-fin-1g-20140701.pdf; American International group, Inc., Resolution Plan, Section I: Public Section (July 1, 2014), available at http://www.federalreserve.gov/bankinforeg/resolution-plans/aig-1g-20140701.pdf.

Appendix A

Number of Mutual Funds by Investment Category, July 14, 2014

Mutual Fund Category	Number of Mutual Funds
Equity Funds	
Multi Cap Growth	172
Large Cap Growth	306
Mid Cap Growth	185
Small Cap Growth	209
Multi Cap Value	255
Large Cap Value	351
Mid Cap Value	199
Small Cap Value	236
Multi Cap Blend	272
Large Cap Blend	454
Mid Cap Blend	141
Small Cap Blend	204
Sector	372
Emerging Market	320
Global	493
International	587
Regional	76
Bond Funds	
High Yield ex. Floating Rate	197
High Yield - Floating Rate	50
Government	149
Mortgage Backed	74
Investment Grade	587
Multi-Sector	142
Global/International	225
Emerging Market	108
State Specific Municipal	336
National Municipal	239
Mixed-Asset Funds	
Hybrid (Balanced, Flexible, Income-Mixed)	569
Alternative Strategies	504

Source: Investment Company Institute

Appendix B

Process for Liquidating and Dissolving a Mutual Fund[*]

1. Consideration of whether to liquidate the fund, by fund manager and fund board
2. Determine whether approval by fund investors is needed, based upon state law and the fund's charter documents
3. Prepare a plan of liquidation and dissolution
4. Fund board to consider and approve the plan of liquidation and dissolution
    a. Fund directors to consider the details of the proposed plan and the rationale for liquidating the fund
        i. Is liquidation and dissolution in the best interests of the fund?
        ii. Are there other viable options?
    b. Directors will make a determination based on their duties to the fund
5. Announce the plan of liquidation and related details
    a. Date on which fund will be closed to new investors
    b. Date on which liquidation proceeds will be paid to investors ("Closing Date")
        i. The Closing Date will depend upon factors such as portfolio liquidity, the degree of ease in converting portfolio securities to cash or cash equivalents, recommendations of the fund's portfolio manager, and the fund's investment strategy and objectives
    c. Description of how purchases, redemptions and exchanges will be conducted during the period prior to the Closing Date
6. Fund to begin the liquidation process
    a. Set aside reserves for liquidation-related expenses (typically limited)
    b. Pay any debts or other obligations (often limited to previously accrued fees to service providers)
    c. Begin to convert portfolio securities to cash or cash equivalents
7. Pay liquidation proceeds to investors on the Closing Date
8. File last financial reports with the SEC
9. File an application with the SEC for deregistration of the fund (on Form N-8F)
10. File with the state to dissolve the fund (typically a perfunctory filing)

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[*] For further detail, *see* Jack Murphy, Julien Bourgeois and Lisa Price, *How a Fund Dies*, Review of Securities & Commodities Regulation, Vol. 43 No. 21 (Dec. 1, 2010).