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SEC Paves Way for M&A With Performance Reporting Relief

By Jill Gregorie May 21, 2018

Relief related to performance advertisements issued by the SEC last week could spur more consolidation among fund companies and advisors, consultants say.

In a May 8 no-action letter, the Securities and Exchange Commission told **South State Bank** that it would not face enforcement action if one of its advisors continued to publish its performance track records after merging with another advisor affiliated with the Columbia, S.C.-based bank.

In doing so, the Investment Management unit acknowledged that **South State Advisory** and **Minis & Co.**, both of which are South State Bank subsidiaries, merged as a matter of law, but continued to "operate in the same manner and under the brand" they had prior to restructuring.

It also noted that the Minis investment team would remain in place, as would "the management, culture and processes that helped give rise" to its products' track records.

As a result, the regulators granted permission, allowing Minis to continue using its performance records in advertisements and marketing materials "with appropriate disclosure."

By granting this relief, the SEC may be helping to facilitate "rollups," wherein private equity shops and other strategic buyers bring two firms under one umbrella "rather than keeping them as orphaned corporate entities," says Todd Cipperman, founding principal of Cipperman Compliance Services.

Previously, large institutions felt "pressure to keep entities separate," in part because of concerns that in consolidating units, managers would have to restart their track records from scratch, Cipperman says. This tended to act as a roadblock to consolidation, since reconciling performance data "made it a little cumbersome administratively to get the benefits of scale and synergy," he says.

"You buy investment firms for two reasons: the assets and the teams," he says. It might "defeat the purpose" of consolidating if a skilled investment team can no longer tout strong past track records, he says.

Prior to South State, the SEC's Division of Investment Management had twice indicated its stance on post-merger performance disclosures in no-action letters.

In 1992, the regulator told **Great Lakes Advisors** that it would be misleading for that company to tout the performance of its predecessor, **Continental Capital Management Corporation**, since some of the people involved in investment decision-making did not stay on to work at Great Lakes.

Four years later, the agency assured **Horizon Asset Management**, a new RIA, that it could advertise performance data associated with a manager it had already acquired, as long as the products adhered to the same investment strategies and objectives.

As with the most recent letter, the division justified its decision in the Horizon case, in part, by noting that "the person or persons who manage accounts at the adviser were also those primarily responsible for achieving the prior performance results."

The SEC’s emphasis on keeping investment teams in place should be at the forefront of compliance officers’ minds during a merger or acquisition, Cipperman says.

“You have to be really strict in making sure you haven’t changed the team and that there’s no additional influence” from staffers who did not contribute to the prior performance getting marketed, he says.

One corollary that may arise from any mergers prompted by the South State letter is portfolio manager retention, Cipperman notes. Consolidation often makes it “harder for a team to roll out if the corporate structure is no longer in existence,” he says.

Broadly, the asset management industry remains “ripe” for mergers and acquisitions, particularly among smaller managers that may be seeing their products booted off distribution shelves, says Renaud Fages, a partner at Boston Consulting Group.

Rising technology costs, especially as they relate to investments in big data, as well as regulatory pressures are also squeezing company profits, he says.

“If you’re a smaller company, you’re going to have a hard time trying to cope with that,” he says.

Many medium-size firms are finding it difficult to merge with peer companies, given that they have to find “distribution that is complementary, a product lineup that is complementary” and deal with the difficulties of integrating portfolio managers into a new culture, Fages says.

These managers may be attractive acquisition targets, however, given the revenue pressures they face, Fages says.

He points to the barbell effect the industry faces.

Globally, asset managers with less than $250 billion have 44% profit margins. On the other end of the spectrum, asset managers with more than $750 billion in assets have 40% profit margins, Fages notes, citing a 2016 BCG benchmarking survey.

For those in between, however, profitability is roughly 10 percentage points lower. Asset managers with $250 billion to $499 billion in assets have 33% profit margins, while those with $500 billion to $750 billion have 31% profit margins.

Such dynamics may lead to large managers' gobbling up smaller firms that offer new capabilities, particularly those that specialize in alternative asset classes, such as private credit.

These acquisitions can allow the manager to “assemble the product lineups they need to create solutions for clients,” Fages says.