AN EXAMINATION OF THE REGULATORY ISSUES ARISING FROM CIS MERGERS

A REPORT OF THE TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Mandate

The members of the Technical Committee Standing Committee on Investment Management (SC5) at its meeting in Madrid in November 2002 agreed to review the regulatory concerns with respect to mergers of collective investment schemes (CIS), including cross-border mergers. This project was accepted by the Technical Committee at its meeting in March 2003. Subsequently, two questionnaires were circulated to SC5 members – the second questionnaire being an elaboration of issues identified in the answers to the first questionnaire. A summary of responses to the Questionnaires is attached as Annex A.

Background

There has been an increase in the number of mergers between CIS in recent years. They are generally the result of commercial considerations e.g. they are often considered to be a cost effective means of winding up a CIS with poor performance or low levels of assets under management or a relatively high total expense ratio. Some are driven by fiscal factors. The increasing globalisation of the CIS industry and the growth of new fund domiciles has seen an increase in the incidences of cross-border CIS mergers.

The main concerns for regulators with respect to mergers/amalgamations of CIS relate to the level of information supplied to and the level of necessary approval from investors. Such concerns are heightened in the case of cross-border mergers.

Current Exercise

The purpose of the exercise is to examine whether and, if so, the conditions under which CIS mergers (including cross-border mergers) are currently permitted by members.

It was considered that the project would be useful in allowing members, when presented with such proposals, to draw on experiences and requirements of other regulators in this area. The questionnaire circulated to members focused on, inter alia:

- The level of permitted mergers
- The relevant legislative and/or regulatory provisions
- Conditions imposed by regulators on merger proposals
- Level of approval required of unit holders
- Level of information to be provided to unit holders prior to any mergers
- Performance disclosure requirements

- Allocation of costs of merger
- The extent, if any, regulators should intervene to encourage mergers
- Whether unit holders have the right to redeem free of charge in advance of the merger

Outcome of Exercise

A summary of the responses to the questionnaires is attached. While no single approach can be identified among members, a number of common themes or core principles emerge which should prove beneficial to both regulators and investors in assessing proposals for mergers/schemes of amalgamations for CIS.

1. Permitted Mergers/Regulatory Approval

In general, regulatory approval is required where a CIS proposes to merge with another CIS either within the local jurisdiction or on a cross border basis (assuming cross border mergers are permitted by the home regulator). Regulators must be satisfied with the arrangement and any proposal must be conducive to the proper and orderly regulation of the end product. This regulatory approval is required in advance of presenting the merger proposal to unitholders for their consideration. Any proposal to merge must comply in full with domestic requirements specified by the regulator as part of the approval process.

2. Unitholder approval

In general, unitholder approval must be sought before a merger can proceed, except in the case of certain contractual funds where no voting rights occur (In such circumstances, the role of the Regulator in insuring unitholder protection is important). The approval/voting requirements are usually a reflection of local Company Law provisions; however, home regulators may extend these conditions and impose more stringent voting requirements based upon the totality of arrangements.

3. Disclosure of information to unitholders

All CIS must provide unitholders with sufficient information to enable them to evaluate the merger proposal and make an informed decision. Regulators may impose specific requirements (e.g. background and rationale for the proposed merger, procedures for the transfer of assets and exchange of shares/units, fees, tax issues and costs) on the nature and content of information; however, the overriding principle is that any information provided to unitholders is accurate, well balanced and not misleading, particularly in the area of performance data.

4. Costs of Mergers

All costs associated with mergers and the entities responsible for these costs should be clearly disclosed in the circular to unitholders. On the basis that most mergers are commercially driven any costs associated with the merger should be borne by the manager/promoter of the CIS; however this is not a requirement imposed by all regulators.

5. Non- Intervention by regulators to encourage mergers

As a rule regulators do not intervene to encourage mergers. While the regulator has obligations as regards the proper and orderly supervision of CIS and ensuring the best interests of unitholders are maintained, most mergers are as a result of commercial, fiscal or for business consolidation reasons.

6. Rights of unitholders to redeem free of charge in advance of the merger

In general dissenting unitholders are offered the right to redeem free of charge. In any event, redeeming unitholders should not be prejudiced by the proposal and redemptions should at a minimum be processed in accordance with the redemption facilities stipulated in the relevant CIS document.

Annex A

SUMMARY OF RESPONSES TO QUESTIONNAIRES

1. Permitted Mergers

All Members permit a regulated CIS in their jurisdiction to merge with another regulated CIS domiciled in the same jurisdiction subject to certain conditions.

With regard to the question of allowing regulated CIS to merge with regulated CIS in other jurisdictions, approximately half would permit such amalgamations subject to certain conditions; the remainder would not permit a merger with a CIS domiciled outside the home jurisdiction under any circumstances.

The majority of regulators surveyed would not permit a regulated CIS to merge with an unregulated CIS either within the local jurisdiction or on a cross border basis. The exceptions include Canada who permit, under certain circumstances, an amalgamation between regulated and unregulated CIS provided both CIS were located in the home jurisdiction; Hong Kong, Jersey, the Netherlands and the US (SEC) would permit an amalgamation with a foreign unregulated CIS subject to conditions. Luxembourg would have no objection provided unanimous consent had been obtained for such arrangements.

2. Legislative Requirements Permitting Such Arrangements

(i) Regulatory Approval

The majority of regulators approve in advance of a proposal for the merger of CIS before it is put forward to the unitholders for consideration. Mexico has no official approval but any proposal is discussed with the Regulatory Authority prior to implementation. The US does not approve the substantive aspects of any merger. There is no formal approval of CIS mergers in Australia, however due to certain provisions of the Corporation Act the Regulator may grant exemptions or modifications from the law. Canada has set down certain pre-approval criteria for schemes of amalgamation; it is only in circumstances where these criteria cannot be met that the Regulatory Authority approves specific proposals. The Netherlands has no specific legislation governing mergers and each proposal is dealt with on a case-by-case basis.

(ii) Mergers with different categories of CIS

A majority of regulators would not impose any specific or additional conditions in such circumstances, for example, the merger of a unit trust with a corporate entity. However they may require additional disclosure to investors on the impact of such a merger. In the case of contractual funds, Switzerland and Germany consider the review by the Regulator to be more important as no voting rights are attached to such funds. In this case, the German and Swiss Authorities assume "a front line" approach in insuring the interests of unitholders are reflected. Luxembourg has issued specific guidelines for mergers between different categories of CIS.

3. Conditions imposed on mergers

(i) General

Most jurisdictions do not impose significant rules or conditions on mergers of CIS, reliance is largely placed on detailed disclosure to investors of the proposal to enable them to make an informed decision regarding the merger prior to its implementation.

(ii) Investment objective and policy

Luxembourg, Brazil, Germany, Canada and Netherlands require that merging CIS have similar investment objectives and policies. Other jurisdictions will permit mergers of CIS with different investment objectives and policies; however, Hong Kong, Ireland and the UK impose specific voting requirements of unitholders for the approval of mergers in these cases.

(iii) Redemption Facilities

Most regulators with the exception of Germany, Brazil and Ireland do not require that merging CIS to have similar dealing facilities. Ireland, UK, Luxembourg, Spain and Mexico require, however, that unitholders have the ability to redeem out of a CIS prior to the implementation of the merger.

(iv) Target Investors

The majority of jurisdictions surveyed do not have specific rules regarding mergers between different types of CIS (e.g. mergers of retail with institutional CIS). Ireland, Luxembourg, Brazil and Canada would not generally permit a retail CIS to merger with a CIS marketed to sophisticated investors. France would, provided the CIS was available for retail subscription following the merger. Jersey would consider such a proposal on a case-by-case basis

(v) Trustee and Auditor Review

Ireland, Luxembourg (for unit trusts), Spain, Hong Kong, France, the Netherlands and Jersey require the trustee to review the merger proposal before its implementation. Many jurisdictions require that the terminating CIS be audited, but only Germany, Brazil and Mexico would require the auditor to review the merger proposal.

(vi) Additional Conditions

In Australia, the Takeover Panel has wide jurisdiction in relation to acquisitions, including mergers of listed CIS and may make a declaration of "unacceptable circumstances" for mergers where, for example:

> " *A CIS merger impaired an efficient, competitive and informed market in the control of the voting interests of a listed CIS*
>
> *If unitholders (i) did not know the identity of the acquiring entity; (ii) did not have a reasonable time to consider the proposal; or (iii) were not given enough information to enable them to assess the merits of the proposal.*
>
> *If unitholders affected by a CIS did not all have reasonable and equal opportunities to participate in any benefits accruing to unitholders under the schemes*."

In Canada the following additional conditions apply to preapproved mergers:

- *CIS involved must be managed by the same management company or affiliate of the management company.*
- *CIS are not in default of any requirements of securities legislation.*
- *The merger is a qualifying exchange with the meaning of the Income Tax Act.*
- *The terminating CIS is wound up as soon as practicable after the merger.*

In Spain, in addition to providing investors with a copy of the circular and the project of the merger, it is also compulsory to publish details of the merger in two newspapers and in the Spanish Official Publication. It must also be made public through CNMV's website.

(vii) Umbrellas

Jurisdictions surveyed impose the same level of disclosure and criteria on mergers of umbrellas as is applied to a single CIS. In Luxembourg the articles of association for companies can delegate the power to merge sub-funds to the board of directors. In the US mergers of sub-funds within an umbrella are considered to involve affiliated CIS and specific rules would then be applied.

(viii) Mergers between CIS with the same management company

In Ireland, for mergers between CIS managed by the same management company, the target CIS is not permitted to charge subscription charges to transferring unitholders. In the US such mergers are permitted only consistent with the provisions of an SEC rule (including approval by the board of directors of any CIS involved in the merger), or pursuant to an SEC exemptive order. In Hong Kong the management company is encouraged to provide investors with the option to switch to other CIS managed by the same management company. Germany, Portugal and Canada will only permit mergers between CIS who have the same management company. No additional rules are imposed by the other jurisdictions.

4. Voting Requirements

All jurisdictions generally require unitholder approval before a merger can proceed; approval usually reflects the local company law provisions as regards voting rights. Ireland, Luxembourg, Spain and Mexico apply more stringent requirements and require that the votes in favour or votes cast represent a percentage of total votes in issue e.g. 50% or 75%. In certain instances, mergers in the US can proceed without a shareholder vote.

In general dissenting unitholders or unitholders who do not vote are automatically transferred to the new CIS although again in most cases there is a right to redeem prior to the transfer. Ireland requires, however, that these unitholders holdings be redeemed automatically from the CIS for cash prior to the transfer unless certain conditions are met.

5. Disclosure of Information

Although not all jurisdictions specify the information to be provided to unitholders prior to the meeting to consider the proposed merger, the information should be accurate and not misleading and sufficient to enable unitholders to evaluate the proposal and enable them to make an informed decision. The type of information to be disclosed would include, inter alia:

- The background and rationale for the proposed merger.
- The procedures to be adopted for the transfer of assets and exchange of shares/units including any option to redeem prior to the effective date.
- Details of the continuing CIS including regulatory status, fees and details of where the prospectus and annual reports (if not attached) can be obtained.
- The tax implications of the proposed merger.
- The costs associated with the merger and who will bear these costs.

6. Inclusion of performance data

The majority of members share the view that past performance is not necessarily a guide to future performances; therefore, most have not set out specific requirements in respect of the inclusion of performance data in the circular on mergers. A number (Ireland and Spain) would agree that where previous performances are being included in the circular to unitholders, it should be highlighted that such information is in respect of the (each) CIS prior to the merger and should be understood in this context. Most jurisdictions would permit the inclusion of performance data without specific requirements; however, US, Canada and Hong Kong impose conditions, such as, (i) the underlying CIS selection process (ii) the potential effect of the merger and its impact on the performance of the merged CIS, or (iii) the inclusion of performance data of each of the CIS involved in the merger, or in certain cases the inclusion of performance data of the CIS most likely to represent the CIS post the merger.

7. Responsibility for the cost of the merger

The general view put forward by members was that any costs associated with the merger, should be borne by the manager/promoter on the basis that most, if not all, mergers are commercially driven, although Luxembourg made the point that in the longer term mergers generally benefit unitholders. Hong, Kong, Portugal and Canada were quite strongly opposed to the costs being incurred by the investors. Brazil, Switzerland and France stated, however, that each CIS should bear its own costs in respect of this arrangement. Germany has no provision in law regarding costs but the regulatory authority would not give its approval if it considered the costs to be inequitable. Members were unanimous on the view that the cost and the entity responsible for those costs should be clearly disclosed in the circular. The French delegate made an interesting point in that where the manager incurred this cost it would in effect be passed on to the unitholders given the manager is in a position to shift this fee to the CIS.

8. Role of the Regulator

Mergers are effected as a commercial decision of the manager/promoter. While the regulator has obligations as regards the proper and orderly supervision of CIS and ensuring the best interest of unitholders are being maintained, no Member supported the direct intervention of

the regulator to effect a merger. In fact, many argued that mergers could be refused on the grounds they significantly altered the risk profile of the CIS for investors.

Where a merger is effected between two similar CIS where the manager or administrator is acting for both, the Brazilian regulator will intervene requiring the promoter to make a decision as to whether its more appropriate for the two CIS merge or alter their investment objective and policies.

Mexico was of the view that perhaps the regulator should intervene in some form to prevent CIS authorisations being revoked because of poor performance of both CIS or, in order to protect or benefit unitholders through advantageous or profitable mergers.

9. Mergers where the investment objective and policies are different

Germany, Ireland, and Brazil supported the view that CIS mergers may only be effected where both CIS have similar investment objectives and policies. All other Members would consider the totality of arrangements taking account of full disclosure to unitholders along with providing sufficient time to investors to redeem. Spain and the UK may require the re-alignment or restructuring of one or other portfolio before the merger.

10. Treatment of mergers where they result in additional fees for unit holders

Germany and Brazil support the view that the fee structures of both CIS should be similar and not result in additional costs for unitholders. All other Members consider sufficient disclosure should be provided and unitholder are offered the option to redeem or vote before the merger becomes effective.

11. Investors to be provided with the right to redeem free of charge in advance of the merger

Almost all jurisdictions support the view that all unitholders should be offered the right to redeem free of charge. While Canada and Ireland do not specifically require that redemptions be effected free of charge for redeeming investors, they stipulate that such redemptions must be processed in accordance with the normal redemption facilities stipulated in each CIS prospectus. While the UK does not specifically require this provision, it is considered that it would be equitable of the manager to reimburse the redemption fee payable by redeeming investors in this respect. Furthermore, the UK Authority will encourage the manager to

confirm that for those investors investing in the CIS three month prior to the effective date of the merger the initial charges will be rebated.