Chapter 42

Mutual Fund Use of Sub-Advisers

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§ 42:1 Introduction

§ 42:1.1 What Is a Sub-Adviser?

Investment advisory services are typically provided to mutual funds pursuant to a contract that a fund enters into with an investment adviser, called an investment advisory agreement. Under such an agreement, the investment adviser assumes responsibility for supervising and managing the fund's assets, including making investment-related decisions, in accordance with the fund's stated investment objectives, policies, and restrictions. Some funds operate in a structure in which they have an investment adviser and one or more sub-advisers. In this variation on the traditional portfolio management arrangement, sometimes referred to as a manager of managers structure, the sub-advisers are responsible for the day-to-day investment related decisions of all or a portion of a fund's portfolio. Generally, sub-advisers are hired by, contract with, and are paid by the investment adviser. The investment adviser delegates one or more duties

to the sub-adviser pursuant to a sub-advisory agreement, and the investment adviser is obligated to monitor and oversee the actions of the sub-adviser. Sub-advisers may be hired as the single sub-adviser to a fund or as one of multiple sub-advisers to a fund.

§ 42:1.2 Why Would a Mutual Fund Use a Sub-Adviser?

A mutual fund complex will often use sub-advisers as a means to make new funds available for which it may not previously have had the management capabilities. The use of sub-advisers allows a fund to have an investment focus, style, or objective beyond the particular expertise of the investment adviser's existing staff, helping the investment adviser to fill in gaps in its existing suite of funds without the need for extensive new resources. Sub-advisers also can help a mutual fund complex develop niche products without the investment adviser having to retain highly specialized portfolio managers on staff. In addition, funds may use multiple sub-advisers to diversify investments. The use of sub-advisers also may have a positive impact on marketing when the sub-advisers are well-known.[1]

Once a sub-adviser has been hired with respect to a fund, the sub-adviser takes on the portfolio management duties that would typically be provided by an investment adviser in a non-sub-advised fund. In particular, the sub-adviser manages all or a portion of the fund's securities portfolio, including the determination of the purchase, retention, and sale of securities and other investments for the fund, in accordance with the fund's investment objectives, policies, and restrictions. This may involve obtaining and evaluating economic, statistical, and financial data and information, and undertaking such additional investment research that is necessary or advisable to manage the investment and reinvestment of the fund's assets. The sub-adviser provides these services subject to the general supervision of the investment adviser and the fund's board of directors, and is often required to report to the board of directors with respect to the implementation of the investment policies of the fund.

In a sub-advised fund, an investment adviser's duties typically include: (i) supervising the general management and setting the overall investment strategies of the fund; (ii) evaluating, selecting, and recommending sub-advisers to manage all or a part of the fund's assets; (iii) allocating and reallocating the fund's assets among multiple sub-advisers; (iv) monitoring and evaluating the portfolio management services provided by each sub-adviser, and the investment performance of the fund, or portion thereof managed by

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1. *See* Jay S. Neuman, Manager of Manager Funds, *2003 Investment Company Regulation and Compliance*, ALI-ABA Course of Study (2003).

the sub-adviser; (v) advising and consulting with the board of directors of the fund with respect to matters relating to the investment operations of the fund, including matters relating to the selection, evaluation, retention, and possible termination of each sub-adviser; (vi) implementing procedures reasonably designed to ensure that the sub-advisers comply with the fund's investment objectives, policies, and restrictions; and (vii) regularly reporting to the board of directors of the fund with respect to the foregoing matters.

§ 42:2 Requirements for Hiring a Sub-Adviser

§ 42:2.1 Legal Basis for Hiring a Sub-Adviser: The Investment Company Act

Generally, the law governing sub-advisers is the same as the law governing investment advisers. When the term "investment adviser" is used in the Investment Company Act of 1940, as amended (the "Investment Company Act"), it also generally means any sub-adviser. The requirements of section 15 of the Investment Company Act, including those relating to initial approval and continuation of investment advisory agreements, apply equally to any sub-advisory agreement. Further, because sub-advisers are "investment advisers" and thereby "affiliates" of funds under the Investment Company Act, they must be considered for section 10(f), section 12(d)(3), and section 17 matters, although certain exceptions are available, and when analyzing the independence of directors.[2] Although the term "investment adviser" in the Investment Company Act generally includes a sub-adviser, the regulations under the Investment Company Act do, in certain instances, draw distinctions between investment advisers and sub-advisers, as discussed below.

Section 15(a) of the Investment Company Act imposes certain requirements on investment advisory agreements (including sub-advisory agreements).[3] Specifically, an investment advisory agreement must be in writing and must precisely describe the compensation to be paid under the agreement. The agreement must be approved by vote of a majority of the outstanding voting securities of the fund and will continue for more than two years from the date of its execution only if such continuation is approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of the fund. In addition, the agreement must provide that it may be terminated at any time, without penalty, by the board of directors or by vote of a majority of the outstanding voting securities

2. Investment Company Act §§ 10(f), 12(d)(3), 17.
3. Investment Company Act § 15(a).

of the fund on not more than sixty-days' written notice to the investment adviser. Finally, the agreement must provide that it will terminate automatically upon its assignment.[4] Section 15(c) of the Investment Company Act further requires that the initial approval of an investment advisory agreement (including a sub-advisory agreement), and any continuation thereof, be approved by vote of a majority of the directors who are not interested persons of the investment adviser or the fund, and cast in person at a meeting called for the purpose of voting on such approval.[5]

[A] Exception to Section 15 Requirements: Manager of Managers Order

Notwithstanding the shareholder approval requirements of section 15(a), many funds have sought and obtained from the Securities and Exchange Commission (SEC) exemptive orders that permit funds and investment advisers to enter into and materially amend sub-advisory agreements without shareholder approval. One rationale for this exemptive relief is that a sub-adviser in a manager of managers arrangement is analogous to a portfolio manager in a traditional management arrangement, who may be hired and fired by the investment adviser without shareholder approval. In 2003, the SEC proposed a rule ("Proposed Rule 15a-5") that would have codified these exemptive orders, including many of their conditions, and permitted the hiring and replacement of sub-advisers without shareholder approval, but this proposed rule was never adopted.[6] Since Proposed Rule 15a-5 was never adopted, many funds continue to seek exemptions from the Section 15(a) shareholder voting requirements for sub-advisory agreements with unaffiliated sub-advisers. The orders typically have the following conditions:

(i) The operation of the fund as a manager of managers fund is approved by a majority of the fund's outstanding voting securities (as defined in the Investment Company Act);

(ii) The fund will disclose in its prospectus the existence, substance, and effect of the exemptive order, and will hold itself out to the public as employing a manager of managers structure. The prospectus will also prominently disclose that the adviser has ultimate responsibility (subject to oversight by

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4. *Id.*
5. Investment Company Act § 15(c).
6. Exemption from Shareholder Approval for Certain Subadvisory Contracts, Release Nos. 33-8312, 34-48683, IC-26230 (Oct. 23, 2003) [hereinafter Exemption from Shareholder Approval].

the fund's board) to oversee sub-advisers and recommend their hiring, termination, and replacement;

(iii) Within ninety days of the hiring of any new sub-adviser, shareholders of the fund will be furnished all of the information about the new sub-adviser that would be included in a proxy statement;[7]

(iv) The adviser will not enter into a sub-advisory agreement with any affiliated sub-adviser without such agreement being approved by the shareholders of the fund;

(v) At least a majority of the fund's board will be independent directors at all times, and the nomination of new or additional independent directors will be at the discretion of the then existing independent directors;

(vi) When a change of sub-adviser is proposed for a fund with an affiliated sub-adviser, the board, including a majority of the independent trustees, will make a separate finding, reflected in the board minutes, that such change is in the best interests of the fund and its shareholders, and does not involve a conflict of interest from which the adviser or an affiliated sub-adviser derives an inappropriate advantage;

(vii) The adviser will provide general management services to each fund, including overall supervisory responsibility for the general management and investment of the fund's assets, and, subject to review and approval by the fund's board, will:

a. set the fund's overall investment strategies;

b. evaluate, select, and recommend sub-advisers to manage all or a part of the fund's assets;

c. when appropriate, allocate and reallocate the fund's assets among multiple sub-advisers;

d. monitor and evaluate the sub-advisers' performance; and

e. implement procedures reasonably designed to ensure that the sub-advisers comply with the fund's investment objectives, policies, and restrictions;

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7. To satisfy this condition, the fund must file with the SEC and transmit to shareholders an information statement on Schedule 14C of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Pursuant to section 14(c) of the Exchange Act, the information statement must contain information that is substantially equivalent to the information that would be required in a proxy statement if shareholders were being asked to vote on the sub-advisory agreement.

(viii) No director or officer of a fund or director or officer of the adviser will own directly or indirectly (other than through a pooled investment vehicle that is not controlled by such person) any interest in a sub-adviser, except for:

a. ownership of interests in the adviser or any entity that controls, is controlled by, or is under common control with the adviser; or

b. ownership of less than 1% of the outstanding securities of any class of equity or debt of a publicly-traded company that is either a sub-adviser or an entity that controls, is controlled by, or is under common control with a sub-adviser; and

(ix) In the event the SEC adopts a rule under the Investment Company Act providing substantially similar relief to that requested in the exemptive application, the requested order will expire on the effective date of that rule.

The exemptive relief may be subject to other conditions as well. For example, some orders require that sub-adviser profitability be shown quarterly.[8] In addition, some orders allow compensation of individual sub-advisers not to be shown publicly.[9] Proposed Rule 15a-5 would have codified this relief by permitting a sub-advised fund to disclose only the aggregate amount of fees that it pays to sub-advisers as a group, based on the rationale that advisers are able to negotiate lower fees with sub-advisers if they are not required have to disclose those fees separately.[10] The specific conditions to exemptive relief will depend on the application for exemption and the corresponding order. A firm that has obtained an exemptive order may amend its order to take advantage of the latest relief provided by the SEC.

[B] Exception to Section 15 Requirements: Rule 15a-4

Another exception to the shareholder approval requirements of section 15(a), primarily applicable when a fund complex does not have a manager of managers order, is Rule 15a-4 under the Investment

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8. *See, e.g.*, Highland Exemptive Orders, Release No. IC-29445 (Sept. 27, 2010), No. IC-29488 (Oct. 26, 2010).
9. *See* Endeavor Series Trust Order, Release No. IC-24054 (Oct. 1, 1999); Frank Russell Investment Co., et al. Release No. IC-21108 (June 8, 1995).
10. Exemption from Shareholder Approval, *Supra* note 6. The proposed rule would also have allowed sub-advisers to exclude fees charged for other similar sub-advised accounts from the information statement filed under 14C in response to Item 22(c)(10) on Schedule 14C. *Id.*

Company Act.[11] Rule 15a-4 allows a person to act as an investment adviser (including a sub-adviser) of a fund, without shareholder approval, on a temporary basis for a period of up to 150 days after certain types of terminations of a prior investment advisory agreement, provided certain conditions are met. Broadly speaking, there are two different avenues of relief, each with its own set of conditions, under Rule 15a-4.[12]

If the previous agreement is terminated by a fund's board of directors or shareholder vote, by a failure to renew, or by an assignment (other than an assignment in connection with which the investment adviser or a controlling person receives a benefit), an investment adviser (including a sub-adviser) can provide advisory services to the fund under an interim contract for up to 150 days if the following requirements are met:

(i) the adviser's compensation under the interim contract must be no greater than what would have been received under the previous agreement; and

(ii) the fund's board of directors, including a majority of disinterested directors, must approve the interim contract within ten business days after termination of the previous agreement.[13]

If the previous contract is terminated by an assignment in connection with which an investment adviser or a controlling person of the adviser receives money or other benefits, an investment adviser (including a sub-adviser) can provide advisory services to the fund under an interim contract for up to 150 days if the following requirements are met:

(i) the adviser's compensation under the interim contract must be no greater than what would have been received under the previous contract;

(ii) the fund's board of directors, including a majority of the disinterested directors, must determine that the scope and quality of services under the interim contract are at least equal to what was provided under the previous contract and must vote in person to approve the interim contract before the previous contract is terminated;

(iii) the interim contract must provide that the fund's board of directors or a majority of the fund's outstanding voting securities may terminate the contract at any time, without penalty,

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11. Investment Company Act Rule 15a-4.
12. *Id.*
13. *Id.*

on not more than ten calendar days' written notice to the investment adviser;

(iv) the interim contract must contain the same terms and conditions as the previous contract, with certain minor exceptions; and

(vi) the interim contract must provide that the compensation earned under the contract will be held in an interest bearing escrow account with the fund's custodian or a bank.[14]

If the fund's shareholders approve a new contract with the adviser within the 150-day period, the amount in escrow (including interest) will be paid to the adviser. If, on the other hand, the fund's shareholders do not approve the new contract within the required time, the adviser will be paid the lesser of any costs incurred in performing the interim contract or the total amount in the escrow account (in either case, plus interest). To take advantage of this relief, the fund's board of directors must satisfy the fund governance standards set forth in Rule 0-1(a)(7) under the Investment Company Act.[15]

§ 42:2.2 Affiliated Versus Unaffiliated Sub-Advisers

An affiliated sub-adviser is one who is an affiliated person (as such term is defined in section 2(a)(3) of the Investment Company Act) of the investment adviser with which it contracts or of the fund (other than by reason of serving as an investment adviser to the fund).[16] When dealing with affiliated sub-advisers it is important to keep in mind certain additional considerations that are not necessarily relevant when dealing with unaffiliated sub-advisers.

Generally, exemptive relief from section 15(a) is not currently being granted with respect to sub-advisers that are affiliated persons of the investment adviser. As such, sub-advisory agreements with affiliated sub-advisers typically must be approved by fund shareholders. This is true even with respect to a fund that has both affiliated and unaffiliated sub-advisers and has obtained exemptive relief for unaffiliated sub-advisory agreements. Funds with affiliated sub-advisers may wish to seek a no-action letter from the SEC staff on an individual basis as an alternative source of relief from the section 15(a) shareholder approval requirements. For example, the staff has granted such no-action relief where fees were reallocated between the primary investment adviser and a sub-adviser, provided that the new arrangement or amendment did not materially change the advisory

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14. *Id*.
15. *Id*.
16. Investment Company Act § 2(a)(3).

relationship or the terms of the advisory agreement that was previously approved by fund shareholders.[17]

The SEC staff also has granted no-action relief from the shareholder approval requirements of section 15(a) with respect to an investment adviser's transfer of its investment advisory operations to an affiliated sub-adviser in the context of an internal reorganization and subsequent periodic reallocations of investment advisory responsibilities between the investment adviser and sub-adviser.[18] The staff's position was based on the representations that neither the initial appointment of the sub-adviser nor any subsequent changes to the sub-advisory arrangement would result in a reduction in the nature or level of services provided to a fund or an increase in the aggregate fees paid by the fund, and that appropriate notice would be given to existing and prospective shareholders.[19] More generally, some firms may use "dual-hatting" arrangements to alleviate concerns under section 15 in connection with restructurings within organizations with multiple affiliated investment advisers (including sub-advisers).[20] Dual-hatting is a practice where two or more affiliated investment advisers employ, or are deemed to employ, the same individuals. Where portions of a firm's investment advisory functions are being transferred from one subsidiary to another (for example, between the primary investment adviser and an affiliated sub-adviser or between affiliated sub-advisers), and where employees are dual-hatted between the two entities, they may be able to continue to manage the portfolios being transferred during and after the restructuring without the transaction being deemed an "assignment" under section 15(a)(4), which would require the termination of the advisory contract and re-approval by shareholders. The role of the dual-hatted employees could support the view that such a transaction does not result in a change in the identity of the provider of investment advisory services.[21]

If a fund's board of directors has approved an investment advisory agreement during the fund's most recent fiscal half-year, the fund is required to include disclosure in its annual or semi-annual report, as applicable, regarding the basis for the board's approval of the

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17. *See* Invesco, SEC No-Action Letter, No. 97-198-CC, 1997 WL 434442 (Aug. 5, 1997) [hereinafter Invesco No-Action Letter].
18. *See* Wells Fargo Bank, N.A. SEC No-Action Letter, 1998 SEC No-Act. LEXIS 458 (Mar. 31, 1998).
19. *Id.*
20. *See, e.g., id.*; Equitable Life Assurance Soc'y of the United States, SEC No-Action Letter 1984 WL 47223 (Jan. 11, 1984).
21. *See* Rule 2a-6 under the Investment Company Act, which provides that "[a] transaction which does not result in a change of actual control or management of the investment adviser" is not considered an assignment for purposes of section 15(a)(4).

agreement.[22] This requirement applies to sub-advisory agreements with both affiliated and unaffiliated sub-advisers. The disclosure must include factors considered by the board relating to both the board's selection of the investment adviser and approval of the advisory fee and any other amounts to be paid by the fund under the agreement.[23] Such disclosures should include to the extent considered by the board, among others, the extent and quality of the services to be provided; the investment performance of the fund and the investment adviser; the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; the extent to which economies of scale would be realized as the fund grows; and whether the fee levels reflect these economies of scale for the benefit of fund investors.[24] The fund also should disclose whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the agreement with those under other investment advisory contracts and how such comparisons assisted the board in concluding that the agreement should be approved. Finally, the fund should disclose, if applicable, any benefits derived by the investment adviser from the relationship with the fund, such as soft dollar arrangements. In preparing the disclosure, conclusory statements or a list of factors is not sufficient. If any factor required to be disclosed is not relevant to the board's evaluation of the investment advisory agreement, the fund must note this fact and explain the reasons why such factor is not relevant.[25]

§ 42:3 Contractual Issues Related to the Use of Sub-Advisers

§ 42:3.1 Sub-Advisory Agreement Considerations

In the typical manager of managers structure, unlike investment advisers who typically contract with a fund and are paid by the fund, sub-advisers contract with the investment adviser and are paid by the investment adviser. There are various factors to consider when entering into a sub-advisory relationship and negotiating the terms of a sub-advisory agreement.

[A] Standards of Liability and Indemnification

Most investment advisory agreements outline the applicable standard of care and scope of liabilities in carrying out the terms of the contract. If desired, sub-advisory agreements may enumerate these

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22. Securities and Exchange Commission Form N-1A, Item 27(d)(6).
23. *Id.*
24. *Id.*
25. *Id.*

standards of liability as well.[26] Investment advisory agreements and sub-advisory agreements also may provide for indemnification of the parties to such agreements. section 17(i) of the Investment Company Act must be considered in structuring liability and indemnification provisions in investment advisory agreements and sub-advisory agreements. That section prohibits investment advisory agreements (including sub-advisory agreements) from including a provision that protects the adviser (or sub-adviser) against liability to the fund or its security holders to which the adviser (or sub-adviser) would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of its duties, or by reason of its reckless disregard of its obligations and duties under such agreement.[27] The SEC has taken the position that a provision allowing indemnification by a fund of its investment adviser does not violate section 17(i), so long as it does not extend to circumstances of willful misfeasance, bad faith, gross negligence, or reckless disregard of duties as described in section 17(i), and sets forth reasonable and fair means for determining whether indemnification will be made.[28] The SEC also has indicated that a provision allowing a fund to advance attorneys' fees or other expenses incurred by its investment adviser in defending a proceeding does not violate section 17(i), provided certain conditions are met.[29]

[B] Sub-Advisory Fee Matters

Sub-advisers may be compensated in a variety of ways, depending on how the board of directors and the investment adviser decide to structure the sub-advisory agreement. In the typical case, the investment adviser contracts with the sub-adviser, and the investment adviser pays the sub-advisory fees out of its own investment advisory fees. In this case, the fund is not typically a party to the agreement, although it would be a third-party beneficiary and this may implicate certain state law rights.[30] In certain other cases, however, a fund contracts directly with a sub-adviser, and the fund pays the

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26. DAVID A. STURMS & RENEE M. HARDT, MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATION, PRACTICING LAW INSTITUTE, REGULATION OF THE ADVISORY CONTRACT §§ 6, 24 (3d ed. 2012) [hereinafter Sturms & Hardt].
27. Investment Company Act § 17(i).
28. Indemnification by Investment Companies, SEC Release No. IC-11330 (Sept. 4, 1980).
29. *See id*.
30. SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS, CONTRACTS FOR THE BENEFIT OF THIRD PERSONS, § 37:1 (4th ed. 2000).

sub-adviser out of the fund's assets and earnings. Sub-advisory fees are often based on a percentage of the fund's assets under management, but can also be based on a percentage of the investment advisory fees. Compensation arrangements can also include fulcrum fees, which are performance-based fees that the sub-adviser charges in reference to a specified benchmark.[31] Regardless of the structure of the compensation arrangement selected by the board of directors and the investment adviser, the compensation to be paid to the sub-adviser must be precisely described in the sub-advisory agreement.[32] The agreement should establish the fee schedule, state when fees are payable, and describe the fee structure.

Fee waivers and expense reimbursements are sometimes tied to a sub-advisory fee arrangement. If the investment advisory agreement provides for the waiver of management fees or reimbursement of fund expenses, the effect of these provisions on the sub-adviser's fees and the question of who will bear the related costs should be considered and addressed in the sub-advisory agreement. An investment adviser and sub-adviser may agree to share the burden of such fee waivers and expense reimbursements. This mutual understanding is often memorialized by a provision or provisions in the sub-advisory agreement providing that during any period in which the investment adviser waives its management fees, the sub-adviser will likewise waive its sub-advisory fees, and/or during any period in which the investment adviser reimburses fund expenses, the sub-adviser will likewise reimburse fund expenses. The particular allocation of costs and operation of the waiver or reimbursement are negotiated by the parties on a case-by-case basis.

In addition, a sub-advisory agreement may include a "Most Favored Nation" or "MFN" clause. Under this contractual provision, the sub-adviser represents that the fee that the other party to the agreement (typically the investment adviser) is paying is the lowest fee rate that the sub-adviser charges to similarly situated clients.

The fees that a sub-adviser receives must be reasonable, in light of the sub-adviser's fiduciary obligations to the fund.[33] In addition, the board of directors must approve any sub-advisory agreement and satisfy itself that the compensation paid under the sub-advisory agreement is reasonable. As discussed above in section 42:2.2, the factors considered in making this determination must then be disclosed in a fund's annual or semi-annual report to shareholders. The role of the board of directors in reviewing the fees paid under a

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31. Investment Advisers Act § 205(b)(2).
32. Investment Company Act § 15(a).
33. Investment Company Act § 36(b).

sub-advisory agreement is also discussed in more detail below in section 42:6.2.

A change in the rate of compensation paid to a sub-adviser under a sub-advisory agreement may or may not require shareholder approval, depending on the circumstances. If an amended sub-advisory agreement would directly or indirectly increase the fees charged to the fund or its shareholders, section 15(a) of the Investment Company Act requires that such increase be approved by fund shareholders. As discussed above in section 42:2.1[A], however, many funds have sought and obtained from the SEC exemptive orders that permit the funds and their investment advisers to enter into and materially amend sub-advisory agreements without shareholder approval. To the extent that a fund has obtained such exemptive relief, a sub-advisory fee with respect to that fund could be increased as long as the total amount of the advisory fees paid by the fund does not exceed the total amount provided by investment advisory agreements that shareholders have approved. Furthermore, the SEC has indicated in a no-action letter that it would not recommend enforcement action under Section 15(a) if advisory fees paid by a fund were reallocated between the fund's investment adviser and sub-advisers without shareholder approval, provided that the total fees paid by the fund under the investment advisory contract and the services provided by the adviser and sub-adviser would remain unchanged following the reallocation.[34]

[C] Other Sub-Advisory Relationship Matters

There are a number of additional business arrangements to consider when an investment adviser and sub-adviser are entering into a sub-advisory contract, and such arrangements may be reflected in a sub-advisory agreement or in another agreement between the investment adviser and the sub-adviser (which is more typical). For example, the investment adviser might be interested in a lock-up or exclusivity provision, which limits the ability of the sub-adviser to manage other funds with similar strategies. In addition, the sub-adviser might seek to obtain a right of first refusal with respect to new products or business opportunities promoted by the investment adviser. The sub-adviser could also agree to reserve some portion of its sub-advisory capacity for one or more funds sponsored by the investment adviser. Finally, the investment adviser may want to obligate the sub-adviser to assist in marketing the investment adviser's funds.

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34. Invesco No-Action Letter, *supra* note 17.

§ 42:3.2 Duties and Obligations of Adviser and Sub-Adviser

[A] Oversight and Termination of Sub-Advisers

[A][1] Termination Requirements

Termination clauses in sub-advisory agreements often track the requirements of section 15(a) of the Investment Company Act, providing that the contract may be terminated at any time, without penalty, by the board of directors or by shareholder vote on sixty days' written notice to the sub-adviser. Sub-advisory contracts also typically provide that the investment adviser and sub-adviser may terminate the contract on sixty days' written notice to the other party, although it is not uncommon to see the notice requirement for termination by the sub-adviser to be longer than sixty days. Some contracts provide other circumstances in which the board of directors is permitted to terminate the contract, including the right to terminate the contract immediately if the sub-adviser becomes statutorily disqualified from serving as a sub-adviser, files for bankruptcy, or becomes insolvent.[35] If the fund is not a party to the sub-advisory agreement, approval on behalf of the fund may not be necessary for the investment adviser to terminate the contract. In practice, however, the investment adviser will typically consult with the fund's board of directors before a significant change is made in the fund's portfolio management lineup. When a sub-adviser is terminated, the fund typically must disclose the change of sub-adviser in its prospectus.[36]

[A][2] Oversight of Valuation

Both advisers and sub-advisers may play a role in assisting with the valuation of securities in a fund's portfolio. As a result, the responsibilities of the adviser, sub-adviser, and the board of directors with respect to valuation issues, especially fair value determinations, should be clearly defined and potentially described in the investment advisory and sub-advisory agreements. The sub-advisers may be asked to provide input regarding fair value determinations, provided that the board of directors is comfortable with the sub-adviser's role in that regard.[37] The investment adviser is generally designated as

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35. *See* Sturms & Hardt, *supra* note 26, at 17.
36. *Id.* at 20.
37. MUTUAL FUND DIRECTORS FORUM REPORT, PRACTICAL GUIDANCE FOR DIRECTORS ON THE OVERSIGHT OF SUB-ADVISERS (2009) [hereinafter MUTUAL FUND DIRECTORS FORUM REPORT], *available at* www.mfdf.org/images/uploads/resources_files/Sub-AdviserGuidance.pdf.

the responsible party for ensuring that the valuation of a fund's portfolio securities is consistent with the valuation procedures approved by the board of directors.[38] Sub-advisers can, however, help in this endeavor.

[A][3] Derivative Transactions and ISDAs

When a fund desires to engage in over-the-counter derivatives transactions, it will typically seek to enter into an ISDA master agreement with a counterparty, which sets out the standard framework for entering into trades that applies to all transactions between those parties. In a sub-advised fund, considerations may arise as to who, between an investment adviser and a sub-adviser, will negotiate the relevant agreements and whether the investment adviser or sub-adviser will be a party to such agreements. Often the investment adviser or sub-adviser will enter into the master agreement and schedules to the master agreement on behalf of the fund. Similar to valuation, the roles and responsibilities of the adviser and sub-adviser with respect to derivative transactions and ISDA agreements should be clearly defined and potentially set forth in the investment advisory and sub-advisory agreements.

[B] Excessive Fee Actions Under Section 36(b)

Section 36(b) of the Investment Company Act imposes a fiduciary duty on investment advisers of investment companies with respect to the receipt of compensation for services or payments of a material nature, from the fund or its shareholders to the investment adviser or an affiliate of the adviser.[39] Section 36(b) expressly provides shareholders with a private right of action, and among the many suits filed under this provision, lawsuits have been filed based on excessive fee claims in funds with sub-advisers. These claims generally allege that because an investment adviser has delegated a significant portion of its investment advisory duties to a sub-adviser, the payments to the investment adviser are excessive in light of the actual services that it provides to the funds.[40] In one instance, the SEC alleged that the compensation paid to an investment adviser by certain funds was excessive in light of the services actually performed by the investment adviser, and that most of the adviser services provided to the funds

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38. *Id*.
39. Investment Company Act § 36(b).
40. *See, e.g.*, Sec. and Exch Comm'n. v. Am. Birthright Trust Mgmt. Co., Inc., SEC Litig. Release No. 9266, 21 S.E.C. Docket 1241, 1980 WL 25434 (D.D.C. Dec. 30, 1980); Sivolella v. AXA Equitable Life Ins. Co. and AXA Equitable Funds Mgmt. Grp., LLC, No. 11-4194, 2012 WL 4464060 (D.N.J. July 21, 2011).

were provided by a sub-adviser.[41] Pursuant to a settlement order with the SEC, the investment adviser was required to reimburse the funds involved for a portion of the fees collected under the advisory contract.[42] Additional lawsuits alleging that the fees paid by certain funds were excessive under section 36(b) have been filed in the U.S. District Court.[43]

In light of the excessive fee claims that have been brought against investment advisers under section 36(b), it is important that the investment adviser is able to clearly identify its duties, which should ideally be stated in the investment advisory agreement or renewed, minutes of the board meeting at which the agreement was approved, the applicable shareholder report disclosure, and/or the statement of additional information. In addition, the delegation of duties by the investment adviser to the sub-adviser should be enumerated. A well-defined division of responsibilities in writing is especially important when a sub-adviser takes over a significant amount of the investment advisory duties for a fund. The establishment of the investment adviser's continuing obligations to the fund, notwithstanding the sub-advisory agreement, could be an important factor in analyzing the investment adviser's potential liability in connection with this type of section 36(b) litigation.

§ 42:4 Investment Company Act Issues and Exceptions

The Investment Company Act contains provisions that prohibit certain transactions between funds and their affiliated persons, and affiliated persons of their affiliated persons. For these purposes, affiliated persons of a fund include its investment adviser and any sub-advisers.[44] Recognizing that the growth of funds and changes in business structures were making it difficult for funds to engage in legitimate transactions, the SEC adopted a series of rules that exempt certain persons (including sub-advisers and their affiliates) from the Investment Company Act's restrictions on affiliated transactions.[45] Under these rules, funds are permitted to enter into transactions with "sub-adviser affiliates," which are persons that are affiliated persons of a fund solely because they are the fund's sub-advisers, affiliated

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41. *Am. Birthright Trust Mgmt. Co., Inc.*, SEC Litig. Release No. 9266.
42. *Id*.
43. Kasilag et al. v. Hartford Inv. Fin. Servs., LLC, No. 11-1083, 2012 WL 6568409 (D.N.J. Feb. 25, 2011); AXA Equitable Life Ins. Co. and AXA Equitable Funds Mgmt. Grp., LLC, No. 11-4194.
44. Investment Company Act § 2(a)(3).
45. Transactions of Investment Companies with Portfolio and Subadviser Affiliates, Investment Company Act Release No. IC-25888 (Feb. 24, 2003) [hereinafter Release No. IC-25888].

persons of the fund's sub-advisers, or sub-advisers of other affiliated funds (for example, other funds in the fund complex), when certain conditions are met. While the Investment Company Act's restrictions are designed to prevent affiliated persons of a fund from managing the fund for their own benefit, rather than for the benefit of the fund's shareholders, the rules under the Investment Company Act are intended to permit transactions between funds and these affiliated persons in circumstances in which it is unlikely that the affiliate would be in a position to take advantage of the fund.[46]

§ 42:4.1 Section 12(d) and Rule 12d3-1

Section 12(d)(3) of the Investment Company Act generally prohibits funds from purchasing or otherwise acquiring securities issued by a broker-dealer, underwriter, or registered investment adviser (including sub-adviser). Rule 12d3-1 under the Investment Company Act provides an exemption from the prohibitions of section 12(d)(3). Under Rule 12d3-1, a fund may purchase securities from an issuer that derives more than 15% of its gross revenues from "securities-related activities" if, immediately after such acquisition, the fund does not own more than 5% of the issuer's outstanding equity securities or more than 10% of the outstanding principal amount of the issuer's debt securities, and has not invested more than 5% of the value of its total assets in the securities of the issuer.[47] This exemption is not available for securities issued by the fund's investment adviser, or an affiliated person of the fund's investment adviser. However, for a fund that is managed by multiple sub-advisers, Rule 12d3-1 allows one portion of the fund managed by one sub-adviser to acquire securities issued by an unaffiliated sub-adviser (or its affiliate) that manages another portion of the fund. To take advantage of this exemption, the sub-advisory agreements must limit each sub-adviser's responsibility to providing advice with respect to a discrete portion of the fund and prohibit the sub-advisers from consulting with each other concerning the fund's securities transactions.[48]

§ 42:4.2 Section 17(a) and Rule 17a-10

Section 17(a) of the Investment Company Act generally prohibits any affiliated person of a fund (or any affiliated person of such person) from knowingly selling to or purchasing securities or other property from, or borrowing money or other property from, the fund or

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46. *Id*.
47. Investment Company Act Rule12d3-1(b).
48. Investment Company Act Rule 12d3-1(c)(3).

any company that the fund controls.[49] Section 17(a) was designed to prohibit affiliated persons of a fund, including the fund's investment adviser and any sub-adviser, from engaging in self-dealing and other forms of overreaching.[50] The section thus prohibits transactions involving a fund when an affiliate of the fund is a party to the transaction and has the ability and motivation to influence the actions of the fund.[51]

Rule 17a-10 was adopted by the SEC in 2003 to permit funds to enter into transactions with certain sub-adviser affiliates.[52] Under this rule, a sub-adviser of a fund may enter into transactions with funds not advised by the sub-adviser but which are affiliated with the fund that it does advise (for example, other funds in the fund complex), and a sub-adviser (and its affiliated persons) may enter into transactions and arrangements with discrete portions of the sub-advised fund for which the sub-adviser does not provide investment advice (for example, the portions advised by unaffiliated sub-advisers).[53] The availability of the rule is subject to two conditions. First, the sub-advisory relationship must be the only reason that section 17(a) would prohibit the transaction; and second, both sub-advisers involved in the transaction must be prohibited by their sub-advisory agreements from consulting with each other concerning the fund's (or portion of the fund's) securities transactions.[54]

The SEC and its staff have also granted exemptive and other relief from the prohibitions of section 17(a) in particular circumstances involving sub-advised funds. In one no-action letter, an investment adviser or an entity controlling, controlled by, or under common control with such investment adviser (collectively, "T. Rowe Price") served as the investment adviser to a number of funds within the fund complex (the "Price Funds") and as a sub-adviser to a number of funds outside the fund complex (the "Sub-Advised Funds").[55] The applicant noted that because T. Rowe Price was an adviser, and therefore an affiliated person, of each Price Fund and Sub-Advised Fund, each Price Fund was therefore an affiliated person of an affiliated person ("second-tier affiliate") of each Sub-Advised Fund. Based on these facts, the sale for cash of the Price Fund's shares to the Sub-Advised

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49. Investment Company Act § 17(a).
50. T. Rowe Price Assocs., Inc., SEC No-Action Letter, 2008 WL 2736745 (July 10, 2008) [hereinafter T. Rowe Price No-Action Letter].
51. *Id*.
52. *See* Release No. IC-25888, *supra* note 45.
53. Investment Company Act Rule 17a-10; *see* Release No. IC-25888, *supra* note 45.
54. Investment Company Act Rule 17a-10.
55. T. Rowe Price No-Action Letter, *supra* note 50.

Fund and the redemption for cash of the Price Fund's shares by the Sub-Advised Fund may have been prohibited by sections 17(a)(1) and 17(a)(2), respectively, even if permitted under the funds of funds provisions of sections 12(d)(1)(A) and 12(d)(1)(G) or the rules thereunder.[56] The SEC granted the requested relief from section 17 to allow certain Sub-Advised Funds to purchase and redeem shares of the Price Funds, in each case, for cash at a price based on the applicable Price Fund's net asset value. In doing so, the staff noted that shares of the Price Funds will be sold to, and redeemed by, the Sub-Advised Funds, in each case, at the applicable Price Fund's net asset value calculated in accordance with Rule 22c-1 under the Investment Company Act, and the pricing policies and procedures described in the Price Fund's registration statement, which is the same price that will apply to any other investor in the Price Fund.[57] In addition, the SEC has granted exemptive relief under section 17(a) where the sub-adviser of a discrete portion of a fund (or an affiliated person of the sub-adviser) wished to engage in principal transactions on behalf of the fund with an unaffiliated entity acting as sub-adviser to another discrete portion of the same fund.[58]

§ 42:4.3 Section 10(f) and Rule 10f-3

Section 10(f) of the Investment Company Act generally prohibits a fund from knowingly purchasing or otherwise acquiring any security during an underwriting or selling syndicate if the fund has certain affiliated relationships with a principal underwriter of the security.[59] The prohibition is intended to protect fund shareholders by preventing an affiliated underwriter from placing unmarketable securities with the fund.[60] The SEC adopted Rule 10f-3 to permit a fund to purchase securities that would otherwise be prohibited by section 10(f) (that is, securities purchased during an underwriting or selling syndicate when a principal underwriter of the security is an affiliate of the fund) if certain conditions are satisfied.[61] One condition that is of particular significance to funds with multiple sub-advisers is that a fund, or funds with the same investment adviser (including sub-advisers), may not purchase more than 25% of the amount of the offering.[62] In calculating the 25% limit, Rule 10f-3 requires funds to

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56. *Id.*
57. *Id.*
58. *See, e.g.*, Merrill Lynch Asset Mgmt., L.P., Investment Company Act Release No. IC-22616, 64 SEC Docket 793 (Apr. 14, 1997).
59. Investment Company Act § 10(f).
60. Release No. IC-25888, *supra* note 45.
61. Investment Company Act Rule 10f-3.
62. Investment Company Act Rule 10f-3(c)(7).

aggregate purchases by accounts over which the fund's adviser exercises investment discretion. For a fund with sub-advisers, however, the percentage limit applies only to purchases made by the sub-adviser that is a member (or affiliated with a member) of the underwriting syndicate; purchases made by sub-advisers that are not participating need not be aggregated to determine compliance with the rule.[63] Also of importance to sub-advised funds is the fact that each managed portion of a fund's portfolio is treated as a separate registered investment company for purposes of Rule 10f-3.[64] This means that for funds with unaffiliated sub-advisers, one managed portion of the fund may purchase securities in an offering where an unrelated sub-adviser to another managed portion of the fund is a member (or affiliated with a member) of the underwriting syndicate. The sub-adviser's sub-advisory agreement must limit the sub-adviser's advice to a portion of the fund and prohibit the sub-adviser from consulting with the other sub-adviser that is a member (or an affiliate of a member) of the underwriting syndicate.[65]

§ 42:5 Compliance

§ 42:5.1 Oversight

[A] Considerations in Overseeing Sub-Adviser Compliance

An investment adviser in a sub-advisory relationship is responsible for overseeing the activities of the sub-adviser and the sub-adviser's compliance with the sub-advisory agreement and applicable regulatory requirements. There are a myriad of issues an investment adviser should consider in connection with its ongoing oversight and monitoring of sub-adviser compliance, including, but not limited to, the frequency of on-site visits to meet with sub-adviser personnel, sub-adviser compliance with prospectus limitations, including fundamental and non-fundamental investment policies, affiliated transactions (for example, transactions effected in accordance with Rule 12d3-1 and Rule 10f-3, discussed above) and review of any sales and marketing materials used by the sub-adviser. An investment adviser also should receive reports from the sub-adviser relating to the sub-adviser's code of ethics and proxy voting policies,

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63. Investment Company Act Rule 10f-3(c)(7); Release No. IC-25888, *supra* note 45.
64. Investment Company Act Rule 10f-3(b).
65. Investment Company Act Rule 10f-3(a) and (b); Release No. IC-25888, *supra* note 45.

if applicable, in connection with the investment adviser's compliance oversight function. Furthermore, sub-advisers, as registered investment advisers, are required to have a compliance program under Rule 206(4)-7 of the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act").

[B] Enhanced Oversight Burden on Chief Compliance Officer

In a fund and/or fund complex with multiple sub-advisers, the fund's Chief Compliance Officer (CCO) will be faced with a heightened compliance oversight burden because it would be difficult for a fund board to receive and review detailed presentations from all sub-advisers. Under Rule 38a-1 under the Investment Company Act, the CCO must, at least annually, provide a written report to the board of directors that addresses, among other things, the operation of the compliance policies and procedures of each investment adviser (including sub-advisers), and any material changes that have been made or are being recommended to the policies and procedures.[66] Where a fund and/or fund complex has multiple sub-advisers, the CCO must spend additional time and effort conducting diligence and preparing this annual report. The CCO also may consider requiring certifications from sub-advisers with respect to other sub-adviser activities,[67] such as soft dollar procedures. Given the enhanced oversight obligations that exist in a manager of managers structure, a fund should ensure that its CCO has the resources and support necessary to handle the increased compliance demands, and that the proper evaluation and monitoring methods are in place to oversee the compliance of all sub-advisers.

§ 42:5.2 Sub-Adviser Reporting Requirements

A sub-adviser's reporting requirements are generally the same as those that apply to an investment adviser.[68] Three principal obligations relate to the sub-adviser's code of ethics, compliance policies and procedures, and certain affiliated transactions. The role of a fund's board of directors regarding each of these compliance obligations is discussed below in section 42:6.4.

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66. Investment Company Act Rule 38a-1.
67. Investment Advisers Act Rule 206(4)-7.
68. This is due to the fact that sub-advisers are generally treated like investment advisers under the Investment Company Act, as discussed *supra*.

[A] Code of Ethics

Rule 17j-1 under the Investment Company Act generally requires investment advisers (including sub-advisers[69]) to adopt a written code of ethics that contains provisions reasonably necessary to prevent directors, officers, and certain employees of the investment adviser ("access persons") from engaging in fraudulent activities. Rule 204A-1 under the Investment Advisers Act also requires registered investment advisers to establish and maintain a written code of ethics.[70] Together, these rules establish minimum requirements, but give substantial discretion to an adviser in devising its own code of ethics. Rule 17j-1 also imposes reporting requirements on an adviser (including a sub-adviser) regarding its code of ethics. Before a fund's board of directors may approve an adviser's code of ethics or any amendment thereto, the board must receive a certification from the adviser that it has adopted procedures reasonably necessary to prevent violations of the code.[71] In addition, at least annually, an adviser (including a sub-adviser) must provide the board of directors with a written report that describes any issues arising under the code of ethics since the last report to the board, including material violations of the code and resulting sanctions, and certifies that the adviser has adopted procedures reasonably necessary to prevent violations of the code.[72] When a fund and/or fund complex employs multiple sub-advisers, a fund CCO will often prepare a summary report of all sub-adviser code of ethics changes and violations reported to the CCO, and must be prepared to address adequately such items to the board, as representatives of the various sub-advisers will likely not be present at many board meetings.

[B] Compliance Policies and Procedures

Rule 38a-1 under the Investment Company Act generally requires a fund's board of directors to approve the policies and procedures of the fund's investment adviser (including any sub-advisers) and obligates the fund to review such policies and procedures on an annual basis.[73] The SEC expects that a fund's CCO should be familiar with each fund's service provider's operations, including advisers and sub-advisers, and understand the operations that present

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69. *See* Letter from Robert E. Plaze, SEC, Division of Investment Management, to Craig S. Tyle, General Counsel, ICI, at Q.1 (Nov. 27, 2000).
70. Investment Advisers Act Rule 204A-1.
71. Investment Company Act Rule 17j-1(c)(1)(ii).
72. Investment Company Act Rule 17j-1(c)(2)(ii).
73. Investment Company Act Rule 38a-1.

compliance risks.[74] It is important for the CCO to maintain an active working relationship with each of the sub-advisers and to have arrangements in place that provide the CCO with direct access to each sub-adviser's compliance personnel.[75] In addition, the CCO should receive periodic reports and special reports from each sub-adviser in the event of compliance problems.[76]

[C] Quarterly Compliance Transactions

As discussed above, under the Investment Company Act, sub-advisers are deemed to be affiliates of the funds they advise, and, as such, are generally prohibited from engaging in certain affiliated transactions. The SEC has adopted exemptive rules that permit funds to enter into transactions with sub-adviser affiliates, including Rule 10f-3, Rule 17a-7, and Rule 17e-1 under the Investment Company Act.[77] Rule 10f-3, discussed above in section 42:4.3, allows a fund to purchase securities in an affiliated underwriting. Rule 17a-7 provides relief for different types of cross trades, allowing purchases and sales of securities between affiliated funds.[78] Rule 17e-1 permits a fund's sub-adviser (or other affiliated person) to receive remuneration for service as a broker, without complying with the record-keeping and review requirements.[79] To the extent a fund's sub-adviser engages in transactions pursuant to these exemptive rules, the sub-adviser may be required to provide summary quarterly reports or similar materials to the fund's board of directors to assist the board in its determination that each transaction was effected in accordance with the relevant rule and any applicable policies and procedures adopted by the fund under such rule.

§ 42:5.3 Increased Complexities for Funds with Multiple Sub-Advisers

Some funds employ more than one sub-adviser, which may present increased complexities in connection with the management of the fund. Often such issues stem from the fact that each sub-adviser is managing a discrete portion of the fund without consultation or coordination with the other sub-advisers. For example, a fund

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74. Compliance Programs of Investment Companies and Investment Advisers, SEC Release No. IC-26299, IA-2204 (Dec. 17, 2003) [hereinafter Release No. IC-26299].
75. *Id*.
76. *Id*.
77. *See* Release No. IC-25888, *supra* note 45.
78. *See* Investment Company Act Rule 17a-7.
79. *See* Investment Company Act Rule 17e-1; Release No. IC-25888, *supra* note 45.

will need to monitor and address investments by multiple sub-advisers in the same industry to ensure that the fund's aggregate investments do not run afoul of its fundamental investment restriction with respect to industry concentration. In addition, it may be the case that one sub-adviser purchases a certain security while another sells the same security, or one sub-adviser takes a long position in a certain security while another takes a short position in the same security. A fund that uses multiple sub-advisers may want to consider adding disclosure to its prospectus regarding the risk that the sub-advisers operate independently and their strategies may at times conflict with one another. Alternatively, a fund's investment adviser may want to coordinate the sub-advisers' investment strategies and ensure that those strategies are implemented uniformly across the various sub-advised portions of the fund. Considerations such as these are important aspects of any sub-advisory relationship that a fund and its investment adviser should address when first engaging a sub-adviser.

§ 42:6 Board Oversight

§ 42:6.1 Oversight of the Selection Process of the Sub-Adviser

There are a number of ways in which a fund's board of directors should be involved in the decision to hire a sub-adviser. The evaluation and initial selection process is typically the primary responsibility of the investment adviser, who identifies sub-advisers that it believes will add value to the fund's investment advisory arrangements. Nonetheless, the board of directors must determine that the hiring of a particular sub-adviser is in the best interest of the fund's shareholders and must approve any sub-advisory agreement.[80] To comply with their fiduciary duties to the fund, the directors should understand the criteria and processes the investment adviser uses to analyze candidates to serve as sub-adviser, understand the reasons why a particular sub-adviser was chosen, and evaluate whether the investment adviser's recommendation to hire the sub-adviser is in the best interest of the fund's shareholders.[81] If a sub-adviser is being replaced with a different sub-adviser, the directors should understand why this new arrangement is preferable to the previous arrangement, and the effect a transition would have on portfolio turnover and any tax consequences of such a transition for shareholders. The board also should ensure that the independent directors

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80. Investment Company Act § 15(c).
81. Mutual Fund Directors Forum Report, *supra* note 37, at 5.

do not own any securities issued by a potential sub-adviser or the sub-adviser's controlling affiliates to avoid undermining their independence as directors.[82]

§ 42:6.2 Approving the Sub-Advisory Contract

Once the sub-adviser has been selected, the board must approve the sub-advisory agreement.[83] In determining whether to approve a sub-advisory agreement, the board typically evaluates the same factors that it would consider in determining whether to approve an investment advisory agreement. These factors may include the nature and quality of services to be provided to shareholders, the performance of similar accounts managed by the sub-adviser, the expected profitability of the fund to the sub-adviser, potential economies of scale, fees, and the expected fallout benefits to the sub-adviser.[84] Information relating to the sub-adviser's profitability may be limited, as some sub-advisers may be hesitant to share such information, while others may not be able to calculate effectively the profits that relate directly to the fund.[85] When boards consider renewing sub-advisory agreements they may consider factors similar to those considered when initially approving such agreements, such as the performance of the fund, the performance of similar accounts managed by the sub-adviser, the nature and quality of services provided to shareholders, the profitability of the fund to the sub-adviser, economies of scale, fees, and the fallout benefits to the adviser.[86] A fund's shareholder reports, as discussed above, and certain proxy statements must include disclosure of the material factors and conclusions that formed the basis for the board's approval of the fund's investment advisory and sub-advisory contracts.[87]

§ 42:6.3 Timing of Termination of Non-Performing Sub-Advisers

A fund's board of directors has ultimate responsibility for overseeing sub-advisers, and has authority to terminate sub-advisers. An investment adviser can also typically terminate the sub-adviser. The board and the adviser should have a practice in place regarding

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82. *Id*.
83. *See supra* section 42:2.1.
84. *See* Gartenberg v. Merrill Lynch Asset Mgmt., 528 F. Supp. 1038 (S.D.N.Y. 1981).
85. Independent Director's Council, Board Oversight of Sub-Advisers (2010).
86. *See* Gartenberg v. Merrill Lynch Asset Mgmt., 528 F. Supp. 1038.
87. SEC, Form N-1A, Item 27(d)(6); Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, SEC Release No. IC-26486 (Aug. 5, 2004).

when the performance of sub-advisers will be considered as a potential cause for termination. The board also should understand or identify the process by which a sub-adviser termination will be carried out. Approval requirements, disclosure requirements, and the business realities of transitioning a sub-adviser out of managing a fund's portfolio, or a portion thereof, are all factors that a board of directors and adviser should consider when determining how and when a sub-adviser's termination will be effectuated. Following the termination of a sub-adviser, the adviser and the board should closely monitor the performance of the fund to ensure that there has been a smooth transition in portfolio management and that the fund has returned to normal operations.

§ 42:6.4 Compliance Oversight

In addition to the compliance oversight functions of a fund's CCO and investment adviser, the fund's board of directors also plays an integral role in ensuring that the fund's sub-advisers comply with applicable rules and regulatory requirements. Under Rule 17j-1 under the Investment Company Act, a board of directors, including a majority of directors who are not interested persons of the fund, must approve the code of ethics of a fund's investment adviser (including any sub-advisers), before hiring the adviser, based on a finding that the code contains provisions reasonably necessary to prevent access persons from violating the rule.[88] The board is also required to approve a material change to the adviser's code within six months after the change is adopted.[89] Furthermore, the board is to receive annual certifications with respect to the operation of the adviser's code of ethics on an ongoing basis.[90] Although, as discussed above, a fund CCO will often play an important role in this review, the board must ultimately be satisfied that it has received sufficient information to make the required determinations and, if it has not, request additional information as necessary.

The board of directors has an important role to play in connection with a sub-adviser's compliance policies and procedures as well. The board of directors, including a majority of directors who are not interested persons of the fund, is required by Rule 38a-1 under the Investment Company Act to approve the compliance policies and procedures of a fund's investment adviser (including any sub-advisers) based on a finding that the policies and procedures are reasonably

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88. Investment Company Act Rule 17j-1(c)(1).
89. *Id.*
90. Investment Company Act Rule 17j-1(c)(2). For a discussion of the annual reports that an adviser is required to provide a board of directors, see *supra* section 42:5.2[A].

designed to prevent violation of the Federal Securities Laws by the adviser.[91] The fund must review the adequacy of the adviser's policies and procedures at least annually, including the effectiveness of their implementation.[92] In considering whether to approve an adviser's compliance policies and procedures, a board should review and evaluate any compliance failures that occurred in the previous year; recent compliance experiences, which may reflect weaknesses in the adviser's compliance programs; changes in the business of the adviser or its affiliates; and any regulatory developments that may require changes to the procedures.[93] Boards also may want to consider best practices used by other fund complexes, and consult with counsel and compliance experts.[94]

As discussed above in section 42:5.2[C], the board must review reports provided by sub-advisers regarding affiliated transactions under Rule 10f-3, Rule 17a-7, and Rule 17e-1 under the Investment Company Act, and ultimately find that each transaction was effected in accordance with the applicable policies and procedures. The board also should consider meeting with the fund's sub-advisers periodically, and should determine the frequency with which such meetings will take place.

Finally, the board should establish how it will evaluate sub-adviser performance. In a fund with multiple sub-advisers, each sub-adviser is responsible for advising different and sometimes discrete portions of the fund's portfolio. As such, an evaluation of the fund's overall performance may not be sufficient to determine how each individual sub-adviser is performing. The board may need to consider different options, such as sleeve-by-sleeve evaluations, to identify how discrete parts of the fund managed by different sub-advisers are performing.[95] The board also may need to look at different performance comparisons if a fund is managed by multiple sub-advisers that use different management styles. For example, if a fund has a growth, a core, and a value sub-adviser, then the board may want to compare the growth sleeve to other growth indices and peers, even if the fund is classified as a core fund. In addition, because all sub-advisers contribute to overall fund performance, a board should consider whether and how a decision to address underperformance in one sleeve may impact the

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91. Investment Company Act Rule 38a-1.
92. *Id.*
93. *See* Release No. IC-26299, *supra* note 74.
94. *Id.*
95. MUTUAL FUND DIRECTORS FORUM REPORT, *supra* note 37, at 10.

other sleeves.[96] The board of directors should establish at the beginning of the sub-advisory relationship, and reevaluate when appropriate, the reports that it will require a sub-adviser to provide and the benchmarks that will be used to evaluate the sub-adviser's performance.

96. *Id.*