MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

Report

of the

Mutual Fund Directors Forum

Practical Guidance for Directors on the Oversight of Sub-Advisers

April 2009

I. Introduction

Many mutual funds choose sub-advisers for day–to-day portfolio management. While sub-advisers frequently manage the assets of funds underlying variable annuities, other open-end funds employ them as well. As of December 2008, 18 percent of open-end funds, representing eight percent of open-end fund assets were managed by sub-advisers.[1] In the variable annuity context, sub-advisers managed 45 percent of the underlying funds, representing 36 percent of variable annuity assets.[2]

Advisers and fund boards rely on sub-advisers for numerous reasons. Most prominently:

- The use of sub-advisers allows the primary adviser to provide an investment focus or objective beyond the expertise of the adviser's existing staff,[3] allowing the adviser to fill gaps in its fund lineup without the need for significant new resources.

- The use of sub-advisers also permits fund complexes, especially variable annuity complexes, to offer funds sub-advised by "best in class" or boutique investment advisers or those that the adviser believes to be prominent for marketing purposes.

When the primary adviser manages money directly but wishes to fill in a few gaps in its expertise, only a few funds within a complex employ sub-advisers. In other instances, where the adviser's primary expertise is selecting and managing sub-advisers rather than actual investment management, virtually every fund in the complex will use sub-advisers, and it is not unusual for particular funds to rely on multiple sub-advisers. Some complexes have hybrid structures that feature both sub-advised funds and funds managed by the primary adviser or an affiliate.

When an adviser turns to a third party to manage a fund, the adviser has a responsibility to oversee the sub-adviser's portfolio management performance. The adviser also takes on some responsibility to oversee the sub-adviser's compliance with the fund's investment and other policies. The fund's board, which has ultimate responsibility for the fund, also has a key role to play in overseeing the sub-adviser, just as it does in overseeing the primary adviser.

While the use of sub-advisers thus offers many potential benefits, overseeing a fund's use of sub-advisers poses a number of unique challenges for fund directors. Though a board's duties with respect to the oversight of sub-advisers are in many respects similar to the oversight of a fund's investment adviser, practical considerations, such as the lack of proximity between a board and sub-advisers, as well as the lack of guidance on

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1 Source: Strategic Insight.

2 Id.

3 See, e.g., George P. Attisano, Investment Company Board Oversight of Sub-Advisory Relationships, The Review of Securities and Commodities Regulation, Vol. 41 No. 5, March 5, 2008.

overseeing sub-advisers, can make it difficult for the board to meet its responsibilities. One fundamental concern, in a context in which access to information is limited, will be to ensure that a sub-adviser meets its compliance obligations to the fund. However, a number of other issues beyond compliance, unique to the use of sub-advisers, also require directors' attention. The Forum has therefore prepared this report to provide fund independent directors with practical guidance to assist them in the complex task of overseeing all phases of their funds' sub-advisory relationships – from entering sub-advisory relationships, through monitoring existing relationships, to ending these relationships.[4]

II. Basic Law Governing the Use of Sub-Advisers

In the most basic sense, the law governing sub-advisers is no different than that governing advisers. A sub-adviser is an "investment adviser"[5] for purposes of the Investment Company Act of 1940 ("1940 Act"). Accordingly, as is the case with a fund's primary adviser, the contract with the sub-adviser must be in writing and must describe all compensation to be paid to the sub-adviser. Moreover, the contract with the sub-adviser requires director and shareholder approval (unless exempt); requires annual renewal by directors if the contract is to continue for more than two years; must provide that it may be terminated within 60 days by the board or a majority vote of the fund's outstanding voting securities; and is automatically terminated if the contract is assigned.[6]

Sub-advisory relationships can be structured as a contract between the adviser and the sub-adviser; directly between the fund and the sub-adviser; or as a three party agreement between the fund, adviser, and sub-adviser. However, the requirements for board (and often shareholder) approval and renewal of the sub-advisory agreement are the same, whether or not the fund is a party to the contract.

A fund complex that relies almost exclusively on sub-advisers for portfolio management services ("manager-of-managers") may be able to avoid the requirement that shareholders approve changes to sub-advisory relationships. Manager-of-managers complexes, working with the SEC, have found ways to minimize the costs associated with managing a "stable" of sub-advisers. Specifically, recognizing both the primary adviser's expertise in selecting and overseeing sub-advisers and that the cost associated with frequent

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[4] This report was developed by a working group of leaders in the independent director community with advice given by members of the Forum's Advisory Board. Members of the working group participated in this report in their individual capacities and not as representatives of their organizations, the fund boards on which they serve, or the funds themselves. Drafts of this report were reviewed by the Forum's Board of Directors and Steering Committee. This report does not necessarily represent the views of all Forum members in every respect.

[5] The definition of "investment adviser" in Section 2(a)(20) of the 1940 Act includes an entity that regularly performs substantially all of the duties of the investment adviser pursuant to a contract with the fund's adviser.

[6] See Section 15(a) of the 1940 Act.

shareholder approval of new sub-advisory contracts is of little benefit to shareholders, the SEC has approved numerous exemptions permitting funds to change one or more sub-advisers without shareholder approval. [7]

These orders rely first and foremost on the expectations of these funds' investors that they are acquiring the services of an adviser with expertise in selecting and managing other advisers, and they are looking to that adviser to select sub-advisers for them. Nonetheless, in order to keep shareholders apprised of the progress of their funds, manager-of-managers orders require that fund shareholders be notified of any sub-adviser changes and also that directors approve the hiring, continuation, and termination of sub-advisers.

Finally, although exemptive orders often do not require disclosure of the fees paid to each individual sub-adviser, they do require that the aggregate amount paid to sub-advisers be disclosed and that the directors not take any action that would increase the overall advisory fee paid by shareholders without first obtaining shareholders' consent. [8]

III. Practical Guidance for Directors – The Oversight of Sub-Advisers

As outlined above, the 1940 Act treatment of sub-advisory relationships is no more complex than the treatment of the relationship between a fund and its primary adviser. However, because hiring a sub-adviser brings a new party into the set of relationships overseen by fund directors, it raises different issues for directors and has the potential to make their oversight more challenging. In order to guide directors through the issues they are likely to encounter when overseeing sub-advisory relationships, the Forum has developed the following practical guidance.

- **Directors Should Understand the Reasons Why a Fund's Adviser Recommends the Use of a Sub-Adviser**

In many instances, engagement of a sub-adviser is a foregone conclusion – for example, in a manager-of-managers complex, the directors and adviser will have already determined that all (or many) of the funds in the complex will be managed by sub-

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[7] For a list of common conditions in manager-of-managers orders see, e.g. Audrey C. Talley, Specialized Investment Companies: Manager of Managers, ALI-ABA Course of Study Materials, Investment Company Regulation and Compliance, June 2000.

[8] There are two genres of exemptions that have been granted by the SEC for manager-of-managers funds. Both permit the retention of sub-advisers without the need for shareholder approval. One also provides an exemption from fund disclosure requirements so that the sub-advisory fee does not need to be disclosed. These orders usually do not excuse a fund from shareholder voting if the sub-adviser is an affiliate of the adviser. The SEC staff has also permitted a change to the fee split between a primary adviser and a sub-adviser without requiring shareholder approval. *See* Invesco, SEC No-Action Letter (August 5, 1997).

advisers. Consequently, the adviser will likely already have well-developed processes for identifying, retaining, monitoring and terminating sub-advisers.

Outside the manager-of-managers complex, directors should understand why the adviser recommends the engagement of a sub-adviser. Among other possible reasons, the adviser may wish to offer a fund in a particular asset class, but does not have the expertise or resources to manage the fund itself or the adviser may conclude that an existing fund could be managed more cost effectively by a sub-adviser. Because directors ultimately need to conclude that hiring a particular sub-adviser is in the best interests of a fund's shareholders, it is important that they understand why, as an initial matter, retaining a sub-adviser is appropriate.

- **Boards Should Thoroughly Understand an Adviser's Search and Selection Process Used to Identify Sub-Advisers**

Boards should understand how an adviser determines to recommend a particular sub-adviser for a fund. Boards should understand the processes and tools the adviser uses to analyze candidates to serve as a sub-adviser, and should be satisfied that the process is sound. Boards may wish to address the following issues when considering how an adviser identifies candidates to sub-advise a fund:

  - What universe of investment managers does the adviser consider and how does the adviser screen for candidates to serve as sub-adviser?
  - What analytics does the adviser use to analyze a candidate's performance, and what time periods are emphasized?
  - Does the adviser consider performance in both up and down markets?
  - Does the adviser consider the potential sub-adviser's investment process, use of derivatives, risk controls, ability to add alpha, resources, or any other relevant factors?
  - Does the adviser look at whether a potential sub-adviser is popular with shareholders and intermediaries to promote sales of the fund?

Boards should consider and communicate with the primary adviser about the stage in the selection process at which the board wishes to be involved, particularly if the board wants to have input in the process before the adviser makes a final recommendation to the board that a particular sub-adviser be hired. Once the adviser settles on a final recommendation, the board should receive a report on why a particular sub-adviser was chosen from the universe of potential sub-advisers, and other sub-advisers considered, particularly the finalists, and the specific reasons for deciding on the recommended adviser. By carefully considering the adviser's process that led to the final recommendation, the board can gain confidence that the final recommendation is in the best interest of the fund's shareholders.

- **Directors Should Assure Themselves that the Adviser has Adequate Resources to Monitor the Sub-Advisory Relationship**

Especially in cases in which a fund complex has not engaged a sub-adviser in the past, the board should be satisfied that the adviser has adequate resources to monitor the sub-advisory relationship. In particular, the adviser should have the necessary resources to monitor the sub-adviser's performance, its compliance program and its compliance with any restrictions imposed on the fund itself. Directors should understand how the adviser intends to monitor the sub-adviser (including how the fund will use its own Chief Compliance Officer ("CCO") to monitor the sub-adviser), and should be confident that the practices and procedures that will be put in place will be adequate.

- **The Fees Paid to the Adviser Must Be Reasonable**

Where a fund's adviser relies upon a sub-adviser for the fund's portfolio management, the board must consider factors beyond investment performance in determining that the fee paid to the primary adviser is fair in light of the remaining services provided by the adviser.[9] For example, the board should consider the adviser's process for the search, selection, and monitoring the performance of sub-advisers. A board may also wish to consider the adviser's compliance program, its administrative services, its fund accounting and legal responsibilities, its assistance in valuing fund assets, oversight of securities lending, and other services the adviser provides to the fund.

- **Directors Should Understand the Capabilities and Expertise of the Sub-Adviser**

Once the adviser recommends retention of a particular sub-adviser, directors should seek to assure themselves that the sub-adviser is capable of serving the fund. For example, if the sub-adviser has been chosen to enable the adviser to offer a fund in a particular asset class or niche, directors should be familiar with the sub-adviser's capabilities in that area. As part of this process, directors should consider meeting with management and portfolio management personnel of the proposed sub-adviser.

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[9] See Securities and Exchange Commission v. American Birthright Trust Management Company, Inc., SEC Litigation Release no. 9266 (December 30, 1980). In that administrative proceeding against American Birthright Trust Management Company, representatives of management, and also the complex's independent directors, the SEC found that the funds' sub-adviser provided day-to-day portfolio management and alleged that the advisory fees paid to the management company were excessive in light of the very limited services provided by the funds' adviser. In a settlement with the SEC, the management company was required to reimburse the funds involved for amounts collected under the advisory contract.

- **Directors Should Obtain Information on the Organization and Compliance Program of the Sub-Adviser Before Entering Into a Sub-Advisory Contract**

As noted above, a sub-advisory relationship is an advisory relationship subject to the 1940 Act. Directors thus have a responsibility for oversight at the sub-advisory level. A fund board is required to approve the compliance policies and procedures of the sub-adviser and conclude that they are reasonably designed to prevent violation of the federal securities laws by the sub-adviser.[10] In fulfilling this duty, a board should seek a certification from the CCO of the sub-adviser.

A board may find it useful to receive a report from the fund's CCO when the adviser wishes to retain a new sub-adviser. The report may include organizational items, such as information about the individuals who are responsible for the sub-adviser's compliance program; review of regulatory documents, including relevant portions of the sub-adviser's Form ADV and, especially relevant information on material compliance deficiencies; compliance matters, including the sub-adviser's code of ethics; a description of the compliance program and the sub-adviser's compliance policies; and a description of any pre-existing relationships the sub-adviser has with the fund or the fund's adviser.[11] In appropriate instances, some boards may prefer to receive the CCO review and reports once the relationship has commenced rather than at the outset of a new relationship.

The board should also determine whether the fund's CCO will have adequate access to the sub-adviser's CCO and/or other appropriate compliance personnel at the sub-adviser.

- **Directors Should Understand Why a New Sub-Adviser is Preferable to the Existing Sub-Adviser**

There are many reasons why an adviser may recommend changing sub-advisers at a fund that is already sub-advised: the current sub-adviser may be failing to meet the adviser's and board's expectations with respect to performance; the adviser may believe that there are other sub-advisers with strong records in the asset class in which the fund invests; the adviser may believe that other sub-advisers are equally good but will be less costly to the fund, the primary adviser, or both; the sub-adviser may be experiencing compliance issues; or there may be other problems in the relationship between the fund, the adviser and the incumbent sub-adviser. Understanding why a change in sub-advisers is appropriate will help directors determine whether the proposed new sub-adviser is more likely to meet the needs of the fund and its shareholders.

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[10] Rule 38a-1 under the 1940 Act.

[11] For a list of suggested due diligence efforts that should be considered by the adviser, see Lemke, Lins and Smith, Regulation of Investment Companies, Section 7:13 – Sub-Adviser Due Diligence Matters, Matthew Bender and Company, 2008.

- **Directors Must Approve Any Sub-Advisory Agreement, Whether Or Not The Fund Is A Party to the Contract**

No matter how the sub-advisory contract is structured, the 1940 Act requires that the contract be in writing, that it meet the requirements imposed by the Act on advisory contracts, and that it be approved by the board. The board must therefore decide whether to enter into a sub-advisory contract (and determine whether to renew the sub-advisory contract) pursuant to the legal standards that govern its review of the contract between the fund and its primary adviser.

The board's process is likely to parallel the process by which it otherwise reviews a contract with the primary adviser, and will generally include consideration of many of the same factors and considerations. (Board review of sub-advisory contracts will thus likely include review of the factors traditionally associated with the *Gartenberg* case[12] as well as any other factors that the board deems relevant.[13]) However, at least in situations involving a sub-adviser that is not affiliated with the fund's primary adviser, some boards may find it reasonable to place less emphasis on a sub-adviser's profitability, instead relying on the notion that the sub-advisory fees have been negotiated in a true arms' length negotiation with the adviser.

In addition, in weighing whatever factors it determines are relevant, the board should keep in mind that the services provided by the sub-adviser will likely be more closely associated solely with portfolio management (in contrast with the potentially broader range of services customarily provided by the primary adviser). Finally, as outlined below, the board may need to modulate its consideration of certain factors if it finds that obtaining relevant information from the sub-adviser is more complex than obtaining similar information from the primary adviser or that the information is proprietary and simply not available.

A fund's annual or semi-annual report to shareholders must include disclosure of the basis for approval of an investment advisory agreement. This requirement applies to sub-advisory as well as advisory agreements. Boards should therefore consider the disclosure that is intended to characterize the material factors the board considered and the conclusions that formed the basis for approval of the sub-adviser. A board of a manager-of-managers complex faces the need for this type of disclosure on a regular basis, and therefore may wish to develop a protocol for this type of disclosure.

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12 *Gartenberg v. Merrill Lynch Asset Management*, 528 F.Supp 1038 (SDNY 1981), articulated the factors generally considered by a fund's board when evaluating the fund's advisory fee. These factors include: the nature and quality of services provided to the shareholders; profitability of the fund to the adviser; economies of scale; how the fund's fees compare to other similar funds; and fallout benefits to the adviser.

13 On March 9, 2009, the Supreme Court agreed to hear an appeal from the Seventh Circuit's decision in *Jones v. Harris Associates* (527 F.3d 627, *cert. granted* No. 08-730, March 9, 2009). Depending upon how the Court decides the case, its opinion may impact how boards determine whether to renew an advisory contract.

- **The Fees Paid Under the Sub-Advisory Agreement Must be Reasonable**

As with the investment advisory agreement, directors must review the fees paid under the sub-advisory agreement to satisfy themselves that fees are reasonable in light of the services rendered under the contract. While the board may reasonably expect that there has been arms' length bargaining in the case of an unaffiliated sub-adviser, independent directors must still be vigilant in their evaluation of the fee paid under the sub-advisory agreement.

Fund directors should be mindful that the adviser itself, rather than the fund, may benefit when the adviser negotiates a lower sub-advisory fee. Indeed, a board may wish to consider whether some of the savings from a lower sub-advisory fee should be shared with shareholders, balancing that against providing necessary incentives for the primary adviser to negotiate the best possible fee on behalf of fund shareholders.

The board should seek some rational basis for assessing the reasonableness of a sub-adviser's fees. Because of the differences in services rendered to a sub-adviser's proprietary funds where it acts as the primary adviser, comparing sub-advisory fees to the fees the sub-adviser charges to its proprietary funds may not be useful. Boards may rely on the arm's length nature of the negotiations over fees between advisers and sub-advisers. Boards also may choose to compare the fees paid under the sub-advisory contract to fees the sub-adviser charges to other sub-advisory clients or institutional accounts; fees paid to other sub-advisers by other similar funds in the complex or in other manager-of-managers complexes; or, for a new sub-adviser, fees negotiated with other candidates to provide sub-advisory services to the fund. If the board chooses to consider fees charged to institutional advisory accounts, it may wish to consider that those accounts have less shareholder servicing needs and also may present the sub-adviser with fewer compliance burdens.

For a fund that uses multiple sub-advisers, the board may wish to pay all sub-advisers the same fee to eliminate an adviser's incentive to direct more assets to the lower cost sub-adviser, and thereby retain a larger portion of the fee. If equal advisory fees are not practical, the board should be comfortable with the adviser's process for allocating assets among a particular fund's sub-advisers and maintain a record of its consideration of this matter.

- **Lack of Access to Complete Information May Make Measuring Profitability in the Sub-Advisory Context Difficult**

The profitability of the contract to a sub-adviser can be difficult to measure, particularly in the case of non-publicly traded, unaffiliated sub-advisory firms. Because sub-advisers are often unwilling to share profitability data and expense allocation data with outside parties, fund directors may not have access to the same depth of information they receive from the adviser with respect to the advisory contract. In the absence of more concrete profitability information, the board should at least be aware of the fees charged by the sub-adviser to other comparable clients and try to satisfy itself that the fee is reasonable

using the suggestions in the discussions above on "The Fees Paid Under the Sub-Advisory Agreement Must be Reasonable."

- **Directors Should Take Special Care When Reviewing Contracts When Multiple Sub-Advisers Manage a Single Fund**

Some funds may use multiple sub-advisers examples might include a small-cap fund that faces limitations on a single sub-adviser's capacity or a blended fund that invests in both growth and value securities. Different sub-advisers will be responsible for different portions or "sleeves" of the fund. Because monitoring only the fund's overall performance may not indicate issues with one particular aspect of the fund, boards should ask the adviser to present information on the performance of each sleeve separately to isolate any issues that are specific to a particular sub-adviser. Because all sub-advisers for the fund contribute to overall performance, a board should consider whether a decision of how to address one underperforming sleeve is complicated by ramifications for the other sleeves. A change to any one portion of the fund may require consideration of overlapping investments or maintaining an appropriate balance within the fund.

- **Affiliated Sub-Advisers Require Additional Attention by the Board**

An adviser may sometimes recommend its own affiliate to serve as a fund's sub-adviser.[14] The board's involvement where an affiliate manages a fund is likely to be different than where an unaffiliated sub-adviser manages a fund. For example, the board may have regular access to the chief investment officer and portfolio managers of the sub-adviser, and, as a practical matter, may choose to treat the affiliated sub-adviser as an extension of the primary adviser, giving the board an opportunity to review performance at a portfolio management level, rather than at the sub-advisory level.

The board also should consider any payments between the adviser and its affiliate to gain a complete understanding of the relationships between them. These relationships are especially important as directors consider the profitability of the advisory contract to the adviser or sub-adviser. Also, in considering annual renewal of sub-advisory agreements, boards should consider whether information on expenses and profitability should be considered separately for the adviser and sub-adviser, or should be presented on a consolidated basis, or both. In addition, the board should be especially attentive to any potential fall-out benefits of the arrangement to the fund's adviser.

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[14] *See In the Matter of Western Asset Management Co. and Legg Mason Fund Adviser Inc.*, Investment Advisers Act Release No. 1980 (September 28, 2001). The SEC sanctioned the adviser and sub-adviser (a wholly owned subsidiary of the adviser) pursuant to Section 203(e)(6) of the Investment Advisers Act for failure to supervise the fund's portfolio manager and failure to have adequate policies and procedures to prevent securities law violations. Further, the adviser did not adequately investigate irregularities in a fund's portfolio holdings and pricing of those securities.

In complexes that use both affiliated and unaffiliated sub-advisers, the board should communicate to the adviser any differences in the standards that will be used to evaluate affiliated and unaffiliated sub-advisers.

- **Directors Need to Exercise Care to Maintain Their Independence**

Boards of manager-of-managers funds need to exercise care that independent directors do not own securities issued by sub-advisers or their controlling affiliates. Inadvertent ownership of these securities can undermine a director's independence and can create legal problems, particularly for items that require approval by independent directors under the 1940 Act and its rules. Boards of complexes that use a large number of publicly-held sub-advisers should develop a procedure for asking directors to periodically check their holdings and confirm to a designated director or counsel that they do not hold securities of sub-advisers. Many directors in manager-of-manager fund complexes have found that it is best to avoid holding securities of major financial institutions with asset management capabilities. Such policies, however, would not prevent directors from investing in mutual funds that concentrate in financial institutions.

Directors need to exercise care when considering a candidate to be a new sub-adviser, and advance notice of potential candidates from the adviser can serve as a trigger for directors to sell pertinent holdings. Ownership of a security issued by a sub-adviser or a controlling affiliate should be promptly reported to management or the fund CCO. Directors should also report whether any members of their immediate families are an officer, director, employee, partner, or 5% shareholder of a sub-adviser or a candidate for sub-adviser.[15]

- **The Board Should Understand the Fund CCO's Capabilities in Overseeing Activities of the Sub-Advisers**

While the adviser generally has a responsibility to oversee the compliance activities of a sub-adviser with respect to the sub-advised fund, boards also should be comfortable that the sub-adviser is meeting its compliance responsibilities. Fund CCOs can be a valuable resource for directors in the monitoring of sub-advisers. For example, some manager-of-managers groups send quarterly questionnaires to sub-advisers seeking representations about compliance. The questionnaire may inquire about: compliance with a fund's investment restrictions and prospectus limits, compliance with the 1940 Act, compliance with requirements under tax law under the control of the sub-adviser, and compliance with the sub-adviser's (or fund's) code of ethics. The fund CCO can be enormously useful in helping boards to receive and understand the results of these inquiries. In any case, boards should receive this type of report from the sub-adviser or a summary from the fund CCO. In addition, directors may look to their fund's CCO to pay periodic visits to the sub-adviser to look into other compliance issues such as best execution, soft dollars, fair value, treatment of derivatives, among others. The CCO could then report to

[15] The rules on independence are in Section 2(a)(19) of the 1940 Act. Members of an immediate family include a parent, parent's spouse, child, child's spouse, and a brother or sister, and include step or adoptive relationships.

the board, prioritizing the information and identifying any issues that require the attention of the board.

The board should be aware that the fund's CCO may have limited access to a sub-adviser's detailed compliance information, particularly in the case of unaffiliated sub-advisers. Nonetheless, the board should expect the CCO to be familiar with the sub-adviser's compliance procedures that are likely to be pertinent to a fund, including those governing soft dollars, valuation, cross trades, and proxy voting, to make sure they are acceptable for the fund.

The fund's CCO can test the operations of a fund's primary adviser and be satisfied that the adviser is complying with the fund's policies and procedures. In contrast, the CCO must rely primarily on representations from the sub-adviser that it is complying with its procedures. However, the CCO should have a basic understanding of the sub-adviser's testing program, require timely notification of any exceptions, and be comfortable with the representations. Establishing a working relationship with the sub-adviser's CCO can help the fund's CCO to achieve this.

In addition, the board can seek the CCO's perspective on less formal aspects of the overall sub-advisory relationship. For example, the CCO can provide insight on the general business health of the sub-adviser and the degree to which the sub-adviser seems to value the relationship, by reporting on the sub-adviser's responsiveness to inquiries, cooperation on fair value determinations, how the sub-adviser brings issues to the attention of the fund's CCO, and the overall environment observed during on-site visits.

- **The Board Should Determine How Best to Communicate with the Sub-Adviser**

Boards differ on how they interact with sub-advisers. The frequency and type of meetings held with sub-advisers can differ widely based on the structure of the fund complex, the board's preferences, the number of funds, the number of sub-advisers, and other considerations that vary from complex to complex. For example, some boards choose to meet with sub-advisers before the inception or at the outset of the relationship. These meetings can be either in-person or by telephone. Thereafter, boards may choose to meet with sub-advisers on a regular schedule or only on an as-needed basis, such as when there have been personnel changes or performance issues. In addition, some boards choose a group of directors to make on-site visits to sub-advisers. Such visits generally focus on the investment process and can afford directors insight into the capabilities of the sub-adviser.

Some boards find a "stop light" approach useful in helping to establish a schedule for meeting with sub-advisers, particularly where a board oversees multiple sub-advisers. A sub-adviser that the board and CCO are familiar with and has had no problems could be assigned a "green light," and the board may conclude that a meeting is not needed. In contrast, a sub-adviser that has experienced some performance issues, compliance issues, investment style drift or personnel changes could be assigned a "yellow light," and directors may determine to meet with the sub-adviser, either in person or telephonically, to discuss issues of concern. Sub-advisers with serious problems would be assigned a

"red light" and asked to attend perhaps a series of meetings until the issue is resolved or the sub-advisory relationship is terminated.

- **The Fund's CCO Should Review a Sub-Adviser's Soft Dollar Procedures**

Boards will likely find that it is much more difficult to monitor and influence the soft dollar practices of a sub-adviser, particularly one that is unaffiliated with the fund's investment adviser. Nonetheless, the fund's CCO should review the sub-adviser's soft dollar procedures and, of course, a sub-adviser should not engage in any (even otherwise permissible) soft dollar practices that do not comply with these procedures. Additionally, the sub-adviser should periodically be asked to represent to the fund's CCO that it complied with its procedures.

As part of a compliance review, the fund's CCO may seek certifications from the sub-adviser that it is in compliance with the federal securities laws with respect to its soft dollar practices. Because neither the adviser nor the CCO is likely to have unfettered access to the sub-adviser's operations, the certifications can provide a reasonable measure of comfort to the adviser, the fund's CCO, and the fund's board.

The board is free to articulate best practices or to notify a sub-adviser that a particular practice used by a sub-adviser is not consistent with the practices of other sub-advisers serving the complex. Such pressure may encourage a particular sub-adviser to change the soft dollar practices it uses with respect to a fund; however, it is not realistic to expect that directors may ordinarily exert influence over the soft dollar practices of a sub-adviser.

- **Boards May Wish to Monitor a Sub-Adviser's Portfolio Allocation Practices**

Boards should understand a sub-adviser's portfolio allocation procedures to make sure the fund is being treated fairly in relation to other clients of the sub-adviser. Again, although a board may responsibly rely on the fund's CCO to understand a sub-adviser's portfolio allocation procedures, the directors should be comfortable with the sub-adviser's representations that those procedures are being followed. Funds may choose to use a dispersion analysis as part of a review of the sub-adviser's trading practices. The analysis will examine the performance of the sub-advised fund compared to the performance of the sub-adviser's similar proprietary funds or other managed accounts. Wide dispersion could be a symptom of favoritism of proprietary funds in allocation.

- **The Board Should Understand How a Sub-Adviser Monitors Risks Associated with the Use of Complex Instruments**

A board should be aware of a sub-adviser's use of complex instruments. In effect, the board should ask the primary adviser to compile adequate information to be comfortable with the sub-adviser's risk management protocol and understand how the sub-adviser handles operational risk, documentation, volatility, segregation of assets where required, collateral, and other related issues.

- **The Board Should Review the Sub-Adviser's Proxy Voting Policies to Ensure They are Compatible with the Fund's Proxy Voting Policies**

Complexes that use sub-advisers take different approaches to proxy voting. Some develop procedures that are administered by the adviser, and proxies are voted on a centralized basis for all funds, frequently with the assistance of a proxy voting service. Boards that choose to centralize proxy voting should consider whether input from a sub-adviser will be permitted, and whether such input will be sought only on certain issues or in cases where the primary adviser has a potential conflict because of a relationship with a portfolio company.

Other complexes rely on sub-advisers to vote proxies under the sub-adviser's procedures. If a sub-adviser will vote the fund's proxies, the board should ask the primary adviser to review the sub-adviser's proxy voting procedures, paying particular attention to differences in the way the sub-adviser may vote proxies in comparison to proxies voted by the fund's adviser.

- **The Adviser and Sub-Adviser May Work Together to Provide Consistent Valuations for Securities Across the Complex**

The board's portfolio valuation responsibilities for sub-advised funds are not significantly different from those for funds without a sub-adviser. The adviser and sub-adviser may each play a role in the valuation of securities in the fund's portfolio consistent with procedures approved by the board. Many sub-advised funds have procedures under which sub-advisers may be asked to assist in fair value determinations and boards should be satisfied with their cooperation in the effort. Although sub-advisers may not wish to take on the legal responsibility for fair value determinations for funds that are not their proprietary funds, they can be expected to provide information in fair value situations and inform the adviser when the sub-adviser uses fair value in its proprietary funds for a security also held by the fund. In evaluating sub-advisers, a board may inquire about whether sub-advisers cooperate in fair value determinations.

It is the adviser's responsibility to assure that the securities in the fund's portfolio are valued in a manner that is consistent with the procedures approved by the board. In the case of a fund complex with multiple sub-advisers, the board should be satisfied that the adviser has a mechanism in place to ensure that the same securities held in different funds – or managed by different sub-advisers – are assigned the same value.

- The Board Should Understand the Necessary Steps When a Sub-Advisory Relationship is Terminated

Even where it may terminate a sub-adviser on its own, the adviser normally consults a fund's board on its decision. Some boards, particularly in manager-of-managers complexes, also sometimes seek to initiate a change in sub-adviser.

Prior to the termination of a sub-adviser, with the approval of the board, the adviser might take a number of cautionary steps, such as putting a sub-adviser on a watch list,

and a board may meet with the sub-adviser to try to ascertain if there are explanations for problems with the sub-adviser's performance. Once a decision is made to terminate a sub-adviser, the board will generally look to the adviser to seek and recommend a replacement.

Fund assets must be protected following the termination of a sub-adviser. The board should ask the adviser to make the transition as smooth as possible, and to monitor the fund until the new sub-adviser is in place to make sure the fund is receiving proper attention. The board may also wish to consider whether the adviser should place restraints on purchases of new securities by a sub-adviser that soon will be replaced, particularly where the adviser feels that new purchases will likely be sold by a new sub-adviser. Where the fund's portfolio includes exotic securities with limited marketability, the board and adviser may wish to consider using a transition manager to ensure that the fund's holdings are seamlessly transitioned to the portfolio desired by the new sub-adviser. A transition manager can take custody of the securities in question and arrange for their orderly transfer to the new sub-adviser, thereby reducing costs of the transition to a new manager by, for example, reducing, to the extent possible, the market impact that would otherwise be incurred by their sale. In less complex cases, the adviser and new sub-adviser will work together to ensure an orderly transition.

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Many fund boards will be confronted with issues associated with the oversight of sub-advisers, whether the complex uses sub-advisers on a limited basis or uses a manager-of-managers structure. Although the issues directors face when evaluating a sub-advisory relationship are substantially similar to those in an investment advisory relationship, directors must understand any differences in order to oversee these relationships effectively.