



INDEPENDENT DIRECTORS COUNCIL

*The voice of fund directors at the Investment Company Institute*

# Board Oversight of Subadvisers

Independent Directors Council  
Task Force Report  
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## EXECUTIVE SUMMARY

A mutual fund board's responsibilities relating to oversight of subadvisers under the Investment Company Act of 1940 (1940 Act) are essentially the same as those relating to oversight of principal advisers. Yet, a board's oversight practices in connection with a subadviser may be quite different than with the principal adviser.

The different approaches to subadviser oversight are mainly—but far from exclusively—a function of two interrelated factors: the role subadvisers play in the overall business model of the fund complex, and the extent of delegation of the principal adviser's obligations to a subadviser. In addition, some of the board's interactions with the subadviser may be indirect, with the principal adviser overseeing and monitoring the subadviser and often serving as the board's go-between. Other factors that might impact how board oversight is carried out include the number of subadvisers engaged and the committee structure of the board. As a result, there is a wide range of practices relating to board oversight of subadvisers.

The Independent Directors Council (IDC) assembled a task force of independent directors, in-house fund lawyers, and compliance personnel (listed in Appendix A) with extensive experience working with subadvisers to explore practices relating to board oversight of subadvisers and provide practical guidance in this regard. The report recognizes there is no one "correct" approach to effective subadvisory oversight by fund boards. The report adds to IDC's compilation of publications on a variety of topics that are intended to assist fund independent directors in fulfilling their fiduciary responsibilities on behalf of almost 90 million fund shareholders.

The report first discusses the business reasons for retaining a subadviser and industry trends in the use of subadvisers. It then covers the board's evaluation of the principal adviser's recommendation of and the due diligence performed on a potential subadviser. The principal adviser and the board should satisfy themselves that retaining the proposed subadviser will not raise any director independence issues or, if it does, take steps to resolve such issues prior to approving the subadvisory agreement. The principal adviser and the board also might discuss the process that will be followed for communications with and reports to the board about the subadviser.

The report also addresses board approval of the subadvisory agreement. As part of this process, the board should understand the degree to which the principal adviser will delegate its investment management and related responsibilities and the fee to be paid to the subadviser under the agreement. The board also should ask the principal adviser about how it will integrate the new subadviser into the fund's business practices and processes, including its policies and procedures relating to valuation and proxy voting.

Once the board approves the subadvisory agreement, it is responsible for overseeing the subadviser on an ongoing basis. In this regard, the report discusses considerations and includes potential questions relating to the subadviser's investment performance and the effectiveness of its compliance program. In some cases, a board may have to consider termination of a subadvisory arrangement, and the report includes a discussion of this circumstance as well.

The report includes in-depth information and sample documents in the appendices.

Specifically:

- » Appendix B depicts trends in the use of subadvisers over the past 10 years by mutual funds (affiliated and unaffiliated), including funds underlying variable insurance products.
- » Appendix C outlines various tasks that may be delegated to a subadviser and highlights some of the common provisions found in subadvisory agreements.
- » Appendix D contains a sample compliance certification.
- » Appendix E contains a sample compliance questionnaire.

## **INTRODUCTION**

Over the past decade, mutual funds, including those that underlie variable insurance products, have increasingly employed subadvisers in their portfolio management. As of April 2009, nearly 40 percent of mutual funds (including funds that underlie variable insurance products) use at least one subadviser to manage at least a portion of the fund's portfolio, compared to 25 percent 10 years ago. This report explores board oversight of subadvisers, starting from the time a principal adviser recommends hiring a subadviser, through board approval of the subadvisory agreement and ongoing board oversight of the subadviser, to possible termination of the subadviser. At each step, the report explores potential issues and considerations of particular interest to boards overseeing subadvised funds. The practices discussed and the sample documents contained in this report are not intended to be a model or a set of "best practices," but are intended to assist directors in considering issues pertinent to the funds they oversee.

## I. FUNDS' USE OF SUBADVISERS

### A. BUSINESS REASONS FOR RETAINING A SUBADVISER

A fund complex may use a subadviser for a variety of reasons to manage all the assets of its funds, all the assets of a particular fund in the complex, or a portion of a fund's assets. The use of one or more subadvisers may be part of the principal adviser's business model from the outset, or a subadviser may be hired after the principal adviser identifies a business or investment need or desire for additional resources. For example, the principal adviser may wish to expand its line of funds offered to investors, enhance its existing investment expertise, address issues of poor investment performance, or forge a strategic partnership with another advisory firm. A fund complex may even "inherit" a subadvised fund from a fund and/or advisory firm merger.

The purpose for retaining a subadviser likely will drive the structure of the arrangement. Set forth below are several common subadvisory arrangements. Each of these models could involve the use of a subadviser that is affiliated with the fund's principal adviser or sponsor.

#### 1. Delegating All Day-to-Day Portfolio Management

A principal adviser may contract with one or more subadvisers to manage a fund's entire portfolio subject to the principal adviser's oversight. In some cases, the principal adviser's business model may call for it to focus efforts on monitoring and overseeing subadvisers and sponsoring, branding, and distributing a fund, rather than on the day-to-day investment management of the portfolio. In other cases, the principal adviser may rely on subadvisers to enhance the investment expertise offered within the fund complex.

***Multi-manager models.*** In arrangements referred to as "manager-of-managers" or "multi-manager," a fund uses multiple subadvisers to manage all its assets. These arrangements are an increasingly common model for funds, including those that underlie variable insurance products.<sup>1</sup> As part of its responsibilities, the principal adviser may determine the allocation of portfolio assets among subadvisers and make adjustments to the allocations over time as it deems appropriate.

***Co-branding models.*** Some principal advisers may seek to partner with a subadviser to capitalize on the reputation of the subadviser or a portfolio manager employed by the subadviser. In many cases, the fund may include the name of the subadviser in the fund's name.

***Selected funds within a complex.*** A principal adviser may retain portfolio management responsibilities for some of the funds in a complex and hire a subadviser to manage one or more of the other funds in the complex. This model may be more common for small fund complexes whose principal adviser has stronger investment expertise in some areas (such as domestic equities) than

in others (such as fixed income or international). A principal adviser's decision to expand its fund offerings into new areas may also be a reason to retain a subadviser. Moreover, subadvisers may be retained to address poor investment performance in a particular fund, sometimes at the suggestion of the board.

## **2. Delegating Some Day-to-Day Portfolio Management**

A principal adviser may use a subadviser to manage a portion of a fund's portfolio—a "sleeve"—while managing the rest of the portfolio assets itself. A principal adviser may employ this model with respect to asset classes or strategies for which it does not have expertise. For example, a principal adviser may want to include foreign securities in one or more portfolios, but may lack the expertise in-house to evaluate such securities. In lieu of hiring individuals with the requisite expertise to manage that segment of the fund's portfolio, the principal adviser may contract with one or more subadvisers for these services. As part of its responsibility to oversee the subadvisers, the principal adviser may be responsible for monitoring and allocating the portfolio's assets among the sleeves managed by the subadvisers.

## **B. INDUSTRY TRENDS IN THE USE OF SUBADVISERS<sup>2</sup>**

Subadvisory arrangements are an important aspect of the fund industry. Subadvising has become increasingly common with respect to proprietary variable insurance trusts: in fact, almost half of the nearly 2,000 mutual funds underlying variable insurance products have at least one subadviser. In terms of assets, \$355 billion, or nearly 40 percent of the assets held in these funds as of April 2009, were held in funds using at least one subadviser. And nearly 40 percent of other mutual funds use at least one subadviser to manage at least a portion of the fund's portfolio. As of April 2009, assets in these funds totaled approximately \$2.7 trillion, of which \$714 billion was invested in funds with unaffiliated subadvisers.<sup>3</sup> The balance was in funds with affiliated subadvisers.

The use of unaffiliated subadvisers has grown rapidly during the past decade, with the total number of mutual funds with unaffiliated subadvisers growing an estimated 80 percent. (Charts depicting trends in the use of subadvisers over the past 10 years are illustrated in Appendix B.) Some of the trends and notable developments over the past decade relating to the use of subadvisers in mutual funds are discussed below.

### **1. Mutual Funds**

- » The number of subadvised mutual funds (excluding those underlying variable insurance products) has grown markedly and steadily over the past decade. The number of funds with affiliated subadvisers grew from 804 in 1999 to 1,284 by April 2009, a 60 percent increase. The



number of funds with unaffiliated subadvisers grew even faster, from 500 in 1999 to 1,130 in April 2009, a 126 percent increase.

- » The growth in the number of subadvised funds far outpaced the 3 percent growth in the total number of mutual funds over the same period, from 7,791 to 7,991. The slower growth in the number of funds in the overall industry primarily reflected a decline in the number of money market funds.

## **2. Mutual Funds Underlying Variable Insurance Products**

- » Over the past decade, the number of subadvised mutual funds underlying variable insurance products grew by 258 (from 644 in 1999 to 902 in April 2009), with essentially all of that growth occurring between 1999 and 2002. Since 2002, the number of these funds has remained fairly stable. The growth between 1999 and 2002 reflects a trend among providers of variable insurance products to replace the products' nonproprietary funds managed by successful advisers with proprietary funds subadvised by the same advisers.
- » From 1999 to April 2009, the assets in subadvised mutual funds underlying variable insurance products grew from \$259 billion to \$355 billion, an increase of almost 40 percent. This was notably faster than the growth in assets of all mutual funds underlying variable insurance products—whether subadvised or not—which increased 15 percent over the same period.

## **3. Multi-Manager Funds**

- » As of April 2009, 14 percent of the subadvised mutual funds underlying variable insurance products used multi-manager arrangements. Twenty-five percent of the subadvised mutual funds not underlying variable insurance products used multi-manager arrangements.
- » As of April 2009, 23 percent of the assets of all subadvised mutual funds used multi-manager arrangements.

## **II. RETAINING A NEW SUBADVISER**

When proposing a new subadviser, the principal adviser should provide the board with information regarding the reasons for retaining a subadviser. As part of its proposal, the principal adviser should explain why it is recommending a particular subadviser over other potential candidates and the results of the due diligence performed on the subadviser. The principal adviser and the board also should consider whether retaining a particular subadviser raises any director independence issues that need to be resolved prior to approving the investment advisory contract with the subadviser. Further, the board may wish to discuss with the principal adviser the process that will be followed for communications with and reports to the board from or concerning the subadviser.

## A. PRINCIPAL ADVISER'S RECOMMENDATION AND DUE DILIGENCE

### 1. General

Once the principal adviser identifies and evaluates the qualifications of subadviser candidates, it can be expected to conduct the necessary due diligence on a particular subadviser, and then present its recommendation to the board that the subadviser be retained.<sup>4</sup> In its recommendation to the board, the principal adviser can be expected to discuss the subadviser's management style and investment strategy, including its compatibility with the fund's mandate, its track record managing similar assets in the same style, the risk characteristics of its investment strategy, and its research and trading desk capabilities. The board may seek information about the subadviser's proposed fee structure compared to those of the other subadvisers that were part of the principal adviser's due diligence review. Other topics that the principal adviser may cover with the board include the reputation of the subadviser in the investment management industry, its compliance record and culture, its compatibility with the principal adviser and any other subadvisers, and its compensation structure and ability to attract and retain talented professionals.

If a fund complex already uses subadvisers on a regular basis, the board may be familiar with the due diligence process; likewise, if the principal adviser uses the proposed subadviser for other funds in the complex or if the proposed subadviser is an affiliate of the fund's principal adviser, the due diligence process for some aspects of the subadviser's business may be less extensive. Nevertheless, the board should still evaluate the process and criteria for the selection of the subadviser as well as the due diligence that the principal adviser performed on the potential subadviser. Among other reasons, the information gleaned will be useful in the board's review of the subadvisory agreement.

Some specific questions a board may consider asking when evaluating the recommendation of a potential subadviser and the due diligence process include:

- » What individual or group within the principal adviser's organization is responsible for the selection and evaluation of the subadviser? What is the person's or group's relevant experience in selecting and evaluating portfolio management teams or firms? Is that same group or individual responsible for the selection and evaluation of internal portfolio management teams? Do they have access to outside resources, such as consultants and/or manager databases?
- » Will that same individual or group within the principal adviser's organization be responsible for the ongoing monitoring of the subadviser?

- » What did the due diligence process include? For example, did it include a comparative review of investment performance and fees against other potential subadvisers, a review of items such as the subadviser's most recent Form ADV, a summary of business operations, an organizational chart, the experience of advisory personnel, the turnover of advisory personnel, the ability to attract and retain capable personnel, any material compliance matters, any D&O/E&O and fidelity bond claims, and the results of any recent regulatory examinations?
- » Has the fund's Chief Compliance Officer (CCO) reviewed the subadviser's compliance program?
- » Is the principal adviser satisfied with the policies and procedures the subadviser has in place to comply with the requirements of the 1940 Act? (While relevant in connection with all subadvisory relationships, this inquiry may be especially important if the subadviser does not have any experience managing funds registered under the 1940 Act.)
- » How will the principal adviser conduct ongoing oversight of the subadviser, and how comprehensive will that oversight be?
- » Is the subadviser financially stable and does it have adequate resources? (The willingness and potential ability of the subadviser to devote adequate resources to the portfolio management of the fund may be particularly relevant in times of economic difficulty, volatile markets, or in the face of prolonged down markets.)
- » Are any ownership changes currently being contemplated by the subadviser that might affect the parties to the subadvisory agreement? Have succession issues at the subadviser been fully considered? Does the subadviser have additional qualified personnel to manage the fund in the event of the death, departure, or incapacity of an executive who makes a significant contribution toward the management of the fund? (This topic may be of heightened interest if the subadviser is a small boutique firm.)
- » Is the subadviser or any advisory affiliate currently, or have they ever been, the focus of any litigation, formal investigation, or administrative proceeding relating to its investment management activities?

## **2. Potential Conflicts of Interest**

As part of its discussion with the board about retaining a specific subadviser, the principal adviser should provide the board a complete picture of its relationship with the proposed subadviser, including any business or financial relationships that may present the potential for real or perceived conflicts of interest. For example, a principal adviser may have a potential conflict of interest in selecting a

subadviser if an affiliate of that subadviser distributes the principal adviser's funds. If a proposed subadviser is an affiliate of the fund's principal adviser, the board should confirm that the factors used by the principal adviser to evaluate all subadviser candidates were uniformly applied.

Boards also should receive information about other business or financial relationships of the subadviser or any of its affiliates with other fund service providers or their affiliates, which also might raise potential conflicts of interest.

Other areas that could raise potential conflicts of interest include practices within the subadviser's organization, such as the side-by-side management of a fund and the subadviser's other accounts. The principal adviser should be prepared to discuss the subadviser's internal controls policies, such as its trade allocation policies, that address potential conflicts of interest.

Some of the questions the board may wish to ask include:

- » Was there any business relationship between the principal adviser and potential subadviser prior to the subadviser's selection?
- » Are there relationships or practices of the subadviser that present the potential for real or perceived conflicts of interest?
- » Does the subadviser follow a similar investment strategy in managing other types of accounts that may present actual or potential conflicts of interest (e.g., the allocation of investment opportunities between the portfolios)? If so, does the subadviser have adequate controls in place to manage these conflicts?

## **B. DIRECTOR INDEPENDENCE CONSIDERATIONS**

The 1940 Act requires that a certain percentage of fund directors on each board be independent.<sup>5</sup> A number of the actions taken by a fund board, such as approval of the investment advisory contract, must be taken by a majority of independent directors. Thus, the potential ramifications in the event that an independent director is deemed to *not* be independent can be significant. While the requirements regarding director independence with respect to a subadvised fund are no different than those with respect to a non-subadvised fund, determining and maintaining that independence is more complicated for directors of a fund complex with multiple subadvisers. The directors must be independent from the principal adviser and its affiliates and from each subadviser and each of its affiliates.<sup>6</sup> Independent directors, therefore, should be vigilant of relationships that could jeopardize their independence as a matter of law or perception.

From a legal perspective, the fund’s principal adviser will need to work with fund counsel and counsel for the independent directors, if any, to monitor personal securities holdings to be sure the directors do not own any securities of a subadviser or any of its “control persons.”<sup>7</sup> The 1940 Act does not have a *de minimis* standard when it comes to share ownership, so a single share owned by an independent director could render him or her an “interested person” under the statute. In connection with the retention of a subadviser, an independent director or a family member of that independent director may have to sell any interest he or she has in the subadviser or its control persons. In addition, a material business or professional relationship between a director and the subadviser or any of its control persons could raise issues under the 1940 Act. As is the case with many parts of the 1940 Act, the provisions relating to a determination of independence are complicated and highly technical. This report, therefore, does not try to describe them in detail, other than to highlight the very serious issues associated with determining the independence of fund directors under the 1940 Act.

The issues related to director independence are not limited to those under the 1940 Act. Directors also should be mindful of any relationships or situations that might call into question the director’s ability to independently discharge his or her fiduciary duties to the fund and its shareholders. Every independent director should carefully review business or financial relationships that he or she (or any immediate family member) has with the principal adviser, each subadviser, and their respective affiliates.

In monitoring for any relationships that may impact a director’s independence, the principal adviser should obtain and periodically update a list of all the affiliates of the subadviser, monitor any changes of control that occur with the subadviser or its affiliates, and ensure that any required disclosures are current. To help facilitate this review, the principal adviser or fund counsel typically provides directors annually with a questionnaire that includes a list of subadviser affiliates. Directors should take great care when filling out these questionnaires and consult with counsel about the implications of any potential independence issues. In the event a new independent director is to be elected, potential candidates should be advised early on in the vetting process of the issues associated with determining his or her independence.

### **C. BOARD REPORTING AND COMMUNICATIONS**

At the outset of establishing a relationship with a subadviser, the board may wish to determine the process that will be followed for communications and reports relating to the subadviser. Practices vary from board to board, and may be influenced in large part by the number of subadvisers a board oversees. Some boards may meet with representatives of the subadviser when the subadviser is first under consideration, and thereafter on an annual or other periodic basis. Once a subadviser is retained, the board may communicate about the subadviser’s services through representatives of the fund’s

principal adviser, the fund’s administrator, and/or the fund CCO. Some boards may ask one of these designees to coordinate requests for information to and responses from the subadviser. Boards may also rely on one or more of these designees to visit the subadviser on a periodic basis and report back to the board or one of its committees. Other boards, or committees thereof, may communicate directly with representatives of the subadviser and may even visit the offices of the subadviser to become familiar with its operations or to get to know its personnel better, including its senior management and investment and compliance personnel.

The board may also wish to ask the principal adviser how it plans to communicate with the subadviser. For example, the board may ask the principal adviser about its process for communicating to the subadviser any proposed changes to the fund’s policies and procedures.

### **III. APPROVING A SUBADVISORY AGREEMENT**

A subadvisory agreement must be approved by the board. As part of this approval, boards generally review the agreement to understand the degree to which the principal adviser will delegate its investment management and related responsibilities and which entity—the principal adviser or the subadviser—is responsible for specific tasks, and the fee to be paid to the subadviser. The board may also consider the terms of the principal advisory agreement to understand the principal adviser’s contractual obligations and undertakings to the fund and its express authority to delegate a portion of its duties to a subadviser. Particularly in the case of affiliated subadvisers, it is not uncommon for the principal advisory agreement to provide that the principal adviser is responsible for the conduct of the affiliated subadviser to the same extent as if it were its own conduct.

#### **A. LEGAL FRAMEWORK**

A fund’s board of directors has the same legal duties with respect to a subadvisory agreement as it does with the agreement with the principal adviser.<sup>8</sup> The 1940 Act requires that a majority of a fund’s independent directors and of the fund’s shareholders initially approve all advisory agreements, which includes subadvisory agreements—regardless of whether the fund is a party to the agreement. Also, after a two-year period, a majority of the independent directors must annually review and approve the renewal of each agreement.<sup>9</sup> Thus, similar to the board’s review and approval of the fund’s principal advisory agreement, the board reviews and approves any subadvisory agreement under Section 15(c) of the 1940 Act.<sup>10</sup> As a practical matter, the board’s focus on particular issues may be weighted differently, depending upon the responsibilities that a particular subadviser assumes under a subadvisory agreement and the structure of that relationship. The factors considered by the board in approving a subadvisory contract are required to be disclosed in the fund’s shareholder reports in the same manner applicable to its consideration of the principal adviser’s contract.

## **B. STRUCTURE OF THE AGREEMENT**

The scope of responsibilities assigned to a subadviser, as well as the manner in which the subadviser will be compensated, may impact which entities are parties to the subadvisory agreement. In most instances, a fund enters into an advisory agreement with the principal adviser, which, in turn, contracts with a subadviser. The board approves the subadvisory agreement, even though the fund is not a party to the agreement. In other cases, there may be a tri-party agreement among the fund, principal adviser, and subadviser. This may be the form of choice in those infrequent instances when the fund pays the subadviser's management fee directly.

## **C. SERVICES UNDER THE AGREEMENT**

Typically, the principal adviser delegates to the subadviser the day-to-day portfolio management services it has contracted to provide to the fund, but retains responsibility to monitor and oversee the subadviser.<sup>11</sup> The terms of the arrangement, including the specific tasks that the subadviser will perform, are reflected in the subadvisory agreement. A list of potential tasks and undertakings of the subadviser is included in Appendix C.

At the time the board considers the subadvisory agreement, either initially or for its annual renewal, the request for information from the subadviser may be included in the board's request for information from the principal adviser. Alternatively, request letters may be delivered to the subadviser by the principal adviser on behalf of the board. In addition to detailed written submissions prepared by the subadviser, the principal adviser is likely to share with the board insights from its routine monitoring activities that may be responsive to the board's request for information and relevant to the board's consideration of the subadvisory agreement.

## **D. SUBADVISORY FEES**

### **1. Overall Analysis**

An integral component in the board's review and approval of the subadvisory agreement is its consideration of the fee to be paid to the subadviser. As part of its evaluation of the subadvisory fee, the board likely also will consider the fee paid to the principal adviser in light of the services performed by the principal adviser versus those that are delegated to the subadviser.<sup>12</sup> Typically, the fund's principal adviser pays the subadviser a fee for its services from the advisory fees the principal adviser receives from the fund. In some instances, the fund may pay a subadvisory fee directly to the subadviser.

When evaluating a fund's subadvisory fee, a board may review the fund's management fee without focusing on whether the principal adviser employs a subadviser or has its own personnel manage the fund (referred to as a "top-down" approach). Other boards may use a "build up" approach, whereby the

board examines each component of the management fee, including the fees charged by the principal adviser and the subadviser, and builds up to an overall fee. This latter approach is typically used when the subadviser is hired to provide some type of special expertise and the fee is structured to reflect the value added by the subadviser. Situations in which the fund pays the subadviser directly also would be described as a “build up” approach because the board considers the subadvisory fee separately from the fee for the principal adviser.

When considering the subadviser’s fee, some of the questions a board may wish to ask include:

- » Are there benefits the fund derives from the subadvisory relationship that are not quantifiable, such as branding?
- » How does the subadvisory fee compare to fees charged to the principal adviser for comparable services by other subadvisers?
- » If the subadviser renders comparable services to its other subadvised and separate accounts, how does the subadvisory fee compare to fees charged by the subadviser for those accounts?

In subsequent annual reviews of the subadvisory fee, the board typically will place considerable emphasis on the nature and quality of the services provided by the subadviser, as well as its contribution to the performance of the fund.

## **2. Profitability**

When evaluating the subadviser’s fee, the board may also consider as part of its analysis the profitability of the fund to the subadviser. The relevance of the subadviser’s profitability may vary depending upon the circumstances. For example, the costs and profitability of unaffiliated subadvisers may be a less relevant consideration. In the case of affiliated subadvisers, the principal adviser may provide the board with profitability information for the principal adviser and the subadviser on a combined basis to reflect the profitability of a particular fund for the advisory organization as a whole.

Information relating to the subadviser’s profitability often may be limited. Some subadvisers are more willing than others to share the information; others may not be able to segregate and quantify the profits directly tied to the services it provides to a fund (e.g., the subadviser may be part of a larger organization and its services to the fund may not be indicated on its own balance sheet). Due to the wide variety of the level of profitability information that is available and presented to boards, and the questionable value of the information, some boards may modify their requests for profitability information based upon what they expect to receive from a subadviser. Other boards may conclude that they will request profitability information, even if there is reason to believe the subadviser is unable or unwilling to provide the information. Either way, the board should consult with its counsel or the



fund's counsel to discuss the pros and cons of the approach it determines is most appropriate for the fund it oversees.

## **IV. INTEGRATING A SUBADVISER**

Once the board approves the subadvisory agreement, the principal adviser will have to integrate the subadviser into the fund's business practices and processes. While the principal adviser may work through these issues without involving the board, the board may nonetheless consider asking the principal adviser questions to satisfy itself that the principal adviser is taking care to ensure appropriate coordination between it and the subadviser. For example, a fund complex that has chosen not to use its affiliated brokers to effect trades may have to reconsider that decision if one of its funds enters into a relationship with a subadviser that uses that broker to effect trades. Another example may occur if the fund restricts the use of certain derivatives or requires certain approvals by the principal adviser before the fund invests in a new type of complex instrument. In these circumstances, the board may ask the principal adviser and the fund's CCO about the processes for ensuring the subadviser's compliance with the fund's guidelines.

Other integration issues may arise in connection with the fund's operations, valuation, proxy voting, and soft dollar policies, as well as with its registration statement, as discussed more fully below.

### **A. OPERATIONS**

Because a subadviser represents a key component of the fund's operations, the board—or the fund CCO or principal adviser on its behalf—may wish to inquire how the subadviser will coordinate its operations with the fund's principal adviser and other service providers, as well as any operational risks associated with the fund's reliance on the subadviser.

Some questions a board may want to ask include:

- » How will the principal adviser ensure that the subadviser will appropriately interface with the fund's other service providers (e.g., custodian, administrator, securities lending agent)?
- » How will the principal adviser monitor the subadviser's operations as they relate to the fund?
- » Are there any operational considerations or accommodations that need to be made by the subadviser to accommodate fund practices or policies (e.g., securities lending, portfolio holdings disclosure, use of affiliated brokers)?
- » Has the principal adviser and/or subadviser identified any critical operational risks and, if so, have they assessed how to eliminate or mitigate those risks?

- » What kind of business continuity plans does the subadviser have in place? When were the business continuity plans last tested and what were the results of those tests?

## **B. VALUATION, PROXY VOTING, AND SOFT DOLLARS**

The board may wish to understand how the principal adviser will coordinate with the subadviser regarding the policies and procedures that relate to the portfolio management of the fund. Areas that may warrant scrutiny by the board include the fund's policies and procedures relating to proxy voting and valuation—both areas in which many boards have a heightened interest due to their specific regulatory oversight responsibilities—and the subadviser's use of “soft dollars,” which is of special interest to many boards.

With respect to the integration of the subadviser into the fund's valuation policies and procedures,<sup>13</sup> the board may wish to consider the following questions:

- » Are the respective roles of the principal adviser, subadviser, accounting agent, and administrator in the valuation process clearly defined?
- » What are the procedures for the subadviser to provide input as to the fair value of a portfolio holding?
- » If the subadviser makes fair value recommendations, how does the principal adviser oversee them?
- » Are procedures in place to address situations in which service providers to the fund (e.g., pricing agent, principal adviser, subadviser) present different fair value recommendations with respect to the same security?

In the case of proxy voting, information about the subadviser's arrangements should be disclosed to and discussed with the board.<sup>14</sup> Areas of inquiry may include:

- » Does the subadvisory agreement provide the subadviser with discretionary authority to vote the fund's proxies? If so, has the fund adopted the proxy voting policy of the subadviser?
- » If multiple subadvisers are used within the fund complex, is it feasible for all the funds to adopt a single proxy voting policy to promote consistency and uniformity in votes cast?
- » Will the subadviser report to the principal adviser and/or the board in instances where it votes counter to the fund's policy?
- » Does the subadviser have a process for timely reporting of votes cast so that the fund meets its annual disclosure requirement?

If the subadviser uses soft dollars, the subadviser may have different practices or policies than those of the principal adviser or another subadviser to the fund. As a result, the retention of a new subadviser may require the integration of those practices and policies. For example, if the subadviser uses soft dollars as an integral part of its business strategy (which may be the case with a boutique management firm), it may be unable to conform its soft dollar practices to those of the fund's principal adviser or another subadviser. In those cases, the board may need to consider exceptions to the fund's policies on the use of soft dollars to accommodate variances in practices. In its consideration of the issue, as with all other board considerations, the threshold issue will be whether the practices are consistent with the best interests of the fund's shareholders.

Some of the questions a board may wish to consider in its analysis of soft dollars include:

- » What are the benefits of the soft dollars arrangement to the fund?
- » Does the subadviser provide reports to the board that disclose the amount of soft dollar commissions paid by the fund and a description of the services received in exchange?
- » Does the board receive confirmation that the subadviser's soft dollar payments are limited to those covered by the safe harbor of Section 28(e) of the Securities Exchange Act of 1934 and consistent with the subadviser's policies and procedures?

## **C. REGISTRATION STATEMENT**

The principal adviser should coordinate with the fund's subadviser and integrate the subadviser into its process of developing and updating the fund's registration statement, which includes both the prospectus and statement of additional information.<sup>15</sup> The subadviser should provide information for the relevant portions of the registration statement and carefully review the disclosure relating to, in particular, the fund's investment policies and restrictions to ensure that such disclosure is accurate and consistent with the subadviser's investment strategy. The registration statement also will include information relating to the subadviser and its business in the same way that information is required to be disclosed for the principal adviser. If the subadviser is replacing a former subadviser, the principal adviser and the new subadviser should work together to ensure that the disclosures in the fund's registration statement are current and that any revisions are promptly filed with the Securities and Exchange Commission (SEC) and provided to shareholders.

## **V. ONGOING BOARD OVERSIGHT**

In connection with their general fiduciary duties, boards have an ongoing responsibility to oversee the fund's subadvisory arrangements. This ongoing oversight responsibility is the same for both subadvisers that are affiliated with the principal adviser and those that are not. In either case, the board's oversight

likely will focus on questions relating to the quality of the subadviser's investment performance, the effectiveness of its compliance program, and other specific areas, such as its code of ethics, affiliated transactions, any litigation, investigations and examinations, and any changes in control.

## **A. PORTFOLIO MANAGEMENT AND PERFORMANCE**

Board oversight of a subadviser's investment performance generally involves a review of the same types of information (e.g., portfolio construction and turnover, risk-return modeling, risk-adjusted returns, explanations of unexpected results—positive or negative) that the board considers in its review of the principal adviser's performance. The primary difference is that board oversight of a subadviser's performance is typically facilitated through the principal adviser, which may also provide its own analysis of the subadviser's performance. That is, the principal adviser monitors a subadviser's investment performance on an ongoing basis and presents performance information periodically to the board, typically on a quarterly basis.

When a subadviser manages only a sleeve of a fund's assets, the board might evaluate the performance of each subadviser's sleeve in connection with appropriate benchmarks. In instances where several investment styles are used in a portfolio, a special benchmark may be created for the portfolio. For example, 50 percent of one index and 50 percent of another index may be used to create a new "blended" index that will serve as the fund's performance benchmark. In this instance, a subadviser will be responsible for managing its sleeve of the portfolio relative to the portion of the blended index that applies to its style. To assist in this evaluation, the board may also consider attribution (i.e., how the subadviser achieves its performance); information provided in subadviser presentations, including the responsiveness of the portfolio managers; and information provided by third-party consultants.

Questions in evaluating a subadviser's performance may include:

- » Is the principal adviser satisfied with the subadviser's performance and responsiveness?
- » Can the subadviser explain particularly poor performance and particularly good performance?
- » Do steps need to be taken to address consistently poor performance by the subadviser?
- » Are benchmarks and peer groupings appropriate?
- » Have there been any material changes in key investment personnel at the subadviser's organization who perform services for the fund?
- » Have there been any material changes to the investment process?
- » Is there a difference in the performance of the subadvised assets and that of any similarly managed accounts of the subadviser? If so, why?

When the performance of a fund or the subadviser's sleeve is trailing its benchmark and peers over prolonged periods, the board may wish to obtain additional information from the principal adviser and/or ask a representative from the subadviser to attend an upcoming board meeting and explain the underperformance. Conversely, if a subadviser's performance is consistently above its benchmark and peers, the board may wish to inquire as to the sources of that outperformance and the level and appropriateness of risk taken to achieve it.

In order to communicate expectations consistently and at times other than at contract renewal, some boards have adopted explicit performance criteria applicable to subadvisers. For example, after a specified period of fourth-quartile performance, actions or a face-to-face meeting may be called for. In the event the performance of a subadvised fund fails to meet expectations, the board, either directly or through the principal adviser, may inquire about whether the subadviser is sufficiently attentive to the performance of the fund, whether it is devoting adequate resources to the management of the fund, and whether the fund or the subadvised sleeve is being measured against the appropriate benchmark or peer group.

Typically, the board and the principal adviser will apply increasing pressure over time on the subadviser to address any poor performance. In the event that the principal adviser works with the subadviser and the subadviser's performance does not improve, the principal adviser may propose to the board that the subadviser be replaced.

## **B. COMPLIANCE**

Fund boards oversee a fund's compliance program as part of their overall oversight responsibilities and have specific responsibilities under Rule 38a-1 under the 1940 Act (the fund compliance program rule).<sup>16</sup> Among other things, boards must approve the policies and procedures of the fund's service providers (including any subadvisers) based on the finding that the policies and procedures are reasonably designed to prevent violation of the federal securities laws by the fund. Fund boards also must review, at least annually, the adequacy of the policies and procedures of the subadvisers. The rule makes the fund CCO responsible for administering the fund's compliance program and for reporting to the board, at least annually, on the operation of the policies and procedures of the fund and each service provider, including any subadvisers. Subadvisers are subject to a similar compliance program rule under the Investment Advisers Act of 1940 (Advisers Act), which requires, among other things, that they have a CCO.<sup>17</sup>

The board may rely on the fund CCO to assist it in overseeing the subadviser's compliance program as it relates to the fund. The fund CCO's annual report to the board about the operation of the subadviser's policies and procedures may include an evaluation of their adequacy. The board may also

designate a board committee (e.g., audit, performance, investment, compliance) to be responsible for overseeing subadvisers and their compliance programs, particularly if the fund has many subadvisers. In some cases, the board may rely on subadviser certifications relating to the effectiveness of subadviser compliance programs or certain policies and procedures. (Samples of a compliance certification and a compliance questionnaire are attached as Appendices D and E.) Likewise, the board may rely on summaries of the subadvisers' compliance programs prepared by the subadviser, the principal adviser, the fund CCO, or others.

The board may receive these summary reports in a variety of ways. Some boards may get the reports directly from the subadviser. If the board oversees a large number of subadvisers, however, this approach may be too cumbersome and voluminous. In these cases, the fund CCO may synthesize the reports and then provide an overview to the board. Other fund complexes with a large number of subadvisers may work with the subadvisers to develop a universal reporting template. While developing a template so that subadviser reports to the board are in the same format can require a great deal of advance work, it may result in a "user-friendly" report that enables the board to focus efficiently on the most important compliance matters related to each subadviser.

In addition, the board should be mindful of policies and procedures unique to a fund that may necessitate particular attention in connection with a subadviser's compliance program (e.g., conditions from an exemptive application or socially responsible investing restrictions). The board should understand the process in place for the principal adviser to notify the subadviser of these types of issues. The board also should assure itself that there is a process in place for the review of compliance violations to ensure that the fund has been reimbursed for a loss when appropriate, to assess whether the violations are reflective of internal control deficiencies, and to make sure the violation has been addressed.

To the extent a subadviser's compliance program is determined to have weaknesses, the board should enlist the assistance of the principal adviser or fund CCO to increase scrutiny of the subadviser and address issues that could pose a risk for the fund. If problems persist and are material, and the subadviser is unresponsive to suggestions from the board or principal adviser for changes, the board may wish to initiate a dialogue with the principal adviser about replacing the subadviser.

Some of the questions a board may wish to ask include:

- » Does the subadviser seem to have a strong compliance "tone at the top"?
- » Do the subadviser's policies and procedures in connection with its services provided to the fund satisfy Rule 38a-1 under the 1940 Act (the fund compliance program rule)?

- » How do the policies and procedures of the subadviser compare to those of other subadvisers for the fund (if any)?
- » Does the subadviser conduct testing of controls related to its compliance program? If so, what types of tests are conducted (e.g., internal testing, independent testing, or a combination of each) and by whom?
- » Have there been any material compliance violations or changes in policies and procedures at the subadviser that would affect the fund?
- » Have there been any material changes to the subadviser’s compliance personnel or resources?

## C. OTHER SPECIFIC AREAS

As the board conducts its ongoing compliance oversight of the subadviser, there are a number of topics (codes of ethics, affiliated transactions, other potential conflicts of interest, and litigation) as well as investigations and examinations that trigger special attention under the 1940 Act and its rules.

### 1. Codes of Ethics

The board must approve each subadviser’s code of ethics and approve any material changes to the code within six months of the change.<sup>18</sup> Each subadviser is required to furnish the board at least annually with a report of any material violations of the code, sanctions imposed as a result of any violations, and a certification that processes are in place to prevent future violations. Reports of frequent or repeated violations of codes of ethics may signal a weakness of internal controls or a lack of attention to compliance by a particular subadviser.

### 2. Affiliated Transactions

Under the 1940 Act, subadvisers are affiliates of the funds they subadvise.<sup>19</sup> Accordingly, subadvised funds are prohibited, unless specifically exempted, from engaging in certain types of transactions with the subadviser or its affiliates, including other funds or accounts managed by the subadviser. Typically, these exemptions impose conditions on the fund’s board to address potential conflicts. Three exemptive rules—Rules 10f-3 (buying securities in an affiliated underwriting), 17a-7 (engaging in cross trades between affiliates), and 17e-1 (using affiliated brokers)—require that the board adopt written procedures reasonably designed to ensure compliance with the particular rule. The rules also require that the board determine on a quarterly basis that transactions were effected in compliance with the rule. In most cases, the principal adviser will monitor affiliated transactions by subadvisers and provide the board with reports confirming that the transactions have met the applicable regulatory requirements.

A 1940 Act rule provides an exemption from the prohibitions against affiliated transactions to permit a subadviser to enter into transactions with other subadvisers (or their affiliates) to that fund or other funds in the same complex.<sup>20</sup> The exemption is subject to two conditions: the subadvisory relationship must be the sole reason why the transaction is prohibited, and the subadvisory contracts must prohibit consultations between the subadvisers about the securities transactions.

When considering issues associated with affiliated transactions, some of the questions a board may ask include:

- » Does the subadviser follow the fund’s policies and procedures relating to affiliated transactions?
- » Do both the principal adviser and the subadviser have processes in place to ensure compliance with the policies and procedures?
- » Has the subadviser provided the fund, and has the principal adviser provided the subadviser, with a current list of all affiliates so that affiliated transactions may be monitored effectively?

### **3. Litigation, Investigations, and Examinations**

The principal adviser should provide the board with information concerning any material litigation, SEC investigations, enforcement actions, or examinations involving a subadviser to a fund. This information should be updated as necessary. If a subadviser is involved in a matter that suggests its ability to perform the responsibilities for which it was hired may be compromised, the board may determine that the principal adviser needs to assume additional responsibility for the fund, if possible, or that it is in the best interest of the shareholders to replace the subadviser. In most cases, the principal adviser will make a recommendation to the board about the best course of action.

### **4. Changes in Control**

The subadviser and the board should be aware that changes in the ownership structure of the subadviser or even adjustments of shareholdings among its existing shareholders could result in a “change of control” that triggers an assignment under the 1940 Act, effectively terminating the subadvisory contract.<sup>21</sup> If a change in control occurs, board and shareholder approval of a new contract will be required. Also, a change in control of the subadviser may impact the fund’s affiliated transactions and, as noted above, the independence of a director. To keep on top of this issue, the fund CCO may wish to ask the subadviser in its compliance questionnaire about any ownership changes that have taken place or are currently being contemplated. The more notice the board and the principal adviser have of possible changes, the more smoothly the board and the principal adviser can react to a possible change of control under the 1940 Act.



## VI. TERMINATING A SUBADVISORY RELATIONSHIP

If the board is dissatisfied with the quality of the services rendered by the subadviser, a number of responses may be appropriate depending upon various factors, such as the severity of the problem and the nature of the relationship among the board, the principal adviser, and the subadviser. For example, the board may simply need to discuss the issue with the subadviser and/or the principal adviser to learn more about a topic of concern or to request a change in process. On the other hand, if the board has serious concerns over a prolonged period of time—and the subadviser has been unwilling or unable to address those concerns—it may be appropriate to consider replacing the subadviser.

Some “manager-of-managers” funds have received exemptive relief from the SEC that permits them to terminate and appoint new, unaffiliated subadvisers without shareholder approval, as long as certain conditions, such as notice to shareholders within a specified period of time, are met.<sup>22</sup> While this exemptive relief eliminates the time and expense of obtaining shareholder approval each time there is a change in subadvisers, the board still must approve each new subadvisory agreement and each subadviser’s compliance program and code of ethics.

Terminating a subadvisory relationship can be disruptive, both operationally and from an investment perspective (e.g., if the new subadviser makes adjustments to the portfolio’s composition), and the board should understand the process in place to ensure a smooth transition. Terminating a subadvisory relationship may be a more feasible option if the board can replace the subadviser without obtaining shareholder approval, replace the subadviser with another subadviser that has already been approved by shareholders (if the fund has more than one subadviser), or direct the principal adviser to take over the subadviser’s responsibilities. Still, the board may wish to be sensitive to the possible reaction from shareholders if a fund has frequent subadviser changes.

## CONCLUSION

A board’s legal obligations under the 1940 Act with respect to subadviser arrangements generally are the same as they are for principal advisers. Yet, as a practical matter, board oversight of subadvisers varies and is influenced by a number of factors, including the nature and structure of the subadvisory relationship and the particular duties delegated to the subadviser. As with many other board responsibilities, there is no single approach for effective board oversight of a subadviser. Accordingly, each board should work to establish practices and processes that are effective for the subadvisory arrangement it oversees.



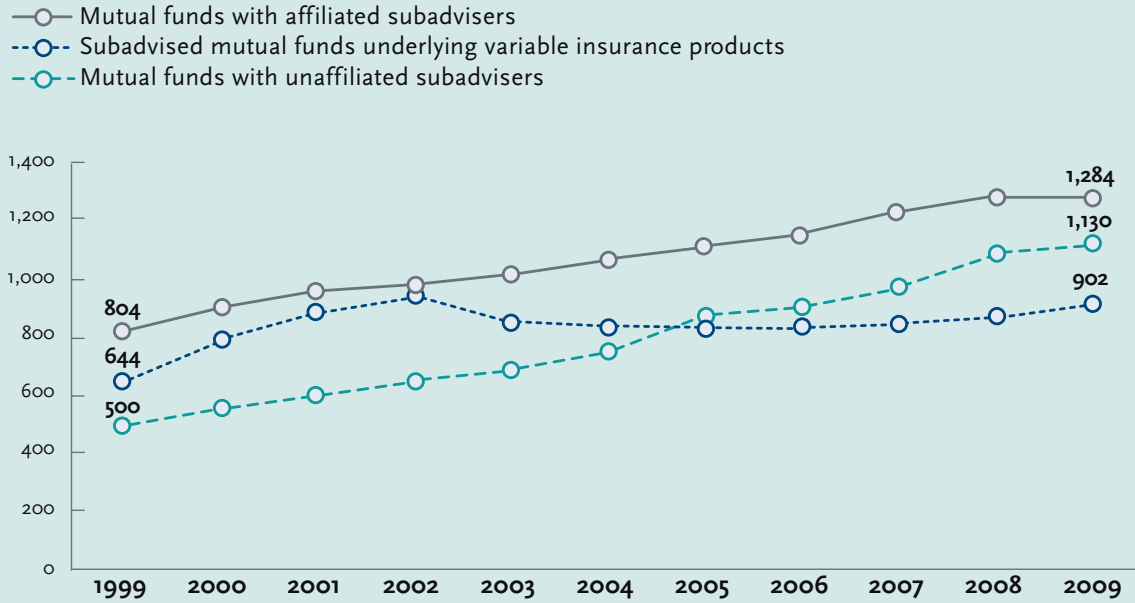
## APPENDIX A: TASK FORCE MEMBERS

|                                   |   |
|-----------------------------------|---|
| Paul K. Freeman, Task Force Chair | Independent Director,<br>DWS Funds  |
| Francis V. Knox Jr.               | Chief Compliance Officer,<br>John Hancock Financial Services, Inc.                    |
| Patricia Louie                    | Vice President and Associate General Counsel,<br>AXA Equitable Life Insurance Company |
| Glenn P. O’Flaherty               | Independent Director,<br>Aquila Funds   |
| Matthew Shea                      | Vice President and Counsel,<br>Wellington Management Company, LLP                     |
| Susan M. Sterne                   | Independent Director,<br>Sentinel Group Funds, Inc.                                   |
| James W. Zug                      | Independent Director,<br>Brandywine Funds and Allianz Funds                           |



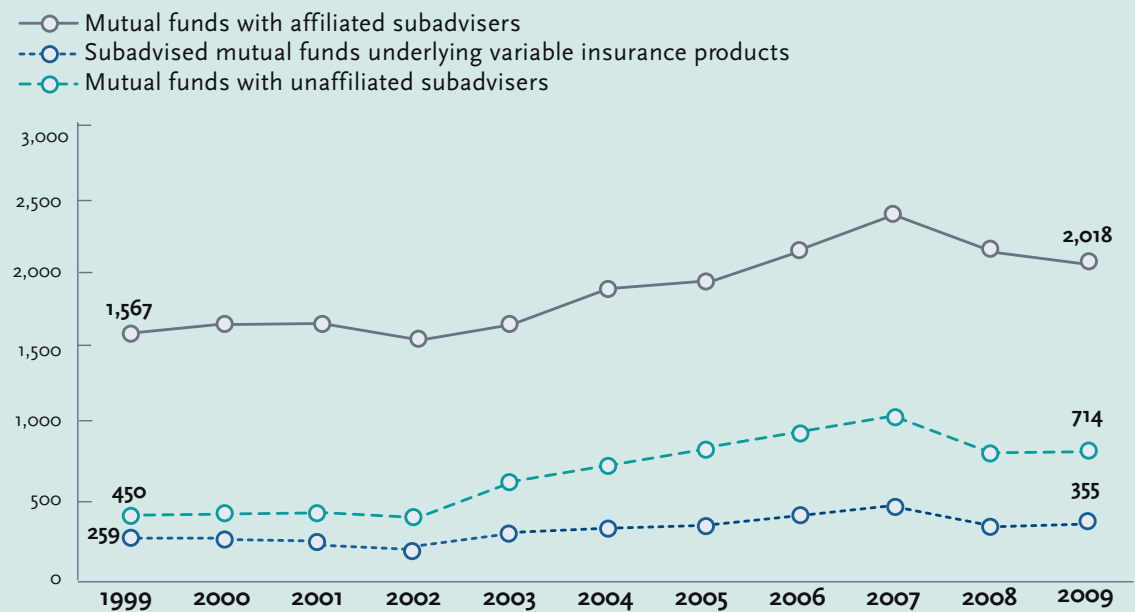
## APPENDIX B: TRENDS IN THE USE OF SUBADVISERS

### NUMBER OF SUBADVISED MUTUAL FUNDS 1999–2009



Sources: Strategic Insight Simfund; Investment Company Institute

### ASSETS OF SUBADVISED MUTUAL FUNDS 1999–2009 (BILLIONS OF DOLLARS)



Sources: Strategic Insight Simfund; Investment Company Institute



## APPENDIX C: SUBADVISORY AGREEMENTS

A subadvisory agreement may include one or more of the following tasks to be performed by the subadviser:

- » Manage a discretionary investment program for a designated fund or asset class;
- » Monitor compliance with the fund's investment objectives, policies, and restrictions;
- » Monitor compliance with relevant diversification and concentration requirements;
- » Select broker-dealers to execute portfolio transactions consistent with its obligation to seek best execution;
- » Give instructions to the custodian as to the delivery or investment of securities and payments of cash for the account of the portfolio;
- » Exercise proxy voting rights;
- » Provide advice and support on valuations of portfolio holdings; and
- » Maintain records relating to the subadvisory services rendered.

A subadvisory agreement may also contain one or more of the following provisions:

- » Mandating that the subadviser is subject to, and shall perform in accordance with, the fund's corporate documents (e.g., declaration of trust, bylaws), the currently effective prospectus and statement of additional information, compliance manual, and written instructions of the principal adviser;
- » Prohibiting the subadviser from consulting with any other subadviser to the fund, any other fund of the trust, or any other fund under common control with the trust concerning transactions of the fund in securities of other assets;
- » Obligating the subadviser to notify the principal adviser of any assignment of the agreement or change of control of the subadviser;
- » Obligating the subadviser to maintain an appropriate level of errors and omissions or professional liability insurance coverage;
- » Allowing for the use of the subadviser's name, logo, trademark, or service mark;
- » Outlining the party responsible for processing class action claims;
- » Requiring that the subadviser maintain all accounts and books and records as required by the Investment Company Act of 1940 and the Investment Advisers Act of 1940;

- » Addressing the liability of the subadviser;
- » Indicating that the subadviser will treat the portfolio security holdings as confidential;
- » Obligating the subadviser to provide its compliance policies and procedures and any material changes to its compliance policies and procedures;
- » Obligating the subadviser to advise the principal adviser as to the commencement of a regulatory examination and its results;
- » Obligating the subadviser to provide notification of any material compliance matter related to services being provided to the fund;
- » Obligating the subadviser to provide certifications, information, and access to resources that the principal adviser may reasonably request; and
- » Requiring regular reporting to the board, including access to portfolio managers.



## APPENDIX D: SAMPLE COMPLIANCE CERTIFICATION

For the period ended [date], to the best of my knowledge:

- » There were no violations of the investment policies outlined in the prospectus, statement of additional information, or the Investment Company Act of 1940 except as described on an attachment.
- » There were no trade errors except as described on an attachment.
- » There were no violations of the subadvisers' policies that affected the fund(s) except as described on an attachment.
- » There were no material violations of the code of ethics by access persons of subadviser except as described on an attachment.
- » Subadviser has adopted a proxy voting policy in compliance with Rule 206(4)-6 under the Investment Advisers Act of 1940 and accepts the delegation of proxy voting in accordance with the fund's proxy voting policy, certifies that proxies of the fund were voted pursuant to the fund's proxy voting policies and procedures and there were no violations of the proxy voting policy or proxies voted in a manner inconsistent with the fund's proxy voting policy except as described on an attachment.
- » Subadviser has adopted and implemented written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder, in compliance with the requirements of Rule 206(4)-7.
- » Subadviser has informed principal adviser of all material changes to the firm's policies and procedures during the quarter.
- » Subadviser, in its capacity as subadviser to the fund, has continuously monitored the liquidity of all securities held in the portfolio and has notified principal adviser as to any material changes in the percentage of holdings in illiquid securities.
- » Subadviser, in its capacity as subadviser to the fund, has executed brokerage transactions for the fund in compliance with the best execution and allocation policies of subadviser, and to the extent that there were any soft dollars utilized certifies that the soft dollar utilization was within the safe harbor of Section 28(e) of the Securities Exchange Act of 1934.
- » Subadviser has managed the fund's assets in compliance with all of the fund's policies and procedures relating to the 1940 Act, including its liquidity policy, proxy voting policy, Rule 2a-7 policy, Rule 10f-3 policy, Rule 17a-7 policy, Rule 17e-1 policy, and dissemination of portfolio information policy.

- » There were no payments from subadviser or its affiliates that were rebated back to principal adviser, its affiliates, employees, or to any other party at the direction of principal adviser relating to the subadvisory fees collected by the subadviser on behalf of the services provided to the fund except as reported on an attachment.
- » Subadviser has not executed any agency or principal cross trades under Rule 206(3)-2 under the Advisers Act except as disclosed on an attachment.
- » Subadviser has provided notification for any securities subadviser believes required fair valuation during the period.
- » No counterparty has contacted subadviser about wanting to exercise a right to terminate its transactions in connection with any provision under any International Swaps and Derivatives Association Master Agreements (if applicable).
- » The commission rate per share paid by the fund is at least as favorable as the rate paid by clients who do not participate in the subadviser's soft dollar program except as disclosed on an attachment.

By: \_\_\_\_\_

Title: \_\_\_\_\_

[insert subadviser's name here]

Date: \_\_\_\_\_

## APPENDIX E: SAMPLE COMPLIANCE QUESTIONNAIRE

For the period ended [date]:

Have you made material changes to your compliance policies or procedures?

YES       NO

Comment:

Has there been any new material litigation or change in status of existing litigation?

YES       NO

Comment:

Have you experienced losses of key personnel or made additions of key personnel? Please describe individuals involved and areas of responsibility.

YES       NO

Comment:

Have there been changes in the organizational structure or ownership of your company? If so, please describe the changes.

YES       NO

Comment:

Have you automated key compliance processes? Please describe.

YES       NO

Comment:

Have you replaced key systems and/or vendors that relate to or support the investment and/or compliance process? Please describe.

YES       NO

Comment:

Have there been regulatory inquiries or examinations? Please explain.

YES       NO

Comment:

Have you made changes to your ADV filing? If so, please describe the changes.

YES       NO

Comment:

Have there been issues that have had a significant impact on your financials during the past quarter? If so, please describe and provide updated financial statements.

YES       NO

Comment:

Are there any new activities by your firm or by any vendors to your firm that relate to the services being provided to the fund? Please describe.

YES       NO

Comment:

Have there been any new products launched by your firm that could impact the way in which you allocate or aggregate trades or investment opportunities?

YES       NO

Comment:

Have there been any material compliance matters that require reporting to [Principal Adviser]? If so, please provide an explanation and back-up.

YES       NO

Comment:

Has any bonding company paid out, denied, or revoked a bond on you? Have you filed for reimbursement under your errors and omissions policy? If so, please explain.

YES       NO

Comment:

Are you entering into any new commission sharing arrangements? If so, please provide documents describing them.

YES       NO

Comment:

## NOTES

- <sup>1</sup> In those cases, the insurance company offers a variable product that invests in a trust, either one that is proprietary (i.e., sponsored by an affiliate of the insurance company) or nonproprietary, with a number of underlying mutual funds managed by different subadvisers. The principal adviser is typically an affiliate of the insurance company, but may also be a dedicated unit of the insurance company. In either structure, the principal adviser coordinates and supervises the operations of the trust. It also communicates with the insurance company on matters relating to any of the underlying mutual funds or subadvisers.
- <sup>2</sup> Figures in this section of the report are based on Investment Company Institute (ICI) analysis of ICI data and data provided by Strategic Insight Simfund as of April 2009, and exclude funds that liquidated or merged after 1999.
- <sup>3</sup> The \$2.7 trillion figure refers to the amount of assets held by these funds, which may be greater by some unknown margin than the amount of assets managed by these funds' subadvisers. This is because there is no readily available data source that provides a breakdown of the assets managed by subadvisers and any assets of those funds that may be managed by the funds' principal advisers.
- <sup>4</sup> For information concerning annual subadviser due diligence reviews by principal advisers, including reviews pursuant to Rule 38a-1 under the 1940 Act, see "Sub-Adviser Due Diligence Review: Sample Certification Letter and Questionnaire," Investment Company Institute and Investment Adviser Association (May 2006), available at [www.idc.org/idc/idc\\_directors\\_resources/idc\\_public\\_other\\_publications/09\\_subadviser\\_due\\_diligence](http://www.idc.org/idc/idc_directors_resources/idc_public_other_publications/09_subadviser_due_diligence).
- <sup>5</sup> See Section 10 of the 1940 Act and the definition of "interested person" in Section 2(a)(19) of the 1940 Act.
- <sup>6</sup> Rules under the 1940 Act also require the independent directors of a fund relying on certain exemptions to determine that its legal counsel, if any, be "independent legal counsel." The SEC has acknowledged that a fund's independent directors, in making their determination, may conclude that representation of the fund's subadviser does not impede counsel's ability to serve the independent directors. See Final Rule: Role of Independent Directors of Investment Companies, SEC Release Nos. 33-7932, 34-43786, IC-24816 at n. 53 (Jan. 2, 2001), available at [www.sec.gov/rules/final/34-43786.htm](http://www.sec.gov/rules/final/34-43786.htm). This is particularly useful for the independent directors of a multi-manager fund because counsel might otherwise face a wide array of potential conflicts if counsel or other members of the law firm represent any of the fund's subadvisers.
- <sup>7</sup> Under Section 2(a)(9) of the 1940 Act, "control" means, in part, "the power to exercise a controlling influence over the management or policies of a company..." In addition, there is a presumption of control if a person or company beneficially owns more than 25 percent of a company's voting securities. *Id.*
- <sup>8</sup> The statutory definition of "investment adviser" in Section 2(a)(20) of the 1940 Act does not differentiate between a principal adviser and a subadviser.
- <sup>9</sup> Under Section 15 of the 1940 Act, as a practical matter, funds do not often solicit shareholders for approval of a subadvisory agreement. In the case of a new fund, the principal adviser typically serves as the fund's initial shareholder, and approves the subadvisory agreement before the fund's shares are publicly offered. Existing funds, as discussed in more detail in section VI of this paper, "Terminating a Subadvisory Relationship," typically seek exemptive relief from the SEC to change subadvisers without obtaining shareholder approval. In addition, the SEC has permitted amendments to advisory agreements for the purpose of reallocating advisory fees between a principal adviser and a subadviser without shareholder approval. See Invesco, SEC No-Action Letter (Aug. 5, 1997). The board, including a majority of the independent directors, would still need to approve the amended advisory agreement.
- <sup>10</sup> In its review and consideration of the advisory contract, a board typically applies the factors from the case *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), in which the court reviewed a claim under Section 36(b) of the 1940 Act. The factors include the following: (i) the nature and quality of the services provided; (ii) the profitability of the fund to the adviser; (iii) any fall-out benefits or indirect profits that the adviser receives for managing the fund; (iv) any economies of scale of managing the fund as it grows larger; and (v) comparative fee structures. The SEC also has incorporated these factors into its disclosure rules. See Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, SEC Release Nos. 33-8433, 34-49909, IC-26486 at n. 31 (June 23, 2004), available at [www.sec.gov/rules/final/33-8433.htm](http://www.sec.gov/rules/final/33-8433.htm). The *Gartenberg* standard has been followed by most courts until 2008 when, in the *Jones v. Harris Associates* case, the Seventh Circuit Court of Appeals expressly "disapprove[d] the *Gartenberg* approach." *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008), cert. granted, 129 S. Ct. 1579 (2009) (No. 08-586). The applicable standard for court review of a Section 36(b) claim will ultimately be decided by the Supreme Court, whose decision is expected by June 2010. Pending the Court's decision, most boards continue to follow the *Gartenberg* approach, at least in part because the analysis supports the disclosure required in shareholder reports.

- <sup>11</sup> The SEC has found under the Advisers Act that a principal adviser failed to supervise the portfolio manager of an affiliated subadviser. *In re Matter of Western Asset Management Co. and Legg Mason Fund Adviser, Inc.*, Inv. Adv. Act Rel. No. 1980, 2001 SEC LEXIS 2042 (Sept. 28, 2001); see also speech by Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission: “Remarks before the Investment Company Institute, Securities Law Developments Conference” (Dec. 6, 2001), available at [www.sec.gov/news/speech/spch527.htm](http://www.sec.gov/news/speech/spch527.htm) (commenting on the *Western Asset Management* case).
- <sup>12</sup> See *SEC v. American Birthright Trust Management Company, Inc.*, SEC Litigation Release No. 9266 (Dec. 30, 1980) (settlement of civil injunctive action in which the SEC alleged excessive compensation paid to a fund’s adviser in light of the services actually performed by the principal adviser while most of the advisory services had been provided by a subadviser; also alleging that the board approved the advisory contracts without requesting information that was reasonably necessary to evaluate the contracts); cf *In the Matter of Smith Barney Fund Management LLC and Citigroup Global Markets, Inc.*, Exchange Act Rel. No. 51761 (May 31, 2005) (settlement of an administrative proceeding in which the SEC found that the funds’ boards were misled when the funds changed from a third-party transfer agent to an affiliated transfer agent even though the third-party transfer agent continued to perform almost all the same services it had performed previously, but at deeply discounted rates, while the affiliated transfer agent kept most of the discount for itself and made a high profit for performing limited work).
- <sup>13</sup> For a discussion of the responsibilities of boards for fair valuation, see *Fair Valuation Series: The Role of the Board*, Independent Directors Council, Investment Company Institute, and ICI Mutual Insurance Company (January 2006), available at [www.idc.org/pdf/o6\\_fair\\_valuation\\_board.pdf](http://www.idc.org/pdf/o6_fair_valuation_board.pdf).
- <sup>14</sup> For a discussion of the responsibilities of boards in overseeing proxy voting of fund portfolio securities, see *Oversight of Fund Proxy Voting*, Independent Directors Council and Investment Company Institute (July 2008), available at [www.idc.org/pdf/ppr\\_o8\\_proxy\\_voting.pdf](http://www.idc.org/pdf/ppr_o8_proxy_voting.pdf).
- <sup>15</sup> Directors have a federal statutory responsibility for the accuracy of the fund’s registration statement filed with the SEC. A director is personally liable for any material inaccuracy or omission in the registration statement, unless a defense is available. See Section 11 of the Securities Act of 1933. Accordingly, as is the case with all of the disclosures in the registration statement, each director should take the appropriate measures to ensure that he or she understands the procedures followed by the principal adviser to ensure the accuracy and completeness of the disclosure relating to any subadvisers.
- <sup>16</sup> For a discussion of the responsibilities of boards in overseeing fund compliance, see IDC’s *Task Force Report on Board Oversight of Fund Compliance* (September 2009), available at [www.idc.org/pdf/idc\\_o9\\_compliance.pdf](http://www.idc.org/pdf/idc_o9_compliance.pdf).
- <sup>17</sup> Rule 206(4)-7 under the Advisers Act.
- <sup>18</sup> Rule 17j-1 under the 1940 Act.
- <sup>19</sup> See Section 2(a)(3) of the 1940 Act, defining “affiliated person” of a fund to include investment advisers and, by extension, subadvisers.
- <sup>20</sup> Rule 17a-10 under the 1940 Act.
- <sup>21</sup> See Section 15(a)(4), requiring advisory contracts to provide for automatic termination in the event of assignment; and Section 2(a)(4), defining assignment to include any direct or indirect transfer of an advisory contract or of a controlling block of the assignor’s outstanding voting stock.
- <sup>22</sup> The SEC proposed to codify this relief in 2003. See Exemption from Shareholder Approval for Certain Subadvisory Contracts, SEC Release Nos. 33-8312, 34-48683, IC-26230 (2003), available at [www.sec.gov/rules/proposed/33-8312.htm](http://www.sec.gov/rules/proposed/33-8312.htm). A final rule has not been adopted.







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