Another Look at an Adviser's Duty to Supervise Sub-Advisers (and Other Advisers)

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INTRODUCTION

In recent years, the compliance landscape has changed dramatically in the investment management industry, with renewed vigor and emphasis on the duty to supervise, now considered a critical part of the federal regulatory regime and brought to the forefront once again by events such as the Bernard Madoff scandal, where financial institutions and other advisers placed client assets for management by Madoff, lost in Madoff's self-professed Ponzi scheme. Accordingly, investment advisers[1] should pay particular attention to the supervision of sub-advisers. In today's legal environment, an adviser must supervise its sub-advisers' compliance in addition to their investment performance, or risk liability if errors, violations or wrongdoing are committed by a sub-adviser or a sub-adviser's personnel.

Part 1 of this paper discusses the legal framework and current developments that underpin an adviser's duty to supervise. Part 2 provides some practical tips on how an adviser can manage its supervisory risk.

[Author's Note: Although this paper makes reference throughout to an adviser's duty to supervise <u>sub-advisers</u>, the same principles apply to an adviser's duty to supervise <u>other advisers</u> subject to oversight as well, whether or not they are technically aligned as sub-advisers.]

Part 1: The Legal Landscape

The Duty to Supervise

An adviser's legal duty to supervise its sub-advisers emanates from a number of sources:

<u>Statutory Provisions</u>. Every adviser has a duty to supervise emanating from Section 203(e)(6) of the Investment Advisers Act of 1940 ("Advisers Act"). That section permits the Securities and Exchange Commission ("SEC") to take action[2] against any adviser if the SEC finds the adviser:

> "…has failed reasonably to supervise, with a view to preventing violations of [the federal securities laws], another person who commits such a violation, if such other person is <u>subject to his supervision</u>."[3]

[1] This article focuses on investment advisers registered at the federal level with the Securities and Exchange Commission. Although many of the issues discussed may apply to all advisers, state-registered advisers may have different or additional requirements which are beyond the scope of this article.

[2] Section 203(e)(6) empowers the SEC to take administrative action and by itself would not appear to support a private right of action by clients, shareholders, or other private parties. *See* <u>Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis</u>, 444 U.S. 11 at 24, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979), in which the Supreme Court, in a 5-4 opinion, held that there exists a limited private remedy under the Advisers Act to void an advisory contract, but that the Advisers Act confers no other private causes of action, legal or equitable. *See also* <u>Patrick V. Morris, et al. v. Wachovia Securities, Inc</u>., 2003 WL 21982233 (E.D.Va.) (August 12, 2003) (the "Morris case"), in which the court stated "only §215 [the Validity of Contracts section] of the [Advisers Act] creates any private right of action."

[3] Section 203(e)(6) of the Advisers Act (emphasis added). The SEC can also seek sanctions and monetary penalties for a violation of Section 203(e)(6) pursuant to Sections 203(f) and 203(i)(1)(D).

Whether any given person -- like a sub-adviser or other adviser selected to manage a client's assets -- is "subject to [an adviser's] supervision" will be a fact intensive matter and will depend on the circumstances of each case.[4] It is clear, however, that supervisory responsibility does not necessarily stop at organizational boundaries.[5] Key factors evidencing a supervisory relationship may include the written agreements among the parties, relevant disclosures, relationships among the individuals involved, course of dealing between the parties, and expressed expectations or intentions.[6]

There is an issue here, however, hidden in the statutory language. Section 203(e)(6) infers that an adviser will be liable for failure to supervise any person "subject to [the adviser's] supervision." It does <u>not</u> utilize the statutory definition of "supervised person" found in Section 202(a)(25) of the Advisers Act and impose or infer liability for failure to supervise any "supervised person." This seemingly small wording difference could be significant because Section 202(a)(25) of the Advisers Act defines "supervised person" to include the adviser's own personnel,[7] plus "any other person who provides investment advice <u>on behalf of the investment adviser</u> and is subject to the supervision and <u>control</u> of the investment adviser."[8] Thus the definition of "supervised person" is narrower than the phrase "person subject to the adviser's supervision" by excluding persons who are not providing advice on the adviser's "behalf" and persons who are not subject to the adviser's "control."[9]

In the real world, this difference could be determinative of whether any given adviser may be held liable under Section 203(e)(6) for failure to supervise a sub-adviser. For instance, one can easily envision a case where a sub-adviser is considered subject to an adviser's supervision, as evidenced by numerous factors including the typical undertaking to that effect in the investment advisory agreement. In those cases, the adviser ostensibly could be held liable for a failure to supervise the sub-adviser under a straightforward reading of Section 203(e)(6). However, the adviser ostensibly could <u>not</u> be held liable under Section 203(e)(6) if the statutory definition of "supervised person" is read into that section, at least not in cases where the sub-adviser either is not providing investment advice on the adviser's "behalf" or is not under the adviser's "control."

We may not soon know how a court would interpret the phrase "subject to the adviser's supervision" in Section 203(e)(6) vis-à-vis the statutory definition of "supervised person" in

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[4] *See, e.g.,* the WAM case discussed *infra* note 25 and text surrounding.

[5] *See* Remarks Before the Investment Company Institute, Securities Law Developments Conference in Washington, DC made by Stephen M. Cutler, Director of the SEC Division of Enforcement (December 6, 2001) ("Cutler's Remarks"); *and* the WAM case discussed *infra* note 25 and text surrounding.

[6] Some of these factors were found relevant in the WAM case discussed *infra* note 25 and text surrounding.

[7] Such as employees, partners, officers, directors or other persons occupying a similar status or performing similar functions.

[8] Section 202(a)(25) of the Advisers Act (emphasis added). In Section 203(e)(6), Congress also did not use the defined term "person associated with an investment adviser" found in Section 202(a)(17), which is similar to "supervised person" but is both more inclusive in that it covers all persons controlling and controlled by the adviser and less inclusive in that it does not cover for certain purposes persons whose functions are clerical or ministerial.

[9] "Control" means "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." Section 202(a)(12) of the Advisers Act.

Section 202(a)(25) since enforcement of Section 203(e)(6) is relegated to SEC proceedings which are typically settled and do not often find their way into the judicial court system. If, however, a court were to read 203(e)(6) as substantively one and the same as the "supervised person" definition in 202(a)(25), the scope of potential failure to supervise liability under Section 203(e)(6) would be narrowed substantially and would potentially exclude a great many adviser/sub-adviser relationships that otherwise might be included.[10]

Regardless of what a court might do, it is evident that the SEC does not read the "supervised person" definition into Section 203(e)(6). This is evident not only from a noteworthy enforcement action discussed in detail later in this paper,[11] but also from remarks made by the SEC Staff about an adviser's duty to supervise, which admonish advisers to pay more meticulous care not only to the supervision of sub-advisers but to the supervision of all service providers, including ostensibly custodians, administrators, pricing agents, and so on, many of whom would clearly not be "supervised persons" within the statutory definition.[12]

Under Section 203(e)(6), advisers with potential supervisory liability are provided an affirmative defense if they have established and implemented a system of procedures that would reasonably be expected to prevent and detect any such violations, insofar as practicable.[13] This means that advisers, although obligated to supervise, are not obligated to "guarantee" or "insure" the conduct of those they supervise. It also means, however, that advisers without adequate procedures and systems are taking a substantial risk of being held responsible for failure to supervise if violations are committed by any sub-advisers determined to be under their supervision.

Section 203(e)(6) in short calls for advisers to prevent violations of the 'federal securities laws.' It would be overly narrow, however, to read this as meaning they should prevent only "classic" violations of the securities laws, such as insider trading violations, registration violations, violations of statutory investment limitations, or the like. There are many other types of compliance problems which themselves may not constitute "classic" violations, but which can nonetheless serve as the basis for other securities law violations and should therefore be among the problems that advisers aim to prevent. For example, a sub-adviser who violates a voluntary investment restriction by purchasing prohibited securities may not violate the securities laws by virtue of the purchase itself. However, the purchase might serve as the basis for a securities fraud violation if relevant disclosures misrepresented to investors that the prohibited securities would not be purchased. Accordingly, supervisory systems intended to meet Section 203(e)(6) should be designed to prevent not only "classic" securities law violations, but this broader category of problems as well.

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[10] The difference in phrasing between the two sections may have been less intentional than accidental since Congress added the "supervised person" definition to the Advisers Act after the enactment of earlier sections, via the National Securities Markets Improvements Act of 1996 (NSMIA), Public Law 104-290 (enacted October 11, 1996, effective July 8, 1997).

[11] *See* the WAM case discussed *infra* note 25 and text surrounding.

[12] Compliance Issues for Investment Advisers Today, Remarks at the Investment Counsel Association/IA Week Investment Adviser Compliance Summit made by Lori A. Richards, Director of the SEC Office of Compliance Inspections and Examinations (April 28, 2003) ("Richards' Remarks").

[13] *See* Section 203(e)(6), subparts (A) and (B). This is similar to the protection afforded under Section 21A(b)(1)(B) of the Securities Exchange Act of 1934 to controlling persons who may be liable for insider trading violations committed by persons under their control if they fail to establish and enforce procedures aimed at preventing those violations.

Regulatory Provisions. The adviser compliance rule, Rule 206(4)-7 under the Advisers Act, requires registered investment advisers to adopt policies and procedures reasonably designed to prevent violations of certain securities laws.[14] The rule as adopted, however, only requires advisers to prevent violations by the adviser and its "supervised persons" using the narrow statutory definition in Section 202(a)(25) of the Advisers Act, discussed in the preceding section. As a result, it is unclear if under a strict reading of the rule, an adviser would be required to adopt policies and procedures aimed at preventing violations of its sub-advisers, at least in a typical sub-advisory relationship where the sub-adviser may not meet the definition of "supervised person" because it is not providing investment advice on behalf of the investment adviser and/or is not subject to the adviser's control.

In some sense, this puts Rule 206(4)-7 at odds with Section 203(e)(6), since under the rule, an adviser's policies and procedures must only address the narrower category of "supervised persons," whereas an adviser's policies and procedures should address the broader category of all persons "subject to [the adviser's] supervision" in order to gain the affirmative defense to failure to supervise claims offered by Section 203(e)(6). But whether or not the SEC could pursue an adviser for failing to supervise an sub-adviser under Rule 206(4)-7 – or more accurately, for failing to establish procedures reasonably designed to do so – does not preclude the SEC from pursuing the adviser under Section 203(e)(6). Indeed, even with the new compliance rules in effect, Section 203(e)(6) may well continue to serve as the principal basis for SEC "failure to supervise" claims, whereas Rule 206(4)-7 will serve more as a vehicle for policing the adviser's compliance program.[15]

Regardless of whether a sub-adviser meets the technical definition of "supervised person" in any given case, it is prudent and not unusual in practice for advisers to adopt compliance policies and procedures under Rule 206(4)-7 governing the selection, retention and monitoring of sub-advisers, which include overseeing the sub-adviser's own compliance. This is most common when a significant part of the adviser's business involves assisting clients with the selection of sub-advisers. In those cases, the adviser could easily conclude that it is wise to include as part of its own compliance system policies and procedures designed to oversee the sub-advisers both in compliance and in investment management matters. The rationale is this: if the adviser's own responsibilities include making sound recommendations whether a client should select or retain a particular sub-adviser, it is appropriate for the adviser to consider whether the sub-adviser is itself maintaining compliance or whether using that sub-adviser might put the client or its assets at undue risk.

Advisers often oversee sub-advisers under the same rationale in the investment company context, but under a slightly different regulatory regime. Funds are subject to the SEC's fund compliance rule, Rule 38a-1, which the SEC adopted under the Investment Company Act at the same time that it adopted the adviser compliance Rule 206(4)-7 under the Advisers Act. Similar to Rule 206(4)-7, Rule 38a-1 calls for funds to adopt policies and procedures reasonably designed to prevent securities law violations. However, in contrast to

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[14] Interestingly, Rule 206(4)-7 was adopted under the rubric of Section 206(4) of the Advisers Act, the anti-fraud section of the act, rather than as part of Section 203, which as discussed above, already contains subsection (e)(6) providing penalties for failure to supervise. This may have more to do with the context of Section 203, however, which serves largely to define the parameters of SEC registration and enforcement authority, whereas Section 206 has served to not only impose anti-fraud obligations on advisers but to impose fiduciary duties on them as well. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 at 194, 84 S.Ct. 275 (1963) ("Capital Gains Research").

[15] For example, *compare* Fidelity, note 25, *infra*, a recent SEC proceeding finding failure to supervise under Section 203(e)(6), *with* the SEC's first case alleging a violation of Rule 206(4)-7, In the Matter of CapitalWorks Investment Partners and Mark J. Correnti, Advisers Act Rel. No. 2520 (June 6, 2006).

Rule 206(4)-7, Rule 38a-1 calls on funds not only to adopt policies and procedures to prevent their own violations, but also expressly requires them to adopt policies and procedures for the oversight of compliance by their service providers, including their advisers and sub-advisers. Since funds typically do not have their own employees, oversight of fund service providers is often delegated to or undertaken by the fund's adviser,[16] and, as a result, the adviser often finds itself overseeing sub-adviser compliance acting on behalf of the fund.

In this way, SEC regulations can also serve as the source for an adviser's obligation to supervise sub-advisers, in the fund context under Rule 38a-1 and/or the non-fund context under Rule 206(4)-7.

Exemptive Orders and Disclosures. Advisers who act in a "manager of managers" or similar "multi-manager" arrangement may have obligations to supervise their sub-advisers apart from Section 203(e)(6) and the SEC rules discussed above. In a typical "manager of managers" arrangement, the adviser oversees multiple sub-advisers for an account or group of accounts and makes recommendations for the hiring, termination and replacement of sub-advisers.

On the strength of their all-encompassing role, some "managers of managers" for mutual funds have obtained an SEC exemptive order permitting them to replace sub-advisers without the otherwise required shareholder vote or consent.[17] A condition commonly imposed under this type of order requires the adviser to monitor the sub-advisers and ensure that they comply with the investment objectives, policies and restrictions of the underlying accounts by, among other things, implementing procedures reasonably designed to ensure compliance.[18] In these cases, advisers have an obligation to supervise their sub-advisers emanating directly from their SEC exemptive order.

Whether or not they are acting under an exemptive order, advisers who use sub-advisers often state that the adviser will monitor the sub-advisers in relevant disclosures, such as the fund prospectus or in the adviser's Form ADV. Thus, advisers may assume an obligation to supervise their sub-advisers in order to stay within the parameters of material disclosures and avoid the commission of fraud.

Contract Law and the Advisory Agreement. Advisers may also have an express contractual obligation to supervise their sub-advisers. Often, an investment advisory agreement will authorize the adviser to engage a sub-adviser and, in that event, specifically require the adviser to monitor and evaluate the sub-adviser and its performance.[19] The adviser's authority,

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[16] Or by employees of the adviser, who might have dual appointments as officers of the fund. Compliance oversight of service providers might also be undertaken by a fund's third party administrator or other parties as well, but most commonly, responsibility for overseeing sub-advisers falls to the adviser, since the adviser's expertise is most useful in determining all the parameters relevant to whether a sub-adviser ought to be selected or retained.

[17] *See*, *e.g.*, EQ Advisors Trust and EQ Financial Consultants, Inc., Rel. No. IC-23093, 63 FR 16596 (Notice of Application) (March 30, 1998).

[18] *See*, *e.g.*, *id.* at Condition 7. A similar condition requiring the adviser to be contractually bound to supervise the sub-adviser has also been included as part of proposed Rule 15a-5 under the Investment Company Act, which would codify the conditions imposed under the exemptive orders commonly issued in "manager of managers" arrangements allowing for changes in sub-advisers without shareholder vote. See Proposed Rule: Exemption from Shareholder Approval for Certain Subadvisory Contracts, Release Nos. 33-8312, 34-48683, IC-26230 (October 23, 2003).

[19] There may be room for arguing that "monitoring" and "evaluating" a sub-adviser is somehow substantively less onerous than "supervising" the sub-adviser, but in practice, little or no distinction appears to exist.

if not its duty, to supervise the sub-adviser is also often reflected in the sub-advisory agreement between the adviser and the sub-adviser, which typically states that the sub-adviser's appointment is subject to the supervision of the adviser.

Even if the advisory agreement does not expressly require the adviser to supervise its sub-advisers, an obligation to that effect might be implied into the contract whenever a sub-adviser is delegated some or all of the adviser's duties. This is particularly true if the adviser's role is broad, akin to that of a "manager" responsible for handling all the affairs -- or at least all the investment affairs -- of the account. All-encompassing investment responsibilities could easily be implied to include ongoing supervision of any person delegated responsibility to make investment decisions on behalf of the account.

Whether or not an obligation to supervise is express or implied, the adviser would likely be liable for breach of the advisory agreement under a straightforward application of contract law, if the breach results from conduct of a sub-adviser to whom the adviser has delegated duties. This is because the delegation in and of itself does not alter the adviser's own contractual liability.[20] Thus, in cases where the advisory agreement requires the adviser to manage the account or fund in accordance with all applicable laws, restrictions and policies, or imposes other responsibilities on the adviser, the adviser could be held liable if a breach is caused by a sub-adviser delegated those responsibilities. This gives the adviser yet another incentive to supervise its sub-advisers in order to avoid a sub-adviser's failure giving rise to a breach of contract claim.

Fiduciary Duty. A duty to supervise sub-advisers might also emanate from an adviser's fiduciary duty to its clients. An adviser has an obligation to manage client affairs not only with the utmost good faith[21] but also with prudence and due care.[22] One could easily argue that

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[20] *See* 4 Corbin on Contracts § 866. *See also* Restatement (Second) of Contracts § 318. This would likely be the result unless the delegation is interpreted to result in a novation, where the adviser and the client both assent to the discharge of the adviser's obligations in substitution for the sub-adviser's. However, a novation would likely be inconsistent with the client's understanding, at least in the typical adviser/sub-adviser relationship.

[21] Capital Gains Research, note 14, *supra*.

[22] A full discussion of the source of an adviser's duty of care and the standard of care applicable is beyond the scope of this paper. However, authority suggests that a duty of care emanates from an adviser's basic fiduciary duty under common law or under the fiduciary principles read into Section 206 of the Advisers Act and, moreover, that advisers will be held to either a negligence or gross negligence standard, which may in certain circumstances be altered by contract. *See*, Capital Gains Research, note 14, *supra*. *See also,* Section 17(i) of the Investment Company Act. Advisers in the role of a "fiduciary" under ERISA will be held to the so-called "prudent man" standard and required to act with the "care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. §1104(a)(1)(B). Advisers managing investment companies are also bound by Section 36(a) of the Investment Company Act to avoid breaches of fiduciary duty "involving personal misconduct" although the authority is not settled on what standard of care applies under that section and what "personal misconduct" means. *Cf.* SEC v. Continental Growth Fund, Inc., et al., Fed.Sec.L.Rep. (CCH) ¶91,437 (1964), cited in Steadman Security Corp. (available April 18, 1983) (which suggests negligence may be enough to ground a claim) *with* Strougo v. Scudder, Stevens & Clark, Inc., 964 F.Supp. 783 (SDNY May 6, 1997) (which suggests something more than mere breach of duty may be required). Advisers that are banks acting in a trust capacity may also be subject to statutes dictating a particular standard of care. *See, e.g.*, the Uniform Prudent Investor Act, as drafted and recommended for enactment by the National Conference of Commissioners on Uniform State Laws in 1994, which dictates that trustees comply with the prudent investor

prudence and due care require the adviser to supervise any sub-adviser engaged for its account, if nothing else to make sure the sub-adviser is fulfilling the terms of its engagement. Although breach of fiduciary duty is not the grounds on which the SEC has pursued advisers for failure to supervise, it cannot be ruled out as a potentially fertile avenue for regulatory, client or shareholder action in an appropriate case.[23]

Good Business. Outside of the strict legal duty to supervise, it is just plain good business for an adviser to supervise its sub-advisers in order to maintain its own professional standards and reputation and keep its clients happy. This means monitoring to avoid more than just poor performance and securities law violations. It means monitoring all aspects of the sub-adviser's organization that could adversely impact the adviser or the client's account, from everything necessary to adhere to the law, to everything necessary to meet the client's basic business expectations and everything in between. Preventing problems before they arise has always been a tried and true method to avoid the waste of money, diversion of resources, internal disruption, bad publicity and loss of clients that often accompany these problems. This is no less true if the problem results from the conduct of a sub-adviser than if it results from conduct within the adviser's own organization.

The Current Enforcement Landscape

The WAM Case. In recent years there have been numerous SEC enforcement actions against advisers under the broad heading of "failure to supervise."[24] As a general rule those

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rule set forth in that act, calling for the exercise of reasonable care, skill and caution.

[23] Of course, claims for failure to meet the requisite standard of care might also be as couched as run-of-the-mill tort claims, such as negligence or negligent mismanagement, in addition to breach of fiduciary duty and other common law equitable claims. For example, claims in one suit brought against an adviser that placed client fund assets under Bernard Madoff's management include breach of fiduciary duty, gross negligence, unjust enrichment, breach of contract, promissory estoppel, and mutual mistake. *See* Pacific West Health Medical Center Inc. Employees Retirement Trust v. Fairfield Greenwich Group, et al., Civil Action No. 09 CV 00134 (USDC, SDNY) (filed Jan. 8, 2009) ("Pacific West").

[24] *See*, *e.g.*, Patrick J. Vaughan, Advisers Act Rel. No. 2842A (February 10, 2009) (director of retail sales at adviser/BD failed to reasonably supervise employee by failing to respond to red flags regarding his misconduct and lack of supervision); Fidelity Management and Research Company and FMR Co., Inc., Advisers Act Rel. No. 2713 (March 5, 2008) ("Fidelity")(adviser failed to reasonably supervise employees' receipt of travel, gifts and entertainment paid for by brokers with a view to preventing violations of Section 17(e)(1) of the Investment Company Act of 1940); John B. Hoffman and Kevin J. McCaffrey, Securities Exchange Act Rel. No. 51713, Advisers Act Rel. No. 2386 (May 19, 2005) ("Hoffman") (employees of registered broker/dealer and adviser firm failed to reasonably supervise analyst employee who published fraudulent research reports in violation of SEC and NYSE rules); Fanam Capital Management, Richard J. Ennis and Seth Morgulas, Advisers Act Rel. No. 2316 (Oct. 29, 2004) (executive VP failed to take reasonable supervisory action, which could have included maintaining accurate records of client account transactions, reviewing daily trading activity, valuing the account's positions and separating trading and administrative operations, rather than relying on trader's spreadsheets, without independently verifying their accuracy, which enabled him to continue fraudulent activity); In the Matter of Robert T. Littell and Wilfred Meckel, Advisers Act Rel. No. 2203 (December 15, 2003) (principal of unregistered hedge fund adviser failed to reasonably supervise employee, which allowed employee to undertake fraudulent activities in connection with hedge funds); Oechsle International Advisors, L.L.C., Advisers Act Rel. No. 1966 (Aug. 10, 2001) (adviser failed to supervise portfolio manager who had manipulated the closing price of certain securities held in advisory accounts). As of the date of this article, the SEC has not announced any failure to supervise actions against advisers that lost assets placed with Madoff, although it would not be surprising to see that occur as the case continues to unfold.

cases involved an adviser's failure to supervise its own employees. However, the following discussion focuses on one case that represents a noteworthy exception to that rule, the Western Asset Management ("WAM") proceeding[25] brought by the SEC in 2001 based on the conduct of a portfolio manager employed at a sub-advisory firm. The portfolio manager, it was asserted, directly violated and aided and abetted other violations of the federal securities laws. Because the WAM case is so unusual in certain regards, it is instructive to discuss it in some detail to gain insight on the SEC's approach to "failure to supervise" claims.

In the WAM case, it was not surprising that the SEC pursued the sub-adviser for failure to supervise the portfolio manager because the portfolio manager was employed by the sub-adviser. However, it was surprising that the SEC also pursued the adviser for failing to supervise the portfolio manager, even though the portfolio manager was not the adviser's employee. This twist raises the question whether the adviser and the sub-adviser's employee needed to be linked directly in some "supervisory" way for the SEC to pursue the adviser and, if so, whether the adviser and the portfolio manager in the WAM case were indeed so linked.

The Supervisory Link. To support its claim against the adviser in the WAM case, the SEC pointed to certain factors which it believed established a supervisory relationship between the adviser and the portfolio manager employed by the sub-adviser. First, the written agreement in which the adviser delegated the investment advisory function to the sub-adviser specifically stated that the sub-adviser's provision of services was subject to the supervision of the adviser. Second, the adviser was "involved in" the appointment of the portfolio manager, although details are not provided in the SEC's order on exactly how the adviser was involved. In addition, when the adviser received complaints from the portfolio manager that the sub-adviser was not providing the portfolio manager with sufficient support, the adviser relayed those complaints to the sub-adviser, which then hired an analyst to assist the portfolio manager.

The SEC also chronicled at least three incidents where the adviser became aware of "red flags" or irregularities and did not adequately follow up on them or investigate them. Moreover, the adviser had not established or implemented procedures for follow-up or review in the event of red flags. If the adviser had properly followed up and investigated these red flags, the SEC asserts that it should have discovered the wrongful conduct. In these circumstances, according to the SEC, the adviser "became" a supervisor of the portfolio manager.[26]

It is not clear from the WAM case why the SEC believed it was necessary or desirable to establish a direct supervisory link between the adviser and the portfolio manager in order to pursue its claims against the adviser. Could the SEC have simply attributed the portfolio manager's wrongful conduct to the sub-adviser[27] and then asserted that the adviser failed to properly supervise the sub-adviser without more? Were more direct connections between the adviser and the portfolio manager even necessary to ground a claim against the adviser, given the advisory agreement provisions, failures to follow up on red flags and lack of internal controls and procedures? There may have been a number of reasons for the SEC's approach,

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[25] Western Asset Management Co. and Legg Mason Fund Adviser, Inc., Advisers Act Rel. No. 1980 (September 28, 2001) ("WAM"). Legg Mason Fund Adviser was the adviser in that case and Western Asset Management was the sub-adviser. The proceeding was settled, resulting in a censure of both respondents, a civil penalty of $50,000 for each and an order requiring each to maintain enhanced supervisory policies and procedures aimed at preventing the wrongful conduct.

[26] *Id.* at Section III.E.2.

[27] An employee's conduct might be attributable to an employer under principles of *respondeat superior* or the like.

perhaps due to the nature of the wrongful conduct alleged or issues with attributing it to the sub-adviser.[28] Or, perhaps since it was novel for the SEC to pursue a failure to supervise claim under Section 203(e)(6) in a case not involving an adviser's own personnel, it believed a more direct connection between the adviser and portfolio manager was necessary or beneficial.[29]

Whatever the rationale for the SEC's approach, it is beneficial to look more closely at the factors that were cited to connect the adviser and the portfolio manager in the WAM case, starting with the written agreement. It is not very compelling that the agreement between the adviser and the sub-adviser stated that the sub-adviser's provision of services was subject to the supervision of the adviser. While this may reflect the adviser's supervisory authority over the <u>sub-adviser</u>, it is a significant stretch to read that provision as establishing a direct supervisory relationship between the adviser and any of the sub-adviser's <u>employees</u>. Presumably, the written agreement was not the linchpin establishing a supervisory link between the adviser and the portfolio manager, even assuming one needed to be established. Indeed, the SEC Staff has publicly said as much. According to remarks made in a speech by the then SEC Director of Enforcement, other indicia of a "mutually recognized supervisory relationship" can establish supervisory liability even absent a written reservation of supervisory authority.[30] He stated that the <u>nature</u> of the relationship between the adviser and the portfolio manager in the WAM case established that the adviser was a supervisor, citing the adviser's involvement in the portfolio manager's appointment and the portfolio manager's complaints to the adviser.[31]

It is also questionable whether the three "red flag" incidents cited by the SEC in the WAM case establish or reflect a supervisory relationship between the adviser and the portfolio manager. Certainly, the adviser could have followed up on the red flags more rigorously and might have discovered the violations if it had. But the facts behind those incidents – at least as recounted in the WAM order -- do not seem to link the adviser and the portfolio manager in any "supervisory" way.[32] Rather, they seem like normal responses of an adviser to pricing and other issues impacting a portfolio it oversees, which do not show the adviser interfacing with the portfolio manager in any supervisory capacity.

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[28] In some cases, serious wrongful actions by employees, or actions by employees that are not sufficiently related to their job duties, will not be imputed to their employers. See, e.g., <u>Millan v. Dean Witter Reynolds, Inc</u>., 90 S.W.3d 760 (Tex. App.– San Antonio 2002, pet. denied), in which a Dean Witter broker stole some $287,000 over a three-year period from his mother's Dean Witter account which the son had established in his role as a Dean Witter broker. The broker engaged in a series of deceitful acts, such as forging his mother's name on checks and creating false account statements. In upholding the trial court's directed verdict in favor of Dean Witter, the appellate court cited, among others, <u>Adami v. Dobie</u>, 440 S.W.2d 330, 334 (Tex. Civ. App.-San Antonio 1969, writ dism'd) for the proposition that in cases involving serious criminal activity, an employer is not liable for intentional and malicious acts that are unforeseeable considering the employee's duties.

[29] Notably, the SEC did not address the interpretive issue discussed in the text surrounding notes 7-9, *supra*. It did not reference the Section 202(a)(25) definition of "supervised person" and did not make findings as to whether the sub-adviser or the portfolio manager were providing investment advice on the adviser's "behalf" or were under the adviser's "control." Rather, it simply recited the language from Section 203(e)(6) and made findings that it believed established a "supervisory relationship" between the adviser and the portfolio manager.

[30] Cutler's Remarks, note 5, *supra*.

[31] *Id*.

[32] This is despite the SEC's somewhat conclusory statement in its order that, in these circumstances, the adviser "became" the portfolio manager's supervisor. WAM case, note 25, *supra*, at Section III.E.2.

Thus, the only links that might actually support the argument that the adviser in the WAM case "supervised" the portfolio manager are the adviser's involvement in the portfolio manager's appointment and the adviser's response to the portfolio manager's complaints about lack of support. These links are perhaps more unusual or far-reaching than typically exist between an adviser and a sub-adviser's employees. They might reflect that the portfolio manager was the adviser's own "pick" or that the adviser was in a position to influence the portfolio manager's working conditions. However, the SEC has stated that "[d]etermining if a particular person is a 'supervisor' depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue." [33] While these two links in the WAM case may be unusual in some respects, they do not necessarily reflect the adviser's responsibility, ability or authority to affect the portfolio manager's conduct at all.

Regardless of what one concludes about the links cited in the WAM case, the fact that the SEC has cited all the factors in a cumulative way to support its claim against the adviser suggests that future actions may similarly be grounded on cumulative factors which individually may not be all that compelling to establish a supervisory relationship.

Lessons Learned….Or Not. What lessons can be learned from the WAM case? The most obvious is that advisers may be pursued under Section 203(e)(6) for failure to supervise sub-adviser personnel who commit wrongdoing, at least those with whom the adviser has a supervisory relationship. A related lesson is that compliance procedures will not provide a defense to a failure to supervise claim if they do not provide for adequate follow-up to red flags, including follow-up at the sub-adviser level if necessary.

It may be equally instructive to discuss what lessons should not be taken away from the WAM case. First, do not assume that the adviser's liability was contingent on the fact that the adviser and the sub-adviser were both wholly-owned subsidiaries of the same company, as they were in that case.[34] Certainly, the affiliation was not central to the operative facts. Moreover, the SEC Staff has stated publicly that the affiliation was not integral to the finding of a supervisory relationship, which may be equally likely to result from an adviser/sub-adviser relationship between two unrelated entities.[35]

Second, the SEC Staff has cautioned against advisers trying to limit their supervisory exposure by modifying their contract language somehow, perhaps by omitting the typical language in the sub-advisory agreement that makes the sub-adviser's services subject to the adviser's supervision.[36] As mentioned, the nature of the relationship can establish supervisory liability quite apart from the contractual provisions.

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[33] In the Matter of John H. Gutfreund, et al., 51 S.E.C. 93, 113, Exchange Act Rel. No. 31554 (Dec. 3, 1992) ("Gutfreund") (emphasis added). It is curious that the SEC did not cite or argue the Gutfreund definition of supervisor in the WAM case, even though it has reiterated the definition in proceedings after Gutfreund, e.g., Hoffman, *supra* note 24; George J. Kolar, Exchange Act Rel. No. 46127 (June 26, 2002); Kirk Montgomery, Exchange Act Rel. No. 45161 (December 18, 2001), 76 SEC Docket 1394, 1402, 1408; Patricia Ann Bellows, Exchange Act Rel. No. 40411 (September 8, 1998), 67 SEC Docket 2910, 2912; and Conrad C. Lysiak, 51 S.E.C. 841, 844 n.13 (1993), aff'd, 47 F.3d 1175 (9th Cir. 1995)(Table).

[34] The adviser and the sub-adviser were evidently both wholly-owned subsidiaries of Legg Mason, Inc.

[35] Cutler's Remarks, note 5, *supra*.

[36] *Id*.

The WAM case does not answer definitely questions like the following, which will have to be fleshed out in future cases:

- What kinds of supervisory links will have to be established between the adviser and the sub-adviser – or the sub-adviser's personnel -- before supervisory liability can be established? Will it be enough to establish that the adviser is generally obligated to monitor or supervise the sub-adviser, for example, under the advisory agreement?

- Will other legal theories be used to ground a failure to supervise case, such as breach of the advisory agreement or breach of fiduciary duty?

- Will other parties, such as clients or shareholders, find failure to supervise claims a fruitful avenue for recovery?[37]

There is at least some indication that private plaintiffs will be pursuing failure to supervise claims, albeit not under Section 203(e)(6). In a federal case in Virginia,[38] a private plaintiff sued an adviser alleging, among other things, failure to adequately monitor the portfolio managers that were handling the plaintiff's account as part of a program offered by the adviser. The court permitted the plaintiff's claim for rescission of the advisory agreement to go forward on the basis of a violation of Section 206(2) of the Advisers Act, the section prohibiting fraud, on the theory that the adviser fraudulently induced the plaintiff to enter its program with untrue promises to monitor the portfolio managers for performance and for adherence to their advertised strategies.

Not surprisingly, the Bernard Madoff scandal has already resulted in a spate of private litigation against, for example, the banks, hedge fund managers and other advisers that selected Madoff to manage their clients' assets, now apparently lost in Madoff's massive Ponzi scheme. One typical complaint alleges claims against the defendant hedge fund managers who placed fund assets with Madoff for breach of fiduciary duty, negligence and unjust enrichment, but the substantive allegations run to the defendants' failure to establish guidelines for selected managers and ensure that the guidelines were being followed, the failure to perform "even a minimum level of due diligence" regarding Madoff's activities, and the failure to find and follow-up on "red flags" in Madoff's management of the funds.[39] Another complaint claims against the fund managers for breach of fiduciary duty, gross negligence, unjust enrichment, breach of contract, promissory estoppel, and mutual mistake, but again bases those claims on the defendants' due diligence failures and failures to perform continuing risk management and oversight.[40]

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[37] Clients that choose to pursue failure to supervise claims under the Advisers Act can be expected to characterize their claims as claims for rescission of the advisory agreement, since the U.S. Supreme Court has held that no private rights of action exist under the Advisers Act except for claims under Section 215 (the Validity of Contracts section). See Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis, *supra* note 2.

[38] The Morris case, note 2, *supra.* In addition to seeking rescission, the plaintiff also tried to characterize its claim separately as a 10b-5 fraud claim under the Securities Act of 1933. Although the court ultimately dismissed the 10b-5 claim, it did so not because the claim failed to state a cause of action, but because the plaintiff failed to plead with particularity how the adviser's inadequate monitoring caused the plaintiff quantifiable economic loss.

[39] *See* Pasha S. Anwar, et al. v. Fairfield Greenwich Group, et al., Index No. 08/603768 (Supreme Court of the State of New York, County of New York (filed Dec. 19, 2008).

[40] *See* Pacific West, note 23, *supra*. Other suits against advisers of hedge funds invested with Madoff allege various federal securities fraud claims, such as violation of the anti-fraud provisions in the Securities Act of

Given the proliferation of sub-advisory and similar arrangements over the years, it would not be surprising to see an increase in cases with more private plaintiffs pursuing what are, in substance, failure to supervise claims. Given the propensity for these cases to settle, however, it is unclear how many of these cases will serve to clarify an adviser's supervisory responsibility in these contexts.

* * *

Accordingly, an adviser's duty to supervise may emanate from a number of sources, creating a legal landscape in which an adviser must supervise its sub-advisers or risk liability if errors, violations or wrongdoing are committed by a sub-adviser or a sub-adviser's personnel. The next section of this paper provides some practical tips on how an adviser can manage its supervisory risk.

Part 2: Practical Tips for Managing Supervisory Risk

Structuring Relationships

An adviser's supervisory responsibilities do not stop at its organizational boundaries.[41] An adviser risks liability for failure to supervise any person -- including a sub-adviser -- that is subject to the adviser's supervision, whether the adviser's duty to supervise emanates from Section 203(e)(6) of the Advisers Act, policies and procedures adopted under the SEC's compliance rules, an SEC exemptive order, relevant disclosures, an advisory agreement, fiduciary duties or elsewhere.[42] However, advisers can mitigate their supervisory risk by thinking through any proposed sub-advisory arrangement carefully and structuring the arrangement so the adviser assumes only the risk necessary to achieve their business goals. Questions like the following should be analyzed:

1) <u>Is the relationship best structured as a sub-advisory relationship</u>? As simplistic as it may seem, an adviser in a "sub-advisory" relationship with another adviser may be viewed as having some level of supervisory responsibility for the sub-adviser simply because the sub-adviser is aligned "under" or "sub" to the adviser. A key question, then, is does the other adviser need to be – or will it in fact be – under the adviser's supervision in any respect? If not, perhaps the relationship should be structured as something other than a sub-advisory relationship, which would better reflect the underlying reality and help to mitigate the adviser's supervisory risk. Another relevant question is does the adviser expect to have an on-going "intermediating" role between the client and the other adviser? If not, something other than a sub-advisory relationship might again be more appropriate.

1933 and anti-fraud provisions in Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934. These claims stem from the fact that the plaintiffs were sold interests in pooled funds (i.e., "securities") placed under Madoff's management, pursuant to allegedly materially misleading disclosures about the fund, its management and the oversight of operations. These types of securities fraud claims may not exist in cases where plaintiffs have non-pooled accounts with the adviser.

[41] The WAM case discussed in Part 1 of this paper illustrates this point. *See also,* Cutler's Remarks, note 5, *supra*.

[42] All of these potential sources for an adviser's duty to supervise were discussed in Part 1 of this paper.

Typically, a sub-advisory relationship would be well-suited to a scenario in which the sub-adviser is delegated some of the adviser's duties and the adviser has an on-going role with the client. An example is the sub-advised fund scenario where an adviser engages a sub-adviser to handle the portfolio of one of the adviser's funds. Here, the adviser and sub-adviser enter into a sub-advisory agreement in which the sub-adviser is delegated portfolio management duties to be performed subject to the adviser's supervision. These duties are among those the adviser is contractually obligated to perform as part of its broad managerial responsibilities under the advisory agreement with the fund. Note that as a matter of contract law, the adviser remains liable to the fund for failure to perform the delegated duties, even if the failure is caused by the sub-adviser.[43] The adviser plays an overarching role in managing the fund and is the key interface with the fund's board of directors, providing on-going input and recommendations to the board about which sub-advisers should be selected and retained. The sub-adviser handles day-to-day portfolio management. This is a classic sub-adviser scenario.

In contrast, some relationships might be better structured as co-advisory relationships or some other type of "alliance" or "side-by-side" arrangement if neither adviser is expected to be under the other's supervision or they are expecting to coordinate more like equals. Still other relationships might be better structured as separate, direct relationships between the client and each of the advisers involved. These different alignments could help to mitigate or eliminate the adviser's duty to supervise the other adviser. An example of this might be where a client engages one adviser to manage only the equity portion of its portfolio and another to manage only the fixed income portion, or where one adviser is engaged only to set asset allocation guidelines, while another is engaged only to select specific securities within those guidelines.

2) <u>What are the client's expectations</u>? The client's expectations could influence the interpretation of whether a sub-adviser is under an adviser's "supervision" in any given case. On a more practical level, advisers should be concerned about meeting the client's expectations since this will help to avoid misunderstandings or disputes with the client and generally keep the client happy, presumably one of the adviser's key business goals.

Therefore advisers should ask questions like: Did the client engage the adviser with a narrow mandate to manage just one area or to perform a single function without further involvement? Or, in contrast, did the client engage the adviser to manage a portfolio and all its affairs, even though the adviser may be permitted to engage another adviser for assistance? Is the client sophisticated enough or does the client have the internal resources or expertise to do any monitoring or supervision itself, or is the client likely to be counting on the adviser to fill that role?

A broad engagement in which the adviser is obligated to manage all the affairs of a portfolio suggests that the client may expect the adviser to stand behind virtually

[43] As discussed in Part 1 of this paper, under straightforward principles of contract law the delegation itself does not alter the adviser's own contractual liability under the advisory agreement, unless the delegation is interpreted to result in a novation, where the adviser and the client both assent to the discharge of the adviser's obligations in substitution for the sub-adviser's. *See* 4 Corbin on Contracts § 866. *See also* Restatement (Second) of Contracts § 318. Of course, the adviser might have a cause of action against the sub-adviser for the sub-adviser's failure to perform under the sub-advisory agreement, but as to the fund client, the adviser still remains liable for failure to perform under the advisory agreement.

any problem that comes up, particularly if the problem was caused by another party selected or recommended by the adviser. In that case, a sub-advisory relationship might be suitable in light of the client's likely expectation that the adviser is in some respect overseeing the sub-adviser. On the other hand, a narrow engagement suggests that the client may expect the adviser to stand behind only the adviser's narrow area of responsibility and not expect or intend it to supervise any other advisers that may also be involved. In that case, something other than a sub-advisory relationship might be more suitable.

Although careful structuring can help to mitigate supervisory risk, structure alone will not determine whether an adviser bears supervisory liability in any given case. Substance prevails over form in determining whether another party is subject to an adviser's supervision, and the analysis will be fact intensive.[44] Certainly, the sub-adviser in the classic sub-advised fund scenario described under Question 1 could easily be found to be under the adviser's supervision. But a supervisory relationship may be more difficult to establish with a sub-adviser not fitting the classic mold. By the same token, advisers in a co-advisory relationship or some other "alliance" or "side-by-side" arrangement should not count on escaping supervisory liability just because they are not aligned as adviser and sub-adviser. Regardless of the structure, it is possible that a supervisory relationship could be established by factors such as:

- provisions in the agreements between the parties
- working relationships among the individuals involved
- statements in relevant disclosure documents or marketing materials
- the parties' expressed intentions and expectations, and
- the course of dealing between the parties.

This point is illustrated by the WAM case discussed in detail in Part 1 of this paper, in which two of the factors cited by the SEC to establish a "supervisory relationship" between an adviser and a portfolio manager employed by a sub-adviser were more compelling than the others: First, the adviser was involved in the appointment of the portfolio manager. Second, when the adviser received complaints from the portfolio manager that the sub-adviser was not providing the portfolio manager with sufficient support, the adviser relayed those complaints to the sub-adviser, which then hired an analyst to assist the portfolio manager.

In light of this, advisers might be tempted to structure their sub-advisory relationships to avoid involvement with the sub-adviser's personnel, on the theory that this will help the adviser to avoid supervisory liability for those personnel. While there may be some merit to that thought, it is probably both unrealistic and undesirable for an adviser to disconnect from all sub-adviser personnel matters. A careful and conscientious adviser will make sure it knows and approves of the key employees the sub-adviser intends to use on an engagement, including the portfolio manager. Moreover, an adviser could be expected to raise with the sub-adviser any personnel problems that come to the adviser's attention if those problems appear to be adversely impacting the engagement. It is unclear in light of the WAM case whether this level of involvement would be viewed as establishing a "supervisory relationship" between the adviser and any of the sub-adviser's employees, but acting in the best interest of its clients, an adviser might be hard-pressed to avoid it. It is dubious at best and could be potentially catastrophic for an adviser to use a "hands-off" or "that's your problem" approach to sub-adviser personnel issues in an effort to mitigate supervisory liability.

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[44] *See* the SEC's definition of 'supervisor' in Gutfreund, *supra* note 33, and text surrounding, indicating that the definition is a "facts and circumstances" determination.

Compliance Policies and Procedures

Beyond careful structuring, an adviser can take other steps to mitigate supervisory risk for its sub-advisers. Most notably, an adviser can establish compliance procedures aimed at preventing and detecting violations, including those committed by its sub-advisers and their personnel. In this way, the adviser can avail itself of the affirmative defense to a failure to supervise claim found in Section 203(e)(6) of the Advisers Act, [45] and go a long way toward fulfilling a duty to supervise no matter what the source of that duty in any particular adviser's case.

Like all internal procedures, an adviser's supervisory procedures must not only be adopted, they must also be implemented. By its terms, an adviser's affirmative defense under Section 203(e)(6) will be lost if the adviser has not actually discharged its duties and obligations under the procedures or if the adviser has reasonable cause to believe that the procedures are not being complied with faithfully. In other words, the adviser can't just go through the motions. The adviser's technical compliance will not be enough if the adviser knows, has reasonable cause to believe, or ought to know, that someone else – like the sub-adviser – is not complying.

For example, assume that under its own compliance procedures, an adviser requires sub-advisers to obtain signed compliance certificates from each of their own personnel and in turn to certify to the adviser that they have been obtained. Once the sub-adviser certifies to the adviser, the adviser has technically complied with its obligations under the procedures by getting the certification called for from the sub-adviser. However, in the event of a violation committed by the sub-adviser or its personnel, the adviser will not have an affirmative defense under Section 203(e)(6) for failure to supervise if the adviser knew or had reasonable cause to believe that the sub-adviser's personnel had in fact <u>not</u> submitted signed compliance certificates to the sub-adviser or that the sub-adviser or its personnel were in fact <u>not</u> in compliance. Not only would the adviser lose its affirmative defense under Section 203(e)(6) in that case, but the adviser might also be found to have failed in its regulatory obligation under Rule 206(4)-7 to implement compliance procedures reasonably designed to prevent violations.

On their face, Section 203(e)(6) and the SEC compliance rules only contemplate compliance policies and procedures aimed at preventing violations of the federal securities laws.[46] Advisers would be better protected, however, if their supervisory procedures were broader and were aimed at preventing violations of all legal and non-legal restrictions that come to bear on the adviser's operations, recognizing that some of the more significant may come from sources outside the federal securities laws, such as the tax laws, the insurance laws, the banking or trust laws or ERISA, or may derive from contractual restrictions or investment mandates imposed by the client. Of course, a sub-adviser's failure in any of these areas could adversely impact a client as readily as the adviser's own failure.

Broader compliance procedures would better protect an adviser in a number of ways. First, they would lower the risk of a failure to supervise claim resulting from the violation of

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[45] *See* Section 203(e)(6), subparts (A) and (B). On its face, Section 203(e)(6) provides an affirmative defense only for a failure to supervise claim brought under that section. However, supervisory procedures might well mitigate the risk of failure to supervise claims brought in other cases as well, including those in which the duty to supervise emanates from one of the other sources discussed in this paper.

[46] *See* Part 1 of this paper where it is pointed out that 'federal securities laws' should be read broadly to include compliance problems which themselves may not be violations of the federal securities laws (such as violations of voluntary investment restrictions) but which nonetheless can serve as the basis for <u>other</u> securities law violations (such as fraud).

something other than the federal securities laws.[47] They would also provide greater "business" benefits, such as better protecting the adviser's reputation and keeping clients happy, by avoiding problems in areas in addition to the federal securities laws.

In general, adopting broader procedures provides advisers with broader protection, with one very important caveat: No adviser should adopt procedures it does not intend to implement or otherwise cannot or does not implement and follow. Adopting procedures that are then not followed could put the adviser in a worse position than if no procedures had been adopted at all. Failure to follow procedures can pile problems on top of problems[48] or, in some cases, create problems where none previously existed.[49] Accordingly, advisers should craft their policies and procedures conscious of the added cost in terms of time, money and personnel the procedures will be required to ensure that they are properly implemented and followed.

A similar caveat applies to the question of whether or how much of an adviser's compliance procedures – such as procedures for supervising sub-advisers -- should be put in writing or simply worked out among the relevant parties and not committed to writing in any formal way. Written specifics offer several advantages:

- they offer the prospect for more complete and more uniform application of the procedures from one account and one sub-adviser to the next;
- they also give relevant personnel a better opportunity to understand their responsibilities, ask questions before problems arise and train newcomers; and
- they provide regulators with tangible evidence that an adviser has considered the appropriate issues and alternatives.

On the other hand, writing procedures with too much detail creates potential stumbling blocks that the procedures will not be followed as written. It may also require a commitment of too many resources to ensure that they are updated as often as necessary to keep them current.

A well-designed compliance program contains several features. These features should be incorporated into any compliance procedures, including those covering the supervision of sub-advisers, with the overall aim of creating an effective, integrated system:

- *Functional separation*: Basically, this means the fox should not be watching the henhouse. Oversight for a particular function should not be left to the sole responsibility of someone who has a vested interest in the outcome. For example, a portfolio manager who has a vested interest in the portfolio's performance should not be left sole responsibility for pricing securities in the portfolio.[50] Instead, checks and balances should be instituted to make sure that

[47] For example, the SEC Staff has identified problems with the advisory agreement, including failure to comply with client mandates, as one of the 10 most common problems they see in examinations of advisers. Richards' Remarks, *supra* note 12.

[48] *See, e.g.*, In the Matter of Fleet Investment Advisors Inc., Advisers Act Rel. No. 1821 (September 9, 1999), in which a substantial portion of the SEC's findings were devoted to a description of the adviser's circumvention of its own internal policies and procedures.

[49] This would be particularly true if an adviser adopted and disclosed a procedure that it then failed to follow. Even if failing to follow the procedure did not itself create a violation, the false disclosure likely did.

[50] This was one of the main problems identified in the WAM case discussed in Part 1 of this paper, where the portfolio manager had virtually unfettered discretion to price certain securities in the portfolio which would

one person cannot get away with unintentional or, worse yet, intentional wrongdoing. In an adviser/sub-adviser relationship, implementing checks and balances at the adviser level could help to smoke out or counterbalance shortcomings at the sub-adviser level.

- *"Red flag" follow-up*: Procedures should not only be instituted to look for problems but should also provide direction on what to do in case one is found. Legally, failure to follow up on a red flag can be as bad, if not worse, than failure to find it.[51] Advisers that identify a red flag involving a sub-adviser should know who to go to at the sub-adviser to have the issue addressed and should insist on getting both assurances that the issue has been addressed and an explanation of what was done to address it. That way, the adviser can assess the strength of the sub-adviser's own system and have greater confidence that any errors or wrongdoing will not be repeated.

- *Identification of responsible parties*: The adviser's chief compliance officer will be responsible for administering the adviser's compliance program under Rule 206(4)-7. That person should have enough seniority, credibility and clout within the organization to be able to give directions, spend resources and take a stand when necessary, even if it is unpopular with others in the organization. Adviser CCOs should develop a strong working relationship with the chief compliance officer within each sub-adviser's organization as well and view them as an ally in the overall effort to maintain compliance.

- *Training*: Everyone in the adviser's organization should be trained to understand the compliance procedures applicable to them and their individual responsibilities, including those pertaining to the relationship with sub-advisers. To be effective, training should involve more than handing out copies of the procedures and hoping that they are read and understood. In-person training sessions would go much further in impressing on individuals the terms of the procedures, the importance of implementing them properly and management's expectation that all personnel will comply. In key areas of the adviser's business involving interface with a sub-adviser, it might be helpful to include sub-adviser personnel in the training or in simulated dry runs, in order to iron out any potential misunderstandings or glitches in the system before they occur in real time.

- *Periodic reassessment*: Procedures must be reevaluated periodically to make sure they stay current. Review is specifically required under the SEC compliance rules not less than annually.[52] Industry, market or legal developments may make amendments necessary or desirable over time. Changes in the adviser's business may as well, including changes in its size, personnel, investment activities or clientele. In the same vein, changes in the number or nature of an adviser's sub-advisory relationships or similar changes in a sub-adviser's business may also necessitate changes in procedures.

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impact the portfolio's net asset value and performance. *See also* In the Matter of Back Bay Advisors, L.P., Release Nos. IA-2070 and IC-25787 (October 25, 2002), where a failure to supervise claim was pressed against an adviser based in part on its heavy reliance on self-reporting and self-monitoring.

[51] *See* the WAM case, *supra* note 25, where the failure to follow up on red flags was repeatedly cited as part of the adviser's failure to supervise in that case. *See also,* Hoffman, *supra* note 24.

[52] *See* Rule 206(4)-7(b) and Rule 38a-1(a)(3).

Reassessment of procedures may be warranted more frequently than annually if “red flags,” problems or significant developments arise in the interim.

Initial Due Diligence

If an adviser’s role includes selecting a sub-adviser, or assisting the client in selecting a sub-adviser, the adviser should make an initial due diligence inquiry to evaluate potential sub-adviser candidates. This initial inquiry will be important not only to selecting a qualified candidate but also to selecting a sub-adviser that will mitigate the adviser’s supervisory risk going forward. Moreover, this initial contact with the sub-adviser is the first opportunity to integrate the sub-adviser into the adviser’s compliance system.

Without doubt, the initial due diligence inquiry should cover the sub-adviser’s investment philosophy and process, performance track record, portfolio management personnel and capabilities, similar products offered, and other matters running to the sub-adviser’s qualifications to perform in the capacity contemplated. In the aftermath of the Bernard Madoff affair, it cannot be emphasized enough that due diligence must go beyond reputation and that secretive operations, including proprietary investment and trading strategies, must be scrutinized with particular care.

Moreover, initial due diligence should go significantly beyond those basic items and inquire into any area of the sub-adviser’s operations that could affect the adviser or the client’s account. Background checks with independent third parties may be warranted in cases. At a minimum, the adviser should ask for copies of, or get a written explanation of, the sub-adviser’s:

- Basic firm information, including brief history, structure, size, lines of business, registrations, personnel turnover and the like.

- Compliance systems. The sub-adviser’s own compliance system will be the adviser’s first line of defense against a sub-adviser problem becoming an adviser problem. Is the sub-adviser’s compliance system computerized or manual? How frequently are checks performed? Who is the chief compliance officer and what is their background? How often do they do compliance training? If they have had any compliance audits, what were the results? etc.

- Internal procedures, policies and guidelines that would impact the sub-adviser’s relationship with the adviser and its accounts (e.g., proxy voting policy, best execution procedures, brokerage allocation policy, soft dollar policy, directed brokerage policy, pricing procedures, trading error policy and the like). Do the sub-adviser’s procedures contain the key features discussed in the prior section (functional separation, red flag follow-up, etc.)?

- Any other policy, procedure or provision that would guide, restrict or apply to the sub-adviser's engagement. For example, is the sub-adviser a bank or affiliated with a bank subject to banking procedures or provisions applicable to their investment operations?

- Code of Ethics.

- Policy for the prevention of insider trading.

- Form ADV (including Part II) and any “brochure” that the sub-adviser gives clients for disclosure or marketing purposes.

- A list of the sub-adviser’s principal service providers (custodians, lawyers, accountants, consultants, etc.) and other significant business relationships (other sub-advisory relationships, wrap program sponsors, etc.). Is the sub-adviser supported by reputable firms with appropriate size and capacity to serve the sub-adviser's operations? Who is the custodian holding client assets? Does the sub-adviser self-custody or use an affiliate for custody, both of which raise the risk of fraud or mishandling of client assets?

- Copies from the last 5 years[53] of all correspondence with the SEC or other primary regulatory authority or SRO pertaining to inspections/examinations (including deficiency letters and responses), compliance matters or regulatory violations (actual, potential or alleged).

- Brief summary of all material legal threats, inquiries, investigations or actions (including private, administrative, regulatory or other) from the last 5 years involving alleged sub-adviser legal, compliance, regulatory or other violations, where the complaining party is the SEC, any other regulatory authority or SRO, a customer or client, a shareholder or similar beneficiary of an advised account, or another party acting in the interest of any of such parties.

This checklist may not cover everything relevant for any particular sub-adviser, but it should serve as a good starting point.

Separate from this checklist, sub-advisers are required by law to disclose all material facts with respect to their financial condition if reasonably likely to impair their ability to meet contractual commitments to clients, and any legal or disciplinary events that are material to an evaluation of the sub-adviser's integrity or ability to meet contractual commitments to clients.[54] However, those required disclosures should be considered supplemental to the due diligence inquiries made by the adviser.

If the sub-adviser objects to or resists providing any of the requested information, a red flag has just been waived. The adviser should inquire thoroughly into the nature of the objection. There may be legitimate concerns behind some of the items requested, but having a clear understanding of what they are will allow the adviser to respond most appropriately. If the sub-adviser objects to discussing a matter of particular sensitivity that has not yet become public, the parties might consider entering into a confidentiality or nondisclosure agreement that would permit the adviser to consider the matter in its evaluation of the sub-adviser but still afford the sub-adviser assurances of confidentiality.

As with any other procedure, the initial due diligence process requires more than just going through the motions. The purpose of the due diligence inquiry is not to line the due diligence file. Information gathered should be read and assessed and any problems followed up and resolved. Moreover, there may be a real benefit to doing more than a "paper" due diligence and actually touring the sub-adviser's offices in order to better assess the sub-adviser's resources, professionalism, atmosphere and other intangible factors that may not be evident on paper. Background checks and other third-party verifications may be warranted as well.

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[53] There is no magic to the 5-year period called for here or in the following item. Five years is suggested just to make sure to cover at least the period since the sub-adviser's last regulatory examination and a long enough period to catch most, if not all, private disputes that may either be unresolved or have the real potential to reemerge. A different period may be appropriate to meet these goals in any particular case.

[54] Rule 206(4)-4 of the Advisers Act. That rule also lists certain events that are rebuttably presumed to be material for this purpose. Note that Rule 206(4)-4 is proposed to be rescinded in conjunction with pending amendments to Form ADV, which if adopted will largely embody the pertinent disclosures as part of the form itself. SEC Rel. Nos. IA-2711 and 34-57419 (March 3, 2008).

On-going Monitoring

Supervision of a sub-adviser should not end with the initial due diligence and engagement. The very nature of "supervision" suggests that monitoring should be done on a periodic basis.[55] Following are a number of steps that might be instituted as part of sub-adviser supervision procedures in addition to the periodic monitoring and reporting of performance that would normally be expected:

- Obtain from the sub-adviser a <u>quarterly certification of compliance</u> with all applicable laws, as well as the sub-adviser's own policies and procedures and any restrictions applicable to adviser accounts managed by the sub-adviser. The stronger the sub-adviser's own internal compliance and supervisory systems, the more reasonable it is for an adviser to rely on these certifications. However, once a problem, weakness or "red flag" has been identified, more direct involvement from the adviser may be required to backstop the sub-adviser's certifications. In all cases, the sub-adviser's certifications will be meaningless unless it is clearly understood between the adviser and the sub-adviser exactly who is responsible for each of the relevant compliance checks and when they are to be done. Based on that understanding, checks and balances, spot checks and reviews can be instituted as appropriate.

- Obtain from the sub-adviser an <u>annual certification of compliance</u> to the same effect, which also includes a certification that the sub-adviser itself has received similar signed certifications of compliance from its personnel.[56]

- Hold <u>periodic meetings with key personnel</u> from the sub-adviser. This should include not just the portfolio management personnel but the compliance and other key relationship personnel as well. Meetings will be more productive if they include an open discussion of issues with a view to resolving them with mutual cooperation. Meetings with portfolio management personnel should occur at least quarterly. Meetings with all key personnel should occur at least annually. In-person meetings should be held until effective meetings can be held by other means, such as conference call.

- <u>Spot check sub-adviser compliance</u> on matters where the underlying information is available to the adviser. This might include, for example, checking periodically to make sure that the investments selected by the sub-adviser are staying within applicable investment restrictions and client mandates. Although the sub-adviser should be checking this as part of its own on-going compliance, adviser spot-checks provide a second layer of protection for the client account and demonstrate the adviser's diligence in overseeing the sub-adviser.

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[55] The SEC Staff has said: "And, after the contract is signed, the adviser needs to perform due diligence on a continuing basis… [and] concern itself with whether the sub-adviser is, in fact, providing the level of fiduciary care that the adviser itself provides to its clients." Richards' Remarks, note 12, *supra*.

[56] The SEC Staff has suggested that the adviser collect these certificates from the sub-adviser's employees itself. Cutler's Remarks, note 5, *supra*. That may be workable for a small operation but could quickly become unmanageable for an adviser with numerous sub-advisers which in turn have numerous employees. Moreover, it may suggest a supervisory connection between the adviser and the sub-adviser's employees which overstates the actual case.

- Require the sub-adviser to update the initial due diligence checklist for any material changes at least annually, including sending the adviser an updated Form ADV, amended compliance procedures, etc.

- Monitor the sub-adviser's implementation of new compliance technologies and systems as they become available. Industry standards continue to evolve toward automating compliance systems as specialized software becomes more readily available and widely used. Sub-advisers that are continually behind the curve on adopting new technologies put advisers and their clients at risk.

- Require the sub-adviser to notify the adviser promptly of any contact from the sub-adviser's securities or other regulators or SRO (such as an examination, inquiry, investigation, institution of a proceeding, etc.) and any threat of material litigation or other dispute from any other party.

- Require the sub-adviser to notify the adviser promptly of any compliance violations and actions taken in response.

- Require the sub-adviser to notify the adviser promptly of material business changes, such as:
  - any material change in the sub-adviser's investment strategy or firm management, ownership, structure or financial condition
  - any change in the portfolio manager(s) responsible for the adviser's account or other key relationship personnel
  - any significant change in market conditions or outlook impacting the adviser's account
  - any other event that is likely to have a significant impact on the sub-adviser's operations.

This list may not be comprehensive for any given sub-advisory relationship, but like the initial due diligence checklist, it should provide a good place to start.[57] As usual, any red flags detected in the process should be timely followed up and resolved.

Periodic Compliance Audits

While not required, some advisers use periodic compliance audits as a routine part of their overall compliance system. Most commonly, audits are conducted in conjunction with the adviser's annual review of its compliance program required under the compliance rules.

Comprehensive compliance audits that go beyond just specific areas could be a valuable way to assess an entire supervisory system, particularly a system involving the interface of multiple organizations like the typical adviser/sub-adviser relationship. As part of their supervisory responsibility for sub-advisers, advisers should consider conducting compliance audits of their sub-advisers, or at least requiring the sub-advisers to provide copies of the results of their own compliance audits.[58]

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[57] Together, the Investment Company Institute, the Investment Adviser Association and others have developed a sample sub-adviser due diligence questionnaire and certification letter for annual use. These documents can be accessed at: http://www.investmentadviser.org/eweb/docs/Publications_News/PublicDocs_UsefulWebsites/PubDoc/due_diligence_review_full.pdf.

[58] The SEC Staff has suggested this as well. Richards' Remarks, note 12, *supra*.

Some advisers use outside consultants to conduct compliance audits.[59] Some use outside law firms for this purpose in an attempt to preserve the attorney-client and/or work product privilege for any findings reported.[60] In turn, the law firms may engage other firms with audit specialists to assist in the effort. Effective compliance audits can also be conducted internally, so long as the personnel conducting the audit are adequately trained, sufficiently independent, and free from the risk of adverse consequences if they report unfavorable results.

As usual, it will be imperative to follow up on any red flags or other weaknesses identified by the compliance audit. As already mentioned, allowing an identified problem to fester or otherwise go unaddressed can be as bad as not finding the problem itself.

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In today's legal landscape, an adviser must supervise its sub-advisers or risk liability if errors, violations or wrongdoing are committed by a sub-adviser or a sub-adviser's personnel. Following the practical tips discussed in this paper can help an adviser to manage its supervisory risk.

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[59] For certain operations, outside audit firms can be engaged to produce a so-called SAS 70 report, using standards found in the AICPA's Statement on Auditing Standards No. 70 addressing auditing controls at certain service organizations. However, the SAS 70 is not generally considered suitable for application to advisers and sub-advisers for this purpose.

[60] Advisers should not necessarily expect to be able to keep the results of a compliance audit confidential. In addition to the usual problems with maintaining the attorney-client privilege or establishing work product or similar protections from disclosure, the SEC will likely request the results of any compliance audits in the course of a routine examination, and it may behoove the adviser to have an unprivileged and non-confidential compliance report to provide to the Staff in that context. Even if the adviser has a legitimate basis for asserting privilege or other protection for some or all of its compliance audit materials, the adviser may find it is in its best interests to waive those protections in any given case in order to gain advantages that may be afforded by having cooperated with regulators or investigators.