ADVISER-SUBADVISER RELATIONSHIPS:
Selected Issues

by
Lorna A. Schnase
Attorney at Law
(September 2006)

Advisers typically have one or more compelling legal reasons to supervise their subadvisers, such as fulfilling a statutory or regulatory duty to supervise, fulfilling exemptive order conditions calling for supervision or fulfilling contractual or fiduciary obligations to their clients.[1] However, these reasons would not normally apply in the reverse, meaning that subadvisers typically would not have a legal obligation to supervise their advisers.[2] Nonetheless, subadvisers can find themselves exposed to liability as a result of the actions or inactions of their advisers and, thus, as a practical matter, subadvisers should consider the need for addressing and mitigating the risks posed to them by the adviser, in much the same way that risk posed by the subadviser should be considered by the adviser.[3]

While advisers may choose to address risk posed by their subadvisers by adopting full-blown subadviser monitoring procedures, subadvisers may often find that risks posed by their advisers are more limited to specific areas. (A number of the more common problem areas are discussed in more detail later in this paper.) In any event, to accurately identify areas of risk in a subadvisory arrangement, it will be critical that both the adviser and the subadviser have a firm understanding of their various rights and responsibilities. Some of these rights and responsibilities may be addressed in the subadvisory agreement, such as:

- The delegation of duties from the adviser to the subadviser for day-to-day portfolio management, along with the authority to make portfolio decisions, select brokers, place trades and so on.
- The obligation of the subadviser to act under the agreement only in accordance with all applicable laws and restrictions, and to avoid taking actions under the agreement which cause the account to not remain in compliance with all applicable laws and restrictions.
- The obligation of the adviser to provide reasonable assistance to the subadviser in operating under the agreement, including providing key information about the account and acting as the interface with the account owner.
- The authority (if desired) for the subadviser to use “soft dollars” or “pay up” under Section 28(e) of the Securities Exchange Act of 1934 when placing brokerage, subject to the required and usual parameters.
- The authority (if desired) for the subadviser to aggregate trades and to allocate securities in accordance with specified parameters.
- The obligation of the subadviser to maintain books and records in accordance with the Investment Advisers Act of 1940 and, relative to any investment company accounts, the Investment Company Act of 1940.
- The obligation of the subadviser to provide certain periodic information or reports to the adviser or the account owner, and to provide notice to the adviser in the event of certain developments (such as material compliance violations, changes in key personnel, SEC investigations or enforcement actions, etc.).
- The authority and responsibility (if desired) for the subadviser to vote proxies with respect to securities in the account.

More detailed subadvisory agreements may dole out other rights and responsibilities to the subadviser, such as the obligation to adopt and implement a compliance program and a Code of Ethics meeting regulatory requirements, the obligation to cooperate and assist in the fair valuation of portfolio securities or the obligation to make or assist with regulatory filings that pertain to the account.

As helpful as these provisions may be in defining rights and responsibilities, they often fall short where the "rubber meets the road," that is, where the adviser and the subadviser (often, their respective CCOs) must come to grips with the practical reality of who will *in fact* perform and take responsibility for each of these tasks, as well as for any other matters that may not be spelled out in detail in the agreement. A lack of understanding on these points can lead to adverse consequences for everyone involved, including confusion, strained relations, compliance violations, harm to the advised account, loss of business, enforcement action or litigation.

Advisers and subadvisers keen on minimizing the potential for problems will work out as many of the specifics as they logically can before the subadvisory arrangement comes into effect. Advisers and subadvisers may choose to include some of these specifics in their written procedures. However, with or without written procedures, issues in implementation will inevitably crop up, requiring that they be worked out in practice as they arise. While some approaches to handling these issues may be more common than others, most will need to be resolved on a case-by-case basis between each adviser and each subadviser, since there is no "one size fits all" suitable for every case.[4]

Among the more common issues where advisers and subadvisers encounter rubs are the following:

Portfolio compliance. For the most part, advisers and subadvisers are well aware that they are responsible for having their own compliance programs under the SEC compliance rule for advisers, Rule 206(4)-7 under the Investment Advisers Act of 1940. Where appropriate, these programs should include procedures aimed at ensuring portfolio compliance, meaning making sure that advised accounts are managed within applicable investment guidelines and restrictions. Under certain circumstances, the advised account may have its own compliance program as well, such as in the case of a registered investment company, which is required to have its own compliance program under Rule 38a-1 of the Investment Company Act of 1940. The question comes up, then, who bears responsibility for ensuring portfolio compliance – the adviser, the subadviser or, in the case of a fund account, the fund? The technical legal answer is probably all three. But the practical answer of what each party should be doing on a day-to-day basis must take into consideration which of them is responsible for what task at each stage of the process.

When the subadviser is responsible for day-to-day portfolio management, the subadviser is, in a practical sense, the "first line of defense" in making sure that the composition of the portfolio is consistent with applicable requirements and restrictions. The subadviser decides what securities to buy and sell and therefore should be in the best position to catch portfolio compliance problems most effectively and efficiently. However, if the subadviser does not have a system for monitoring compliance before trades are placed, such as compliance software built into its trade order management system, it might be monitoring portfolio compliance only after the fact. In that case, the subadviser's portfolio compliance monitoring may be no more timely or robust than the compliance monitoring being conducted by the adviser overseeing the subadviser or, in the case of a fund account, by the fund itself (or its third party administrator), based on period-end portfolio reports reviewed after the fact. As a result, there may be no front-end safeguards in place and only belated or redundant checks in place at period-end.

It would likely be more efficient and more effective if the adviser and subadviser (and fund, where applicable) worked out in advance exactly what safeguards and tests will be in place at both the front end and the back end of the portfolio management process. This should include understanding what systems will be used, whether they will be automated or manual systems, who will conduct the checks, when they will be conducted and what double-checks, audits or inspections will be conducted after the fact, with the aim of avoiding an inefficient use of compliance resources and, more importantly, avoiding undetected compliance problems that can quickly become very costly to correct.

Valuation of securities. A subadviser's close involvement with managing a portfolio day-to-day makes it a logical candidate for assisting in the valuation of any securities in the account where market prices are not readily available and the securities must therefore be “fair valued.” Having a clear understanding between the adviser and subadviser of the procedures applicable in those cases and the subadviser’s obligation to assist in that process will be important to ensuring accurate and timely valuation. This will be particularly critical for an account like a mutual fund which is required to be priced every day. If the account owner (like a mutual fund) has its own policies and procedures for fair valuation, the subadviser must be made aware of and agree to cooperating under those procedures in addition to any other procedures adopted by the adviser or the subadviser itself.

Proxy voting. In recent years, advisers and subadvisers have become more aware of the need to address proxy voting in the context of their arrangements, in part because of the SEC’s adoption of Rule 206(4)-6 under the Investment Advisers Act of 1940, which requires advisers (and subadvisers) exercising voting authority with respect to client securities to adopt proxy voting policies and procedures and disclose them as called for by the rule. According to the adopting release, it is an adviser’s fiduciary responsibility to vote proxies, consistent with the best interests of the client. Moreover, according to the adopting release, the proxy voting rule applies when the advisory agreement specifically delegates proxy voting authority to the adviser, as well as when the advisory agreement is silent but the adviser's voting authority is implied by an overall delegation of discretionary authority. Advisers who don’t intend to have voting authority are told they could revise their advisory agreements or make other disclosure to their clients to make explicit their lack of responsibility for voting proxies.

In light of this, the question of whether the adviser or subadviser is responsible for proxy voting really isn’t any different than the question faced by advisers vis-à-vis their clients. In either case, the responsibility for proxy voting would be best addressed in the advisory (or subadvisory) agreement itself, which it often is, and most commonly the party with day-to-day portfolio management responsibility is also given the discretion (and the responsibility) to vote proxies.

Even where assignment of proxy voting responsibility is clear, advisers and subadvisers should also consider whose proxy voting policy will govern voting on the account -- those of the account owner (such as a fund’s own proxy voting guidelines, in the case of a fund account), the adviser or the subadviser. This will be influenced largely by the account owner’s wishes and disclosures made by the adviser and/or subadviser to the account owner (such as in their Form ADVs).

Advisers and subadvisers should also resolve mechanical issues such as how will the subadviser’s voting be monitored by the adviser and who will be responsible for pulling together and transmitting the proper proxy voting information required to fulfill any reporting requirements, such as reporting to an account owner who requests information on how their proxies have been voted, or reporting in proxy-related SEC filings (such as a fund’s Form N-PX).

Class action lawsuits and proofs of claims. Similar to proxy voting, advisers face the question of who is responsible for filing proofs of claim in class action lawsuits relating to securities in an advised account. Private litigation in the last year or two, as well as increased SEC scrutiny, has raised awareness on this issue. Owners of securities that do not file proper and timely proofs of claim can be denied their share of settlement amounts to which they would otherwise be entitled as a member of the plaintiff class. The question then is who is responsible for filing and tracking these proofs of claim – the account owner, the adviser or the subadviser?

Some commentators argue that the responsibility for filing proofs of claim should go along with responsibility for managing the account, similar to voting proxies. Others argue that, no, advisers (and subadvisers) are not in a position to make legal decisions on behalf of the account owner like those that are required when deciding whether to opt out of a plaintiff class or to pursue filing a proof of claim, nor are they equipped to track the potentially thousands of claim filings that might be required in the case of large advisers with many accounts holding many securities. They argue, rather, that the account owner should retain responsibility for class action decisions and proofs of claim unless the adviser expressly agrees to assume it. Further complicating the issue, many custodians will file – often automatically -- proofs of claim relating to any securities which they hold in accounts as custodian.

A similar debate can be had about other actions owners of securities in an advised account may be permitted to take as a result of their ownership, such as actions to approve or reject a bankruptcy reorganization of the issuer and the like. In any event, it would behoove advisers to address with the account owner who is responsible for taking these types of actions, and then to make sure that any engaged subadviser is aware of those responsibilities, is in agreement with them and is adequately equipped to act accordingly.

Form 13F filings. Generally speaking, advisers (and subadvisers) exercising investment discretion over $100 million or more in certain equity securities are required to report to the SEC on Form 13F.[5] "Investment discretion" in this context is defined broadly enough that advisers and their subadvisers are often both required to report with respect to the securities in an advised account, even when the adviser has delegated day-to-day portfolio management to the subadviser.

In order to avoid duplicate reporting of securities by multiple reporting persons, Form 13F is permitted to be filed as a "holdings" report (reporting all the adviser's holdings on the form), a "notice" report (no holding reported; all holdings reported by another reporting person), or a "combination" report (some holdings reported on the form, some holdings reported on another reporting person's form). Accordingly, in order to make sure that the securities in an advised account get reported by someone, but at the same time avoiding unnecessary duplicate reporting, advisers and subadvisers should address which one of them will report the securities in any account holding securities over which they must both report. Assuming -- without asking -- that the other party will report can result in holdings going unreported. By the same token, assuming -- without asking -- that you must report can result in duplicate and inconsistent reporting.

Use of firm name, performance and other information. Advisers will often include in the subadvisory agreement restrictions on the subadviser's use of the adviser's name (or fund's name, in the case of a fund account), account performance or other information pertaining to the adviser or the subadvised account in the subadviser's advertising or marketing material, in an effort to avoid liability for misuse. Pre-approvals may be required and/or indemnifications against liability included. When pre-approvals are granted, follow-up monitoring may be conducted by the adviser aimed at detecting improper use.

In the same way, the adviser's (or fund's) misuse of the subadviser's name, performance or other information may pose risk to the subadviser. However, the subadvisory agreement often does not provide the same type or level of indemnification to the subadviser on these issues as it does the adviser. Whether or not addressed in the subadvisory agreement, it would be wise for subadvisers to address these matters with their advisers on a practical level, if the subadviser anticipates use of its name or information that could lead to liability. In appropriate cases, written procedures should be prepared governing the adviser's use of the subadviser's name, performance or other information, with the aim of ensuring compliance with legal parameters and mitigating the subadviser's risk to the extent possible. In cases where use is permitted, the subadviser would be wise to conduct follow-up monitoring to ensure that agreed procedures and restrictions are being met. Note in particular if the adviser desires to use the subadviser's performance track record, the subadviser must provide the adviser not only the track record, but the supporting back-up documentation as well, which will be required to be preserved under applicable SEC books and records along with the ads or other materials utilizing the track record.

Books and records. Books and records is one area where advisers and subadvisers are increasingly aware of their responsibility under applicable regulations but where the SEC Staff continues to identify numerous violations and deficiencies. Moreover, the subadvised account scenario can be even more problematic for advisers and subadvisers from a books and records standpoint, if the client has its own books and records requirements -- like a registered investment company would under the Investment Company Act of 1940 -- and if some of the client's books and records are then maintained on behalf of the client by the adviser or subadviser. This is because the books and records requirements under the Investment Company Act are in some respects broader and require records to be preserved for longer periods of time than the books and records requirements under the Investment

Advisers Act. Accordingly, for subadvised accounts subject to their own books and records requirements, advisers and subadvisers should exercise particular care to ensure that all required books and records are created and maintained, and in accordance with all applicable requirements.

Compliance disclosures and documentation. Disclosure concerning an organization's compliance record is another sensitive area between advisers and subadvisers. On the one hand, advisers often inquire about the subadviser's record on compliance as part of their oversight function, in much the same way as the SEC might inquire as part of its regulatory function upon inspection. This accounts for many advisers requesting subadvisers to provide copies of their annual compliance review report (or a summary of the process and findings), as well as copies of such items as third-party compliance audits and any SEC deficiency letters and responses. Subadvisers, on the other hand, have legitimate concerns about such sensitive information being disclosed outside of their firms, particularly if disclosure jeopardizes the confidential or privileged status of the information. Frankly, advisers should have some appreciation of those concerns, since they are often faced with the same issues when their clients – or the SEC – request similar information from them.

At this juncture, no identifiable industry standard has developed on whether and how this type of information should be provided, and with what level of detail and specificity. Nonetheless, several observations can be made:

- In reality, all advisers (and subadvisers) will be expected to have written documentation of their compliance reviews, despite the fact that the Investment Advisers Act compliance rule, Rule 206(4)-7, does not expressly require a written report of the annual compliance review for advisers.[6] The SEC Staff will expect to be provided written documentation of the compliance review when they come to inspect, and many clients are now demanding that advisers (and subadvisers) provide this information as part of their initial and ongoing engagement due diligence.

- In the usual case, written compliance review reports are unlikely to be attorney-client privileged or protected under the work product doctrine or similar non-disclosure doctrines[7] and, even in cases where they are or could be, advisers (and subadvisers) will have to weigh the advantages of non-disclosure against the disadvantages posed by not having that information available to share with the SEC examination Staff and with prospective or current clients who have requested the information for evaluative purposes.

- In compliance reports that are subject to SEC inspection and/or discovery by plaintiffs in the event of litigation, advisers and subadvisers should seek to strike a balance between, on the one hand, providing enough information to properly document their procedures and findings and, on the other hand, avoiding disclosure of unnecessary and sensitive details that may create a "roadmap" for claims against them. Even if the entire compliance review report is not protected by the attorney-client privilege or other protective doctrine, consideration should be given to limiting discussion of sensitive details (about, for example, material compliance violations) to separate communications with counsel that are protected by the privilege or are at least contained in separate documentation where dissemination can be handled in a manner that is appropriate to the sensitivity of the matters discussed.

- Advisers (and subadvisers) who might be willing to make limited disclosure of sensitive compliance matters to certain requesting parties (for example, other advisers or clients) but who would be nonetheless concerned about further dissemination might consider asking the requesting party to sign a confidentiality or non-disclosure agreement. While this approach may not preserve the attorney-client privilege when disclosure is made to a party outside the organization, it could nonetheless help to protect against wide-spread or indiscriminate dissemination of sensitive information or provide for specified remedies in the event unauthorized disclosure does occur.

Compliance certificates. Hand-in-glove with the issue of compliance disclosures is the issue of compliance certificates. It is now rather standard for an adviser to request periodic compliance certificates from a subadviser.[8] These certificates can run the gamut from simple and straightforward to complex and problematic. Some advisers use compliance certificates to discharge the bulk of their oversight responsibility relative to their subadvisers. Other advisers request certificates as back-up, but do not rely on them as their primary vehicle for oversight. Still others use certificates as a primary vehicle for subadvisers they believe are well staffed, well organized and trustworthy, but if evidence of a problem comes to light, the adviser then becomes more proactive and devotes more time, attention and resources to monitoring the details of the subadviser's compliance.

Negotiating the form and contents of a compliance certificate can be as difficult as negotiating representations and warranties in an acquisition agreement. Some requesters ask that the certificate be signed by the CCO personally (as an officer of the relevant organization) and others by the organization as an entity, with the CCO as the executing officer. Each has its advantages and disadvantages from a legal perspective, but either way, the certificate should be asking the organization or its CCO to certify only to matters that are within their purview and consistent with their particular role. Overreaching in this context generally has little legal benefit and can serve as a flash point for strained relations.

Citing concerns similar to those that prompt advisers to request certificates from subadvisers, some subadvisers have questioned whether they should be requesting compliance certificates from their advisers or, in the case of a fund account, from the fund. Because the subadviser would not typically be overseeing the adviser or the fund, these certificates may not need to be as all-encompassing as the certificates obtained from the subadviser. Nonetheless, they might cover those compliance matters for which the adviser or fund maintain responsibility and which, if not undertaken in an appropriate, accurate and timely manner, could adversely affect the subadviser. This might include, for example, the adviser's or fund's use of the subadviser's name, track record or other information in sales materials, or the routine pricing of fund portfolio securities by the fund or its pricing agent, which serves as the basis for calculation of the subadviser's fee. It might also include any of the other topics discussed in this paper – proxy voting, filing proofs of claim, books and records, and so on -- to the extent delegated to the responsibility of the adviser or fund.

* * *

These are but a few of the more common problem areas faced by advisers and subadvisers in their relationships. Addressing these issues as early in the process as possible will help to avoid the potential for confusion, friction or worse, and mitigate risk for both advisers and subadvisers.

[1] A number of these reasons are discussed in detail in the paper entitled "A Fresh Look at an Adviser's Duty to Supervise Sub-Advisers," by Lorna A. Schnase, Attorney at Law (November 1, 2005), available from the author or on the Investment Adviser Association website (member area). Adviser oversight of subadvisers can be facilitated in part by materials such as the subadviser due diligence review package developed by the Investment Adviser Association, available on its website at:

http://www.icaa.org/public/due_diligence_review_full.pdf.

[2] For example, an adviser would not normally be a “supervised person” of a subadviser under the SEC’s compliance rule for advisers, which requires advisers to adopt a compliance program covering their supervised persons, nor would an adviser normally be considered “subject to the [subadviser’s] supervision” under Section 203(e)(6) of the Investment Advisers Act, which might give rise to an implied duty to supervise. Similarly, the express or implied contractual or fiduciary duties that might compel advisers to supervise subadvisers would not normally apply in the reverse.

[3] Indeed, this source of potential risk should logically be considered by subadvisers in the risk identification and assessment process that all advisory firms should undertake in order to define the proper contours of their compliance programs.

[4] As a result, advisers may have different arrangements with each of their subadvisers. Without doubt, this increases the imperative for careful tracking, recordkeeping and disclosure.

[5] See the SEC’s FAQ on 13F for more detail on the specific requirements: http://www.sec.gov/divisions/investment/13ffaq.htm.

[6] This is in contrast to the compliance rule for investment companies, Investment Company Act Rule 38a-1, which specifically requires the fund CCO to prepare a written report of the annual compliance review.

[7] This is discussed in more detail in the paper, “The Basics: Reviewing an Adviser’s Compliance Program,” by Lorna A. Schnase, Attorney at Law (January 17, 2006), available from the author or on the Investment Adviser Association website (member area).

[8] Even the Investment Adviser Association has made public on its website a form of certification for a subadviser certifying as to compliance on a fund account. See http://www.icaa.org/public/due_diligence_review_cert_letter.doc.