



# FUND BOARD VIEWS

## Viewpoints

### Considerations for mutual fund boards overseeing sub-adviser transitions

March 30, 2023

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Mutual fund boards have a myriad of duties and oversight responsibilities arising under state and federal law, notably the Investment Company Act of 1940. Certain funds utilize investment advisers that delegate some or all of the portfolio management functions and related services to one or more sub-advisers. For such sub-advised funds, boards are presented with a confluence of oversight and regulatory responsibilities whenever there's a proposed sub-adviser change. The purpose of this article is to familiarize a fund board member with various potential aspects of sub-adviser transitions, including examples and topics to think about, but the article is not meant to be a comprehensive review.<sup>1</sup>

*Many funds utilize a manager-of-managers arrangement.*

Many funds and their primary investment advisers have received exemptive orders from the Securities and Exchange Commission to operate under a manager-of-managers structure. This typically permits the adviser, with the approval of the fund board, to appoint and replace sub-advisers and enter into and make material amendments to the related sub-advisory agreements without the shareholder approval otherwise required by Section 15 of the 1940 Act, among other things. The SEC has granted various orders over the years to permit this structure for sub-advisers affiliated with the primary adviser as well as for unaffiliated advisers. Under a MoM structure, the adviser is ultimately responsible, subject to oversight by the fund board, for overseeing sub-advisers and recommending their hiring, termination, or replacement to the board.

MoM orders may impose additional requirements on the fund board separate and apart from the Section 15(c) process (discussed below), and such requirements may vary across fund groups. The SEC staff has also issued a "no-action" letter that allows certain funds with existing MoM orders to rely instead on a 2019 version of a MoM order assuming certain conditions can be met. One of the primary benefits of a MoM structure is to avoid the costs and delays associated with obtaining shareholder approvals for matters relating to sub-advisers or sub-advisory agreements. A MoM structure tends to improve the efficiency of



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1. For a more extensive review of sub-adviser oversight topics, including a more granular look at the technical regulatory requirements (some of which have been revised in the intervening years), see, e.g., [Board Oversight of Sub-Advisers, Independent Directors Council Task Force Report](#) (Jan. 2010); [Practical Guidance for Directors on the Oversight of Sub-Advisers](#), Mutual Fund Directors Forum (Apr. 2009).

sub-adviser transitions but does not permit an increase in the overall advisory fees paid by a fund without shareholder approval, and shareholders are required to be notified and sent an information statement about the change when a sub-adviser is hired.

*The adviser may recommend a sub-adviser change for many reasons.*

Sub-advisers are hired for varied reasons, including for expertise in a particular investment strategy or asset class or for compatibility with other sub-advisers managing a fund, and a subsequent decision to recommend a sub-adviser change is no different. It is important for a fund board to understand what part of the original hiring thesis changed in connection with a proposed transition. The recommendation from the adviser for the board to approve a new sub-adviser is often part of broader changes to a fund. In some instances, the adviser could be replacing an existing sub-adviser for underperformance or because the adviser is wary about changes to the sub-adviser's investment team or corporate structure. There is likely a combination of factors. To effect the change, an underperforming sub-adviser could be replaced with another sub-adviser implementing the same or similar strategy, but in other instances the adviser could be adding a new investment strategy to the fund or adjusting the strategy or risk allocation of the fund.

The board should consider any proposed sub-adviser changes within the context in which they are recommended by the adviser and also be aware of proposed changes that increase the complexity of a fund, such as increasing the number of sub-advisers or hiring a sub-adviser to utilize complex instruments for the fund for the first time (which could have other regulatory implications).

*Sub-advisory arrangements are subject to the Section 15(c) process.*

Sub-advisory agreements are generally subject to the same regulatory requirements under Section 15(c) of the 1940 Act as applicable to an investment advisory agreement with the primary fund adviser, but the process is usually adapted to address the specific nature of the sub-advisory arrangements. This means that a board, including its independent directors, should understand the fiduciary principles that apply under state law and the relevant provisions of the 1940 Act that drive the approval of advisory agreements and consider their application to proposed sub-advisory arrangements. From a technical perspective, Section 15 calls for fund shareholder approval under certain circumstances but, as discussed above, many funds alleviate that burden by utilizing a MoM structure. There are also potential temporary exemptions available to permit an interim sub-advisory agreement under certain circumstances.

### **'Reasonably Necessary' Information**

Section 15(c) of the 1940 Act imposes on fund directors an enforceable duty to request and review all such information as may reasonably be necessary to evaluate the terms of the sub-advisory agreement. The SEC has signaled in various enforcement actions the importance of independent directors receiving all of the information that is relevant to their decision-making and following up on the requested information as necessary.

The 1940 Act and rules thereunder do not set forth the specific factors that independent directors should consider when approving a sub-advisory agreement, or otherwise define what is "reasonably necessary," but a number of guidelines have developed through case law (all the way up to the U.S. Supreme Court) and pursuant to required public disclosures to fund shareholders that can inform the board's process. The key line of cases for these purposes arose under Section 36(b) of the 1940 Act and focused on the determination of what constitutes an excessive advisory or sub-advisory fee.

In view of the above, the following factors should be considered as deemed relevant by the board:

- the nature, extent, and quality of the services to be provided by the sub-adviser;
- the historical investment performance of the sub-adviser;
- the costs of the services to be provided and profits to be realized by the sub-adviser;
- the extent to which economies of scale have been taken into account in setting the sub-advisory fee schedule;
- a comparison of services to be rendered and the sub-advisory fees to be paid to those of similar accounts managed by the sub-adviser (as applicable); and
- the existence of any ancillary or “fall-out” benefits to the sub-adviser.

Among other things, the board should have a fulsome understanding of the investment strategy to be employed for the fund and other services to be delegated to the sub-adviser, the investment processes and resources (including personnel) dedicated to supporting such services, and why the sub-advisory fee to be paid is reasonable based on the nature of the services provided.

In practice, the request for information and the evaluation of responses are usually part of a broader due diligence process conducted by the adviser in collaboration with the board and counsel, but individual fund and adviser processes and allocation of responsibilities in that regard may vary. Like all fund board oversight areas, the amount and kinds of information provided to the board with respect to sub-adviser transitions will likely differ in many respects as compared across boards due to various processes developed over time with different advisers and boards. Furthermore, given the adviser’s responsibility for the sub-advisory arrangements, the board should not necessarily expect (or want) to be provided with all of the information solicited by the adviser or counsel in connection with the sub-adviser due diligence process. The adviser may provide summary information and recommendations based on their reviews.

The key focus for the board under Section 15(c) is whether they have received information as reasonably necessary for them to support their decision to approve a sub-advisory agreement. The material factors and the board’s conclusions with respect to such factors that formed the basis for the board’s approval must be publicly disclosed (*i.e.*, discussed in reasonable detail) in fund shareholder reports and certain other filings.

### **Additional Information**

In many respects, a proposed sub-adviser is “just” another fund service provider that the board will oversee as part of its overall responsibilities—one that will play a significant role in the day-to-day operations of the fund. The board may wish to consider information on a variety of topics that do not necessarily fall within the technical public disclosure requirements or those driven by caselaw, but are or could be relevant to the services the sub-adviser is to provide to the fund. Such information is often requested in connection with the 15(c) process or is otherwise part of the adviser’s due diligence with respect to the sub-adviser.

This could include, for example:

- the corporate structure and ownership of the sub-adviser, including any recent (or anticipated) corporate transactions involving the sub-adviser;
- the sub-adviser’s history and industry reputation, including the amount of assets managed for similar funds or accounts;

- information that would allow the board to evaluate the financial condition of the sub-adviser (or a parent company);
- any material relationship or business arrangement between the adviser and the sub-adviser (or any of their respective affiliates);
- the sub-adviser's insurance coverage; and
- whether the sub-adviser is subject to any litigation, investigations, or other legal proceedings.

There are countless variations for a sub-adviser's corporate and regulatory structures. For example, a sub-adviser may be a solitary U.S. corporate entity owned largely by internal personnel, just one business line of a larger U.S. or global financial services firm, or a subsidiary of an asset management firm that owns several investment advisers that operate independently. A sub-adviser based outside of the U.S. raises some unique jurisdictional considerations from an operational and regulatory perspective. Certain sub-advisers employ a "participating affiliate" arrangement, where the SEC staff has generally permitted (via a line of no-action letters) a registered U.S. adviser to utilize personnel of an unregistered foreign affiliate. A sub-adviser could also operate under a "sub-subadvisory" arrangement where the adviser enters into a sub-advisory agreement with a sub-adviser, and the sub-adviser enters into an underlying advisory agreement with another adviser, which is often an affiliate. The sub-subadvisory agreement itself may be subject to the Section 15(c) process.

Many boards seek to obtain an additional understanding of sub-adviser characteristics and operational resiliency in line with broader industry trends and current events. For example, this has included in recent years a focus on the stability and diversity of the sub-adviser's workforce, as well as the sub-adviser's planning and testing around disaster recovery, business continuity, and information security. Some boards have also sought information from sub-advisers on the impact or anticipated impact of the global COVID-19 pandemic or major geopolitical events.

### **Sub-Advisory Agreement Terms**

Section 15 also contains provisions addressing the content of sub-advisory agreements. Particularly in a MoM structure, the adviser may utilize a form of sub-advisory agreement that provides some consistency in the contractual relationship with each sub-adviser, but it's important for the board to understand (with the assistance of counsel) the key terms of the agreements. In addition to the sub-advisory fee structure, a sub-advisory agreement will expound on the tasks to be performed by the sub-adviser (including investment and compliance functions) and may address other aspects of the relationship such as indemnification and liability or board reporting. A typical sub-advisory agreement is between the adviser and the sub-adviser, but there are potential additional considerations if the agreement is structured as a direct contractual relationship between a fund and the sub-adviser.

### **In-Person Approvals**

As a general matter the board, including a majority of the independent directors, must approve sub-advisory agreements at an in-person board meeting under Section 15, but the SEC staff has provided relief for this requirement due to unforeseen or emergency circumstances and (as of the time of publication) when necessary or appropriate due to circumstances related to the current or potential effects of COVID-19. In recent years, the SEC has also issued exemptive orders to a number of fund groups permitting funds and the adviser to enter into and materially amend sub-advisory agreements that have been approved by the board at a non-in-person meeting. In each case such relief is subject to certain conditions being met.

*An independence analysis should be conducted in connection with sub-adviser transitions.*

The fund governance standards of the 1940 Act, as well as various exemptive rules and MoM order conditions, require a majority of the board to be independent. This means that such board members are not “interested persons” of the fund or its adviser (including sub-advisers) as defined in the 1940 Act. This is notable in connection with unaffiliated sub-adviser transitions, as due diligence should be conducted to ensure that the independence of current board members is not compromised in connection with hiring a new sub-adviser. For example, independent directors cannot own securities issued by hired fund sub-advisers or their controlling affiliates.

*Fund boards are required to approve sub-adviser compliance policies and procedures and codes of ethics.*

Rule 38a-1 under the 1940 Act requires the fund board to approve the sub-adviser’s compliance policies and procedures based on a finding that such policies and procedures are “reasonably designed” to prevent violations of the federal securities laws by the sub-adviser. And Rule 17j-1 under the 1940 Act requires the board to approve the code of ethics of the sub-adviser based on a determination that the code contains provisions “reasonably necessary” to prevent the sub-adviser’s access persons (who may have non-public information available to them) from engaging in unlawful actions prohibited by the rule, such as certain fraudulent or manipulative practices.

This is another core aspect of the initial approval of a new fund sub-adviser, but the board is not required to be intimately familiar with the sub-adviser’s compliance policies and procedures. The SEC has stated that the rule does “not require the board of directors to read every policy and procedure” and that the board may “make its decisions about the adequacy of the compliance policies and procedures based on summary reports.” In that regard, the board should understand:

- the analysis conducted by the chief compliance officer of the fund;
- the CCO’s conclusions with respect to the sub-adviser’s compliance functions; and
- the ongoing ability of the CCO to oversee the compliance activities of the sub-adviser.

The board may wish to evaluate various items in connection with its consideration of the sub-adviser’s compliance program, including the sub-adviser’s regulatory and disciplinary history, the adequacy of resources dedicated to compliance functions, and how the sub-adviser expects to adapt to a changing regulatory environment. The sub-adviser’s experience in managing strategies in a 1940 Act vehicle is also relevant given the pervasive federal regulation applicable to them.

*Fund boards should consider their oversight responsibilities after a new sub-adviser appointment.*

Another aspect of a sub-adviser change is the board’s oversight and evaluation of the transition itself after the new sub-adviser is approved (*i.e.*, the process of moving assets under management). This may include the transition costs to onboard a new sub-adviser and how the transition will be managed. An adviser may utilize a third-party transition broker in an effort to maintain market exposure and minimize transaction costs, or the adviser could facilitate the transition itself with similar goals in mind. After the transition, the board may wish to review metrics regarding such costs or the impact on fund performance. Conducting the transition in this manner could be more efficient and economical for a fund than, for example, the current sub-adviser selling its full portfolio allocation to cash and the adviser redeploying the cash to a new sub-adviser. Transitions can also be complicated where certain holdings have liquidity or other restraints. Other

direct and indirect costs for the board to consider may include legal and other fees associated with the preparation and mailing of required fund documents. The board may see projections with respect to certain transition costs in advance.

Following the transition, the board should consider the disclosures that will be made that describe their consideration and approval of the sub-advisory agreement, as noted above. This will be included in a shareholder report and in a proxy statement sent to shareholders for agreements requiring shareholder approval or, for funds utilizing a MoM structure, in an information statement to shareholders. Information regarding the board's approval will also be included in the board meeting minutes.

The success of the sub-adviser transition will largely be monitored and evaluated in the normal course, such as with respect to fund performance and ongoing compliance obligations, and there may be other checks on the transition, such as additional audit procedures during the next fund financial statement audit or a specific follow-up with the adviser and/or sub-adviser after a designated period of time. Overseeing sub-advisory relationships is a multifaceted task, and fund boards should ensure that they are adequately prepared to meet their fiduciary and regulatory obligations and to help promote smooth sub-adviser transitions.

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