SEC and Investor Scrutiny of Sub-Adviser Oversight

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Over the last few years, the SEC has fundamentally altered a fund adviser's responsibility to oversee sub-advisers. Rather than the more traditional laissez-faire approach where the adviser's job ended when it delegated assets, the SEC has stressed in public statements and examinations that a fund adviser's fiduciary duty requires significant oversight. And, institutional investors have followed the SEC's lead by reviewing sub-adviser oversight as part of the Operational Due Diligence process. It is now (past) time for fund boards and fund advisors to revisit their current sub-adviser oversight policies and procedures by considering a more direct and interactive approach. This can be accomplished by: 1) establishing well defined oversight procedures; 2) performing comprehensive initial and ongoing due diligence of sub-advisers; and 3) documenting any oversight reviews of a sub-adviser's fund activities.

Many fund advisers have taken a "hands off" approach to the day-to-day management of sub-advisers. Focusing on macro-level fund activity, these advisers limit their oversight to reviewing, confirming and relying on the policies, procedures and compliance certifications of the sub-advisers.

Over the last few years, we have seen a shifting regulatory environment. The most significant case in this area involved the failure of a mutual fund series trust board to properly review the compliance policies and procedures of the advisers in the trust. (See https://cipperman.com/2013/05/03/funds-trustees-and-administrator-faulted-for-inadequate-compliance-program/). The SEC and the courts have demanded heightened scrutiny of sub-adviser services and fees, requiring that both the adviser and sub-adviser perform legitimate and reasonable services commensurate with the fees received. (See https://cipperman.com/2014/07/14/director-of-investment-management-targets-advisersub-adviser-fee-splits/ and https://cipperman.com/2013/01/09/federal-court-demands-more-scrutiny-of-advisersub-adviser-fees/). In the wrap context, the SEC has been very critical of how advisers oversee and select sub-advisers. (See e.g. https://cipperman.com/2017/03/14/wrap-sponsor-fined-failing-monitor-trading-away-practices/). During exams, the OCIE staff spends significant time reviewing sub-adviser oversight selection and monitoring procedures and often raise deficiencies.

Although the implementation of a more robust oversight program does not guarantee success, it will, however, allow the fund adviser to demonstrate further support of its fiduciary duty to the SEC and the investors. In this context, several areas deserve greater scrutiny:

Best Execution & Broker Selection: In a sub-advised fund structure, fund advisers usually delegate best execution responsibility to the sub-adviser and may require that a sub-adviser provide periodic compliance certifications or best execution reports that are subsequently shared with fund boards. What we have learned from recent regulatory examinations is that fund advisers should take a deeper dive into the best execution practices of sub-advisers. Simply relying on a sub-adviser certification or claiming that the sub-adviser has best execution responsibility may no longer be satisfactory to the regulators during their inspection of a fund or fund complex. Fund advisers should not rely solely on certifications or periodic reports, but should augment their oversight practices by performing a secondary review of fund transactions to ensure that a sub-adviser has sought best execution on behalf of a fund and its shareholders. A fund adviser should have a thorough understanding of a sub-adviser's trading practices and platforms, broker selection, and best execution review criteria as well as policies and procedures that clearly outline its oversight responsibilities for best execution.

Corporate Actions: Corporate actions are typically a mundane function that a fund adviser may not consider to be an integral part of its oversight of a sub-advised fund. Frequently, fund advisers tend to be completely removed from the corporate action process if the function has been delegated to a sub-adviser. However, based on our recent fund examinations, the regulators have stated that certain corporate action elections could have a material effect on a fund's NAV and therefore, may be potentially detrimental to shareholders. Fund advisers should have well-crafted policies and procedures for the oversight of those corporate actions which have been delegated to a sub-adviser. Such policies do not necessitate that a fund adviser co-participate in every corporate action;

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however, they should be drafted with a risk-based approach and should clearly outline the fund adviser's responsibilities in overseeing the corporate action elections of a sub-adviser.

Illiquid Securities: The SEC's longstanding concerns with fund liquidity prompted it to adopt Rule 22e-4 which will require open-end funds to establish written liquidity risk management programs. Fund advisers who may have historically relied solely upon a sub-adviser's determination of liquidity should now consider a more collaborative approach. To help comply with Rule 22e-4, fund advisers should implement analytical tools and processes which will help categorize the fund's holdings into the liquidity "buckets" required by the rule. Fund advisers should also have ongoing documented discussions with its Board and sub-adviser regarding the liquidity of the fund's holdings, as well as establish comprehensive policies and procedures that clearly outline the fund adviser's oversight responsibilities.

Reliance on a sub-adviser's performance data/algorithms: There have been several recent high-profile SEC enforcement cases (See, e.g. https://cipperman.com/2016/08/29/sec-fines-13-advisers-for-failing-to-verify-third-partys-performance/) regarding investment advisers' reliance on the performance data and investment algorithms of sub-advisers. These enforcement cases send an alarmingly loud message to advisers that reliance without conducting the proper due diligence is a breach of fiduciary duty that will result in both financial and reputational penalties. Fund advisers who employ sub-advisers must conduct a level of due diligence above and beyond a basic review of sub-adviser produced brochures and other marketing collateral. In hiring a sub-adviser, fund advisers should have staff experienced enough to be able to test any algorithmic trading processes and verify all performance data whether actual, hypothetical or back-tested. These due diligence reviews should be well documented and ongoing. The fund adviser's responsibility for oversight does not stop once the sub-advisory agreement is approved.

Policies and Procedures: Inadequate policies and procedures have always been the low-hanging fruit for regulatory examiners. If a fund adviser does not have comprehensive sub-adviser oversight policies which define its specific oversight responsibilities, it will very likely be on the receiving end of a deficiency letter. Fund advisors should consider ensuring its oversight procedures are well documented, and more importantly, followed.

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