

# Best practices for multiple sub-adviser mutual funds

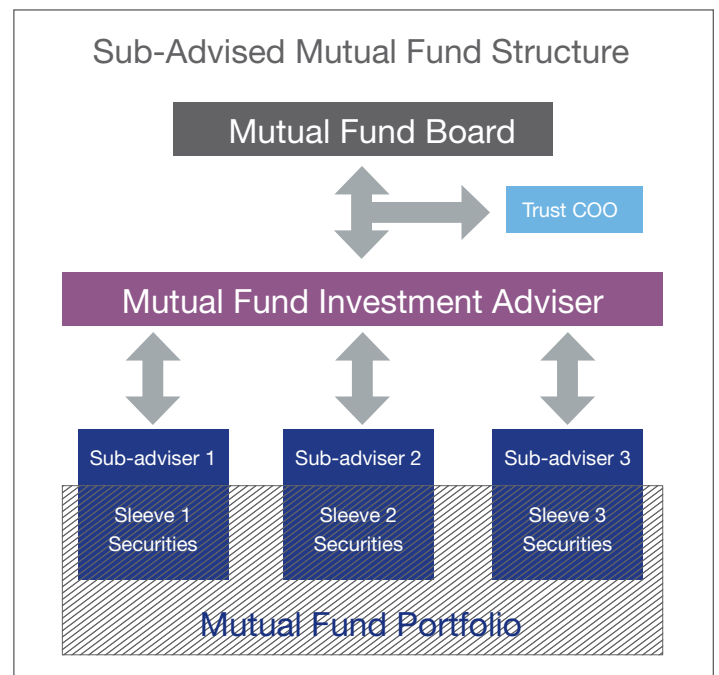
Operational and compliance best practices for mutual fund portfolios with multiple sub-advisers



## Proliferation of sub-advised mutual funds

The continual evolution of open-end mutual fund manufacturing and distribution compels asset managers to adapt to investor preferences, distribution channels and industry collaboration opportunities. Investment managers with strong relative performance in a given strategy will generally see a demand for their expertise in many forms, including the potential sub-adviser role for an open-end mutual fund, either solely or in a sleeve of an allocation to multiple sub-advisers. Also, platform innovation at many wealth management sponsors combines the exceptional talent and scale of third party investment firms within a single mutual fund to produce a differentiated single or multi-strategy investment offering. The wealth management fund sponsor will often engage as many as five or more mutual fund sub-advisers, depending upon either single fund asset size or multi-strategy focus.

The combination of multiple sub-advisers in a single mutual fund portfolio creates challenges for both the investment manager (fund sponsor) as well as the different sub-advisers managing their respective investment “sleeves.” This model is sometimes referred to as a “manager of managers” structure. Although this model complicates certain



operational and compliance aspects for the mutual fund and manager, experienced accounting and compliance talent, along with prudent daily processing procedures and controls, will support efficient and successful fund operations for the fund, manager, sub-advisers, investors and fund board.

Origins of multiple sub-adviser fund trend	
Growth of specialized sub-adviser expertise	Divergence in fund manufacturing and distribution
Expansion of sub-adviser distribution channels	Liquid alternative mutual fund structures
Wealth platform product demand	Multi-strategy fund trends
Platform demand for adviser and asset diversification	Large fund diversification to multiple sub-advisers for performance enhancement

## SEC Exemptive Relief

The availability of exemptive relief from the Securities and Exchange Commission (SEC) for manager-of-managers mutual funds, which permits a fund to change sub-advisers without shareholder approval, has made the manager-of-managers model both effective and economical. Although this SEC exemptive relief filing process can take 4-8 months, once approved, the adviser and fund board can efficiently make changes to the fund's sub-advisers to more effectively manage the assets of the fund. The exemptive relief also permits funds to reallocate assets among the fund's sub-advisers at the investment adviser's discretion.

## Multiple sub-adviser fund challenges

Multiple sub-adviser mutual funds create complexities for the investment manager seeking to generate the maximum value, efficiency and controls with this fund structure. The combination of multiple sub-advisers compounds all aspects of fund processing and compliance in direct proportion to the number of sub-advisers. Without careful planning, consideration and adherence to compliance requirements, operational processes and communications, the sub-adviser model can exacerbate the fund compliance and processing risks as well as impede fund performance.

Considerations for the sub-advised mutual fund model	
Adviser oversight of sub-advisers	Mutual fund portfolio compliance testing
Mutual fund sub-adviser responsibilities	Portfolio allocation and cash management
Onboarding and transitioning sub-advisers	Mutual fund CCO and board best practices

Any one of the above items by itself would not necessarily pose an issue for the fund manager, but the combination of these items in a multiple sub-adviser fund can complicate the processing and compliance for a mutual fund, potentially placing the fund in financial risk, compliance risk and reputational risk for all parties.

However, adopting **the following best practices** for robust operational and compliance procedures, both at fund inception and ongoing, will significantly mitigate these risks.

## 1. Adviser responsibilities in a sub-advised mutual fund

An investment adviser is charged with the fiduciary responsibility for all investment management activities of the mutual fund. This includes supervising and managing the fund's assets and all sub-adviser investment activities in accordance with the fund's stated investment policies and objectives as well as SEC and Internal Revenue Service (IRS) regulations. The mutual fund's board will review and approve an investment advisory agreement and all sub-adviser agreements, including the adviser and sub-adviser fee arrangements. The sub-advisers generally contract directly with the investment adviser and are generally, although not always, paid from the investment adviser fee pursuant to a board approved agreement with each sub-adviser. Sample investment adviser best practices in overseeing mutual fund sub-advisers include the following:

**Adviser due diligence of sub-advisers** – Mutual fund boards will look to the fund investment adviser to perform complete due diligence on each sub-adviser and present the sub-adviser(s) and due diligence materials to the fund board for approval. Best practice adviser considerations for detailed sub-adviser due diligence include a review, both initially and ongoing, of the following for each sub-adviser:

- Firm history, ownership, succession
- Full form ADV
- Firm income statement and balance sheet
- Assets managed by strategy
- Client base
- Portfolio management team
- Staffing, resources by asset strategy
- Compliance resources
- Compliance history, program, manual
- Fee structures for all assets, products
- Performance history
- Investment philosophy
- Portfolio manager compensation structure
- Support model to the mutual fund/adviser

Adviser best practice for sub-adviser due diligence generally involves the use of a standard questionnaire that the sub-advisers will complete initially and each year for Section 15(c) purposes. This practice supports the process for collecting required information as well as creating a record for the fund board's documentation of diligence, review and assessment. The fund's administrator can facilitate the collection, evaluation and preparation of these sub-adviser documents for the adviser and for the board.

**Sub-adviser fees** – Critical consideration should be given to the investment manager and sub-adviser fee arrangements in any sub-advised mutual fund. The proportion of management fee shared with the sub-advisers must reflect the responsibilities of each party in managing the mutual fund assets. In addition, each sub-adviser





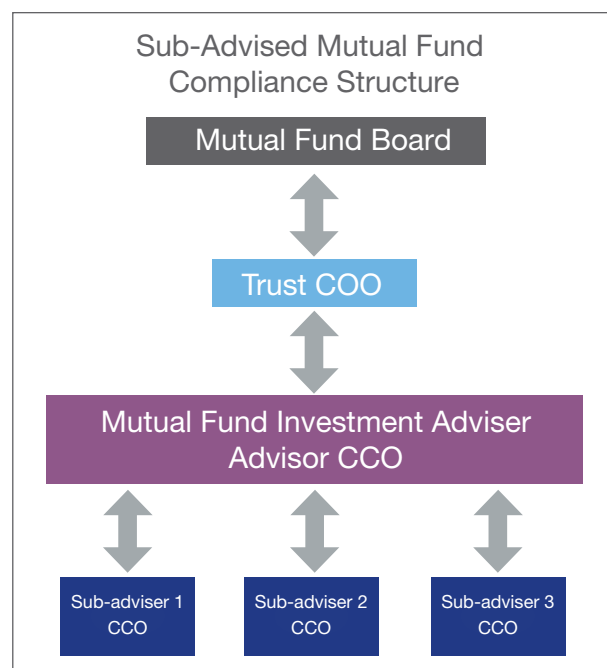
should consider their mutual fund sub-adviser responsibilities in light of their fees for managing identical assets in either separate accounts or in their fee for directly managing, or sub-advising, another mutual fund. The mutual fund board's annual Section 15(c) process of reviewing and approving the adviser and sub-adviser fees paid by the mutual fund investors should include proper documentation and analysis of the respective roles that each adviser and sub-adviser plays in managing the fund's assets.

**Portfolio compliance** – The adviser is responsible to ensure that the mutual fund portfolio consistently meets all compliance requirements for a Regulated Investment Company (RIC), including requirements identified in the fund prospectus, Statement of Additional Information (SAI), fund policies and procedures, and applicable federal securities laws. The adviser's responsibility extends to providing guidelines for, and oversight of, all sub-adviser compliance as well.

**Fund board reporting** – As a service provider to the fund, the adviser is responsible to report to the fund's board as requested, generally quarterly, regarding the adviser firm, personnel, investment performance, portfolio attribution and contribution, distribution and compliance. The adviser will meet with the board and provide detail supporting the performance and activities of each sub-adviser, including any recommended changes in the sub-advisers to the mutual fund.

**Reporting to the fund COO** – The adviser will meet with, and provide periodic reporting to the fund's CCO regarding the adviser's activities and changes in the adviser and its personnel. The fund CCO will want to meet in person with the adviser to observe, understand and document for the fund board, the adviser's control environment and the adviser's oversight program of all sub-advisers.

**Adviser CCO responsibilities** – The adviser CCO is responsible for monitoring the adequacy of the compliance program of each sub-adviser, both initially and on an ongoing basis. An adviser CCO best practice includes an annual (at minimum) on-site meeting with each sub-adviser to personally view and test each sub-adviser's compliance processes to be in action, as well as the sub-adviser CCO's management of the compliance program regarding:



- The adequacy of the sub-adviser's compliance program to ensure compliance with the fund prospectus, SAI, fund policies and procedures, and applicable federal securities laws.
- The ongoing effectiveness of the sub-adviser's compliance processes to be reasonably designed to prevent, detect, and remedy violations of the fund's compliance program and federal securities laws.
- The provision of periodic reporting with respect to monitoring, testing and evaluating the operational compliance risk assessment of each sub-adviser.

**Sub-adviser performance management** - One of the most critical roles of the investment manager is oversight of each sub-adviser's sleeve performance, along with the associated performance reporting to the fund board. The investment manager and the fund board will want to ensure that the sub-adviser consistently adheres to its stated mandate, as well as maintains strong performance relative to peers.

## 2. Mutual fund sub-adviser responsibilities

The sub-adviser responsibilities to the fund adviser and fund board include investment management, portfolio compliance, and adherence to fund policies and procedures. In addition, mutual fund sub-advisers are responsible for providing daily and periodic portfolio and compliance reporting to the investment manager, fund and fund board, such as:

**Portfolio management** – The sub-adviser must perform investment management and compliance within all applicable fund prospectus, SAI, fund policies and procedures, and applicable federal securities laws.

**Trading and reconciliation** – Sub-adviser responsibilities include effective daily trading, reconciliation and best execution within all policies and procedures of the fund and under the supervision of the adviser.

**Adviser, fund CCO and board reporting** – Sub-advisers must provide periodic (and as requested) reporting to the adviser, board and the fund CCO with regard to the activities of the sub-adviser, generally including sleeve performance, compliance, policies and procedures, and firm and personnel changes.

**Sub-adviser CCO considerations** – Each sub-adviser to a mutual fund must be registered with the SEC, and its CCO must implement a compliance program reasonably designed to prevent, detect, and correct violations of applicable federal securities laws and requirements.

- Each sub-adviser CCO should provide information to the adviser CCO and fund CCO, as requested, with respect to the sub-adviser's compliance with the applicable federal securities laws, policies and procedures regarding the sub-adviser's duties in managing the mutual fund.



### 3. Best practices for onboarding and transitioning sub-advisers to mutual funds

The process of concurrently onboarding multiple investment managers for sub-adviser services to a mutual fund involves careful collaboration and project management in order to effectively implement services. The mutual fund administrator will help to facilitate a project plan that involves the following onboarding elements:

- Adviser/sub-adviser daily trade communication process for efficient and compliant trading activities
- Sub-adviser mutual fund education – portfolio compliance, trading processes, NAV processing, valuation procedures, SEC requirements, tri-party agreements, fund expense structure, logistics, board reporting requirements and performance
- Portfolio compliance monitoring – establish pre- and post-trade compliance testing and reporting such as diversification, concentration and exception tracking
- Collateral management process
- Sub-adviser sleeve reporting
- Sub-adviser performance reporting

The adviser process for selecting sub-advisers to manage sleeves of a mutual fund portfolio involves several contractual items that may take some time to resolve, such as sub-adviser fees, investment guidelines and indemnification. A best practice involves the inclusion of the specific investment guidelines in the sub-adviser agreement so that there is no doubt as to the mandate parameters. In preparation for the fund's investment management, portfolio compliance and accounting, the administrator will want a sample of all sleeves managed by each sub-adviser to identify and plan for compliance testing both within the sleeve and at the portfolio level. This includes diversification testing, asset coverage, potential security overlap, preliminary security pricing costs and fund expense modeling.

Best practices for onboarding sub-advisers include having dedicated onboarding resources and a specific project plan with the following tasks and milestones: onboarding project manager and team to assist each sub-adviser, weekly conference calls with each sub-adviser candidate, technology resources to support the establishment of SWIFT or FTP file transfers of both daily sub-adviser trade communication and portfolio sleeve data delivery, global market setup for foreign direct investments, tri-party agreements, and ISDA agreements.

The onboarding process entails creating the processes and procedures for certain critical mutual fund functions, such as:

**Fund registration process** – Although the adviser maintains control of the investment process for the fund, the sub-advisers should participate in the review of the investment policy identified in the registration materials at the start of a fund.



**Communication processes** – The key to successful administration of sub-advised funds is establishing strong communication channels (both communication content and delivery method) as well as escalation channels and exception management. This includes items such as daily trade communication and valuation among all parties – adviser (portfolio managers, authorized signors, traders and operations), sub-advisers, administrator, custodian, transfer agent, independent audit firm, independent legal counsel and fund board.

**Valuation process** – Valuation procedures to value portfolio securities in the event a security is not priced or significant events require fair valuation. Generally, both the adviser and the sub-adviser participate in this time-sensitive process as necessary at the close of trading each business day.

**Proxy voting** – Generally, the sub-adviser votes the proxies for mutual fund holdings within their respective sleeve and under the supervision of the fund's adviser.

**Transition manager** - A common practice in replacing a sub-adviser is for the fund manager to hire a transition manager to obtain best execution in unwinding a portfolio sleeve and moving the assets to an index investment until the new sub-adviser takes over managing the sleeve.

## 4. Mutual fund compliance testing best practices

Some of the more significant challenges with multiple sub-adviser mutual funds are the regulated investment company (RIC) compliance tests and verification that the fund consistently meets all tests. The adviser may impose additional restrictions to the specific investment guidelines of the sub-advisers. Daily compliance testing and reporting is generally required to make sure that each sub-adviser sleeve, and the portfolio as a whole, meet all requirements. The optimal solution to ensure compliance with all applicable RIC regulations requires:

**Education** – A strong compliance program starts with the adviser and sub-adviser portfolio management teams having a complete understanding of all RIC requirements. The administrator will educate the portfolio management teams regarding the various RIC rules, testing and reporting of the RIC compliance rules, consequences of violating a given rule and potential cures in the event of an exception.

**Pre-trade testing** – Each sub-adviser's investment management process should include a pre-trade testing program to verify portfolio compliance, preferably utilizing an automated pre-trade compliance program integrated with the sub-adviser's portfolio management system.

**Post-trade testing** – The third party administrator should provide a robust daily post-trade compliance testing and reporting program and system that will automatically identify and report exceptions to all RIC requirements.

### “Bull Pen” Sub-advisers

An efficient means of changing sub-advisers involves an approved “bull pen” – the mutual fund investment adviser can submit several sub-advisers for approval by the fund's board, even though the adviser will not initially utilize the sub-adviser(s). The investment manager and fund board are required to complete all due diligence documentation, fee arrangements and 15(c) contract approval process, with continued annual diligence as if each sub-adviser were actively managing a sleeve of the fund. In a manager of managers structure, having additional sub-advisers at the ready allows for efficient changes in sub-advisers within a portfolio, provided that the adviser has obtained SEC exemptive relief for changing sub-advisers without shareholder approval.

## Sample RIC Tests

Below are sample mutual fund tests that may be completed in a manager of managers model:

- Diversification tests across multiple managers for security level concentration
- Borrowing – maintain 300 percent asset coverage for all borrowing
- Industry concentration – 25 percent of total fund assets
- Loans to other parties – maximum lending of 33-1/3 percent of total fund assets for repurchase agreements, securities lending, etc.
- Investment company securities – maximum holding of 3 percent of the outstanding voting stock of the acquired company; 5 percent of the acquired company's total assets; 10 percent of total fund assets invested in investment company securities
- Illiquid securities – maximum holding of 15 percent of fund net assets
- Affiliate holding test

**Additional testing and reporting** – Both the adviser and sub-adviser(s) should have effective testing and reporting programs for their internal compliance processes, such as Rule 17j-1 compliance with the adviser and sub-adviser codes of ethics.

**Board reporting** – The fund CCO should provide detailed compliance reporting to the fund board within the regular quarterly board materials and associated discussion, as well as in the CCO annual assessment, as a demonstration of the fund's adherence to compliance.

If a sub-adviser creates a compliance exception, the adviser will need to resolve the exception on a timely basis by working with the sub-adviser and administrator. One of the compliance challenges in multiple sub-adviser funds is the asset coverage testing for lending and short sales. Although collateral testing is at the fund (portfolio) level, the sub-advisers will only see their given sleeve of securities. The administrator and adviser must perform collateral management at the portfolio level and remain in constant daily communication with the sub-advisers to meet RIC coverage tests. One suggested best practice that minimizes RIC compliance risks is to require each sub-adviser to meet all RIC compliance requirements for their respective sleeve. If the investment strategy allows for sleeve level compliance, the fund will naturally meet compliance requirements at the portfolio level.

A best practice RIC compliance culture entails a fund compliance calendar, checklist and summary reporting coordinated by the administrator to provide standard compliance questionnaires, assessment and compliance reporting of the fund, adviser, sub-advisers, officers, board and service providers. Given the constantly changing mutual fund regulatory environment, strong communication regarding compliance is essential, including the administrator's role to keep all parties informed of compliance events and regulatory changes that impact the fund.

## 5. Portfolio allocation and cash management best practices

In the development of the fund's processes and procedures prior to launch, the adviser and administrator for the multiple sub-adviser mutual fund will create a standard process for daily allocation of portfolio cash activity, which originates from several sources: shareholder subscriptions and redemptions, portfolio security interest and dividends, portfolio trade settlements, margin variation, and periodic fund expense payments, such as monthly management fees. There are two options for cash management, depending upon the manager's preference to support the fund's cash needs: portfolio-level cash managed by the adviser for daily liquidity needs or sleeve-level cash balances managed as a component of each sub-adviser's investment sleeve.

**Portfolio cash balance** – The adviser and sub-advisers are best served by maintaining a core short-term cash sleeve at the fund level, rather than holding multiple cash balances at the sleeve level. For example, the manager can maintain a 3-5 percent



cash balance to cover anticipated daily portfolio cash needs with any excess “allocation amount” distributed to the sub-advisers once it exceeds a threshold established by the manager (e.g., 3-5 percent or \$200,000 above/below the core cash amount on a daily basis). The custodian and fund accountant will coordinate this daily cash evaluation process on behalf of the adviser and provide daily reconciliation and cash reporting to the adviser. As the allocation amount is reached, the custodian distributes the allocation amount to each sub-adviser based upon standing allocation percentage instructions from the adviser. The adviser controls and changes the allocation percentages based upon rebalancing requirements. This process allows for a meaningful allocation amount to the different sub-advisers, while at the same time managing the daily cash needs of the fund with minimal disruption to the sub-adviser sleeves. More rarely, additional cash management processes can assist multiple sub-adviser funds, such as a liquidity line of credit to support short-term cash needs without disrupting the sub-adviser sleeves and inter-fund lending for large, diverse fund complexes.

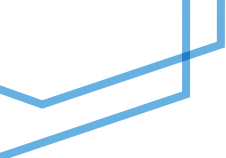
**Sleeve cash balance** – This option provides for all cash to be allocated to each sub-adviser’s sleeve by the custodian and fund accountant. Cash relating to sleeve investments (coupon payments, dividends and securities trade settlements) settle to the corresponding sub-adviser sleeve (subaccount) in which the investments are held. Each sub-adviser manages its own cash levels depending upon their individual strategies. In this example, a long-only manager is going to have very little cash in its sleeve, while one with derivatives will likely hold more cash for collateral and asset coverage. In this cash option, daily cash is either allocated to (shareholder subscriptions) or drawn from (redemptions and fund expenses) each sub-adviser’s sleeve.

## 6. Fund CCO and board best practices in sub-advised mutual funds

The fund CCO is responsible to implement, monitor, test and report on the fund compliance program on behalf of the mutual fund board, which includes the compliance programs of both the adviser and each sub-adviser. The fund compliance program must be reasonably designed to prevent, detect and correct violations of the applicable federal securities laws to which the fund is subject.

Gartenberg <sup>(1)</sup> standard for mutual fund trustee approval of the adviser contract – also applies to sub-adviser approval
(1) Nature and quality of services performed for the fund.
(2) Profitability of the fund to the sub-adviser.
(3) Comparative fees for similarly managed assets.
(4) Economies of scale in managing the fund assets.
(5) Additional benefits that may accrue to the sub-adviser from managing the fund.

<sup>(1)</sup> Gartenberg v. Merrill Lynch Asset Management, Inc.



The fund CCO must ensure the adviser CCO is effectively monitoring the sub-advisers and reporting on both adviser and sub-adviser compliance with the prospectus, SAI, fund policies and procedures, and applicable federal securities laws.

Best practice fund CCO process includes requiring annual sub-adviser certification(s) of their processes relevant to managing the mutual fund assets, such as soft dollars, trading policies, procedures and code of ethics compliance. Fund CCOs should also report to the fund board regarding their review of the sub-adviser(s) compliance manual, recommended changes to maintain compliance with fund policies and procedures, as well as the status of sub-adviser completing the requested changes.

The mutual fund board best practices with respect to the fund CCO include validating that the CCO has adequate authority, receives effective responsiveness from the adviser and sub-advisers, is adequately compensated, and has sufficient resources to effectively fulfil the fund CCO function involving multiple sub-advisers.

The fund board has a fiduciary duty to ensure that all fund activities are performed in the best interest of the investors. This includes the selection of the adviser and sub-advisers, and the approval of the adviser and sub-adviser investment management agreements with the fund. The board should understand the adviser's process for selecting sub-advisers and the circumstances under which the adviser would terminate a sub-adviser. The board will also expect periodic fund and sub-adviser performance reporting, including sector and security level attribution and contribution, so that the board understands the origin of both superior and inferior portfolio and sleeve investment performance. Although the adviser is charged with making recommendations for selecting and replacing sub-advisers, the board has the ultimate responsibility for the oversight of the fund's investment management, including both the adviser and sub-adviser services to the fund.

In fulfilling its fiduciary duty, the board should have transparency to the sub-advisers, their businesses and their services to the fund. Board members should require that the sub-advisers present to the board in person, both initially and at least annually. If there are a significant number of sub-advisers, the board may wish to have the adviser set a rotation of sub-advisers presenting at each quarterly meeting in order to spread out the board's workload. This practice ensures that the board receives transparency and detail directly from the adviser and sub-advisers servicing the mutual fund(s), covering topics such as sub-adviser firm changes, significant events, investment performance and compliance.

## Continual improvement in multiple sub-adviser best practices

Best practices for multiple sub-adviser mutual funds continue to develop within the mutual fund industry by those managers and administrators with significant experience and thought leadership. Careful planning of communication among all parties in the daily workflow, operational processes, controls and procedures prior to fund launch or changing a sub-adviser will help to ensure stability within the mutual fund. The adviser should rely on high-quality fund administration talent and technology to support their multiple sub-adviser mutual fund structure in order to gain maximum efficiency and minimize operational, financial and reputational risks.

### Electronic Board Books

An electronic board book portal is an essential means of coordinating, assembling and disseminating mutual fund board materials where there may be a significant number of sub-advisers. The Section 15(c) process, which requires significant due diligence information and reporting to the Trustees, can be hundreds to thousands of pages – and best supported by an electronic board book portal with easy navigation for board review, discussion and approval processes.





“Through nearly 50 years of continually enhancing our fund services and by working with our clients to grow their business, we are fortunate to support more than 30 percent of all mutual fund complexes.”

## About the author

Bob Kern is a Managing Director and Executive Vice President of U.S. Bancorp Fund Services, LLC. He began his career with U.S. Bancorp in 1982 and has served as a manager within the fund services subsidiary since 1984. From 1984 to 1994, Bob managed business development efforts as well as the mutual fund Transfer Agent operation including the Investor Services group, Account Services, Legal Compliance, Document Processing, and Systems Support divisions. During that time, Bob assisted in the management and implementation of both services and technologies related to transfer agent and shareholder services, fund accounting, fund administration, literature fulfillment and fund distribution services.

## Education and credentials

Bob received his undergraduate degree from Marquette University in business administration with specializations in finance and marketing. Bob serves as a board member of U.S. Bancorp Fund Services, LLC, Quasar Distributors, LLC, and interested Trustee and Chair of Managed Portfolio Series, an open-end mutual fund multiple series trust.

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