Common Provisions in Investment Subadvisory Agreements for Registered Funds

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A registered investment adviser ("adviser") that advises an investment company ("fund") registered under the Investment Company Act of 1940, as amended ("1940 Act") may engage one or more unaffiliated advisers as a subadviser ("subadviser") to perform all or a portion of the adviser's investment management services for the fund. Advisers generally engage subadvisers for the subadviser's expertise and reputation for investing within a particular asset class, or for other strategic reasons. Some fund advisers delegate to the subadviser either the management of an entire fund, or only a portion of the assets of the fund. The fund's adviser must enter into a written subadvisory agreement with the subadviser ("fund subadvisory agreements") to comply with the 1940 Act. While the 1940 Act expressly requires certain terms to be included in a contract for advisory services to a fund (*e.g.,* that the contract automatically terminates in the event of its assignment, which is required by Section 15(a)(4) of the 1940 Act), many terms that are typically included in fund subadvisory agreements are not so prescribed. This article discusses some broad categories of provisions found in fund subadvisory agreements that are not necessarily prescribed by applicable law.[i]

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Discussion

As a general matter, and taking into consideration the nature of the adviser's business and typical course of dealing with its service providers, contractual arrangements with subadvisers should specify a subadviser's responsibilities for any issue that involves the risk that a subadviser's performance could cause a fund to violate applicable law or its own compliance policies and procedures, or could lead to liability for prospectus misstatements or omissions. The main categories of fund subadvisory agreement provisions discussed below are: (i) compliance with instructions and restrictions in the fund's prospectus and other operative documents; (ii) indemnification and limitation of liability; (iii) the subadviser's responsibility for compliance-related matters; (iv) the subadviser's responsibility to provide assistance with respect to custody and administrative services; (v) the subadviser's responsibility to review documents and provide certifications; (vi) the subadviser's responsibility to update the fund's adviser and the fund's board; (vii) the subadviser's responsibility for proxy voting and exercising other rights; (viii) notifications of adverse events affecting the subadviser; and (ix) reporting responsibilities under Section 13 of the Securities Exchange Act of 1934, as amended ("1934 Act").

Compliance with Instructions and Restrictions in the Fund's Prospectus and Other Operative Documents

In addition to the requirements imposed by the Investment Advisers Act of 1940, as amended ("Advisers Act") and rules thereunder, subadvisers that are responsible for a portion of a fund's portfolio are required to comply with investment restrictions that are contractually imposed upon them. A subadviser that is responsible for the management of an entire fund is required to comply with all limitations applicable to the fund imposed under the 1940 Act and rules thereunder. Generally, fund subadvisory agreements require the subadviser to comply with applicable prospectus restrictions and with specific instructions from the adviser or the fund. Half of the sample subadvisory agreements expressly required compliance with the

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funds' organizational documents and compliance policies and procedures adopted pursuant to Rule 38a-1 under the 1940 Act.

Indemnification and Limitation of Liability

As noted recently by the SEC in an interpretive release dated June 5, 2019 regarding the standard of conduct for advisers, an adviser has a fiduciary relationship with its client that can be shaped by the agreement forming that relationship, but the adviser cannot limit its liability as a fiduciary in a way that would be misleading and violate Sections 206(1) and 206(2) of the Advisers Act. Section 17(i) of the 1940 Act prohibits fund subadvisory agreements from including provisions that limit the subadviser's liability to a standard that is lower than one of willful misfeasance, bad faith, gross negligence, or reckless disregard with respect to the subadviser's duties or obligations under the fund subadvisory agreement.

With respect to limitation of the subadviser's liability and indemnification obligations, most fund subadvisory agreements surveyed use language that mirrors Section 17(i) to limit the subadviser's liability or impose an obligation for the subadviser to indemnify the adviser and the fund (*e.g.,* "[a]bsent willful misconduct, bad faith, gross negligence, or reckless disregard of obligations or duties hereunder on the part of the [s]ub-adviser… the [s]ub-adviser… shall [not] be liable for any act or omission in the course of, or connected with, rendering services hereunder or for any losses."). Several fund subadvisory agreements include indemnification obligations that are reciprocal (with the subadviser indemnifying the adviser and the fund and certain of their affiliates and the adviser indemnifying the subadviser and certain of its affiliates). Few fund subadvisory agreements include an indemnification obligation that is one-way: either from the subadviser to the adviser and the fund, or from the adviser to the subadviser. In cases where the adviser provides indemnification to the subadviser, the adviser's indemnification obligation is commonly contingent on the adviser's willful misfeasance, bad faith, gross negligence or reckless disregard with respect to its obligations or duties under the fund subadvisory agreement. Multiple fund subadvisory agreements with reciprocal indemnification include exceptions to the adviser's and the subadviser's indemnification obligations, and the most common exception is the other party's willful misfeasance, bad faith, gross negligence, or reckless disregard with respect to its contractual duties or obligations.

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Few fund subadvisory agreements include contractual provisions imposing liability or indemnification obligations for trade errors. The term "trade errors" in this context generally refers to executions or settlements of trades that were not executed for the intended investments, were out of compliance with existing investment guidelines, or were made for the wrong client account. One fund subadvisory agreement provides that the existence of a trade error and the subadviser's liability would be determined by reference to the fund's procedures. Another fund subadvisory agreement imposes liability on the subadviser for trade errors (as defined by the fund's or the subadviser's compliance manual) caused by the subadviser's negligence.

The Sub-Adviser's Responsibility for Compliance-Related Matters

Rule 38a-1 under the 1940 Act requires a fund's board to approve the policies and procedures of the fund's subadviser, which must be based on a finding that the subadviser's policies and procedures are reasonably designed to prevent violation of the federal securities laws by the fund and by the subadviser. Typically, a fund's chief compliance officer ("CCO") and the subadviser provide the board with materials or information that supports this finding. Rule 38a-1 also requires a fund's CCO to provide the board with, on an annual or more frequent basis, a report that addresses material changes to a subadviser's compliance policies and procedures that have been approved by the board and any "material compliance matter," which as defined in the rule includes a violation of the federal securities laws by the fund or its subadviser, a violation of the policies and procedures of the fund or its subadviser, or a weakness in the design or implementation of the policies and procedures of the fund or its subadviser. Rule 206(4)-7 under the Advisers Act requires subadvisers to review the adequacy of their policies and procedures at least annually.

Most fund subadvisory agreements include a provision that obligates the subadviser to provide the fund or the adviser with access to information, documents, and facilities of the subadviser for purposes of evaluating their compliance program. A minority of fund subadvisory agreements include provisions that require notification of material compliance violations, certifications as to compliance-related matters, delivery of the subadviser's annual compliance report required by Rule 206(4)-7 under the Advisers Act to the fund's CCO, or notifications related to material changes to the subadviser's compliance program or SEC examinations of the subadviser. Some parties do not specifically address any of these points in their fund subadvisory agreements.

The Subadviser's Responsibility to Provide Assistance with Respect to Custody and Administrative Services

Funds that operate as a mutual fund

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or ETF are required to strike a net asset value ("NAV") every business day. Fund boards typically adopt valuation policies and procedures that provide guidelines for purposes of calculating the fund's NAV and delegate responsibility for fair valuing any asset of the fund consistent with those procedures.

Most fund subadvisory agreements require the subadviser to reconcile trades daily on the next business day after a trade (T+1) to the fund's service providers. Some subadvisory agreements do not address reconciliations. In addition, several fund subadvisory agreements surveyed also require the subadviser to assist with valuations (but not to assign valuations to particular assets).

The Subadviser's Responsibility to Review Documents and Provide Certifications

Only a fund's principal executive and financial officers are required to provide certifications for shareholder report filings, and only a fund's board and certain principal officers are required to sign registration statement filings. However, many fund subadvisory agreements require the subadviser to provide information or certifications generally or that specifically relate to the fund's SEC filings. Specifically, fund subadvisory agreements require sub-certifications from persons involved in providing information for, or reviewing, shareholder report and registration statement filings. To the extent the issue is addressed, the fund subadvisory agreements often require the subadviser to respond to requests for information for SEC filings or to provide certifications regarding shareholder reports, registration statements, or other matters generally.

The Subadviser's Responsibility to Update the Fund's Adviser and the Fund's Board

Section 15(c) of the 1940 Act requires subadvisers to furnish information in response to the board's requests

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regarding approvals or renewals of fund subadvisory agreements. For fund subadvisory agreements to continue past an initial two-year term, subadvisers are required to respond to requests from the fund's board for information relating to its consideration of approving the annual renewal of the fund subadvisory agreement.

A majority of fund subadvisory agreements require subadvisers to provide information or reports as reasonably requested by the fund or the adviser on an annual or more frequent basis. Five fund subadvisory agreements require that the subadviser make personnel available for board meetings. Many fund subadvisory agreements require subadvisers to provide specific reports on soft dollars and trading practices. Generally, fund subadvisory agreements impose an ongoing responsibility on the subadviser to provide updates to the fund's adviser or its board on material developments in the fund's portfolio.

The Subadviser's Responsibility for Proxy Voting and Exercising Other Rights

Rule 206(4)-6 under the Advisers Act requires advisers to adopt proxy voting policies and procedures for how they vote proxies where they accept a delegation of proxy voting authority from their clients. Funds are required to disclose their proxy voting policies and procedures in their registration statement, and, pursuant to Rule 30b1-4 under the 1940 Act, disclose their annual proxy voting record. A fund typically delegates its proxy voting authority to its adviser and adopts the adviser's proxy voting policies and procedures. Absent the adviser's subdelegation of its delegated authority to the subadviser, the adviser retains authority to vote proxies and exercise other rights with respect to a fund's portfolio securities.

Most fund subadvisory agreements delegate proxy voting authority to subadvisers. However, with regard to other rights associated with the fund's underlying portfolio securities, there does not appear to be a clear standard. For example, some fund subadvisory agreements delegate class action authority or authority with respect to other rights associated with the portfolio securities while others do not.

Notifications of Adverse Events Affecting the Subadviser

Under Section 9(a) of the 1940 Act, persons with certain types of criminal histories (*e.g.,* felony convictions within the last ten years arising out of conduct in certain registered capacities in the securities industry) or bars from acting in certain registered capacities in the securities industry ("securities industry bars") cannot serve as advisers or subadvisers to funds. Similarly, Section 203(e) of the Advisers Act permits the SEC to revoke the registration of any adviser if the entity or an associated person has, among other things, made a false or misleading statement in an SEC filing, been convicted of a felony or misdemeanor involving the purchase or sale of a security, or has received a securities industry bar. Forms N-1A and N-2 require disclosure of material pending legal proceedings involving a fund or its subadviser, other than ordinary routine litigation incidental to their businesses. "Materiality" in this context means any proceeding that is likely to have a material adverse effect on the fund or the subadviser's ability to perform under the fund subadvisory agreement.

Many fund subadvisory agreements require immediate notification to the adviser if the subadviser becomes statutorily disqualified from serving as a sub-

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adviser or is no longer registered. They also require notice of investigations, threatened litigation or pending regulatory or legal proceedings involving the subadviser that relates to the fund or threatens the subadviser's ability to perform under the agreement.

Several fund subadvisory agreements also require notification of transactions or events affecting the subadviser that would terminate the agreement because of an "assignment," as that term is defined in the 1940 Act. In most cases, the notification is required before the event. A few fund subadvisory agreements surveyed require the subadviser to pay costs related to the assignment (such as expenses of preparing and sending prospectus supplements to shareholders). A minority of fund subadvisory agreements surveyed require timely notification if a member of the management team or the portfolio managers assigned to the fund leave the subadviser.

Reporting Responsibilities under Section 13 of the 1934 Act

Sections 13(d) and (g) of the 1934 Act generally require beneficial owners of certain equity securities registered under the 1934 Act to file a Schedule 13D or 13G if an ownership level of 5% or more of a class is reached. "Beneficial ownership" for this purpose includes voting or dispositive power over the securities. Section 13(f) of the 1934 Act generally requires institutional investment managers that exercise investment discretion over Section 13(f) securities to file reports on Form 13F. "Investment discretion" for this purpose includes the power to determine what securities are to be purchased or sold for an account.

Several fund subadvisory agreements surveyed address responsibility for filings on Schedules 13D and 13G and Form 13F. These fund subadvisory agreements provide that these filings are the subadviser's responsibility if the form is required to be filed with respect to portfolio securities held by the fund.

Conclusion

Evaluating provisions potentially available for fund subadvisory agreements may be helpful in guiding future fund subadvisory agreement negotiations. Firms should also consider that arrangements in some of these areas may be documented in other ways between the parties (*e.g.*, investment and/or operational guidelines governing the subadviser's engagement that require the subadviser to reconcile trades to the fund's custodian and administrator daily).

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[i] The summary of terms discussed in this column is based on an informal survey of a group of fund subadvisory agreements that is publicly available on the U.S. Securities and Exchange Commission's ("SEC") EDGAR website filed by 10 fund registrants (referred to herein as the sample of subadvisory agreements). These fund registrants are series trusts (either single series trusts, or multiple series that range up to over 100 series) and have unrelated advisers. Each registrant and its adviser can rely on an exemptive order from the SEC that permits the adviser to hire and fire subadvisers without shareholder approval.

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