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Sub-Adviser Compliance With A Mutual Fund's Compliance Policies and Procedures

A sub-adviser to a mutual fund must comply with the fund's compliance policies and procedures in providing advisory services to the fund. This may seem straightforward, but upon closer inspection may present novel compliance issues for sub-advisers – particularly for those sub-advisers unfamiliar with the regulatory obligations of mutual funds. Although many of the fund's compliance obligations may be similar to the sub-adviser's existing obligations, many obligations are likely to be new obligations.

This article discusses some of the fund compliance policies and procedures that may be applicable to a sub-adviser to a mutual fund. A sub-adviser should review and become familiar with all of a fund's compliance policies and procedures and incorporate into its compliance program those fund policies for which it is responsible. In addition, the sub-adviser should review its advisory agreement with the fund or the fund's adviser and identify any policies that the sub-adviser is given responsibility for under the agreement. In some cases, the fund's investment adviser may retain overall responsibility for compliance with a particular fund's policy. In such cases, the adviser should provide the sub-adviser with written guidance concerning the sub-adviser's responsibility with respect to such policy.

Investment-Related Policies

A sub-adviser to a mutual fund must ensure that its portfolio management of the fund (or the portion of the fund's assets entrusted to the sub-adviser) complies with the fund's investment objective and strategies, which are

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Discretionary Investment Advisory Programs and Rule 3a-4 Under the 1940 Act

In a recent speech, Buddy Donohue, Director of the SEC's Division of Investment Management, reflected on the conditions of Rule 3a-4 under the 1940 Act, which provides a non-exclusive safe harbor from the definition of investment company for certain investment advisory programs. He expressed his view that the SEC staff should periodically review the conditions in Rule 3a-4 to consider whether they provide an appropriate level of individualized treatment to support an exception from the definition of investment company for discretionary investment advisory programs.

This article discusses some of the investment advisory programs prevalent in the marketplace today, explores briefly the history of Rule 3a-4 and examines the requirements of the Rule. It concludes by questioning the utility of the Rule's individualized treatment conditions in light of their potential underutilization by clients participating in discretionary investment advisory programs.

Discretionary Investment Advisory Programs

There are a variety of discretionary investment advisory programs in the marketplace. The most

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reflected in the fund's prospectus and statement of additional information ("SAI"). Again, this may seem straightforward, but upon closer inspection may present novel compliance issues for the sub-adviser. For example, the fund may have an investment policy that implicates Rule 35d-1 under the Investment Company Act of 1940 ("1940 Act") - the Names Rule. This type of policy would likely require knowledge of SEC staff positions addressing the Rule.

A sub-adviser to a fund should ensure that its agreement with the fund or the fund's investment adviser requires the fund or adviser to provide the sub-adviser periodically with copies of the fund's prospectus and SAI and any amendments to these documents. A good practice for sub-advisers is to request copies of the prospectus and SAI within ten days after any annual update of the documents.

Other investment-related policies of a fund to which the sub-adviser must adhere include policies addressing concentration (e.g., the fund's ability to invest more than 25% of its assets in one industry) and the diversification requirements of the 1940 Act and Sub-Chapter M of the Internal Revenue Code. If, for example, the fund is "diversified" for purposes of the 1940 Act, the sub-adviser must ensure that at least 75% of the fund's total assets is represented by cash and cash items, government securities, securities of other investment companies, and other securities (limited in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of the fund and to not more than 10% of the outstanding voting securities of such issuer). Sub-Chapter M provides, among other things, that a fund satisfies Code diversification requirements if, at the close of *each quarter of its taxable year*, (1) at least 50% of its assets are invested in cash and cash items, government securities, securities of other registered investment companies and other securities, except to the extent such other securities exceed 5% of the value of the total assets of the fund or exceed 10% of the outstanding voting securities of the issuer of such securities and (2) no more than 25% of the value of its assets are invested in the securities of any one issuer or of two or more issuers that are controlled by the fund and are engaged in the same or related trades or businesses.

To the extent the sub-adviser engages in transactions on behalf of the fund that create leverage, the sub-adviser must comply with the fund's policies addressing the application of Section 18 of the 1940 Act. Transactions that involve leverage include (i) transactions in derivatives, e.g., options, futures, forwards and swaps, (ii) short sales, (iii) purchases on margin, (iv) reverse repurchase agreements, and (v) standby commitment agreements, e.g., when-issued or delayed delivery securities. In general, a fund must either hold a position offsetting a leveraged transaction or establish (and mark-to-market on a daily basis) a segregated account holding cash or liquid securities in an amount that, together with any amount that may be required to be deposited with a broker for the transaction, covers the leverage position.

Exemptive Rule Policies

Most mutual funds rely on certain exemptive rules under the 1940 Act that permit them to engage in certain prohibited activities. The rules include:

- *Rule 10f-3* (addresses purchases of securities in an underwriting or selling syndicate if any principal underwriter of the issuer is an affiliate of the fund);
- *Rule 12d3-1* (addresses purchases of securities issued by brokers and investment advisers and other arrangements (e.g., swap transactions) in which a broker or investment adviser is a counterparty);
- *Rule 17a-7* (addresses purchases and sales of securities between the fund and its affiliates); and
- *Rule 17e-1* (addresses the use of an affiliated broker to effect securities transactions for the fund).

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Sub-Adviser Compliance
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Funds maintain compliance policies designed to ensure compliance with these rules that apply to a sub-adviser's activities.

Compliance with the policies may require periodic reporting to the fund's board of directors. For example, if the sub-adviser uses an affiliated broker to execute securities transactions for the fund, the sub-adviser must report those transactions to the fund at least quarterly so that the board can review and approve the transactions.

Portfolio Holdings Disclosure Policy

A sub-adviser to a mutual fund must be mindful of the fund's portfolio holdings disclosure policies and procedures, which are described in the fund's SAI. A mutual fund may only disclose portfolio holdings consistent with the antifraud provisions of the federal securities laws. Disclosing non-public portfolio holdings information to selected third parties is permissible *only when* the fund has a legitimate business purpose for doing so and the recipients are subject to a duty of confidentiality, including a duty not to trade on the non-public information.

A fund's portfolio holdings policy will reflect the foregoing concerns and govern the release of the fund's portfolio holdings. Because a sub-adviser to a fund will have access to the non-public portfolio holdings of the fund, the sub-adviser must adhere to any restrictions provided in the fund's portfolio holdings disclosure policy.

Brokerage Policies

A sub-adviser to a mutual fund must also comply with the fund's brokerage policies, which include policies addressing "soft dollar" arrangements. Section 28(e) of the Securities Exchange Act of 1934 allows a sub-adviser to a fund to use portfolio commissions to pay for "brokerage and research services," subject to certain requirements. This provision permits a sub-adviser to cause the fund to pay more than the lowest available commission if the sub-adviser determines in good faith that the amount of commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer, viewed in terms of the particular transaction or the sub-adviser's overall responsibilities to its discretionary accounts. In making a good faith determination, the sub-adviser may consider not only the benefit derived by the account paying the commission, but also the benefits derived by other accounts.

In connection with its compliance with these brokerage policies, the sub-adviser must adhere to the fund's related recordkeeping requirements. For example, Rule 31a-1(a)(9) under the 1940 Act requires a fund to maintain "a record for each fiscal quarter… showing specifically the basis or bases upon which the allocation of orders for the purchase and sale of portfolio securities to named brokers or dealers and the division of brokerage commissions or other compensation on such purchase and sale orders among named persons were made during such quarter." The record must indicate "the consideration given to… the supplying of services or benefits by brokers… to the investment adviser…" and must show "the nature of the services or benefits made available."

Conclusion

A sub-adviser to a mutual fund must review carefully the fund's compliance policies and procedures and incorporate those policies applicable to it into its compliance program. Often, the compliance officer of the fund will require the sub-adviser to certify that it complies with applicable fund policies. Non-compliance by the sub-adviser subjects both the fund and sub-adviser to regulatory and legal risks.

If you have any questions concerning this article, please contact Paul Miller via e-mail (millerp@sewkis.com) or by phone at (202) 737-8833.

common investment advisory program is the traditional wrap fee program in which certain services, including portfolio management, brokerage (transaction execution), custody and other administrative services, are bundled and for which a client pays a single asset-based fee. Mr. Donohue noted in his speech that of the 10,817 investment advisers registered with the SEC as of September 30, 2007, 486 advisers indicated that they sponsor a wrap fee program and 1,110 advisers indicated that they act as a portfolio manager for a wrap fee program.

Recently, new variations of the traditional wrap fee program have developed. These variations include "multiple style portfolios" programs and "overlay portfolio management" programs. In these programs, a client is provided with access to multiple investment strategies (managed by different managers through "sleeves") in one unified managed account (or UMA). In an overlay portfolio management program, an overlay manager receives trade and investment recommendations from each sleeve manager (based on a model portfolio for the selected investment strategy) and implements each strategy within the UMA. In this way, the overlay manager can monitor transactions, reduce tax liabilities and minimize trading costs.

Other investment advisory programs are available on an "unbundled" basis. In these programs, a client enters into two agreements - one with a broker-dealer sponsor providing brokerage, administrative and custody services for a fee, and a separate agreement with an investment adviser providing investment management services.

Despite the variety of programs, most have common characteristics. The programs are typically organized and administered by a sponsor that provides asset allocation advice and administrative services. Portfolio management may be provided by the sponsor (or an affiliate of the sponsor) or by a third party adviser or advisers selected by the sponsor or the client with the assistance of the sponsor. Regardless of the entity providing advisory services, a client's program account is managed on a discretionary basis in accordance with pre-selected investment objectives.

The common characteristics of discretionary investment advisory programs raise concerns under the 1940 Act. Rule 3a-4 was adopted to address these concerns and provide a safe harbor within which these programs could operate without registering as an investment company under the 1940 Act.

History of Rule 3a-4

The 1940 Act defines an investment company to include any issuer that is engaged primarily in the business of investing, reinvesting or trading in securities. The 1940 Act defines an issuer to include any organized group of persons that issues or proposes to issue securities. A discretionary investment advisory program raises concerns under these definitions because the program could be viewed as an issuer of securities that engages in the business of investing or trading in securities. As the SEC indicated in its release proposing Rule 3a-4, the client accounts participating in the program could be viewed as comprising an organized group of persons, and investors in the program could be viewed as purchasing securities issued by the program in the form of investment contracts.

Rule 3a-4 was designed primarily to preserve two distinctions among client accounts participating in a program, thereby avoiding the "pooling" of client accounts and the implication of an organized group of persons. The first distinction addresses the individualized treatment of clients. Each client of an investment adviser is provided with individualized advice regarding the management of the client's account. Such advice is based on the client's financial situation and objectives. In contrast, an adviser to an investment company need not consider the individual needs of the company's shareholders when providing advice to the company, i.e., making investment decisions with respect to the company's portfolio. The adviser has no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder.

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The second distinction deals with the indicia of ownership of securities and funds. Each client of an investment adviser is the beneficial owner of the securities and funds held in the client's account. In contrast, an investment company, not each of its shareholders, is the beneficial owner of securities and funds held in the fund's portfolio and a shareholder has only a pro-rata undivided interest in the portfolio and its assets.

Requirements of Rule 3a-4

To utilize the safe harbor provided by Rule 3a-4, an investment advisory program must be structured, managed and operated in accordance with the following conditions of the Rule.

1. Managed Based on Customer's Circumstances. Each client's account in the program must be managed on the basis of the client's financial situation and investment objectives and in accordance with any reasonable restrictions imposed by the client on the management of the account.

2. Customer Contact.
   (a) At the opening of the account, the sponsor (or another person designated by the sponsor) must obtain information from the client regarding the client's financial situation and investment objectives and must give the client the opportunity to impose reasonable restrictions on the management of the account.
   (b) At least annually, the sponsor (or another person designated by the sponsor) must contact the client to determine whether there have been any changes in the client's financial situation or investment objectives and must inquire as to whether the client wishes to impose any reasonable restrictions on the management of the account or modify existing restrictions.
   (c) At least quarterly, the sponsor (or another person designated by the sponsor) must notify the client in writing to contact the sponsor if there have been any changes in the client's financial situation or investment objectives or if the client wishes to impose any reasonable restrictions on the management of the client's account or modify existing restrictions and must provide the client with a means through which such contact may be made.
   (d) The sponsor and personnel responsible for the client's account must be reasonably available to the client for consultation.

3. Reasonable Restrictions. Each client must have the ability to impose reasonable restrictions on the management of the client's account, including the designation of particular securities or types of securities that should not be purchased for the account or that should be sold if held in the account.

4. Customer Reporting. The sponsor (or another person designated by the sponsor) must provide each client with a statement, at least quarterly, containing a description of all activity in the client's account during the preceding period, including all transactions made on behalf of the account, all contributions and withdrawals made by the client, all fees and expenses charged to the account, and the value of the account at the beginning and end of the period.

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5. Indicia of Ownership. Each client must retain, with respect to all securities and funds in the account, to the same extent as if the client held the securities and funds outside the program, the right to (i) withdraw securities or cash, (ii) vote securities, or delegate the authority to vote securities to another person, (iii) be provided in a timely manner a written confirmation or other notification of each securities transaction, and all other documents required by law to be provided to the security holder, and (iv) proceed directly as a security holder against the issuer of any security in the client's account and not be obligated to join any person involved in the operation of the program, or any other client of the program, as a condition precedent to initiating such proceeding.

These conditions of Rule 3a-4 are typically built into the documentation governing an investment advisory program. For example, clients participating in a traditional wrap fee program are required to provide the sponsor with information concerning their financial situation and investment objectives upon opening an account through the program. These clients are also provided the ability to withdraw securities or cash from their accounts upon notice to the sponsor.

Conclusion

Mr. Donohue suggested that it may be time for the SEC staff to review the conditions of the Rule to determine whether the conditions provide an appropriate level of individualized treatment to support a safe harbor from the definition of investment company under the 1940 Act. The individualized treatment conditions, which are set forth primarily in (1) through (3) above, may be underutilized. The SEC staff should take this opportunity to review the extent to which clients utilize their ability to notify the sponsor of changes to their investment objectives and financial situation and to place reasonable restrictions on their accounts. Depending on the results of such review, a more appropriate question may be whether certain of the conditions are necessary at all or whether other conditions of the Rule, e.g., (1), (4) and (5) above, would be sufficient to support a safe harbor from the definition of investment company under the 1940 Act.

If you have any questions concerning the issues discussed in this article, please contact Paul Miller via e-mail (millerp@sewkis.com) or by phone at (202) 737-8833.

Legislative and Regulatory Update

Summary Prospectus Proposal

On November 15, 2007, the SEC published for comment proposed rule and form amendments intended to provide mutual fund investors with information that is easier to use and more readily accessible than is currently the case. The proposals would require every mutual fund to include certain key information about the fund (investment objectives and strategies, risks, costs and performance), succinctly in "plain English" and in a standardized order, at the front of the fund's statutory prospectus. In addition, the proposals would provide a mutual fund with a new option for satisfying its obligation to deliver a statutory prospectus by delivering a "summary prospectus" and providing the statutory prospectus on its web site or, at the request of the investor, sending the statutory prospectus in paper format or by email.

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We have prepared a memorandum describing the SEC's proposals. To request a copy of the memorandum, please contact Kathleen Clarke via e-mail (clarke@sewkis.com) or Paul Miller via e-mail (millerp@sewkis.com) or either by phone at (202) 737-8833.

A copy of the SEC's proposals is available at http://www.sec.gov/rules/proposed/2007/33-8861fr.pdf.

Mandatory Electronic Submission of Applications for Orders under the 1940 Act

The SEC has published for comment a proposed rule that would require all applications for orders under the 1940 Act to be submitted electronically on EDGAR. The proposed rule would also mandate the electronic submission of Regulation E filings by business development companies.

A copy of the proposed rule is available at http://www.sec.gov/rules/proposed/2007/33-8859.pdf.

Money Market Fund No-Action Letters

The staff of the SEC's Investment Management Division recently issued four no-action letters to money market funds holding notes issued by Cheyne Finance LLC, a structured investment vehicle, and other issuers, which had been downgraded to default status in October due to their failure to comply with certain financial requirements. The no-action letters approved proposals by affiliated parties of the funds to enter into arrangements under which financial support would be provided to the funds.

The letters are available at http://www.sec.gov/divisions/investment/im-noaction.shtml#chron.

Latest Developments Concerning the SEC's New York Regional Office's Information Request Letter

At the ICI Securities Law Developments Conference (December 6-7), John Walsh, OCIE chief counsel, discussed several changes to the SEC NYRO's information request letter. He stated that the SEC staff had created a new letter that (i) is shorter, (ii) reflects a two-step approach to requesting insider trading-type information, (iii) permits a firm to respond orally or in writing to such requests, and (iv) does not include certain requests for information, e.g., the "bad" thoughts request (Item 2.II.A.1. of the letter). He noted that the previous letter was part of a "pilot" program and no longer in use.

SEC Amends Rule 144 to Shorten Holding Period for Restricted Securities

The SEC has adopted amendments to Rule 144 under the Securities Act of 1933, the "safe harbor" rule for resales of restricted securities (that is, securities acquired privately from either the issuer or an affiliate of the issuer) in the public markets. The key amendment shortens the primary holding period for restricted securities of companies that have been public reporting companies for at least 90 days from one year to six months. The amendments will become effective February 15, 2008.

If you have any questions concerning these amendments, please contact Anthony Tu-Sekine via e-mail (tu-sekine@sewkis.com) or by phone at (202) 737-8833.

SEC's CCOutreach National Seminar

The SEC hosted a panel discussion/seminar on November 14, 2007 for Chief Compliance Officers of registered investment advisory firms. The seminar was divided into four segments: Compliance and Operations – The Importance of Synergy; CCO's Role in a Changing Environment; Compliance Concerns Unique to Fixed-Income and Derivative Managers; and Examination and Risk Assessment Process. Staff members of the SEC led a panel of compliance experts in discussing the topics covered during the seminar.

We have prepared a memorandum discussing the seminar. To request a copy of the memorandum, please contact Chris Riccardi via e-mail (riccardi@sewkis.com) or by phone at (212) 574-1535 or Paul Miller via e-mail (millerp@sewkis.com) or by phone at (202) 737-8833.

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