



As with Fund-of-Funds, the release adopting Rule 18f-4 (the "Adopting Release") devotes a [section to sub-advised funds](#). We again consider three types of funds:

- [VaR Funds](#) in which a sub-adviser manages their entire portfolio ("Single Sub-Adviser Funds");
- VaR Funds in which one or more sub-advisers manage a portion or "sleeve" of their portfolio ("Sleeve Funds"); and
- Sub-advised funds that seek to qualify as [Limited Derivatives Users](#).

The Adopting Release discusses the first two circumstances but is silent on the third.

## Single Sub-Adviser Funds

The Adopting Release states that, in this circumstance, "a sub-adviser alone ... could serve as a fund's derivatives risk manager." This should be particularly useful for a sub-adviser that manages several Single Sub-Adviser Funds using the same investment strategy, as it could limit inconsistencies in the derivatives risk management programs (the "DRM Programs") of these funds. Alternatively, officers of the sub-adviser could serve on a committee that acts as the sub-advised fund's derivatives risk manager. Even if the sub-adviser does not act as the derivatives risk manager, a Single Sub-Adviser Fund can

delegat[e] to a sub-adviser specific derivatives risk management activities that are not specifically assigned to the derivatives risk manager in the final rule, subject to appropriate oversight."

The DRM Program may even permit a sub-adviser to sub-delegate activities. Delegated activities might include risk identification and assessment, compliance with risk guidelines, preparing stress test and back testing. While determining which VaR Test Limit to apply cannot be delegated, conducting the VaR test can be. Escalating material risks and reporting to the fund's board of directors cannot be delegated. A DRM Program that permits delegation to sub-advisers

generally should address the oversight of any delegated activities, including the scope of and conditions on activities delegated to a sub-adviser(s), as well as oversight of the sub-adviser(s)."

The Adopting Release further acknowledges that a "derivatives risk manager also may reasonably rely on information provided by sub-advisers in fulfilling his or her responsibilities under the rule."

## Sleeve Funds

On the other hand—

delegation to a sub-adviser that manages a sleeve of a fund's assets generally would not be consistent with the fund's obligations to implement a [DRM Program]."

This is because many elements of a DRM Program, particularly VaR testing and stress testing, relate to the entire portfolio. Sleeve managers nevertheless

may be appropriately positioned to assist the derivatives risk manager by providing information relevant to the derivatives risk management program at a more granular level, ... [including] risk identification, risk assessment, and monitoring the program's risk guidelines."

This poses a challenge to the derivatives risk manager, who will need to coordinate each sub-adviser's contribution to the fund's VaR so as to comply with the applicable VaR Test Limit. To further complicate matters, some sleeves may reduce the fund's VaR and thereby provide greater latitude for other sleeves. Derivatives risk managers should also bear in mind that investments other than derivatives transactions can increase a fund's VaR. We do not know whether it would be feasible to have each sub-adviser use the same software to monitor the fund's VaR and evaluate how their management of the sleeve could affect it. At a minimum, we would anticipate that the derivatives risk manager would need to provide sub-advisers with daily

VaR results and the extent to which their sleeve contributed to or reduced those results. Managers might also give each sub-adviser a "VaR budget" so that one sleeve does not inadvertently use up the VaR required by other sleeves.

## Limited Derivative User Sub-Advised Funds

The Adopting Release does not discuss sub-advised funds that qualify as Limited Derivatives Users, perhaps because these funds are not required to adopt DRM Programs. Nevertheless, such funds must rely on their sub-adviser(s) to maintain their [derivatives exposure](#) within the 10% of net assets limit. We believe that the reasons for differentiating between Single Sub-Adviser Funds and Sleeve Funds should also apply to sub-advised Limited Derivatives Users. When a fund has a single sub-adviser responsible for managing its portfolio (or the use of derivatives transactions by the fund), then the fund's policies and procedures could make the sub-adviser responsible for compliance with the Limited Derivatives User requirements. On the other hand, when a fund has multiple sub-advisers who may use derivatives transactions, the primary investment adviser should be responsible for coordinating their use. This would pose the same problems as coordinating the VaR of several sleeves with different sub-advisers and require regular communication between the adviser and the sub-advisers regarding the use of derivatives transactions. Our next post will bring this series on Rule 18f-4 to a close.

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