

MEMO# 34328

October 28, 2022

SEC Proposes New Oversight Requirements for Certain Services Outsourced by Investment Advisers

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TO: Chief Compliance Officer Committee

Investment Advisers Committee

SEC Rules Committee RE: SEC Proposes New Oversight Requirements for Certain Services Outsourced by Investment Advisers

On Wednesday, October 26, 2022, the SEC approved in a 3-2 vote a proposal for a new rule and related amendments to prohibit SEC-registered investment advisers from outsourcing certain services or functions to service providers without meeting minimum requirements.^[1] The SEC's stated purpose for the proposed rule and related amendments was that advisers have increased reliance on outsourcing and more needs to be done to protect investors and enhance oversight.

The ICI plans to file a comment letter with the SEC opposing the proposal. If you have comments on the proposal that you would like us to consider raising in our comment letter, please provide them to the undersigned via email (kevin.ercoline@ici.org) no later than Friday, November 25th. The public comment period for the proposal will remain open for 60 days after the date of issuance and publication on SEC.gov or 30 days after the date of publication in the Federal Register, whichever period is longer.

Summary of the Proposed New Rule and Related Amendments

In general, the proposal would establish:

- New requirements for advisers to conduct due diligence before outsourcing and to periodically monitor service providers' performance and reassess whether to retain the service providers;
- Related requirements for advisers to make and/or keep books and records related to the due diligence and monitoring requirements;
- Amendments to the adviser registration form, Form ADV, to collect census-type information about advisers' use of service providers; and
- A requirement for advisers to conduct due diligence and monitoring for third-party

recordkeepers, along with a requirement to obtain reasonable assurances that the third-party will meet certain standards.

The proposal provides a compliance date of ten months after the effective date of any adoption.

Proposed Rule 206(4)-11

While the proposal entails several new requirements and amendments, the principal aspect of the proposal is the newly proposed Rule 206(4)-11. The proposed rule would establish an oversight framework for advisers that outsource a "covered function" to a "service provider." A "covered function" would be defined as "a function or service that is necessary for the investment adviser to provide its investment advisory services in compliance with the Federal securities laws, and that, if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services." Clerical, ministerial, utility, or general office functions or services are explicitly excluded from the definition. A "service provider" would be defined as "a person or entity that: (i) Performs one or more Covered Functions; and (ii) is not a supervised person . . . of the investment adviser." Such a definition would include affiliates, unless the affiliate is a supervised person of the adviser.

While the proposal states that the determination of what is a covered function would depend on the facts and circumstances, the SEC does provide several examples.[\[2\]](#) Examples provided include a service provider "providing investment guidelines (including maintaining restricted trading lists), creating and providing models related to investment advice, creating and providing custom indexes, providing investment risk software or services, providing portfolio management or trading services or software, providing portfolio accounting services, and providing investment advisory services to an adviser or the adviser's clients (subadvisory services)" as well as any technology integral to an adviser's decision-making process, such as artificial intelligence or other software.

If an investment adviser intends to outsource a covered function to a service provider, then, as part of the newly prescribed oversight framework and prior to retaining the service provider to perform a covered function, the adviser would be required to reasonably identify and determine through due diligence that outsourcing the covered function to that service provider would be appropriate by considering:

- The nature and scope of the covered function;
- Potential risks resulting from the service provider performing the covered function, including how to mitigate and manage such risks;
- The service provider's competence, capacity, and resources necessary to perform the covered function;
- The service provider's material subcontracting arrangements related to the covered function;
- Coordination with the service provider for Federal securities law compliance; and
- The orderly termination of the performance of the covered function.

The proposal would also require the adviser periodically to monitor the service provider's performance and to reassess the selection of the service provider under the aforementioned due diligence requirements.

Related Amendments

In addition to proposed Rule 206(4)-11, the SEC proposed several related amendments:

- Proposed Rule 204-2(a)(24), which would require advisers to make and keep certain books and records attendant to their obligations under the proposed Rule 206(4)-11 oversight framework, such as lists or records of covered functions and records documenting their due diligence and monitoring of each service provider.
- Proposed Rule 204-2(l), which would require advisers relying on third-party recordkeepers to conduct due diligence and monitoring of that third-party consistent with the requirements under proposed rule 206(4)-11 and obtain reasonable assurances related to the third-party's ability to:
 - Adopt and implement internal processes and/or systems for making and/or keeping records that meet the requirements of the adviser recordkeeping rule;
 - Make and/or keep records that meet all of the requirements of the adviser recordkeeping rule;
 - Provide access to electronic records; and
 - Ensure the continued availability of records if the third-party's operations or relationship with the adviser ceases.
- Proposed amendments to Form ADV to require advisers to provide census-type information about service providers performing covered functions.

Chair and Commissioner Statements

SEC Chair Gary Gensler and Commissioners Peirce, Crenshaw, Uyeda, and Lizárraga delivered statements on the proposal:

- Chair Gensler^[3] stated that the proposal would help advisers better meet their fiduciary duties, whether performing duties internally or outsourced. He noted that while investment advisers have used service providers for decades, their increased use has led staff to make recommendations on oversight. He noted that the proposed rule takes a principles-based approach, which he agrees with, but is interested in comment feedback as to whether that is the correct approach. He stated the proposed rule would cover, among other services, bespoke index providers, model programs, and artificial intelligence services.
- Commissioner Peirce^[4] stated that because investment advisers are fiduciaries, it is not clear why the SEC needs to enact itemized handholding regulations. She stated that she could have supported staff guidance, but not the repackaging of fiduciary duties into a rulemaking. She noted that there was no basis for this rule, as there has not been an uptick in enforcement actions or examinations, and the required fiduciary duty owed by advisers covers this proposed rule. She noted the impact on competition that this will have, both on smaller advisers seeking to comply with the rule and boutique service providers looking to enter the market.
- Commissioner Crenshaw^[5] noted that while outsourcing can reduce costs and increase efficiencies, it may also create vulnerabilities. She also noted that use of a service provider can create conflicts of interest or reduce insight into core advisory functions. She stated her belief that where an adviser outsources covered functions, they must make a determination that outsourcing to that specific service provider is adequate.
- Commissioner Uyeda^[6] questioned whether this rule was necessary, as there was no data provided regarding whether there was confusion among advisers as to how to interpret their fiduciary duty for oversight of service providers. When discussing

enforcement actions cited in the proposing release, he noted that there was no discussion regarding how the proposed rule would have prevented those violations or why existing tools would not allow the SEC to continue to bring enforcement actions without the proposed rule. He noted that the rule is likely to insert uncertainty into the market, as the definitions are not clear. He discussed the lack of analysis on the impact this rule will have with smaller advisers and finished by noting that this rule is likely premature as the SEC has not yet determined whether it will be amending how it categorizes index providers.

- Commissioner Lizárraga^[7] discussed the concern that outsourcing could have on systemic risk. He stated that the proposed rule can increase visibility and that the data gathering aspect of the proposal would assist maintaining security in concentrated outsourced service providers.

Kevin Ercoline
Assistant General Counsel

Notes

[1] Outsourcing by Investment Advisers, Advisers Act Release No. 6176 (Oct. 26, 2022), available at <https://www.sec.gov/rules/proposed/2022/ia-6176.pdf>.

[2] Id. at 21-26.

[3] Chair Gary Gensler, Statement on Proposed Amendments Regarding Service Providers Oversight (Oct. 26, 2022), available at <https://www.sec.gov/news/statement/gensler-statement-service-providers-oversight-102622>.

[4] Commissioner Hester M. Peirce, Outsourcing Fiduciary Duty to the Commission: Statement on Proposed Outsourcing by Investment Advisers (Oct. 26, 2022), available at <https://www.sec.gov/news/statement/peirce-service-providers-oversight-102622>.

[5] Commissioner Caroline A. Crenshaw, In Service of the Investor: Statement on Outsourcing by Investment Advisers (Oct. 26, 2022), available at <https://www.sec.gov/news/statement/crenshaw-statement-service-providers-oversight-102622>.

[6] Commissioner Mark T. Uyeda, Statement on Proposed Rule Regarding Outsourcing by Investment Advisers (Oct. 26, 2022), available at <https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622>.

[7] Commissioner Jaime Lizárraga, Accountability in an Evolving Asset Management Industry (Oct. 26, 2022), available at <https://www.sec.gov/news/statement/lizarraga-statement-service-providers-oversight-102622>.

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