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# SEC Proposes New Requirements for Outsourcing by Investment Advisers

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## **Proposed Oversight, Due Diligence, Monitoring and Recordkeeping Requirements Seek to Address SEC Observations Regarding Investment Advisers' Increased Use of Outsourcing and Related Risks.**

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### **SUMMARY**

On October 26, 2022, the Securities and Exchange Commission (the "SEC") voted 3-2 to propose new Rule 206(4)-11 under the Investment Advisers Act of 1940, which would impose due diligence and monitoring requirements on registered investment advisers that outsource certain functions to affiliated or unaffiliated service providers.<sup>1</sup> The SEC is also proposing corresponding amendments to the Advisers Act books and records rule, including an amendment that would apply to advisers that rely on a third party to make and/or keep books and records, as well as amendments to Form ADV to collect census-type information about covered service providers. In the proposing release, the SEC notes that it has become concerned about the extent to which investment advisers are relying on outside service providers to perform services necessary to the provision of advisory services (defined as "covered functions" in the proposed rule).<sup>2</sup> The proposed rule and related amendments are intended to address this concern by creating a consistent oversight framework for the outsourcing of such covered functions, and to address the SEC's related concern that it has limited visibility into advisers' outsourcing, and thus the potential extent to which advisory clients face outsourcing-related risks.

The SEC is seeking comment from the public on the proposal, including responses to specific questions included in the proposing release. Comments are due on the later of 30 days after the date of publication of the proposed amendments in the Federal Register or December 27, 2022.

## BACKGROUND

According to the proposing release, investment advisers increasingly provide full-service wealth management and financial planning services for their clients, including tax, retirement, estate, education and insurance offerings. At the same time, investment advisers are facing increased fee pressures and competition and are thus seeking to offer clients a wide array of specialized products and services in a cost-effective way. These factors are leading many advisers to rely on outside service providers. Investment advisers may outsource a number of functions to service providers, including compliance, collateral management, research and analytics, performance management, index development and technology.

The SEC notes in the proposing release that it has become concerned about the extent to which investment advisers are relying on outside service providers, as well as the potential risks of outsourcing. Specifically, the SEC states its belief that “it is a deceptive sales practice and contrary to the public interest and investor protection for an investment adviser to hold itself out as an investment adviser, but then outsource its functions that are necessary to its provision of advisory services to its clients without taking appropriate steps to ensure that the clients will be provided with the same protections that the adviser must provide under its fiduciary duty and other obligations under the Federal securities laws.”<sup>3</sup> According to the SEC, there is risk that clients could be significantly harmed by certain types of outsourcing, including as a result of disruptions or interruptions to outsourced services; poor oversight of outside service providers (which can result in financial losses for clients) and excessive oversight (which can outweigh intended cost-savings of the outsourcing arrangement); loss or negligent maintenance of sensitive client data; service providers further outsourcing their services without the adviser’s knowledge; and systemic risks associated with multiple advisers relying on a single service provider to perform a highly specialized function.

The SEC states in the proposing release that more needs to be done to protect advisory clients and enhance the oversight of advisers’ outsourced functions, notwithstanding the existing legal framework regarding the duties and obligations of investment advisers (the federal fiduciary duty of investment advisers that comprises a duty of loyalty and a duty of care). The SEC further states that disclosure cannot address the client “deception” that necessarily arises if significant aspects of an adviser’s advisory services are outsourced and not effectively overseen.<sup>4</sup> Accordingly, the SEC believes that a consistent oversight framework is needed for investment advisers outsourcing functions or services that are necessary for the investment adviser to provide its advisory services in compliance with the federal securities laws.

Commissioners Peirce and Uyeda voted to oppose the proposed rule and rule amendments. Commissioners Peirce and Uyeda both expressed concerns that the proposal is overly prescriptive and will be difficult to interpret and implement in practice, that the proposal represents an answer in search of a problem, and that the proposal’s implementation would be excessively burdensome on smaller advisers. Both Commissioners Peirce and Uyeda also emphasized the applicability of investment advisers’ fiduciary

duties and questioned the notion that investment advisers misunderstand the application of their fiduciary duties to outsourced functions.<sup>5</sup> Commissioner Peirce cautioned that “[t]he rule thus may end up abrogating fiduciary duty and replacing it with our predefined approach to best interest—one not responsive to unique facts and circumstances.”<sup>6</sup>

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## OVERVIEW OF THE PROPOSAL

Proposed Rule 206(4)-11 would “establish a set of minimum and consistent due diligence and monitoring obligations for an investment adviser outsourcing certain functions to a service provider.”<sup>7</sup> The proposed rule would apply to any investment adviser that is either registered or required to be registered with the SEC and which outsources a “covered function.” The proposed rule does not make a distinction between third-party providers and affiliated service providers, with the SEC noting that risks associated with outsourcing covered functions exist whether the service provider is affiliated or unaffiliated. Although an affiliate may be in a control relationship with the adviser, the adviser must nevertheless determine if it is appropriate to retain the affiliate’s services and oversee the affiliate’s performance of a covered function.

### “Covered Function”

The SEC is proposing to define a covered function as a function or service that (1) “is necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws,” and (2) “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.”<sup>8</sup> This definition would not include clerical, ministerial, utility or general office functions. Advisers would be responsible for making a “facts and circumstances” determination based on the particular investment advisory services provided. The release notes that the SEC would generally consider functions or services that are related to an adviser’s investment decision-making process and portfolio management to meet the first element of the definition.<sup>9</sup>

With regard to the second element of the definition, the release does not provide any guidance on the standard for functions or services that are “performed negligently” and does not attempt to reconcile this standard with the more nuanced fiduciary standard applicable to the adviser itself. The proposed definition also leaves open to interpretation what could be considered a material negative impact on clients and what can be considered immaterial. The release notes that an adviser should consider a variety of factors when determining what would be “reasonably likely to have a material negative impact,” such as the day-to-day operational reliance on the service provider, the existence of a robust internal backup process at the adviser, and whether the service provider is making or maintaining critical records, among other things.

### Due Diligence and Monitoring Requirements

Under Proposed Rule 206(4)-11, prior to engaging a service provider to perform a covered function, an investment adviser would be required to “reasonably identify and determine through due diligence that it

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would be appropriate to outsource the covered function, and that it would be appropriate to select that service provider.”<sup>10</sup> The adviser would be required to comply with six specific elements:<sup>11</sup>

- Identify the nature and scope of the covered function to be outsourced;
- Identify and determine how to mitigate and manage the potential risks of outsourcing the covered function;
- Determine that the service provider has the competence, capacity and resources necessary to perform the covered function in a timely and effective manner;
- Determine whether the service provider has any subcontracting arrangements that would be material to the service provider's performance of the covered function, and identify and determine how the adviser will mitigate the potential risks of such subcontracting arrangements;
- Obtain reasonable assurance from the service provider that it is able to, and will, coordinate with the adviser for purposes of the adviser's compliance with federal securities laws; and
- Obtain reasonable assurance from the service provider that it is able to, and will, provide a process for orderly termination of its performance of the covered function.

Investment advisers would also be required to periodically monitor the service provider's performance of the outsourced covered functions in accordance with these six elements, as well as periodically assess that it remains appropriate to continue to outsource the covered function and to outsource it to the specific service provider. Such monitoring is required “with a manner and frequency such that the adviser can reasonably determine that it is appropriate” to maintain the outsourcing arrangement, with the manner and frequency of monitoring dependent on the facts and circumstances applicable to the covered function.<sup>12</sup>

### Related Recordkeeping Requirements

In addition to the due diligence and monitoring requirements set out in Proposed Rule 206(4)-11, the SEC is proposing related amendments to the Advisers Act books and records rule that would require advisers to make and keep certain books and records related to these obligations. Specifically, advisers would be required to maintain a list or other record of the covered functions that the investment adviser has outsourced and the name of each service provider performing the covered functions, along with a record of the factors corresponding to each listed function, that led the adviser to list the functions as covered functions. However, the SEC does not intend to specify any particular method for making the list or record, nor does it intend to specify the factors to be considered and listed. According to the SEC, these recordkeeping requirements would “help advisers monitor, and determine whether to modify, their approach to outsourcing a particular function,”<sup>13</sup> while also helping the SEC in evaluating compliance with Proposed Rule 206(4)-11.

### Due Diligence and Monitoring of Third-Party Recordkeepers

The SEC is also proposing an amendment to the Advisers Act books and records rule that would require advisers that outsource their books and records function to service providers to conduct the same due diligence and monitoring of those service providers as required by Proposed Rule 206(4)-11. Additionally,

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advisers would be required to obtain reasonable assurances that the books and records service provider will:

- Adopt and implement internal processes and/or systems for making and/or keeping records that meet the recordkeeping rule requirements;
- Actually make and/or keep records that meet the recordkeeping rule requirements;
- Provide both the SEC and the adviser easy access to electronic records during the required retention period; and
- Make arrangements to ensure the continued availability of records in the event that the service provider ceases operations, or otherwise following the termination of the service provider's arrangement with the adviser.

The SEC states in the proposing release that these requirements “are intended to protect required records from loss, alteration, or destruction and to help ensure that such records are accessible to the investment adviser and the Commission staff while allowing investment advisers to continue to contract with a wide variety of service providers to assist with recordkeeping functions.”<sup>14</sup>

### Form ADV Amendments

In connection with the proposed promulgation of Rule 206(4)-11 and the related amendments to the Advisers Act books and records rule, the SEC has proposed amendments to Form ADV to better allow both the SEC and investment adviser clients to know and understand the service providers performing covered functions. Under new Item 7.C in Part 1A and Section 7.C in Schedule D, advisers would have to provide census-type information about these service providers. New Item 7.C would require SEC-registered advisers to check a box to indicate whether they outsourced any covered functions to a service provider. For those services determined to be covered functions and outsourced to one or more service providers, advisers would report more detailed information about each such service provider in new Section 7.C of Schedule D. The adviser will also be required to note in Section 7.C whether the identified service provider is a related person of the adviser, as well as the date the service provider was first engaged, which the proposing release notes will be helpful to the SEC in developing and targeting examinations.<sup>15</sup> According to the SEC, these disclosures would “provide more information about outsourced functions, enabling clients to make better informed decisions about the retention of an adviser and enabling the Commission and its staff to identify and address risks related to outsourcing by advisers and oversee advisers’ use of service providers better.”<sup>16</sup>

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ENDNOTES

- <sup>1</sup> Outsourcing by Investment Advisers, SEC Release Nos. IA-6176; File No. S7-25-22 (Oct. 26, 2022) (“Release”), *available at* <https://www.sec.gov/news/press-release/2022-194>.
- <sup>2</sup> *See id.* at 13-14.
- <sup>3</sup> *Id.* at 14.
- <sup>4</sup> *Id.*
- <sup>5</sup> 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>.
- <sup>6</sup> 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>.
- <sup>7</sup> Release at 16.
- <sup>8</sup> *Id.* at 20.
- <sup>9</sup> The proposing release lists some specific examples of functions and services that satisfy the first prong of the definition, including those related to providing: investment guidelines, investment advice models, custom indexes, investment risk software or services, portfolio management or trading software or services, portfolio account services or subadvisory services. *Id.* at 22.
- <sup>10</sup> *Id.* at 17.
- <sup>11</sup> *Id.* at 40-41. The proposing release further details these six elements, providing illustrative examples for each. At the same time, the SEC observes in the Release that “conducting due diligence is not a one-size-fits-all process,” and that whether “an adviser tailors its due diligence such that it is reasonable under the proposed rule would depend on the facts and circumstances applicable to the services to be performed and the identified service provider.” *Id.* at 43.
- <sup>12</sup> *Id.* at 66.
- <sup>13</sup> *Id.* at 18.
- <sup>14</sup> *Id.* at 18-19.
- <sup>15</sup> *Id.* at 74.
- <sup>16</sup> *Id.* at 19.

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