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Eversheds Sutherland (US) LLP
1114 Avenue of the Americas, 40th Floor
New York, NY 10036-7703

D: +1 212.389.5014
F: +1 212.389.5099

May 8, 2023

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: File Number S7-25-22: Outsourcing by Investment Advisers

Dear Ms. Countryman:

This letter is submitted on behalf of certain clients of Eversheds Sutherland (US) LLP ("Eversheds") in response to the U.S. Securities and Exchange Commission's ("Commission") proposed new rule and related amendments that would prohibit Commission-registered investment advisers from outsourcing certain services or functions to service providers without meeting specified requirements (the "Proposal").[1]

While we appreciate the Commission's concerns underlying the Proposal, it is unnecessary and poorly designed. The Commission has not met its burden of demonstrating the need for the Proposal and if adopted, the Proposal would adversely affect investment advisers, and their service providers and drive up costs to the investing public. There are several aspects of the proposed rule and amendments that are unclear, unworkable or counterproductive. In addition, the Commission has significantly underestimated the unintended consequences of the Proposal and the costs that would be incurred by investment advisers to comply with the Proposal. Accordingly, we urge the Commission not to move forward with the Proposal.

THE PROPOSAL LACKS AN ADEQUATE EXPLANATION FOR A NEW COMPREHENSIVE OVERSIGHT REGIME

The Proposing Release begins with a discussion of the evolution of the asset management industry since the adoption of the Advisers Act, including with respect to the outsourcing of various functions.[2] Like many aspects of our modern economy, the asset management industry has become increasingly sophisticated and specialized over time. It often makes no sense from an economic, operational or resource perspective for an investment adviser to house all of the functions necessary to conduct business in-house. In this respect, the investment advisory industry is still very much a main street industry. Most SEC-registered advisers are small businesses, employing 50 or fewer people (88.1% in 2021)[3] with the median investment adviser employing eight people.[4] Likewise, the majority of investment advisers operate from a single office.[5] Such a business cannot realistically be expected to design, build and maintain all of the

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[1] *Outsourcing by Investment Advisers*, Advisers Act Rel. No. 6176 (Oct. 26, 2022), 87 Fed. Reg. 68816 available at https://www.federalregister.gov/documents/2022/11/16/2022-23694/outsourcing-by-investment-advisers (the "Proposing Release").
[2] Proposal at 68817.
[3] *Investment Adviser Industry Snapshot 2022*, Investment Adviser Association and National Regulatory Services, located at https://investmentadviser.org/wp-content/uploads/2022/06/Snapshot2022.pdf
[4] *Id.*
[5] *Id.*

infrastructure necessary to manage tasks such as trade order management, pricing, valuation, reporting, cybersecurity, risk management, portfolio accounting, electronic communications, tax reporting, desk trade communication, trade reconciliation, billing, performance reporting, best execution evaluation etc. There is no way the median investment adviser can manage all of these functions in-house. Outsourcing at least some of these functions is often a necessity for an investment adviser to be able to conduct business in today's world.

While the Commission's experience with some of the potential shortfalls of outsourcing is real, the Proposal is disproportionate to the harms identified by the Commission. In this respect, the Commission fails to meaningfully identify substantial harms to the public necessitating the Proposal; rather it identifies a few cases where a service provider hired by an investment adviser did not properly fulfill its functions. As one Commissioner has already noted, with respect to one example in the Proposing Release, "there is no discussion of whether and to what extent the mutual funds' investment advisers conducted oversight of the Service Provider in accordance with their existing obligations, and whether the specified oversight requirements contemplated by the proposed rule would have prevented or mitigated the problem."[6] With respect to another example in the Proposing Release, this Commissioner observed that "[i]n this case, the adviser ignored several existing legal obligations and there is no explanation as to how the overlay of a prescriptive Service Provider rule would have altered the adviser's conduct."[7] The Commissioner added that "[t]ellingly, the observations cited in the proposing release as a basis for proposing this rule do not appear to describe Service Provider failures that would have been prevented had the rule been in effect."[8]

The Proposal does not contain a coherent explanation for why an entirely new and comprehensive oversight regime is necessary or appropriate. Citing a few instances of service provider failures does not justify imposing a new and far reaching oversight regime. If the Commission believes a new oversight regime of service providers is called for, then it must demonstrate the need for such a regime. The rationale provided in the Proposing Release stands out for its dearth of substance in comparison to the vast oversight regime that is being proposed and lack of a relationship to the specific requirements in the proposed rule.

THE COMMISSION'S SKEWED VIEWS OF OUTSOURCING

While the Commission recognizes some of the benefits of outsourcing, it gives short shrift to these benefits and the need for most investment advisers to outsource at least some functions to third parties. While the Proposing Release contains a robust discussion of the various challenges and risks presented by outsourcing, the Commission's view of such challenges and risks is skewed. For example, proposed rule 206(4)-11 (the "Proposed Rule") under the Investment Advisers Act of 1940, as amended ("Advisers Act") would prohibit an adviser registered with the Commission from retaining a "Service Provider" (as defined in the Proposed Rule) to perform a "Covered Function" (as defined in the Proposed Rule) unless, among other things, before engaging the Service Provider the adviser reasonably identifies, and determines that it would be appropriate to outsource the Covered Function and that it would be appropriate to select that Service Provider. In conducting this analysis, the adviser would be required to examine six factors. One of the factors involves "[d]etermining that the Service Provider has the competence, capacity, and resources necessary to perform the Covered Function in a timely and effective manner." However, the Commission does not consider, either in the Proposed Rule or the Proposing Release whether the adviser itself has the competence, capacity, and resources necessary to perform the Covered Function in a timely and effective manner.[9]

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[6] *Statement on Proposed Rule Regarding Outsourcing by Investment Adviser,* Commissioner Mark T. Uyeda, available at https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622.

[7] *Id.*

[8] *Id.*

[9] An example of the Commission's skewed views on outsourcing can be seen in the following language in the Proposing Release: "There is a risk that clients could be significantly harmed, however, when an adviser

It is surprising that the Commission proposes to adopt a rule on outsourcing without considering the adviser's own competence, capacity, and resources to provide a given Covered Function. By crafting the Proposed Rule in the way it did, the Commission effectively assumes there are greater risks requiring a new oversight regime if an adviser outsources a Covered Function. However, the reality often is that outsourcing is the <u>only</u> viable way of providing a Covered Function. For many Covered Functions, the only real question is which vendor should be selected to provide a Covered Function, since the adviser has no ability to provide a Covered Function itself. The median investment adviser with 8 employees typically does not have the competence, capacity and resources to provide all Covered Functions and will have to outsource at least one or some Covered Functions to a Service Provider. By ignoring this reality, the Proposed Rule is skewed and rests on an assumption that is not accurate for the majority of investment advisers registered with the Commission. For such advisers, the requirement in the Proposed Rule that they determine it is appropriate to outsource the Covered Function makes little sense.

More broadly speaking, the Proposal raises the question of whether it is appropriate for the government to impose its views regarding outsourcing or particular Service Providers on investment advisers. While the information available to the Commission and its staff about investment advisers registered under the Advisers Act is significant (as a result of the information filed under Form ADV, Form PF, Form 13F and other forms filed with the Commission or documents reviewed by Commission staff in the course of examinations), the amount of information filed with the Commission or observed by the staff pales in comparison to the information known to the adviser about its own operations. What will happen if, in the course of a routine examination by the Division of Examinations ("DoE"), the staff comes to believe that a given adviser should not have (i) outsourced a Covered Function or (ii) should not have selected the chosen Service Provider? What happens next?

Will the staff keep its thoughts to itself? Given the tenor and purpose underlying the Proposed Rule, that seems unlikely. After all, what would be the point of the staff examining an adviser regarding its outsourcing activity if it would not share its thoughts with the adviser? That raises the following question: how involved will the staff be in the decision to remove an existing Service Provider and/or hire a new Service Provider? How involved will the staff be in such decisions by investment advisers? If the rule is adopted, should the advisory industry expect the DoE staff to second guess routine business decisions made by investment advisers to outsource Covered Functions or to use a particular Service Provider? The answers to these questions are not clear from the Proposed Rule or the Proposing Release. We submit that the DoE staff is poorly positioned and ill-suited to make these kind of judgments and that it would be improper for the Commission staff to second guess outsourcing decisions made by investment advisers or to

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outsources to a service provider a function that is necessary for the provision of advisory services without appropriate adviser oversight. The risk is <u>in addition to any risks</u> that would exist from the adviser providing these functions." (Emphasis added). For the median investment adviser with only eight employees (see footnote 4 and the accompanying text, supra), the risks associated with outsourcing a complicated operational function to a company specializing in providing that function often are considerably less than if the adviser tried to design, build and operate the requisite infrastructure itself. As noted, for many advisers, outsourcing of certain complicated operational functions is the only viable option. The Commission's assumption that outsourcing involves additional risks than if an adviser tried to design, build and operate a solution itself is at odds with the reality faced by many investment advisers. It makes no sense for the median adviser with eight employees to seek to design, build and operate an in-house solutions so it could itself conduct trade order management, pricing, valuation, reporting, cybersecurity, risk management, portfolio accounting, electronic communications, tax reporting, desk trade communication, trade reconciliation, billing, performance reporting, best execution evaluation, etc. We suspect that most advisers with eight employees would go bankrupt long before they would be able to roll out in-house solutions they designed. In short, in today's modern and highly specialized investment management industry, the Commission's assumption that outsourcing involves additional risks should be turned on its head.

substitute its judgment such matters for the judgment of the investment advisers it examines. And yet if the Commission staff will not assess the outsourcing decisions made by investment advisers under the Proposed Rule and communicate its assessments to advisers, then why examine advisers for compliance with the rule? Why require investment advisers to jump through the various hoops required by the Proposed Rule if the staff will not assess the outsourcing decisions made by investment advisers? Won't the Commission staff have to make such assessments and communicate its conclusions?

It would be one thing if it were clear that the Proposed Rule was intended to ensure that investment advisers have a reasonable process by which to decide whether to outsource Covered Functions and to whom it should outsource such functions. But language in the Proposed Rule and the Proposing Release suggests the Commission staff would examine not only the process used by investment advisers to make outsourcing decisions but the merits of their decisions as well. For instance, among other things, the Proposed Rule would prevent an adviser from outsourcing Covered Functions unless an adviser "reasonably identifies, and determines that it would be appropriate to outsource the Covered Function and that it would be appropriate to select that Service Provider." (Emphasis added) In other words, even if the process utilized by an adviser satisfies the conditions of the Proposed Rule, an adviser would violate the rule if it were to unreasonably determine, in the Commission's view, to outsource a given Covered Function or to select a given Service Provider. Stated alternatively, the language of the rule requires the Commission staff to assess the merits of the outsourcing determinations made by investment advisers in order to conclude whether they are reasonable. Various provisions in the Proposing Release make this point even more clear.[10]

We are concerned that the language of the Proposed Rule and the Proposing Release would cause the Commission staff to assess and second guess the merits of outsourcing decisions made by investment advisers. Contrast the language in the prior paragraph and in footnote 10, supra, with the language of Rule 206(4)-7 under the Advisers Act which provides, in relevant part, that "it shall be unlawful within the meaning of section 206 of the Act (15 U.S.C. 80b-6) for you to provide investment advice to clients unless you . . . [a]dopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act." The merit based evaluation required by the Proposed Rule of advisers stands in sharp contrast to Rule 206(4)-7's focus on the reasonableness of the policies and procedures adopted by the adviser.

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[10] For instance, the first paragraph of the Proposing Release states, among other things, "[i]t would further require advisers to periodically monitor the performance and reassess the retention of the service provider in accordance with due diligence requirements to reasonably determine that it is appropriate to continue to outsource those services or functions to that service provider." (Emphasis added.) Other language in the release provides that "[b]efore engaging a service provider to perform a covered function, the adviser would have to reasonably identify and determine through due diligence that it would be appropriate to outsource the covered function, and that it would be appropriate to select that service provider . . . ." (Emphasis added.) Similarly, the release asserts that "[s]pecifically, the proposed rule would require an adviser to reasonably identify and determine that it would be appropriate to outsource the covered function, that it would be appropriate to select the service provider, and once selected, that it is appropriate to continue to outsource the covered function . . . ." (Emphasis added.) It also states that "[i]n order to continue outsourcing the service or function to the service provider, the adviser should be able to determine reasonably that the outsourcing remains appropriate." (Emphasis added.) As another example, the release provides that "[s]pecifically, an investment adviser would be required to reasonably identify and determine through due diligence that it would be appropriate to outsource the recordkeeping, and that it would be appropriate to select a particular third-party recordkeeper . . . ." (Emphasis added.) It also states that "[i[f adopted, the rule would require such monitoring and reassessment to occur with a manner and frequency such that the investment adviser reasonably determines that it is appropriate to continue to outsource the covered function and that it remains appropriate to outsource it to the service provider." (Emphasis added.)

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It is important to underscore that an investment adviser's fiduciary obligations means it is not "off the hook" if its policies and procedures are reasonably designed. In this respect, the Commission itself notes in the Proposing Release that:

> "Outsourcing a particular function or service does not change an adviser's obligations under the Advisers Act and the other Federal securities laws. In addition, the adviser is typically responsible for the advisory services through an agreement with the client that represents or implies the adviser is performing all the functions necessary to provide the advisory services. An adviser remains liable for its obligations, including under the Advisers Act, the other Federal securities laws and any contract entered into with the client, even if the adviser outsources functions. In addition, an adviser cannot waive its fiduciary duty. Accordingly, an adviser should be overseeing outsourced functions to ensure the adviser's legal obligations are continuing to be met despite the adviser not performing those functions itself."

The Commission also observes in the Proposing Release that "[a]dvisers' fiduciary duty comprises a duty of loyalty and a duty of care, the latter of which includes providing investment advice in the best interest of the client, based on the client's objectives. . . ." Accordingly, the Proposed Rule is not necessary as the existing regulatory framework already governs outsourcing activity.[11]

Accordingly, there is ample protection provided to clients of investment advisers under the existing regulatory framework. There is no need for a merit based rule whereby Commission staff will assess the adequacy of investment advisers' business judgments and potentially overrule or undo their business decisions. The fact that the Commission has successfully brought enforcement actions against investment advisers when they have done a poor job in diligencing or overseeing Service Providers is evidence that the current framework adequately monitors investment advisers' outsourcing activities. The Commission does <u>not</u> claim in the Proposing Release that it does not have the tools needed to police advisers' outsourcing activities. Nor does it claim that outsourcing problems are common or regularly causing substantial harm to clients or investors. Until the day comes when the Commission demonstrates that the existing regulatory framework is hindering its ability to protect the investing public, a change to the existing regulatory framework is unwarranted. And even if such a change were warranted, a prescriptive rule that <u>requires</u> the Commission staff to act as a "merit board" and assess the outsourcing decisions of investment advisers is not appropriate.

THE SCOPE OF THE PROPOSAL

The Proposing Release asserts that "[t]he proposed rule is designed to apply in the context of outsourcing core advisory functions." That is not accurate; unfortunately, the Proposed Rule is much broader than this statement indicates. An investment adviser is defined in Section 202(a)(11) of the Advisers Act as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." A "core advisory function" is therefore a function that enables an adviser to (i) advise others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities or (ii) issue or promulgate analyses or reports concerning securities. Nothing else can fairly be characterized as a core advisory function. Certain of the functions listed in the proposed revisions to Form ADV that are viewed by the Commission as being Covered Functions, such as client servicing, cybersecurity, portfolio accounting, reconciliation, regulatory compliance clearly fall outside the plain meaning of "core advisory function."[12] None of these examples involve the

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[11] Moreover, as noted, Rule 206(4)-7 under the Advisers Act already requires investment advisers' policies and procedures to be reasonably designed to prevent violations of the Advisers Act and the rules thereunder.
[12] Other items listed in the proposed amendment to Form ADV also may not be a core advisory function.

provision of investment advice – they are therefore not a core advisory function.[13] That is not to say these functions are not critical to the continued operation of an investment adviser - they clearly are – but if the touchstone of the Proposal is a "core advisory function," as the Commission asserts it is, then it is important to recognize that the scope of the Proposal is not consistent with the stated aims of the Commission.

If the Commission nonetheless believes is critical for the functions set out above to be captured by the Proposed Rule, then it needs to be forthright and acknowledge that it intends for the Proposed Rule to apply to services that are ancillary (but important) to core advisory functions, such as client servicing, cybersecurity, portfolio accounting, reconciliation, and regulatory compliance. Otherwise, the Commission risks losing credibility and having a rule that will cause a lot of confusion. As just one small example, if the items listed in proposed Form ADV are considered by the Commission to be "core advisory functions," then General Instruction 3 of Form ADV,[14] together with Item 4 of Part 2A of Form ADV,[15] would require each investment adviser registered with the Commission to provide full and fair disclosure of its provision of such services, including its provision of client servicing, cybersecurity, portfolio accounting, reconciliation, and regulatory compliance services. By characterizing such ancillary services (some of which are, in fact, middle office, back office or operational services[16]) as "core advisory services" the Commission has, in a single stroke, materially changed the disclosure obligations of investment advisers such that a failure to provide full and fair disclosure of client servicing, cybersecurity, portfolio accounting, reconciliation, and regulatory compliance practices (and the like) would constitute a material omission under the instructions of Form ADV and a violation of the anti-fraud provisions of Section 206 of the Advisers Act. Of course, disclosure of things such as portfolio accounting would be of almost no interest to most clients and prospective clients and are hardly material to the decision of whether to hire or retain an investment adviser. Including disclosure of such activities in Part 2A brochures would not provide useful information or help clients or prospective clients in any way – it would merely obscure information in the brochure that actually is important to clients. And yet, the Commission's Proposal, including its characterization of such services as "core advisory services," would obligate advisers to include such disclosure in their brochures. We submit that such a result would do nothing to further investor protection and would instead reduce the utility of Form ADV Part 2A brochures.

The foregoing discussion makes clear that the scope of the Commission's proposal is too broad since it captures various activities that are not central to the provision of investment advice. Functions such as client servicing, cybersecurity, portfolio accounting, reconciliation, and regulatory compliance are not core to the advisory services provided by investment advisers and

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[13] The fact that the Commission needed to include a statement that a Covered Function does not include things like utility services proves this point; but for this statement, the Commission's proposed definition would capture utility services.

[14] Instruction 3 of Form ADV Part 2A provides, in relevant part, as follows:

"Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them. To satisfy this obligation, you therefore may have to disclose to clients information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require." (Emphasis added).

[15] Item 4.B of Form ADV Part 2A requires, in relevant part, investment advisers to "[d]escribe the types of advisory services you offer."

[16] This reality will cause confusion in the advisory industry since no adviser we have ever worked with views functions such as servicing, cybersecurity, portfolio accounting, reconciliation or regulatory compliance as constituting core advisory functions.

should not be captured by the rule: only those functions that relate to the provision of investment advice should be captured. As one Commissioner has observed, "[m]any functions or services that do not relate to an adviser's investment advisory function nonetheless are necessary for the adviser to provide its investment advisory services in compliance with the federal securities laws. Therefore, under a technical reading of the proposed definition of "Covered Function," almost any function outsourced by an investment adviser could trigger the numerous oversight functions set forth in the proposed rule."[17]

VIOLATIONS OF THE RULE SHOULD NOT BE DEEMED VIOLATIONS OF SECTION 206(4) OF THE ADVISERS ACT

The Proposed Rule would be promulgated under Section 206(4) of the Advisers Act, which prohibits an adviser from engaging in "any act, practice, or course of business which is fraudulent, deceptive, or manipulative." We believe such an approach would be ill-advised. Adopting the proposed oversight regime in reliance upon Section 206(4) of the Advisers Act means that if an adviser fails to strictly follow any of the required elements or is deemed to have made an unreasonable determination, the adviser could be deemed to have engaged in fraudulent, deceptive, or manipulative conduct. This would be the case even if the adviser's outsourcing policies and procedures were reasonably designed and even if the adviser was diligent in following those procedures. A finding of a violation under Section 206(4) could be catastrophic to an investment adviser; such severe consequences would be disproportionate as compared to the failure of such an adviser. Imposing a prescriptive Service Provider oversight regime as part of an anti-fraud rule is inappropriate. As one Commissioner opined,

> "Even were I in favor of specific requirements regarding outsourcing, I would have concerns about promulgating them under section 206(4) of the Investment Adviser Act . . . While the release states that it is being adopted as a "means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business," the release also seems to suggest that departing from the proposed requirements would itself be deceptive. An adviser need not engage in a fraudulent, deceptive, or manipulative act, practice, or course of business to fall afoul of the rule, but any resulting enforcement charges likely will include section 206(4), which could lead people to believe that the adviser has engaged in much more nefarious conduct." (Emphasis added.)

Minor violations of the Proposed Rule for failing to follow a particular requirement would be deemed to involve fraud even if there is no material weakness in an adviser's oversight of a Service Provider or client harm. This point is particularly important given the high risk of technical violation that stems from the challenging nature of some of the proposed requirements. As an example, it would appear that an adviser's failure to identify a subcontracting arrangement that would be material to the Service Provider's performance of a Covered Function would violate the rule and therefore result in a Section 206(4) violation. That would be an unfortunate result because it is utterly disproportionate to the adviser's failure, especially if it is due to a lack of transparency on the part of the Service Provider.

The foregoing highlights that under the Proposed Rule an adviser might be subject to a claim of fraud even if it has well-designed policies and procedures and has acted reasonably to implement such policies and procedures. The Proposed Rule thus effectively creates a standard of strict liability for investment advisers that use Service Providers to provide Covered Functions. Such a result would not protect clients of the adviser or the investing public and would adversely impact the advisory industry, particularly advisers that, by necessity, have no choice but to outsource services that the Commission proposes to include within the definition of Covered

[17] *Statement on Proposed Rule Regarding Outsourcing by Investment Adviser,* Commissioner Mark T. Uyeda, available at https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622.

Function. A failure to follow a prescribed element of the rule, by itself, should not result in a claim of fraud.

In this respect, our clients are very concerned that the Commission staff will assess an adviser's compliance with any final rule that is adopted by playing 'Monday morning quarterback.' One concern is that the staff will conclude that an adviser conducted insufficient due diligence whenever a Service Provider fails to satisfy a given regulatory or contractual obligation or makes a mistake. A related concern is that there is no way for an adviser to be confident that it has done enough to comply with the Proposed Rule. One consequence that flows from this concern is that the Proposed Rule will have a significant impact on the market for outsourced services and the relationships investment advisers have with Service Providers. The process of hiring and reviewing Service Providers will become much more cumbersome and involve significantly more friction and expense.

Finally, we are concerned that the Commission has not sufficiently considered the impact on investment advisers that are themselves performing Covered Functions for other investment advisers and that will thus become subject to more extensive and frequent due diligence requests in the future. The challenge for these advisers relates to the volume of due diligence requests they will receive. As the industry has moved to "open architecture" platforms in recent years, many investment advisers that serve as portfolio managers or model providers for investment strategies have sought to have their strategies and/or model portfolios available on as many investment advisory programs and platforms as possible. Similarly, sponsors of investment advisory programs (*e.g.,* SMA, UMA and wrap-fee programs) and turn-key asset management platforms (commonly referred to as "TAMPs") have sought to increase the number of third party retail firms using the advisory programs available through the TAMP. The result is that it will not be unusual to have dozens (or in certain cases, hundreds) of investment advisers conducting due diligence simultaneously on a given portfolio manager, model provider, investment advisory program sponsor or TAMP (collectively, "Platform Advisers").

Each investment adviser conducting due diligence on a Platform Adviser will have its own questions and its own list of documents it wants to review; while there will be a large amount of duplication across requests,[18] there will also be a significant amount of unique requests. Managing extensive due diligence requests under the Proposed Rule from dozens or hundreds of investment advisers will create its own set of risks that the Commission should consider in connection with the Proposal. With dozens or hundreds of investment advisers conducting due diligence on Platform Advisers, it is inevitable that the Platform Advisers will be asked to provide sensitive or confidential information, such as internal work product, information about investment management decisions and decision making process and criteria, securities transactions, trade data, client data (including personally identifiable information), material non-public information, cybersecurity vulnerabilities, cybersecurity protections and fixes, preferred and recommended lists of securities, investment and buy/sell criteria, proprietary research, evaluations of broker-dealers and trading centers, pricing information, information about personnel, information about future business plans, information about examinations and investigations conducted by regulatory authorities, the results of mock audits and third party audits, financial information, policies, procedures, confidential audit reports etc. The nature and amount of information requested will vary, but it is fair to conclude that the type and amount of information requested under any final rule will, on the whole, be much more extensive, confidential and proprietary in nature than what is typically requested or provided today, due to the regulatory pressures and risks that advisers

[18] Such duplication raises the question of whether and how advisers can rely on due diligence efforts conducted by other investment advisers or other third parties. Should the Commission adopt a final rule, it would be important for it to explicitly note that investment advisers do not need to repeat due diligence efforts conducted by others so long as reliance on the due diligence efforts of others is reasonable under the circumstances (e.g., there is no indication that the due diligence conducted by a third party rests on faulty information or ignores information that raises red flags).

conducting due diligence will face under any final rule that is substantially similar to the Proposed Rule.

Likewise, the Platform Advisers will be under tremendous pressure to appease retail advisers conducting due diligence and to provide the information that is requested of them (including information of the type referenced in the prior paragraph). In fact, some advisers are already considering whether they will need to adjust their privacy notices (and corresponding practices) to disclose that confidential information may be provided in response to due diligence requests under the Proposed Rule. As a result, the enhanced due diligence required under the Proposal will create its own set of risks. It also will change the dynamics of the relationships between retail advisers and Platform Advisers and add a substantial amount of friction and cost to the process of hiring and monitoring Platform Advisers.

THE PROPOSAL CREATES SIGNIFICANT INTERPRETIVE ISSUES

The Proposal raises various interpretive issues that are central to the Proposed Rule. Unfortunately, the Proposed Rule is rather vague in a number of important respects. For instance, the scope of the definition of "Covered Function" is unclear. It is hard to know where the line is that turns an outsourced function into a Covered Function. It is simply too hard to distinguish between outsourced functions that fall within the two prongs of the Commission's proposed definition of Covered Function and those that fall outside this definition. As noted above, one Commissioner has already observed that "almost any function outsourced by an investment adviser could trigger the numerous oversight functions set forth in the proposed rule."[19] The challenge facing advisers is that that almost any vendor used by an investment adviser will meet the definition of Covered Function. This is because almost any vendor used by advisers provides 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. The reality is that the Commission's definition does not filter out many types of vendors. If almost any vendor used by an investment adviser fails to provide its services properly, it could have a material adverse impact on the adviser's ability to provide its advisory services; this conclusion is, in part, a result of the Commission's incredibly broad view of what constitutes a "core advisory function," as discussed above. The result is that almost any vendor supporting an adviser's business would seem to relate to an adviser's advisory function (as Covered Function is proposed to be defined by the Commission).

It is also worth noting that because the definition of "Covered Function" will be determined in the context of an examination or investigation by the Commission staff, advisers will likely construe the term broadly out of fear of being second guessed. The result will be that, in practice, the definition of Covered Function will serve little purpose and almost all vendors used by investment advisers will effectively need to be treated as providing a Covered Function.

Similarly, because the definition of "Service Provider" is based on the definition of "Covered Function," it too suffers from the same deficiencies. As proposed, the term "Service Provider" would include certain affiliates that provide certain shared services to the adviser (and potentially other companies within the family) or that operate as part of a single organization but are organized as separate legal entities. The proposed definition also includes other Commission registrants, such as broker-dealers and investment advisers, and financial institutions that are highly regulated by other federal or state regulators, such as broker-dealers, banks, credit unions and insurance companies. Adding an additional overlay of regulation to such registrants would provide little benefit. We do not believe that including the foregoing entities within the scope of the Proposal is warranted, particularly when the Commission's justification for the rule is so thin

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[19] *Statement on Proposed Rule Regarding Outsourcing by Investment Adviser,* Commissioner Mark T. Uyeda, available at https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622.

and the benefits of the rule so amorphous. This is especially true for Commission registered entities, such as broker-dealers and investment advisers that are already subject to the Federal securities laws and to Commission oversight and examination.

THE PROPOSAL CREATES RISKS FOR INVESTMENT ADVISERS AND WILL CAUSE ADVERSE, UNINTENDED CONSEQUENCES

The Commission's Proposal creates the potential for adverse unintended consequences. Because (i) the Proposed Rule would create a burdensome oversight regime for investment advisers that outsource Covered Functions and (ii) the Commission effectively assumes such risks do not exist if an adviser itself carries out the Covered Functions, if the rule is adopted there is a significant risk that certain investment advisers will seek to provide certain functions themselves.[20] If that were to occur, then the clients of such investment advisers may end up being worse off than they would have been had the advisers continued outsourcing activities and functions to Service Providers that specialize in, and have experience in, providing one or more Covered Functions. As one Commissioner has stated, "[f]orcing strapped smaller advisers to DIY functions perhaps better performed by third parties is a recipe for investor harm, not investor protection."[21]

The Proposal is primarily geared at risks associated with the conduct and/or omissions or failures of Service Providers that provide services and functions to investment advisers and/or their clients. In determining how to respond to these risks, the Commission faced a dilemma – many Service Providers are not regulated by the Commission. Given this reality, the Commission has sought to address the actions and omissions of Service Providers and impact their behavior by crafting a rule that shifts liability for their inappropriate or negligent acts or omissions to those entities (*i.e.*, investment advisers registered or required to be registered with the Commission) over which it does have jurisdiction. Putting aside that the Commission's justification for proposing a new regulatory regime for the advisory industry rests on a few isolated examples in which Service Providers did not properly fulfil their functions and were not diligently overseen by investment advisers, the rule is structured to target investment advisers, in the form of examinations, investigations, claims of fraud and resulting sanctions, for the acts and omissions of third party Service Providers.

What makes the structure of the Proposed Rule so dangerous for investment advisers is that, as discussed above, it effectively creates a standard of strict liability. Unfortunately, there are provisions built into the rule text itself (and additional language in the Adopting Release) that increase the risk of violations by advisers and exacerbate the risks they face. For instance, the proposed due diligence provision would require an adviser to obtain reasonable assurance from a service provider that it is able to, and will, coordinate with the adviser for purposes of the adviser's compliance with the Federal securities laws, as applicable to the Covered Function. In describing this obligation the Commission in the Adopting Release states that:

> "[an] adviser may wish to consider obtaining written assurances or written representations from the service provider that it is aware of the adviser's obligations under the Advisers Act, and that it will assist the adviser, as applicable, in complying with its obligations as a fiduciary. For additional clarity, the adviser may wish to consider articulating specific responsibilities of the service provider in relation to assisting the adviser to comply with its legal obligations. . . . Such an adviser may want to obtain assurances or representations from the service

[20] It is also important to note that the Commission would, in effect, be revising the economics of outsourcing and thus changing the calculations advisers conduct in deciding whether to outsource a given function or to build and carry out the function itself. In other words, the government would be modifying the market for outsourced services, something that should not be tinkered with without substantial and irrefutable support. However, as noted above, we submit that the Commission's justification for the rule is rather insubstantial.

[21] *Outsourcing Fiduciary Duty to the Commission: Statement on Proposed Outsourcing by Investment Advisers*, Commissioner Hester Peirce, available at https://www.sec.gov/news/statement/peirce-service-providers-oversight-102622.

provider that it has sufficient knowledge of the adviser's business such that the adviser's Form ADV will be accurate and contain all required disclosure."

It is hard to imagine a Service Provider would be willing to revise its template service agreement to enable an adviser to satisfy the proposed reasonable assurance due diligence requirement. Doing so would introduce liability and risk for the Service Provider, including potential liability for aiding and abetting a fraud. Not to mention that agreeing to such terms would substantially increase the Service Provider's own costs. As noted above, the median investment adviser has eight employees. It is not realistic to think that such an adviser is going to successfully negotiate the types of terms envisioned by the Commission. In our experience, most vendors are not willing to negotiate the terms of their agreements with investment advisers, particularly in instances where the vendors are large companies with many clients. And in those instances in which a given Service Provider is willing to agree to the terms described by the Commission, it would seem evident that the Service Provider would do so only on the condition that the adviser pay increased expenses to the Service Provider, which may end up being passed on to the adviser's clients.

The outcome will be that this prescriptive requirement will have little chance of being implemented, which, in turn, means that most advisers will not be able to comply with the Proposed Rule. Looked at from a broader perspective, it is odd for the Commission to seek to micromanage the manner in which an adviser seeks to comply with the anti-fraud provisions of the Advisers Act. We urge the Commission to instead let investment advisers determine the best way for them to oversee their Service Providers. If an adviser acts unreasonably and fails to effectively oversee an important Service Provider, the Commission already has the tools it needs to sanction the adviser. Imposing prescriptive requirements on advisers to affect the conduct of third party Service Providers is unlikely to be effective in achieving the Commission's goals.

While many in the industry have recognized the burden the Proposal will create for small investment advisers, the implications, costs and resources needed for large investment advisers to comply with the Proposal will be enormous. In addition to the controls, procedures and processes that will need to be implemented, large firms will need to make significant systems and technology changes. In connection with such changes, significant technology development will be required. Substantial time and resources will be needed to ensure such technology development is well designed, constructed, tested and implemented and to ensure that systems and technology changes do not have material adverse effects on ancillary systems and processes. These changes cannot be rolled out quickly. Given the scope of the Proposal and the anticipated amount of programming changes that would be required to comply with the Proposed Rule, some of our clients will need over twenty four months to comply with a final rule.

WHEN A SERVICE PROVIDER IS ANOTHER ADVISER

In several places in the Proposing Release, the Commission asks for comment as to whether the various components of the Proposed Rule should apply to investment advisers. As noted, we believe the Proposed Rule should not apply if the Service Provider is another investment adviser that is registered (or required to register) with the Commission. Like any other investment adviser registered with the Commission, Service Providers that are registered under the Advisers Act are fiduciaries to their advisory clients and are subject to the Advisers Act and the rules thereunder, including Rule 206(4)-7 thereunder. Accordingly, they must adopt and implement policies and procedures reasonably designed to achieve compliance with the Advisers Act and the rules thereunder. In addition, they are subject to examination and inspection by the Commission staff and to sanction by the Commission should they fail to satisfy their fiduciary or other obligations under the Advisers Act which, of course, includes the duty of care and the duty of loyalty. These obligations and the level of transparency the Commission (as well as other advisers that use their services) has as to their activities reduce the risk to the public and the benefit of subjecting such advisers to the Proposed Rule.

If notwithstanding the foregoing, the Commission decides not to exclude from the Proposed Rule investment advisers that serve as Service Providers, then the Commission should

explicitly note that the due diligence and monitoring obligations arising under the Proposed Rule should follow any contractual arrangements agreed to between the parties. The Proposing Release already notes that

> "The proposed rule also requires that service provider due diligence be conducted "reasonably." This would mean an adviser's due diligence must reasonably be tailored to the function or services that would be outsourced and to the identified service provider. An adviser's analysis of a specific service provider's competence, capacity, and resources generally would not require boundless analysis or the identification of every conceivable risk of outsourcing, but must be reasonable under the facts and circumstances. The proposed rule is intended to allow registrants to tailor their due diligence practices to fit the nature, scope, and risk profile of a covered function and potential service provider. . . .
>
> 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.
>
> What is included in "nature and scope" under the proposed rule would vary depending on the facts and circumstances, and the level of detail should reasonably reflect relevant factors such as the nature, size, and complexity of the covered functions involved."

Building on this guidance, the Commission should explicitly note that the level of due diligence and monitoring should be based on the nature of the services contracted for and the allocation of responsibilities contractually agreed to by an investment adviser and another investment adviser (or other third party) utilized as a Service Provider.

While the foregoing principle is relatively straightforward, it can be difficult to apply in multi-adviser scenarios. In this respect, the Proposing Release addresses a relatively simple adviser/sub-adviser scenario whereby an investment adviser hires a sub-adviser as a Service Provider to discretionarily manage all or a portion of the portfolios of clients of the adviser. It is less clear how the Commission's Proposal would work in a more complex scenario, such as when a retail adviser ("Adviser 1") hires a Platform Adviser as a Service Provider ("Adviser 2") to make available on Adviser 2's advisory platform, third party sub-managers and model providers that can be selected by Adviser 1 for Adviser 1's retail clients. In this scenario, Adviser 1 and Adviser 2 have allocated responsibilities so that Adviser 1 selects third party sub-managers and model providers for its clients from a menu of sub-managers and model providers created and maintained by Adviser 2. In putting together the menu of available sub-managers and model providers, Adviser 2 typically creates and distributes research on the sub-managers and model providers to Adviser 1. Typically, the contract between Adviser 1 and Adviser 2 delegates responsibility for selection of the sub-managers and model providers for clients of Adviser 1 to Adviser 1. How would this structure impact the due diligence and monitoring responsibilities of Adviser 1 and Adviser 2? Would anything change if the contract between Adviser 1 and Adviser 2 explicitly provided that Adviser 1 is responsible for conducting its own due diligence of the sub-managers and model providers Adviser 1 selects from the menu made available by Adviser 2? Would it matter if the contract between the 2 advisers states that the research provided by Adviser 2 to Adviser 1 is provided for information purposes only? What if the contract explicitly limits Adviser 2's responsibilities to ensuring that the information it provides on the sub-managers and model providers is accurate? Would the analysis change if Adviser 2 also provides recommendations of the sub-managers and model providers it makes available on its platform or creates a "select list" of sub-managers and model providers for the various asset classes and investment styles comprising a portfolio?

The foregoing illustrates that the principles in the Proposal may not be easy to apply in practice for many investment advisory arrangements and programs. And the scenario described above often is more complex; as a simple example, Adviser 1 (or the client) may also hire a

different adviser to serve as an "overlay manager" of the portfolios managed in accordance with the advice provided by the sub-managers and model providers. And the overlay manager may have authority to override the investment decisions made by any particular sub-manager or the model allocation advice provided by a particular model provider. Has the Commission considered how its rule would apply when investment advisory responsibilities are spread out over multiple advisers?

THE DANGERS CREATED BY THE RIGIDITY OF THE PROPOSED RULE

The proposed rule is too rigid because it does not take into account the fact that certain events may require an investment adviser to take immediate action. Question 36 in the Proposing Release asks, among other things, if there should be an exception for emergencies from the requirement to conduct due diligence before a Service Provider is engaged. Yes, of course there needs to be such an exception. If an adviser needs to terminate a Service Provider because of poor service, a breach of contract, a cybersecurity attack, loss of key personnel, an interruption in business continuity, a pending bankruptcy, an operational problem, a regulatory violation or some other material adverse event, it may need to hire an alternate Service Provider immediately. In such a scenario, the need to diligence a replacement Service Provider needs to be balanced against the need to provide as smooth a transition as possible as quickly as possible and it may not be possible to complete the due diligence or to even make significant headway in conducting due diligence before the replacement Service Provider is engaged. Requiring the adviser to conduct all of the due diligence before the replacement Service Provider is engaged will be tantamount, in many cases, to requiring the adviser to breach its duty of care. If the adviser hires a new Service Provider immediately in order to prevent a loss of advisory service to its clients, it will violate the Proposed Rule (by failing to requirement to conduct due diligence before a Service Provider is engaged) and will be deemed to have committed fraud. If it waits to hire a new Service Provider until the due diligence is conducted, it may not be able to provide advisory services to its clients for an extended period of time and it will be in breach of its duty of care and its investment management agreements and its clients could be materially and irreparably harmed. Either way, the adviser will have violated its fiduciary obligations to its clients. The Proposed Rule should not force advisers to make such a Hobbesian choice.

In many cases it simply will not be possible to complete the requisite due diligence for some period of time (and potentially for an extended period of time if the outsourced activity is complex). In such circumstances, if there is no exception for emergencies then the risk of an adviser concluding it cannot act quickly to help its clients (because doing so would trigger an enforcement action under the Proposed Rule) increases greatly if the risk of an enforcement action comes with the risk of a fraud charge. In such instances, an adviser could be wise to think the best course of action is to cease terminate an advisory relationship the moment it realizes there is no way for it to proceed without being deemed to have violated its fiduciary obligations under the Advisers Act. While such an outcome may be horrendous for the adviser's clients, that would be a logical decision for an adviser that finds itself in that situation. Another unfortunate consequence of not building in an exception for emergencies is that it incentivizes advisers to continue with a poorly performing or deficient Service Providers for a longer period of time than it otherwise would due to the need to complete the due diligence of a replacement Service Provider before firing the existing Service Provider.[22]

We believe the foregoing considerations demonstrate that the Proposed Rule, as currently formulated, is too rigid and fails to take account of some of the challenges advisers face in servicing

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[22] We believe similar considerations dictate "yes" answers in considering the first two questions posed in question 48 of the Proposing Release ("Are there circumstances in which an adviser might determine that abrupt termination was reasonably necessary to protect clients? If so, should the provision requiring obtaining reasonable assurance for orderly termination of the performance of a covered function be revised to permit advisers to exercise their judgment in such cases?").

clients. The dangers of such rigidity and the problems created by not having an exception for emergencies are greatly amplified if the rule is adopted under Section 206(4) of the Advisers Act.

MISCELLANEOUS COMMENTS

If adopted, the SEC should provide a 24-month compliance and transition period. The Commission underestimates the impact of the Proposed Rule on the investment advisory industry. This rule changes will force certain investment advisers to wind down their business. Others will be forced to revise their outsourcing arrangements. Many advisers will have to significantly revise their policies, procedures, contracts and practices. The scope of the changes that will be required dictates a compliance period of two years.

We also note that the short comment period for the Proposal during the holiday season did not provide an appropriate amount of time to evaluate and comment thoroughly on the Proposal. The short comment periods made it challenging for commenters to provide meaningful and thoughtful comments, which will harm the effectiveness of any final rule that is adopted.

Sincerely,

Michael Koffler

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