December 20, 2022

Via Electronic Mail (rule-comments@sec.gov)

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

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

Dear Ms. Countryman:

The Loan Syndications and Trading Association ("LSTA")[1] writes today to convey its serious concerns with the rule proposed by the U.S. Securities and Exchange Commission ("SEC" or "Commission") under the Investment Advisers Act of 1940 ("Advisers Act") regarding the outsourcing of services by investment advisers ("Proposal").[2] The Proposal would establish a prescriptive antifraud rule governing the standards and methods used by investment advisers to evaluate and contract with certain service providers, as well as corresponding disclosure and recordkeeping requirements. We strongly urge the Commission to reconsider or withdraw the Proposal and reevaluate its rushed approach to this rulemaking, which we believe has adversely impacted the quality of the Proposal and will adversely affect the quantity and quality of industry feedback on the Proposal.

I. Introduction

The LSTA recently joined several other financial industry trade associations in submitting a comment letter expressing its concerns regarding the Commission's unreasonably short comment periods for this Proposal and other proposed rules.[3] The Commission has provided only 30 days for industry comment on the Proposal. As a result of the short comment period for the Proposal

[1/] The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trade of commercial loans. The 575 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty. For more information, visit www.lsta.org.

[2] Outsourcing by Investment Advisers, 87 Fed. Reg. 68816 (Nov. 16, 2022) ("Proposing Release").

[3] Letter to Vanessa A. Countryman, Secretary, SEC, from Elliot Ganz, General Counsel and Co-Head Public Policy, LSTA, et al., *Re: Management Programs and Swing Pricing, Form N-PORT; Outsourcing by Investment Advisers; File Nos. S7-26-22, S7-25-22; RIN 3325-AM98; RIN 3235-AN18 (November 2, 2022), (October 26, 2022)* (Nov. 16, 2022), *available at* https://www.sec.gov/comments/s7-26-22/s72622-20150876-319897.pdf.

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and the flood of additional complex rule proposals from the Commission, we are not in a position to submit our own detailed cost-benefit analysis at this time. We reiterate here the concerns expressed in the joint trade associations letter and again request a reasonable comment period. We expect the Proposal, if adopted, would have a far-reaching impact on investment advisers and service providers alike. A proposal as sweeping as this demands greater consideration.

As we describe below, the Proposal has potential consequences that could upend the current operating model for how investment advisers, including the more than 200 investment advisers involved in the institutional commercial loan market which manage over $2 trillion of loans, utilize and oversee service providers. While the Proposal introduces new problems and complications, it does not identify any existing problem giving rise to the need for a rule. It does not adequately contemplate the processes by which advisers already assess service providers within the contours of their fiduciary duty to clients or how advisers' processes may vary based on differing circumstances. Nor does it account for existing arrangements between advisers and service providers.[4] Instead, the Proposal would establish overly prescriptive, complex requirements for what an investment adviser must do to vet and monitor its service providers. The Proposal also introduces significant uncertainty through a new antifraud rule that incorporates subjective standards vulnerable to second-guessing at every turn by examiners and enforcement staff.

We firmly believe that the Proposal will introduce significant costs and risks for advisers and investors without a corresponding benefit. Moreover, based on conversations with our members, we believe that the Commission's cost-benefit analysis <u>significantly understates</u> the costs of the Proposal. The Commission therefore should reconsider or withdraw the Proposal.

II. Comments

A. The Proposal is a solution in search of a problem.

Investment advisers' existing regulatory obligations already provide a framework sufficient to manage risks relating to their service provider arrangements. There is no identified problem that the Proposal would solve—even where the Commission has identified risks in the Proposing Release, it is unclear how the Proposal would address them. Unlike the Proposal, the existing framework provides investment advisers with the necessary flexibility to tailor their vendor management processes to their own business needs. In contrast, the Proposal would require investment advisers to adopt a more expensive and more complex approach than may be necessary and would increase costs but does not appear to enhance investor protection. By taking a prescriptive instead of a principles-based approach, the Proposal also increases enforcement risk for failing to adhere to specific processes, regardless of whether such processes are necessary or

[4] Indeed, the Proposal will impose significant costs and new burdens on industry service providers, which are outside of the Commission's jurisdiction and, in most cases, likely are not even aware of the Proposal. As a result, their interests are likely to be absent or underrepresented in the Proposal's comment record.

appropriate considering the nature of the outsourced relationship. The Commission could have achieved the same degree of investor protection by issuing general guidance regarding outsourcing and oversight of service providers.

The Proposing Release makes several general observations regarding investment advisers' use of service providers and identifies only a handful of examples of conduct that the Commission identified as problematic. The Commission points to the mere potential for service provider disruptions and certain recordkeeping issues as primary reasons for the Proposal and summarily concludes that "despite the existing legal framework regarding the duties and obligations of investment advisers, more needs to be done to protect clients and enhance oversight of advisers' outsourced functions."[5] It is not evident to us that investment advisers are not doing enough for their clients with respect to outsourcing to service providers, and it is even less evident that the Proposal would improve client outcomes. Moreover, the specific examples proffered by the Commission involved independent violations of the adviser's existing duties, calling further into question why the Proposal is needed.[6] Indeed, the settlement orders cited in the Proposing Release make it quite clear that the Commission already has the ability to pursue enforcement against investment advisers for failures relating to outsourcing to service providers.

Nor is the Proposal additive to investor protection. Advisers already have a fiduciary duty to act in their clients' best interests; this duty does not simply disappear when delegating to a service provider.[7] The existing Compliance Rule,[8] which requires policies and procedures reasonably designed to ensure compliance with the requirements of the Advisers Act (including fiduciary obligations), already is sufficient to address the Commission's concerns relating to service provider vetting. Based on existing rules, many advisers already maintain sophisticated review processes for service providers, which are tailored to their specific businesses and would be disrupted by the imposition of the Proposal. The Proposal would establish costly prescriptive

[5] Proposing Release at 68819.

[6] *See, e.g.*, In the Matter of Morgan Stanley Smith Barney LLC, Investment Advisers Act Release No. 6138 (Sept. 20, 2022); In the Matter of Pennant Management, Inc., Investment Advisers Act Release No. 5061 (Nov. 6, 2018); In the Matter of Aegon USA Investment Management, LLC, et al, Investment Advisers Act Release No. 4996 (Aug. 27, 2018); In the Matter of AssetMark, Inc. (f/k/a Genworth Financial Wealth Management, Inc.), Investment Advisers Act Release No. 4508 (Aug. 25, 2016); In the Matter of Virtus Investment Advisers, Inc., Investment Advisers Act Release No. 4266 (Nov. 16, 2015).

[7] *See, e.g.*, Proposing Release at 68819 ("[a]n 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"); SEC Division of Examinations, *2022 Examination Priorities* (Mar. 30, 2022), at 17, *available at* https://www.sec.gov/files/2022-exam-priorities.pdf ("EXAMS will review [adviser] compliance programs to examine whether they address that … oversight of service providers is adequate…."); *Evolving Compliance Environment: Examination Focus Areas*, 2009 CCOutreach Regional Seminars (Apr. 2009), at 9, http://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf ("when a service provider is utilized, the adviser still retains its fiduciary responsibilities for the delegated services. As a result, advisers should review each service provider's overall compliance program for compliance with the federal securities laws and should ensure that service providers are complying with the firm's specific policies and procedures.").

[8] 17 C.F.R. § 275.206(4)-7.

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requirements that provide neither the protections the Commission seeks nor the flexibility for advisers to determine how to act in their clients' best interests consistent with their unique business models. The Proposal would force advisers into taking an approach that may not make sense for their business or the outsourced relationship and may require unnecessary additional steps.

If the Commission insists on moving forward with the Proposal, the rule should be more principles-based. A principles-based approach allows for flexibility and innovation in serving business needs in a manner that is consistent with an adviser's fiduciary duty. The Commission has recognized the merits of such an approach in serving the diverse needs of advisory businesses, including in the Compliance Rule itself.[9] Advisers and service providers should not be required to fulfill requirements that are superfluous or inapposite.

B. An antifraud rule is not an appropriate mechanism to regulate investment adviser outsourcing and vendor management, and the rule is too prescriptive.

The Proposal would create a new antifraud rule to address investment adviser vetting and oversight of service providers. This approach is inappropriate for rules pertaining to managing service providers. Additionally, the Proposal contains numerous interpretive questions that would make the rule challenging for advisers to apply. The ambiguity present in the Proposal fails to provide adequate notice to advisers of what is required—a critical problem in the context of an antifraud rule due to the collateral consequences of an antifraud violation.

Vague standards for what is a "covered function" and the appropriate level of due diligence and monitoring would allow Commission examinations and enforcement staff to second-guess advisers' decisions. The definition of "covered function" is unclear and is made less clear by the examples in the Proposing Release. The Proposing Release identifies certain examples that do not appear to involve "covered functions," such as a moving and storage company, as relevant service provider failures supporting the Proposal.[10] Further, each of the six steps in the due diligence process would require subjective judgments by the adviser regarding materiality or reasonableness. Each is an opportunity for the Commission or Commission staff to disagree with the adviser's assessment. We are unsure what actions would satisfy the requirement to "mitigate and manage potential risks" of using the service provider, much less the risks associated with the service provider's subcontracting arrangements.[11] Similarly, we are concerned that any failure or disruption that occurs with respect to the termination of a service provider or coordination with a service provider regarding compliance with the federal securities laws will lead to a conclusion that the adviser must have failed to obtain reasonable assurance with respect to these issues in

[9] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669, 33671 (July 12, 2019) ("In our experience, the principles-based fiduciary duty imposed by the Advisers Act has provided sufficient flexibility to serve as an effective standard of conduct for investment advisers, regardless of the services they provide or the types of clients they serve.").
[10] *See* Comm'r Mark T. Uyeda, *Statement on Proposed Rule Regarding Outsourcing by Investment Advisers* (Oct. 26, 2022), https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622.
[11] Proposing Release at 68878.

violation of the proposed antifraud rule.[12] This uncertainty could lead to a strict liability standard for the adviser whenever a service provider commits an error. Even if the adviser followed the rule, we expect that the Commission would need to scrutinize the adviser's decisions in the many procedural steps required by the Proposal to determine whether a violation occurred.

With so much room for interpretation, potential antifraud violations for minor infractions would be a constant threat to advisers who outsource services. Antifraud violations have significant collateral consequences—those found to have violated (or who have settled to) antifraud violations find themselves faced with fines, disclosures, and statutory disqualification, restricting their ability to participate in capital markets, that would not be appropriate for "foot faults" and technical violations of the Proposal's many requirements.

C. The Proposal seeks to regulate indirectly entities outside the Commission's jurisdiction.

While Congress granted the Commission jurisdiction over investment advisers, the Commission does not possess independent jurisdiction over most of the service providers described in the Proposing Release. The Proposal seemingly asserts that the Commission's jurisdiction should reach service providers, even when they do not provide investment advice, by virtue of the fact that their service is utilized by a registered investment adviser. The Proposal would seek to require these service providers to comply with prescriptive requirements in connection with servicing the investment adviser industry. Service providers that are deemed to provide covered functions would have to agree to submit themselves and their subcontractors to a significant amount of due diligence and monitoring, develop new processes to assist advisers in complying with the proposed rule, and provide various assurances regarding their ability to coordinate with the adviser for purposes of complying with the securities laws and orderly termination of services.

The Commission also does not provide service providers with sufficient notice or opportunity to weigh in on these important issues, which have the potential to impose significant burdens on servicing the investment adviser industry and may cause some of these companies to decline to do so because of the additional cost and disruption to their businesses. The Commission's decision to set a 30-day comment period for the Proposal means that there is little time for these service providers even to become aware of the Proposal, much less provide any meaningful input on how the Proposal will impact their businesses. The result may be an unwillingness to provide services to the investment adviser industry, which may result in fewer options and/or a consolidation of service providers as well as increased costs for advisers, and, ultimately, their clients.

The Commission's statutory authority is limited to its Congressional mandate. Seeking to regulate indirectly what the Commission is unable to regulate directly will result in challenges to

[12] *See id.*

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the Commission's rulemakings, creating further uncertainty and turmoil for the securities industry. Moreover, the Commission is not equipped to account for the costs and other externalities involved in regulating industries not clearly within its jurisdiction and area of expertise—the Commission acknowledges as much in the Proposing Release, stating that it is "unable to quantify [the] direct costs that would be incurred by service providers as a result of this rule…."[13] The Commission's attempt to regulate these service providers would lead to negative outcomes for both the industry and the Commission.

D. The Proposal would disrupt arrangements between investment advisers and service providers and ultimately increase costs for investors.

The Proposal would impose significant costs on investment advisers and service providers that will raise barriers to entry for investment advisers and their service providers, having an outsized impact on smaller investment advisers and service providers, which do not have the same amount of resources as more established firms. These costs ultimately will be borne by investors.

Investment advisers have a federally established fiduciary duty to act in their clients' best interests. The Proposal would require investment advisers to undertake a rigorous analysis of its service providers and any subcontractors to determine who is within scope of the rule, coordinate specific due diligence and monitoring processes to assess those service providers and subcontractors, and mitigate and manage any identified risks. The Proposal also would have a significant impact on contractual arrangements, including existing arrangements, between investment advisers and service providers that the Commission does not appear to have considered fully. Even if service providers agreed to comply with the requirements of the Proposal, such requirements would increase costs associated with the Proposal further. Moreover, based on discussions with our members, we believe that these costs are significantly understated in the Proposing Release; these costs likely would be passed on to clients.

The Proposal seems to require that advisers produce a de facto legal opinion to document its reasoning for decisions made at each step in the scoping, due diligence, monitoring, and risk management processes. Each of these processes as laid out in the Proposal contains multiple sub-processes that are impractical and involve significant judgment calls. The due diligence process alone contains six steps, each of which require the adviser to guess at whether its decisions comport with the Commission's expectations. In many cases, the methods of compliance suggested by the Commission result in unreasonable outcomes. For example, the level of due diligence and monitoring suggested by the Commission may require the hiring of experts to evaluate service providers at a technical level, which will significantly increase costs for advisers that will be passed onto investors. Advisers would be required to evaluate sub-contractors of service providers in the same manner. Additionally, the Proposing Release suggests that an adviser may "establish a redundancy in the outsourced service or function" to mitigate risks associated with disruptions of

[13] *Id.* at 68856.

service.[14] Practically speaking, this guidance suggests that advisers need to contract with multiple service providers for certain services, potentially doubling costs and compliance burdens. Inevitably, these burdens will be amplified for smaller advisers that do not have resources in-house to manage these processes.

These costs are not borne solely by investment advisers—service providers too must bear the burden of compliance with the Proposal. Service providers will have to submit to investment advisers' due diligence processes, which include an intrusive assessment of their businesses and provision of assurances about compliance with the securities laws and orderly termination of their services, as well as ongoing monitoring. Some service providers may not be able or willing to abide by the Proposal's requirements, making compliance by investment advisers virtually impossible and/or eliminating services providers from the market.[15] Service providers may question whether they somehow are exposed to liability for aiding and abetting an adviser's violation of an antifraud rule, which may deter firms from providing these services. Instead, service providers may decide to or be forced to stop servicing investment advisers, leading to industry consolidation—a problem the Commission aptly identifies.[16]

Consolidation could increase costs for advisers by lessening competition among service providers and could introduce systemic risks into the investment advisory industry, as services could be limited only to a few select providers. Service providers that do not exit the market also may expect advisers (and therefore investors) to foot the bill of these additional compliance requirements. These requirements would stifle innovation and competition that would come from new, up-and-coming service providers. Because these firms do not have an established track record, investment advisers may not feel comfortable using their services, even if they prove to be better than the services of established service providers. The Commission should not be in the business of picking winners and losers, particularly in industries over which it lacks knowledge and jurisdiction.

Perhaps most worrisome is that the imbalance in contractual liability that the Proposal would create seems to have gone unnoticed by the Commission. The Proposal applies to "covered functions," which are defined as "(1) a function or service that is necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws, and (2) 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

[14] *Id.* at 68829.

[15] For example, some service providers may not wish to divulge specific details regarding how their businesses operate or may not be able to submit to such scrutiny as the Proposal would require.

[16] *See, e.g.,* Proposing Release at 68861; Comm'r Hester M. Peirce, *Outsourcing Fiduciary Duty to the Commission: Statement on Proposed Outsourcing by Investment Advisers* (Oct. 26, 2022), https://www.sec.gov/news/statement/peirce-service-providers-oversight-102622; Comm'r Mark T. Uyeda, *Statement on Proposed Rule Regarding Outsourcing by Investment Advisers* (Oct. 26, 2022), https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622.

services." (emphasis added).[17] Adviser fiduciary standards require, in the Commission's view, a negligence standard of care.[18] The overly broad and vague definition of covered function effectively regulates service providers that are not subject to such fiduciary standards, or to the SEC's jurisdiction, by implicitly requiring that their contracts with investment advisers hold them to a negligence standard of conduct. It is unlikely that any service provider would be willing to commit to a negligence standard, which could either result in service providers avoiding the investment adviser industry or leave advisers filling the void and becoming strictly liable for the negligence of its service providers. In some cases, it also could result in advisers "in-sourcing" certain functions that are best left to service providers with greater economies of scale and expertise in handling those functions.

E. Investment adviser outsourcing is not an issue that is ripe for rulemaking.

The Commission has myriad tools at its disposal to solicit input from the industry and provide guidance to market participants that do not involve rulemaking. Based on the scant evidentiary basis for the Proposal and the numerous, fundamental questions embedded in the Proposing Release, we believe the Commission should have taken more time and solicited more industry input in developing its views on and approach to investment adviser outsourcing to service providers. The Commission should take this opportunity to consider alternatives to rulemaking to solicit feedback and discuss its expectations with market participants.

For example, the Commission could undertake to publish a concept release or request for comment to better understand industry views and practices. By leveraging the experience of industry members, the Commission can better develop practical solutions to real problems. After industry consultation, the Commission or Commission staff could publish guidance describing principles-based expectations in outsourced arrangements rather than engage in rulemaking. These requirements could be based on existing rules applicable to investment advisers, such as the Compliance Rule or recordkeeping rules. Application of these rules already is well understood in the industry.

The Proposal is a departure from the principles-based rules that historically have applied to investment advisers, and it does not provide a workable framework for investment advisers' service provider arrangements. The Commission should reconsider its approach for providing guidance and its expectations to market participants, for the Proposal and its other initiatives, to align with existing standards, the expectations of market participants, and the Commission's historical practice.

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[17] Proposed rule 206(4)-11(b).

[18] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16886 (Mar. 24, 2022) (prohibiting an investment adviser to a private fund from "[s]eeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund").

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III. Conclusion

We firmly believe that the Commission understates the costs and overstates the benefits of the Proposal in the Proposing Release. The LSTA is deeply concerned about the significant collateral consequences and substantial costs of the Proposal. The Proposal is extraordinarily prescriptive and seeks to replace a working, existing framework with which the Commission has struggled to identify any material problem. It has the potential to upend the investment advisory industry by restricting advisers from using many service providers and leading many service providers to drop out of this market. Moreover, the Proposal would create a costly and disruptive imbalance in the contractual liability framework that supports service provider relationships with advisers, resulting in advisers losing the many benefits that outsourcing provides. These concerns are compounded when it comes to smaller advisers and service providers, which do not share access to the same resources as larger firms yet must comply with the same requirements.

The Proposal also is emblematic of a broader concern—that the Commission's rapid-fire approach to rulemaking does not grant adequate time or consideration to the reliance interests impacted by its proposals. We question whether the Commission has had the opportunity to conduct a meaningful cost-benefit analysis of the many significant proposals it has put forward in recent months. Moreover, market participants impacted by these proposals have been compelled to triage their responses to the myriad new proposals because of the meager comment periods provided by the Commission. Market participants have not had the time or resources necessary to assess or draw meaningful conclusions regarding the costs and benefits of the Commission's numerous proposals, much less to provide those conclusions to the Commission in the form of a comment letter.

We therefore urge the Commission to reconsider or withdraw the Proposal and reevaluate its recent, rushed approach to rulemaking.

Sincerely,

Elliot Ganz
Head of Advocacy, Co-Head Public Policy