December 21, 2022

VIA SEC COMMENT SUBMISSION PORTAL

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

Re: ***Oversight Requirements for Certain Services Outsourced by Investment Advisers (File No. S7-25-22)***

Dear Ms. Countryman:

The National Society of Compliance Professionals ("NSCP")[1] appreciates the opportunity to provide comments to the United States Securities and Exchange Commission (the "Commission") on proposed new rule 206(4)-11 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and proposed related amendments to Advisers Act rule 204-2 (proposed rule 206(4)-11 and the proposed amendments to rule 204-2 (collectively referred to herein as, the "Proposed Amendments").[2] NSCP is well positioned to comment on the Proposed Amendments and has sought the views of both its members that are compliance personnel with investment advisers and those associated with service providers to investment advisers through a survey circulated generally and focus groups.

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[1] NSCP is a nonprofit, membership organization with approximately 2,000 financial services compliance professionals dedicated to advancing the expertise of financial services compliance professionals and the long-term success of the compliance profession. The principal purpose of NSCP is to provide its membership best-in-class resources, provide opportunities for professional development, promote the exchange of knowledge, and advocate for the compliance profession.

NSCP's membership is drawn principally from traditional broker-dealers, investment advisers, bank and insurance affiliated firms, as well as third-party service providers that serve them. The asset management members of NSCP span a wide spectrum of firms, including employees from the largest brokerage and investment management firms to those operations with only a handful of employees. The third-party service provider members of NSCP include, but are not limited to, law firms, accounting firms, compliance consultants, risk management consultants, cybersecurity consultants, and technology providers. The diversity of our membership allows NSCP to represent a large variety of perspectives in the asset management industry.

[2] See "Proposed Rule: Oversight Requirements for Certain Services Outsourced by Investment Advisers Release No. IA-6176, File No. S7-25-22, October 26, 2022 (the "Proposing Release").

While NSCP strongly supports the Commission's efforts to protect investors with the Proposed Amendments, we nevertheless have significant concerns regarding elements of the Proposed Amendments, particularly as it relates to smaller advisers.

1. Our members generally believe the Proposed Amendments are unnecessary.

Our ability to fully obtain information from our members has been limited by the short comment period open during the year-end and holiday season.[3] Nevertheless, nearly all of our members who responded to the survey advised that they had never experienced a situation where a vendor failed to perform services or performed these services negligently, causing a material negative impact on clients of the firm. The few reported instances of vendor failure were linked to potential client harm in only one instance, and in that case, the harm was reported not to be reasonably estimable but involved the loss of personal information. We did not receive information indicating whether additional diligence foreseeably would have caused the firm not to use the services of the vendor who failed to perform adequately.[4]

We cannot determine whether the instances of vendor failure cited in the Proposing Release were related to a corresponding weakness in diligence. We do note that even robust diligence may not identify a vendor's weakness and determine its foreseeable likelihood of resulting in material harm to clients.

All of the members responding to the survey reported that they already conduct some form of due diligence with respect to service providers that they have determined to require such oversight. In response to an open-ended question for comment, many of the members responding said that the rule was unnecessary or redundant. Few commented that the Proposed Amendments were necessary or appropriate. These views appear to reflect the fact that investment advisers already have a strong incentive to avoid the risk of material vendor failures that can be foreseen through reasonable diligence. Indeed, a failure that causes material client loss also threatens the adviser's business and, potentially, its viability.

Overall, we are skeptical that the Proposed Amendments will materially enhance investor protection considering the infrequent occurrence of a vendor failure causing material harm to clients and the level of diligence already undertaken by based on the firms' risk assessments.

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[3] On December 2, 2022, we filed a comment letter requesting that the comment period be extended to March 26, 2023, in part to facilitate our collection of information from members.
[4] Our members responding to the survey are associated with firms of all sizes and service providers that work with firms on compliance matters. Approximately half of those responding are associated with long-only advisory firms; approximately a quarter are associated with private fund managers.

2. **Most of our members believe that the proposed rule would unnecessarily result in materially increased burden on compliance personnel.**

Additional and expanded diligence and documentation of that diligence could be the responsibility of firm personnel outside of the compliance function, but many members think that this work largely will fall to compliance. At a minimum, the compliance function will have substantial expanded responsibilities in administering a compliance program that includes review of the prescribed broad-scale vendor management program and mandated assessments and documentation. As the Commission notes in its Proposing Release, adviser margins are being compressed by increased costs, including regulatory costs arising from myriad rule changes and continuing downward pressure on fees. The likely consequence is that compliance budgets will not be expanded (or expanded commensurately), even if the duties of the compliance function again grow as a result of the Proposed Amendments. Whatever the Commission's expectations, additional responsibilities without additional resources could result in some compliance personnel being forced to make difficult choices, prioritizing vendor diligence at the expense of other, more critical, compliance activities that address non-speculative risks. This is particularly the case for smaller firms with correspondingly smaller compliance staff. We note that smaller firms, often with proportionally less in-house capacity and expertise than larger firms, may externalize many operations more frequently than larger firms and, accordingly, may face disproportionate burdens if the Proposed Amendments were adopted.

Moreover, many of our members believe that the proposed rule would mandate formality and documentation that would not meaningfully reduce risk of inadequate performance by a vendor but would materially increase expense and the burden on the compliance function. We are skeptical that the mandated assessment processes, prescribed diligence measures, and required documentation in the Prosed Amendments would materially reduce the low incidence of material vendor failure.

3. **Uncertainties associated with the Proposed Amendments were of concern to many of our members and we believe could negatively affect the compliance function**.

Many of our members are concerned about the ambiguous and potentially expansive scope of the term "covered function," noting that many services, including some apparently excluded from the Commission's intended scope, would interfere with compliance with the Federal securities laws if not provided or if provided inadequately. Many of our members also are concerned about the level and nature of diligence that would be sufficient to demonstrate that it would be "appropriate" to select or retain a particular vendor.

Uncertainties of this type make it difficult for compliance personnel to implement or oversee appropriate policies and procedures with the risk of not doing "enough" to satisfy the Commission's expectation (and potentially incurring liability) or doing "too much" to avoid that risk and causing unnecessary expenditures. When compliance personnel cannot advise management on what is required with fair certainty, their credibility with management may be undermined, and at a minimum, management may

respond by electing to undertake only that which is clearly required.

There are potential alternatives. Diligence mandates could be narrowly focused on services where the examination process identifies and can document repeated occurrences of failure resulting in material harm to clients. Or, more consistent with industry practice, the Commission could expressly allow a firm to maintain tailored diligence programs based on its assessment of the risk associated with the services

provided by a particular vendor, potentially sharply narrowing the scope of diligence activities and related documentation and corresponding pressure on the compliance function.

We note that other regulators have found less prescriptive approaches to outsourcing.[5] For example, in October 2013, the Office of the Comptroller of the Currency ("OCC") provided guidance to national banks, Federal Savings Associations, and Federal Branches and Agencies on third-party relationship management.[6] In 2021, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency issued Proposed Interagency Guidance on Third-Party Relationships: Risk Management, which provides a framework with processes that are commensurate with the identified level of risk and complexity from the third-party relationships, and with the organizational structure of each banking organization.[7] Likewise, FINRA has issued Regulatory Notices, which provide information for consideration by their members as they employ practices that are reasonably designed to achieve compliance with relevant regulatory obligations based on the firm's size and business model.[8]

4. **Vendor resistance may challenge effective implementation of some elements of the Proposed Amendments.**

Compliance personnel associated with many firms expressed concern that they would not be able to effect arrangements with vendors that would allow compliance with the Proposed Amendments. They note that, unless they are associated with the largest of firms, they have little negotiating leverage and may be limited in the scope and nature of diligence that the vendor will facilitate and the terms of arrangements that the vendor will accept. This could prevent a firm from using a vendor that is otherwise best equipped to provide the service, potentially contrary to the best interests of the firm's clients.

[5] We are not endorsing all of the elements of this guidance but note that it generally permits greater flexibility and tailoring, including a measure of recognition of the particular challenges facing smaller firms.
[6] https://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29 html
[7] See, Proposed Interagency Guidance on Third-Party Relationships: Risk Management, 86 fr 38182, July 19, 2021, available at: https://www.occ.gov/news-issuances/federal-register/2021/86fr38182.pdf
[8] Regulatory Notice 21-29: FINRA Reminds Firms of their Supervisory Obligations Related to Outsourcing to Third-Party Vendors; https://www finra.org/rules-guidance/notices/21-29

The element of the Proposed Amendments addressing outsourcing recordkeeping is especially problematic in this regard, as vendors may be unwilling to provide the "reasonable assurances" necessary for the adviser to retain it. Among other things, vendors may be unwilling to take the risk that the Commission could view it as "causing" a violation of the securities laws if the record-keeping fails to meet the Commission's standards. The firm, of course, cannot compel an unwilling vendor to agree.

Conclusion

Thank you for considering our comments. As a non-profit dedicated to supporting compliance personnel, we share the Commission's goal of efficient and effective investor protection. We would be happy to provide any additional information that may be helpful and invite you to contact the undersigned if needed.

Sincerely,

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