FINANCIAL SERVICES INSTITUTE | VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

December 22, 2022

Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

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

Dear Secretary:

On October 26, 2022, the Securities and Exchange Commission ("SEC" or "Commission") proposed a new rule and rule amendments under the Investment Advisers Act of 1940, as amended (the "Advisers Act") requiring registered investment advisers that outsource certain services and functions to conduct due diligence and monitor the service providers they utilize for these functions ("Proposal" or "Proposed Rule"). The Proposed Rule was published in the Federal Register on November 16, 2022.[1] The Financial Services Institute ("FSI") appreciates the opportunity to comment on the Proposed Rule.

Background on FSI Members

FSI is an industry group comprised of members from the independent financial services industry. The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52 percent of all producing registered representatives.[2] These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers ("IBD").[3] FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. The majority of FSI's IBD member firms have affiliated Registered Investment Advisors ("RIAs") and are thus dually registered. FSI also has some Independent RIA members as well.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate $35.7 billion in economic activity. This activity, in turn,

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[1] *See* Securities Exchange Act Release No. IA-6176 (Oct. 26, 2022) 87 FR 68816 (File No. S7-25-22), available at https://www.federalregister.gov/documents/2022/11/16/2022-23694/outsourcing-by-investment-advisers (the "Proposing Release").
[2] Cerulli Associates, Advisor Headcount 2016, on file with author.
[3] The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a dually registered representative of a broker-dealer and an investment adviser representative of a registered investment adviser firm. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the Securities and Exchange Commission (SEC) or state securities division as an investment adviser.

supports 408,743 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly $7.2 billion annually to federal, state, and local government taxes.[4]

Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI members and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

Discussion

FSI's comments focus squarely on whether there is a true necessity for the Proposed Rule, and whether the Proposed Rule's projected impact on investor protection is appropriately aligned with the anticipated substantial burden and cost for investment advisers to come into compliance. FSI's letter focuses on five specific areas which are summarized below. Our members believe each of these areas deserve further examination.

- The SEC should consider that many SEC-registered investment advisers – including many FSI members – are often subject to enterprise-wide due diligence and vendor management compliance programs because of their affiliation with FINRA-registered broker-dealers, and other regulated entities.

- The Proposed Rule's definitions of "Service Provider" and "Covered Function" are overly broad.

- The economic analysis conducted by the SEC is flawed. We believe the Proposed Rule would result in substantial burdens on SEC-registered investment advisers without a corresponding investor protection benefit.

- If adopted, the SEC should provide an 18 to 24-month compliance and transition period.

- The Proposed Rule should not be classified as an anti-fraud rule under Section 206(4) of the Advisers Act.

I. The SEC Should Take Into Account Existing Due Diligence and Vendor Management Requirements Applicable to Dually-Registered Advisers

A significant subset of SEC-registered investment advisers are not standalone businesses, but rather are affiliated with regulated entities, including broker-dealers. More specifically, we note that many FSI members are dually-registered entities. Broker-dealers are subject to FINRA-specific supervision and vendor management requirements and expectations. The Proposing Release acknowledges a subset of these requirements, noting that "firms that are dually-registered broker-dealers are subject to FINRA Rule 3110 which requires members to establish and maintain

[4] Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2020).

a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations."[5]

A FINRA-registered broker-dealer's supervisory system, including its written supervisory procedures, must consider activities or functions performed by third-party vendors.[6] FINRA Regulatory Notice 21-29 ("RN 21-29"), issued in August 2021, notes that a broker-dealer's "supervisory obligation extends to member firms' outsourcing of certain 'covered activities' – [defined as] activities or functions that, if performed directly by a member firm, would be required to be the subject of a supervisory system and WSPs pursuant to FINRA Rule 3110."[7]

RN 21-29 details the "four phases of a firm's outsourcing activities" under FINRA Rule 3110, which include: (i) deciding to outsource an activity or function; (ii) conducting due diligence on prospective vendors; (iii) onboarding vendors; and (iv) overseeing or supervising outsourced activities or functions.[8] While FINRA's rules and guidance regarding vendor management do not align precisely with the SEC's Proposed Rule, there are certain similarities, such as with regard to conducting due diligence of a potential, or existing, service provider.

By way of example, the Proposed Rule would require an adviser to identify potential risks that would result from a service provider performing a covered function, including how to mitigate and manage said risks.[9] In comparison, RN 21-29 suggests that a broker-dealer that outsources an activity or function should "identify risks that may arise from outsourcing a particular activity or function", "take a risk-based approach to vendor due diligence", and "evaluate the impact to [customers] or [the] firm if a Vendor fails to perform . . . by not fulfilling a regulatory obligation."[10]

The requirements applicable to broker-dealers when it comes to due diligence and vendor management under FINRA Rule 3110 are particularly important in light of the fact that, as noted above, many federally-registered investment advisers are part of organizational structures that include FINRA-registered broker-dealers.[11] Often, the SEC-registered investment advisers that are affiliated, or dually-registered, with broker-dealers are under the ambit of enterprise-wide, financial services-focused, due diligence and vendor management compliance programs.

Should the SEC proceed with this Proposal, FSI urges the SEC to consider aligning the outsourcing requirements in the Proposed Rule with existing requirements applicable to FINRA-registered broker-dealers. In the alternative, FSI requests that the SEC consider providing an exclusion from the Proposed Rule for SEC-registered investment advisers that are subject to enterprise-wide outsourcing policies and procedures that are compliant with FINRA rules. This would contribute to ensuring a significant level of uniformity across organizations housing SEC-registered investment advisers and FINRA-registered broker-dealers and would achieve the investor protection objectives sought from the Proposal.

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[5] 87 FR 68816, 68848.
[6] *See* FINRA Regulatory Notice 21-29, available here.
[7] *Id.*; *see also* FINRA Regulatory Notice 05-48 ("outsourcing an activity or function to . . . [a vendor] does not relieve the member of their ultimate responsibility for compliance with all applicable federal securities laws and regulations and [FINRA] and MSRB rules regarding the outsourced activity or function.")
[8] *See* FINRA Regulatory Notice 21-19.
[9] Proposed Rule § 275.206(4)-11)(a)(1)(ii).
[10] *See* Regulatory Notice 21-29.
[11] The same is true with regard to advisers that are part of organizational structures including federally regulated banks, which are also subject to regulatory requirements regarding their management of risk involving third-party vendors. *See* Office of the Comptroller of the Currency Bulletin 2013-29 (Oct. 30, 2013), available here.

II. The Requirements in the Proposed Rule Are Overbroad and Not Needed to Achieve the SEC's Goals

The Proposed Rule seeks comment on whether the "proposed scope of the rule [is] appropriate" and whether the "proposed definition of covered function" could be modified to "better match [the SEC's] policy goals."[12] FSI believes that the definitions of "Service Provider" and "Covered Function" in the Proposed Rule are overly broad and are not appropriately tailored to serve the SEC's stated policy goal, which is to mitigate the risk of potential investor harm "when an adviser outsources to a service provider a function that is necessary for the provision of advisory services without appropriate adviser oversight."[13]

a. The Proposed Definitions of "Service Provider" and "Covered Function" Are Overly Broad

The Proposed Rule would define a Service Provider "as a person or entity that performs one or more covered functions and is not an adviser's supervised person as defined in the Advisers Act."[14] A "Covered Function" would be defined as "a function or service that is necessary for the investment adviser to provide its investment advisory services in compliance with the Federal securities laws, and that, if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services."[15]

FSI believes that the proposed definition of a "Covered Function", if adopted as proposed, would make it difficult for advisers to design adequate and reasonable supervisory controls around which service providers are encompassed by the rule's broad definition. FSI is concerned that, without further clarification as to which service providers are captured by these definitions, most advisers will feel it necessary to be over-inclusive. This will result in increased costs to advisers and divert advisers' limited resources away from compliance functions that would provide more tangible investor protection benefits.

With this in mind, FSI believes that the SEC should more specifically define and narrow what constitutes a "Covered Function" by providing bright-line examples for certain "core" advisory functions and a materiality test for other functions. Functions far removed from "core" advisory services are less likely to cause the type of investor harm that the SEC is trying to protect against, and a more tailored approach better aligns with the type of cost-benefit analysis that should come with new regulations.

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[12] 87 FR 68816, 68824.
[13] *Id.* at 68817.
[14] Proposed Rule § 275.206(4)-11)(b).
[15] *Id.* The Proposed Rule notes that a "Covered Function" does not include "clerical, ministerial, utility, or genera office functions or services."

b. The Definition of "Covered Function" Should Be Narrowed To Exclude Service Providers and Functions That Are Already Subject to Extensive Regulatory Requirements

i. Broker-Dealers Should Be Excluded from the "Service Provider" Definition

The SEC requests comment through the Proposing Release on whether the "proposed rule should provide an exception for firms that are dually registered broker-dealers" that already "comply with existing broker-dealer provisions such as FINRA Rule 3110 (Supervision) . . . ."[16]

The Proposing Release specifically provides that the Proposed Rule "would not include an exception for service providers that are subject to other provisions of the Advisers Act, including SEC-registered advisers, or other Federal securities laws."[17] The Proposing Release also notes that an adviser's engagement of a broker-dealer for certain services, such as the provision of an electronic trading platform, would not be excepted from the Proposed Rule.[18]

As the Commission is well aware, broker-dealers operate in a heavily regulated environment and must comply with various federal laws, state laws, and FINRA rules. FINRA Rules 3110[19], 3110(b)[20], 3120[21], and 3130[22] form a regulatory scheme addressing the supervision of broker-dealers and their associated persons. The strict set of rules and guidelines that broker-dealers are required to abide by are intended to further FINRA's stated policy goal of "help[ing] to keep investors and their investments safe."[23] Furthermore, both investment advisers and broker dealers are bound by the information sharing and data protection requirements of the Gramm-Leach-Bliley Act.[24]

FSI believes that an investment adviser should not be required to subject a broker-dealer performing an outsourced function to the specific due diligence and monitoring requirements under the Proposed Rule given that the broker-dealer's activities are already subject to substantial oversight by the SEC and FINRA. The adviser's client is ultimately protected by the significant regulatory requirements applicable to broker-dealers. This is not to say that an adviser bears no responsibility for a broker-dealer's performance of an outsourced function. As the SEC acknowledges in the Proposing Release, "[a]n adviser remains liable for its obligations, including

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[16] 87 FR 68816, 68826.
[17] *Id.* at 68823.
[18] *Id.*
[19] As noted above, FINRA Rule 3110 requires that a member "establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."
[20] FINRA Rule 3110(b) requires each firm to adopt written supervisory procedures to supervise the business in which it engages and the activities of its associated persons in compliance with applicable securities laws, regulations, and rules.
[21] FINRA Rule 3120 requires each firm to establish supervisory control policies and procedure to test and verify that the firm's written supervisory procedures are reasonably designed with respect to the activities of the firm and its associated persons.
[22] FINRA Rule 3130 requires a firm's Chief Executive Officer to certify annually that the firm has in place processes to establish, maintain, review, test, and modify policies and procedures reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules.
[23] See https://www.finra.org/about.
[24] 15 U.S.C. Sections 6801-6809.

under the Advisers Act, the other Federal securities laws and any contract entered into with the client, even if the adviser outsources functions."[25]

For these reasons, FSI requests that the SEC exclude broker-dealers from the definition of "Service Provider" in the Proposed Rule.

ii. The Rule Should Exclude Outsourced Functions Where The Requirement for an Oversight or Supervisory Process Already Exists

The Proposed Rule's definition of a "Covered Function" is overbroad and captures certain functions for which advisers have already implemented substantial oversight and supervision policies and procedures. For example, FSI believes that for certain arrangements, such as those involving financial planning and/or proposal generation, investment advisers have, as a matter of business practicalities, already implemented oversight and supervision processes related to the outputs generated by those vendors that are designed to protect clients. FSI suggests that the SEC narrow the definition of "Covered Function" to exclude functions for which investment advisers have already implemented substantial supervisory controls.

III. The SEC's Economic Analysis of the Proposed Rule Demonstrates The Potential Negative Impact that the Proposed Rule Would Have on Investor Protection and Choice

a. The SEC's Economic Analysis Underestimates the Number of Covered Functions an Adviser Outsources to Service Providers

The Proposing Release contains a detailed discussion regarding the cost estimate for an adviser coming into, and remaining in, compliance with the Proposed Rule. To arrive at its cost estimate, the SEC was required to make several assumptions, including an assumption that each investment adviser outsources five covered functions.[26] The Proposing Release does not provide any support for this estimate.

FSI members overwhelmingly disagree with the SEC's estimate. Based on FSI members' experience, the typical adviser outsources far more than five covered functions. This is particularly true when considering the breadth of the definition of "Covered Function" in the Proposed Rule, which, as noted above, is broadly defined to include "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." Members may outsource compliance, asset management, performance management and analytics, technology functions, recordkeeping functions, clearing and custody, platform providers, marketing, continuing education and training services, and "middle office" support functions. Outsourcing these areas allows for investment advisers to obtain "best in class" expertise and functionality through the benefit of scale. In particular, smaller firms may outsource more functions and this proposal has a disproportionate cost and resource impact on small firms.

[25] 87 FR 68816, 68819.
[26] *Id*. at 68855.

FSI requests that the SEC reconsider its cost analysis in the Proposed Rule to better align with the reality that most advisers outsource significantly more than five "Covered Functions."

b. The High Cost of Compliance with the Proposed Rule Will Harm Investors.

The Commission's cost estimate, which, as noted above, undervalues the cost of compliance, reflects an initial cost of over $130,000 per adviser and an ongoing annual cost of over $40,000 per adviser to comply with the Proposed Rule.[27] For many advisers, this will require the adviser to either: (i) add additional personnel within the compliance department or (ii) place additional pressure on existing personnel to "do more" with the same resources. This necessarily will result in compliance personnel having less time to focus on higher risk concerns.

Given the high cost of compliance with the Proposed Rule (both in monetary terms and in that it will result in compliance departments having less time to focus on other regulatory priorities), it is worth noting that investment advisers are already subject to rules and regulations that implicitly address the oversight of an adviser's outsourcing arrangements – a point that the SEC explicitly addressed in the Proposing Release.[28]

Advisers, as a result of the fiduciary duty they owe clients under Section 206 of the Advisers Act, have always been responsible for vetting service providers to whom they outsource various tasks and requirements. For example, if an adviser were to outsource tasks such as asset management, recordkeeping, or client management, the adviser would be ultimately responsible for any failure or breach on the part of the service provider.[29]

The SEC notes in the Proposing Release that pursuant to Rule 206(4)-7 under the Advisers Act, advisers must "consider, among other things, their regulatory obligations and formalize policies and procedures reasonably designed to prevent violations of the Advisers Act."[30] The SEC acknowledges that "advisers may already be assessing the various risks created by their particular circumstances in hiring service providers when developing their compliance policies and procedures to address such risks" under Rule 206(4)-7.[31]

FSI believes that the SEC has not set forth a sufficient justification in the Proposing Release for the enactment of a prescriptive anti-fraud rule covering outsourcing arrangements when many advisers either (i) rely on existing policies and procedures under Rule 206(4)-7; or (ii) rely on enterprise-wide policies and procedure that comply with FINRA rules.

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[27] 87 FR 68816, 68856.
[28] *Id*. at 68874.
[29] *Id*. at 68847.
[30] *Id*. at 68874.
[31] *Id*.

IV. The SEC Should Provide A Longer Period for Transition and Compliance if the Proposed Rule is Adopted

The Proposing Release would require SEC-registered advisers to comply with the Proposed Rule starting ten months from the rule's effective date.[32] The SEC requested comment in the Proposing Release on whether a ten-month transition period is appropriate.[33]

Given the substantial impact that the Proposed Rule would have on advisers' outsourcing arrangements, FSI strongly believes that the SEC should consider a more reasonable, and practical, 18 to 24-month compliance period. This would allow advisers to, among other things, include the resulting costs in their annual budgets, develop necessary compliance programs, hire necessary personnel, and train their staff.

In addition to providing ample time for advisers to include the costs of compliance in their annual budgets, there are practical considerations for FSI's request that the SEC consider a longer compliance period. For example, some FSI member firms send out their due diligence questionnaires annually. Should the Proposed Rule be approved, advisers would need to make enhancements to their due diligence questionnaires, and could possibly be forced to unnecessarily duplicate previous due diligence efforts in an effort to bring them into strict compliance with the Proposed Rule. A longer compliance period would allow an adviser to make the necessary changes to their questionnaires and only send the questionnaire once.

As an additional practical matter, many advisers use the same vendors and third-party service providers. Each adviser will need time and resources to conduct appropriate due diligence on these providers. This will undoubtedly lead to many challenges for third-party vendors and advisers such as: (1) delayed responses as third-party vendors work to respond to a significant number of due diligence requests; (2) review of contractual language to ensure that adequate controls and protections are in place for the service provider and the adviser, which could entail obtaining legal representation, drafting contract language, negotiating the terms, and potentially finding alternative vendors if an agreement cannot be reached; and (3) the hiring and onboarding of new personnel by service providers and advisers to support due diligence requests.

Should the SEC advance this proposal, to lessen the compliance burden on advisers and third-party service providers (and to realistically implement a compliance period shorter than 18 to 24 months), FSI suggests that the SEC could consider allowing service providers to provide due diligence information aligned with the parameters of the Proposed Rule to all of the advisers that seek to hire them – rather than requiring the third-party service providers to respond to advisers' requests on a one-by-one basis.

V. The Proposed Rule Should Not Be Classified as an Anti-Fraud Rule under Section 206(4) of the Advisers Act

If the SEC proceeds with the adoption of the Proposed Rule, FSI recommends that the SEC use a different vehicle than a new anti-fraud rule under Section 206(4) of the Advisers Act. As the SEC explicitly emphasizes, the Proposed Rule is an anti-fraud rule, and, if adopted, the failure of an adviser to conduct due diligence and monitoring consistent with the Proposed Rule could constitute

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[32] *Id.* at 68841.
[33] *Id.*

an "act, practice, or course of business which is fraudulent deceptive, or manipulative" within the meaning of Section 206(4) of the Advisers Act.[34] Therefore, an adviser could be found to have violated the anti-fraud section of the Advisers Act without having committed any substantive violation that harmed or impacted clients. FSI strongly believes that a technical deficiency in an adviser's due diligence and/or monitoring of a third-party service provider should not constitute *per se* fraud.

FSI believes that classifying a violation of the Proposed Rule as *per se* fraud would serve to mislead clients and the general public as to the severity of an adviser's violation. Further, it would encourage the SEC to engage in further "regulation by enforcement" – whereby the SEC would have the opportunity to charge advisers with fraud under Section 206(4) of the Advisers Act for technical violations of the Proposed Rule.

<u>Conclusion</u>

FSI is committed to constructive engagement in the regulatory process and welcomes the opportunity to work with the SEC on this and other regulatory efforts. Thank you for considering FSI's comments. Should you have any questions, please contact me at [redacted].

Respectfully submitted,

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Executive Vice President & General Counsel

[34] *Id.* at 68821.