AMERICAN INVESTMENT COUNCIL
Growth Through Long-Term Investment

December 22, 2022

VIA ELECTRONIC SUBMISSION
Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: Proposed Rule Regarding Outsourcing by Investment Advisers (File No. S7-25-22)

Dear Ms. Countryman:

The American Investment Council (the "AIC")[1] appreciates the opportunity to submit this letter in response to the proposal by the Securities and Exchange Commission (the "SEC") to adopt a new rule under the Investment Advisers Act of 1940 ("Advisers Act") to prohibit investment advisers registered with the SEC from outsourcing certain services or functions unless they meet certain requirements specified in the proposed rule (the "Proposal").[2] We submit this letter on behalf of our members, which are the world's leading private equity and private credit firms, united by their commitment to growing and strengthening the businesses in which they invest.[3]

As an initial matter, we reiterate our comments separately submitted to the SEC by a consortium of other associations urging the SEC to provide more time to comment on the Proposal.[4] The inappropriate brevity of the SEC's comment period is punctuated by the comment due date – December 27, which is in the midst of major religious and secular holidays in the U.S. and in other countries in which registered investment advisers operate. Accordingly, we do not

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[1] For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

[2] Proposed Rule: Outsourcing by Investment Advisers, Release SEC No. IA-6176, File No. S7-25-22 (Oct. 26, 2022) (the "Proposing Release").

[3] For purposes of this letter, we generally refer to private equity and private credit fund advisers as "private equity advisers" and the funds such advisers manage as "private equity funds."

[4] *See* Letter from Elliot Ganz, General Counsel, Co-Head Public Policy, Loan Syndications and Trading Association *et al*. (Nov. 16, 2022) available at: https://www.sec.gov/comments/s7-26-22/s72622-20150876-319897.pdf. *See also* Letter from Lisa Crossley, Executive Director, National Society of Compliance Professionals (NSCP) (Dec. 2, 2022), available at: https://www.sec.gov/comments/s7-25-22/s72522-20152208-320215.pdf (explaining that, in addition to coming amongst a suite of other proposals affecting investment advisers, "the Proposal was issued just ten days before the required compliance date for the [SEC's] new Marketing Rule" and annual compliance reviews, registration renewals, and year-end deadlines and holidays, all of which makes NSCP "very concerned about our ability, as well as that of our [compliance professional] members and others in the industry to have sufficient, meaningful time to participate in the rulemaking process.").

have the opportunity to provide a fully responsive set of data to the SEC in response to the Proposal and its more than 260 questions (the majority of which embed multiple questions), and again request at least a 90-day extension of the Proposal's comment due date.[5] Nonetheless, in an effort to be responsive to the SEC's request for comment, we provide our initial comments to the Proposal below.[6]

AIC Recommends an Alternative to the Proposal

We encourage the SEC not to adopt the Proposal, but instead to use it as an opportunity to foster a constructive dialogue with the investment advisory industry and advisory clients regarding the appropriate role of outsourced service providers. This dialogue could provide the SEC's staff an opportunity to learn more about appropriate and effective practices investment advisers that manage private equity funds use to oversee service providers. This is particularly important because the Proposal does not reflect the extent to which the use of outsourcing service providers for a private equity fund is subject to negotiation and due diligence between the adviser to the fund and the limited partners that invest in the fund.

Private equity fund managers, as fiduciaries, take protecting the interests of their clients – the funds they manage – seriously, including by taking steps to identify and mitigate the risks presented by the use of outsourced service providers. The dialogue we recommend could, for example, focus on types of services an investment adviser outsources, observed best practices or considerations investment advisers use to establish a risk-based framework for overseeing outsourcing relationships and how they appropriately tailor that oversight to the size and complexity of the adviser's business and outsourced relationships.[7] One potential outcome of the dialogue, among others, could be staff guidance issued to the industry. This would be consistent

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[5] Our request is consistent with the views expressed by a bipartisan group of 47 Congressional leaders in an April 13th letter regarding the SEC's "private fund proposal." *See* Letter from Congressmen Bill Foster and Andy Barr, et al (Apr. 13, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20127548-288697.pdf. We believe the serious concerns expressed in that letter about the SEC providing inadequate time for Congress and the public to analyze and comment on a significant rule proposal apply equally to the Proposal.

[6] That we submit this letter before the December 27th due date does not indicate that we have had time to fully assess and respond to the Proposal. Instead, it reflects the appropriate desire to spend time during the holiday season with friends and family.

[7] Consistent with the Proposal, we anticipate focusing the dialogue for private equity fund managers on services that are "core advisory services." We believe many functional services private equity fund managers outsource are outside that scope, including non-disclosure agreement (NDA) review and negotiation services, corporate services (such as facilities, to the extent engaged by the registered investment adviser), finance services (such as processing of invoices, purchase orders, reporting and procurement), various legal and tax services, and human resources services (including recruitment and data analytics). Because these services, among others, are not core advisory services, they will not be the focus of the dialogue we recommend.

with the resolution of a previous proposal by the SEC regarding business continuity practices by SEC-registered investment advisers. We look forward to engaging in the dialogue we recommend.

While we cannot support the Proposal, we wish to make clear that we and our members support an appropriate regulatory framework for private equity funds and their advisers, and we appreciate that outsourcing of services is an important consideration within that framework. As the SEC explains in the Proposing Release, advisory clients can benefit from an investment adviser outsourcing to a service provider, which can result in better quality of service and lower costs.[8] At the same time, we recognize that the SEC has observed a variety of outsourcing practices across a wide range of SEC-registered investment advisers, and we agree with the importance of investment advisers thoughtfully planning for and considering risks related to outsourcing.

We do not agree that there is any need, however, for new regulation to address these topics, especially not to the degree mandated in the Proposal. Indeed, the Proposing Release demonstrates that the SEC can regulate outsourcing practices through existing rules and regulations.[9] For justification of the Proposal, the Proposing Release points to settled enforcement actions, some that constituted highly unusual and idiosyncratic facts. More critical, we believe the Proposal, if adopted in its proposed form, will have significant and negative impacts on SEC-registered investment advisers. We discuss these impacts in more detail below, but to identify some of the more significant concerns, we believe that the Proposal will: (1) have damaging and disproportionate impacts on small investment advisers; (2) impede competition among investment advisers; and (3) introduce costs and burdens that are wholly disproportionate to any benefit provided by the Proposal.

Discussion of Select Issues Presented by the Proposal

The Proposal would prohibit SEC-registered investment advisers from outsourcing certain "covered functions" to service providers without meeting several requirements, including conducting initial due diligence and periodic ongoing monitoring on service providers, maintaining books and records related to the due diligence and monitoring, conducting due diligence and monitoring on third-party record-keepers, and reporting all service providers to the

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[8] *See*, *e.g.*, Proposing Release at 7 ("Service providers may give the adviser or the adviser's clients access to certain specializations or areas of expertise, reduce risks of keeping a function in-house that the adviser is not equipped to perform, or otherwise offer efficiencies that are unavailable to or unachievable by an adviser alone.").

[9] This is demonstrated by the fact that the Proposing Release points to several outsourcing practices that were the subject of settled enforcement actions, indicating that the SEC already has ample ability to regulate outsourcing practices through existing rules and regulations. *See, e.g.*, Morgan Stanley Smith Barney LLC, Advisers Act Release No. 6138 (Sept. 20, 2022) (Settled enforcement action in which the SEC asserted that an investment adviser contracted with a moving company, which the SEC asserted performed data destruction services negligently); AssetMark, Inc. (f/k/a Genworth Financial Wealth Management, Inc.), Advisers Act Release No. 4508 (Aug. 25, 2016) (Settled enforcement action in which the SEC asserted that an investment adviser negligently relied in its marketing materials on another adviser's materially inflated, hypothetical and back-tested, performance track record.).

SEC on Form ADV. Because we were provided inadequate time to comment, we discuss below what we have identified as the most significant concerns presented by the Proposal.

The definition of the term "Covered Function" is so confusing and vague that it is unworkable.

The definition of the term "Covered Function" forms a critically important foundation for the Proposal because the prescriptive elements of the rule turn on whether or not an outsourced function falls within that definition. The Proposal defines a Covered Function 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 services." Both prongs of the definition must be met for an outsourced function to be a Covered Function.

Unfortunately, the Proposal's foundation is unstable and flawed. The Proposing Release makes efforts to explain the scope of the two prongs of the definition, but they remain unclear to the point of being unworkable. Given the confused discussion in the Proposing Release regarding this term, and the limited time permitted to comment, we are unable to provide the SEC a workable alternative but reiterate our intention to engage in a substantive dialogue with the SEC staff regarding outsourced services in the private equity industry.

First prong. Regarding the first prong of the definition, the Proposing Release seeks to explain what is and is not a "function that is necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws." Unfortunately, the definition remains unclear and overly expansive. This definition could potentially bring any third-party function (other than ministerial or other functions specifically identified in the Proposal) in scope and trigger the numerous requirements contemplated by the Proposal.

The SEC's analysis does not acknowledge the nature by which certain outsourced service providers for private equity funds are selected and overseen. Indeed, many of these distinctive practices support our view that outsourcing is not an area in need of regulatory intervention. This is because the allocation of the risks and costs related to outsourcing for private equity funds can be, and regularly are, dealt with through contractual arrangements with investment advisers, and subsequently disclosed to the limited partners that are a fund's investors. Private equity fund managers inform the limited partners of the identity of key service providers, and the specific oversight the manager provides relative to those outsourced service providers. We question the need for the SEC to add a regulatory overlay on top of, and inconsistent with, those commercially negotiated agreements, particularly when they are understood by each investor as a matter of pre-commitment disclosure. We believe the private equity fund managers are better suited than the SEC to determine which outsourced functions to identify and determine the standard of oversight.

The proposed definition also is overbroad in that it does not distinguish between services that a fund limited partner would reasonably expect to be provided by a third-party service provider as compared to in-house at the adviser itself. Indeed, the Proposal's use of the term "outsourcing" assumes a service that an adviser could itself provide, but has elected to delegate to a third party. This is an important distinction because we believe private equity investors would have different expectations as to whether a service would be outsourced depending on the nature of, and disclosure with respect to, the service provided. For example, some negotiated terms may complement outsourcing others and may place restrictions on the ability of an investment adviser to rely on an outsourced service provider for services expected to be provided by the investment adviser. This is an important distinction that is not addressed in the Proposing Release.

With respect to sub-advisors, the Proposal would inappropriately capture a fund-retained sub-adviser as within scope. This is not appropriate because the fund, not the adviser, retains that sub-adviser. Further, the Proposing Release does not adequately address why any SEC-registered investment adviser should be considered within scope of the Proposal given the extensive regulatory framework applicable to it. The same is true for SEC-registered broker-dealers, as well as banks and other regulated entities.

Second prong. We interpret the second prong of the definition as an attempt by the SEC to narrow the scope of the term Covered Function. While we appreciate the spirit in which the SEC seeks to limit that scope, the second prong lacks any clarity, and subjects the investment adviser to second guessing given the perfect lens of hindsight.

The problem with the second prong is the difficulty in predicting what service, if provided negligently or not provided as required, 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. Far too much variability exists to make such a prediction, as evidenced by the SEC's own diverse set of settled enforcement actions cited in the Proposing Release.

The second prong will be difficult to apply because impacts that are unintentional when a service provider is engaged will be judged in hindsight. The term Covered Function, for example, presumably would not capture a law firm or consulting firm that advises an SEC-registered investment adviser on its corporate structure. This is because those types of services generally would not be necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws. Nor would such services, if not performed or performed negligently, reasonably be likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services. However, uncertainty exists as to whether the SEC would consider the consulting services as Covered Functions if the recommended corporate restructuring results in dismissal of personnel that provide advisory or support functions. Another question that could arise is whether a consulting firm's recommendation to eliminate an adviser's middle office function be a Covered Function if that recommendation were determined in hindsight to be grossly negligent because that function was critical to the adviser's services. Similarly, given the ambiguity of the proposed definition, the services of a consulting firm that negligently introduces a cyber-risk to the registered investment adviser could be recharacterized as a Covered Function because such negligence has the potential to harm investors. We raise these hypotheticals in an attempt to illustrate the challenge with relying on the second prong of the definition to exclude any outsourced service from the scope of the rule. The Proposal's ambiguity, and the likelihood of reviewing risks from an after-the-fact perspective, imposes a regulatory regime on private equity advisers that lacks predictability.

The second prong also does not contemplate that some outsourced service providers are more easily replaced than others. There exists a plausible scenario, whereby a service provider that is providing outsourced services negligently, or not providing them at all, is replaced before the service provider's shortcomings would be reasonably likely to result in a material negative impact to a private equity fund. This comfort, however, is undermined by the Proposal's requirements that, before using the services of an outsourced service provider for a Covered Function, all due diligence must be completed and the contractual terms with the service provider must include reasonable assurances that the service provider "is able to, and will, coordinate with the adviser for purposes of the adviser's compliance with the Federal securities laws."[10]

Negotiating terms, in particular terms introducing new requirements for compliance with the Federal securities laws, takes time, but the Proposal would require these negotiations take place before hiring a new service provider, including in a situation where moving to a new service provider is necessary to avoid client harm. In other words, in addition to a lack of clarity, the Proposal would increase risk by making it far more difficult to fire a negligent service provider and hire a new one to take its place. It is critically important for a private fund adviser to have the flexibility, within the contractual terms between it and the fund the adviser manages, to readily replace a service provider, whether for negligent performance of services or otherwise.

The Proposal imposes many more burdens than contemplated in the Proposing Release without any apparent benefit.

While the time provided for comment does not allow us to provide specific estimates of burdens, we believe the Proposing Release's economic analysis grossly underestimates those burdens. The Proposal requires a registered investment adviser to make a determination of whether an outsourced service is a Covered Function or not on a case-by-case basis, based on the facts and circumstances of each outsourced function. This requirement alone is significantly burdensome. At a minimum, the broad and uncertain scope of the term Covered Function will create a need to analyze the performance of services provided by each of these vendors to determine whether or not they are within scope of the rule. After such an identifying exercise, the Proposal would require

[10] Proposed Rule 206(4)-1(a)(1)(v).

specific due diligence and oversight to be conducted, and to do so on an annual basis. The Proposal's burdens do not, regrettably, end there. The Proposal would require the adviser to then look through each outsourced service provider to sub-contractors, which expands the burdens of the Proposal by magnitudes (and likely is not even feasible in many instances). For context, one of our members informed us that just one of its several business segments used about five hundred (500) unique service providers in 2022, very many of which likely utilized sub-contractors. This would include many service providers who have been reliably providing services for decades.

Given the risk of having their scoping determinations second guessed in hindsight, advisers will be left with little choice but to default to being over-inclusive thereby exacerbating the compliance costs imposed by the Proposal without appropriate calibration to the risks posed by a particular service provider relationship. Perhaps ironically, the rule likely would add additional costs by effectively requiring advisers to hire yet more vendors to assist in identifying and analyzing the services of each of the other vendors. All this while investment advisers already oversee outsourced service providers, just not in the burdensome and inflexible manner prescribed in the Proposal.

The Proposal also would impose significant costs and competitive impacts on service providers, which the SEC acknowledges but does not analyze in its economic analysis. Service providers are not the direct focus of the Proposal but are effectively covered nevertheless since they would be required to cooperate in the due diligence and monitoring processes to be engaged by advisers. The Proposal likely will create a barrier to entry for smaller or start-up service providers entering the marketplace or working with investment advisers, and larger or more established service providers may choose to stop providing certain services or increase their fees in response to costs imposed by the Proposal.

The Proposing Release does not make a compelling case for the benefits of the Proposal, in particular in light of the heavy burdens introduced by it. In fact, the Proposing Release makes a compelling case that no rule is needed. Throughout the Proposing Release, the SEC cites to a handful of settled enforcement actions where over the past several years the SEC alleges investment advisers inadequately selected or oversaw outsourced service providers. The Proposing Release and its economic analysis, furthermore, do not account for the already existing practice by the SEC staff to examine investment advisers' practices regarding oversight of outsourced service providers. Given that the SEC has the tools already needed to oversee this area, we believe there can be little benefit that would justify the Proposal's very significant burdens.

The Proposal would negatively impact small registered investment advisers and competition.

The Proposal's burdensome requirements will fall heaviest on small advisers. The Proposal extends the same requirements regarding diligence of service providers, record keeping and reporting obligations to all advisers, regardless of the adviser's size. A tiered approach, as opposed to the currently proposed one-size-fits-all structure, would be more appropriate.

Given the likelihood that a very significant number of outsourced services will be viewed as Covered Functions, the Proposal would dramatically expand the financial costs to advisers and greatly increase the human resources needed by an adviser to comply with the due diligence, monitoring, reporting and record-keeping requirements. We do not suggest that small advisers fail to oversee service providers, but that they do not currently do it in the mechanistic manner that the Proposal would require. Further, small investment advisers tend to have less commercial bargaining power, likely resulting in higher fees, especially for the commercial terms the Proposal would require with outsourced service providers. One could reasonably question whether the SEC would consider the Proposal a success if it results in small investment advisers taking outsourced services in house due to cost and burden concerns, when an outsourced provider potentially could be more expert and efficient at providing the Covered Function. This outcome could be an unintended consequence of the SEC's flawed approach proposed.

The Proposal likely will also contribute to existing industry trends toward consolidation of investment advisers, driven in part by the ability of larger firms to leverage technology, centralized operations, and compliance infrastructure. This concern is exacerbated by the cumulative impact of the SEC's "Regulation Raceway" under which it has proposed a large volume of rules.[11] Each of the rule proposals affecting private equity fund managers would significantly increase costs and require more staff.

Publicly disclosing service providers presents material cyber security risks to advisers.

In connection with the proposed Form ADV requirements, SEC-registered investment advisers would be required to provide identifying information regarding service providers and vendors to which they have contracted. The SEC's Cybersecurity Risk proposal acknowledges that cyber threat actors have grown more sophisticated, increasing the risk of significant financial, operational, legal and reputational harm, as well as substantial harm to investment advisers' clients and investors.[12] Public disclosure of the identity and other information about outsourced service provider can only make it easier for cyber threat actors to wage cybersecurity threats against an adviser that may lead to theft of intellectual property, confidential client information and other confidential and proprietary information or client assets. As a direct result, an adviser may incur

[11] *See* Wall Street Journal, Opinion, Gary Gensler's SEC Regulation Raceway (Apr. 29, 2022), available at: https://www.wsj.com/articles/gary-genslers-regulatory-raceway-securities-and-exchange-commission-house-democrats-letter-11650489485 (subscription required) (noting that as of April 2022, "The SEC [had] undertaken more than 50 rule-makings that would affect nearly every investor and public company in America, and many private ones too.").

[12] Proposed Rule: Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, Release SEC No. IA- 5956, File No. S7-04-22 (Feb. 9, 2022).

substantial remediation costs due to a cybersecurity incident, as well as ancillary negative harm such as increased insurance premiums and expensive technological changes to reinforce an adviser's ability to respond and recover to a cybersecurity incident. The SEC should take great care to avoid adding to cybersecurity risks through its regulations.

The Proposal introduces duplicative but inconsistent reporting requirements.

The SEC has proposed different disclosures for certain environmental, social and governance ("ESG") service providers in its proposed ESG disclosure rule for investment advisers.[13] The Proposal does not clearly provide as to whether or not this leads to the underlying assumption that advisers will have to provide two different sets of ADV disclosures under each of these rules for the same service providers. The SEC's ESG proposal would amend Item 10 of Part 1 of Form ADV to require a registered investment adviser to, among other things, describe any relationship or arrangement that is material to the adviser's advisory business or to its clients, that the adviser or any of its management persons have with any related person that is an ESG consultant or other ESG service provider. The language in either proposal is ambiguous as to whether the obligations put forth by the Proposal would be covered by the disclosures in the ESG proposal or would impose, what essentially becomes, duplicative yet different reporting obligations for ESG service providers. The SEC should avoid imposing inconsistent requirements for adviser disclosures, and should analyze the economic impact of its proposals cohesively, not in isolation from one another.

Any final rule must exclude service providers affiliated with the adviser.

The Proposal's requirement to conduct due diligence on affiliate service providers of the adviser is unnecessary. Affiliates are those who the adviser already will know best and in the case of a portfolio company, for example, will have already performed diligence and aligned on the need to provide the required services and avoid potential issues and client harm.

Sections 211(h) and 206(4) do not provide the SEC with authority to adopt the Proposal.

The SEC seeks again to assert rulemaking authority under Section 211(h) of the Advisers Act for a rule that is not within the scope of that authority. As it has done in the past, the SEC asserts authority under that provision without any explanation or analysis. To be clear, that provision does not provide the SEC the authority to adopt any rule applicable to an SEC-registered investment adviser's management of a private fund. Rather than repeat our analysis of the statutory construct of that provision, as well as the limitations on the SEC's rulemaking authority under Section 206(4) of the Advisers Act, we incorporate herein the analysis from our April 25th

[13] Proposed Rule: Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies, Release SEC No. IA- 6034, File No. S7-17-22 (May 25, 2022).

comment letter to the SEC's "Private Fund Adviser" proposal.[14] To elaborate, however, on the aggressive and novel assertion of the SEC's rulemaking authority, we note that the SEC itself did not assert Section 211(h) as authority to adopt a business continuity rule it proposed in 2016, well after Section 211(h) was added to the Advisers Act.[15] The proposed business continuity rule shares very similar characteristics to the Proposal, and the lack of a reference to Section 211(h) as authority for that proposed rule serves as an implicit acknowledgment that it provides no such authority for it, for the current Proposal, or for the Private Fund Proposal.

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The AIC would be pleased to answer any questions that you might have concerning our comments.

Respectfully submitted,

/s/ Rebekah Goshorn Jurata

Rebekah Goshorn Jurata
General Counsel
American Investment Council

[14] Letter from Drew Maloney, President and CEO, American Investment Council (Apr. 25, 2022) (at pages 8-19), available at: https://www.investmentcouncil.org/wp-content/uploads/2022/06/2022.04.25-aic-private-funds-commet-letter-with-appendices-final-2.pdf. SEC Commissioner Peirce expressed a different, but equally concerning, sentiment regarding authority under Section 206(4) in her statement explaining her dissent from the Proposal ("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 . . . . Section 206(4) authorizes the Commission to 'define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.' . . . 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. This proposal is not the first to take such an approach, but I hope commenters nevertheless think about the collateral consequences advisers will face if their due diligence or monitoring is deemed inadequate and thus unlawful under section 206(4). Would adopting this type of rule under section 206(4) serve to confuse investors given that more serious conduct also could be charged under that section?'). As a general matter, we believe the SEC should reconsider its practice of finding a violation of Section 206(4) of the Advisers Act when it finds a violation of a rule adopted under that section.

[15] Proposed Rule: Adviser Business Continuity and Transition Plans, Release SEC No. IA-4439; File No. S7-13-16 (June 28, 2016) available at: https://www.sec.gov/rules/proposed/2016/ia-4439.pdf ("The Commission is proposing new rule 206(4)-4 and amendments to rule 204-2 under the rulemaking authority set forth in sections 204, 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b-4, 80b-6(4), and 80b-11(a)].").