

Submitted Electronically

December 27, 2022

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

**RE: Release Nos. IA-6176; File No. S7-25-22; RIN 3235-AN18**  
**Proposed Rule: Outsourcing by Investment Advisers**

Ladies and Gentlemen:

Morningstar welcomes the opportunity to comment on the Outsourcing by Investment Advisers, or Proposed Rule, recently published by the Securities and Exchange Commission, SEC or Commission.<sup>1</sup> Morningstar is a leading provider of independent investment research and has a long history of advocating for transparency in global markets and brings several perspectives to the Proposed Rule. Morningstar's mission is to help investors reach their financial goals. Because we offer an extensive line of products for individual investors, investing for retirement and other purposes, professional financial advisors, and institutional clients, we have a distinct view on the Proposed Rule's possible effect on the financial advice retirement investors will receive.

In addition, as an index and data provider, Morningstar has perspective on the potential effects of regulating third-party service providers. Morningstar is an important part of the index ecosystem globally, with a strong track record of growth and innovation. We have staff who have been involved in index governance and administration working with industry participants for more than 30 years. As a firm we have been compliant with the International Organization of Securities Commission Principles for Financial Benchmarks, or IOSCO Principles, and regulated under both the U.K. and E.U. benchmarks regulations since the introduction of each. As such we believe that we have useful insights into how the Proposed Rule will affect index providers.

**Executive Summary**

To further facilitate the Commission's goals, we submit the following comments and suggestions:

1. We believe the Commission should exempt arrangements subject to the Employee Retirement Income Security Act of 1974, or ERISA, from the Proposed Rule.
  - Service providers and arrangements covered under ERISA are already obligated to provide ERISA fiduciaries a significant volume of information consistent with the Proposed Rule.
2. Morningstar supports the Commission's Proposed Rule prohibiting registered investment advisers, or RIAs, from outsourcing certain services or functions without first meeting minimum requirements and urges the Commission to clarify the definition and provide guidance on where research and data analytics fall in terms of covered functions.
  - We believe that providing publicly available research and aggregating public data should not be covered functions.

---

<sup>1</sup> SEC. 2022. Outsourcing by Investment Advisers. <https://www.federalregister.gov/documents/2022/11/16/2022-23694/outsourcing-by-investment-advisers> (Proposed Rule).

3. Morningstar supports the Commission's proposal to require advisers to conduct reasonable due diligence prior to engaging a service provider in cases when function is within scope.
  - In many cases, service providers are already providing appropriate levels of information to investment advisers as per their requests, so the Proposed Rule need not be prescriptive in how due diligence requirements are met.
4. Morningstar supports the Commission's regulation of index providers and affiliates that perform covered functions and suggests some clarifying guidance.
  - We urge the Commission to clarify in the preamble to the final rule that index providers that meet the obligations of the IOSCO Principles satisfy the due diligence requirements.
  - We support the Commission's application of the requirements for index providers to affiliated entities in the same way as unaffiliated entities.

## **I. Arrangements subject to ERISA should be exempt from this Proposed Rule.**

Advisers subject to ERISA already have a robust regulatory overlay. In cases where an RIA is also an ERISA fiduciary, contracts between these advisers to ERISA plans and service providers require due diligence, and often the service provider represents themselves as an ERISA fiduciary. In cases where the service provider under ERISA is being monitored by an ERISA fiduciary, we believe that the Proposed Rule should not apply because it would add a duplicative, time-consuming, and unnecessary layer of review.

The current set of laws and guidance already results in a high standard of due diligence and monitoring in these retirement plan outsourced arrangements. The selection of service providers is a fiduciary act subject to general fiduciary standards of care described in section 404 of ERISA.

The Department of Labor, or DOL, has long approved the outsourcing of investment advice functions by an RIA to third-party providers. For instance, in the SunAmerica Advisory Opinion, the DOL permitted RIAs to outsource fund line-up construction to third party service providers under an arrangement that allows ERISA fiduciary advisers to avoid a conflict and a potential prohibited transaction.<sup>2</sup> Congress also passed a class exemption, ERISA section 408(b)(14) and 408(g), which provides an exemption to ERISA's prohibited transaction rules for certain computer-generated advice recommendations. The exemption requires the use of an independent third-party "eligible investment expert" to certify that the model fits the conditions of the exemption.

ERISA requires that fiduciaries monitor and perform due diligence on service providers. "With regard to the prudent selection of service providers generally, the DOL has indicated that a fiduciary should engage in an objective process that is designed to elicit information necessary to assess the providers qualifications, quality of services offered, and reasonableness of fees charged for the service. The process also must avoid self-dealing, conflicts of interest, or other improper influence."<sup>3</sup>

Further, under ERISA, fiduciaries hiring investment advisers have a number of considerations. The fiduciary should consider the experience and qualifications of the investment adviser and the willingness of the adviser to assume fiduciary status and responsibility under ERISA with respect to the advice provided to participants. In monitoring investment advisers, the DOL expects that fiduciaries will "periodically review, among other things, the extent to which there have been any changes in the information that served as the basis for the initial selection of the investment adviser, including whether the adviser continues to

---

<sup>2</sup> DOL. 2001. Advisory Opinion 2001-09A. <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/advisory-opinions/2001-09a>.

<sup>3</sup> DOL. 2007. Field Assistance Bulletin No. 2007-01. <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2007-01> (Field Assistance Bulletin).

meet applicable federal and state securities law requirements, and whether the advice being furnished to participants and beneficiaries was based upon generally accepted investment theories. Fiduciaries also should consider whether the investment advice provider is complying with the contractual provisions of the engagement; utilization of the investment advice services by the participants in relation to the cost of the services to the plan; and participant comments and complaints about the quality of the furnished advice.”<sup>4</sup>

For the fiduciary to ensure that all of these considerations are satisfied, the investment adviser would, in turn, have to monitor any service providers with which it contracts in such an arrangement to facilitate the highest standards of prudence and care. Thus, investment advisers are obligated to meet the standards of the ERISA fiduciaries they serve, and they often represent themselves as ERISA fiduciaries. To meet the standards to which they are obligated, these RIAs must monitor the service providers they select.

Given the volume of information outsourcers expect in ERISA relationships, we recommend that the Commission exempt arrangements covered by ERISA from the Proposed Rule to avoid duplicative regulation that will needlessly complicate the regulatory landscape for retirement investment advice. In our experience providing services as an independent financial expert under ERISA, we are expected to provide our policies regarding business continuity planning, cyber security, and model methodology to clients under the due diligence obligations of being a service provider to an ERISA fiduciary. ERISA fiduciaries ask for, and we provide, information on investment allocation methodologies, historical returns, and the assumptions underlying expected returns. We answer numerous questions about our qualifications, our business practices, and our systems and controls. We also provide our clients with information on how exactly we use and protect their personal information in our data privacy policies. In sum, expectations already exist that are consistent with the Proposed Rule and may go beyond it in some cases.

## **II. We urge the Commission to clarify which research and data analytics services are covered functions.**

Morningstar supports the Commission in requiring advisers to conduct reasonable due diligence prior to engaging a service provider to perform covered functions; however, we believe the Proposed Rule needs to be clarified because the definition is unclear as to what functions are covered, and which are not, especially when pertaining to research and data analytics.

Morningstar views the Commission’s ability to provide specific definitions as integral to the Commission’s opportunity to provide clear guidelines. The Commission notes that it is targeting outsourced functions that meet two elements; those necessary for the adviser to provide its investment advisory services, and those if performed negligently or not, would be reasonably likely to cause a material negative impact.<sup>5</sup>

The Proposed Rule states that a function is covered if the adviser retains the service provider to perform a function necessary for providing advisory services. The Commission mentions these supporting functions may include investment research and data analytics; however, the Proposed Rule mentions the word “research” only once.<sup>6</sup> The Commission needs to devote more space to clarifying that providing research that is public or widely available, such as data aggregation, is **not** a core investment adviser function and therefore should not be a covered function. We believe that generally only core functions should be covered functions, but at a minimum, such general services that provide data for investment advisers to use at their discretion should not be covered functions.

---

<sup>4</sup> Field Assistance Bulletin.

<sup>5</sup> Proposed Rule, P. 68821.

<sup>6</sup> Proposed Rule, P. 68817.

The Commission indicates that investment guideline/restriction compliance is a potential covered function category; however, the Commission does not expand on what this activity encompasses.<sup>7</sup> Advisers use a variety of research tools when providing advice, often to filter investment options by ratings, expense ratios, and other factors. We believe that data provided for the convenience of advisers, such as expense ratios and ratings, should not be covered functions since the adviser exercises discretion on how to use this data. While it is important to abide by reasonable due diligence standards for functions covered under the rule, the provision of any aggregated data, such as fund data, environmental, social, and governance data, and other commonly used aggregations should not be covered functions. Publicly available information such as SEC filings and expense ratings are available for adviser use; service providers assist by aggregating this data, making it more convenient for the RIA to utilize and service clients. It is then up to the RIA's discretion on how to screen and use this data when providing advisory services.

Morningstar agrees with the Commission that covered functions may include model portfolios, portfolio management and valuation, but when service providers are aggregating data that advisers may choose to use, this research and data are not part of the core functions essential for the adviser's advisory services and therefore should not qualify them as a covered function. The Commission should clarify this important distinction in more detail, to avoid confusing RIAs. As it stands, the Commission mentions in footnote 39 of the Proposed Rule that an adviser's use of valuation service providers for assistance in fair value determinations is an example of a covered function and distinguishes this from common market data providers providing publicly available information.<sup>8</sup> We agree that valuation service providers may be covered; however, this footnote makes no specific mention of what does not count as a covered function. Since the Commission finds common market data provision is not covered under the definition of covered function, clarification on what data is derived from "common market data" and "publicly available information" would explain where research tools fall with respect to covered functions. While the Commission notes that a covered function depends on the facts and circumstances, definitive guidance that when an adviser uses software and data for research and analytics purposes it would not be a covered function would clarify the reasonable due diligence obligations of RIAs. We respectfully submit that incorporation of a third element to the definition of covered function that "those functions that would otherwise be performed by the adviser itself" would provide much-needed clarification without undermining the intended purpose of the Proposed Rule.

### **III. In cases when function is within scope, we support the Commission's proposal that would require advisers to conduct reasonable due diligence prior to engaging a service provider as long as the requirements are not overly prescriptive.**

We support the Commission's due diligence requirements for covered functions, as we believe requiring advisers to conduct reasonable due diligence that enables them to identify and address the relevant risks before engaging a service provider and monitoring those risks appropriately during the term of the engagement with the service provider is valuable. Morningstar's suggestions in this section reflect common due diligence practices for service providers. We detail our recommendations below.

The Commission's Proposed Rule requires advisers to reasonably identify and determine if it is appropriate to outsource covered functions, appropriate to select the service provider, and once selected, if it is appropriate to continue to outsource the covered function by complying with six specific elements.<sup>9</sup> Service

---

<sup>7</sup> Proposed Rule, P. 68821.

<sup>8</sup> Proposed Rule, P. 68822.

<sup>9</sup> Proposed Rule, P. 68820.

provider due diligence needs to be “reasonable,” allowing these practices to fit the name, scope, and risk profile of a covered function.<sup>10</sup>

Morningstar recognizes what is reasonable is not a one-size-fits-all determination and will differ between service providers. We think appropriate measures of reasonableness should include the provision by service providers of policies and procedures regarding cyber security, asset and information management, access control and business resiliency. Service provider security questionnaires provide information about the service provider’s system that may be useful when assessing the risks arising from interactions with the system. Such questionnaires typically include information about the system control that the service provider designs, implements, and operates to provide reasonable assurances of the robustness of the system. These system requirements are designed to support the goals of information security and confidentiality, as well as to meet compliance with relevant laws and regulations.

We believe that many RIAs already conduct meaningful due diligence reviews and therefore service providers are often held to a high standard of monitoring and due diligence. For example, many service organizations voluntarily comply with certain compliance standards, such as Systems and Organizational Controls II, or SOC 2.<sup>11</sup> Consequently, the Commission need not be too prescriptive on what advisers should do to meet their obligations. General requirements around security and business continuity are likely to elicit sufficient questionnaires and monitoring to protect clients. These questionnaires can be altered to meet a client’s needs and to fulfill relevant regulations. The Commission notes that an adviser should confirm that the service provider has the competency, capacity, and resources to perform the covered function.<sup>12</sup> In practice, this requirement is often already met as service providers answer a host of questions on a variety of topics including compliance, business resiliency, network security, server security, privacy, risk management, asset and information management, cloud hosting, and threat management. In a scenario where outsourcing a covered function represents high risk, the adviser may want to assess competency by focusing on the service provider’s expertise, and through altering a security questionnaire with the service provider, they would be able to do such tailoring. Thus, we believe that the final rule need not be prescriptive in how due diligence requirements are met, as in many cases service providers are already providing appropriate levels of information to investment advisers as per their requests; the regulation should seek to focus current industry practices on risk identification and mitigation and make them consistent, but not alter them in a substantive way.

#### **IV. Morningstar supports the Commission’s Proposed Rule around the regulation of index providers and suggests some clarifying guidance.**

Morningstar supports the Commission in its proposal to clarify due diligence obligations of RIAs outsourcing covered functions to index providers. The Commission provides examples of what activity by an index provider may fall under the definition of a covered function, including, being retained by an adviser for purposes of formulating the adviser’s investment advice, implementing an investment decision, or creating or providing a bespoke index specifically for an adviser. While outsourcing these activities to index providers can be cost-effective for the adviser and benefit investors by lowering fees and increasing the quality of service, risk may result when an adviser outsources to an index provider without adviser oversight. A consistent oversight framework requiring investment advisers to comply with specific

---

<sup>10</sup> Proposed Rule, P. 68826.

<sup>11</sup> See description of SOC 2 at <https://www.aicpa.org/topic/audit-assurance/audit-and-assurance-greater-than-soc-2>.

<sup>12</sup> Proposed Rule, P. 68829.

elements as part of a due diligence and monitoring process to oversee the provision of covered functions could mitigate that risk. We believe the Commission can help index providers and advisers leverage the existing IOSCO Principles for Financial Benchmarks to meet due diligence requirements.

**A. We urge the Commission to clarify in the preamble to the final rule that meeting the obligations of the IOSCO Principles satisfies the due diligence requirements.**

Morningstar recommends that if the arrangements between the investment advisers and the index provider are consistent with the IOSCO Principles, then the SEC should clarify that its due diligence requirements are more than satisfied under the Proposed Rule. The Proposed Rule would require advisers to conduct reasonable due diligence before engaging a service provider to perform a covered function by complying with the six elements identified by the SEC, all of which align with one or more of the 19 IOSCO Principles.<sup>13</sup>

- (i) Identify the nature and scope of the covered function the service provider is to perform: This requirement aligns with IOSCO Principle 1, which requires the establishment of credible and transparent governance, oversight, and accountability procedures. This IOSCO Principle not only includes identifying the nature and scope of the service provider's function, but also provides for the designation of an overall entity to be responsible for the integrity of the benchmark.
- (ii) Identify and determine how it would mitigate and manage the potential risks to clients or to the investment adviser's ability to perform its advisory services, resulting from engaging a service provider to perform a covered function and engaging that service provider to perform the covered function: This requirement aligns with the entire IOSCO framework—Principles 1-19—in general, which promotes the mitigation of risks, and in particular through Principles 11 and 12, which promote transparency by requiring clear documentation of the benchmark methodology.
- (iii) Determine that the service provider has the competence, capacity, and resources necessary to perform the covered function in a timely and effective manner: This requirement aligns with IOSCO Principle 4 requiring implementing a framework for the process of determining and distributing the benchmark. This framework should be reviewed periodically and should ensure that benchmark determinations are made by personnel who possess the relevant levels of expertise, with a process for periodic review of their competence.
- (iv) Determine whether the service provider has any subcontracting arrangements that would be material to the service provider's performance of the covered function and identifying and determining how the investment adviser will mitigate and manage potential risks to clients or to the adviser's ability to perform its advisory services in light of any such subcontracting arrangement: This requirement aligns with IOSCO Principle 2 requiring a clearly defined written arrangement which sets out the roles and obligations of the parties involved in the monitoring of the third party's compliance with those arrangements. Administrators under IOSCO Principle 2 must consider adopting policies and procedures that:

---

<sup>13</sup> IOSCO. 2013. Principles for Financial Benchmarks Final Report. P. 13.  
<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf> (IOSCO Principles).

“a) Clearly define and substantiate through appropriate written arrangements the roles and obligations of third parties who participate in the Benchmark determination process, as well as the standards with which the Administrator expects these third parties to comply;

b) Monitor third parties’ compliance with the standards set out by the Administrator;

c) Make Available to Stakeholders and any relevant Regulatory Authority the identity and roles of third parties who participate in the Benchmark determination process; and

d) Take reasonable steps, including contingency plans, to avoid undue operational risk related to the participation of third parties in the Benchmark determination process.”<sup>14</sup>

(v) Obtain reasonable assurance from the service provider that it is able to, and will, coordinate with the adviser for purposes of the adviser’s compliance with the federal securities laws: This requirement aligns with IOSCO Principles 16 through 19 requiring written records, relevant documents, and a written complaints policy. The IOSCO Principles also discuss accountability, specifically establishing complaints processes, documentation standards, and audit reviews that are intended to provide evidence of compliance. The establishment of the written complaints policy is intended to promote the reliability of benchmark decisions. The frequency of internal audits is proportionate to the size and complexity of the Administrator’s operations.

(vi) Obtain reasonable assurance from the service provider that it is able to, and will, provide a process for orderly termination of its performance of the covered function: This requirement aligns with IOSCO Principle 13, which requires clearly written policies and procedures that address the need for possible cessation and has additional factors required, such as, that the policies and procedures should be proportionate to the estimated breadth and depth of contracts and the economic and financial stability impact that might result from a cessation.

Morningstar recommends that the assessment of index providers as to whether they meet the obligations of the IOSCO Principles be conducted by an independent internal audit, consistent with the IOSCO Principles. An internal audit can provide uniformity to the assessment.

Morningstar complies with the 19 IOSCO Principles. Under Principle 1, Morningstar holds responsibility for all stages including the development, determination, dissemination, operation, and governance of the benchmark.

Under Principle 2, we have clearly defined written arrangements in place designed to ensure that third-party involvement in the benchmark determination process maintains accuracy and minimal operational risks. We engage in robust due diligence of our external vendors prior to engaging their services and run validations to further confirm the accuracy of the index calculations on a daily basis. The controls

---

<sup>14</sup> IOSCO Principles, P. 15.



framework of Morningstar Indexes is designed to duly manage the potential operational risks arising from third parties under Principles 11 and 12, including monitoring third-party vendors by establishing data delivery agreements and standards, file delivery times and other quality assurance checks in place to actively track the integrity of third-party services, and procedures to alert the third-party vendor's client services representative in the event of a data discrepancy or delay. Vendors are evaluated for the accuracy and timeliness of the data, service levels, operational excellence, and the breadth and depth of the data offering, and ultimately, selected based on further due diligence, including on-site visits. The quality of data from our vendors is verified daily for accuracy, completeness, and timeliness via automated checks on input data and data calculations.

Under Principle 4, Morningstar Indexes implements various controls frameworks to improve the benchmark-determination process. The Morningstar Index Methodology Committee oversees all new index development, index methodology changes, the annual review of existing index methodologies, and the cessation of indexes. Morningstar Indexes promotes index quality, provides data integrity, and implements a disaster recovery framework. To make certain that all employees of Morningstar Indexes are properly qualified, all Morningstar Indexes personnel undergo an annual review and are trained and regularly updated on ethics and conflict-of-interest expectations.

Under Principles 11 and 12, Morningstar provides fact sheets, index methodologies, and methodology change process documents, all of which educate stakeholders of all criteria and procedures used for the determination of benchmarks and notify them of any changes to the methodology of indexes. Morningstar, under Principle 13, clearly documents cessation procedures, evaluates the impact of any potential cessation, and provides specific transition assistance. Under Principles 16 through 19, Morningstar's internal auditor periodically reviews and reports on its adherence to the stated criteria and the Morningstar Index Team reviews all complaints. All complaints and all data used in index determination and maintenance are kept for at least five years and Morningstar cooperates with all regulatory authorities. The Index Governance Committee may elect to use Morningstar's compliance and/or internal audit department to periodically review and report on the index team's adherence to its stated policy. When warranted, the committee may appoint an independent external auditor to review and report on the administrator's adherence to its stated criteria.

The above referenced actions are designed to facilitate provision of proper information to investors who use it. Complying with these Principles extends due diligence above and beyond the SEC's requirements, thereby facilitating the satisfaction of the stated regulatory purpose of the Proposed Rule. At the same time, it promotes global regulatory harmonization. Thus, treating compliance with the IOSCO Principles for Financial Benchmarks as meeting the due diligence requirements of the Proposed Rule is appropriate in the case of index providers.

**B. Morningstar supports the Commission's proposal to extend requirements to affiliate service providers.**

Morningstar supports imposing the same requirements on affiliate index providers as well as third-party providers. The Proposed Rule does not distinguish between third-party providers and affiliated service providers who also fit the definition of service providers performing a covered function. This lack of distinction recognizes that the risks addressed by the Proposed Rule can exist whether a provider is affiliated or unaffiliated, meaning the rule will apply to both in the same way. Risks result from the lack of



independence of index providers and eliminating conflicts of interest when working with affiliate service providers is critical. This equal application of the rule helps to provide adequate protection for investors.

The Commission could provide guidance that in the case of affiliated indexes, the investment adviser and index provider should look to the IOSCO Principles for Financial Benchmarks which provide a framework for ensuring best practices in index administration. In particular, Principle 3, “Conflicts of Interest for Administrators,” guides index administrators to “document, implement, and enforce policies and procedures for the identification, disclosure, management, mitigation, or avoidance of conflicts of interest.”<sup>15</sup> In their statement of compliance, index administrators should note their policies and procedures in addition to any material conflicts of interest. This IOSCO Principle aims to “protect the integrity and independence of Benchmark determinations,”<sup>16</sup> which we believe is the Commission’s primary concern when considering conflicts that may arise from an RIA requesting the creation of an index for use as a reference index for a fund or managed account. By requiring such indexes to be compliant with the IOSCO Principles, the Commission can ensure that the index methodology is independent and that conflicts of interest are disclosed, mitigated, and avoided when possible while still providing sufficient flexibility for investment advisers to choose an appropriate designated reference index.

## Conclusion

In summary, we support the Commission’s goal of ensuring that RIAs engaging in outsourcing certain services or functions conduct reasonable due diligence; however, given the work many firms already do to ensure service providers will meet certain standards, we offer several suggestions to improve the final rule. We urge the Commission to exempt arrangements subject to ERISA from the rule in order to avoid duplicative regulation. We encourage the Commission to clarify that research and data analytics often do not constitute covered functions. While reasonable due diligence is appropriate for covered functions, the Commission need not be prescriptive in its requirements given the sophistication of the market in this regard. Morningstar supports the Commission’s regulation of index providers that perform one or more covered functions and recommend the Commission clarify that satisfaction of the IOSCO Principles would meet the index provider’s due diligence requirements. We further support the Commission in not distinguishing between affiliated and nonaffiliated index providers in the Proposed Rule.

Morningstar thanks the Commission for the opportunity to comment on the Proposed Rule. We would be pleased to engage with the Commission on an ongoing basis, leveraging our global organization of experts operating in multiple jurisdictions. Should you wish to discuss these and other comments, please do not hesitate to contact either of us as indicated below:

Jasmin Sethi at [REDACTED]  
Aron Szapiro at [REDACTED]

Sincerely,

*Aron Szapiro*  
Head of Retirement Studies and Public Policy  
Morningstar, Inc./Morningstar Investment Management, LLC

---

<sup>15</sup> IOSCO Principles, P. 16.

<sup>16</sup> IOSCO Principles, P. 16.

*Jasmin Sethi*

Associate Director of Policy Research  
Morningstar, Inc.