American Bankers Association
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Submitted via email to *rule-comments@ sec.gov*

December 27, 2022

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

Re: Proposed Rule, Outsourcing by Investment Advisers, File No. S7–25–22, 87 Fed. Reg. 68816 (Nov. 16, 2022).

Dear Ms. Countryman:

The American Bankers Association[1] (ABA) appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC or Commission) proposed rule pursuant to the Investment Advisers Act of 1940 that would require certain due diligence, monitoring, recordkeeping, and disclosure by registered investment advisers (RIAs) when engaging third parties to perform certain services.[2] According to the release, the proposal would address SEC concerns with increased outsourcing by RIAs and the attendant risks that these arrangements may pose to clients and to the ability of the RIA to perform its services. Although advisers currently conduct due diligence on third parties under a fiduciary duty to clients, the proposal would expressly prescribe specific requirements for those processes and further require certain assurances from third parties.

On behalf of our member banks, savings associations, and trust companies (collectively, banks), we urge the SEC to (i) consider the effect this proposal would have on well-regulated third parties and on the continued availability of the services they provide, (ii) better align the

[1] The American Bankers Association is the voice of the nation's $23.6 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $19.4 trillion in deposits and extend $12 trillion in loans.
[2] Proposed rule *available at* https://www.federalregister.gov/documents/2022/11/16/2022-23694/outsourcing-by-investment-advisers.

proposal with existing bank third-party due diligence and oversight obligations, and (iii) if the SEC proceeds to finalize the rulemaking, adopt the recommendations as provided below.

Summary of the Proposal

The SEC proposes to establish a new Rule 206(4)-11 (*Service Providers*), as well as amend Rule 204-2 (*Books and records to be maintained by investment advisers*), and Form ADV. The new rule defines a "covered function" as one that "is necessary for the investment adviser to provide its investment advisory services" and that if not performed properly would likely "cause a material negative impact" on clients or the RIA's services. A "service provider" is defined as one that performs a covered function, but is not a supervised person of the RIA.

In order "to prevent fraudulent, deceptive, or manipulative acts, practices or courses of business," new proposed Rule 206(4)-11 would make it unlawful for investment RIAs to retain a service provider to perform covered functions unless the requirements of the rule are met. These requirements include specific due diligence and monitoring to be performed, such as identifying the nature and scope of the services to be performed, how potential risks will be mitigated and managed, a determination of the competency and capability of the service provider, a determination of material subcontracting arrangements of the service provider, and lastly, receipt of "reasonable assurances" from the service provider that it will coordinate with the RIA's regulatory compliance obligations and provide a process for orderly termination of service.

Rule 204-2 would be amended to require additional recordkeeping on the due diligence and monitoring performed on service providers, written agreements with the service provider, as well as receipt of certain assurances from service providers that make or keep any books and records required under the rule. In particular, an RIA must obtain assurances that the service provider will "adopt and implement internal processes" to keep records required under the rule, as well as "allow the investment adviser and staff of the Commission to access the records easily through computers or systems during the required retention period pursuant to the section."

Form ADV would be amended to require additional disclosure about service providers. Although the purpose of such disclosure is to "help the Commission and its staff in their efforts to oversee" RIAs and to "enhance client and investor disclosures," the now confidential information about service providers would be made available to the public on the Commission's website.

Concerns about Insufficient Time to Comment on Proposal

As noted in the October 2022 SEC Inspector General's report, there has been a significant increase in rulemaking issued by the agency in 2022 alone when compared to historical trends.[3] This voluminous rulemaking would affect all aspects of the capital markets, investors, SEC regulated entities, as well as other financial institutions, such as banks, that are not regulated by the Commission. With respect to the outsourcing proposal, Commission implicitly recognizes the great number of policy, legal, and economic issues in play when it poses 101 sets of questions, totaling several hundred sub-questions focused on the proposal's terms, scope, and implications for various business arrangements. Unfortunately, despite the wide-ranging and dynamic consequences this and the over 30 other outstanding proposals will have (especially if concurrently finalized), the SEC has not provided sufficient time for affected parties to analyze and comment on the substance. We are concerned that the truncated comment period will lead to rulemaking that, because it is not fully informed and vetted, will be unreasonably burdensome to our members, potentially compromise the availability of third party services to RIAs and investors, and be counterproductive to the SEC's market reform objectives.

Scope of Proposal is Too Broad and Will Impose Undue Burden on Regulated Institutions

We are not convinced that the case has been made for broadly imposing prescriptive due diligence and monitoring requirements beyond what is already conducted by investment advisers under fiduciary principles and other existing rules, especially as it may impose costly and time-consuming changes to technology systems, internal policies and procedures, as well as employee training. As others have noted, it is unclear whether the proposed requirements would have prevented or mitigated the examples of third party failure that are highlighted in the release. Therefore, if the SEC proceeds with this rulemaking, we urge the adoption of the following alternatives that are intended to minimize the economic impact on regulated financial institutions.

[3] Office of the Inspector General, The Inspector General's Statement on the SEC's Management and Performance Challenges (October 13, 2022), *available at* https://www.sec.gov/files/inspector-generals-statement-sec-mgmt-and-perf-challenges-october-2022.pdf. The Report notes that as of August 2022, there were 26 proposals issued. Since that time seven more significant proposals, including the one discussed here, have been released, for a total of 33 proposals in 2022 alone.

Regulated Banks Should Be Exempt from Definition of Service Provider

The proposal would indirectly apply to service providers providing covered functions to an investment adviser. Given the extensive federal and state statutory, regulatory, and supervisory framework in which they operate as principal and as service providers, banks should be explicitly exempt from the definition of service provider to the extent they may be covered. Pursuant to 12 USC section 1820(d), banks must receive a full-scope, on-site examination every 12 or 18 months. Larger institutions have examiners within the bank's premises throughout the year to monitor activities continuously. During these mandated examinations, federal and state banking regulators routinely look at compliance with a myriad of laws and regulations, including those related to safety and soundness, information technology and cybersecurity,[4] consumer compliance, third party relationships, asset management and custody services, as well as the bank's management of various risks.

Covered Functions Should Not Include Services of a Qualified Custodian

Although the preamble suggests that these services would not be covered functions, we urge the Commission to make clear that custody and ancillary services are not "outsourced" services and therefore not within the scope of the proposal. Except in very limited circumstances, Rule 206(4)-2 prohibits investment advisers from having custody of client assets and further requires a "qualified custodian," such as a bank, to maintain those client funds and securities. Outsourcing, although not specifically defined in the proposal, typically means "a business practice in which a regulated entity uses a service provider to perform tasks, functions, processes, services or activities (collectively, 'tasks') that would, or could in principle, otherwise be undertaken by the regulated entity itself."[5] In the case of custody of client funds, a non-dually registered adviser cannot "outsource" that function to a third party, because it does not have the

[4] FFIEC IT Examination Handbook InfoBase contains booklets, guidance and other tools for banks and their examiners on audit, management, information security, operations, outsourcing, and other related information technology matters, *available at* https://ithandbook.ffiec.gov/.

[5] IOSCO, Principles on Outsourcing Consultation Report (May 2020), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD654.pdf. The Basel Committee similarly defines outsourcing to mean activity that "would normally be undertaken by the regulated entity, now or in the future." Basel Committee on Banking Supervision, Outsourcing in Financial Services (February 2005), available at https://www.bis.org/publ/joint12.pdf.

authority to do so itself without it being deemed "a fraudulent, deceptive, or manipulative act, practice or course of business."[6]

Further, the contractual agreement for custody services is between the investor and the custodian. Even if the RIA has a relationship with the custodian and does perform a certain level of due diligence pursuant to its fiduciary duties, it is the investor client, not the advisor, who ultimately chooses and contracts with the custodian. In the case of a registered investment company, the fund's board of directors would exercise its own oversight of the contract for custody or ancillary services pursuant to its fiduciary duties and/or Rule 38a-1.

Proposal Should Reflect Enterprise-Wide Risk Management by Bank-Affiliated RIAs

The SEC should avoid conflicting or redundant standards for bank-affiliated RIAs that comply with comprehensive third-party risk management and oversight guidance on an enterprise-wide basis.[7] Federal bank regulator guidance outlines the obligations of national and state chartered banks to implement an effective risk management process throughout the lifecycle of a third-party relationship. Similar to the SEC's proposal, this guidance includes expectations on the selection, assessment, and oversight of third-party relationships. These existing obligations apply to third parties that perform critical activities, including those that perform critical functions for bank-affiliated RIAs.

We urge the SEC to deem RIAs that comply with existing and comparable regulatory guidance related to third-party oversight, such as the bank regulator guidance noted above, to be in compliance with any rule adopted for investment advisers. This approach will allow bank-affiliated RIAs to follow on an enterprise-wide basis a comprehensive standard for third-party risk management without creating a conflicting or duplicative SEC standard.

[6] Rule 206(4)-2 (a).

[7] *See* OCC Bulletin 2013-29, Third-Party Relationships: Risk Management Guidance (for national banks and federal thrifts); Federal Reserve Board SR 13-19 / CA 13-21, Guidance on Managing Outsourcing Risk (for state-chartered member banks); FDIC FIL-44-2008, Guidance for Managing Third-Party Risk (for state-chartered nonmember banks). *See also*, OCC/Federal Reserve/FDIC Proposed Interagency Guidance on Third-Party Relationships: Risk Management, *available at* https://www.federalregister.gov/documents/2021/07/19/2021-15308/proposed-interagency-guidance-on-third-party-relationships-risk-management.

Proposal's Requirements Pose Unreasonable Compliance Burdens on Third Parties

The proposal would impose unreasonable compliance burdens on third parties deemed service providers of covered functions that will ultimately affect the availability and terms of those services. Of particular concern are four requirements for RIAs to obtain certain information or assurances from the service provider, as well as to disclose information that is currently not made public:

1. Proposed 206(4)-11 (a)(1)(iv) would require RIAs to determine whether a service provider has subcontracting arrangements material to their performance of a covered function. To fulfill this requirement, a service provider would have to conduct an assessment of its third parties to determine whether any are "material" as defined under the securities laws before providing the list to the RIA. We expect such a broad assessment to be a time-consuming, labor-intensive manual process for service providers, especially ones that are already subjected to third party risk management guidance and oversight under other applicable laws. The service provider's willingness to undertake and maintain such an analysis before and during any retention may dissuade certain providers from providing the full scope of services now performed.
2. Under proposed 206(4)-11 (v), the RIA must obtain reasonable assurance from the service provider that "it is able to, and will, coordinate with the investment adviser for purposes of the adviser's compliance with the Federal securities laws, as applicable to the Covered Function." This vague and potentially broad requirement not only defies compliance certainty, but also could pose conditions on service providers that may compel them to act outside of their contractually specified duties and beyond the normal course of business. Some services are provided by entities on a directed basis, meaning that they are simply taking direction and executing transactions as authorized in the agreement by the RIA. That service would not entail monitoring or policing the RIA for its compliance with securities laws. To require service providers to take on that additional responsibility could undermine the economics of the business and unnecessarily expose the service provider to liability under an ill-defined standard.
3. Amended 204-2 (l)(2)(iii) requires the RIA to obtain "reasonable assurances" that the service provider will allow Commission staff access through computers or systems to records during the required retention period. Providing SEC staff with separate access to electronic records,

as opposed to having RIAs obtain and provide such records during examination would pose cost and operational burdens on service providers, especially those subject to heightened information technology requirements. To provide access in a proper way, service provider operational personnel would need to create electronic access that is both unique to SEC staff and segregated from other confidential and sensitive systems. This access would likely need to be opened, maintained, and subsequently closed for each Commission staff request during the retention period and not simply left open in an ongoing fashion. The alternative of having the RIA obtain its records held by the service provider through its established access and providing that to Commission staff is a more reasonable approach.[8]

4. Proposed Section 7.C of Schedule D of Form ADV would require RIAs to disclose information about service providers and the covered functions they perform. This information, which is now confidential, would be made available to the public on the Commission's website. Both parties to these arrangements have legitimate security, proprietary, and business concerns about sharing this information publicly. At a minimum, this information if collected for the purpose of assisting Commission staff should be kept confidential.

Conclusion

ABA appreciates the opportunity to comment on the SEC's proposal on outsourcing by RIAs, notwithstanding concerns about the short comment period provided. The proposal, as written, is too broad and would impose unnecessary and undue compliance burdens on those entities deemed to be service providers. We therefore recommend that if the SEC proceeds with this rulemaking it adopt the alternatives identified and described in this letter, which are intended to minimize the burdens on all parties.

Sincerely,

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[8] We also note that 12 USC Section 484 imposes limits on visitorial powers over national banks.