December 27, 2022

Submitted electronically through rule-comments@sec.gov

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

Re: Outsourcing by Investment Advisers (Investment Advisers Act Release No. 6176) [File Number S7-25-22]

Dear Ms. Countryman:

The Money Management Institute (the "MMI") appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") in response to the Commission's proposed rules under the Investment Advisers Act of 1940 (the "Advisers Act") governing investment adviser outsourcing arrangements and related amendments to Form ADV (the "Proposal").[1]

MMI is the national organization for the advisory solutions industry, representing a broad spectrum of investment advisers that manage separate accounts as well as sponsors of investment consulting programs. MMI was organized in 1997 to serve as a forum for the industry's leaders to address common concerns, discuss industry issues, and work together to better serve investors. Our membership comprises firms that offer comprehensive financial consulting services to individual investors, foundations, retirement plans, and trusts; related professional portfolio-management firms; and firms that provide long-term services to sponsor, manager, and vendor firms. MMI is a leader for the advisory solutions industry on regulatory and legislative issues.

For the reasons discussed below, we oppose the Proposal and believe that the Commission has not adequately evaluated the need for, or articulated the framework of, the Proposal. In particular, we believe that (1) the illustrations cited in the Proposing Release of harms and risks caused by investment adviser outsourcing are insufficient to justify the Proposal, and the Proposal would not necessarily alleviate the harms and risks if adopted; (2) the Commission's issuance of the Proposal as an antifraud rule is without justification; (3) the scope of "covered functions" in the Proposal is overbroad and vague; (4) the Proposal is not tailored to the realities of managed-account and wrap-fee programs and would result in

[1] *Outsourcing by Investment Advisers*, Investment Advisers Act Release No. 6176, 87 Fed. Reg. 68,816 (Proposed Oct. 26, 2022) (to be codified at 17 C.F.R. Pts. 275 and 279) (the "Proposing Release").

significant redundancies and costs to industry participants and clients alike; (5) the Proposal does not account for the challenges that investment advisers encounter when contracting with service providers; (6) as drafted, the Proposal would inappropriately and indiscriminately expose investment advisers to potential responsibility or liability for the conduct of their service providers when it should instead provide for a non-exclusive safe harbor from such liability; (7) the Proposal would pose unreasonable costs to the industry, with disproportionate impact on smaller investment advisers and their clients; (8) the Proposal disregards important distinctions between affiliates and third parties and regulated versus unregulated service providers that should be accounted for in the Proposal's framework; (9) the Proposal inappropriately requires public disclosure of an investment adviser's service provider relationships on Form ADV, which imposes significant competitive and cybersecurity risks; and (10) any policy or rulemaking relating to outsourcing should be based on consideration of other Commission rules, the Commission's enforcement authority, and the approaches taken by other regulators.

Below, we discuss each point in detail.

1. The illustrations cited in the Proposing Release of harms and risks caused by investment adviser outsourcing are insufficient to justify the Proposal, and the Proposal would not necessarily alleviate the harms and risks if adopted.

Throughout the Proposing Release, the Commission provides various illustrations of harms purportedly caused, and risks posed, by investment adviser outsourcing in an effort to justify the Proposal. However, we echo Commissioner Mark T. Uyeda's sentiment that the "observations cited in the [Proposing Release] as a basis for proposing this rule do not appear to describe service provider failures that would have been prevented had the rule been in effect."[2] Appendix A to this letter lists the illustrations cited in the Proposing Release and our brief analysis of why those illustrations do not support the Proposal. In this regard, we believe the Commission does not allege that the investment advisers cited in the illustrations lacked the controls that would be required by the Proposal, nor does the Commission demonstrate that the noted harms or risks would have been prevented or mitigated had the controls required by the Proposal been in place. Further, certain illustrations appear to involve a contracting party that is either not an investment adviser[3] or a service provider that does not appear to perform a function that would be a covered function under the Proposal.[4] We strongly disagree that these illustrations justify the Proposal and urge the Commission to reconsider whether the Proposal is necessary or appropriate based on the limited support provided by the illustrations and the Commission's responsibility when pursuing rulemaking under the provisions of the Advisers Act cited by the Commission as conferring it authority for the Proposal.

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[2] *See* Commissioner Mark T. Uyeda, Securities and Exchange Commission, Statement on Proposed Rule Regarding Outsourcing by Investment Advisers (Oct. 26, 2022), (*hereinafter* "Commissioner Uyeda Statement"), https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622.

[3] *See* Proposing Release at 68,818 n.12 and accompanying text.

[4] *See* Proposing Release at 68,819 n.19 and accompanying text.

2. The Commission's issuance of the Proposal as an antifraud rule is without justification.

The Commission issued the Proposal (other than the recordkeeping rule provisions) as an antifraud rule under the Advisers Act. We believe that proposing the Proposal as an antifraud rule is inappropriate and without any offered justification. For example, an investment adviser may reasonably conduct due diligence and monitoring of a vendor in good faith based on the investment adviser's historical experience in dealing with such vendors. However, the Commission does not present any meaningful justification for the investment adviser's actions to be classified as defrauding, manipulating or deceiving investors if the Commission later determines such due diligence or monitoring to be inadequate. In this regard, Commissioner Hester M. Peirce rightly focuses on the Commission's disregard of this responsibility, stating that "[a]n 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."[5] As an antifraud rule, a violation could lead to serious reputational harm for a comparatively minor violation, and, as such, the Commission should explain why any rule in this area should be an antifraud rule.

3. The scope of "covered functions" in the Proposal is overbroad and vague.

The Proposal defines a "covered function" as any function or service that "is necessary for the investment adviser to provide its investment advisory services in compliance with the Federal securities laws" or "that, if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's ability to provide investment advisory services."[6] Commissioner Uyeda encapsulated our concern when he observed that "many functions or services that do not relate to an adviser's investment advisory function nonetheless are necessary for the adviser to provide its investment advisory services in compliance with the federal securities laws."[7] This overexpansive and vague definition leaves room for significant ambiguity and is likely to cause confusion in its interpretation and implementation across the industry.

An example of such ambiguity is reflected in the Proposal's discussion of the treatment of index providers. Throughout the Proposing Release, the Commission cites to index providers as being both covered and not covered, depending on the situation. Specifically, the Proposing Release states that a contract for the licensing of a widely known index as a performance hurdle would not involve a covered function, while licensing an index to develop an investment strategy for clients (e.g., an index fund) would be a covered function. However, an investment adviser to a product that does not track an index but simply uses an index as a performance benchmark may still reference the benchmark in various ways (e.g., holdings or constituents,

[5] *See* Commissioner Hester M. Peirce, Securities and Exchange Commission, Outsourcing Fiduciary Duty to the Commission: Statement on Proposed Outsourcing by Investment Advisers (Oct. 26, 2022), https://www.sec.gov/news/statement/peirce-service-providers-oversight-102622.

[6] Proposing Release at 68,879.

[7] *See* Commissioner Uyeda Statement.

volatility, risk metrics) as part of the product's investment strategy. For example, the investment adviser may compare the product's holdings to the performance benchmark's constituents to understand where opportunities for alpha exist relative to the benchmark to assist in outperforming the benchmark. As another example, an investment adviser seeking to differentiate its product from the product's performance benchmark (i.e., exhibit or improve "active share") may refer to the benchmark during the investment selection process. The Proposal does not provide investment advisers or index providers with guidance sufficient to analyze whether and how the Proposal applies to uncertain scenarios such as these and others. As a result, investment advisers conceivably could have to treat every outsourcing (unless expressly excluded) as potentially involving a covered function if the arrangement could remotely be viewed as a covered function or could at some point in the future morph into that. This is especially true if the Proposal is issued as an antifraud standard, where investment advisers likely would want to mitigate potential regulatory scrutiny or liability, including possible Commission enforcement action, premised on the investment adviser taking too narrow a view of what constitutes a covered function under the circumstances.

There is a wide variety of functions that investment advisers may choose to outsource, and vagaries in whether and in what respect those functions cross over into covered functions will pose formidable challenges for investment advisers of all kinds. Moreover, investment advisers can be expected to use multiple service providers for any particular function. The typical range of service providers performing these functions runs a broad gamut, including the following:

1. Accounting firms (including for surprise verifications and internal control reviews under Rule 206(4)-2)
2. Alternative trading systems
3. Attorneys
4. Bankruptcy, class action and other claims administrators
5. Banks and other businesses providing sweep programs for investment of client free-credit balances
6. Benchmark providers
7. Broker-dealers
8. Clearing agencies
9. Compliance consultant
10. Customer relationship management (CRM) system vendors
11. Cybersecurity consultants
12. Delivery vendors (e.g., Form ADV Part 2As, prospectuses)
13. Distributors
14. Due diligence service providers
15. Electronic platform service providers (e.g., e-delivery and cloud-computing platforms)
16. Expert network firms
17. Financial planning software providers
18. Foreign-exchange firms
19. Index providers
20. Industry experts
21. Information technology consultants and vendors
22. Insurance carriers (including for fidelity and fiduciary bonding)
23. Investment guideline / Restriction compliance service providers
24. Investment risk consultants
25. Investment sub-advisers
26. Language-translation providers
27. Model providers
28. National securities exchanges

29. Order management system vendors
30. Outsourced trading desks
31. Overlay managers
32. Participating affiliates
33. Performance presentation consultants
34. Physical and electronic recordkeeping service bureaus
35. Placement agents
36. Portfolio accounting vendors
37. Portfolio analysis tool vendors
38. Portfolio management system vendors
39. Pricing and valuation firms
40. Promoters (including under Rule 206(4)-1)
41. Proposal generation tool providers
42. Providers of data analytics
43. Providers of market data
44. Proxy voting advisers and processors[8]
45. Qualified custodians
46. Rating agencies
47. Research providers
48. Service providers facilitating beneficial ownership reporting
49. Technology consultants
50. Trade implementation vendors
51. Trade reconciliation service providers
52. Transfer agents

The above non-exhaustive list shows the breadth of potential covered functions and further supports the notion that the Commission should more thoughtfully evaluate and clarify the definition of covered functions and provide related interpretive guidance. This list also demonstrates that the Proposal should distinguish between when an investment adviser truly "outsources" an advisory function to a vendor and when an investment adviser simply engages a vendor to provide a product or service related to the investment adviser's investment advisory services. Not every product or service provided by a vendor that touches upon investment advisory services can reasonably be expected to constitute the outsourcing of investment advisory functions.[9] However, without further clarification, investment advisers are likely to take a conservative approach and deem every service performed by a service provider that is not expressly excluded from the definition to be a covered function. Otherwise, investment advisers risk Commission examination and enforcement staff second-guessing the investment advisers' determinations with the benefit of hindsight.

4. The Proposal disregards the thoughtful architecture of managed-account and wrap-fee programs and would result in significant redundancies and added costs to investment advisers and their clients.

We fundamentally disagree with the Commission's proposed approach with managed-account or wrap-fee programs to the extent that it would have the effect of forcing each participating investment adviser that retains the same service provider to separately, and

[8] Commissioner Uyeda highlighted this point, stating that "[t]he outsourcing of proxy voting advice presumably would be a 'Covered Function' under the rule. However, when the release requests comment on whether various types of specified services or services providers should be identified in the final rule text, proxy voting advisory businesses are noticeably absent." *Id.*

[9] For example, the Commission should thoughtfully consider the extent to which various software solutions (e.g., CRM, cloud storage, financial planning tools) are covered functions.

redundantly, evaluate each service provider involved in providing services under the particular arrangement. In this regard, the Commission stated:

> The proposed rule could also have provided an exception for separately managed accounts and other wrap fee programs. As proposed, an adviser in such a program would be subject to the proposed rule if they retain a service provider for its provision of advisory services. As such, multiple advisers that retain the same service provider may need to conduct due diligence and monitoring on that service provider, depending on whether such services are covered function. As an alternative, the proposed rule could provide an exclusion for advisers that engage service providers to perform covered functions as part of a larger program or arrangement, such as the sponsor of a wrap fee program or other separately managed account program in which the sponsor is subject to the proposed rule with respect to the participation of the service providers in the program. One advantage of such an exception could be reducing the potential for redundancy in the due diligence and monitoring of service providers conducted in wrap fee programs. However, we believe that sub-advisers that retain service providers are best positioned to conduct appropriate due diligence and monitoring of a service provider in connection with its particular sub-advisory role. For instance, while a sub-adviser overseeing fixed-income portfolio strategies and a sub-adviser overseeing equity portfolio strategies may retain the same service provider, there may be different operational risks, conflicts of interest, or other problems discovered upon due diligence or monitoring with respect to each of these roles. Therefore, we do not believe that it would be appropriate to provide an exception for such cases.[10]

Managed-account or wrap-fee programs are notable for the sophisticated and well-constructed and coordinated approach to delivering an array of services that tap the expertise of many service providers—including investment advisers. However, each service provider is typically allocated or tasked with performing relatively discrete roles. The fact that an investment adviser participating in a managed-account or wrap-fee program retains and relies on other service providers to perform facets of the overall services in no way should be taken to mean that each investment adviser needs to separately conduct due diligence and monitor the performance of service providers, especially where the service provider is supervised by another investment adviser or service provider or by the client itself. Indeed, requiring that each participating investment adviser separately be responsible for conducting due diligence and monitoring the activities of program service providers introduces a high level of unnecessary redundancy and corresponding cost that will ultimately be passed on to clients. The Commission should permit investment advisers in managed-account programs that retain the same service provider to designate—and delegate responsibility to—another investment adviser or service provider to conduct due diligence and monitor the service provider. Moreover, an investment adviser should not be deemed to have retained a service provider

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[10] Proposing Release at 68,862.

solely by virtue of the investment adviser being party to an agreement with a service provider or being a third-party beneficiary of any such agreement.

5. The Proposal does not account for the challenges that investment advisers encounter when contracting with service providers.

The Proposal establishes a compliance date 10 months from the effective date of the final rule. Investment advisers will need time to identify and classify vendors and outsourced functions into covered and not covered functions and develop a due diligence process tailored to each covered function, all of which will take considerable time. Absent grandfathering that is not provided in the Proposal, these requirements will also extend to existing vendor relationships, which will require investment advisers to evaluate whether outsourcing relationships they intend to maintain, continue, or renew fall under the Proposal (and the respects in which they do), and whether such relationships have been properly evaluated through due diligence and monitoring, and documented.

After determining the service providers that perform covered functions and developing a due diligence process with respect to those service providers, investment advisers then would be required to negotiate (with new service providers) and renegotiate (with existing service providers) contractual terms governing the outsourced arrangements to bring those arrangements into compliance with the Proposal. However, outsourced arrangements can take considerable time to negotiate, and we are extremely concerned that investment advisers will not have sufficient time to properly put in place new arrangements with service providers that comply with the Proposal. This problem will be exacerbated by the fact that over 15,000 investment advisers, subject to the same, accelerated timeline, will be approaching their service providers simultaneously to negotiate and renegotiate terms. Some service providers may not know that their services are covered functions under the Proposal (especially given the vagaries of what is a covered function), leading to these service providers being unprepared for the negotiations that will be required. This influx of investment adviser requests will likely require service providers to extend negotiation timelines and jeopardize compliance by the compliance date.

The Proposal also fails to account for challenges in vendor negotiations (including re-opening past negotiations over legacy arrangements) to bring vendor arrangements in compliance with the Proposal. For example, an investment adviser’s current service providers may be unwilling to renegotiate contractual terms in previously negotiated contracts. Further, not all investment advisers have economic or other leverage to negotiate or renegotiate contracts, especially with large, incumbent service providers that are willing to forgo or terminate outsourcing arrangements that they view as undesirable. This lack of leverage will be most sharply felt by small investment advisers. Alternatively, such service providers may increase their fees, which would have a particularly adverse effect on smaller investment advisers and their clients.

We also have concerns with the Proposal’s approach to subcontracting by an investment adviser’s service providers. First, subcontracting could vastly expand the scope of

covered functions. This concern is best illustrated by way of example. Assume that an investment adviser hires a service provider to track error resolution, which the investment adviser considers to be a covered function. All details of an error are stored within the service provider's system, which acts as a record of the issue. The system would render standard image files of all data to make the record immutable (e.g., converting database records, Word documents, Excel files, etc., into standard unalterable image files). Further assume that the service provider relies on a subcontractor to provide the technology to perform that imaging function through a license and service arrangement. Because that image file is part of the record, the subcontractor's performance could, under the Commission's reasoning, be deemed necessary to the functioning of the service provider's system, making the subcontractor part of the covered function. If the investment adviser were to simply license technology to convert regular files to standard, immutable image files, the investment adviser would not consider that a covered function. But, because that same technology is being used to generate a record as part of the service provider's solution to the investment adviser, the investment adviser must consider whether the subcontractor's services are a covered function. This principle could result in the expansion of the universe of service providers providing covered functions beyond an investment adviser's practical ability to comply with the Proposal.

The Proposal also seems to require an investment adviser to look through to subcontracting arrangements used by its service providers that are material to the performance of a covered function and determine how to mitigate and manage risks in light of the facts and circumstances of such subcontracting arrangements. The Commission overstates the transparency into subcontractor arrangements available to investment advisers. While service providers might be willing to give their investment adviser clients information or representations regarding subcontractors intended to mitigate related risks, it is unlikely that investment advisers will have sufficient visibility into the subcontractors to meet the requirements of the Proposal. Using the example above, while an investment adviser may (but also may not) be successful in securing information or representations from the error-tracking vendor relating to the risks of the imaging subcontractor, it is unlikely that the investment adviser will have sufficient access to the imaging subcontractor to determine how to mitigate and manage the risks of the subcontractor within the intent of the Proposal. Indeed, we expect that service providers will be stridently opposed to investment adviser clients seeking to undertake due diligence and monitoring of the service providers' subcontractors if that, in turn, forces them to renegotiate those subcontracting arrangements (including financial terms) to address the burdens that the subcontractors would face when fielding requests from what could be a large publication of investment adviser clients.

Accordingly, we believe that the Commission has not fully considered (1) the amount of time that investment advisers will need to identify and classify vendors as providing covered functions and develop the required due diligence and monitoring protocols; (2) the practical realities inherent in investment adviser—vendor relationships that will render negotiating and renegotiating outsourcing arrangements (and subcontracting arrangements) complicated and time-consuming; and (3) the vast array of subcontractor arrangements that could be brought within the ambit of the Proposal, and the lack of visibility that investment advisers may have

into subcontracting arrangements that might be necessary to comply with the Proposal. We therefore recommend that the Commission undertake a more thorough and thoughtful study into these matters when evaluating whether to adopt the Proposal and, if the Commission determines to adopt a final rule, provide a far longer transition period to allow investment advisers and their service providers appropriate time to come into compliance with the final rule.

6. The Proposal would inappropriately and indiscriminately expose investment advisers to potential responsibility and liability for the conduct of their service providers.

We are concerned about the Commission's sweeping assertion about investment advisers' potential liability for functions that they outsource to other service providers, without regard to any apparent consideration of the particular services, the circumstances of the outsourced arrangements and various factors relating to them. Specifically, the Commission asserts that "[w]hen an investment adviser holds itself out to clients and potential clients as providing advisory services, the adviser implies that it remains responsible for the performance of those services and will act in the best interest of the client in doing so. . . . In addition, the adviser is typically responsible for the advisory services through an agreement with the client that represents or implies the adviser is performing all the functions necessary to provide the advisory services. An adviser remains liable for its obligations, including under the Advisers Act, the other Federal securities laws and any contract entered into with the client, even if the adviser outsources functions."[11]

In this regard, the Commission's position appears to be based on the notion that an investment adviser is invariably a fiduciary and therefore should be held to a fiduciary's standard of care in all matters relating to its clients. However, the definition of "investment adviser" under the Advisers Act has been construed broadly by the Commission to include persons who provide impersonal investment advice or otherwise would not be viewed as a fiduciary under common law or, therefore, subject to common-law fiduciary obligations. Even in circumstances where a particular investment adviser is deemed a fiduciary under common law, courts in various U.S. jurisdictions have developed extensive case law on the circumstances in which a fiduciary can—and cannot—limit liability for its services, including limitations on liability absent wrongful misconduct or gross negligence, as well as other limitations on liability, including caps on liability. Accordingly, we strongly disagree with the Commission asserting, in dicta in a proposal such as this, statements on the liability of investment advisers that do not fully reflect the decisional case law that informs fiduciary principles that are incorporated into the Advisers Act by virtue of Sections 206(1) and (2). Moreover, even when an investment adviser is performing fiduciary services, that does not invariably mean that all of the services it performs are fiduciary in character or subject to a fiduciary's standard of care. Further, it is well accepted that contracting parties may set reasonable limits on liability, including for matters

[11] Proposing Release at 68,819.

involving so-called “force majeure” or for consequential damages. The Commission’s sweeping assertion misses the mark to these important issues.

7. The Proposal will pose unreasonable costs to the industry, with disproportionate impact on smaller investment advisers and their clients.

Related to timing concerns surrounding implementation, we are also concerned that the Proposal will pose unreasonable costs to the industry, and ultimately clients, with smaller investment advisers and their clients feeling a disproportionate impact. In the Proposal, the Commission seemingly assumes that the average investment adviser would only have five vendors whose services come within the purview of the Proposal. However, the basis for or source of this number is unclear.[12] After considering discussions internally with our members and investment advisers’ likely conservative approach to addressing the ambiguity surrounding the definition of “covered function” discussed above, we believe that this number could be much higher in reality—potentially reaching dozens, if not hundreds.

Even if, for example, only one-quarter of the service categories listed in Section 3 of this letter constitute covered functions (i.e., 13 of 52), an investment adviser using service providers for those functions would use over twice the number of service providers than the Proposal assumes in its cost-benefit analysis (and potentially more if the investment adviser uses multiple vendors within a category). The Commission should conduct a proper cost-benefit analysis based on a clear concept of what is a covered function, and, correspondingly, which service provider arrangements are covered. We are concerned that the Commission is narrowly construing both concepts in its analysis set forth in the Proposing Release but may take a far more expansive approach and view when it comes to examining and considering enforcement against investment advisers.

Because of the fact that many investment advisers outsource functions–some of which may be “covered functions” depending on how one interprets its scope–to a number of different service providers that themselves, in turn, outsource functions (some of which may be interpreted to be covered functions) to yet other service providers, the burdens on investment advisers both large and small will be substantial especially if each investment adviser itself needs to perform due diligence, monitoring, and Form ADV reporting on what may be a broad circle of direct and indirect or remote service providers. These burdens will be magnified if investment advisers will be overinclusive in their classification of service providers (and service providers to those service providers) that perform covered functions because of the vagaries of what may be viewed as covered functions and the operation of the Proposal as an antifraud rule. To address these concerns, and the fact that some arrangements may involve a daisychain of service providers, we urge the Commission to expressly permit investment advisers to delegate due diligence and monitoring obligations to another investment adviser or service provider so long as the investment adviser has a reasonable basis to believe that the delegate is

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[12] Proposing Release at 68,855 n.206 (stating that “[w]hile there are no publicly available granular data on adviser outsourcing of operations that would be covered functions, this assumption is consistent with frequent outsourcing of custodial, administrative, prime brokerage, auditing, and recordkeeping services among RIAs.”).

performing those functions properly. In this circumstance, an investment adviser should be expressly permitted to rely on the third party's due diligence and monitoring without being subject to potential antifraud or other liability.[13]

The Commission should particularly consider these costs as they relate to smaller investment advisers that may have less financial flexibility to bear added operational and compliance costs. Smaller investment advisers that currently rely on external service providers to help lower costs may not have the operational resources to bring outsourced functions in-house or the financial resources to continue outsourcing and comply with the Proposal. This may cause some investment advisers to leave the business, or even create barriers to entry for small investment advisers looking to enter the business, which would further promote industry concentration. The Commission even concedes that it does not have enough information to "quantify certain economic effects" of the Proposal.[14] This concession is a surprising and troubling acknowledgment that the Proposal was issued too quickly without full and required consideration of applicable costs, and therefore is not appropriate for adoption in its proposed form.

8. The Proposal disregards important distinctions between affiliates and third parties and regulated versus unregulated service providers.

We disagree with the Proposal's approach of disregarding important differences between third-party providers and affiliated service providers. Here, the Commission acknowledges that "[t]he proposed rule does not . . . make a distinction between third-party providers and affiliated service providers because the risks that the proposed rule are designed to address exist whether the service provider is affiliated or unaffiliated, and the service provider is not necessarily already being overseen by the adviser."[15] While the Commission asserts that both affiliated and unaffiliated service providers present the same risks, that disregards the fact that an investment adviser typically will have a far greater ability and facility to evaluate an affiliated service provider both when conducting due diligence and in monitoring its services, and this difference should be recognized when evaluating the reasonability of any steps that an investment adviser takes in this regard.

We also disagree with the Proposal's approach of disregarding important differences between regulated providers and unregulated ones. In this regard, the Commission stated that "[t]he proposed rule would not include an exception for service providers that are subject to other provisions of the Advisers Act, including Commission-registered advisers, or other Federal securities laws. An adviser remains liable for its legal and contractual obligations and should be overseeing outsourced functions to ensure the adviser meets its legal and contractual

[13] The notion that investment advisers and other regulated entities may rely on third parties is consistent with regulatory norms in other contexts, including mutual fund board reliance on fund CCOs, oversight of sub-advisers, the approach to liability of supervisors under the federal securities laws and FINRA rules, the ability of members of an underwriting syndicate to rely on the due diligence undertaken by the lead underwriter, etc.

[14] Proposing Release at 68,842.

[15] *See* Proposing Release at 68,823.

obligations, regardless of whether the service provider has its own legal obligations under the Federal securities laws."[16] We disagree with the Commission's not differentiating between unregulated service providers and those service providers subject to the Advisers Act or other parallel bodies of regulation. Regardless of the particular functions or services being outsourced, the fact that they are being undertaken by an entity that is regulated under the Advisers Act or other parallel schemes of regulation (e.g., state laws governing investment advisers, federal or state banking laws, federal or state law governing broker-dealers and Financial Industry Regulatory Authority ("FINRA") rules, and federal or state commodity laws and National Futures Association ("NFA") rules) should be a factor, indeed a significant one, that an investment adviser should be able to consider when selecting and evaluating a service provider, including undertaking due diligence and monitoring of the service provider.

9. The Proposal inappropriately requires public disclosure of an investment adviser's service provider relationships on Form ADV, which imposes significant competitive and cybersecurity risks.

The Proposal requires investment advisers to disclose publicly on Form ADV the names and addresses of their service providers that provide covered functions, the covered functions provided, and the date when the service providers began providing the covered functions. We strongly disagree with this proposed requirement.

Investment advisers view many of their service provider relationships as proprietary and confidential. Many investment advisers spend significant time and money researching and then vetting vendors to solve a specific problem, implement a proprietary investment strategy, or develop a new product or service. Making the identity of those vendors available to competitors undercuts a key competitive advantage in the investment adviser industry. Further, publicly disclosing the identity of investment adviser service providers will give cybercriminals a window into the industry-vendor ecosystem and provide a roadmap to execute a cyberattack on the most critical and impactful targets. We believe that there is little benefit to this public disclosure and that the harms discussed above far exceed any such benefits. Rather, we believe that the Commission's examination authority is precisely the mechanism best suited for the Commission to gather the information it considers important.

10. Any policy or rulemaking relating to outsourcing should be based on consideration of other Commission rules, the Commission's enforcement authority, and the approaches taken by other regulators.

The outsourcing risks noted in the Proposing Release are or could be addressed by other rules adopted (or, if they are actually lacking, proposed) by the Commission. However, there is no indication in the Proposing Release that the Commission considered whether other Commission rules already adopted (or proposed) properly address the risks of investment adviser outsourcing. For example, the Commission cites to a cyber-security breach of systems

[16] *Id.*

maintained by a third-party vendor hired to maintain fund investor data.[17] The risks or harms that the Commission seeks to prevent would, or at least could, be addressed by the Commission's recently proposed rule governing cyber-security risk management by registered investment advisers, although it is not clear given prior statements by the Commission or its staff why other existing Commission rules (e.g., Regulation S-P, Regulation S-ID, or Rule 206(4)-7) do not already address these risks or harms.[18] In the Commission's proposing release for its recently proposed rule governing cyber-security risk management, the Commission stated that "as part of an adviser's or fund's reasonably designed cybersecurity policies and procedures, an adviser or fund would be required to oversee any service providers that receive, maintain, or process adviser or fund information, or are otherwise permitted to access their information systems and any information residing therein. Advisers and funds would be required to document that the adviser or fund is requiring such service providers, pursuant to a written contract, to implement and maintain appropriate measures, including measures similar to the elements advisers and fund must address in their own cybersecurity policies and procedures, designed to protect adviser and fund information and systems. Such policies and procedures generally should also include other oversight measures, such as due diligence procedures or periodic contract review processes, that allow funds and advisers to assess whether, and help to ensure that, their agreements with service providers contain provisions that require service providers to implement and maintain appropriate measures designed to protect fund and adviser information and systems (e.g., notifying the adviser or fund of cybersecurity incidents that adversely affect an adviser's or fund's information, systems, or operations)."[19] Beyond this approach recently proposed by the Commission, existing Commission rules already require oversight of outsourcing arrangements in the area of privacy of consumer data under Regulation S-P and identity theft under Regulation S-ID, which as noted by the Commission in the Proposing Release requires covered firms to "exercise appropriate and effective oversight of service provider arrangements." [20] However, the Proposing Release does not address why the Proposal would be necessary, and would not be duplicative, in light of existing and proposed rules, including ones that may be more appropriately tailored to perceived harms or risks.

As another example, the Commission cites to actions where an investment adviser was disseminating advertisements with false information provided by a third-party vendor.[21] The Commission noted that the investment adviser's "due diligence was insufficient to confirm the accuracy of performance data from a third-party," and therefore the investment adviser "failed to have a reasonable basis for the accuracy of the performance and performance-related claims made in its advertisements." First, it is far from certain that the investment adviser would have

[17] *See* Proposing Release at 68,818 n.12 and accompanying text.

[18] *Cybersecurity Risk Management for Investment Advisers, Registered Investment, Companies, and Business Development Companies*, Advisers Act Rel. No. 5956, 87 Fed. Reg. 13,524 (Feb. 9, 2022).

[19] *Id.* at 13,531.

[20] Regulation S-ID, 17 CFR 248.201(e)(4).

[21] *See* Proposing Release at 68,826 n.50 and accompanying text.

been able to detect the inaccuracy of the information provided by the vendor if the investment adviser had undertaken the due diligence prescribed by the Proposal. Second, the Commission already has ample means to address concerns in this area, including through its regulation of investment adviser advertisements, such as under the recently adopted rule governing investment adviser marketing, Rule 206(4)-1 ("Marketing Rule").[22] Indeed, the adopting release for the Marketing Rule expressly provides that "if an adviser incorporates information it receives from a third party into its performance advertising, the adviser has adopted the third-party content, and the third-party content will be attributed to the adviser. An adviser is liable for such third-party content under the marketing rule just as it would be liable for content it produced itself."[23] The Proposing Release does not explain why yet another rule is necessary to prevent harm already addressed by an existing rule that the Commission refreshed only two years ago.

This Marketing Rule example also demonstrates that the Commission already has ample enforcement authority to deter and punish investment advisers for outsourcing-related violations under existing Commission rules. This point is further demonstrated by the fact that most of the illustrations cited in the Proposing Release to justify the Proposal involved administrative proceedings initiated by the Commission.[24] The Commission clearly has existing enforcement tools to press claims in this area, including against investment advisers for violations of the federal securities laws and, potentially, against service providers or vendors for aiding and abetting those violations. The Commission's enforcement authority further renders the Proposal unnecessary.

If, however, after proper and thoughtful deliberation, the Commission believes that it is prudent to pursue rulemaking in this area, the Commission should consider the approaches it has taken previously with service providers in other Commission rules. For example, the Proposal requires investment advisers to *periodically* monitor and reassess the performance by service providers of covered functions at a frequency determined by the investment adviser based on the facts and circumstances of the covered function.[25] We believe that this facts-and-circumstances approach will likely cause significant confusion among investment advisers regarding how frequently they must monitor and reassess service provider performance.

Instead, the Commission should look to its approaches taken in Rule 206(4)-7 under the Advisers Act and Rule 38a-1 under the Investment Company Act of 1940 and provide a safe harbor for monitoring at least annually. Rule 206(4)-7 requires an investment adviser's chief

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[22] *Investment Adviser Marketing,* Investment Advisers Act Release No. 5653, 86 Fed. Reg. 13,024 (Dec. 22, 2020).

[23] *Id.* at 68,822 nn.43-46 and accompanying text.

[24] *See* Proposing Release at 68,818 nn.11, 18, 19, 50 and 68.

[25] *See* Proposing Release at 68,833 n.70 and accompanying text ("The proposed rule would require an adviser to monitor its service providers with a manner and frequency such that the adviser reasonably determines that it is appropriate to continue (i) to outsource the covered function and (ii) to outsource to the service provider. The manner and frequency of an adviser's monitoring would depend on the facts and circumstances applicable to the covered function, such as the materiality and criticality of the outsourced function to the ongoing business of the adviser and its clients.").

compliance officer to review its compliance policies and procedures *at least annually* to determine their adequacy and the effectiveness of their implementation. Rule 38a-1 imposes a similar responsibility on a registered fund's chief compliance officer to review the policies and procedures of the fund and its primary service providers annually. The annual review periods set forth in Rule 206(4)-7 and Rule 38a-1 provide certainty to the industry and have proven over time to be effective in achieving the goals of those rules. Similarly, an annual monitoring and reassessment period under any final outsourcing rule would provide investment advisers with certainty regarding their compliance obligations while being consistent with the review periods found satisfactory under other regulations with similar goals.

The Commission further should consider the approaches taken by other regulators as well. FINRA, NFA, and the bank regulators have all taken positions on outsourcing in the past, and all three of those groups have taken the same approach: requiring a supervisory framework based on an analysis of the risks of particular outsourced arrangements, as opposed to the prescriptive requirements such as those set out under this Proposal.[26] To this end, the Commission should strongly consider working with other functional regulators—including regulators of financial institutions that provide investment advice (e.g., federal and state banking agencies, regulators of commodity trading advisors, state securities regulators) to develop a coordinated framework to managing the risks of outsourcing. This collaborative approach could be particularly helpful from the standpoint of the country's largest institutions that tend to include regulated entities across the realm of federal and state regulators performing services that are functionally equivalent. However, the Proposal does not demonstrate that the Commission sought the views of any other regulators regarding whether the Proposal conflicts with the requirements of those regulators' outsourcing rules or otherwise considered how effectively investment advisers subject to multiple regulatory regimes will be able to comply with the Proposal and other regulators' outsourcing rules simultaneously.

[26] NFA Compliance Rules 2-9 and 2-36 (Members' Use of Third-Party Service Providers) require members to adopt and implement a supervisory framework over their outsourcing function, covering minimum areas that should be addressed. These areas are (i) initial risk assessment (primary areas of risk being information security, regulatory, and logistics); (ii) onboarding due diligence (varying scope and written agreements); (iii) ongoing monitoring (including escalation process and contract renewal); (iv) termination; and (v) recordkeeping. FINRA requirements follow a risk-management approach. FINRA member firms have an obligation to "establish and maintain a supervisory system, including written supervisory procedures (WSPs), for any activities or functions performed by third-party vendors, including any sub-vendors (collectively, Vendors) that are reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable FINRA rules." In this connection, FINRA has recognized that "there is no one-size-fits-all approach to Vendor management and related compliance obligations, and that firms use risk-based approaches that may involve different levels of supervisory oversight, depending on the activity or function Vendors perform." See FINRA NTM 05-48 (applying FINRA Rule 3110 to outsourcing of "covered activities"); FINRA NTM 21-29. Bank regulators have also proposed guidance in relation to third-party relationships that also is structured as more of a risk-management framework. The proposed banking guidance provides that effective risk-management generally follows a continuous life cycle and incorporates six general principles: "(1) making assessments and plans regarding the inherent risks, strategic purposes and other relevant factors of the activity, (2) conducting proper due diligence in third-party selection, (3) adequately negotiating contracts, (4) requiring the board of directors and management to review the banking organization's risk management process, (5) performing ongoing monitoring of the third-party activity and overall performance and (6) planning a contingency strategy for terminating a third-party relationship." *See* Proposed Interagency Guidance on Third-Party Relationships: Risk Management.

We strongly believe any final outsourcing rule that does not take into account the impact of and interplay with the Commission's other adopted or proposed rules or the outsourcing rules of other functional regulators would be inappropriate.

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Ultimately, we believe that the Commission has not sufficiently evaluated or justified the need for the Proposal. We further believe that the Proposal does not represent an appropriate, clearly defined framework that reasonably can be implemented by the investment adviser industry. Rather, we believe that the Proposal may expose investment advisers to inappropriate responsibility and/or liability for the conduct of their service providers and will lead to unreasonable costs, with small investment advisers and their clients feeling a disproportionate impact. We have highlighted these issues in greater detail above and oppose the enactment of this Proposal without further analysis, research, and justification from the Commission.

We hope that our comments are helpful to the Commission and its staff. We would be glad to answer any questions or provide further assistance. Please feel free to contact me at [redacted] or contact Chad Papanier at [redacted].

Very truly yours,

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Craig Pfeiffer

President and CEO

Money Management Institute

APPENDIX A

1. *Mutual fund vendor calculation glitch (FNs 10 and 17).* Commissioner Uyeda rightly criticizes the Commission's reliance on a mutual fund vendor's glitch in calculating fund net asset values as not backing the Proposal. He wisely observed that "the release cites an article describing problems encountered by a mutual fund service provider when it temporarily was unable to calculate net asset values ("NAVs") on approximately 1,200 mutual funds in 2016. However, there is no discussion of whether and to what extent the mutual funds' investment advisers conducted oversight of the service provider in accordance with their existing obligations, and whether the specified oversight requirements contemplated by the proposed rule would have prevented or mitigated the problem."[27]

2. *Outsourced CCO's Form ADV overstatement of AUM and clients (FN 11).* The Proposing Release provides no explanation why the alleged failures of an outsourced Chief Compliance Officer and the investment adviser's Chief Operating Officer resulting in Form ADV overstatements of the registrant's assets under management and total number of clients would have been in any way averted had the Proposal been in place.

3. *Ransomware attack on vendor (FN 12)*. The Proposing Release points to an alleged ransomware attack against an investment adviser's vendor to justify the Proposal but provides no explanation why the alleged ransomware attack would have in any way been averted had the Proposal been in place or why the existing framework for approaching business continuity and related issues does not suffice in this regard. In fact, the article cited by the Commission indicates that the party contracting with the vendor was the funds' administrator, not an investment adviser, and thus this illustration would not even be addressed by the Proposal. Moreover, the Commission has a pending rule proposal from March 2022 that directly addresses cybersecurity preparedness by investment advisers and registered investment companies. The Commission, in the Proposing Release, does not speak to why the Proposal is necessary in light of the foregoing proposed requirements of the proposed cybersecurity rule, how the two proposed rules are intended to interact with each other, or how investment advisers should manage compliance with both rules.

4. *Use of third-party vendor that did not properly safeguard customers' personal identifying information (FN 19).* The Proposing Release points to allegations in a settled administrative proceeding against an investment adviser for using a third-party vendor—a moving and storage company—that allegedly did not properly safeguard customers' personal identifying information. Again, there is no indication from the Proposing Release how the imposition of the Proposal would have altered the investment adviser's conduct or averted risks to customers' personal identifying information, especially since a moving and storage company would likely not

[27] *See* Commissioner Mark T. Uyeda, Securities and Exchange Commission, Statement on Proposed Rule Regarding Outsourcing by Investment Advisers (Oct. 26, 2022) at nn.5-6 and accompanying text, https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622 (*hereinafter* "Commissioner Uyeda Statement").

involve core functions covered by the Proposal. Again, Commissioner Uyeda rightly points out that "[t] he release . . . discusses two service provider matters that do not appear to involve core advisory functions, including one matter that involves a breach of customer data that resulted from an investment adviser's hiring of a moving and storage company. However, the matters appear to be included because the proposal would extend the requirement to conduct service provider oversight to third parties that make and/or keep any books and records required to be kept by Rule 204-2 under the Advisers Act. Again, the Proposing Release is silent as to whether these service provider issues resulted from a failure of proper oversight and how the proposed rule would prevent or mitigate the perceived problems."[28]

5. *Use of models and volatility guidelines from a third-party sub-adviser (FN 18).* The Proposing Release points to allegations in a settled administrative proceeding against an investment adviser for using models and volatility guidelines from a third-party sub-adviser without first confirming that they worked as intended. As Commissioner Uyeda observed, "[t]he settlement order details numerous violations, including failure to verify the proper functioning of the model, misleading disclosure to clients, and misrepresentations to the mutual fund boards that were tasked with overseeing certain of the investment products. In this case, the adviser ignored several existing legal obligations and there is no explanation as to how the overlay of a prescriptive service provider rule would have altered the adviser's conduct."[29]

6. *Use of false performance information (FN 50).* The Proposing Release points to allegations in a settled administrative proceeding against two investment advisers for use of misstated performance and other information provided by another investment adviser. The Commission alleged that the investment advisers took insufficient steps to confirm the accuracy of data from the service provider, which separately settled an administrative proceeding with the Commission. Again, the Proposing Release is silent on how the Proposal would have prevented or mitigated the issues cited by the Commission.

7. *Failure by investment adviser to perform due diligence and monitoring of certain investments contrary to Form ADV Part 2A representations (FN 50).* The Proposing Release points to allegations in a settled administrative proceeding against an investment adviser for failing to conduct "adequate due diligence of a third party." Rather than supporting the Commission's case for the Proposal and its requirement to conduct due diligence of vendors, this proceeding focused largely on the investment adviser's failure to conduct "due diligence and monitoring of certain investments contrary to representations in its Form ADV Part 2A and in certain communications with its clients."

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[28] Commissioner Uyeda Statement at nn.9-10 and accompanying text.

[29] *Id.* at nn.7-8 and accompanying text.