

December 27, 2022

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

Re: *Outsourcing by Investment Advisers Rule Proposal; File No. S7-25-22*

Dear Ms. Countryman:

The Independent Directors Council¹ appreciates the opportunity to comment on the Securities and Exchange Commission's ("Commission") proposed rule on outsourcing by investment advisers, Rule 206(4)-11 under the Investment Advisers Act of 1940 ("Advisers Act").² The proposed rule would establish due diligence and monitoring obligations for investment advisers that outsource certain functions to service providers.³ The proposal also would require investment advisers to collect and report certain data about service providers, and to conduct due diligence and monitor third-party recordkeepers.⁴

While we acknowledge that investment advisers should oversee functions outsourced to third-party service providers, we question the need for the proposed rule. In our view, the proposed due diligence and monitoring obligations for investment advisers overlap with existing effective regulatory oversight requirements. We are also concerned that the Commission seeks to impose a burdensome compliance regime on investment advisers, when the Release acknowledges that the Commission cannot "quantify certain economic effects because it lacks the information necessary to provide estimates or ranges of costs."⁵

¹ The Independent Directors Council ("IDC") serves the US-registered fund independent director community by advancing the education, communication, and public policy priorities of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute ("ICI") member funds. ICI's members manage total assets of \$27.8 trillion in the United States, serving more than 100 million US shareholders, and an additional \$7.4 trillion in assets in other jurisdictions. There are approximately 1,600 independent directors of ICI-member funds. The views expressed in this letter do not purport to reflect the views of all independent directors.

² See *Outsourcing by Investment Advisers, Advisers Act Release No. IA-6176 (October 26, 2022) ("Release")*, available at <https://www.sec.gov/rules/proposed/2022/ia-6176.pdf>.

³ Release at p. 16.

⁴ Release at p. 1.

⁵ Release at p. 98.

While the proposal focuses on outsourcing by investment advisers, the proposed rule unnecessarily duplicates, and potentially complicates, elements of the board's oversight role under an existing regulatory regime that has worked well over time. We do not believe that the proposed prescriptive mandates justify the costs that may ultimately be borne by investors—particularly shareholders of funds advised by small investment advisers that may be disproportionately impacted by the proposal.

I. Overview of the Commission's Proposal

The Commission's proposal would require investment advisers to conduct due diligence, considering certain elements, before outsourcing "covered functions"⁶ to "service providers."⁷ Investment advisers also would be required to periodically monitor the service providers' performance, considering the prescribed elements, and reassess whether to retain the service providers.⁸ The elements include:

- the nature and scope of the services to be provided;
- potential risks resulting from the service provider performing the covered function, including how to mitigate and manage such risks;
- the service provider's competence, capacity, and resources necessary to perform the covered function;
- the service provider's subcontracting arrangements related to the covered function;
- coordination with the service provider for federal securities law compliance; and
- the orderly termination of the provision of the covered function by the service provider.⁹

In addition, investment advisers would be required to collect and report "census-type" information about their use of service providers in their investment adviser registration form (Form ADV).¹⁰ Finally, the proposed rule would require investment advisers to conduct due diligence and monitor third-party recordkeepers and obtain reasonable assurances that third-party recordkeepers will meet certain standards.¹¹

According to the Commission, these due diligence and monitoring obligations are designed to "promote a more comprehensive framework to address—and thereby reduce—risks to advisers and

⁶ A "covered function" is defined in the proposed rule as "(1) a function or service that is necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws, and (2) that, if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services." Release at p. 16.

⁷ "Service providers" include any "person or entity that (1) performs one or more covered functions; and (2) is not a supervised person of the adviser." The rule does not distinguish between third-party providers and affiliated providers. Release at p. 26.

⁸ Release at p. 1.

⁹ Release at p. 17.

¹⁰ Release at p. 1.

¹¹ *Id.*

their clients that result from an adviser's use of service providers."¹² In this letter, we focus on aspects of the proposed framework that bear on the roles and responsibilities of fund independent directors.

II. Governance and Oversight of Fund Compliance Programs

Current, longstanding regulations establish the compliance oversight framework for both boards and investment advisers, relative to key service providers. The discussion below addresses existing board and investment adviser oversight obligations.

A. Rule 38a-1 Compliance Framework

Independent directors have a fiduciary duty, comprised of a duty of loyalty and a duty of care, to protect the interests of the fund and its shareholders, and have general oversight responsibilities for the operations and management of the fund. Fund boards also are responsible for safeguarding investor interests under the federal securities laws, including through oversight of a fund's compliance program pursuant to Rule 38a-1 under the Investment Company Act of 1940 ("Investment Company Act").¹³

Rule 38a-1 (the "Fund Compliance Rule") establishes the compliance oversight framework for fund boards. The rule requires funds to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the federal securities laws by the fund.¹⁴ Fund boards also are required to review the adequacy of the policies and procedures and effectiveness of their implementation at least annually.¹⁵

Rule 38a-1 requires fund boards to designate a chief compliance officer ("CCO") who will administer the fund's compliance program and report directly to the board¹⁶ and, at least annually, provide a written report to the board. At a minimum, the CCO's report to the board addresses the operation of the fund's policies and procedures and each material compliance matter that occurred since the date of the last report,¹⁷ including those matters that the "board of directors would reasonably need to know [about] to oversee fund compliance."¹⁸ CCOs also meet separately with independent directors.¹⁹

The language of Rule 38a-1 empowers a board to oversee a fund's compliance program, including the activities of principal service providers to the fund, in the manner the board deems most effective. The

¹² Release at p. 127.

¹³ 17 CFR 270.38a-1.

¹⁴ 17 CFR 270.38a-1(a)(1).

¹⁵ 17 CFR 270.38a-1(a)(3).

¹⁶ 17 CFR 270.38a-1(a)(4)(i).

¹⁷ 17 CFR 270.38a-1(a)(4)(iii).

¹⁸ 17 CFR 270.38a-1(e)(2).

¹⁹ 17 CFR 270.38a-1(a)(4)(iv).

compliance program may be tailored to suit the fund's size, organizational structure, resources, and product offerings, among other things. This flexible, holistic approach has worked effectively since Rule 38a-1 was adopted, even as the asset management industry, business models, and technological tools have evolved.

B. Investment Adviser Oversight Role

The Advisers Act establishes a fiduciary duty for investment advisers requiring them to act in their clients' best interests at all times.²⁰ The investment adviser must ensure that its legal obligations are met, even when the adviser is not performing the function or service itself. Rule 206(4)-7 under the Advisers Act (the "Investment Adviser Compliance Rule") establishes the compliance oversight framework for advisers.²¹ The rule requires investment advisers to adopt and implement policies and procedures reasonably designed to prevent violations of the securities laws.²² Rule 206(4)-7 provides flexibility, permitting each investment adviser to adopt policies and procedures considering the nature of the firm's operations.

Taken together, the Fund Compliance Rule and Investment Adviser Compliance Rule establish a comprehensive, yet *flexible*, compliance framework for service provider oversight. Under this approach, the board's and investment adviser's respective oversight roles can be tailored to the fund's particular circumstances. The Commission has not supplied compelling evidence in the proposal suggesting that this approach is inadequate.²³

III. **Comments on the Proposal**

A. The Proposal is Unnecessary and Counterproductive

The Commission's proposal seeks to establish a prescriptive framework for adviser oversight of a broad spectrum of "covered functions" that may include some functions and services related to an adviser's investment decision-making process and portfolio management (*e.g.*, the provision of sub-advisory services and development of custom indexes).²⁴ These and other services and functions that presumably

²⁰ Release at p. 12-13. As the proposing release observes, the fiduciary duty cannot be waived and is enforceable through the antifraud provisions of the Advisers Act.

²¹ 17 CFR 275.206(4)-7.

²² 17 CFR 275.206(4)-7(a).

²³ In the Release, the Commission identifies two enforcement cases involving outsourcing to third party service-providers. These matters (or the perceived delay in delivering data in response to Commission requests) are not sufficient evidence to create an entirely new regulatory regime prescribing rigid requirements. *See* Release at p. 11-12.

²⁴ Release at p. 22.

would fall within the definition of “covered functions” are subject to fund board oversight under Rule 38a-1²⁵ and investment advisers’ regulatory obligations under Rule 206(4)-7.

Rule 38a-1 focuses on the fund’s principal service providers (*i.e.*, the investment adviser, distributor, administrator, and transfer agent).²⁶ Consistent with fiduciary principles, fund boards also generally oversee the quality of services received by the fund from its service providers. The Commission has acknowledged that its proposal may overlap with Rule 38a-1, as some investment advisers and service providers to funds may be subject to relevant provisions of the rule.²⁷ Likewise, the Commission has affirmed that, pursuant to Rule 206(4)-7, investment advisers already may be assessing the risks created by their “particular circumstances” in hiring service providers.²⁸

In IDC’s view, the proposed outsourcing rule for investment advisers is not necessary. The proposed rule would layer an inflexible regulatory regime on top of an existing compliance framework that has functioned effectively. By requiring investment advisers to satisfy rigid due diligence, monitoring, and other requirements, the proposed rule would create redundancies and unnecessarily complicate service provider oversight, including board oversight of the fund’s investment adviser.

In addition, because investment advisers would be required to satisfy the obligations contained in the proposed one-size-fits-all outsourcing rule, fund boards, in turn, would be required to oversee advisers with respect to each such requirement. This prescriptive exercise may divert board attention away from oversight of the services and functions that may be most material to a particular fund complex and its service providers.

Given the existence of a time-tested regulatory framework that already addresses the critical importance of service provider oversight, the bar for moving forward with the proposal should be set high. Yet, the Commission’s concerns expressed in the proposal appear to be more theoretical—that client harm could²⁹ or may³⁰ result from the increased use of service providers and the services provided. In our view, the limited economic analysis set forth in the proposal³¹ and the number of enforcement actions

²⁵ See Request for Comment on Certain Information Providers Acting as Investment Advisers, Advisers Act Release No. 6050 (June 15, 2022), *available at* <https://www.sec.gov/rules/other/2022/ia-6050.pdf>; Comment Letter of Independent Directors Council (Aug. 16, 2022), *available at* <https://www.sec.gov/comments/s7-18-22/s71822-20136249-307283.pdf>.

²⁶ 17 CFR 270.38a-1(a)(1).

²⁷ Release at p. 117.

²⁸ Release at p. 210.

²⁹ See Release at p. 8 (“outsourcing necessary advisory functions *could* have a material negative impact on clients, such as: inaccurate pricing and performance information . . .”) (emphasis added).

³⁰ See Release at p. 9 (“(c)lients also *may* be harmed when a service provider has significant operations in a single geographic region . . .”) (emphasis added).

³¹ In the economic analysis set forth in the Release, the Commission states that, “[w]here possible, the Commission quantifies the likely economic effects of its proposed amendments and rules. However, the Commission is unable to quantify certain economic

mentioned³² do not justify the costs and complexities that would result from this sweeping, highly-prescriptive proposed rule.

B. The Cost of the Proposal Would Negatively Impact Fund Shareholders

In the Release, the Commission identifies potential compliance burdens and costs associated with the proposed rule that may be borne by shareholders. For example, investment advisers may incur new expenditures related to updating their compliance programs, including expenses connected to the proposed due diligence, monitoring, recordkeeping, and reporting requirements.³³ The Commission acknowledges that advisers may pass on such costs to their clients. Likewise, expenses incurred by service providers outside of their normal course of business may cause them to charge additional fees to advisers, which may be passed on to advisers' clients.³⁴

These costs would pose hurdles for many funds and must be seriously considered in determining whether the proposal should move forward. In particular, small funds often managed by small advisers may be disproportionately impacted by the cost and compliance burdens flowing from the proposal, as they do not benefit from economies of scale in the same way as larger complexes.³⁵ As resource and operational constraints lead many small advisers to outsource covered functions, the impact on small fund complexes would be acute.

The proposal also appears to assume that investment advisers would be in a position to bargain effectively with all service providers that deliver "covered functions" and impose on them the proposed prescriptive due diligence requirements. Depending on the nature of the service and the entities involved, even larger investment advisers may encounter barriers in negotiations, but in particular, small advisers often lack the market strength to negotiate effectively with some service providers. The

effects because it lacks the information necessary to provide estimates or ranges of costs. Further, in some cases, quantification would require numerous assumptions to forecast how investment advisers, service providers, and other affected parties would respond to the proposed rule and amendments, and how those responses would in turn affect the broader markets in which they operate." Release at p. 98-99.

³² See *supra* note 23.

³³ In fact, "even an adviser who conducts little outsourcing or who already conducts substantial due diligence in accordance with their fiduciary duty would likely still undertake a careful review" to confirm it is meeting the new regulatory requirements. Release at p. 136.

³⁴ Release at p. 128-129.

³⁵ Release at p. 206.

burdensome nature of the proposed oversight requirements could very well lead to increased costs for such services, which could be passed on to fund shareholders without a commensurate benefit.

Ultimately, the costs and compliance burdens arising out of the proposal may cause certain service providers to limit their services³⁶ and, when coupled with the considerable economic and human resources required to comply with the Commission's other recent rule proposals, may cause investment advisers to consolidate or exit the market.³⁷ The resulting reduction in market participants would run contrary to the Commission's goals and its mission of fostering capital formation.³⁸

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IDC appreciates the opportunity to comment on the Commission's proposed rule on investment adviser outsourcing. We question the need to replicate the existing compliance regulatory framework through the proposed rule, and we have substantial concerns over the collateral impacts of the proposal and its effects on fund shareholders. Accordingly, we urge the Commission not to move forward with the proposal.

If you have any questions regarding our letter or would like additional information, please contact Nicole Baker, IDC Associate Counsel, at 202-326-5822 or me at 202-326-5463.

Sincerely,

/s/ Thomas T. Kim

Thomas T. Kim
Managing Director
Independent Directors Council

cc: Gary Gensler, Chair, Securities and Exchange Commission
Hester M. Peirce, Commissioner, Securities and Exchange Commission
Caroline A. Crenshaw, Commissioner, Securities and Exchange Commission
Mark T. Uyeda, Commissioner, Securities and Exchange Commission
Jaime Lizárraga, Commissioner, Securities and Exchange Commission

³⁶ See "Statement on Proposed Rule Regarding Outsourcing by Investment Advisers," Commissioner Mark T. Uyeda (Oct. 26, 2022), *available at* https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622#_ftnref8.

³⁷ For example, the number of fund sponsors fell from 877 at year-end 2015 to 825 at year-end 2021 due to, among other things, larger fund sponsors acquiring smaller ones. See 2022 Investment Company Fact Book, Investment Company Institute (2022), at p. 34, *available at* https://www.icifactbook.org/pdf/2022_factbook.pdf.

³⁸ *Cf.*, SEC Strategic Plan for Fiscal Years 2022-2026, at p. 6-11, *at* https://www.sec.gov/files/sec_strategic_plan_fy22-fy26.pdf.