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Filed Electronically

Ms. Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549

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

Dear Ms. Countryman:

Pickard Djinis and Pisarri LLP[1] submits these comments in response to the above-referenced proposal to impose detailed due diligence, monitoring and recordkeeping obligations on investment advisers who engage certain types of service providers.[2] This proposal is yet another in an unfortunate string of recent Commission actions that seem designed to transform the principles-based regulatory regime established under the Investment Advisers Act of 1940 (Advisers Act) into a prescriptive, rules-based regime. Upending a highly successful 82-year-old regulatory system in this way is unnecessary and would have a devastating effect on the small businesses that comprise the bulk of the investment adviser industry and the investors who rely on them. We respectfully ask the Commission to withdraw this proposal.

Due Diligence, Monitoring and Recordkeeping Requirements for Outsourced Services

Proposed Advisers Act Rule 206(4)-11 would require every federally regulated investment adviser to satisfy a half-dozen explicit requirements before engaging an affiliated or unaffiliated party (other than a supervised person) to perform a range of functions material to the adviser's investment advisory services.[3] On an ongoing basis, advisers would have to periodically satisfy the same requirements again in order to monitor each service provider's performance of a covered function. Proposed changes to the Advisers Act recordkeeping rule would impose even more extensive

[1] Pickard Djinis and Pisarri LLP is a law firm specializing in securities regulation relating to investment advisers, broker-dealers and service providers thereto. Our investment adviser client base ranges from global firms with hundreds of employees and billions of dollars of regulatory assets under management and to solo practitioners with relatively modest amount of managed assets. This letter reflects the views of a number of our federally regulated clients, particularly the smaller ones.

[2] *Outsourcing by Investment Advisers,* IA Rel. No. 6176 (Oct. 26, 2022); 87 Fed. Reg. 68816 (Nov. 16, 2022), available at: Proposed rule: Outsourcing by Investment Advisers (sec.gov) (Proposing Release).

[3] Such "covered functions" would include, but not be limited to, subadvisory services, client servicing, cybersecurity, investment guideline or restriction compliance, portfolio accounting, pricing/valuation, trading, regulatory compliance and recordkeeping.

requirements where an adviser engages a service provider to make and/or keep required books and records.

While the truncated comment period precludes a thorough analysis of this proposal, we summarize three fundamental problems with this rulemaking:

The Commission Has Failed to Establish a Need For This Rulemaking.

Advisers are already required to exercise due care in the selection and monitoring of service providers.

The Advisers Act establishes a principles-based regulatory regime grounded in the fiduciary duties of care and loyalty.[4] The duty of care obliges the adviser to provide advice that is in a client's best interest, which, in turn, requires the adviser to take reasonable steps to avoid basing advice on materially inaccurate or incomplete information.[5] The duty of care also requires the adviser to seek best execution of clients' transactions, which entails a reasonable examination of the full range and quality of services provided by the brokers selected to perform that task.[6] The fiduciary duty of loyalty obliges the adviser not to subordinate clients' interests to its own. A critical component of this duty involves the adviser's obligation to "eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice [that is] not disinterested."[7]

An adviser's fiduciary duties to its clients infuse every aspect of the adviser-client relationship, including the engagement of service providers to perform covered functions. It is well established that an adviser cannot escape its fiduciary obligations simply because it hires another party to perform an advisory function.[8] For example, with or without proposed Rule 206(4)-11, an

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[4] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, IA Rel. No. 5248 (Jun. 5, 2019), 84 Fed. Reg. 33669 (Jul.12, 2019) (Fiduciary Standard Release); *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963).

[5] Fiduciary Standard Release at 16, *citing* Concept Release on the U.S. Proxy System, IA Rel. No. 3052 (Jul. 14, 2010), 75 Fed. Reg. 42981 (Jul. 22, 2010).

[6] Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 28, 1986).

[7] Fiduciary Standard Release at 23, *quoting Capital Gains.*

[8] Proposing Release at 13, 52, 87 Fed. Reg. 68819, 68829; SEC 2009 CCOutreach Regional Seminars, "The Evolving Compliance Environment: Examination Focus Areas" (Apr. 2009), available at https://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf, at 9 (an adviser "still retains its fiduciary responsibilities for . . . delegated services"); *Proxy Voting by Investment Advisers,* IA Rel. No. IA-2106 (Jan. 31, 2003), 68 Fed. Reg. 6585 (Feb. 7, 2003), n.8 ("Nothing in this rule reduces or alters any fiduciary obligation applicable to any investment adviser"). *See also* Advisers Act, § 205(a)(2). The same principal applies under the Employee Retirement Income Security Act of 1974 (ERISA). *See* Letter from Alan D. Lebowitz, Deputy Assistant Secretary, U.S. Dept. of Labor to Mr. Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (February 23, 1988), *codified in* 29 C.F.R 2509.2016-01 ("ERISA contains no provision which would relieve an investment manager of fiduciary liability for any decision he

adviser cannot rely on prices supplied by a valuation service, investment recommendations supplied by a subadviser or trade allocations suggested by a broker's platform without taking reasonable steps to ensure that such reliance is in clients' best interests. And if the engagement of a service provider somehow creates a conflict of interest between the adviser and its clients, that conflict must be properly managed and disclosed, whether or not a specific anti-fraud rule says so.

> The Commission has offered no evidence of a widespread failure by advisers to satisfy their fiduciary obligation to carefully select and monitor service providers.

Investment adviser compliance examinations routinely include an assessment of whether the subject adviser comprehensively views each activity performed by its service providers; whether the adviser understands the risks generated from outsourced activities and incorporates those risks into its overall compliance program; and whether its use of service providers is consistent with its disclosures and representations to clients. Although the Proposing Release cites a handful of settled enforcement actions over the past decade that involved advisers' inadequate due diligence and monitoring of service providers,[9] these few examples do not begin to justify the adoption of a prescriptive new outsourcing rule. If anything, the established examination practice and sporadic enforcement cases demonstrate that the Commission already has the ability to monitor advisers' use of service providers and that material failures to satisfy fiduciary duties in this area are few and far between.

The Proposal Would Impose an Unjustifiable Burden on Advisers, Especially the Small Businesses Who Comprise the Bulk of the Investment Adviser Industry

Although the benefits of this rulemaking are illusory, the costs are all too apparent. Relying on fiduciary principles to govern the selection and monitoring of service providers allows investment advisers to satisfy their duties of care and loyalty in a way that best suits their particular circumstances, while imposing a set of rigid prescriptions may cause advisers to expend precious compliance resources on "checking boxes" for their own sake. As the Commission recognized when it adopted the Advisers Act Compliance Program Rule in 2003, advisers "are too varied in their operations . . . to impose a single set of universally applicable required elements."[10] Yet, that is precisely what this rulemaking seeks to do.

While proposed Rule 206(4)-11 and the proposed changes to Rule 204-2 would be costly for all advisers, they would impose a special hardship on small firms who comprise the bulk of the investment adviser industry. As of the end of 2021, more than one-third of federally registered investment advisers had five or fewer employees; more than half had ten or fewer employees; and roughly 88 percent had fifty or fewer employees.[11] When assessing the practicality of the Proposal

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made at the direction of another person").

[9] Proposing Release at notes 11, 18, 19, 50 and 68.

[10] *Compliance Programs of Investment Companies and Investment Advisers*, IA Rel. No. 2204 (Dec. 17, 2003), 68 Fed. Reg. 74714, 74715-16 (Dec. 24, 2003).

[11] Investment Adviser Association, NRS, "Investment Adviser Industry Snapshot 2022," *available at* https://investmentadviser.org/wp-content/uploads/2022/06/Snapshot2022.pdf (IAA Snapshot) at 7, 16, 39

for the majority of registered advisers, it is also important to keep in mind that employees in small firms typically wear multiple hats; increasing their responsibilities in one area may diminish their ability to perform in another.

In estimating the costs of this Proposal, the Commission suggests that conducting due diligence on, and ongoing monitoring of, service providers would require the assistance of compliance managers, a chief compliance officer, attorneys, assistant general counsel, junior business analysts, senior business analysts, paralegals, senior operations managers, operations specialists, compliance clerks and general clerks.[12] It is unclear how the typical adviser who manages money primarily for individuals, who has on average only eight employees,[13] could ever hope to comply with such labor-intensive requirements.

Some aspects of proposed Rule 206(4)-11 are not just impractical, but are practically impossible for small firms to comply with. For example, requiring an adviser to obtain granular information about its service providers' material subcontracting arrangements and reasonable assurance that its service providers will coördinate with the adviser for purposes of the adviser's compliance with the federal securities laws applicable to the covered function assumes that small advisers have a bargaining power that simply does not exist. As we pointed out in our cybersecurity proposal comments earlier this year,[14] service providers' contracts are typically non-negotiable, and their willingness to have their operations monitored by every small adviser they deal with is limited, at best. That being the case, requirements such as those proposed in 206(4)-(11)(a)(iv) and (v) are tripwires for a large segment of the investment adviser industry. The Commission's assurance that reasonable due diligence "would not require boundless analysis or the identification of every conceivable risk of outsourcing"[15] provides cold comfort to an adviser facing the prospect of an antifraud charge stemming from a *post-hoc* regulatory determination that its efforts to comply were not enough.

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and 41. We believe that all of these firms are appropriately characterized as small advisers. We further believe that the standard the Commission employs to identify "small entities" for purposes of the Regulatory Flexibility Act is flawed because the obsolete assets-under-management test incorporated into Advisers Act Rule 0-7(a) ensures that the Commission's assessment of the effect of its rules on small advisers will eliminate virtually the entire population of federal registrants from consideration. Because an adviser's ability to shoulder regulatory compliance burdens depends on its human and financial resources, we believe that Rule 0-7 should be amended to identify small entities by looking at their staff and revenues, not their R-AUM.

[12] Proposing Release at 144, 157, 87 Fed. Reg. 68855, 68860.

[13] IAA Snapshot at 43.

[14] Letter of Mari-Anne Pisarri to Vanessa A. Countryman (May 3, 2022), *available at* s70422-20127866-289154.pdf (sec.gov).

[15] Proposing Release at 42, 87 Fed. Reg. 68826.

The Proposal Would Harm Clients

Under the best of circumstances, the proposed rulemaking will increase the cost of investment advisory services; under the worst, it will diminish the quality and/or availability of those services. In either case, clients stand to lose if the proposed rule and amendments are adopted.

It is axiomatic that clients engage investment advisers to render investment advice, not to address perpetually accreting lists of compliance tasks. But adding the requirements of proposed Rules 206(4)-11 and 204-2(a)(24) and (*l*) to the many other regulatory requirements adopted and proposed over the past few years[16]—which themselves were superimposed on an already robust regulatory regime—threatens to drive small advisers out of the market, and to make those that remain struggle to focus on their core fiduciary functions. This is not in clients' best interests. We respectfully ask the Commission to withdraw this Proposal.

Additional Comments

In addition to the foregoing, we offer the following thoughts on some of the specific questions the Commission has raised about this Proposal:

11. and 33. Rule 206(4)-7 has been successful precisely because it does not attempt to micromanage advisers' compliance programs. This rule should not be touched.

27. – 30. For the reasons explained above, we submit that the vast majority of advisers already take appropriate steps to select and monitor their service providers and to keep records of same. As such, the proposed rule is, in our view, unnecessary. The prescriptive aspects the proposal that go beyond current practice are, for the most part, impractical,[17] meaningless,[18] counter-productive[19] or not cost-justified.

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[16] *See e.g.,* Enhanced Reporting For Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, Rel. No. 33-11131 (Nov. 2, 2022); Investment Adviser Marketing, IA Rel. No. 5653 (Dec. 22, 2020), 86 Fed. Reg. 13024 (Mar. 5, 2021); Form CRS Relationship Summary; Amendments to Form ADV, IA Rel. No. 5247 (Jun. 5, 2019). 84 Fed. Reg. 33492 (Jul. 12, 2019); Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social and Governance Investment Practices, IA Rel. No. 6034 (May 25, 2022), 87 Fed. Reg. 36654 (Jun. 17, 2022); Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies and business Development Companies, IA Rel. No. 5956 (Feb. 9, 2022) 87 Fed. Reg. 13524 (Mar. 9, 2022); Private Fund Advisers; Documentation of Registered Investment Advisers Compliance Reviews, IA Rel. No. 5955 (Feb. 9, 2022), 87 Fed. Reg. 16886 (Mar. 24, 2022). This is not an exhaustive list.

[17] *E.g.,* Proposed Rule 206(4)-11(a)(1)(iv) and (v); Proposed Rule 204-2(*l*)(2)(i).

[18] *E.g.,* Proposed Rule 204-2(a)(24)(i). Creating a record of the factors that led an adviser to treat any specific function as a "covered function" under Rule 206(4)-11 is most charitably described as "busywork." Furthermore, in at least one area, the proposed change to the recordkeeping rule duplicates an existing requirement. *See* Proposed Rule 204-2(a)(24)(iii) and existing Rule 204-2(a)(10).

[19] The Proposal's expensive prescriptive requirements could incentivize advisers to avoid outsourcing

32. Advisers should not be required to obtain third-party experts, audits or other outside assistance to oversee any type of service provider. Not only would such measures be cost-prohibitive for most advisers, but they would add yet more covered functions subject to the prescriptive outsourcing requirements.

35. For the reasons explained above, in its current form, 17 CFR 275.0-7 does not serve its purpose. It should be amended to reclassify a small business as one with fewer than 50 employees. Although we believe that this entire Proposal should be withdrawn, if the Commission decides to adopt the proposed rules, an exemption should be provided for advisers with fewer than 50 employees.

39. We believe the proposed rule should be less, not more, prescriptive.

48. The circumstances regarding the termination of any service provider engagement should be left to the best judgment of the investment adviser, consistent with its fiduciary duty.

51. The Commission should not prescribe the frequency of monitoring. For the reasons explained above, this should be left to the fiduciary's best judgment.

54. Nor should the Commission prescribe the manner in which monitoring should be conducted. References to "onsite" visits are especially inappropriate given many service providers' continued, and possibly permanent, virtual work environment.

62. For the same reason, questions relating to the location of service providers should be eliminated from Form ADV.

66. The same problems identified with Rule 206(4)-11 pertain to the proposed Rule 204-2 amendments. We do not believe the proposed recordkeeping changes afford fiduciaries sufficient flexibility.

78. As explained above, it is highly unlikely that a small adviser would be in a position to obligate a large service provider (a cloud storage provider, for example) to comply with all of the applicable requirements of the Advisers Act recordkeeping rule.

83. A ten-month transition period for the proposed rules is not appropriate. Given the number of discrete tasks required for compliance, including but not limited to, renegotiating service provider agreements (where that is even possible), a transition period of at least eighteen months should be provided.

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We appreciate the opportunity to submit these comments. We would be happy to supply any additional information you may desire about the matters discussed above. Kindly contact the undersigned at [redacted] for further assistance.

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covered functions even where doing so is in clients' best interest.

Respectfully submitted,

Mari-Anne Pisarri

cc: The Honorable Gary Gensler, Chairman
The Honorable Hester M. Peirce
The Honorable Caroline A. Crenshaw
The Honorable Mark T. Uyeda
The Honorable Jaime Lizárraga
William A. Birdthistle, Director, Division of Investment Management