

December 27, 2022

BY EMAIL ONLY

Securities and Exchange Commission
Attn: Vanessa Countryman, Secretary
100 F Street NE
Washington, DC 20549-1090
rule-comments@sec.gov

**RE: Outsourcing by Investment Advisers
Release No. IA-6176 // File No. S7-25-22**

Dear Secretary Countryman:

I write in connection with the SEC's solicitation of public comments on proposed rule 206(4)-11 under the Investment Advisers Act of 1940 (the "Proposed Rule").¹ My law firm specializes in recovering investment losses for fund investors, and the comments below are based on observations we have made in litigation involving service provider misconduct.

First, the SEC asks whether the Proposed Rule should "apply to any service providers an adviser retains on behalf of all of the adviser's clients . . . including clients that are registered investment companies or private funds." (Proposal at 37) We strongly believe that an adviser's oversight obligations are just as important (or more important) when a fund is the party to the contract, and thus the Proposed Rule should apply to any contract that an adviser has arranged on behalf of a fund. While we acknowledge that a fund's board of trustees also has oversight obligations with respect to counterparties, in our experience, an investment adviser's personnel typically select the service provider, directly interact with its personnel, and have meaningful visibility into its operations. Thus, it is reasonable, in our view, to impose the type of diligence obligations contemplated by the Proposed Rule on the adviser, even when the fund is the party to the contract.

¹ See Release No. IA-6176, File No. S7-25-22, Outsourcing by Investment Advisers (the "Proposal").

Second, the SEC asks whether it should “require a written agreement” for such arrangements. (Proposal at 36.) We have never seen an oral agreement with a fund service provider, but we see no benefit whatsoever to allowing one. While a written contract may not always be necessary for delineation of day-to-day operations, the scope of services to be provided is often the subject of dispute when a problem arises, and the parties should be required to agree in advance, in writing, as to the precise scope of services to be provided. Investors are also entitled to a clear description of the services in order to understand what particular services are being provided for the price, and how the cost relates to the fund’s overall fees and expenses.

Third, and our primary reason for writing, the SEC asks “what provisions should we require” in an agreement between an adviser (or a fund managed by the adviser) and a fund service provider. (Proposal at 36.) Among other things, we believe that every contract should provide plainly that the service provider will have no recourse against the adviser’s clients—particularly, a registered investment company—in the event that any losses are caused by the service provider’s own conduct. While the Investment Company Act of 1940 (“ICA”) expressly precludes an investment company from indemnifying certain persons for losses caused by their own conduct,² the SEC should make clear, under the same rationale, that no fund service provider may seek indemnification from a fund for losses caused by their own conduct. For example, any indemnification provision, limitation on liability, or agreement to advance legal expenses should be expressly qualified by the provider’s conduct and should state that the fund will not indemnify any provider or advance expenses where the fund has a reasonable basis to believe that the provider was responsible or otherwise contributed to the losses.³

While it may seem farfetched that a service provider would seek indemnification from a fund or its investors for losses caused by the provider’s own conduct, some industry participants appear to view this as the norm. For example, consider the Infinity Q Diversified Alpha Fund, which liquidated its portfolio in early 2021 because of extensive securities valuation errors.⁴ After liquidation, the trustees determined to retain a “special reserve” of \$750 million for, among other things, “expenses, including legal fees, incurred by service providers and others who are indemnified by the [f]und.”⁵ Multiple of those parties were responsible for calculating or overseeing the erroneous securities prices that caused the fund to liquidate (resulting in substantial losses to investors). As of today, over \$500 million continues to be tied up in reserve, in part, because of the perception that the fund has indemnification obligations to parties with culpability

² Sections 17(h) and 17(i) of the ICA preclude investment advisers, underwriters, officers and directors from seeking indemnification for losses caused by their own “willful misfeasance, bad faith [or] gross negligence.”

³ Such a requirement would be consistent with the SEC’s interpretation of Sections 17(h) and 17(i). *See* Interpretive Matters Concerning Independent Directors of Investment Companies, 17 CFR Part 271, Release No. IC-24083 (Oct. 14, 1999) (“[B]efore advancing legal fees to a director, a fund's board must either (1) obtain assurances, such as by obtaining insurance or receiving collateral provided by the director, that the advance will be repaid if the director is found to have engaged in disabling conduct, or (2) have a reasonable belief that the director has not engaged in disabling conduct and ultimately will be entitled to indemnification.”).

⁴ *See* [Investment Company Act Release No. 34198](#), Infinity Q Diversified Alpha Fund, File No. 812-15205.

⁵ *See* [Plan of Distribution of Assets](#) at 5 (as submitted to the SEC June 7, 2021).

for the losses. This confusion has even trickled into private actions by investors to recover losses: in a pending class action, counsel for plaintiffs have argued that the fund's indemnification obligations to a culpable service provider would "render any judgment against [the service provider] a pyrrhic victory for the class," given that the fund would purportedly be on the hook for the provider's liability.⁶ While such a position is baseless as a matter of law and fact, clearer contract language might have prevented this result.

We propose that any contract relating to services to be provided to a registered investment company must state plainly that:

- (1) the service provider will be liable, with no limitation of liability and no right to indemnification, for losses caused by its own conduct;
- (2) the service provider will have no right to expense advancements if a fund's trustees find, after reasonable investigation, that the provider was at fault in any way for the losses or liabilities; and
- (3) the service provider will never have a right to indemnification or expense advancements in connection with claims asserted under the federal securities laws.⁷

One advantage of this approach is that it will place a clear onus on the fund's trustees, subject to their state-law fiduciary duties, to consider carefully, on a fully informed basis, any provider's entitlement to indemnification or expense advancements. We believe this is not only fair but an important protection against the potentially lazy assumption that all fund service providers are automatically entitled to indemnification and expense advancements until adjudicated otherwise.

We appreciate your time and attention to this matter.

Sincerely,



Aaron T. Morris

⁶ See *In re Infinity Q Diversified Alpha Fund Securities Litigation*, Index No. 651295/2021 (Doc. No. 170) (N.Y. Supr. Ct).

⁷ The SEC has taken the view that securities violations are never subject to indemnification: "in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is therefore unenforceable." See, e.g., 17 CFR § 229.510.