

SEC Proposes New Investment Adviser Outsourcing Oversight Requirements

WRITTEN BY

Genna Garver | David S. Idokogi

On October 26, the Securities Exchange Commission (SEC) kicked off what's expected to be an active season of fall rulemaking by proposing new [Rule 206\(4\)-11](#) under the Investment Advisers Act of 1940, as amended (Advisers Act). This latest proposal comes in response to the SEC's observations of increased outsourcing and the related risks of client harm, despite the existing legal framework regarding the duties and obligations of investment advisers. The SEC believes more needs to be done to protect clients and enhance oversight of advisers' outsourced functions. As stated in the [proposed rule release](#), an investment adviser cannot just "set it and forget it" when outsourcing. Proposed Rule 206(4)-11 intends to create a consistent oversight framework for the industry and specific standards for which registered investment advisers conduct initial and periodic due diligence on third-party service providers. The proposal also includes related amendments to Form ADV to help the SEC quickly analyze the potential impact of a critical failure at a service provider. The SEC also proposed amendments to the Advisers Act Books and Records Rule 206(4)-2 to require specific conditions for all advisers using third parties to make and keep records required by the rule.

Proposed Rule 206(4)-11: Outsourcing Oversight Requirements

As stated in the [proposed rule release](#), the SEC believes, "... it is a deceptive sales practice and contrary to the public interest and investor protection for an investment adviser to hold itself out as an investment adviser, but then outsource its functions that are necessary to its provision of advisory services to its clients without taking appropriate steps to ensure that the clients will be provided with the same protections that the adviser must provide under its fiduciary duty and other obligations under the Federal securities laws." The SEC makes it clear that disclosure alone will not address this deception. Advisers must have effective and sufficient oversight over the service provider so as to fulfill the adviser's fiduciary duty, comply with the federal securities laws, and protect clients from potential harm. If the proposed Rule 206(4)-11 is adopted, it would apply to **SEC-registered investment advisers** that outsource a "covered function." Under the rule, the definition of a "covered function" has two parts:

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.

Notably, clerical, ministerial, utility, or general office functions or services are excluded from the definition of a “covered function.”

Before engaging the service provider, the adviser would need to reasonably identify and determine through due diligence that it would be appropriate to outsource the covered function and that it would be appropriate to select that service provider by considering the following considerations:

- The nature and scope of the services;
- 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.

Accordingly, if an adviser decides to outsource a covered function, proposed Rule 206(4)-11 would require registered advisers to:

- Conduct due diligence before outsourcing and periodically monitor the service providers’ performance;
- Make and/or keep books and records related to the due diligence and monitoring requirements;
- Amend the Form ADV to collect information about advisers’ use of service providers; and
- Conduct due diligence for third-party recordkeepers and obtain reasonable assurances from those third parties.

Proposed Form ADV Amendments: New Part 1 A, Item 7.C. and Related Section 7.C. of Schedule D

New Item 7.C. in Part 1A and Section 7.C. in Schedule D would require advisers to provide census-type information about service providers performing covered funds. While the proposed disclosures would help clients make informed decisions about retaining advisers, they also provide greater visibility for the SEC to identify potential risks and allocate exam resources. Specifically, the amendments would require registered advisers to:

- Identify their service providers that perform covered functions;
- Provide the location of the office principally responsible for the covered functions;

- Provide the date they were first engaged to provide covered functions; and
- State whether they are related persons of the adviser.

The SEC would also request information to clarify the service providers' services or functions by selecting from predetermined categories of covered functions or services set forth in the item (or selecting "other" where the service or function is not represented). With this information, the SEC can identify advisers' use of particular service providers that may pose a risk to clients and investors, such as in situations where the SEC learns that a service provider experiences a significant and ongoing disruption to its operations.

Proposed Books and Records Maintained by Third Parties

Additionally, the SEC has proposed to add a new provision in the recordkeeping rule (Rule 204-2 of the Advisers Act). This new provision would require every investment adviser that relies on a third party to keep books and records required by the recordkeeping rule to conduct due diligence and monitoring of the third party, as consistent with the requirements under proposed Rule 206(4)-11. The proposed provision will require the adviser to obtain reasonable assurances that the third party will meet four standards that address the third party's ability to:

1. Adopt and implement internal processes and/or systems for making and/or keeping records that meet the requirements of the recordkeeping rule applicable to the adviser in providing services to the adviser;
2. Make and/or keep records that meet all of the requirements of the recordkeeping rule applicable to the adviser;
3. Provide access to electronic records; and
4. Ensure the continued availability of records if the third party's operations or relationship with the adviser ceases.

Proposed Compliance Date

Under the proposal, all advisers registered or required to be registered with the SEC must comply with the rule, if adopted, starting 10 months from the rule's effective date (compliance date). The rule would apply to all new service provider engagements made on or after the compliance date, while the ongoing monitoring requirements would apply to existing engagements beginning on the compliance date. However, the SEC has requested comment on whether the rule should provide an exclusion for such existing engagements, as well as for service provider engagements that are short term in nature (e.g., less than three months).

Comment Period

The SEC has requested comments on the proposed rule, including on whether the rule should explicitly apply to index providers, model providers, valuation agents, or other service providers central to an adviser's investment

decision-making process. The SEC also requests comments on whether the proposed rule should apply to service providers that an adviser retains on behalf of all clients, including clients that are registered investment companies or private funds. Particularly, the request for comment includes whether or not the SEC should provide an explicit exception from the proposed rule if a service provider engagement is approved in the case of a registered fund by the board, including a majority of the independent directors, or in the case of a private fund by a majority of the Limited Partner Advisory Committee or equivalent body.

Comments are due 30 days after publication in the *Federal Register* (which at the time of this client advisory has yet to occur) or December 27, 2022, whichever is later. Comments can be submitted electronically online at <http://www.sec.gov/rules/submitcomments.htm>, by email via rule-comments@sec.gov, (include File Number S7-25-22 in the subject line), or by paper.

RELATED INDUSTRIES + PRACTICES

- [Investment Funds + Investment Management Services](#)