November 8, 2022

SEC Proposes to Regulate Investment Advisers' Outsourcing, Recordkeeping Included

On October 26, 2022, the SEC issued a release (the "Release") proposing new Rule 206(4)-11 under the Advisers Act (the "Proposed Rule") to prohibit registered investment advisers from retaining a service provider to perform certain services or functions without first meeting minimum requirements. If adopted as proposed, the Proposed Rule would require investment advisers to:

- Conduct due diligence prior to engaging a service provider to perform certain services or functions for the purpose of making a reasonable determination that it would be appropriate to outsource those services or functions and to select that service provider; and
- Periodically monitor the performance and reassess the retention of the service provider for the purpose of making a reasonable determination that it is appropriate to continue to outsource to that service provider.

The Release would amend Form ADV to collect census-type information about the service providers within the scope of the Proposed Rule.

The Release also would amend the Advisers Act books and records rule to (i) specify new records evidencing an investment adviser's compliance with the Proposed Rule and (ii) require an investment adviser that relies on a third party to make and/or keep books and records to conduct due diligence and monitor that third-party recordkeeper and to obtain certain reasonable assurances that the third-party recordkeeper will meet required standards.

The Release is described in detail below.

The Proposed Rule

I. Applicable Definitions

Under the Proposed Rule, it would be unlawful for an investment adviser registered or required to be registered with the SEC to retain a "service provider" to perform a "covered function," unless the investment adviser conducts certain due diligence and monitoring of the service provider.

The Proposed Rule defines "covered function" as:

> a function or service that is necessary for the investment adviser to provide its investment advisory services in compliance with the Federal securities laws, and 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. A covered function does not include clerical, ministerial, utility, or general office functions or services.

"Service provider" is defined by the Proposed Rule as a person or entity that (i) performs one or more covered functions and (ii) is not a supervised person (as defined in Section 2(a)(25) of the Advisers Act) of the investment adviser.

II. Guidance on Covered Function Elements

The Proposed Rule targets only outsourced functions that meet two elements (i) those necessary for an investment adviser to provide its investment advisory services in compliance with the federal securities laws and (ii) those that, if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the investment adviser's clients or on the investment adviser's ability to provide investment advisory services.

The Release notes that, ultimately, the determination of "whether an adviser has retained a service provider to perform . . . a covered function would depend on the facts and circumstances."

The Release notes that the proposed amendments to Form ADV, Section 7.C of Schedule D, provide examples of "potential covered function categories an adviser may wish to consider," which include:

> Adviser/Sub-adviser; Client Services; Cybersecurity; Investment Guideline/Restriction Compliance; Investment Risk; Portfolio Management (excluding Adviser/Sub-adviser); Portfolio Accounting; Pricing; Reconciliation; Regulatory Compliance; Trading Desk; Trade Communication and Allocation; and Valuation.

The First Element. The Release states that, in general, "functions or services that are related to an adviser's investment decision-making process and portfolio management . . . meet the first element of the definition." As examples, the Release indicates that some of the functions and services covered under the first element would be those related to:

- Providing investment guidelines (including maintaining restricted trading lists);
- Creating and providing models related to investment advice;
- Creating and providing custom indexes;
- Providing investment risk software or services;
- Providing portfolio management or trading services or software;
- Providing portfolio accounting services; and
- Providing investment advisory services to an adviser or the adviser's clients (sub-advisory services).

The Release provides the following additional examples of functions or services that may meet the first element of the definition of a covered function:[1]

- *Index Providers*. The services of an index provider, if retained by an adviser for purposes of formulating the adviser's investment advice (because such services would be necessary for the adviser to provide investment advice to its client).
- *Implementation and Allocation Services*. Implementing an investment decision, including identifying which portfolios to include or exclude, determining how to allocate a position among portfolios, and submitting the final orders to the broker.
- *Compliance Functions, Valuation and Pricing Services*. Ensuring that an investment adviser complies with the regulatory requirements applicable to its advisory services. This would include outsourced compliance functions, including outsourced chief compliance officers and outsourced regulatory filings and valuation and pricing services.[2]

The Second Element. The Release notes that determining what is a material negative impact would depend on the facts and circumstances, but that it could include a material financial loss to a client or a material disruption in the adviser's operations resulting in the inability to effect investment decisions or to do so accurately. Therefore, an adviser should consider a variety of factors when determining what would be "reasonably likely to have a material negative impact, such as the day-to-day operational reliance on the service provider, the existence of a robust internal backup process at the adviser, and whether the service provider is making or maintaining critical records, among other things."

As noted above, the Proposed Rule excludes from the definition of "covered function" clerical, ministerial, utility, or general office functions or services.[3]

III. Service Providers

The Proposed Rule's definition of service provider excludes the investment adviser's supervised persons because "such persons are already being directly overseen by the adviser." However, the Proposed Rule would not distinguish between third-party providers and affiliated service providers. Accordingly, while an affiliated service provider may be in a control relationship with the adviser, the Release states that "it remains important for the adviser to determine if it is appropriate to retain the affiliate's services and to oversee the affiliate's performance of a covered function."

The Proposed Rule would not provide an exception for service providers that are subject to other provisions of the federal securities laws (*e.g.*, broker-dealers and other investment advisers, including sub-advisers). The Release states that an investment adviser "remains liable for its legal and contractual obligations and should be overseeing outsourced functions to ensure the adviser meets its legal and contractual obligations, regardless of whether the service provider has its own legal obligations under the Federal securities laws."

IV. Due Diligence

The Proposed Rule would require investment advisers to conduct reasonable due diligence before engaging a service provider to perform a covered function. In particular, the Proposed Rule would require an adviser to reasonably identify and determine that it would be appropriate to outsource the covered function, appropriate to select the service provider and, once selected, appropriate to continue to outsource the covered function, by complying with six specific elements:

1. Identifying the nature and scope of the covered function the service provider is to perform;

2. Identifying and determining how the investment adviser would mitigate and manage any potential risks to clients or to the investment adviser's ability to perform its advisory services resulting from engaging a service provider to perform a covered function and engaging that service provider to perform the covered function;

3. Determining that the service provider has the competence, capacity, and resources necessary to perform the covered function in a timely and effective manner;

4. Determining whether the service provider has any subcontracting arrangements that would be material to the service provider's performance of the covered function, and identifying and determining how the investment adviser will mitigate and manage potential risks to clients or to the adviser's ability to perform its advisory services in light of any such subcontracting arrangement;

5. Obtaining reasonable assurance from the service provider that it is able to, and will, coordinate with the adviser for purposes of the adviser's compliance with the federal securities laws; and

6. Obtaining reasonable assurance from the service provider that it is able to, and will, provide a process for orderly termination of its performance of the covered function.

The Release describes various considerations that may arise in connection with complying with each of the six specific elements. However, the Release states that "conducting due diligence is not a one-size-fits-all process" and that whether an investment adviser's due diligence is reasonable under the Proposed Rule "would depend on the facts and circumstances applicable to the services to be performed and the identified service provider."

V. Monitoring

Once a service provider is engaged, the Proposed Rule would require an investment adviser to periodically monitor the service provider's performance of the covered function and reassess the retention of the service provider in accordance with the Proposed Rule's due diligence requirements. The Release notes that the proposed monitoring requirement leverages processes similar to due diligence, which – as is the case with due diligence – is not a one-size-fits-all analysis. This means that:

- All monitoring generally should continue to take into account all of the required elements for due diligence, including the nature and scope of the service provider's services as well as the risks of engaging the particular service provider performing that function; and

- An investment adviser generally should periodically evaluate the validity of its conclusions drawn during the initial due diligence process and should adjust its monitoring to reflect (i) changes in the functions or services the service provider is engaged to perform and in the industry or market that may affect the covered function and (ii) the findings of any prior monitoring.

The Proposed Rule would require an investment adviser to monitor its service providers with a manner and frequency 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 Release states that 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. The Release further indicates that, in determining an appropriate frequency of monitoring, advisers should consider whether there has been any change in the risk profile of the covered function or the service provider.

VI. Recordkeeping in Connection with the Proposed Rule

Covered Function Records. The Release would amend the Advisers Act books and records rule (Rule 204-2) to require an investment adviser to make and keep a list or other record of covered functions that the adviser has outsourced to a service provider and the name of each service provider, along with a record of the factors, corresponding to each listed function, that led the investment adviser to list it as a covered function. In addition, investment advisers would be required to maintain a copy of any written agreement (including any amendments, appendices, exhibits, and attachments) entered into with a service provider regarding covered functions.

Due Diligence Records. The Release would amend Rule 204-2 to require investment advisers to make and retain specific records related to their due diligence assessments. The due diligence records would include any policies or procedures or other documentation showing how the adviser would mitigate and manage the risks it identifies, both at a covered function and a service provider level.

Monitoring Records. The Release would amend Rule 204-2 to require investment advisers to make and retain records documenting the periodic monitoring of a service provider of a covered function. The Release states that investment advisers generally should consider including information such as performance reports received from the service provider, findings of any financial, operational, or third-party assessments of the service provider, identification of any new or increased service provider risks and a summary of how the adviser mitigates or manages those risks, any amendments to written agreements with a service provider, the adviser's written policies and procedures applicable to monitoring, a record of any changes to the nature and scope of the covered function the service provider is to perform, and a record of any inadequate or failed performance by a service provider and responses from the adviser.

Form ADV Amendments

The Release would amend Form ADV Part 1A to require registered advisers to identify, and provide specified information about, their service providers that perform covered functions. Currently, Item 7 of Form ADV requires investment advisers to disclose information about financial industry affiliations and activities and to state whether they advise any private funds (and, if so, provide certain information related to those private funds). New Item 7.C. would require SEC-registered advisers to check a box to indicate whether they outsourced any covered functions to a service provider. For those services determined to be covered functions and outsourced to one or more service providers, investment advisers would report more detailed information about each such service provider in new Section 7.C. of Schedule D. The required information would include the legal and primary business names of the service provider, the legal entity identifier (if applicable) and the address of the service provider.

New Section 7.C. would require disclosure of whether the identified service provider is a related person of the investment adviser and the date the service provider was first engaged. Section 7.C. would further require an investment adviser to classify the covered functions provided using predetermined categories of functions and services set forth in the item.

Third-Party Recordkeepers

Many investment advisers outsource various recordkeeping functions. The Release's amendments to Advisers Act Rule 204-2 include a new provision requiring every investment adviser that relies on a third party to make and/or keep any books and records required by Rule 204-2 to comply with a comprehensive oversight framework, consisting of due diligence, monitoring, and recordkeeping elements.

- An investment adviser would be required to reasonably identify and determine through due diligence that it would be appropriate to outsource the recordkeeping and that it would be appropriate to select a particular third-party recordkeeper, by complying with each of the six due diligence elements (described in section IV, above) specified in the Proposed Rule.

- Once a third party is engaged to provide recordkeeping functions required by amended Rule 204-2, the investment adviser would be required to monitor the third party's performance of the recordkeeping function periodically and reassess the retention of the third party in accordance with the monitoring requirements prescribed by the Proposed Rule.

- An investment adviser also would be required to comply with the recordkeeping requirements prescribed in amended Rule 204-2. Thus, in addition to performing the required due diligence and monitoring for third-party recordkeeping, an adviser must also make and keep records documenting its due diligence and periodic monitoring of that third party as though the recordkeeping function were a "covered function" and the third party were a "service provider," each as defined in the Proposed Rule.

- In addition to due diligence and monitoring obligations, an investment adviser that relies on a third party to perform any recordkeeping function under Rule 204-2 would be required to obtain reasonable assurances that the third party will meet four standards specific to recordkeeping, as such standards would apply to the adviser. Specifically, the investment adviser must have reasonable assurance that:

    1. The third party will adopt and implement internal processes and/or systems for making and/or keeping records on behalf of the investment adviser that meet the requirements of Rule 204-2;

    2. When making and/or keeping records on behalf of the adviser, the third party will, in practice, actually make and/or keep records in a manner that meets the requirements of Rule 204-2;

3. For electronic records, the third party will allow the investment adviser and the SEC staff to access the records easily through computers or systems during the required retention period of Rule 204-2; and

4. Arrangements will be made to ensure the continued availability of records that will meet the requirements of Rule 204-2 if the third party ceases operations or the relationship with the investment adviser is terminated.

Comment Period

Comments on the Release must be received no later than 30 days after date of publication in the *Federal Register* or December 27, 2022, whichever is later.

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For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray attorney contacts.

1. The Release also specifies certain services that typically would not be deemed covered functions, including services performed by marketers and solicitors (as such services are not used by an adviser to provide investment advice to its clients).
2. The Release notes that an adviser may use valuation service providers to assist in fair value determinations and, therefore, these services would be included under the Proposed Rule as covered functions. In contrast, common market data providers providing publicly available information are likely outside the scope of the Proposed Rule.
3. For example, the Release states that covered functions would not include an investment adviser's lease of commercial office space or equipment, use of public utility companies, utility or facility maintenance services, or licensing of general software providers of widely commercially available operating systems, word processing systems, spreadsheets, or other similar off-the-shelf software.