SpencerFane

Proposed Rule for Outsourcing by Investment Advisers

The Securities and Exchange Commission is proposing a new rule, Rule 206(4)-11, under the Investment Advisers Act of 1940, that would require registered investment advisers to satisfy specific requirements if they outsource certain services or functions. In addition, the Proposed Rule would impose due diligence and monitoring obligations for the engagement and retention of the service provider. The SEC is also proposing changes to Form ADV and to the recordkeeping requirements under Rule 204-2. If adopted, advisers will be required to comply with the new rule ten months from the rule's effective date for new service provider engagements that occur on or after the compliance date. The ongoing monitoring obligations, however, would apply to existing arrangements beginning on the compliance date.

Background

The asset management industry has changed in many respects since the Advisers Act was adopted. In response to some of these changes, advisers have sought administrative and specialized expertise from outside service providers. While clients may benefit from certain outsourced services and functions, the SEC believes clients could also be harmed if outsourcing occurs without appropriate due diligence and oversight. The Proposed Rule is intended to address these potential outsourcing risks by creating due diligence and monitoring obligations for investment advisers.

Proposed Rule

The Proposed Rule applies to investment advisers who outsource a covered function. The definition of a "covered function" is broad and consists of two parts: (1) a function or service that is necessary for the adviser to provide its investment advisory services in compliance with applicable laws; and (2) if not performed (or performed negligently) would be reasonably likely to cause a material negative

impact on the adviser's clients or the adviser's ability to provide services. Clerical, ministerial, utility, or general office functions or services are excluded from the definition.

If an investment adviser is considering whether to engage a service provider to perform a covered function, the adviser must assess the service provider to determine that it would be appropriate to engage the provider. The adviser's assessment must address six specific elements:

1. The nature and scope of the services;
2. Potential risks resulting from outsourcing the function to the service provider, plus risk mitigation strategies;
3. The service provider's competence, capacity, and resources to perform the covered function;
4. The service provider's subcontracting arrangements related to the covered function;
5. Coordination with the service provider regarding compliance with applicable law; and
6. The orderly termination of the service provider's engagement.

On an ongoing basis, the investment adviser must monitor the service provider's performance and assess the provider's continued engagement pursuant to the Proposed Rule's due diligence requirements.

The Proposed Rule does not require explicit written policies and procedures related to an investment adviser's oversight of the service provider. Nevertheless, the SEC believes that investment advisers would be required under existing Rule 206(4)-7 to have policies and procedures reasonably designed to prevent violations of the Proposed Rule, and be required to make and keep books and records related to their oversight obligations. Further, advisers relying on a service provider to make and/or keep records required under the Advisers Act must conduct due diligence and monitoring of the service provider that is consistent with the Proposed Rule and obtain reasonable assurances that the service provider: (1) adopts and implements internal processes and/or systems that meet the recordkeeping rule requirements applicable to the investment adviser, (2) makes and/or keeps records that meet all of the recordkeeping rule requirements applicable to the adviser, (3) provides

access to electronic records, and (4) ensures the continued availability of records if the service provider's operations or engagement cease.

The final component of the Proposed Rule would modify Form ADV and require investment advisers to provide census-type information about the outsourcing service provider. Through this change, the SEC is seeking improved visibility for itself and advisory clients relating to the service providers, so that clients can make informed decisions about engaging an investment adviser and so that the SEC can identify and address risks related to outsourcing.

The SEC has received numerous comments on the Proposed Rule (which were due December 27, 2022), including criticism that the rule is unnecessary and burdensome. Nevertheless, investment advisers should become familiar with the Proposed Rule to ensure timely compliance, if it is adopted.

This blog was drafted by Beth Miller, an attorney in the Spencer Fane Overland Park, Kansas, office. For more information, visit www.spencerfane.com.