

ALERTS

SEC Proposes Service Provider Oversight Regime for Investment Advisers

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Highlights

The Securities and Exchange Commission (the “SEC”) has proposed new rules that would dictate with great specificity the manner in which advisers oversee their service providers. While the proposed rule is described as covering “outsourcing” by investment advisers, in fact it would go far beyond delegation arrangements. The service providers covered by the rule as proposed would also include those who “assist” the adviser with certain services or functions, for example a valuation firm that assists the adviser in fair valuation determinations even though the fair valuation determinations are performed by the adviser. Advisers would not only be required to satisfy the specific ongoing oversight requirements prescribed by the proposed rule, they would also have to disclose in Form ADV the fact that they have “outsourced” such services and disclose the names and addresses of all of the outsourced service providers and the nature of the services provided. Failure to satisfy the specific oversight and documentation requirements dictated by the rule could be charged as fraud under the Advisers Act.

The Proposed New Oversight, Recordkeeping and Reporting Regime

On Oct. 26, 2022, the SEC proposed a new rule under the Investment Advisers Act of 1940 (the “Advisers Act”) that imposes due diligence, monitoring, recordkeeping and disclosure obligations on registered

investment advisers that outsource certain functions to service providers. Although Proposed Rule 206(4)-11 (the “Proposed Rule”) is presented as “a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the Act”,^[1] it will likely have a greater direct impact on advisers’ outsourced arrangements across a wide range of products, services and service providers.

“Covered Functions” Provided by “Service Providers”

The Proposed Rule does not use or define the term “outsourcing”. Rather, the types of relationships covered under the Proposed Rule are defined by new and vague standards. The Proposed Rule applies to any registered investment adviser that retains a “service provider”^[2] to perform a “covered function,” which is defined as a function or service: (1) 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 if 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.^[3] To help identify the types of third parties that might provide covered functions, the Proposing Release includes some examples: “Adviser/Subadviser; Client Services; Cybersecurity; Investment Guideline/Restriction Compliance; Investment Risk; Portfolio Management (excluding Adviser/Subadviser); Portfolio Accounting; Pricing; Reconciliation; Regulatory Compliance; Trading Desk; Trade Communication and Allocation; and Valuation.”^[4] The list is not exhaustive and it suggests that advisers should take a critical eye to how the Proposed Rule might impact many of its critical third party arrangements.

The first part of the covered function test is aimed at “functions or services that are related to an adviser’s investment decision-making process and portfolio management.”^[5] The Proposing Release encourages a broad interpretation of the first part of the test by including as examples services like portfolio accounting services, compliance services and valuation and pricing services. It adds, however, that “certain of these functions may be covered functions for one adviser but not for another adviser, depending on the facts and circumstances.”^[6]

The SEC provides as an example a valuation service provider. “For example, an adviser may use valuation service providers to assist in fair value determinations. Such services would be included under the

proposed rule as covered functions, as opposed to, for example, common market data providers providing publicly available information.”[7]

Although the valuation service provider is not delegated the authority to value the investments, the SEC indicates that by utilizing such a service provider to assist in fair valuations, the adviser has “outsourced” its valuation function.

The second part of the covered function test is also unclear. What is a function 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? Will it be possible for advisers to rule out certain services under this formulation? The Proposing Release suggests that 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.”[8]

The Proposing Release includes a number of examples, some of which suggest that this part will be interpreted broadly, as well. The SEC advises that “if an adviser licenses a commonly available index and its stated investment strategy involves management against that index, failure to receive the index or an inaccurate delivery of the index could have a material negative impact on the adviser’s ability to manage that portfolio.”[9] In this case, the adviser’s relationship with the index provider would, presumably, be subject to the Proposed Rule.

Due Diligence and Ongoing Monitoring Requirements

Once an adviser determines that a service provider will perform a covered function, the Proposed Rule requires due diligence that directs advisers to confirm and document six aspects of the intended covered function services, including:

- 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.

The Proposed Rule requires documentation of an adviser’s third-party due diligence assessment, including “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.”^[10] The Proposed Rule also requires ongoing monitoring of the covered function services, assessments of the engaged service provider’s performance, and that an adviser retain books and records associated with the monitoring and assessment of the service provider.

Additional Requirements for Outsourcing of Recordkeeping Functions

The Proposed Rule also includes requirements specific to advisers that rely on third parties to make and/or keep any books and records required by the recordkeeping rule (“Recordkeeping Function”). In particular, the Proposed Rule requires advisers to conduct due diligence and monitoring for all third parties performing Recordkeeping Functions and obtain reasonable assurances that the recordkeepers will meet certain standards. In particular, the investment adviser must have reasonable assurance that the third party recordkeeper will:

- 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;
- Make and/or keep records in a manner that meet all of the requirements of the recordkeeping rule applicable to the adviser;
- For electronic records, provide access to electronic records by the adviser and the SEC; and
- Ensure the continued availability of required books and records if the third party’s operations or relationship with the adviser cease.

Recordkeeping Requirements

The Proposed Rule’s recordkeeping requirements will obligate advisers “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 adviser to list it as a covered function.”^[1]

Form ADV Disclosures

The SEC also has proposed amendments to Form ADV under new Item 7.C in Part 1A and Section 7.C in Schedule D, which would require advisers to provide “census-type information” about the third parties that provide covered functions. Such information would include the names and addresses of the service providers and an indication as to the types of services provided. All of this would be categorized in the ADV as “outsourced” functions.

Comment Period and Engagement with the SEC

Comments on the proposal are due on the later of Dec. 27, 2022, or 30 days from the date of publication in the Federal Register. We are preparing comments on the Proposed Rule to provide information and perspective to the Commission and welcome dialogue with our clients on these issues.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] <https://www.sec.gov/rules/proposed/2022/ia-6176.pdf> (“Proposing Release”) at 19.

[2] A “service provider” is defined 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 Investment Advisers Act, of the adviser. The Proposed Rule does not distinguish between affiliated service providers and third-party service providers. Proposing Release at 26.

[3] Covered functions would not include “the 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.” Proposing Release at 25. Also, the SEC “would not consider functions performed by marketers and solicitors to be covered functions, however, because such services are not used by an adviser to provide investment advice to its clients.” Proposing Release at 24. Covered functions would not include the 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.

[4] Proposing Release at 21.

[5] Proposing Release at 22.

[6] Proposing Release at 23.

[7] Proposing Release at 24.

[8] Proposing Release at 24.

[9] Proposing Release at 26.

[10] Proposing Release at 61.

[11] Proposing Release at 28-9.

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