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SEC Proposes Due Diligence and Monitoring Rule for Investment Advisers Comment Period Ends December 27, 2022

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INTRODUCTION

The Securities and Exchange Commission (“SEC” or “Commission”) proposed new rulemaking, Rule 206(4)-11 under the Investment Advisers Act of 1940 (“Act”), to require investment advisers to perform a diligence review of and periodically monitor certain outsourced services and service vendors.¹ Proposed Rule 206(4)-11 prescribes four basic regulatory obligations in respect of outsourced arrangements: (1) vendor diligence, (2) vendor monitoring, (3) books and records documentation, and (4) disclosure. This recent rulemaking is one of 29 current proposals pending for 2022, significantly more than double the number of proposed rules for 2021,² and one of eight proposals expressly directed at or having a material effect on the asset-management sector.

CONTACT

The comment period for proposed Rule 206(4)-11 expires **December 27, 2022**. Do not hesitate to contact C. Dirk Peterson at (202) 659-3905 or dpeterson@mcintyrelf.com for additional information or any assistance.

SUMMARY

Proposed Rule 206(4)-11 prohibits investment advisers registered with the SEC (or required to be registered with the SEC) from enlisting a “service provider” unless prior to engagement the service provider and outsourced services arrangement were the subject of the adviser’s due diligence review based on six prescriptive elements described below. The proposed diligence and monitoring obligations extend broadly to all outsourced services “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 the adviser’s ability to provide investment advisory services”³ (the “Covered Functions”). A “service provider” captured by the rule is any vendor (affiliated or unaffiliated) that provides a Covered Function but does not include services performed by professionals of the adviser (e.g., management, employees, or similar persons) who are “supervised persons” of the adviser. Nor does proposed Rule 206(4)-11 extend to exempt reporting advisers or to clerical, ministerial, utility, or general office functions or services for an adviser.

¹ Investment Advisers Act Release No. 6176 (Oct. 26, 2022), 87 F.R. 68816 (Nov. 16, 2022) (“Proposing Release”).

² See *The Inspector General’s Statement on the SEC’s Management and Performance Challenges*, Office of Inspector General, U.S. Securities and Exchange Commission (Oct. 13, 2022) at p. 2. At the time of publication, the report included rulemaking proposals through August 29, 2022, which numbered 26 for that period. Since that time, the SEC has proposed three other rules, including proposed Rule 206(4)-11.

³ 17 C.F.R. §275.206(4)-11(b).

This latest rulemaking effort reflects the Gensler Commission's transition to a more prescriptive approach to regulating investment advisers to the extent the material increase in prescriptive rules directed at the asset-management sector can be viewed as a trend to a more prescriptive regulatory philosophy.⁴ This trend significantly departs from the prudential and principles-based approach advocated by the Clayton Commission just three years ago.⁵ That is, the principles-based approach of an adviser's fiduciary duty already applies to all aspects of an advisory relationship, including outsourcing arrangements in respect of servicing a client's advisory account. An adviser's fiduciary duty, which encompasses a duty of care and duty of loyalty to a client – a duty the Commission described as “broad and [applicable] to the entire adviser-client relationship”⁶ – already obligates an adviser to ensure its vendor arrangements are in the client's best interest notwithstanding any redundancies implicit in the particular prescriptions of proposed Rule 206(4)-11.

OBLIGATIONS AND ELEMENTS OF PROPOSED RULE 206(4)-11:

Proposed Rule 206(4)-11 extends broadly. Although not codified into the proposed rule, the SEC noted that outsourcing arrangements, such as investment research, data analytics, risk management, investment guidelines administration, compliance, bespoke indices, sub-advisory services, records creation and maintenance, valuation, pricing reconciliation, performance calculations, portfolio modeling, trading desk services, adviser-selected custodial services, cybersecurity, risk and/or trading technology, trade communications, and trade allocation services, could be Covered Functions subject to the rule.⁷

If subject to the proposed rule, the SEC seeks to substitute the following six prescriptive elements of review for an adviser's own prudential review as reasonable evidence of an arrangement's appropriateness:

- **Six Prescriptive Diligence Elements**
 1. Identify the services and their scope.
 2. Identify risk and establish risk management and mitigation protocols.
 3. Evaluate vendor competence, capacity, and resources.
 4. Identify relevant vendor sub-contracting arrangements and their competency.
 5. Assure vendor coordination for compliance purposes.
 6. Assure the orderly termination and seamless transition of Covered Functions.

⁴ See, e.g., Investment Advisers Act Release No. 6176 (Oct. 26, 2022), 87 F.R. 68816 (Nov. 16, 2022) (outsourcing proposed rule); Investment Advisers Act Release No. 6083 (Aug. 10, 2022), 87 F.R. 35938 (Sept. 1, 2022) (Form PF proposed amendments for advisers to large hedge funds); Investment Advisers Act Release No. 5956 (Feb. 9, 2022), 87 F.R. 13524 (March 9, 2022) (proposed requirements for adviser cybersecurity policies and procedures); Investment Advisers Act Release No. 5955 (Feb. 9, 2022), 87 F.R. 16886 (March 24, 2022) (prohibiting certain fee structures of private fund advisers and requiring standardized performance and quarterly account statement delivery of private fund advisers); and Investment Advisers Act Release No. 5950 (January 26, 2022), 87 F.R. 9106 (Feb. 17, 2022) (Form PF proposed amendments for advisers to large private equity funds).

⁵ See Investment Advisers Act Release No. 5248 (June 5, 2019), 84 F.R. 33669, 33670 (July 12, 2019) (noting the “relationship between an investment adviser and its client has long been based on fiduciary principles not generally set forth in specific statute or rule text”).

⁶ *Id.* at 33670.

⁷ Proposing Release at 68817-18, 68821-22, 68835, 68837, and 68883.

- **Vendor Monitoring**

For any outsourced services subject to the rule, proposed Rule 206(4)-11 requires an adviser periodically to monitor the outsourced arrangement against the six prescriptive diligence elements initially applied to the arrangement. The SEC did not codify an express frequency for monitoring other than to observe that an arrangement cannot be effectively forgotten once executed, and that complexity and/or potential risks of the outsourced service should determine the frequency of monitoring.

- **Books and Records**

In conjunction with proposed Rule 206(4)-11, the SEC proposed to amend its adviser books and records rule, Rule 204-2 under the Advisers Act, to require documentation of the outsourced services, the service provider, and evidence of diligence and monitoring reviews. In addition, and notably, the outsourcing of recordkeeping itself is treated as a Covered Function (although not specifically for purposes of Form ADV disclosure), with particular attention to vendors storing records in the cloud, and therefore outsourced recordkeeping is subject to the diligence and monitoring requirements of proposed Rule 206(4)-11, as well as additional and express substantive obligations tailored to Advisers Act records compliance and records access.

- **Disclosure**

To assist SEC oversight of outsourced arrangements, the SEC proposed amendments to Item 7.C of Part 1A of Form ADV to require the identity of the outsourcing service provider, principal place of business of the service provider, control affiliations (if any) with the adviser, date of the outsourced engagement, and a tick-the-box identification of the outsourced services from a non-exclusive list of specific Covered Funds and “other” such functions not specifically named.

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