MCINTYRE | LEMON

DIRECT DIAL

C. Dirk Peterson

202-659-3905

dpeterson@mcintyrelf.com

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VIA Electronic Mail Delivery
Ms. Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549-1090

Re: File Number S7-25-22

Dear Ms. Countryman:

We represent certain institutional asset managers that have expressed interest in the recent outsourcing rule – Rule 206(4)-11 under the Investment Advisers Act of 1940 [17 C.F.R. §275.206(4)-11] – proposed by the Securities and Exchange Commission ("Commission" or "SEC").[1] Proposed Rule 206(4)-11 is one of eight rulemaking proposals specifically directed at the asset-management sector and one of more than 30 rules currently proposed overall by the Commission in calendar year 2022. The volume of rulemaking, often combined with a short turnaround for commenting, predictably jeopardizes meaningful opportunities to fully assess the collective regulatory and economic impacts of the Commission's expansive rulemaking agenda across the asset-management sector. Objective observers share our and the industry's overall perception of potential adverse industry and investor-protection effects raised by the pace of the Commission's rulemaking agenda.[2]

Therefore, we request the Commission reconsider the necessity of proposed Rule 206(4)-11 in light of the broad fiduciary duty that already applies to all aspects of an advisory business, including an adviser's use of service vendors. The Commission instead could publish guidelines or highlight outsourcing as an examination priority as a more cost-effective and less-burdensome alternative to a seemingly overly prescriptive solution in search of a problem. Absent withdrawing proposed Rule 206(4)-11 (or simply not acting on it), the Commission should

[1] Release No. IA-6176 (Oct. 26, 2022), 87 F.R. 68816 (Nov. 16, 2022) ("Proposing Release").

[2] *See, e.g.,* Office of Inspector General, U.S. Securities and Exchange Commission, The Inspector General's Statement on the SEC's Management and Performance Challenges (Oct. 13, 2022).

consider excluding institutional advisers in consideration of their negotiated and heavily vetted arrangements that do not seem to suffer from the competency presumptions or the "set-it-and-forget-it" risks expressed by the Proposing Release. Lastly, the scope of the rule recharacterizes arrangements with subject-matter experts or reliance parties that often are material to an institutional adviser's evaluation of asset classes and its asset-management business but that are not generally considered or negotiated as outsourced in line with the elements of the proposed rule. Thus, if proposed Rule 206(4)-11 moves to adoption, the Commission should consider modifications to the meaning of "covered functions" to capture more precisely only core advisory functions identified in the Proposing Release (*e.g.,* index solutions, sub-advisory arrangements, portfolio modeling, valuation) and provided by unaffiliated, third-party service vendors.

Our comments below are in line with these general observations and represent a more detailed exposition about the questionable presumptions raised by the Proposing Release and the necessity and efficacy of proposed Rule 206(4)-11 in its current iteration. We appreciate the opportunity to comment on proposed Rule 206(4)-11 and the Commission's consideration of our comments.

1. Proposed Rule 206(4)-11 Is Not Necessary

We wholeheartedly agree with the Commission's position that an "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 . . . ."[3] We, however, disagree that "more needs to be done to protect clients and enhance oversight of advisers' outsourced functions"[4] in addition to (or instead of) existing duties prescribed by the Advisers Act and current rules. We do not believe "compliance gaps" exist that require the substitution of the prudential principles requiring an adviser to act in a client's best interests for a prescriptive rule that runs the risk of becoming perfunctory "check-the-box" window dressing.

More specifically, the Advisers Act already grants the Commission enforcement and antifraud authority to remedy (to the extent it needs correcting) the manufactured outsourcing and recordkeeping crises presumed (but not robustly supported) by the Proposing Release. Most notably, an investment adviser is subject to a fiduciary duty under federal law, a position unambiguously affirmed by the SEC just three years ago (and again in the Proposing Release), a duty which the SEC described at the time as "important to the Commission's investor protection efforts."[5] Additionally, Rule 204A-1 under the Advisers Act requires an investment adviser to

[3] Proposing Release, *supra*, note 1, at 68823.

[4] *Id.* at 68819.

[5] Release No. IA-5248 (June 5, 2019), 84 F.R. 33669, 33671 (July 12, 2019) ("Fiduciary Interpretation"). Section 206(1) and Section 206(2) of the Advisers Act form the bases for the federal fiduciary standard applicable to investment advisers. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963) (stating that the Advisers Act reflected "a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,'. . . .") (footnotes omitted). The fiduciary standard of care between an adviser and its clients generally includes the duty to, among other things, act with utmost and exclusive loyalty to clients. *See* Fiduciary Interpretation at 33675. *See also In the Matter of Alfred C. Rizzo*, Investment Release No. IA-897 (Jan. 1, 1984); *In*

adopt a Code of Ethics that requires, among other things, the adviser to establish a standard of conduct commensurate with the adviser's fiduciary obligations.[6] Thus, an adviser's broad fiduciary duty, spanning the entirety of the Advisers Act and the adviser-client relationship,[7] extends to an adviser's ongoing decision-making to outsource integral services and seeks to protect the public from the adverse consequences of an adviser's negligently or harmfully entered outsourced arrangements, especially those purportedly unvetted or negligently vetted.

Contrary to the "what-if" presumptions expressed in the Proposing Release, a competent institutional adviser and careful steward of its reputation does not willy nilly enlist key service vendors. Typically, institutional advisers subject key service vendors to a procurement process that includes extensive review of their business, capacity, history, and performance. The procurement process often takes the form of detailed requests-for-proposal (RFP) and/or other vetting processes. An additional protection in the institutional market stems from the clients own vetting of the adviser. Institutional clients often subject the adviser in their own right to the RFP process and ongoing reviews to vet the adviser's business, history, experience, performance, material agreements, and risk profile. The Proposing Release presumes that these vetting processes and best practices are absent in the institutional marketplace. They are fairly standard practices that an additional prescriptive rule would not seem to enhance or extend any meaningful protections to institutional clients beyond that which already exist and are required by existing fiduciary and ethics requirements.

The Proposing Release speculates on the potential to defraud or mislead clients in the outsourcing of pricing and performance calculations or other integral services to a service vendor having poor operational and technical management, lax risk measurement, unmanaged conflicts of interest, and sub-par confidentiality protocols.[8] In all of these hypotheticals, the broad fiduciary duty and specific Advisers Act statutory and regulatory requirements (*e.g.,* 15 U.S.C. §§80b-6(1), 80b-6(2), 80b-4a; 17 C.F.R. §§275.204A-1 and 206(4)-7]) extend to require an adviser to observe prudential standards of care and to oversee a compliance process when enlisting the services of others. If an adviser fails in its standard of care or, worse, inexplicably turns a blind eye to the incompetence of, and operational or other risks posed by, a service

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re Kidder, Peabody & Co., Inc., 43 S.E.C. 911, 915 (1968); and *Interfinancial Corporation*, SEC No-Action Letter (pub. avail. Mar. 18, 1985).

[6] 17 C.F.R. §240.204A-1. The Commission adopted this rule under the authority of Section 204A, which requires investment advisers to implement protocols reasonably designed to prevent the abuse of material, non-public information. The Proposing Release seems to rely on a faulty premise that the proposed outsourcing prescriptions are the only protections against misuse by service providers of confidential client information, such as client trade information. Proposing Release, *supra*, note 1 at 68818. Section 204A and Rule 204A-1 clearly are more direct bulwarks against the abuse of confidential client information than any outsourcing rule. The Proposing Release further ventures into a flight of fancy suggesting that advisers are just ignoring their significant duties under Section 204A and Rule 204A-1 and hiring fraudster or unscrupulous service vendors, never mind the regulatory and reputational risk to the adviser. These simply are not credible and supportable presumptions justifying the adoption of the outsourcing rule. An adviser's fiduciary duty, combined with Section 204A, Rule 204A-1 and Rule 206(4)-7, are fully functional for the protection of investors.

[7] Fiduciary Interpretation, *supra*, note 5 at 33671.

[8] Proposing Release, *supra*, note 1 at 68818.

vendor to the harm of its clients, the adviser could be in breach of its fiduciary duty and Code of Ethics subject to Commission enforcement and private actions. A prescriptive rule does not expand or enhance this reality but does contradict the Commission's own commendation just three years ago of the prudential and principles-based protection of investors extended by the Adviser Act's fiduciary duty.[9]

The Proposing Release cites little evidence of actual systemic harm justifying proposed Rule 206(4)-11 and why an adviser's fiduciary duties are insufficient to apply to the totality of a client relationship. The Proposing Release's conjecture does not persuasively substitute as evidence of widespread and imminent harm posed by outsourcing arrangements or support regulating that which is already regulated. Better yet, the Commission should look to the regulation of outsourcing by broker-dealers. Broker-dealers must observe standards of conduct prescribed by the SEC, self-regulatory organizations, and common law that are similar to an adviser's duties of care and loyalty.[10] Like advisers, broker-dealers also outsource key functions to service vendors, yet an additional prescriptive regulatory regime does not apply (nor are we advocating for one to apply) to the decision-making by broker-dealers in their choices of service vendors. No rule requires broker-dealers to observe six mandatory elements as assurance of a fully reviewed vendor arrangement.

Rather, broker-dealer outsourcing arrangements are the subject of non-binding guidelines that remind broker-dealers that their outsourced arrangements are subject to the firm's supervisory responsibilities derived from their obligations to observe just and equitable principles of the trade.[11] Although this guidance recommended that firms have a formalized due diligence process, it did not prescribe mandatory elements required of that process, leaving the scope and frequency of review to the firm consistent with its standards of conduct and oversight responsibilities.

Like broker-dealers, investment advisers also have statutorily and regulatorily prescribed oversight responsibilities. For example, Section 203(e)(6) of the Advisers Act requires investment advisers to have a system of supervision. Rule 206(4)-7 under the Advisers Act requires investment advisers to adopt and implement written supervisory procedures that memorialize their compliance responsibilities and supervisory process reasonably designed to comply with applicable law. These legal requirements already form the basis for requiring investment advisers to implement outsourcing arrangements consistent with their fiduciary duty and ongoing obligations to supervise those arrangements. Guidelines that expressly address outsourcing as a function of an adviser's duty to supervise could elevate the review process for outsourced arrangements as an examination priority while permitting the adviser the flexibility to implement the necessary oversight of the arrangement consistent with its business, fiduciary

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[9] Fiduciary Interpretation, *supra*, note 5 at 33670.

[10] *See, e.g.,* 17 C.F.R. §240.15l-1 (Regulation Best Interest); 15 U.S.C. §78o(b)(4)(E) (duty to supervise); FINRA Rule 2010 and FINRA Rule 3110 (business conduct rule and supervisory rule, respectively); and *In re Duker & Duker*, 6 S.E.C. 386, 388-389 (1939) (establishing the "shingle theory" obligating a broker-dealer to deal fairly with customers in accordance with industry standards).

[11] *See, e.g.,* Notice to Members 05-48 (July 2005).

duty, and history with the service vendor. This approach is a far more flexible, effective, and less costly alternative to a new prescriptive rule.

2. The Scope of the Rule Is Not Appropriate

In light of our recommendation to withdraw proposed Rule 206(4)-11 entirely, our more technical comments are posed only as a less desirable alternative should the Commission proceed to the adopting stage. These comments regarding scope should not be viewed as advocating for Rule 206(4)-11. We again emphasize that the rule is not necessary.

Proposed Rule 206(4)-11 in any iteration should not apply to institutional advisers. As noted above, institutional advisory arrangements are negotiated and vetted. Institutional advisory clients typically have strong negotiating power and use the RFP or other vetting processes to glean detailed information about an adviser's business, key professionals, material service arrangements, and contingency planning. Furthermore, the institutional market is sophisticated and informed. Therefore, a competent institutional adviser would not jeopardize its hard-earned market reputation by haphazardly outsourcing material services to an incapable or incompetent service vendor. Nor is the institutional market particularly ripe for services rendered on an autopilot setting of "set-it-and-forget-it," as mistakenly presumed by the Proposing Release. Accordingly, any final rule should expressly exclude advisers to institutional clients. To fashion such an institutional exclusion, the SEC could consider the definition of "institutional account" in FINRA Rule 4512(c), which extends to, among others, any person with total assets of $50 million or more.

The definition of "covered function" is ambiguous. That is, services that are "necessary for the investment adviser to provide its investment advisory services" could sweep in a wide swath of subject-matter experts that have not generally been characterized as outsourced "service providers." For example, advisers typically rely on a host of subject-matter experts that inform an adviser's independent asset review and ongoing asset management. These subject-matter experts can include, among others, property managers (in the case of real estate equity advisers), loan or securities structuring agents, and tax advisers – all of which supplement an adviser's considerations of asset classes. These services are not typically considered outsourced because they supplement part of an evaluation of asset classes recommended for investment.[12] They typically do not form core advisory functions. These subject-matter experts nevertheless are relied upon by the adviser and are vetted based on their expertise, experience, and typically past business dealings. These matters should not, however, be recharacterized as outsourced arrangements subject to the proposed prescriptions.

The second part of the definition of "covered function" – whether an unperformed or negligently performed function has a "material negative impact" on the client – is equally unworkable. The text of the proposed definition of "covered function" does not seem to consider market losses attributable to market events unknown to or not sufficiently reflected in relied-upon market analyses of subject-matter experts. Thus, to the extent unevaluated or negligently evaluated

[12] Notice to Members 05-48 identified an outsourced arrangement as "activities and functions related to [a broker-dealer's] business operations and regulatory responsibilities that the member would otherwise perform themselves [*sic*] . . . ."

market events "materially negatively" impact the client, the rule text, as proposed, makes the adviser an insurer of the infallibility of key subject-matter experts.

The construction of proposed Rule 206(4)-11 would seem to create an overinclusive network of inadvertent "service providers" that could unwittingly capture accounting, legal, tax, property management, and investment-banking experts relied upon (but not necessarily expressly retained by) an investment adviser. If the Commission moves to adopt proposed Rule 206(4)-11, at a minimum, the meaning of "covered function" will need to be modified and narrowed to cover only retained services pursuant to a negotiated, written agreement with third parties for services that an adviser would legally and regulatorily be required to perform itself. We believe this recommended narrowing of scope better captures the investing public most susceptible to harm and services most likely described by the Commission as "core" advisory services.

Additionally, this recommended iteration of Rule 206(4)-11 would exclude affiliates. Often affiliates operate in a holding company structure under services agreements whereby professionals, IT, accounting, legal, payroll, benefits, and other functions may be shared and provided on an enterprise-wide basis by a company separate from the adviser. These services typically are subject to substantial risk management oversight tailored for each regulated firm in the enterprise and are subject to internal and external audit, regulatory oversight, and access that should not be part of any redundancies contemplated by the proposed outsourcing prescriptions.

3. Disclosure

We generally support disclosure as a means of highlighting outsourced arrangements, provided that it can be made in way that does not breach confidentiality covenants between the adviser and service vendor. Thus, Form ADV disclosure could create conflicts with confidentiality covenants in vendor agreements. Disclosures via management agreements or confidential offering documents may be a more optimal solution. The compilation of records and data of service vendors from management agreements also may more precisely address the Commission's concerns of concentration risk where, for example, a single service provider occupies the particular service across the asset-management sector, which, of course, the proposed prescriptions of Rule 206(4)-11 are incapable of addressing. We recommend, however, that any disclosure requirements follow needed modifications narrowing the scope of a "covered function" along the lines noted above.

4. Books and Records

Rule 204-2(a)(10) under the Advisers Act [17 C.F.R. §275.204-2(a)(10)] requires an investment adviser to maintain all agreements "relating to the business of such investment adviser as such." Under this provision, an adviser must maintain agreements relating to its "business as such," which would seem to include agreements with material service vendors. If the Commission believes that more tailored records are necessary (we believe guidelines would be more appropriate), then the scope of "covered functions" for purposes of records amendments will need to be modified, as previously discussed.

Rule 204-2(a)(17) under the Advisers Act [17 C.F.R. §275.204-2(a)(17)] requires records of all written policies and procedures of an adviser that are tailored to an adviser's business, including, at a minimum, written procedures that address the adviser's responsibilities for outsourcing and other business arrangements. This provision would seem to give the Commission information about an adviser's outsourced arrangements not otherwise addressed in the Proposing Release. Rule 204-2(e)(1) under the Advisers Act [17 C.F.R. §275.204-2(e)(1)] requires an investment adviser to maintain its agreements relating to its business for a minimum of five years, two years of which in an easily accessible place. Thus, where the Proposing Release recounts instances in which the examination staff has not received timely responses about outsourcing arrangements or highlights failures of advisers to document compliance with the Advisers Act,[13] we are unclear why those delays in producing records or failures in documenting compliance are not potential records violations under current recordkeeping rules. If there are issues in obtaining outsourcing information, we recommend the Commission enforce existing recordkeeping rules as opposed to implementing a new prescriptive regulatory regime.

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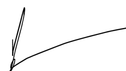
We appreciate the opportunity to comment on proposed Rule 206(4)-11 and appreciate the Commission's consideration of our comments. We are available to discuss any additional information the Commission may seek in order to be fully informed in its decision-making process. Please do not hesitate to contact the undersigned at (202) 659-3905, with any questions or requests for more clarity.

Sincerely,



C. Dirk Peterson
McIntyre & Lemon, PLLC

[13] Proposing Release, *supra* note 1, at 68819.