# Managed Funds Association
The Voice of the Global Alternative Investment Industry

Washington, D.C. | New York | Brussels


December 20, 2022

**Via Electronic Submission**

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

**Re: Outsourcing by Investment Advisers; File Number S7-25-22**

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**SEC**") in response to the SEC's proposed new rule under the Investment Advisers Act of 1940 (the "**Advisers Act**") governing outsourcing of certain services or functions by investment advisers and related amendments to the Advisers Act books and records rule and Form ADV (together, the "**Proposal**").[2]

Our members recognize the importance of proper diligence and monitoring of service providers that facilitate the provision of investment advisory services to clients. However, we have significant concerns with the scope of the Proposal and its likely impact on investment advisers (including potentially disproportionate impacts on smaller advisers), advisory clients and service providers, and we do not believe that the requirements set out in the Proposal are necessary or appropriately tailored to address actual or potential risks of "outsourcing" by investment advisers. For the reasons set forth below, we believe the Proposal should not be adopted.

Section I of this letter outlines our main concerns with the Proposal and the reasons it should not be adopted. As described in more detail below, the requirements set forth in the Proposal are unnecessary and overly prescriptive, the Proposal would be costly and burdensome

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1 Managed Funds Association (MFA), based in Washington, DC, New York, and Brussels, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 150 member firms, including traditional hedge funds, crossover funds, and private credit funds, that collectively manage nearly $2.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

2 *See* Outsourcing by Investment Advisers, 87 Fed. Reg. 68,816 (Proposed Oct. 26, 2022) (to be codified at 17 C.F.R. Pts. 275 and 279) ("**Proposing Release**").

to implement, it would negatively impact advisers, advisory clients and service providers, and it would be difficult to interpret and implement in practice. We also believe the SEC has not performed an adequate cost-benefit analysis, has failed to justify the need for the new rule and the resulting costs, and has exceeded its statutory authority.[3]

Section II of this letter recommends two alternatives to the Proposal: that the SEC regulate outsourcing by investment advisers either (1) through a combination of enhanced Form ADV disclosure and advisers' existing fiduciary duties to clients, or (2) by establishing a principles-based risk management framework specific to outsourcing relationships, pursuant to which advisers would adopt policies and procedures reasonably designed to mitigate potential risks that are tailored to the adviser's operations.

Finally, Section III recommends eight key changes that the SEC should make to the Proposal, if the SEC determines to move forward with the Proposal in its current form, to more appropriately tailor the Proposal, mitigate ambiguities and alleviate unnecessary costs.

## I. The Proposal Is Overly Prescriptive, Would Have Significant Negative Consequences, and Should Not Be Adopted

### 1. The Proposal is unnecessary in light of the existing legal and regulatory framework and could have significant negative consequences, particularly to smaller advisers, as well as to advisory clients and service providers.

The existing legal and regulatory framework applicable to investment advisers, including advisers' non-waivable fiduciary duties under the Advisers Act, obligates investment advisers to act in the best interest of their clients and implement policies and procedures reasonably designed to ensure compliance with the Advisers Act. These principles extend to the use of service providers in appropriate circumstances. Our member firms and others in the industry already conduct extensive vetting, monitoring and oversight of services providers in

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[3] The SEC cites Section 206(4) as a key source of its statutory authority to implement the Proposal. Section 206(4) authorizes the SEC to promulgate rules that are "reasonably designed to prevent . . . fraud[], decept[ion], and manipulat[ion]." 15 U.S.C. § 80b-6(4); *see id.* § 80b-3(d). Yet multiple aspects of the Proposal appear to extend well beyond fraud prevention, instead targeting negligent and sub-par business practices by investment advisers and entities acting on their behalf. *See, e.g.*, Proposing Release at 68,826. ("The due diligence requirement would provide guidelines to help ensure that the nature and scope of the covered function, as well as the risks associated with the adviser's use of service providers are identified and appropriately mitigated and managed. This also could reduce the risk that the adviser's outsourced services are not performed or are performed negligently.") To the extent the Proposal contains rules designed to prevent behavior that is not fraudulent, deceptive, or manipulative, it exceeds the SEC's statutory authority and should not be adopted. In addition, the SEC cites Sections 211(a) and 211(h) as support for proposed rule 206(4)-11, but does not provide any explanation or analysis for the applicability of these provisions, which in relevant part authorize the SEC to issue rules consistent with statutory functions and powers otherwise conferred on the SEC and to "promulgat[e] rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes," respectively. Neither of these subsections of Section 211 provide authority for a rule designed to regulate the engagement of vendors by investment advisers.

circumstances where such actions are appropriate to ensure compliance with the Advisers Act, and evidence of non-compliance with these obligations is sparse.[4]

Accordingly, we are concerned that the diligence and oversight regime contemplated by the Proposal is overly prescriptive and unnecessary. Moreover, we believe that the Proposal, if implemented, could actually undermine investor protection by disincentivizing the use of third-party service providers[5] (depriving advisory clients of the benefit of service providers' expertise, efficiencies and third-party oversight services) and reducing advisers' existing diligence and monitoring processes to a "check-the-box" compliance exercise in which adviser resources are not proportionally expended in areas where the risk profile of a particular Covered Function or Service Provider would warrant specific focus.[6]

2. <u>The Proposal will result in increased costs, which will ultimately be borne by clients and investors, and would present significant challenges for smaller advisers</u>.

The Proposal will significantly increase the costs of providing investment advisory services, given the considerable costs of either implementing the regime contemplated by the Proposal or performing the functions in-house, as well as the expected increase in service providers' fees, which we expect will ultimately be borne by investors in the form of higher fees or expenses passed through to investors. For example, we are concerned the proposing release's suggestion of due diligence techniques to comply with the Proposal—including interviewing key personnel of the service provider, obtaining the right to audit the functions being performed by the service provider, and conducting site visits—would be unreasonably burdensome and may in some instances not be accommodated by service providers.[7] Additionally, we believe the proposed amendments to the Advisers Act books and records rule requiring advisers to keep and maintain certain books and records of the due diligence process is overly prescriptive and not

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4 The SEC indicates in the proposing release that it has successfully brought enforcement actions against those advisers who have not conducted due diligence and monitoring of service providers in accordance with their legal and regulatory obligations. Proposing Release at 68,819. However, the proposing release does not provide details regarding the scope of the issue as perceived by the SEC, pointing to only two examples of enforcement actions brought by the SEC in the past four years. *See id*. *See also* Commissioner Hester M. Peirce, Outsourcing Fiduciary Duty to the Commission: Statement on Proposed Outsourcing by Investment Advisers (Oct. 26, 2022), *available at* https://www.sec.gov/news/statement/peirce-service-providers-oversight-102622 ("Peirce Statement") ("Has there been a surge of enforcement actions against advisers for service provider-related failures or infractions? Are our examiners seeing advisers running from their fiduciary obligations with respect to outsourced functions? Are we aware of widespread investor harm due to advisers not overseeing their service providers? If the answer to any of these questions is yes, the release does not tell us so.").

5 Registered investment advisers may be incentivized to perform as many functions in-house as possible, both to mitigate the enforcement risks related to their inability to fully comply with the rule, as well as to reduce the frequency with which they need to carry out these costly obligations.

6 *See also* Peirce Statement (expressing concern that the Proposal "may end up abrogating fiduciary duty and replacing it with our predefined approach to best interest— one not responsive to unique facts and circumstances").

7 Proposing Release at 68,828.

appropriately tailored to the objective of facilitating advisers' ability to substantiate their compliance with oversight requirements.[8] This onerous documentation would likely divert advisers' compliance resources away from mitigating risks and towards simply documenting them.

We are especially concerned about the disproportionate impact that the Proposal could have on smaller advisers. Smaller advisers that rely more heavily on external service providers to lower costs would not likely have the operational resources to comply with the extensive requirements set out in the Proposal. These significant hurdles could cause some smaller advisers to exit the market, or could discourage new entrants from starting advisory businesses. Additionally, some new adviser entrants could be discouraged from outsourcing certain services (even when doing so could be in the best interests of the adviser's clients), given the burdens associated with doing so under the Proposal.

In addition, the Proposal disproportionately burdens advisers with built in redundancies (by either directly "shadowing" the functions they outsource or engaging another service provider to "shadow" those functions). Advisers that utilize multiple external service providers to mitigate the risk of an external service provider's failure to perform a particular function through redundancies should be subject to fewer—not more—burdens under the rule. As the Proposal is currently written, however, advisers would be disincentivized from establishing back-up service provider relationships that could provide this type of protection.

Thus, we are strongly concerned that the Proposal would negatively impact investors by resulting in increased costs, which will ultimately be borne by clients and investors, and would harm small businesses and competition by presenting significant challenges for smaller advisers.

3. <u>The Proposal will have negative and unintended consequences for service providers</u>.

The Proposal will be detrimental to service providers, both as a result of impacts to competition and the costs and burdens of facilitating advisers' compliance. Competition among service providers will be harmed to the extent that larger, well-established providers are better equipped to facilitate the advisers' oversight obligations, and advisers are therefore less willing to engage "boutique" or startup service providers that may have special technologies, skills or services that could benefit the adviser and its clients, but may not be as well-positioned as large service providers to enable advisers to demonstrate compliance with the requirements. This is likely to erect strong barriers to entry, dissuading potential service providers from attempting to work with advisers. Service providers, particularly those widely used in the industry, would

8 *See* Proposing Release at 68,832 (requiring that due diligence records include "a list or other record of covered functions the adviser outsourced to a service provider including the name of each service provider, the factors that led to listing it as a covered function on Form ADV, and documentation of the adviser's due diligence assessment," as well as "documentation showing how the adviser would mitigate and manage the risks it identifies").

likely feel the strain of fielding requests from numerous advisers seeking to comply with the Proposal, including from advisers seeking to amend existing contractual arrangements, as suggested by the SEC, within a limited transition period.[9] As a result, advisers will have decreased leverage to negotiate fee discounts and demand high-quality service—ultimately resulting in advisory clients bearing higher fees and receiving potentially lower quality services—and increased reliance on a more concentrated group of service providers could result in heightened risk that any one service provider's failure might cause operational failures at multiple investment advisers. The prescriptive requirements set out in the Proposal referenced above which directly impact service provides (personnel interviews, audits, and onsite visits) effectively amount to regulation of service providers, some of who may not even be aware the Proposal exists.

In addition, service providers may be unwilling or unable to facilitate advisers' compliance with the rule. Smaller or newer service providers may not have the resources to engage in renegotiations of their service agreements or to adhere to the requirements outlined by this Proposal and may therefore choose not to work with advisers. Larger, well-established providers often have stronger negotiating power relative to advisers seeking to engage them and similarly may choose either not to provide their services to advisers if the cost of maintaining the relationship is too high—as would be the case to comply with the Proposal—or substantially increase service fees in a manner that could be cost prohibitive. The SEC overestimates the negotiating leverage of advisers, particularly in cases where the service provider is a large company with a diversified client base (*e.g.*, large cloud service providers), or a non-U.S. based company (*e.g.*, a foreign exchange). These companies often use a "take it or leave it approach" when negotiating with advisers, and if the adviser were to "leave it" because the adviser is unable to confidently confirm that the provider's contract form permits the adviser to comply with the requirements of the Proposal, the clients of the adviser would likely be harmed. Advisers that lack negotiating leverage with existing service providers may be required to find substitutes for the underlying services. Even smaller "start-up" service providers are unlikely to be willing to comply with some of the requests that the SEC is recommending advisers make—for example, providing financial statements. Most private companies view their financial statements as highly confidential and are unlikely to share them with advisers unless the advisers meet a certain spend threshold for their services. As a result, smaller service providers may be disincentivized to work with advisers, not only putting them at a disadvantage to larger companies, but also limiting advisers' outsourcing options.

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[9] There were over 15,000 registered investment advisers as of June 2022, all of whom would be seeking to engage with their service providers on a constricted time frame in order to come into compliance during the transition period after the rule is adopted. Proposing Release at 68,842. The SEC suggests advisers consider, among other things, "obtaining contractual representations and warranties about the service provider's procedures." *Id*. at 68,828.

Thus, we are concerned that the Proposal is also detrimental to service providers, both as a result of impacts to competition and the costs and burdens of facilitating advisers' compliance.

4. <u>The Proposal is overly broad and will be difficult to interpret and implement in practice</u>.

We are concerned that the Proposal will be difficult for advisers both to interpret and implement in practice. As we discuss further below, the definition of "Covered Function" is broad and imprecise, and seemingly extends the scope of the rule to the engagement of nearly any "Service Provider" irrespective of whether the adviser has "outsourced" a particular function. This could make the requirements set out in the Proposal applicable to engagements and relationships that should not be (and we do not believe were intended to be) captured, magnifying the costs and unintended consequences imposed by the Proposal without providing any clear benefits to advisory clients or other industry participants. Such an expansive application of the Proposal's requirements would extend beyond addressing the SEC's articulated concern in the proposing release regarding an adviser's ability to maintain full control or direct transparency when outsourcing certain functions.[10]

The Proposal also enumerates diligence standards and practices to be considered by advisers when evaluating their service provider engagements, with the implication that advisers who engage in different diligence practices consistent with their operations and risk profiles may be second-guessed in an examination context. In addition, as discussed below, the requirement to monitor and reassess service providers with a "manner and frequency" determined based on the relevant facts and circumstances could leave advisers in a position of needing to engage in monitoring and reassessment on an almost real-time basis. In the absence of clear standards, advisers may resort to being over-inclusive to avoid having their initial determinations judged as incorrect in hindsight. This would magnify the costs and burdens of the Proposal significantly.

As such, , we are concerned that the Proposal is overly broad and will be difficult to interpret and implement in practice.

5. <u>The SEC has not performed an adequate cost-benefit analysis and has failed to justify the need for the new rule and the resulting costs</u>.

As we noted in our comment letters submitted earlier this year in response to the SEC's proposed rules relating to private fund advisers ("Private Fund Adviser Proposal"), a robust evidentiary record, including a cost-benefit analysis, is an integral part of the rulemaking

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10 Proposing Release at 68,823.

process.[11] However, the SEC has not provided a credible rationale for the Proposal's passage, instead asserting that the rule is justified on the basis of theoretical "market failures" and examples of service provider failures which would not likely have been prevented had the Proposal been in effect. Nor has the SEC addressed the potential interaction of the Proposal with the Private Fund Adviser Proposal, if both are adopted.[12] Further, the SEC itself concedes that it does not have the information required to "quantify certain economic effects" of the Proposal.[13] In fact, the SEC acknowledges in the proposing release that service providers may, in some circumstances, be able to "provide the same or similar levels of service as an adviser in a manner that is more cost-effective to clients" or "offer efficiencies that are unavailable to or unachievable by an adviser alone."[14] In light of this, we believe that the SEC should not move forward with this rulemaking at this time, and should instead conduct a serious research process so that it is in a position to meaningfully compare the proposed action with reasonable alternatives, including the alternative of not adopting a rule, as the SEC is required to do.[15]

We also think it is notable that the proposing release does not consider the overlap of the new requirements for outsourcing by investment advisers with the National Futures Association's Compliance Rules on the use of third-party service providers adopted last year (the "**NFA Compliance Rule**"), which apply to many of our members, or seek to mitigate the costs of duplicative requirements.[16] Indeed, the NFA Compliance Rule is not even mentioned by the SEC in its discussion of outsourcing and oversight of service providers by advisers. Given that the NFA Compliance Rule is still in the early stages of implementation, we believe the SEC should study how firms subject to the NFA Compliance Rule implement measures to comply with the new rule and its impact on advisers and service providers before finalizing sweeping and prescriptive requirements governing outsourcing by investment advisers. If the SEC

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[11] *See* Managed Funds Association, Comment Letter on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Apr. 25, 2022), *available at* https://www.sec.gov/comments/s7-03-22/s70322-20126631-287270.pdf; Managed Funds Association, Comment Letter on Reopening of Comment Period for Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (June 13, 2022), *available at* https://www.sec.gov/comments/s7-03-22/s70322-20131144-301341.pdf. (together, "MFA Comment Letters on Private Fund Advisers").

[12] Both the Proposal and the Private Fund Adviser Proposal raise questions about the scope of adviser liability, but the SEC does not draw a connection to this aspect of the Private Fund Adviser Proposal in the proposing release for the Proposal. *See infra* notes 27-29 and related discussion.

[13] Proposing Release at 68,842.

[14] Proposing Release at 68,844.

[15] *See* SEC, Memorandum on Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16. 2012) ("High-quality economic analysis is an essential part of SEC rulemaking. It ensures that decisions to propose and adopt rules are informed by the best available information about a rule's likely economic consequences, *and allows the Commission to meaningfully compare the proposed action with reasonable alternatives, including the alternative of not adopting a rule*. The Commission has long recognized that a rule's potential benefits and costs should be considered in making a reasoned determination that adopting a rule is in the public interest.") (emphasis added).

[16] NFA Interpretive Notice 9079, NFA Compliance Rules 2-9 and 2-36: Members' Use of Third-Party Service Providers (Sept. 30, 2021) *available at* https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9079.

ultimately determines to adopt the Proposal, the cost-benefit analysis conducted by the SEC in support of adoption should expressly account for the applicability of the NFA Compliance Rule to many advisers and justify the need for an overlapping, but distinct, regulatory regime.

Accordingly, we believe the SEC has not performed an adequate cost-benefit analysis and has failed to justify the need for the new rule and resulting costs. For all the reasons discussed, we urge the SEC to abandon the Proposal as it is unnecessary and would not better serve investors.

## II. The SEC Should Consider Alternative Approaches to Regulating Oversight by Investment Advisers

If the SEC nonetheless determines to move forward with a rulemaking at this time, we believe two alternative approaches would more appropriately tailor applicable regulatory requirements to the potential risks associated with outsourcing by investments advisers.

The first alternative we recommend is that, as suggested by the SEC in the release, the SEC require enhanced Form ADV disclosure to clients and potential clients regarding an adviser's outsourcing of certain functions (excluding disclosure of specific service provider names and identifying information for the reasons we discuss below), but not adopt any of the other prescriptive requirements in the Proposal. Together with the adviser's existing fiduciary duty to clients, this will ensure consistent and comparable disclosure, as well as an appropriate level of diligence and oversight consistent with the adviser's obligation to provide advice that is in the best interest of the client.[17]

The second alternative we recommend is that the SEC establish, either through rulemaking or Commission Guidance, a principles-based risk management framework applicable to registered investment advisers that outsource certain critical functions to external service providers. This would ensure that advisers apply consistent oversight principles to specific service providers, but would mitigate many of the concerns we discuss in this letter because advisers would be permitted to apply those principles in an appropriately tailored manner. In addition, a risk management framework approach would be more commensurate with approaches taken by other regulatory bodies that have addressed outsourcing and the use of service providers, including FINRA's guidance applicable to registered broker-dealers,[18] the NFA

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17 Proposing Release at 68,824. In this alternative, for the reasons described below, it will be important not to require disclosure of the names of Service Providers on Form ADV, which in many cases would reveal confidential and competitively sensitive information.

18 *See* NASD, NTM 05-48, Outsourcing: Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers (July 2005), *available at* https://www.finra.org/rules-guidance/notices/05-48; FINRA, RN 21-29, Vendor Management and Outsourcing (Aug. 13, 2021), *available at* https://www.finra.org/sites/default/files/2021-08/Regulatory-Notice-21-29.pdf. Many registered investment advisers are also registered broker-dealers or are affiliated with registered broker-dealers and thus are already subject to obligations set out in FINRA's guidance.

Compliance Rule and Federal Reserve Board guidance.[19] This alternative would also help ensure that advisers focus on those vendors they believe pose the highest risks to their firms.

In developing a rule or guidance establishing a risk management framework, we believe the NFA Compliance Rule could serve as a useful model. It is principles-based, allowing advisers to take their own business and risk profile into account; it is more narrowly tailored in scope than the Proposal to service provider relationships that may pose risks to advisers provision of advisory services; and we believe it is generally consistent with what is required under the Advisers Act for advisers to comply with their fiduciary duties and other obligations under the Advisers Act.[20]

## III. <u>If a Version of the Proposal Is Ultimately Adopted, the SEC Should Make Certain Changes to Mitigate Ambiguities and Unnecessary Costs</u>

If the SEC does adopt prescriptive new requirements for outsourcing by investment advisers, we believe that a number of key refinements and clarifications should be made to mitigate the ambiguities and unnecessary costs that would be imposed by the Proposal in its current form.

Specifically, we believe that the SEC should:

- Define "outsource" as the full delegation by an investment adviser of the performance of a Covered Function to a Service Provider (as opposed to applying the rule any time an adviser *engages* a Service Provider to support the adviser's activities);
- Refine and clarify the definition of "Covered Function" to appropriately tailor the scope of the new requirements to the risks posed by outsourcing relationships;
- Refine the definition of "Service Provider" to exclude adviser affiliates and regulated entities (such as SEC-registered sub-advisers and broker-dealers);
- Replace the ongoing monitoring and reassessment requirements with a requirement for an adviser to conduct an annual review of its outsourcing policies and procedures, including reviewing the frequency for reassessment of a Service Provider set forth in the adviser's policies and procedures;

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19 *See* Federal Reserve Board, SR 13-19 / CA 13-21, Guidance on Managing Outsourcing Risk (Dec. 5, 2013), *available at* https://www.federalreserve.gov/supervisionreg/srletters/sr1319a1.pdf. (applicable to banking organizations supervised by the Board of Governors of the Federal Reserve System).

20 Further, the SEC should consider for any risk management framework the possibility of substituted compliance, for example, allowing a registered investment adviser who is also subject to the NFA Compliance Rule to demonstrate compliance with the SEC framework through conformity with the NFA Compliance Rule.

- Allow the engagement of a Service Provider prior to completing due diligence in limited circumstances where there is an urgent need to replace a critical vendor or fill an operational gap;
- Eliminate the proposed amendments to the Advisers Act recordkeeping rule;
- Eliminate the requirement to disclose the names of Service Providers on Form ADV, which in many cases would reveal confidential and competitively sensitive information and expose advisers and their clients, as well as Service Providers, to unwarranted cybersecurity risks; and
- Provide a transition period of at least 18 months to allow advisers sufficient time to come into compliance with the new rule and to manage the significant costs, compliance adjustments, and modifications of existing Service Provider contracts that the rule will necessitate.

We discuss each of these recommendations in more detail below.

1. <u>The SEC should define what it means to "outsource" a Covered Function and only apply the rule requirements when the adviser actually *outsources* a Covered Function</u>.

The Proposal would make it unlawful for a registered investment adviser to *retain* a "Service Provider" to perform a "Covered Function" unless the adviser, among other things, complies with an extensive and prescriptive set of due diligence and monitoring requirements.

Although the SEC has positioned the Proposal as "Outsourcing by Investment Advisers," the Proposal in fact seemingly applies to *any* engagement of a Service Provider (affiliated or third-party), with certain extremely limited exceptions. This approach is not tailored to the SEC's stated concerns regarding *outsourcing* necessary functions *without further oversight*.[21] We believe that the rule should only apply when an adviser "outsources" Covered Functions—not merely when an adviser *engages* a Service Provider that performs a Covered Function.

When an adviser engages a Service Provider to assist with performing a function, it does not necessarily mean that the adviser is *outsourcing* that function. Outsourcing exists when an adviser fully delegates the performance of a function to a Service Provider.[22] In that true outsourcing context, we believe it is reasonable to expect an adviser to perform more extensive

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[21] *See* Proposing Release at 68,817-18 (listing specific risks the SEC has identified as being attendant to an outsourced function).

[22] That definition is consistent with the agency's limited statutory authority to prevent fraud by either investment advisers or persons "acting on behalf of" a registered investment adviser. *See* 15 U.S.C. §§ 80b-3(d), 80b-6(4).

diligence and ongoing monitoring on the Service Provider, given that the Service Provider is performing the function on the adviser's behalf.

On the other hand, an adviser may hire a Service Provider to help support the adviser's own performance of the function—for example, an adviser may engage a Service Provider to conduct market research, act as a financing counterparty for certain transactions, assist with its cash and collateral management, provide environmental reports with respect to an investment, or provide technology tools or data that the adviser will use in the provision of its investment advisory services. However, in this context the adviser has not "outsourced" the performance of that function.[23] As another example, an adviser may engage a law firm to advise on certain aspects relating to the adviser's compliance with the Advisers Act, but that does not mean the adviser has "outsourced" its Advisers Act compliance function to the law firm. Similarly, we do not believe that a function has been "outsourced" to a Service Provider in situations where an adviser has engaged multiple providers to perform the same service. From a risk management standpoint, advisers should be encouraged to build redundancies into their operations and should not be discouraged by prescriptive compliance obligations from having relationships with multiple providers who are able to offer the same services. As the Proposal is currently structured, advisers would likely be forced to conclude that nearly any engagement of a Service Provider may be captured by the new rule.

Accordingly, if the SEC determines to move forward with a final rule, we recommend that the SEC modify the scope of the rule so that it applies only when an adviser actually *outsources* a Covered Function, not when an adviser merely *retains* a Service Provider to perform or assist with a Covered Function. We recommend that the SEC define "outsource" as the full delegation by an investment adviser of the performance of a Covered Function to a Service Provider.

2. The SEC should refine and clarify the definition of "Covered Function".

The Proposal defines a "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."[24] The definition specifically excludes clerical, ministerial, utility, or general office functions or services, which we generally agree with, as further discussed below.

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[23] *See* Proposing Release at 68,821 (explaining that covered functions would include those "related to" creating and providing custom indexes, among other things).

[24] Proposing Release at 68,820.

We believe that the first prong of this definition is overly broad and could conceivably capture any function or service that is provided by any Service Provider (other than those expressly excluded).[25] This is at odds with the SEC's stated intention in the proposing release to define a narrower universe of functions and not capture all services that an adviser could outsource to third parties.[26] Advisers engage Service Providers for a variety of functions, including general technology, cloud services, research, storage, legal, data, data scrubbing and analytics, monitoring, penetration testing, consulting, and other services. Such functions may not relate directly to the provision of investment advisory services but could nonetheless be considered "necessary" for an investment adviser's operations and therefore "necessary" to provide its investment advisory services in compliance with the federal securities laws. For example, as noted above, the engagement of a law firm in connection with an adviser's compliance with the Advisers Act could conceivably come within this definition, although we do not believe the SEC intended this result.[27]

In the absence of refinement of this aspect of the definition of "Covered Function," advisers may be compelled to apply the rule requirements to all Service Providers; for advisers with a broader interpretation of the Proposal, this could affect upwards of one hundred vendor relationships. This would be overly burdensome, resulting in unnecessary costs and use of the adviser's resources, potentially at the expense of its clients, and potentially reducing the adviser's diligence and monitoring to a "check-the-box" exercise that is less effective than a thoughtful, risk-based approach to overseeing key Service Providers. This would also disincentivize the use of third-party Service Providers. Alternatively, we could see wide variation in application of the requirements by advisers, which could ultimately be harmful to competition and cause confusion to the industry, to the SEC staff, and, importantly, to clients.

With regard to the second element of the definition of "Covered Function," the proposing release does not provide any guidance as to how advisers would evaluate the extent to which functions or services may be "performed negligently" and does not attempt to reconcile this standard with the more nuanced fiduciary standard applicable to the adviser itself. We are concerned that the introduction of the negligence standard in the context of Service Provider

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25 *See also* Commissioner Mark T. Uyeda, Statement on Proposed Rule Regarding Outsourcing by Investment Advisers (Oct. 26, 2022), *available at* https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622. (observing that "[m]any functions or services that do not relate to adviser's investment advisory function nonetheless are necessary for the adviser to provide its investment advisory services in compliance with the federal securities laws. Therefore, under a technical reading of the proposed definition of 'Covered Function,' almost any function outsourced by an investment adviser could trigger the numerous oversight functions set forth in the proposed rule.").

26 *See* Proposing Release at 68,821.

27 As noted in Section III.1, above, this could be addressed by properly limiting the scope of the rule to circumstances where the adviser *outsources* a Covered Function. This modification would, for example, capture circumstances where an adviser outsources its entire compliance function to an external compliance consultant, but not when an adviser merely engages a consultant or law firm to advise the adviser on its compliance.

diligence and monitoring could wrongly suggest that advisers would be liable for simple negligence of a Service Provider.[28]

In addition, the SEC requests comment in the proposal release regarding whether the rule should "include an express provision that prohibits an adviser from disclaiming liability when it is not performing a covered function itself."[29] No such provision should be adopted. Such a prohibition would substantially alter the existing legal and contractual arrangements between advisers and clients, which are the result of informed and careful balancing of relevant costs and benefits that have developed over time through extensive negotiation by sophisticated parties. It would also significantly increase the costs of providing investment advisory services, as advisers would be forced to raise fees to offset increased liability for trade and other errors caused by Service Providers and a heightened risk of frivolous lawsuits, thereby decreasing certain clients' access to compelling advisers.

The proposed definition of "Covered Function" also leaves open to interpretation what could be considered a "material negative impact" on clients. The proposing release notes 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.[30] In practice, advisers will be forced to assume that every function provided by a Service Provider, other than those expressly excluded from the definition, could meet this threshold, or otherwise risk second-guessing by SEC examination and enforcement staff in hindsight.

Accordingly, if the SEC determines to move forward with a final rule, we recommend that the SEC refine and clarify the definition of "Covered Function" consistent with the following recommendations. We believe our suggestions to both define "outsource" (as described above) and exclude additional functions from the definition of "Covered Function" (as described below) will work to narrow the overly broad first prong of the definition. If the SEC does not implement these recommendations, it should consider other ways to narrow the first

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[28] We similarly expressed concerns in our comment letters submitted earlier this year in response to the Private Fund Adviser Proposal. *See* MFA Comment Letters on Private Fund Advisers, *supra* note [10]. As we noted in that context, imposing a more stringent liability standard on private fund advisers than what is required under the adviser's fiduciary duty and what is applicable by statute to the engagement of an investment adviser by other clients, including registered investment companies, is illogical, is contrary to the SEC's recent interpretation of the scope of fiduciary duties under Section 206 of the Investment Advisers Act of 1940, and has not been adequately justified by the SEC. Further, if the proposed negligence standard were construed as a substantive standard for conduct and not merely a convoluted mechanism for identifying material delegations, it would also exceed the agency's statutory authority to issue rules "reasonably designed to prevent . . . . "fraud[], decepti[on], and manipulati[on]"—acts which require scienter. 15 U.S.C. § 80b-6(4); *see id*. § 80b-3(d).

[29] Proposing Release at 68,824.

[30] Proposing Release at 68,822.

prong to avoid an overly broad application of the rule, such as by capping the number of vendors in scope per adviser to the five most critical Service Provider relationships.

In addition, we believe that the following change to the second prong of the definition is a more appropriate standard that eliminates the potential conflict with the scope of an adviser's obligations under its fiduciary duty to its clients: a covered function is a function "that if not performed *or not performed in material conformance with the terms of the Service Provider's engagement*" would be reasonably likely to cause a material negative impact on the adviser's clients or the adviser's ability to provide services. Regarding the "material negative impact" standard, the SEC should expressly state in the adopting release that the SEC staff will not second-guess an adviser's reasonable, documented determination in this regard.

We are supportive of the examples of functions and services that the SEC identifies in the proposing release as not being Covered Functions.[31] We believe that the SEC should expressly exclude additional functions from the definition, including employee training, data scrubbing, cyber testing, customer relationship management software, data, hardware, off-the-shelf and readily available software (including software that requires straightforward customization prior to utilization). Data center space and cloud services should be excluded from the definition of Covered Function in the same way that lessors of physical office space are excluded. Many companies (including highly regulated entities, such as FINRA and CME) choose to migrate data and applications to the cloud because they view it as risk-reducing.[32] The Proposal would discourage advisers from moving to the cloud, even though there are distinct and widely recognized benefits to doing so, including business continuity and enhanced information security.

The SEC should also specifically exclude functions which *require* reliance on an external Service Provider and for which there is a single or limited pool of Service Providers. For example, certain exchange data services can only be provided by NYSE or Nasdaq. Many advisers are effectively compelled to use these exchanges in order to trade or receive relevant market data.

We believe these modifications will provide investment advisers a much clearer indication of the scope of services that would and would not be included within the definition of "Covered Function." Critically, these changes would ensure that the rule aligns with an adviser's

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[31] *See* Proposing Release at 68,822.

[32] FINRA's CAT is on the cloud and CME has partnered with Google Cloud to transform how global derivatives markets operate. *See* Press Release, CME Group, CME Group Signs 10-Year Partnership with Google Cloud to Transform Global Derivatives Markets Through Cloud Adoption (Nov. 4, 2021), https://www.cmegroup.com/media-room/press-releases/2021/11/04/cme_group_signs_10-yearpartnershipwithgooglecloudtotransformglob.html; Press Release, AWS, FINRA CAT Selects AWS for Consolidated Audit Trail (Dec. 4, 2019), https://press.aboutamazon.com/2019/12/finra-cat-selects-aws-for-consolidated-audit-trail.

fiduciary duty, as recently interpreted by the SEC, and does not impose a more stringent liability standard.

Thus, if the SEC determines to move forward with a final rule, we recommend that the SEC refine and clarify the definition of "covered function" in accordance with our recommendations above.

3. The SEC should revise the definition of "Service Provider" to exclude adviser affiliates and regulated entities.

We believe the definition of "Service Provider" as proposed is too broad and not appropriately tailored to the risks associated with outsourcing advisory functions to third parties. The SEC's proposed definition currently includes any person or entity, other than a supervised person, that performs one or more Covered Functions. We believe this definition unnecessarily captures two groups to which the application of the requirements of the rule is not appropriate: adviser affiliates and entities subject to regulation and oversight by the SEC. As described below, we believe that applying the rule to such entities is duplicative and unnecessary.

With respect to oversight of affiliated Service Providers, the SEC explains in the proposing release its rationale for extending the proposed oversight requirements to both affiliated and unaffiliated Service Providers, noting 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."[33] Here, the SEC overlooks the fact that it is common for a firm's personnel that provide services to a registered investment adviser to be employed by a legal entity that is separate from the registered entity. This is often a matter of corporate formality, and employees are generally still treated as "persons associated with" the registered investment adviser and are subject to the adviser's supervisory control system. There is no justification for treating these employees as Service Providers, and considering their work to be "outsourced" under the proposed rule.[34] Advisers also use affiliates in many other circumstances, including internal limited purpose broker-dealers as solicitor for separate accounts and placement agent for affiliated private funds; internal servicing agreements to facilitate centralized trading structures as well as operations, compliance, and legal functions; and delegation from one affiliated adviser to other affiliated advisers to enable collaborative portfolios.

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[33] Proposing Release at 68,823.

[34] The Commission's proposed carve-out for "supervised persons" would not be sufficient because the definition of "supervised persons" is limited to persons "who provide[] investment advice on behalf of the investment adviser…." 15 U.S.C. § 80b-2(a)(25) (2020). Many affiliate employees do not provide investment advice. This includes most, if not all, back-office functions such as accounting, compliance, client services, and legal. Although they are subject to an adviser's supervisory system, in many cases they are not supervised persons and therefore could fall within the proposed rule.

In the above situations, the adviser's fiduciary duties to its clients, along with market expectations, address the SEC's concerns in issuing the Proposal. An adviser's determination to engage an affiliate may be a material fact relating to the advisory relationship or involve a conflict of interest that must be fully and fairly disclosed, and the client must provide informed consent.[35] An adviser is therefore currently unable to outsource functions to affiliates without first determining that the engagement is consistent with the adviser's fiduciary duties. Extending the new oversight requirements to affiliates therefore imposes additional costs and compliance burdens on advisers with limited incremental benefit to the advisers' clients.[36] Therefore, we strongly believe that affiliates should be excluded from the definition of "Service Provider." At a minimum, the SEC should specifically tailor the rule to align with the SEC's stated concern of affiliated service providers where the adviser has limited control over or visibility into the affiliate.[37]

With respect to entities directly subject to SEC regulation and oversight, such as registered investment advisers and broker-dealers, applying the new rule would be overly burdensome and duplicative. For example, advisers that have responsibility to select broker-dealers to execute client trades are already required pursuant to their federal fiduciary duty to seek the best execution on behalf of customers and consider the full range and quality of a broker's services in placing brokerage, including, among other things, the value of research provided, as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser.[38] It is also not necessary to address the SEC's stated concern of lack of oversight and visibility relating to Service Providers in these cases. With respect to SEC-registered sub-advisers, there is perhaps the least justification and the most unnecessary duplication, given that the sub-adviser would itself be subject to all of the compliance requirements under the Advisers Act, including the requirements of the rule.

Accordingly, if the SEC determines to move forward with a final rule, we recommend that the SEC revise the definition of "Service Provider" to explicitly exclude adviser affiliates and entities subject to regulation and oversight by the SEC.

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[35] The SEC has previously stated that a client's informed consent can be either explicit or implicit, depending on the facts and circumstances. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, at 33,677; 15 U.S.C. § 80b-6 (2020).

[36] For example, advisers frequently engage affiliates to provide services in order to comply with local law requirements applicable to investment vehicles domiciled in foreign jurisdictions, which can provide cost efficiencies for clients. Applying the new rule to affiliate engagements would impose unnecessary compliance burdens.

[37] Proposing Release at 68,823.

[38] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, at 33,674-75.

4. The SEC should replace the ongoing monitoring requirements with a requirement for an adviser to conduct an annual review of its outsourcing policies and procedures, including reviewing the frequency for reassessment of a Service Provider set forth in the adviser's policies and procedures.

The Proposal would require advisers to periodically monitor the Service Provider's performance of the Covered Function and reassess the retention of the Service Provider in accordance with the due diligence requirements "with a manner and frequency such that the investment adviser reasonably determines that it is appropriate to continue to outsource the Covered Function and that it remains appropriate to outsource it to the Service Provider."[39] According to the proposing release, the "manner and frequency" of monitoring and reassessing Service Provider performance would "depend on the facts and circumstances applicable to the Covered Functions, such as the materiality and criticality of the outsourced function to the ongoing business of the adviser and its clients."[40]

We are concerned that the "facts and circumstances" approach proposed by the SEC as to frequency of monitoring and reassessment will leave advisers with significant uncertainty about the frequency with which they are required to monitor and reassess Service Providers, including in certain circumstances necessitating nearly real-time monitoring and reassessment, which would be extremely disruptive and impractical.

Instead, we believe the final rule should provide that advisers must review their outsourcing policies and procedures on an annual basis, including reviewing the frequency for reassessment of a Service Provider set forth in their policies and procedures. This could include a determination of whether or not changes in the risk profile of a Service Provider or the adviser make a reassessment of such Service Provider necessary or appropriate. This annual review process would be consistent with the approach taken by the SEC in adopting Rule 206(4)-7, which requires each registered adviser to review its compliance policies and procedures annually to determine their adequacy and the effectiveness of their implementation, as well as Rule 38a-1 under the Investment Company Act, which requires a fund to review its policies and procedures, as well as those of its service providers, annually.

We believe that requiring review of an adviser's outsourcing policies and procedures on an annual basis in the manner we've described will more appropriately balance the costs and benefits of this aspect of the rule. One clear benefit of our proposed alternative is that advisers will have certainty regarding the monitoring frequency necessary to comply with the new rule.

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[39] Proposing Release at 68,879.

[40] Proposing Release. at 68,856.

Accordingly, if the SEC determines to move forward with a final rule, we recommend that the SEC modify the rule to require an annual reassessment of an adviser's outsourcing policies and procedures, which would include reviewing the frequency for reassessment of a Service Provider set forth in the adviser's policies and procedures.

5. The SEC should expressly allow advisers to engage Service Providers prior to completing due diligence in exigent circumstances.

The formal due diligence prescribed by the proposal would likely require a lengthy onboarding process for new Service Providers. For example, the process to complete due diligence questionnaires that our members distribute to their Service Providers in the ordinary course of business can take up to two months. The Proposal would prohibit advisers from engaging Service Providers to perform Covered Functions without first completing the detailed due diligence review required under the proposed rule, and, critically, the Proposal fails to provide exceptions for situations in which an adviser might have an urgent need to engage a Service Provider within a shorter time frame. For example, if a critical vendor fails to perform its obligations, an adviser would need to be able to quickly replace that vendor to mitigate any disruptions to the adviser's operations or adverse impacts to clients. Furthermore, based on changing technologies and other factors, advisers may from time to time discover gaps in their cybersecurity, risk management, technology, or other processes and determine that the adviser needs to engage a Service Provider to immediately fill such gap.

In exigent circumstances like those described above, advisers should have the flexibility to address critical needs in a timely manner. We believe the SEC should provide an exception from the due diligence requirement for such limited circumstances, allowing advisers to retain new Service Providers while the due diligence process is still ongoing, so that advisers can act quickly to address these types of circumstances without violating the rule. Advisers would then complete the due diligence process as promptly as practicable following the engagement of the Service Provider.

Accordingly, if the SEC determines to move forward with a final rule, we recommend that the SEC expressly allow advisers to engage Service Providers prior to completing due diligence in exigent circumstances.

6. The SEC should not adopt the proposed amendments to the Advisers Act recordkeeping rule.

The proposed amendments to the Advisers Act recordkeeping rule would require advisers to keep extensively prescribed books and records of their diligence and monitoring efforts, and would require advisers that outsource recordkeeping functions to perform the same oversight, monitoring, and due diligence requirements on third-party recordkeepers, as if recordkeeping were a Covered Function. In addition to these requirements, the Proposal would require advisers to obtain certain reasonable assurances from third-party recordkeepers related to the third party's ability and willingness to meet the requirements of the recordkeeping rule applicable to the adviser, provide the adviser and the SEC with access to electronic records, and ensure continued availability of such records if the third party ceases to operate or maintain a relationship with the adviser.[41]

We believe these changes to the recordkeeping rule are overly prescriptive, unnecessarily burdensome, and redundant. Advisers are already required to maintain books and records under the recordkeeping rule and to adopt policies and procedures to ensure compliance with the rule, and necessarily must engage in risk-appropriate diligence, monitoring, and oversight whenever the recordkeeping function is outsourced. Without such monitoring and oversight, advisers would not be able to ensure that they are in compliance with the existing recordkeeping requirements. Further, we believe that requiring the assurances from certain third-party recordkeepers, such as large cloud service providers, would be challenging (if not impossible) given the "take it or leave it approach" these companies typically take to their service contracts. In addition, requiring assurances to allow the staff of the Commission to directly access electronic records through computers or systems may be inconsistent with non-U.S. law. Finally, the prescriptive recordkeeping requirements should be replaced with a more customary principles-based approach requiring the adviser to maintain records sufficient to demonstrate compliance with the final rule.

Accordingly, if the SEC determines to move forward with a final rule, we recommend that the SEC preserve the recordkeeping rule as is and abandon the proposed amendments to it.

7. <u>The SEC should eliminate the requirement to disclose the names of "Service Providers" on Form ADV</u>.

The proposed amendments to Form ADV would require advisers to provide the SEC and the public with census-type information about the Service Providers they use. This includes the Service Provider's name and address, as well as the Covered Function(s) for which they provide services and the date they began providing such service(s).[42]

We do not see a benefit to requiring public disclosure of such information and we are concerned about the implications of doing so. The public disclosure of outsourcing relationships could jeopardize important competitive information.[43] For example, some of our members invest a significant amount of time and resources into finding and vetting Service Providers to provide data or research or assist in the development of technology to implement the advisers' trading strategies. Our members view these Service Provider relationships as confidential and

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[41] Proposing Release at 68,820.

[42] *Id*. at 68,882.

[43] The SEC recognized the possibility of such a risk when it specifically requested comment as to whether certain Service Providers "should not be publicly disclosed due to competitive, trade secret, compliance, or other risks." *Id*. at 68,836.

proprietary information and a key competitive advantage in the industry. Advisers and Service Providers could be significantly harmed from a competitive standpoint if the adviser is required to publicly identify the Service Providers that provide these functions. Furthermore, such disclosures could expose advisers and their clients, as well as Service Providers, to increased cybersecurity risks as cybercriminals expand the scope of their attacks in search of vulnerabilities. In addition, particularly where a smaller adviser has engaged one or more large firms to provide certain services, the public disclosure of the Service Provider's identity could expose the Service Provider to potential increased litigation risk in circumstances where the Service Provider is perceived to have a "deep pocket" relative to the adviser.

Accordingly, if the SEC determines to move forward with a final rule, we recommend that the SEC eliminate the requirement to disclose the names of Service Providers on Form ADV because the risks of such public disclosure outweigh any potential benefits. Instead, the SEC could amend Form ADV to require disclosure to clients and potential clients describing the types of Covered Functions that the adviser outsources. This would provide clients and prospective clients with information regarding the adviser's use of Service Providers without revealing confidential and competitively sensitive information and without overloading clients and potential clients with a lengthy list of Service Providers, when clients would benefit most from disclosure of the types of critical Covered Functions that the adviser outsources. At the same time, the SEC will continue to have access to information about specific Service Provider engagements through its examination of investment advisers.

8. The SEC should provide a sufficient transition period for compliance with the new oversight requirements if they are adopted.

The SEC has proposed a 10-month transition period for compliance with the new and amended rules following the effective date. The final rules would become effective for any new Service Provider relationships entered into after the compliance date, while the ongoing monitoring requirements would become effective for existing relationships beginning on the compliance date.[44]

Given the significant cost and adjustments to existing compliance policies and procedures, as well as substantial modification to existing contractual arrangements with Service Providers, that would be required to come into compliance with the proposed rule, we think a minimum of 18 months would be a more appropriate transition period. This longer period would be more likely to give advisers sufficient time to assess all of their existing Service Provider relationships that would be captured under the new rule.

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[44] *Id*. at 68,841.

Accordingly, the SEC should provide a sufficient transition period for compliance with the new oversight requirements if they are adopted.

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MFA recognizes the importance of proper diligence and monitoring of service providers. We do not believe, however, that the requirements set out in the Proposal would further protect investor interests, nor are necessary or appropriately tailored to risks associated with the engagement of service providers by investment advisers. We are concerned that the Proposal could undermine the existing fiduciary duty standard applicable to advisers, cause interpretation and implementation problems, impose unnecessary costs on investment advisers and advisory clients, and significantly and disproportionally impact smaller advisers and service providers. However, if the SEC does move forward with new requirements for outsourcing by investment advisers, we strongly believe that the key changes we have suggested in this letter would address the concerns raised by the SEC in the proposing release while permitting advisers to target their diligence and monitoring activities on services or functions identified through a tailored, risk-based analysis.

MFA appreciates the opportunity to provide comments to the SEC on the Proposal. If you have any questions about these comments, please do not hesitate to contact David Lourie, Vice President & Senior Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Jennifer W. Han
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cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner
The Hon. Mark T. Uyeda, SEC Commissioner
The Hon. Jaime Lizárraga, SEC Commissioner
Mr. William Birdthistle, Director, Division of Investment Management