



December 27, 2022

Submitted by SEC Webform (<http://www.sec.gov/rules/submitcomments.htm>)

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

RE: File No. S7-25-22: Outsourcing by Investment Advisers

Dear Ms. Countryman:

On behalf of the North American Securities Administrators Association (“NASAA”),¹ I am writing in response to U.S. Securities and Exchange Commission (“SEC” or the “Commission”) Release No. IA-6176, *Outsourcing by Investment Advisers* (the “Proposal”).² The Commission proposes to prohibit SEC-registered investment advisers from outsourcing certain services or functions to third-party service providers without first conducting due diligence on such service providers, and to require advisers to perform periodic monitoring of service provider performance.³ The Proposal also includes corresponding amendments to Form ADV to require census-type disclosures about an adviser’s service providers, as well as a new recordkeeping rule specifically pertaining to service providers engaged to maintain an adviser’s books and records.⁴

We recognize that the outsourcing of certain advisory functions can benefit advisers by, for example, helping them deal with client demands, facilitate staffing flexibility, and provide clients with access to certain areas of expertise that advisers may not otherwise be equipped to handle.⁵ However, notwithstanding such potential benefits, advisers must always satisfy their

¹ Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA’s membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

² The Proposal is available at <https://www.sec.gov/rules/proposed/2022/ia-6176.pdf>.

³ *Id.* at 16.

⁴ *Id.* at 18-19.

⁵ *Id.* at 7.

regulatory obligations and especially their fiduciary duties to clients.⁶ This means that, among other things, clients should have sufficient information to make informed decisions about the selection and retention of an adviser, as well as how their money is managed.⁷ The Proposal would provide investors with more clarity into how their assets are being handled, how fees are being earned and spent, and the extent to which an adviser is providing value commensurate with the fees it charges.⁸

As it currently stands, the Proposal would subject service providers performing certain outsourced advisory functions to enhanced oversight. Advisers themselves are already subject to a detailed regulatory framework, and therefore NASAA believes it is appropriate to subject service providers that perform critical functions for advisers to similar oversight. We agree that insufficient supervision of and disclosure regarding such service providers can leave clients insufficiently informed as to how their assets are being managed and protected, how their fees are being spent, and what value advisers are providing.⁸

While NASAA supports the Proposal generally and encourages its adoption, we offer several considerations and points for clarification below.

I. Application and Scope of the Proposal

The Proposal provides that an adviser registered, or required to be registered, with the Commission cannot retain a service provider to perform a covered function unless it conducts certain due diligence and monitoring of the service provider.⁹ A “covered function” subject to the proposed rule would be one which is (i) necessary for an adviser to provide its investment advisory services and (ii) reasonably likely to cause a material impact on the client or adviser’s ability to provide services if performed negligently or not at all.¹⁰ Specifically excluded from the definition, however, would be clerical, ministerial, utility, or general office functions or services.¹¹

The determination as to whether a service provider performs a covered function would be subject to a facts and circumstances analysis.¹² NASAA appreciates the Commission’s flexible approach. Mandating a highly prescriptive single approach would be ill-advised given the variety of advisory business models, and could impose unnecessary burdens that could have negative material impacts on clients and/or an adviser’s operations.

⁶ *See id.* at 116.

⁷ *See id.* at 163, 167, 221.

⁸ *See id.* at 14.

⁹ *Id.* at 16.

¹⁰ *Id.* at 20.

¹¹ *Id.*

¹² *See id.* at 21.

II. Due Diligence

NASAA generally supports the Proposal's due diligence requirements, specifically those elements that encourage advisers to prioritize the mitigation and management of potential risks inherent in outsourcing certain services and functions. In NASAA's view, the proposed due diligence requirements would encourage advisers to adopt more protective standards when selecting service providers to perform covered functions. Specifically, the elements for compliance enumerated in the Proposal¹³ would cover the reasonable identification and determination of the suitability of outsourcing a particular function, the selection of the service provider, and continued outsourcing of the covered function.¹⁴ The due diligence requirements should be an appropriate mechanism to clearly identify, mitigate, and manage the risks associated with an adviser's use of service providers. Furthermore, the requirements should ensure that the nature and scope of a covered function are appropriate at all stages of performance and continue to serve the operational needs of an adviser and, in turn, the best interests of its clients.¹⁵

Requiring advisers to conduct due diligence prior to engaging with certain service providers is likely to cause those providers to take a close look at their own operations and make enhancements in order to meet due diligence standards and retain business. Thus, third-party service providers who frequently provide covered services to advisers may be encouraged to implement internal mechanisms that more effectively identify, mitigate, and manage risks.

As part of the due diligence framework, the Proposal would also require an adviser to determine whether a service provider has subcontracting arrangements material to the performance of the covered function.¹⁶ NASAA generally supports this inclusion. However, more clarity – in line with questions posed in the Proposal – would be appropriate.¹⁷ We believe that requiring an adviser to identify select subcontracting arrangements, as opposed to all such arrangements, would reduce the risks associated with a lack of transparency and control by an adviser over a service provider. An adviser may receive inadequate service, or potentially put clients at risk, if it does not know who is actually performing critical aspects of an outsourced covered function.

¹³ *Id.* at 17.

¹⁴ *See id.* at 40.

¹⁵ *Id.*

¹⁶ *Id.* at 54.

¹⁷ *See id.* at 65, Question 44 (“Should we provide more guidance on the term “material”? Should we broaden the requirement to any subcontracting arrangements? Should we exempt or alter this requirement for service providers that are also investment advisers? Finally, should we omit the requirement that the adviser determine whether the service provider has any subcontracting arrangements?”).

NASAA supports the Commission's effort to require advisers to use a heightened level of diligence when selecting service providers. However, we recommend that the Commission avoid imposing inflexible due diligence standards. Strict standards could cause an undue burden to advisers and have unintended effects on the availability of service providers, which could in turn prove counterproductive to the underlying purposes of the Proposal. Further, it is important to note that overly prescriptive due diligence standards may impose a disproportionate burden on smaller advisers. While the Proposal provides no exceptions for smaller advisers, we would encourage the Commission to consider how this rule and its subsequent costs would burden those smaller advisers. We also encourage the Commission to provide guidance on the evaluation touch points it may use in determining whether an adviser has maintained compliance with the due diligence requirements. This would enable advisers to identify the standards that should be prioritized.

III. Periodic Monitoring

NASAA supports the Proposal's requirement that an adviser periodically monitor the performance of a service provider of a covered function and reassess whether retention is appropriate.¹⁸ Mandatory periodic monitoring would help ensure that advisers are allocating their resources prudently and are continuing to fulfill their duty of care to clients. Additionally, periodic monitoring would increase the likelihood that an adviser is making a conscious selection of the provider best equipped to handle a covered function. Similar to the anticipated ancillary effect due diligence requirements may have on the internal operations of service providers, as described above, periodic monitoring may also encourage service providers to implement more efficient and appropriate internal practices.

However, some events – like a change in control – could warrant an immediate re-evaluation of a provider. Advisers should not be left with the impression that periodic monitoring is sufficient. To alert advisers to the fact that certain circumstances may require immediate action, the text of proposed Rule 206(4)-11(a)(2) should make clear that a reasonable determination as to when to monitor a provider is not just a matter of “manner and frequency,” but is also one that accounts for “material changes to the service provider.”

IV. Recordkeeping

The Proposal would amend Rule 204-2 under the Investment Advisers Act of 1940 (the “Advisers Act”) to require that advisers make and retain specific records related to their due diligence assessments,¹⁹ periodic monitoring efforts,²⁰ and overall compliance with the

¹⁸ *Id.* at 66.

¹⁹ *Id.* at 61.

²⁰ *Id.* at 69.

Proposal.²¹ NASAA is generally supportive of rulemaking that fosters uniformity in conduct among registrants.

Rule 204-2 identifies specific records to be maintained by advisers.²² NASAA agrees that an adviser is responsible for complying with recordkeeping requirements in the Advisers Act and other federal securities laws, whether the records are made or kept by a third party or the adviser directly.²³ The Proposal establishes an oversight framework for third-party recordkeepers aimed at protecting adviser records and ensuring timely and efficient compliance when the Commission conducts examinations or investigations for which records are requested.²⁴ NASAA supports a recordkeeping rule that ensures records are reliable and bolsters the Commission's examination and enforcement processes.²⁵

V. Amendment to Form ADV

In addition to incorporating new due diligence and monitoring requirements, the Proposal includes corresponding amendments to Form ADV to collect census-type information about service providers. This information would include the service provider's legal name, primary business name, legal entity identifier, whether the service provider is a related person of the adviser, date of first engagement, location of the service provider's office, and what covered functions the service provider is engaged to perform.²⁶

These amendments could give the Commission visibility into concentrations of risks posed by excessive reliance on particular service providers. This information could also position the Commission – as well as the Financial Stability Oversight Council – to be better prepared to prevent or mitigate failures by service providers performing covered functions that could have systemic consequences, especially during times of market instability.

NASAA generally supports the amendments to Form ADV and encourages the Commission to consider additional disclosures that may be material to clients and advisers' provision of quality advisory services. Additional disclosures could include disclosure of how the costs of engaging service providers affects advisory fees and whether the adviser has disclosed all material risks to clients regarding use of the third-party service provider at issue.²⁷

²¹ *See id.* at 82.

²² 17 CFR § 275.204-2.

²³ *See* Proposal at 81.

²⁴ *See id.* at 82, 112 n.131. The Commission asserts that its staff have observed that advisers are unable to provide timely responses to examination and enforcement requests because of outsourcing.

²⁵ *See id.* at 80.

²⁶ *Id.* at 191.

²⁷ *See id.* at 78, Question 62 (“*Would any additional or other information be material to an adviser's clients or prospective clients regarding outsourcing that is not included in the proposal and is not currently disclosed to investors through Form ADV or elsewhere (e.g., whether the service provider arrangement is subject to a written*

The ability to better recognize risks allows for better preparation, planning, and allocation of resources both for advisers and the Commission.

If the Proposal is adopted, NASAA encourages the Commission to make effective use of the information gathered by issuing guidance that reflects any concerns with service provider arrangements or any issues found in examination sweeps surrounding service provider arrangements. Advisers would benefit from having such guidance because, if used in conjunction with due diligence and monitoring information, an adviser would be able to make more informed decisions as to issues found in service provider arrangements or with the use of service providers generally. Such public guidance could also help investors make more well-informed selection and retention decisions.

VI. Conclusion

For the reasons expressed above, NASAA supports the Proposal and encourages its adoption. The Proposal would set reasonable standards for outsourcing by SEC-registered investment advisers. We encourage the Commission to revise the Proposal as outlined above. Should you have any questions about this letter, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Sincerely,



Andrew Hartnett
NASAA President and
Deputy Commissioner,
Iowa Insurance Division

agreement or information about passed-through fees)? Should we add any other service provider information to the Form ADV disclosure? If so, what information and why? For example, should Form ADV, Part 2 require information in the adviser's brochure about the use of service providers and related conflicts and other risks? Or is information about outsourced services already adequately being disclosed in connection with disclosures related to conflicts of interest or other risks? For example, should we require disclosure of potential conflicts of interest of the service provider? Should we require that, in addition or in place of the service provider's principal office, advisers report the principal office where the service provider's services are performed? Alternatively, should we delete any of the service provider information proposed to be disclosed? If so, what information and why?").