

SEC Proposes New Oversight Requirements for Certain Services Outsourced by Investment Advisers

by David Tang and Michael Schmieder

The Securities and Exchange Commission (the “SEC”) recently proposed new rule 206(4)-11¹ and related recordkeeping and reporting requirements (collectively, the “Proposed Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”) that would prohibit an SEC-registered investment adviser (“adviser”) from outsourcing certain “Covered Functions” (as defined below) unless the adviser conducts due diligence prior to retaining the service provider and subsequent periodic monitoring of the service provider.

Covered Function

Under the Proposed Rule, Covered Function means a function or service (i) that is necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws; and (ii) 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.² According to the Proposed Rule release, potential Covered Function categories include: Adviser / Subadviser; Client Services; Cybersecurity; Investment Guideline / Restriction Compliance; Investment Risk; Portfolio Management (excluding Adviser / Subadviser); Portfolio Accounting; Pricing; Reconciliation; Regulatory Compliance; Trading Desk; Trade Communication and Allocation; and Valuation.

Due Diligence

The Proposed Rule would prohibit an adviser from engaging a service provider to perform a Covered Function unless the adviser reasonably identifies, and determines that it would be appropriate to outsource the Covered Function and that it would be appropriate to select that service provider, by:

1. Identifying the nature and scope of the Covered Function;
2. Identifying and determining how the adviser will mitigate and manage the potential

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risks to clients and the adviser's ability to perform its advisory services resulting from outsourcing the Covered Function;

3. Determining that the service provider has the competence, capacity, and resources necessary to perform the Covered Function in a timely and effective manner;
4. Determining whether the service provider has any subcontracting arrangements that would be material to the service provider's performance of the Covered Function and how the adviser will mitigate and manage the potential risks of any such subcontracting arrangement;
5. Obtaining reasonable assurance from the service provider that it is able to, and will, coordinate with the adviser for purposes of the adviser's compliance with the Federal securities laws; and
6. Obtaining reasonable assurance from the service provider of its ability to provide an orderly termination of the performance of the Covered Function.

Monitoring

After a service provider is engaged to perform a Covered Function, the Proposed Rule would require the adviser to periodically monitor the service provider's performance of the Covered Function and reassess the retention of the service provider pursuant to the Proposed Rule's due diligence requirements. Monitoring is required with a manner and frequency such that the adviser can reasonably determine that it is appropriate to continue to outsource the Covered Function to the service provider.

Recordkeeping and Form ADV

The Proposed Rule includes (i) requirements for advisers to make and/or keep books and records related to the due diligence and monitoring requirements, and (ii) amendments to Form ADV to collect census-type information about advisers' use of service providers.

Third-Party Recordkeepers

An adviser relying on a third-party recordkeeper would be required under the Proposed Rule to (i) conduct the above-described due diligence and monitoring of the third-party recordkeeper and (ii) obtain reasonable assurances that the third-party recordkeeper will:

1. Adopt and implement internal processes and/or systems for making and/or keeping records on behalf of the adviser that meet the requirements of the Advisers Act;
2. Make and/or keep records of the adviser that meet all of the recordkeeping requirements applicable to the adviser;
3. Provide easy access to electronic records; and
4. Ensure the continued availability of the adviser's records if the third party's relationship with the adviser is terminated or the third party's operations cease.

Dorsey Observations

The Proposed Rule is consistent with the SEC's continued focus on advisers that outsource investment advisory activities and responsibilities to third-party service

providers.³ In light of the Proposed Rule, advisers may consider a reassessment of their policies and procedures regarding due diligence and monitoring of third-party services providers. Dorsey’s investment adviser compliance services assists advisers with the design and implementation of policies and procedures regarding the oversight of third-party service providers.

¹ Outsourcing by Investment Advisers, SEC Release Nos. IA-6176; File No. S7-25-22 (Oct. 26, 2022), *available at* <https://www.sec.gov/news/press-release/2022-194>.

² Covered Function does not include clerical, ministerial, utility, or general office functions or services.

³ See, e.g., the SEC examinations staff’s (“Staff”) observations on the oversight of third-party service providers in SEC Risk Alert “OCIE Observations: Investment Adviser Compliance Programs” (November 19, 2020) *available at* https://www.sec.gov/files/Risk%20Alert%20IA%20Compliance%20Programs_0.pdf and the Staff’s observations on outsourced chief compliance officers in SEC Risk Alert “Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers” (November 9, 2015) *available at* <https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf>.