

October 13, 2023

Via Electronic Filing

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

Re: Outsourcing by Investment Advisers (SEC Rel. No. IA-6176; File No. S7-25-22)

Dear Ms. Countryman:

The Investment Adviser Association (IAA)¹ is submitting these additional supplemental comments (**Second Supplemental Letter**) on the Commission's rule proposal on outsourcing by investment advisers.² We respectfully offer additional comments³ on third-party service provider arrangements for affiliated investment advisers, following discussions with Commission staff. We believe our recommendations would streamline unnecessary operational and compliance burdens on advisers without reducing investor protection.

¹ The IAA is the leading organization dedicated to advancing the interests of investment advisers. For more than 85 years, the IAA has been advocating for advisers before Congress and U.S. and global regulators, promoting best practices and providing education and resources to empower advisers to effectively serve their clients, the capital markets, and the U.S. economy. The IAA's member firms manage more than \$35 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

² *Outsourcing by Investment Advisers*, 87 Fed. Reg. 68816 (Nov. 16, 2022), available at <https://www.govinfo.gov/content/pkg/FR-2022-11-16/pdf/2022-23694.pdf> (**Proposal**). The Proposal comprises proposed Rule 206(4)-11 (**Proposed Outsourcing Rule**) and proposed amendments to the Advisers Act Recordkeeping Rule (Rule 204-2) and Form ADV.

³ We incorporate and reiterate the serious concerns raised and comments made in our initial and first supplemental letters on the Proposal. See Letter from Gail C. Bernstein, General Counsel, Investment Adviser Association, to the Commission re: *Outsourcing by Investment Advisers* (Dec. 23, 2022), available at <https://investmentadviser.org/resources/iaa-letter-to-sec-on-service-provider-outsourcing/> (**Initial Letter**) and Letter from Gail C. Bernstein, General Counsel, Investment Adviser Association, to the Commission re: *Outsourcing by Investment Advisers* (Apr. 20, 2023), available at <https://investmentadviser.org/resources/iaa-submits-supplemental-letter-on-outsourcing-proposal/> (**First Supplemental Letter**).

We make the following recommendations:

- (i) An affiliated investment adviser should be permitted to rely on its parent organization's due diligence of third-party service providers engaged to provide Covered Functions to the adviser.
- (ii) An affiliated investment adviser should be permitted to rely on its parent organization's monitoring of third-party service providers for oversight unrelated to Covered Functions, for example, monitoring whether the third-party service provider has the competence, capacity, and resources necessary to perform the Covered Function.

In addition, we reiterate and offer suggested rule text for our previous recommendations that the Commission exclude certain entities from the definition of "Service Provider."

I. Recommendations

A. Allow Affiliated Investment Advisers to Rely on Their Parent Organization's Due Diligence and Monitoring of Third-Party Service Providers

It is quite common today for affiliated investment advisers to rely in whole or in part on their parent organization to manage and oversee third-party service provider relationships. For example, the parent organization may contract directly with a third-party service provider on behalf of itself and one or more of its affiliates, or on behalf of its affiliates where services are not provided directly to the parent organization. The affiliated investment advisers can then rely on that engagement for services in common, or in some cases, with modifications to meet each adviser's specific needs. In other cases, one or more affiliated investment advisers may contract directly with a third-party service provider based on the due diligence conducted by the parent organization.

The Proposal would require affiliated investment advisers to unnecessarily duplicate costly due diligence and monitoring efforts for third-party service providers. This goes against common industry practice, where affiliated advisers rely on their parent organization's due diligence. Parent organizations are often well positioned to conduct due diligence on third-party service providers. They typically have the resources and expertise to assess the risks and capabilities of service providers, and they have a vested interest in ensuring that their investment adviser subsidiaries use high-quality service providers. This practice is cost effective and reduces risk, especially for smaller advisers that can leverage their parent's expertise and resources.⁴ This

⁴ Footnote 184 in the Proposal notes that in certain circumstances a parent entity may "determine[] that an adviser must purchase services or otherwise consume services from the parent or from another affiliate. The adviser that is outsourcing, if permitted to do its own analysis, might have opted to use a different provider or not to outsource at all." We strongly disagree with the Commission that the mere possibility that an adviser "might" opt to use a different provider or not outsource at all warrants the extensive compliance obligations that the Proposal would impose on affiliates in these circumstances. This is an example of how the Commission continues to underestimate the burdens associated with new prescriptive mandates that would have marginal benefit relative to their associated

may be particularly helpful in the context, for example, of assessing whether the third-party service provider has the competence, capacity, and resources necessary to perform the Covered Function.

We thus recommend that the Commission permit affiliated investment advisers to rely, in whole or in part, on the due diligence of third-party service providers conducted by parent organizations.

We also recommend that affiliated advisers be able to rely on parent organizations' monitoring of third-party service providers that is not directly related to the provision of Covered Functions to the affiliated adviser. As a parent organization would not be directly involved with respect to the provision of services to an affiliated entity, any monitoring directly relating to Covered Functions would continue to be performed by the affiliated adviser. For example, a parent organization could monitor the service provider's general business risk profile, but it could not monitor whether the service provider is still meeting the appropriate standard for providing the Covered Function to the affiliated advisers.

Accordingly, we propose the following additional amendments (in blue) to the Proposed Outsourcing Rule, marked to compare to the Proposal:⁵

206(4)-11(a)(1) *Due diligence.* Before engaging such Service Provider to perform a Covered Function, the adviser and/or the parent organization of the adviser in the case of an affiliated investment adviser reasonably identifies, and conducts due diligence commensurate with the levels of risk and complexity of the Covered Function and the Service Provider, and the exigency of the circumstances, such that the adviser can reasonably determine that it would be appropriate to: (i) outsource the Covered Function and (ii) select that Service Provider, by:

206(4)-11(a)(2) *Monitoring.* The adviser periodically monitors the Service Provider's performance of the Covered Function and reassesses the retention of the Service Provider ~~in accordance with the due diligence requirements of paragraph (a)(1) of this section and~~ 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. An affiliated investment adviser may rely on its parent organization's monitoring of third-party service providers to the extent it is not directly related to the provision of Covered Functions.

B. Amend the Service Provider Definition

In our First Supplemental Letter, we recommended that service providers affiliated with one or more investment advisers operating under a shared services or similar model be excluded

costs. We urge the Commission to seriously consider the mounting costs for advisers where the potential benefits are so small.

⁵ The amendments proposed in this letter are in addition to those proposed in our First Supplemental Letter (in red).

from the definition of “Service Provider.”⁶ We explained that, in a shared services model, the affiliated entity that performs the relevant functions generally only provides these services to its affiliates pursuant to an internal arrangement between or among the affiliated entities and does not make these same services available to the broader marketplace.

In some cases, the affiliates share centralized or integrated third-party service provider management processes, while in others, they effectively operate as a single entity even though they are organized as separate legal entities. While the affiliated advisers participating in these arrangements may be legally separate from one another and from the affiliated entity that performs the functions on their behalf, these affiliated service providers function as a closely integrated part of each adviser’s operations.

In our First Supplemental Letter, we also requested the exclusion of an entity regulated by the Commission or another Federal financial regulator,⁷ an entity that performs one or more Covered Functions for funds registered under the Investment Company Act of 1940, or a custodian not already excluded because it is regulated by the Commission or another Federal financial regulator.

In light of the exclusions noted above, we recommend the following amendments (in blue) to the definition of “Service Provider” in the Proposal, marked to compare to the proposed definition:

Service Provider means a person or entity that:

(i) Performs one or more Covered Functions; and

(ii) Is not:

(a) a supervised person, as defined in 15 U.S.C. 80b-2(a)(25), of the investment adviser;

(b) an entity affiliated with an investment adviser that performs one or more Covered Functions for the investment adviser under a shared services agreement or similar arrangement;

(c) an entity regulated by the Commission or another Federal financial regulator;

⁶ The Proposed Outsourcing Rule does not distinguish between affiliated and unaffiliated service providers, based on the Commission’s expressed belief that “the risks that the proposed rule are designed to address exist whether the service provider is affiliated or unaffiliated, and the service provider is not necessarily already being overseen by the adviser.” Proposal at 68823.

⁷ If the Commission does not accept this recommendation, we request that the Commission, at a minimum, exclude affiliated sub-advisers as Service Providers. To the extent that an affiliated investment adviser serves as a sub-adviser to multiple affiliated investment advisers, it would be particularly onerous and burdensome to duplicate due diligence and monitoring undertakings.

Ms. Vanessa A. Countryman
U.S. Securities and Exchange Commission
October 13, 2023
Page 5 of 5

(d) an entity that performs one or more Covered Functions for a fund registered under the Investment Company Act of 1940, as amended; or

(e) a qualified custodian that is not otherwise excluded under this paragraph.

* * *

We appreciate the Commission's consideration of our comments on the Proposal and would be happy to provide any additional information that may be helpful. Please contact the undersigned at (202) 293-4222 if we can be of further assistance.

Respectfully Submitted,

/s/ Gail C. Bernstein

Gail C. Bernstein
General Counsel

/s/ William A. Nelson

William A. Nelson
Associate General Counsel

cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
The Honorable Jaime Lizárraga, Commissioner
William A. Birdthistle, Director, Division of Investment Management