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New Proposed Rules for Investment Adviser Outsourcing

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On October 26, 2022, the US Securities and Exchange Commission (the "SEC") proposed a new rule (206(4)-11) and amendments under the Investment Advisers Act of 1940 that prohibit registered investment advisers from outsourcing certain services or functions to service providers without first meeting certain minimum requirements.

Although investment advisers may achieve certain cost and other efficiencies by outsourcing certain functions, the proposed rule reflects the current Commission's apparent concern that current outsourcing may lack sufficient investment adviser oversight. The Commission thus proposed these new requirements in an effort to allow advisers to enjoy outsourcing benefits while also complying with certain minimum standards.

Summary of Proposed Rule and Amendments

Who does it apply to?

- The proposed rule would apply to registered investment advisers outsourcing covered functions to a service provider.

Who is considered to be a service provider?

- A person or entity that:
 - Performs one or more covered functions, and
 - Is not a supervised person of the adviser
- Note that there is no distinction between third-party providers and affiliated service providers.

What are covered functions?

- Covered functions are those that:
 - a. Are necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws, and
 - b. 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.
- Clerical, ministerial, and general office functions are excluded from this definition.

What are the requirements under the rule?

- Advisers must conduct reasonable due diligence before engaging a service provider to perform a covered function.
- The adviser must comply with the six specific elements identified in the proposed rule:
 - Identify the name and scope of the covered function of the service provider;
 - Identify how it will mitigate and manage the potential risk to clients relating to performance of the covered function by the service provider;
 - Determine that the service provider has the competence, capacity, and resources to perform its tasks in a timely and effective manner;
 - Assess the service provider's material subcontracting arrangements related to the covered function;
 - Obtain assurance from the service provider that it is willing and able to coordinate to comply with the Federal securities laws; and
 - Arrange a process for orderly termination of the service provider's performance of the covered function.
- The proposal would also require periodic monitoring of the service provider's performance and reassessment of the selection of the service provider under the due diligence requirements.
- And the proposal would amend the Advisers Act books and record rule to require advisers to make and retain specific records related to their due diligence assessment. The adviser would be required to:
 - Keep a record of the name of each service provider and the covered functions they perform; and
 - Keep a copy of any written agreement relating to such covered functions performed by the service provider.
 - These records will have to be maintained while the adviser outsources the covered function and for a period of five years thereafter.
- Finally, the proposal would add certain Form ADV disclosures about service providers that perform covered functions.

The current Commission appears split 3-2 on the proposal, based on statements released at the time of the proposal announcement. Concerns about the proposal from the minority of Commissioners include questioning the need for specific guidance in this area and the impact of the rule on smaller advisers. The majority of the Commissioners generally focused on the perceived need to emphasize advisers' oversight responsibilities and the prevalence of outsourcing in the investment advisory industry.

Public Comment

The SEC will accept comments on the proposal until the later of the 30 days after the proposal is published in the Federal Register, or until December 27, 2022.

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