U.S. Chamber of Commerce

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December 21, 2022

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

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

Dear Ms. Countryman:

The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness ("the Chamber") submits these comments in response to the recent rule proposal issued by the Securities and Exchange Commission ("SEC") regarding outsourcing by investment advisers ("the Proposal").

The Proposal[1] would establish a prescriptive and costly regulatory framework for investment advisers to follow when outsourcing certain services or functions to third party service providers. Compliance with the Proposal would be especially costly for small investment advisers and their retail investor clients. The Proposal puts in place a problematic set of incentives that encourages advisers to insource activities even though it may be more efficient and provide investors more protection if the adviser outsourced the activity to subject matter experts.

Yet nowhere in the Proposal is there adequate discussion or any compelling evidence to show that investment advisers are currently failing in their obligation to oversee third parties. As the Proposal itself notes, proper oversight of outside service providers is already widely understood to be part of an investment adviser's existing legal obligations. Investment advisers take this obligation seriously and often dedicate significant resources to oversee service providers. There is simply no data or track record of compliance failures that could justify the sweeping new mandates included in the Proposal.

Equally as concerning, the SEC has again limited the amount of time the public has to submit comments on a consequential rulemaking proposal, in this case providing only 30 days for comments to be submitted after the Proposal was published in the Federal Register. As the Chamber has argued in several recent comments to the SEC, the limitation of public feedback on rule proposals undermines the rulemaking process and increases the likelihood that final rules will cause unintended and harmful consequences for the capital markets and broader economy.

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[1] Securities and Exchange Commission, Release No. IA-6176; File No. S7-25-22 (October 26, 2022), available at https://www.sec.gov/rules/proposed/2022/ia-6176.pdf ("Proposal").

For all these reasons, the Chamber recommends that the SEC drop the Proposal in its entirety and instead re-focus its rulemaking agenda on efforts that would fulfill the SEC's mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.

The Chamber wishes to provide the following observations regarding the Proposal:

**I. The Proposal fails to appropriately consider the extent to which investment advisers already fulfill their legal obligations to oversee service providers and does not provide sufficient evidence of a regulatory failure;**

**II. Rooting the Proposal under section 206(4) of the Investment Advisers Act would allow the SEC to use its antifraud authority against investment advisers for even minor process infractions;**

**III. The Proposal would micromanage investment adviser oversight of third parties and impose one-size-fits-all regulation on all investment advisers;**

**IV. The Proposal's definitions of "covered functions" and "service provider" are unclear at best and could be viewed as elastic by regulated entities;**

**V. The Proposal's public disclosure of service providers is problematic and would create competitive and security risks for investment advisers;**

**VI. The Proposal is inexplicably silent regarding the outsourcing of proxy voting services to proxy advisory firms;**

**VII. The SEC has again provided the public an insufficient amount of time to comment on substantive changes in regulation and has failed to consider the cumulative economic impact of its current regulatory agenda.**

## Discussion

### I. The Proposal fails to appropriately consider the extent to which investment advisers already fulfill their legal obligations to oversee service providers and does not provide sufficient evidence of a regulatory failure.

Investment advisers have a fiduciary duty to their clients under the Investment Advisers Act of 1940. This obligation is comprised of a duty of care and a duty of loyalty and applies to all facets of a relationship between an adviser and its clients. The SEC has long taken a principles-based approach towards regulation of this fiduciary duty given the wide variety of facts and circumstances that may apply to a particular adviser-client relationship.

The Proposal itself notes that the hiring and oversight of third-party service providers is not outside the limits of an adviser's fiduciary obligations to its clients. As the Proposal states:

> Outsourcing a particular function or service does not change an adviser's obligations under the Advisers Act and the other Federal securities laws. In addition, the adviser is typically responsible for the advisory services through an agreement with the client that represents or implies the adviser is performing all the functions necessary to provide the advisory services. An adviser remains liable for its obligations, including under the Advisers Act, the other Federal securities laws and any contract entered into with the client, even if the adviser outsources functions.[2]

Advisers have long understood that it would be a violation of their obligations under the Advisers Act to hire an outside provider to perform services that are core to the advisers' business, then neglect to conduct proper due diligence and oversight regarding those activities. To the best of the Chamber's knowledge, there is no general view amongst investment advisers that they can "set and forget" their relationship with outside service providers.

Commissioner Peirce echoed this reality in her statement regarding the Proposal:

> The actual number of advisers who think that they are off the hook when it comes to outsourced services is likely negligible and, even if it is not, we do not need new rules to hold them to account…The fiduciary duty that attaches to an adviser is intrinsic to the role. While the scope of that duty will be interpreted within the context of the agreed-upon relationship with the client, the adviser cannot wish it away by deciding to contract out services to a third-party.[3]

Tellingly, the SEC provides no data or robust evidence that demonstrates or even suggests that there is a current overall lack of third-party oversight by investment advisers that the Proposal needs to rectify. The SEC's economic analysis estimates that advisers will only have an average of five covered functions. Yet, against that backdrop, the justification for the Proposal instead is largely explained through a litany of hypotheticals. The Proposal explains that investors *could* be harmed if an adviser outsources certain functions to a service provider without proper oversight. The Proposal also veers into a discussion about advisers conducting *too much* oversight of third parties, which the SEC says could create costs that outweigh benefits.[4]

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[2] Proposal, p. 13.
[3] Commissioner Hester Peirce, Outsourcing Fiduciary Duty to the Commission: Statement on Proposed Outsourcing by Investment Advisers (October 26, 2022), available at https://www.sec.gov/news/statement/peirce-service-providers-oversight-102622 ("Peirce Statement").
[4] Proposal, p. 8

The proposing release does cite a handful of recent enforcement actions and other developments as justification for new rules. However, as Commissioner Uyeda explained, it is unclear at best whether the facts and circumstances of some of these cases are applicable to the Proposal, or whether prescriptive rules regarding adviser oversight would have prevented any kind of negative outcome for investors.[5]

What is lost in the proposing release is that in all of the isolated examples used to justify the need for the Proposal, the current principles-based structure has worked. Further, it is clear based on the discussion in the Proposal about the SEC's enforcement actions that the SEC already has sufficient authority to take action against advisers for violations of their fiduciary duties related to service provider oversight. If the SEC decides to move forward with this Proposal, which we believe would be ill-advised, we recommend that it continue to take a principles-based approach.

## II. Rooting the Proposal under section 206(4) of the Investment Advisers Act would allow the SEC to use its antifraud authority against investment advisers for even minor process infractions.

The Proposal would be promulgated under section 206(4) of the Investment Advisers Act, which makes it unlawful for an investment adviser to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." In dissenting from the Proposal, Commissioner Peirce stated:

> An adviser need not engage in a fraudulent, deceptive, or manipulative act, practice, or course of business to fall afoul of the rule, but any resulting enforcement charges likely will include section 206(4), which could lead people to believe that the adviser has engaged in much more nefarious conduct.[6]

The Chamber echoes this concern, as the reputational damage to investment advisers for even a minor infraction under the proposed rules would be severe. Section 206(4) exists to protect against serious violations of customer trust and to take actions against individuals that engage in fraudulent or egregious behavior. The Proposal effectively treats every error – no matter how minor - made by a service provider as a regulatory failure by the investment adviser to properly oversee that service provider – and then classifies that regulatory failure as a violation of the SEC's antifraud rules. The headline of an eventual enforcement action could read something to the effect of "Adviser Commits Fraud." That would be a fundamentally misleading and unfair outcome but would be made fully possible under this Proposal. Accordingly, we urge the SEC to re-think its entire approach to this issue and whether new rules – particularly rooted under section 206(4) – are warranted.

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[5] Commissioner Mark Uyeda, Statement on Proposed Rule Regarding Outsourcing by Investment Advisers (October 26, 2022), available at https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622.
[6] Peirce Statement.

## III. The Proposal would micromanage investment adviser oversight of third parties and impose one-size-fits-all regulation on all investment advisers.

The Proposal sets forth six specific elements of service provider oversight that an investment adviser would have to follow regardless of an adviser's size, and the service provider's importance, capabilities, and mission-critical day-to-day risk to the business. Advisers would be required to:

(I) Identify the nature and scope of the covered function the service provider is to perform;

(II) Identify and determine how it would mitigate and manage the potential risks to clients or to the investment adviser's ability to perform its advisory services, resulting from engaging a service provider to perform a covered function and engaging that service provider to perform the covered function;

(III) Determine that the service provider has the competence, capacity, and resources necessary to perform the covered function in a timely and effective manner;

(IV) Determine whether the service provider has any subcontracting arrangements that would be material to the service provider's performance of the covered function, and identifying and determining how the investment adviser will mitigate and manage potential risks to clients or to the adviser's ability to perform its advisory services in light of any such subcontracting arrangement;

(V) Obtain 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

(VI) Obtain reasonable assurance from the service provider that it is able to, and will, provide a process for orderly termination of its performance of the covered function.

While parts of the release, such as those concerning due diligence and recordkeeping, are extremely prescriptive, contained within these six elements are a number of considerations that are excessively broad and ill-defined. The proposing release states that investment advisers "could" or "should" factor these unclear considerations into their compliance programs. These considerations will likely be read as *de facto* mandates for investment advisers and will serve to micromanage the way in which advisers conduct oversight of all their service providers, to the detriment of the efficiency gains that many advisers currently have by taking a risk-based approach to service provider oversight.

The proposed elements of oversight also create practical problems for advisers. For example, the requirement regarding subcontracting arrangements does not consider the fact that advisers typically are not able to compel a third party to provide commercially sensitive information about their subcontractors. This requirement would therefore be

impossible for advisers to comply with in some cases, or cause advisers to renegotiate contracts with certain service providers – a costly and uncertain process. The Proposal does not properly consider either of these outcomes or the associated costs that would fall on investment advisers and their clients.

Additionally, the Proposal would likely create conflicting and redundant standards for some investment advisers. For example, national banks, including national banks with affiliated registered investment advisers, already follow comprehensive guidance focused on third-party risk management and oversight. OCC Bulletin 2013-29 outlines the obligations of national banks to ensure an "effective risk management process," throughout the lifecycle of a third-party relationship.[7] Similar to the Proposal, this includes obligations related to how a bank selects, assesses, and oversees third-party relationships. These existing obligations apply to third parties that perform critical activities today, including third parties that perform critical functions for bank-affiliated registered investment advisers. In contrast to the Proposal, however, the OCC Bulletin 2013-29 underscores third-party risk management should be "commensurate with the level of risk and complexity of its third-party relationships."

The one-size-fits-all approach taken by the Proposal will prove to be costly for investment advisers and their clients without enhancing the existing level of service provider oversight. The inflexible requirements of the Proposal will also fail to evolve as technology and innovation continue to develop, depriving advisers and their clients from the benefits that derive from those efficiency improvements.

The impact of the rule will be especially problematic for small advisers who do not have the same compliance resources as their larger counterparts and may not have the market power to compel certain service providers to modify contracts in order to assist that adviser with compliance. Many such advisers have already made determinations that outsourcing certain services is in the best interest of clients and that third parties can perform certain functions more effectively. The Proposal will create a scenario where small advisers and their clients either pay the excessive costs of new rules or bring certain services back in-house. Either outcome raises the possibility of harm to investors, who have benefited from advisers being permitted to select "best of breed" solutions from third parties with subject matter expertise. Mandating a prescriptive compliance framework unrelated to demonstrated risk and with higher associated costs will deprive many investors of the efficiencies and benefits of appropriate outsourcing.

Some asset management firms may have centralized groups (e.g., regulatory compliance, trading desk, investment risk, valuation, client services, etc.) that provide support and services to a number of internal registered investment advisers, but they do not provide actual investment advice. While these groups may not be housed within the legal entity that is the registered investment adviser, they effectively function as one entity, subject to the adviser's supervisory control system. Whether an asset management firm has a matrix

[7] Office of the Comptroller of the Currency, Third-Party Relationships: Risk Management Guidance, OCC Bulletin 2013-29 (October 30, 2013), available at https://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html.

structure or houses everything in one legal entity should not change the regulatory requirements. There is simply no rational basis for treating services provided by these employees as "outsourced" under the Proposal. Potential new rules should not apply to internal support groups that are wholly owned by the same entity as the registered investment adviser (i.e., under common control).

## IV. The Proposal's definitions of "covered functions" and "service provider" are unclear at best and could be viewed as elastic by regulated entities.

The Proposal defines a covered function as (1) those [functions] necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws; and (2) those 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.[8] The Proposal cites potential examples of what would be included under the definition of "covered function," including functions involving the adviser's investment decision-making process and portfolio management, portfolio accounting services, and certain technology or software services. The Proposal only provides for a narrow list of potential exclusions from the definition of "covered function," including functions performed by marketers or solicitors, along with clerical, ministerial, utility, or general office functions or services.

This broad interpretation of a "covered function" will put advisers in a difficult position. If an adviser takes an overly inclusive approach in determining what functions are covered under the Proposal, that adviser and its clients will be burdened with spending an enormous number of resources to comply with new requirements, despite the questionable benefit of such additional measures to investors. However, if an adviser takes a more under-inclusive approach based upon their interpretation of the SEC's murky definition, they run the risk of committing a minor process deficiency and a potential enforcement action by the SEC. Put another way, an adviser who conducts (entirely sufficient) oversight of a third party that is performing certain functions may make a reasonable determination that those functions do not necessarily meet the proposed definition of "covered function." However, the Proposal would allow the SEC to second-guess those decisions and bring enforcement actions based on minor process fouls, even if there was no resulting harm to investors or evidence that the adviser abjectly failed to oversee the activities of a service provider.

A "service provider" is defined by the Proposal as a person or entity that (1) performs one or more covered functions; and (2) is not a supervised person of the adviser. Similar to the definition of a "covered function," exclusions to the service provider definition are narrow in scope. The Proposal also explicitly states that both affiliated and SEC-regulated service providers would be covered by the rule.

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[8] Proposal, p. 20.

At an absolute minimum, affiliated and regulated service providers should be excluded from any consideration of new mandates. In terms of affiliated services providers, advisers of large institutions frequently leverage the function of teams or individuals within their organization who are perceived and treated as part of the adviser but are technically employed by separate legal entities under common control. Imposing a diligence obligation on affiliated service providers simply because the service provider is legally distinct from the adviser would create an unjustified obligation for an adviser to conduct diligence on itself.

The Proposal should also exclude other regulated service providers, such as broker-dealers or other service providers that have their own compliance obligations under the federal securities laws. An adviser that acts as service provider to other advisers would be required not only to establish processes to comply with the oversight obligations of those advisers, but then also create frameworks of engagement and oversight for its own service providers. This will create an unduly onerous system focused on meeting the rule requirements rather than the performance of the covered function. The Proposal is unnecessary for service providers that are overseen by the SEC or other regulators.

The SEC's economic analysis appears to be at odds with the contextual definitions in both the text and the proposed rule estimating that advisers will only have an average of five covered functions. In order to arrive at that narrow estimate, the SEC's economic analysis appears to apply a much narrower definition and set of standards used to identify what constitutes "critical" outsourced functions for the purpose of the Proposal. If the SEC is able to articulate and demonstrate through data a regulatory need for the Proposal, then it should repropose the rulemaking based on the definition that was used to arrive at the economic analysis estimates.

Furthermore, as part of any rulemaking process, the SEC is required to identify reasonable alternatives to any proposal under consideration and explain why any such alternatives would not achieve the stated regulatory objectives. Many investment advisers are already complying with rules specific to third-party relationships.[9] It is entirely material to the SEC's analysis that existing rules from self-regulatory organizations serve the same intended purpose as this rulemaking, and this fact should have been addressed in the Proposal. For firms already complying with similar rules, the SEC's proscriptive requirements would result in significant costs to comply. However, it is unclear that the SEC's approach would provide incremental benefits.

While the Proposal takes an expansive view of both covered functions and service providers, it appears to deliberately exclude both proxy voting and proxy advisory firms. Our concerns and views on that matter are discussed in further detail below.

[9] Self-regulatory organizations such as the Financial Industry Regulatory Authority and National Futures Association maintain rules specific to third-party relationships.

## V. The Proposal's public disclosure of service providers is problematic and would create competitive and security risks for investment advisers.

The Proposal would mandate that investment advisers publicly disclose service providers who perform covered functions. While the benefit of making such disclosure public is not readily apparent, the risks to advisers are of great concern. The SEC indicates in the Proposal that the main benefit of service provider identification would be to the SEC itself, which could then assess potential service provider conflicts and "serve as an input to the risk metrics by which [SEC] staff identifies potential risk and allocates examination resources."[10]

Confidential disclosure to the SEC could accomplish the same goals as the Proposal without creating the competitive and security risks inherent in public disclosure. Public disclosure is at odds with the SEC's focus on cybersecurity. Individual disclosures can provide an indication of where sensitive investor identification data may be located. While the Proposal seeks to use Form ADV to identify service concentration risks, its public disclosure easily introduces systemic risk.

Public disclosure could distort the competitive dynamics between advisers. Some of the critical outsourced services that an adviser may use (AI, valuation, alternative data sources and analytics) to form their investment decisions and how an adviser chooses to implement an investment strategy is arguably a form of intellectual property that differentiates each adviser's approach and performance. This Proposal makes those relationships public, which could adversely impact competitive dynamics among advisers.

Furthermore, a service provider may not ultimately agree by contract to have their information disclosed publicly due to concerns that it could subject that service provider to SEC regulation. Some investment advisers may not have the ability therefore to compel such disclosure due to market dynamics between advisers and service providers. The Proposal is notably silent on that risk and the potential for advisers being forced to insource certain activities.

The Proposal's public disclosure requirement would also be a global outlier when compared to oversight frameworks in other countries, for example in the United Kingdom, Australia, and Singapore.

## VI. The Proposal is inexplicably silent regarding the outsourcing of proxy voting services to proxy advisory firms.

As this letter makes clear, the Chamber questions the entire purpose and rationale behind this rulemaking effort and is skeptical that any new rules are necessary to regulate outsourcing by investment advisers. Still, it is difficult to comprehend how the SEC could propose a rule on this topic and make no mention whatsoever of proxy advisory firms.

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[10] Proposal, p. 75.

Proxy voting is a core component of an investment adviser's fiduciary duty, a fact the SEC has reminded advisers on many occasions over the years. SEC staff has also opined on the importance of investment adviser oversight of proxy voting service providers, including proxy advisory firms. As articulated previously by Staff Legal Bulletin 20:

> "The staff believes that an investment adviser that has retained a third party (such as a proxy advisory firm) to assist with its proxy voting responsibilities should, in order to comply with the Proxy Voting Rule, adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients."[11]

Proxy advisory firms would appear to be tailor-made for this proposed regulation. This industry has a long history of operating with conflicts of interest, little transparency, and providing services of questionable quality to investment advisers – all problems that the Proposal ostensibly tries to address. It is entirely reasonable to think that proxy advisory firms would at least make a single appearance in this 232-page rulemaking effort, and the absence of even a mention is more than notable.

Recent research has also shown that some investment advisers may still engage in the practice of "robovoting," in which they automatically follow the voting recommendations of proxy advisory firms while conducting insufficient due diligence regarding the analysis or potential behind those recommendations.[12] For these reasons, the Chamber strongly supported reforms to the proxy advisory system adopted by the SEC in 2020.

Given the SEC's longstanding position regarding the importance of proxy voting decisions and the oversight of proxy advisory firms to an adviser's fiduciary duty, it is hard to imagine how the Proposal could not consider proxy voting recommendations to be a "covered function" or proxy advisory firms to be a covered "service provider." The only possible explanation is that exclusion of proxy advisory firms is part and parcel of the SEC's ongoing efforts to weaken the 2020 proxy reforms and curtail oversight of the proxy advisory industry. In our view, this only further taints the Proposal as an ill-conceived project that will do little or nothing to protect investors.

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[11] SEC Staff Legal Bulletin No. 20 (June 30, 2014), available at https://www.sec.gov/investment/slb20-proxy-voting-responsibilities-investment-advisers.

[12] Proxy Advisors and Market Power: A Review of Institutional Investors Robovoting. Paul Rose (Report of the Manhattan Institute) (April 2021), available at https://media4.manhattan-institute.org/sites/default/files/proxy-advisors-market-power-review-investor-robovoting-PR.pdf.

## VII. The SEC has again provided the public an insufficient amount of time to comment on substantive changes in regulation and has failed to consider the cumulative economic impact of its current regulatory agenda.

The Chamber and many other organizations have consistently communicated our concerns over the unusually short comment periods the SEC has allowed to respond to a wide array of new and complex proposals. Most of these proposals are hundreds of pages in length and collectively ask thousands of questions on highly technical and complex matters. The comment period provided for the Proposal was only 30 days, similar to many other rule proposals that the SEC has issued over the last 18 months. This is simply an insufficient amount of time for the public to identify every potential unintended consequence that could result from this rulemaking initiative, and it increases the likelihood that the costs of any final rule will vastly outweigh the benefits. Together with other organizations, on November 16, 2022, the Chamber requested the SEC to extend the comment period an additional 90 days given the "breadth, economic and operational significance, and complexity" of the Proposal so that all interested parties can "benefit from a deliberate, orderly, and timely process for developing and formulating major regulatory policy decisions."[13]

Moreover, investment advisers are already dealing with potential ramifications of pending rules involving new mandates for private funds, environmental, social, and governance (ESG) disclosures, climate change disclosures, and other matters. There is no discussion whatsoever in the Proposal about the cumulative impact of these rule proposals and potential costs to investment advisers and the overall economy.

## Conclusion

For all of the reasons outlined in this letter, we urge the SEC to drop this Proposal in its entirety and to instead refocus its rulemaking agenda on efforts that would fulfill the SEC's tripartite mission. The Chamber looks forward to continuing to serve as a resource for SEC commissioners and staff on this and other important policy matters.

Sincerely,

Kristen Malinconico
Director
Center for Capital Markets Competitiveness
U.S. Chamber of Commerce

[13] Joint Trades Letter to the SEC (November 16, 2022), available at https://www.centerforcapitalmarkets.com/wp-content/uploads/2022/11/SEC-Comment-Letter-from-LSTA-et-al.-2022.11.16.pdf?#.