

**Outsourcing and Vendor Due Diligence
(Smaller and Medium Firms)**

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Investment Adviser Association Compliance Conference

March 8, 2024

On October 26, 2022, the U.S. Securities and Exchange Commission (“SEC”) proposed rule 206(4)-11 (the “Proposed Rule”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) regarding outsourcing by investment advisers.¹ While the Proposed Rule is still pending, it continues to be listed as one of the rules that is in the final rule stage on the SEC’s Fall 2023 Agency Rule List.² The Proposed Rule provides a more prescriptive approach to outsourcing, and articulates specific requirements that must be met to satisfy an investment adviser’s fiduciary duties when outsourcing. The Proposal also includes new recordkeeping requirements and amendments to Form ADV Part 1A, which will require certain census-type information about an investment adviser’s service providers.

The SEC issued the Proposal to seek to address the increased use of outsourcing by investment advisers and the risks that accompany outsourcing of certain types of functions. The SEC expressed concern that outsourcing, in many cases, relates to functions that are critical to the investment adviser’s business. The SEC notes that outsourcing of certain types of functions, without proper oversight by the investment adviser, creates or otherwise increases the risk that clients could be significantly harmed, particularly if the services are not performed or performed in a negligent manner. Therefore, the SEC issued the Proposal, which seeks to provide an oversight framework for investment adviser outsourcing, which the SEC believes will further an adviser’s compliance with its fiduciary responsibilities.

Why are investment advisers increasingly turning to outsourcing?

There are many reasons why an investment adviser may turn to outsourcing, particularly for smaller and medium-sized firms. Outsourcing can reduce risk, costs or other burdens on an investment adviser to perform certain functions. Outsourcing can also be used to access

¹ Outsourcing by Investment Advisers, 87 Fed. Reg. 68816 (Nov. 16, 2022), available at <https://www.sec.gov/files/rules/proposed/2022/ia-6176.pdf> (the “Proposal”).

² Office of Management and Budget, Office of Information and Regulatory Affairs, Agency Rule List – Fall 2023, available at: https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235&csrf_token=486A7B8189805E1B9B94CC2326F47332ECFDB6F679CA67A030DB218B3A5203ADA8D6590412C365766E0A82575A97FE5FACB7

specialized expertise to perform complex functions, thereby avoiding the need to invest in significant infrastructure and personnel. For example, an investment adviser may outsource middle and back-office functions to a third-party service provider whose entire business is dedicated to providing these functions. Such a service provider will have the infrastructure, systems, capabilities and expertise necessary to perform these functions and can oftentimes provide turnkey solutions to an investment adviser. Moreover, service providers generally can provide the outsourced services with more rigor, process and oversight than an investment adviser may reasonably be able to do on its own. Outsourced service providers oftentimes can offer their services at scale, which is much more economical for the investment adviser than building out the needed capabilities itself. Outsourcing can therefore result in investment advisory clients paying lower fees while obtaining better quality services.

Isn't an investment adviser already required to oversee its service providers?

Investment advisers are required to adopt and implement written policies and procedures that are reasonably designed to prevent violation by the adviser or its supervised persons of the Advisers Act.³ There isn't a current rule that dictates the manner and methods by which an investment adviser supervises an outsourced service provider. While the Proposed Rule does not require an investment adviser to specifically adopt policies and procedures related to outsourcing, if adopted as proposed, investment advisers would be required to adopt such policies and procedures, where applicable, to prevent a violation of the Advisers Act.

What does the Proposed Rule require?

The Proposed Rule would require investment advisers to:

- conduct due diligence prior to engaging a service provider to perform certain services or functions; and
- periodically monitor the performance and reassess the retention of the service provider in accordance with certain due diligence requirements to reasonably determine that it is appropriate to continue to outsource those services or functions to that service provider.

The Proposal would also:

- amend Part 1A of Form ADV to collect census-type information about each of an investment adviser's service providers; and
- amend the Advisers Act books and records rule (Rule 204-2), including a new provision requiring investment advisers that rely on a third-party to make and/or keep books and records requiring the adviser to (i) document the due diligence conducted,

³ See Rule 206(4)-7 under the Advisers Act.

(ii) maintain a copy of any agreements entered into with a service provider regarding covered services, and (iii) maintain records documenting the periodic monitoring of each third-party service provider (collectively, the “Proposed Recordkeeping Amendments”).⁴

Who is a Service Provider?

Under the Proposed Rule, a Service Provider is an entity that performs a Covered Function (defined below) and is not a “supervised person”⁵ as defined in the Advisers Act.⁶

What is a Covered Function?

Under the Proposed Rule, there isn’t a finite list of Covered Functions as each potential service provider and the services it will perform would need to be evaluated on a case-by-case basis. Additionally, a service or function may be a covered function for one investment adviser but may not be a covered function for another investment adviser depending on how the service is used.

Under the Proposed Rule, a Covered Function is defined as:

- a function or service that is necessary for the investment adviser to provide its investment advisory services in compliance with the Federal securities laws, and
- 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.
- A Covered Function does not include clerical, ministerial, utility, or general office functions or services.⁷

Proposed Non-Exhaustive List of Covered Functions:

- functions or services that are related to an adviser’s investment decision-making process and portfolio management
- providing investment guidelines (including maintaining restricted trading lists)
- creating and providing models related to investment advice

⁴ See Proposed Rule 204-2.

⁵ See Section 2(a)(25) of the Advisers Act. A supervised person is defined as any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.

⁶ Proposed Rule 206(4)-11(b).

⁷ *Id.*

- creating and providing custom indexes
- providing investment risk software or services
- providing portfolio management or trading services or software
- providing portfolio accounting services
- providing investment advisory services to an adviser or the adviser's clients
- services to identify which portfolios to include or exclude in a trade
- determining how to allocate a position among portfolios and submitting final orders to a broker
- outsourced compliance functions, such as regulatory filings or any other services to assist an investment adviser with complying with regulatory requirements
- a sub-adviser who manages client investments
- affiliated entities (even those that are otherwise regulated entities (either under the Advisers Act or any other Federal securities law) and those entities that are in a control relationship with the investment adviser.⁸

Proposed Non-Exhaustive List of Activities that Would not be Covered Functions:

- clerical, ministerial, utility, or general office functions or services⁹
- an investment adviser's lease of commercial office space or equipment
- use of public utility companies, utility or facility maintenance services,
- licensing of general software providers of widely commercially available operating systems, word processing systems, spreadsheets or other similar off the shelf software.

These functions are proposed to be excluded because they are not necessary for an investment adviser to provide investment advisory services in compliance with the Federal Securities laws.

Many investment advisers obtain technological solutions that are integral to an adviser's investment decision making processes, portfolio management or other functions that are necessary for the adviser to provide its investment advisory services (e.g., artificial intelligence or software as a service). Importantly, in 2018, the SEC settled an enforcement action against an investment adviser that used models and volatility guidelines from a third-

⁸ The Proposal notes that risk still exists if an investment adviser outsources to an unaffiliated entity or an affiliated entity. Proposal at 26.

⁹ Proposed Rule 206(4)-11(b).

party sub-adviser without first ensuring that the models worked as intended.¹⁰ The Proposal specifically notes that when engaging a third-party technology provider, an investment adviser may not (which also means an adviser may) need to conduct a detailed analysis and review of the underlying computer code but the investment adviser should have a reasonable understanding of how the technology is intended to operate and determine that the technology operates as intended. Depending on the type of technology, there may be other relevant considerations based on the applicable facts and circumstances. Given the move to greater automation and the substantial use of third-party technology solutions, enhancing an investment adviser's due diligence practices may warrant significant consideration.

What is a "Material Negative Impact"?

The second prong of a Covered Function includes those that, if not performed or performed negligently, would be reasonably likely to cause a *material negative impact* on the investment adviser's clients or on the investment adviser's ability to provide investment advisory services. (*emphasis added*) Under the Proposal, a material negative impact would depend on the particular facts and circumstances, but would include a material financial loss to a client or a material disruption in the investment adviser's operations resulting in the inability to effect investment decisions or to do so accurately.¹¹ The Proposal suggests that an investment adviser should consider a variety of factors when determining what would be reasonably likely to have a material negative impact on a client, such as the day-to-day operational reliance on the service provider, the existence of a robust internal backup process at the investment adviser, and whether the service provider is making or maintaining critical records.¹²

What are the proposed initial due diligence requirements?

Under the Proposal, before engaging a Service Provider, an investment adviser would be required to reasonably identify and determine that it would be appropriate to outsource a Covered Function and it would be appropriate to select the Service Provider by:

- Identifying the nature and scope of the Covered Function(s) the Service Provider is proposed to perform;
- Identifying and determining how the investment adviser will mitigate and manage, the potential risks to clients or to the investment adviser's ability to perform its

¹⁰ See *In the Matter of Aegon USA Investment Management, LLC, et al*, Investment Advisers Act Rel. No. 4996 (Aug. 27, 2018). In this action, four affiliated adviser entities agreed to pay nearly \$53.3 million in disgorgement, \$8 million in interest, and a \$36.3 million penalty.

¹¹ Proposal at 24

¹² *Id.*

advisory services resulting from the engagement of that Service Provider to perform the Covered Function;

- Determining that the Service Provider has the competence, capacity, and resources necessary to perform the Covered Function in a timely and effective manner;
- Determining 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 investment adviser's ability to perform its advisory services in light of any such subcontracting arrangement;
- Obtaining reasonable assurance from the Service Provider that it is able to, and will, coordinate with the investment adviser for purposes of the investment adviser's compliance with Federal securities laws, as applicable to the Covered Function; and
- Obtaining 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.¹³

Under the Proposal, investment advisers would have to engage in this due diligence prior to onboarding a new Service Provider or adding services to an existing Service Provider engagement. Due diligence must be reasonably tailored to the function or services that are proposed to be outsourced to the Service Provider. The Proposal states that whether an investment adviser's due diligence is reasonable would depend on the facts and circumstances of the services and the service provider.¹⁴

(Collectively, these are referred to herein as the "Proposed Initial Due Diligence Requirements")

What are the proposed ongoing due diligence requirements?

Under the Proposed Rule, an investment adviser must periodically monitor the Service Provider's performance of any Covered Function and reassess the retention of the Service Provider in accordance with the Proposed Initial Due Diligence requirements.¹⁵ Due diligence activities would be undertaken in a manner and frequency so that the investment adviser can reasonably determine that it is appropriate to continue to outsource the Covered Function and that it remains appropriate to continue to outsource the Covered Function to the Service Provider.¹⁶

¹³ Proposed Rule 206(4)-11(a)(1)(i)-(v).

¹⁴ Proposal at 43.

¹⁵ See Proposed Rule 206(4)-11(a)(2).

¹⁶ *Id.*

The Proposal also includes examples of methods of monitoring, including, automated reviews of Service Provider data feeds, periodic meetings with the Service Provider to review service metrics, or contractual obligations to test and approve new systems prior to implementation.¹⁷

What initial due diligence records would an investment adviser have to retain under the Proposal?

The Proposal would amend Rule 204-2 under the Advisers Act (the “Proposed Recordkeeping Amendments”)¹⁸ to require specific records to be maintained in support of the selection and ongoing retention of a Service Provider. In particular, the Proposed Recordkeeping Amendments would require an investment adviser to maintain the following records:

- A list or other record of Covered Functions that the investment adviser has outsourced to a Service Provider, including the name of each Service Provider, a record of the factors, corresponding to each listed function, that led the investment adviser to list it as a Covered Function on Form ADV (see “What are the Proposed Amendments to Form ADV” below);
- Records documenting the due diligence assessment conducted pursuant to Proposed Rule 206(4)-11, including any policies and procedures or other documentation as to how the investment adviser will comply with applicable due diligence requirements related to conflicts of interests;
- A copy of any written agreement, including any amendments, appendices, exhibits, and attachments, entered into with a Service Provider regarding Covered Functions.

The Proposed Recordkeeping Amendments require such books and records to be maintained in an easily accessible place throughout the time period during which the investment adviser has outsourced a Covered Function to a Service Provider and for a period of five years thereafter.¹⁹

What records would an investment adviser have to retain relating to Service Provider monitoring?

The Proposed Recordkeeping Amendments would require an investment adviser to make and retain records documenting the periodic monitoring of a Service Provider of a Covered Function.²⁰ The Proposal suggests some examples of information that investment advisers should consider, where applicable:

¹⁷ Proposal at 68.

¹⁸ Proposed Rule 204-2(a)(24).

¹⁹ See Proposed Rule 204-2(e)(4).

²⁰ See Proposed Rule 204-2(a)(24)(iv).

- performance reports received from the Service Provider;
- the time, location and summary of findings of any financial, operational or third-party assessments of the Service Provider;
- identification of any new or increased Service Provider risks and a summary of how the investment adviser will mitigate and manage those risks;
- any amendments to written agreements with a Service Provider;
- the adviser's written policies and procedures applicable to monitoring;
- a record of any changes to the nature and scope of the Covered Function the Service Provider is to perform; and
- and a record of any inadequate or failed performance by a Service Provider of a Covered Function and responses from the adviser.²¹

These records would be required to be maintained in an easily accessible place while the investment adviser outsources the Covered Fund and for a period of five years after the investment adviser ceases outsourcing the Covered Function.²² The SEC noted that these records would help it assess an investment adviser's compliance with the Proposed Rule.

Do the Proposal apply to outsourced recordkeeping?

Many advisers outsource certain recordkeeping functions. This includes when an investment adviser retains a Service Provider to maintain and store certain required records created by the Service Provider. Accordingly, an investment adviser may not maintain all of the records that it is required to store based on its business activities. Notwithstanding whether a required record is created by the investment adviser or a Service Provider, the adviser is responsible for complying with the Advisers Act recordkeeping requirements and those required by other Federal securities laws.

Proposed Rule 204-2(l) therefore would require every investment adviser that relies on a third-party to make or keep any required adviser books and records, to develop a comprehensive oversight framework consisting of due diligence and monitoring requirements (similar to oversight of other Service Providers). This oversight framework is designed to protect against loss, alteration, or destruction of an adviser's records and help to ensure that those records are available to the adviser and the SEC staff upon request. The Proposal notes that this specifically includes cloud service providers whereby the investment adviser should have a reasonable understanding of the cloud service and the risks of the service and be able to conclude that it can mitigate and manage those risks. The

²¹ See Proposal at 69-70.

²² See Proposed Rule 204-2(e)(4).

Proposal suggests that an investment adviser could review the following, during its diligence of a cloud service provider:

- Comparative cloud-based recordkeeping services, including their respective parameters, benefits, and risks;
- The cloud service provider's capability and experience with making and/or keeping records required under the recordkeeping rule;
- The cloud service's compliance and operational policies and procedures for the protection of data, and its policies and procedures addressing the maintenance and oversight of the data;
- The cloud service's prevention and detection of, and response to, cybersecurity threats; and
- The experience or lack thereof of other similarly situated advisers that have previously engaged the cloud service and any risks identified in those experiences or lack thereof.²³

Once a third-party recordkeeper is retained, an adviser would be required to monitor the third-party's performance of the recordkeeping function and reassess the retention of the third-party similar to the requirements for other Service Providers. Methods for monitoring and the frequency can vary based on the recordkeeping services provided (e.g., cloud vs. physical storage).

Additionally, an investment adviser would be required to obtain reasonable assurances from the Service Provider that:

- it will adopt and implement internal processes and/or systems for making and/or keeping records on behalf of the investment adviser that meet all of the requirements of the recordkeeping rule;
- when making and/or keeping records on behalf of the adviser, the Service Provider will, in practice, actually make and/or keep records in a manner that will meet all of the requirements of the recordkeeping rule as applicable to the investment adviser;
- the Service Provider will allow the investment adviser and SEC staff to access the records easily through computers or systems during the required retention period of the recordkeeping rule; and
- arrangements will be made to ensure the continued availability of records that will meet all of the requirements of the recordkeeping rule as applicable to the

²³ Proposal at 83-84.

investment adviser in the event that the Service Provider ceases operations or the relationship with the investment adviser is terminated.²⁴

What are the Proposed Amendments to Form ADV?

The Proposal includes amendments to Form ADV Part 1A, which would require advisers to:

- identify service providers that perform Covered Functions;
- provide the location of the office principally responsible for the Covered Functions;
- provide the date the Service Provider was first engaged to provide Covered Functions; and
- state whether they are a related person²⁵ of the investment adviser.

The Proposal would also require an investment adviser to categorize and report those Covered Functions or services provided by each Service Provider from predetermined categories of Covered Functions, which are proposed to include:

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| ▪ Adviser / Sub-Adviser | ▪ Pricing |
| ▪ Client Services | ▪ Reconciliation |
| ▪ Cybersecurity | ▪ Regulatory Compliance |
| ▪ Investment Guideline / Restriction Compliance | ▪ Portfolio Management (excluding Adviser / Subadviser) |
| ▪ Investment Risk | ▪ Trade Communication and Allocation |
| ▪ Trading Desk | ▪ Valuation |
| ▪ Portfolio Accounting | ▪ Other |

If a Covered Function does not fit in a pre-defined category, the investment adviser may use the “Other” category. This information would be publicly available.

Compliance Consideration and Recommendations

While the Proposal has not been finalized, compliance officers should, as a best practice, review their existing diligence practices. Below are some examples of questions you may wish to consider when conducting such a review. Additionally, any evaluation of your

²⁴ See Proposed Rule 204-2(l)(2)(i)-(iv).

²⁵ A related person is defined in the Glossary of Terms to Form ADV as any advisory affiliate and any person that is under common control with the adviser.

diligence practices should be based on the nature of the investment adviser's business, the specific relationship and risks associated with the applicable Service Provider and the functions or services performed.

- Does your firm have a due diligence process? Are there any guidelines regarding when due diligence is necessary and who is responsible for it? What does the diligence process entail? Are these practices appropriate to evaluate the service provider and the services to be provided?
- Are the correct people/teams at the investment adviser evaluating each Service Provider? Is due diligence scaled based on the services to be provided and risks presented to investment adviser and its clients? How are Service Provider risks evaluated and mitigated?
- What information is obtained and reviewed when a new vendor is onboarded (in addition to the sales materials, slide decks, contracts and service levels, if any)? Are there standards of information that must always be obtained from the service provider and reviewed, e.g., as applicable, financial information, management teams, compliance and regulatory background, business continuity plan, information security program, technological interfacing, third-party evaluations, such as a SOC1/SOC2, etc.
 - All diligence materials must be reviewed. It is important to go through the materials in detail to look for any red flags or concerns about the service provider and its offering.
- What kind of ongoing monitoring is performed on service providers? Do you obtain and review updated diligence materials, do onsite visits, or use other methods to re-evaluate the proposed services? Has the scope of services evolved? Does the vendor have any material updates to its business, management, personnel, regulatory history or manner in which it is providing its services? These analyses must be tailored to the facts and circumstances based on the nature of the relationship and services provided.
 - Review your documentation around your diligence processes. For example, if an on-site diligence visit occurs, be sure and document that along with any information learned and reviewed. Do you keep thorough records of diligence activities?
 - If you become aware of an issue with a service provider (e.g., a critical outage that affects the service provider's ability to provide its services or a regulatory enforcement action) it is very important to follow-up promptly on these matters to understand (i) the nature of the issue, (ii) the steps being taken to promptly correct the issue, (iii) any impact on the services that were provided

to the investment adviser or its clients, (iv) what the vendor is doing to correct the matter, and (v) what will be done to ensure that the issue (or any similar issues) does not recur. Service providers do not always proactively reach out on these matters, so it is important to be vigilant in understanding the implications of issues when they arise.

- Do you need to review your existing, or develop standard, contract clauses that you require when entering into outsourcing agreements? For example, you may seek to have a contractual right to conduct onsite due diligence visits, or you may want the service provider to be obligated to provide required records it is maintaining within a certain period of time. You may also want to consider requiring a service provider to proactively inform the investment adviser of certain events (e.g., loss of any applicable registration that is required to perform the services, claims on insurance, regulatory matters, key man departures, material errors, data security or BCP events etc.). These are just examples. Contractual provisions should be considered in light of the nature of the arrangement between the adviser and the service provider.
- Recordkeeping
 - How is recordkeeping currently addressed with an adviser's service providers? Do the service providers have an obligation to maintain required records for the adviser? If so, does the service provider have appropriate recordkeeping policies and procedures for any records it maintains on the adviser's behalf?
 - Have you ensured that your service providers have appropriate backup systems for adviser records to ensure that they are not lost, altered or deleted?
 - Have you conducted any testing on whether the service provide can produce any adviser required records in a timely fashion and in a manner that is acceptable for your needs?
 - Have you listed all service providers that maintain required records in Form ADV Part 1A, Item 1.L?