

# 2024 / Investment Adviser Compliance Conference

MARCH 6-8 / WASHINGTON, DC

EFFECTIVE STRATEGIES & BEST PRACTICES

## Outsourcing and Vendor Due Diligence

Smaller and Medium Firms

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## Fiduciary Obligations of Investment Advisers

### Fiduciary Standard

- ❖ Duty of Care – act in client’s best interests
- ❖ Duty of Loyalty – prevent, mitigate and disclose conflicts

These standards apply to “supervised persons” but also apply to the oversight of third parties that perform certain functions for the adviser

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## Why Outsource?

- ❖ Technical expertise
- ❖ Less expensive than building out functionality
- ❖ Lack of appropriate personnel
- ❖ Efficiency

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## Overview of Proposed Rule 206(4)-11

### Create a Framework for Service Provider Oversight:

- ❖ Conduct *reasonable* due diligence before engaging a Service Provider to perform a Covered Function
- ❖ Periodically monitor the performance and reassess the retention of the Service Provider to reasonably determine it is appropriate to continue to outsource to the Service Provider
- ❖ Recordkeeping Amendments – Proposed Rule 204-2
- ❖ Form ADV amendments

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## Overview of Proposed Rule 206(4)-11

### What is a Covered Function?

- ❖ those necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws; and
- ❖ 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.

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## Overview of Proposed Rule 206(4)-11

### Who is a Service Provider?

A Service Provider is an entity that performs a Covered Function and is not otherwise a supervised person of an investment adviser

- ✓ The Proposal does not provide an exclusion for affiliates

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## Overview of Proposed Rule 206(4)-11

### Examples of Service Providers and Covered Functions

- ❖ Sub-Adviser / provides investment advice
- ❖ Pricing service / provides critical data
- ❖ Model provider / provides algorithms used to run a strategy
- ❖ Compliance functions / outsourced CCO, routine filings agent
- ❖ Ministerial/clerical activities are not a Covered Function

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## Overview of Proposed Rule 206(4)-11

### Pre-Engagement Due Diligence

- ❖ Scope of Services
- ❖ Mitigation of Risks
- ❖ Determination of capacity/competency/resources
- ❖ Assess Service Provider's material subcontracting arrangements, if any, and how to mitigate/manage risks
- ❖ Reasonable assurance of recordkeeping
- ❖ Reasonable assurance Service Provider will provide an orderly process for termination

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## Overview of Proposed Rule 206(4)-11

### Post Engagement Due Diligence

- ❖ Must conduct reasonable ongoing due diligence
- ❖ Periodic monitoring of performance - timing and frequency depends on facts and circumstances
- ❖ Determine Service Provider remains appropriate to continue to outsource the Covered Function

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## Overview of Proposed Rule 206(4)-11

### Methods to Conduct Due Diligence

- ❖ Tailored to scope and function (has there been any change in the services)
- ❖ Conduct risk assessment and mitigate risks
- ❖ Review standard reports or DDQs (SOC1, SOC2 reports)
- ❖ Onsite meetings
- ❖ Technology demonstrations, changes in applications, testing

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## Overview of Proposed Rule 204-2

### Proposed Recordkeeping Amendments

- ❖ Record of Service Providers and Covered Functions
- ❖ Records of initial due diligence assessment and ongoing monitoring
- ❖ Written agreements with a Service Provider
- ✓ Maintain in easily accessible place during relationship and 5 years after.
- ✓ Due diligence and monitoring applies to outsourced recordkeepers (e.g., cloud storage)

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## Overview of Proposed Rule 204-2

### Proposed Recordkeeping Amendments

- ❖ Obtain reasonable assurance that the Service Provider will:
  - Implement processes for maintaining records that meet the adviser's obligations under Proposed Rule 204-2
  - Allow the adviser and the SEC staff to access the adviser's electronic records easily through computers or systems
  - Ensure continued availability of records after termination of the Service Provider

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## ADV Amendments

### Proposed Amendments to Form ADV

- ❖ New Item 7.C to Part 1A
  - Name and other information about the arrangement
  - Classify nature of Covered Functions – check boxes
  - Doesn't apply to recordkeepers – duplicative of Item 1.L

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# QUESTIONS?

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