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December 23, 2022

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1091

Re: *Outsourcing by Investment Advisers; File No. S7-25-22*

Dear Ms. Countryman:

The Investment Company Institute[1] is writing to provide comments on the "Outsourcing by Investment Advisers" proposal issued by the Securities Exchange Commission (the "Commission" or "SEC").[2] The SEC has proposed a new rule, Rule 206(4)-11, under the Investment Advisers Act of 1940 (the "Advisers Act"), that would prohibit registered investment advisers from outsourcing certain services or functions without first meeting specified requirements. The proposed new rule seeks to prescribe an adviser's initial and ongoing due diligence oversight obligations, as well as periodic monitoring and reassessment of a service provider's performance. The SEC has also proposed revising: (1) Form ADV to require advisers to disclose certain information about their service providers; and (2) Rule 204-2 to require advisers to maintain records documenting compliance with the new rule as well as new provisions requiring due diligence and monitoring of third-party recordkeepers.

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[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of $27.8 trillion in the United States, serving more than 100 million investors, and an additional $7.4 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

[2] *See Outsourcing by Investment Advisers,* Advisers Act Release No. 6176 (Oct. 26, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-6176.pdf ("Proposal" or "Proposing Release").

The ICI recommends that the SEC abandon this Proposal. We concur with Commissioner Peirce that the Proposal "is neither statutorily grounded nor protective of investors."[3] Attempting to adopt an anti-fraud rule "repackaging existing fiduciary obligations into a new set of prescriptions for investment advisers"[4] is unnecessary, burdensome, and something we cannot support.

Executive Summary

The SEC and staff have a long history of taking actions to assist registrants in fulfilling their regulatory responsibilities.[5] Notwithstanding this history, the SEC elected to address alleged concerns related to advisers overseeing service providers in a prescriptive and blunt manner: by promulgating a new anti-fraud rule. Compounding our concerns with a new anti-fraud rule is the fact that the Proposal's approach to regulating outsourcing arrangements reflects serious flaws. Based on the Proposing Release, the SEC does not appear to be fully informed of the operational processes and interactions between registered investment advisers and their service providers. The Proposal is overly broad, allows for arbitrary application and second guessing, and raises significant and highly serious cybersecurity concerns. Moreover, the Proposal includes requirements that are outside the SEC's authority under the Federal securities laws and the cost-benefit analysis is wholly inadequate. As a result, the SEC should not move forward on this Proposal.

We oppose the SEC proceeding with this Proposal for the following reasons:

- There is no evidence that this Proposal is needed;

- Current law, including advisers' fiduciary duty, appropriately addresses the SEC's concerns, thereby obviating the need for this targeted and prescriptive rule as the SEC has sanction (and examination) authority under existing law;

- The SEC should have developed more information to gain a better understanding of the advisory ecosystem and service provider engagement before considering what, if any, actions were appropriate. The Proposing Release demonstrates significant misunderstandings of, and would significantly disrupt, advisory and fund operations. For example:

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[3] *See* Hester M. Peirce, Commissioner, SEC, *Outsourcing Fiduciary Duty to the Commission: Statement on Proposed Outsourcing by Investment Advisers* (Oct. 26, 2022), *available at* https://www.sec.gov/news/statement/peirce-service-providers-oversight-102622.

[4] *Id.*

[5] *See e.g.,* Guidance published by the SEC's Division of Investment Management, *available at* https://www.sec.gov/investment/im-guidance-updates.html; Guidance published by the SEC's Division of Examinations, *available at* https://www.sec.gov/exams (including yearly exam priorities memos and risk alerts). *See also, e.g.*, Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Advisers Act Release No. 5325 (Aug. 21, 2019), *available at* https://www.sec.gov/rules/interp/2019/ia-5325.pdf; Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019), *available at* https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

  - Proposed Rule 206(4)-11 is vague, disrupting and complicating how advisers oversee their service providers;

  - Proposed Rule 206(4)-11 would create duplicative costs and impose barriers of entry; and

  - The Proposal introduces substantial and serious cybersecurity risks due to the assurances it would require from cloud data providers and the public Form ADV disclosure;

- The Proposal attempts to expand the SEC's jurisdiction beyond its Congressional mandate to persons outside its authority;

- Proposing Rule 206(4)-11 as an antifraud rule is inappropriate and beyond the SEC's authority; and

- The Proposal's costs and burdens are not adequately identified or considered by the SEC.

1. The Proposal is Unnecessary

Proposed Rule 206(4)-11 is intended to address advisers' use of service providers. Many of the reasons offered by the SEC in support of proposed Rule 206(4)-11 involve advisers abrogating their unwaivable fiduciary duty.[6] The Proposing Release fails to explain or provide adequate support for why an anti-fraud rule – or any additional rule – governing advisers' relationships with their service providers is necessary. Advisers have long employed service providers and relationships with service providers have long been a focus of SEC examiners when inspecting advisers for compliance with the Federal securities laws and their fiduciary duty.

Notwithstanding this and the thousands of exams the SEC has conducted of advisers over the decades, the Proposing Release does not include relevant findings or other information from the Division of Examinations or the Division of Investment Management to support this new rule.[7] Further, the Proposing Release contains no discussion of the SEC Enforcement Division's lack of authority under existing law to sanction advisers for investor protection issues posed by their use of service providers. On the contrary, when the full Commission considered this Proposal at its open meeting, Commissioner Crenshaw noted that the SEC can, and has, "brought some key enforcement actions where inadequate oversight of third-party providers has led to investor harm."[8]

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[6] *See* Proposing Release at 13 ("[A]n adviser cannot waive its fiduciary duty.").

[7] We do note that the Proposal does cite anecdotal commentary from the Division of Examinations to support the amendments related to third-party recordkeepers, but does not adequately explain why those amendments are necessary given that refusal to turn over records would constitute a violation under existing recordkeeping rules.

[8] *See* Caroline A. Crenshaw, Commissioner, SEC, *In Service of the Investor: Statement on Outsourcing by Investment Advisers* (Oct. 26, 2022), *available at* https://www.sec.gov/news/statement/crenshaw-statement-service-providers-oversight-102622.

We are not alone in failing to find in the Proposing Release evidence supporting proposed Rule 206(4)-11. As Commissioner Peirce noted in her statement opposing this Proposal:

> Why this sudden urgency to propose a rulemaking reconfirming the incontrovertible fact that outsourcing does not terminate an adviser's fiduciary duty? Has there been a surge of enforcement actions against advisers for service provider-related failures or infractions? Are our examiners seeing advisers running from their fiduciary obligation with respect to their outsourced functions? Are we aware of widespread investor harm due to advisers not overseeing their service providers? If the answer to any of these questions is yes, the release does not tell us so.[9]

Regarding the proposed third-party recordkeeping amendments, it bears noting that, according to the Proposing Release, the SEC believes it necessary to specifically address advisers' use of third-party recordkeepers because the SEC is "troubled that the Commission staff have observed some advisers unable to provide timely responses to examination and enforcement requests because of outsourcing."[10] This statement overlooks that fact that every adviser – without regard to whether it outsources its recordkeeping obligations – is required to maintain the records required under Rule 204-2 and to make available to the SEC upon request such records. If the SEC were to request records and the adviser were to refuse, such as by claiming that it did not have the records because they were maintained by a third-party, the SEC could bring an investigation or charges for a violation of Section 204 of the Advisers Act and Rule 204-2 thereunder. The adoption of proposed Rule 204-2(l) is not necessary to address the concerns discussed in the Proposing Release.

2. Current Law Addresses the Commission's Cited Concerns

As stated in the Proposing Release:

> 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. In addition, an adviser cannot waive its fiduciary duty. Accordingly, an adviser should be overseeing outsourced functions to ensure the adviser's legal obligations are continuing to be met despite the adviser not performing those functions itself.[11]

In other words, the SEC acknowledges that advisers are currently required to oversee their service providers and cannot waive the fiduciary duty they owe to clients when outsourcing services. The SEC however attempts to justify proposed Rule 206(4)-11 by explaining that the proposed Rule would provide "explicit due diligence and monitoring obligations" for advisers'

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[9] Peirce, *supra* note 3.

[10] Proposing Release at 12.

[11] Proposing Release at 13.

use of service providers that "would be complementary to existing obligations and practices rather than duplicative or conflicting."[12] The SEC then seemingly contradicts this explanation by detailing, *over five pages*, other rules and regulations that *already* require advisers to perform obligations similar to those proposed by Rule 206(4)-11.[13] This new rule is duplicative and unnecessary.

As the Proposal repeatedly notes, advisers are already performing oversight functions as required under their fiduciary duty.[14] Providing the SEC an additional course of action to sanction an adviser for violating its fiduciary duty is unnecessary and will not enhance investor protection. In support of a rulemaking, the Commission should, *at a minimum,* conduct an informed assessment of existing regulations and how such regulations are working, including actions that can be taken to redress a problem once identified, studied, and understood by the Commission and staff. As demonstrated by the SEC's own regulatory analysis, the SEC has authority to sanction advisers for inadequate oversight of their service providers.[15] As the Commission proposes new rules, it must remain committed to its mission – to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

3. The Proposal Lacks Adequate Substantiation and Analysis

3.1 Advisory Ecosystem and Service Provider Engagement

Prior to proposing a rule that seeks to provide a "minimum and consistent oversight framework for all investment advisers outsourcing functions or services,"[16] it is necessary to understand the advisory ecosystem as well as how advisers currently engage and oversee their service providers. Often, the SEC has institutional knowledge to navigate and tailor rulemakings, but such

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[12] Proposing Release at 210.

[13] Proposing Release at 211-15.

[14] *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 194 (1963) ("Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be . . . ."); *see also* Investment Adviser Codes of Ethics, Advisers Act Release No. 2256 (July 2, 2004); Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003); Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Advisers Act Release No. 1862 (April 5, 2000).

[15] In describing the supporting reasons, the Proposing Release cites three instances in which the SEC has "observed an increase in . . . issues related to the outsourcing and advisers' oversight." Proposing Release at 11. The three examples cited involved (1) an adviser that used third-party models without first confirming that the models worked as intended (*See* In the Matter of Aegon USA Investment Management, LLC, et al., Advisers Act Release No. 4996 (Aug. 27, 2018) (settled order)); (2) an adviser failing to oversee a third-party vendor that did not properly safeguard customers' personal identifying information (*See* Morgan Stanley Smith Barney LLC, Advisers Act Release No. 6138 (Sept. 20, 2022) (settled order)); and (3) advisers being unable to provide timely responses to examination and enforcement requests because of outsourcing (Proposing Release at 12). Regarding examples (1) and (2), it bears emphasizing that these examples are from recent enforcement actions in which the SEC was successful in sanctioning advisers for their conduct under current law. For example (3), the SEC already has authority to sanction advisers that refuse to produce required records.

[16] Proposing Release at 199.

understanding of advisers and service providers appears lacking from the Proposal.[17] More time studying outsourcing and engaging with advisers and service providers needs to be done before the SEC takes action, whether by staff action or otherwise.[18] The Proposing Release reflects an inadequate study and understanding of how advisers function on a day-to-day basis and interact with their service providers.

For example, entering into written agreements with a service provider *prior* to retaining the service provider is typical and, before executing such agreements, advisers frame their due diligence before engagement consistent with their fiduciary duties.[19] Further, after conducting due diligence into a service provider and establishing a relationship pursuant to a written agreement, advisers routinely monitor the service provider's activities and performance. A more thorough effort to understand how advisers oversee their service providers, including assessing standards and best practices along with identified weaknesses (if any), would have enabled the Commission to develop a more tailored and calibrated approach, including leveraging its existing rules and authority to align better with its mission. Instead, the SEC issued this Proposal seeking to implement a top-down regulatory regime that is not well-suited for the contours of the industry it seeks to regulate.[20]

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[17] We note there have been questions raised about staff attrition and other issues impacting the work of the Commission:

> We met with managers from the SEC's divisions of Trading and Markets, Investment Management, Corporation Finance, and Economic and Risk Analysis[. Due to attrition,] managers reported relying on detailees [for rulemaking work], in some cases with little or no experience in rulemaking. Others told us that they may have not received as much feedback during the rulemaking process, either as a result of shortened timelines during the drafting process or because of shortened public comment periods. . . . [S]ome believed that the more aggressive agenda . . . potentially (1) limits the time available for staff research and analysis. . . . [T]he SEC has seen a significant increase in attrition over the last few years, from 3.8 percent in FY 2020 to an estimated 6.4 percent in FY 2022 (as of September 20, 2022) – the highest attrition rate in 10 years. Most concerning is the increased attrition in Senior Officer and attorney positions, expected to be about 20.8 percent and about 8.4 percent for FY 2022, respectively.

See Office of Inspector General, The Inspector General's Statement of the SEC's Management and Performance Challenges (Oct. 13, 2022), *available at* https://www.sec.gov/files/inspector-generals-statement-sec-mgmt-and-perf-challenges-october-2022.pdf.

[18] For example, the SEC recently engaged with the industry via a request for comment on certain information providers that may meet the definition of "investment adviser." *Request for Comment on Certain Information Providers Acting as Investment Advisers*, Advisers Act Release No. 6050 (June 15, 2022), *available at* https://www.sec.gov/rules/other/2022/ia-6050.pdf. According to the Proposal, the SEC is still going through comments received. Proposing Release at n.38.

[19] In discussing the Proposal with ICI's members regarding advisers to registered funds, surveyed members affirmed a service provider is retained only *after* conducting due diligence of the service provider and they require a written agreement. Once retained, to remain compliant with the Federal securities laws, these advisers also monitor the operations and performance of their service providers on an ongoing basis.

[20] Additionally, as a basis for support in issuing the Proposal, the SEC also posits the questionable idea that "if a client learns of a significant disruption at a major service provider, that client could easily and quickly determine whether its adviser uses that service provider for a service or function the client considers material and whether to take remedial action." Proposing Release at 75. It is unrealistic to think that an advisory client, in retaining an investment adviser, would focus upon which service providers the adviser relies upon to conduct business.

3.2 The Definition of "Covered Function" is Vague

The Commission proposes to regulate advisers' outsourcing arrangements by defining a universe of "Covered Functions" that an investment adviser cannot outsource without first determining the appropriateness of outsourcing such function and complying with proposed Rule 206(4)-11's prescriptive outsourcing requirements. Proposed Rule 206(4)-11 defines "Covered Function" 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.[21]

A "Covered Function" excludes any clerical, ministerial, utility, or general office functions or services.[22]

The definition of "Covered Function" is excessively vague as to who it would apply to and introduces uncertainty around what activities are within scope.[23] For example, as stated by the SEC, whether a service provider is performing a "Covered Function" depends on the "facts and circumstances" and "certain functions may be covered functions for one adviser but not for another adviser[.]"[24] The fact that something could be a "Covered Function" for one adviser but not for another will surely create significant issues and confusion. Further, it will foster and invite second-guessing by the SEC that something is or should have been treated as a "Covered Function." If one adviser concludes that a service is not a "Covered Function," but other advisers do, the vagueness of the definition will allow the SEC to contradict that adviser's determination on a post-facto basis. This uncertainty will likely lead to conservative positions and over-inclusion of what constitutes "Covered Functions."[25]

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[21] Proposed Rule 206(4)-11(b).

[22] *Id.*

[23] For example, many advisers utilize off-the-shelf software and platforms and bring the management and function of the software or platform in house while maintaining a license with the provider for updates. It is not obvious from the Proposing Release whether the software or platform would be subject to Rule 206(4)-11 when the license is necessary for the operation of the software or platform but the licensor is not the entity performing the function. *See also, e.g.*, David Isenberg, *Questions Loom Over Who's Covered in New SEC Rule*, Ignites (Nov. 4, 2022), *available at* https://www.ignites.com/c/3808054/493144/questions_loom_over_covered_rule?referrer_module=emailMorningNews&module_order=2&code=YTJWMmFXNHVaWEpqYjJ4cGJtVkFhV05wTG05eVp5d2dNVFl3TnpBM09UUXNJREV3Tnpjd09USTBNVEU9.

[24] Proposing Release at 20-21.

[25] We particularly note here members' concerns as to how proposed Rule 206(4)-11 would apply to research providers. Many advisers would consider research provided by a third-party to be "necessary" to making investment management decisions. If an adviser only used one research provider, that may be clearer whether that service provider is providing a "Covered Function," but because many investment advisers source research from multiple research providers, it is difficult to determine which ones would be providing a "Covered Function" and which

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Moreover, one adviser's determination that a "function or service" is a "Covered Function" may compel service providers to force other advisers utilizing a similar service from them to treat the provided service as a "Covered Function."[26] The resulting increased operational costs and complexity for advisers could, in turn, create new challenges in engaging service providers and otherwise unduly impact market competition and capital formation. To be administrable and appropriately tailored to address supported concerns, a more objective and clear definition is required.

3.3 The Proposal Would Unduly Disrupt Many Types of Advisers

3.3.1 Proposal Is Unduly Prescriptive While Creating Duplicative Costs

In the SEC's attempt to create a "comprehensive oversight framework" for all investment advisers outsourcing functions or services,[27] the SEC has proposed a rule that imposes a prescriptive, top-down regulatory regime that removes the ability of advisers to allocate resources and oversight based on a risk determination. Currently, advisers allocate oversight resources to service providers based on assessed risk. This assessment is generally documented as a matrix, determining which service providers represent the most risk with oversight resources allocated accordingly. Proposed Rule 206(4)-11 removes that flexibility (and its benefits) and instead would require advisers to conduct the same level of due diligence and the same level of monitoring and oversight regardless of perceived or assessed risk. This will deprive advisers of the current approach granted under a fiduciary standard and increase costs exponentially without any clear stated benefit.[28]

Further, while proposed Rule 206(4)-11 would be unduly restrictive in practice, it would also create duplicative costs. For advisers to registered investment companies, certain service providers are already subject to an extensive review process as part of Rule 38a-1 under the Investment Company Act of 1940, as amended ("1940 Act").[29] The SEC specifically notes in the

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would not. That may lead to a conservative approach and advisers treating all research providers as providing a "Covered Function," which the SEC's economic analysis does not assess.

[26] Presumably, due to the increase in risk and due diligence required, service providers could develop two cost-tiers in response to the Proposal: one for "Covered Functions" and one for "non-Covered Functions." The "Covered Function" tier would likely cost more, and if some advisers designate service from a provider as a "Covered Function," that service provider may prefer, for the sake of simplicity and efficiency, that all of their adviser-customers view that function as a "Covered Function."

[27] Proposing Release at 210.

[28] For example, proposed Rule 206(4)-11 appears to sweep in affiliates. The fact that affiliates would require the same resource costs to onboard and oversee as service providers performing functions perceived to be of higher risk demonstrates a failure to adequately consider the cost and benefit impact of the Proposal. Advisers should be able to assess the risk a service provider poses and allocate resources accordingly. The proposed prescriptive, top-down regulatory regime removes flexibility for advisers to efficiently and most effectively allocate resources.

[29] Rule 38a-1 requires policies and procedures to provide for oversight of certain service providers to the registered investment company, including its investment advisers, principal underwriters, administrators, and transfer agents. The rule also requires the registered investment company's board of directors, including a majority of its

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Proposing Release that there will be overlap between Rule 38a-1 oversight and proposed Rule 206(4)-11.[30] Additionally, broker-dealers, banks, and other investment advisers are subject to extensive regulatory oversight regimes. The SEC has a long history of excepting from prescriptive regulations entities that are already subject to comparable regulatory oversight regimes.[31] Yet, the Proposing Release does not propose any carve-outs for service providers already subject to extensive existing regulatory oversight regimes. This lack of consideration as to the adequacy of additional regulatory regimes that certain service providers are already subject to underscores the inadequate consideration of existing regulations in place that govern and impact the advisory ecosystem. The significant, unnecessary, and duplicative costs created by the Proposal will be pushed down to retail investors, which our members feel is not in investors' best interests.

3.3.2 The Proposal Would Disrupt Both Large and Smaller Advisory Operations

Large advisory complexes often have multiple registered advisers and other entities under their corporate structure. Within these complexes, it is not uncommon for there to be staff dedicated to vendor management. These staff are responsible for ensuring uniformity in conducting due diligence of service providers across the complex, negotiating contracts with such service providers, and overseeing the service providers' performance in line with an adviser's fiduciary duty. For complexes with this structure, vendor management is handled through a centralized function and not based upon individual business units, affiliates, or subsidiaries within the complex. The Proposal fails to take account of complexes with this structure and instead would require advisers to deconstruct their current vendor management process and then reconstruct that process at the adviser legal-entity-level. Not only would this be incredibly disruptive to existing mature and effective vendor oversight programs, but it would significantly increase costs if vendor management must be performed on a bespoke basis.[32] The Proposal would also

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independent directors, to approve the investment adviser's policies and procedures based on a finding that the policies and procedures are reasonably designed to prevent violations of the Federal securities laws by the registered investment company and the adviser.

[30] Proposing Release at 117 ("Registered investment companies are subject to similar compliance procedures and practices pursuant to rule 38a-1 under the Investment Company Act of 1940 and to the extent certain advisers have clients that are registered investment companies, the adviser and certain specified service providers may be subject to relevant provisions of the rule.").

[31] *See, e.g.*, Information Update for Advisers Relying on the *Unibanco* No-Action Letters, IM Update (March 2017), *available at* https://www.sec.gov/investment/im-info-2017-03.pdf ("In the *Unibanco* letters, the staff provided assurances that it would not recommend enforcement action to the Commission regarding the applicability of the substantive provisions of the Advisers Act with respect to a non-U.S. adviser's relationships with its non-U.S. clients. In addition, the staff agreed not to recommend enforcement action to the Commission under section 203(a) of the Advisers Act if a non-U.S. advisory affiliate of a registered adviser, often termed a ''participating affiliate,'' shares personnel with, and provides certain services to U.S. clients through, the registered adviser, without such participating affiliate registering under the Advisers Act.").

[32] Additionally, many large advisory complexes engage in "shared services models" with their affiliates whereby a group of affiliated investment advisers choose to outsource functions to a central affiliated entity. The affiliated entity that performs these functions under a shared services model generally does not make such services available to the broader marketplace nor does it hold itself out as a service provider to unaffiliated entities. Using this model, investment advisers can decrease costs and achieve greater efficiency by centralizing the provision of certain

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disrupt current recordkeeping arrangements as individual advisers within a complex would have to tailor their recordkeeping to document compliance separate and apart from vendor management programs. This potential and significant disruption and cost impact was not even considered or addressed in the Proposal.

Further, with regard to smaller advisers, the Proposal will likely create an undue burden with its complexity and costs. While the SEC may state in the Proposing Release that "[s]ome advisers, particularly the smallest advisers or those who do no outsourcing, are likely to face costs that are below [the] lower bound for the average cost across all advisers[,]"[33] we disagree. Such a statement does not reflect the advisory ecosystem for smaller advisers and even contradicts other statements in the Proposing Release.[34] In this ecosystem, it is not uncommon for small advisers to outsource comparatively more of their operations and, due to their size, they tend to have less bargaining leverage over larger service providers.[35] Notwithstanding this, the Commission has not addressed these dynamics nor fairly evaluated the problems and costs likely to impact small advisers. It also does not appear that the Commission has fairly evaluated how the Proposal may arbitrarily impose barriers to entry for new advisers and the related impact on market competition.

3.4 The Proposal Raises Serious and Significant Cybersecurity Risks

3.4.1 Cloud Data Providers as Recordkeepers

We are very concerned with the SEC attempting, through the Proposal's proposed revisions to Rule 204-2, to regulate advisers' use of cloud data providers to maintain required records. As proposed, new Rule 204-2(l) would require an investment adviser "that relies on a third party to make and/or keep books and records" to conduct due diligence as required by proposed Rule 206(4)-11 as well as obtain additional assurances.[36] This would require that a cloud data provider not only provide reasonable assurances to the investment adviser that it will coordinate with the adviser regarding compliance with the Federal securities laws, including the prescriptive requirements of proposed Rule 206(4)-11(a)(1)(v)**,** but it would have to provide the following assurances:

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services in one affiliated entity that serves the entire group of affiliates. Requiring each adviser to perform the prescriptive and detailed due diligence and monitoring requirements under the Proposal as opposed to allowing the due diligence to be centralized with oversight dependent on adviser-assessed risk as is currently allowed would significantly and needlessly disrupt current practices, defeating economy of scale efficiencies without any identified benefit.

[33] Proposing Release at n.206 and accompanying text.

[34] Proposing Release at 164 ("[T]he proposed rule would create new costs of providing advisory services, which could disproportionately impact small or newly emerging advisers who may be less able to absorb or pass on these new costs.").

[35] We note that even large advisers have limited leverage over the largest service providers, for example, as further described herein related to cloud data providers.

[36] Proposed Rule 204-2(l).

> First, the adviser must have reasonable assurance that the third party 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. Second, the adviser must have reasonable assurance that, when making and/or keeping records on behalf of the adviser, the third party 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. Third, for electronic records, the adviser must have reasonable assurance that the third party will allow the investment adviser and Commission staff to access the records easily through computers or systems during the required retention period of the recordkeeping rule. . . . Fourth, the adviser must have reasonable assurance that 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 investment adviser in the event that the third-party ceases operations or the relationship with the investment adviser is terminated.[37]

The SEC suggests in the Proposing Release that an adviser obtain these assurances either in the main written agreement governing the adviser's relationship with the cloud data provider or in a separately negotiated letter of understanding.

The cloud data provider market is currently consolidated around three companies (approximately 66% of the market): Amazon, Microsoft, and Google.[38] As the SEC likely has experienced first-hand from its own use of cloud data providers, not only do cloud data providers limit transparency and due diligence into their operations, but cloud data agreements are presented on a "take-it-or-leave-it" basis with little room for negotiation. It defies business realities for the SEC to expect that the major cloud data providers will execute written agreements in which they represent that they understand the intricacies of Federal securities laws, among other proposed representations, and agree to allow advisers to bring subrogated securities law claims under the agreements as required by the Proposal. Further, when cloud data providers refuse to provide these accommodations and assurances, where will this leave investment advisers? The SEC's Proposal risks restricting advisers to a more limited group, if any, of cloud data providers, disadvantaging advisers and their clients.[39]

3.4.2 The Proposed Form ADV Disclosure Will Be an Attractive Target for Bad Actors

The Proposal would require advisers to publicly disclose each of their service providers that perform "Covered Functions." They would also have to publicly disclose the location of the

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[37] Proposing Release at 86.

[38] Felix Richter, *Amazon, Microsoft & Google Dominate Cloud Market*, Statista (Nov. 15, 2022), *available at* https://www.statista.com/chart/18819/worldwide-market-share-of-leading-cloud-infrastructure-service-providers/.

[39] Also, it is worth noting that several of the remaining major cloud data providers are Chinese companies. *See id.* (noting that Alibaba and Tencent constitute about 7% of the market). Aside from standard cybersecurity concerns raised from not being able to access market-leaders, this Proposal could also increase national security concerns if foreign providers are the only entities willing to provide the proposed assurances.

office principally responsible for the "Covered Functions" as well as other information.[40] The SEC believes that this data would be useful because "if a large number of investment advisers used a common service provider, operational risks could be correspondingly concentrated."[41]

Requiring public disclosure of information about all investment advisers' service providers that perform a "Covered Function" will present a huge cybersecurity threat to all advisers as well as to their service providers *and* such service providers' non-advisory clients. As proposed, hackers and other bad actors would now have a government-funded database to enable them to target their efforts when seeking to attack asset management infrastructure systems. Indeed, in lieu of attacking and trying to disrupt the operations of individual investment advisers, bad actors can target *all* investment advisers reliant upon a major service provider by attacking the service provider's operations. This Proposal could result in a highly effective and efficient cyberattack on the industry at large. Needless to say, creating a public database that enables bad actors to determine points where a cyber-attack would be most effective is not good public policy. While we recommend the SEC withdraw this Proposal in its entirety, we cannot underscore strongly enough the critical importance that this element must be dropped and never repurposed in any future regulatory requirement.

4. The Proposal Attempts to Expand the Reach of the Advisers Act to Service Providers Beyond the Commission's Congressional Mandate

Proposed Rule 206(4)-11(a)(vi) would require, as a condition of an adviser retaining a service provider to perform a "Covered Function," that the adviser obtain "reasonable assurance from the Service Provider that it is able to, *and will coordinate with the investment adviser for purposes of the adviser's compliance with the Federal securities laws* . . .." [Emphasis added.] The Proposing Release sheds additional light on how the Commission believes an adviser might fulfill its responsibilities under this provision:

> While not required under the proposed rule, [an] adviser may wish to consider obtaining written assurances or written representations from the service provider that it is aware of the adviser's obligations under the Advisers Act, and *that it will assist the adviser, as applicable, in complying with its obligations as a fiduciary.* For additional clarity, the adviser may wish to consider *articulating specific responsibilities of the service provider in relation to assisting the adviser to comply with its legal obligations.* [Emphasis added.]

This aspect of the Proposal appears to demonstrate Commission overreach by attempting to extend indirectly its regulatory jurisdiction over persons that Congress has not authorized it to

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[40] Proposing Release at 72.

[41] Proposing Release at n.239 and accompanying text. While this section of our letter addresses cybersecurity concerns, from a basic operational standpoint, we are uncertain what actions the SEC envisions it could take in the event that there is an undue concentration of advisers using certain service providers.

regulate.[42] In fact, the rule text and related discussion in the Proposing Release indicate that the SEC expects an adviser to fulfill its responsibilities under Rule 206(4)-11(a)(vi) by having its service providers affirmatively acknowledge *the adviser's* legal duties and obligations and *affirmatively agree to assist* the adviser with fulfilling these duties and obligations.

5. An Antifraud Rule is Inappropriate and Beyond the SEC's Authority

As discussed above, the SEC proposed Rule 206(4)-11 under Section 206(4) of the Advisers Act.[43] Section 206(4) prohibits advisers from engaging "in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."[44] In other words, it prohibits an adviser from engaging in any fraudulent, deceitful, or manipulative conduct.

Consistent with Section 206(4), any rules the Commission adopts under Section 206(4) should be "designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[45] Section 206(4) does not appear to provide the Commission the authority to adopt rules, such as proposed Rule 206(4)-11, that govern the day-to-day business operations of an adviser or to impose new requirements on them when such adviser is acting in a manner consistent with its fiduciary duty and has disclosed all conflicts of interest. We are concerned that the vagueness of proposed Rule 206(4)-11 will lead to claims of fraud from the SEC against advisers solely because an interruption in service from a service provider providing a "Covered Function" occurred. If the Commission makes a post-facto determination that an adviser's relationship with a service provider is somehow deficient, regardless of the nature of the deficiency, the adviser could be cited for engaging in fraud under proposed Rule 206(4)-11. And yet, but for this rule being promulgated under Section 206(4), such deficiencies would not rise to the level of fraud, deceit, or manipulation as those terms are commonly understood.[46]

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[42] Other recent SEC issuances attempting this regulatory overreach include: *Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies,* Advisers Act Release No. 5956 (Feb. 9, 2022), *available at* https://www.sec.gov/rules/proposed/2022/33-11028.pdf; and *Request for Comment on Certain Information Providers Acting as Investment Advisers*, *supra* note 18.

[43] *See also* Proposing Release at 223 ("The Commission is proposing rule 206(4)-11 under the Advisers Act under the authority set forth in sections 203(d), 206(4), and 211(a) and (h) of the Advisers Act of 1940.").

[44] Section 206(4) of the Advisers Act.

[45] *Id.*

[46] There are generally six elements of common law fraud and deceit: there must be (1) a false representation of; (2) a material; (3) fact; (4) knowledge by the defendant of the falsity (i.e., scienter), but stated nonetheless for the purpose of inducing the plaintiff to rely on it; (5) justifiable reliance by the plaintiff; and (6) damages suffered as a consequence. The enumeration of these elements in large measure carries over to the securities laws. *See* Loss, Seligman, and Paredes, *Fundamentals of Securities Regulation* at 1261 (Sixth Ed. 2011). *See also United States v. Elliott*, 62 F.3d 1304, 1312 (11th Cir. 1995), *amended per curiam*, 82 F.3d 989 (11th Cir.) (quoting S. Rep. No. 1760, 86th Cong., 2d Sess. (1960), which identified the elements of fraud and deceit that were acknowledged in adding Section 206(4) to the Advisers Act). We recognize that as the case law addressing fraud under the federal securities statutes (including the Advisers Act) has developed, claims of fraud need not include all of these elements. The less applicable those elements are to a particular course of conduct, however, the less compelling the argument for labelling such conduct as fraudulent or deceptive.

Advisers should not be exposed to fraud claims solely because the SEC, after the fact, deems certain steps taken to be inadequate. Proposed Rule 206(4)-11 covers activities far broader than what courts have interpreted as "fraud" or "deceit" under the Advisers Act.[47] Additionally, promulgating proposed Rule 206(4)-11 under Section 206(4) seems both unduly punitive and unnecessary, particularly in light of the fact that the Commission already has authority to sanction an adviser if its relationship with its service providers results in a violation of the adviser's fiduciary duty. We believe the SEC's grant of the authority under Section 206(4) is limited and does not include authority to promulgate Rule 206(4)-11.[48]

6. The Proposal's Economic Analysis is Deficient

Section 203(c) of the Advisers Act states that:

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[49]

In the Proposing Release's economic analysis, the SEC specifically states that "[w]e are unable to quantify [the] direct costs that would be incurred by service providers as a result of this rule, as the cost range would be too wide to be informative."[50] By failing to fairly analyze and assess the impact the Proposal will have on service providers – particularly critical service providers and the related costs that such service providers will pass on – the SEC has not appropriately evaluated the Proposal's impact on efficiency, competition, and capital formation.[51] Further,

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[47] *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) (finding that "fraud" and "deceit" under Section 206(2) of the Advisers Act includes the failure to disclose conflicts of interest that have a potential for abuse); *also* S. 3580, 76th Cong., 3d Sess., § 202 ("Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission . . . it is hereby declared that the national public interest and the interest of investors are adversely affected -- . . . (4) when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients."). Even if an adviser is acting in accordance with their fiduciary obligations and have accurately disclosed all conflicts of interest, proposed Rule 206(4)-11 is drafted so as advisers could be charged with fraud. Proposed Rule 206(4)-11 seeks to essentially make advisers serve as guarantors of their service providers, regardless of whether the adviser was acting in accordance with its fiduciary duty and had disclosed all conflicts. Such a standard is not within the limits of authority granted to the SEC by Congress under Section 206 of the Advisers Act.

[48] While the SEC may have authority under Section 211 of the Advisers Act to promulgate a service provider oversight rule, for the reasons outlined in this letter, no rule is necessary and we do not support such a promulgation.

[49] Section 203(c) of the Advisers Act.

[50] Proposing Release at 148.

[51] *See Bloomberg L.P. v. SEC*, No. 21-1088 (D.C. Cir. 2022) (finding the SEC's action arbitrary and capricious under the Administrative Procedure Act as the SEC neglected to give a reasoned explanation in response to significant concerns about the costs that would be incurred in connection with the creation and maintenance of a regulatorily mandated data service); *Business Roundtable v. SEC,* 647 F.3d 1144 (D.C. Cir. 2011) (vacating the SEC's rule because the SEC failed to adequately consider the rule's effect upon efficiency, competition, and capital formation).

when the SEC does attempt to quantify costs that will be imposed directly on advisers, it bases its analysis on the presumption that an adviser only outsources five "Covered Functions" to service providers.[52] The presumption that an adviser only outsources five "Covered Functions" and will only have to perform the Proposal's prescriptive requirements five times is inadequate and incorrect. As mentioned throughout this letter, some members have stated that an exponentially larger amount of service providers will be subject to the Proposal's requirements. If the SEC had undertaken more study and engagement, it would better appreciate, understand, and realize the significant impact that the Proposal will have on efficiency, competition, and capital formation on the wide range and variety of advisers and service providers.

We also find unhelpful the description of broad, ethereal benefits that cannot be quantified but are measured via a "qualitative assessment."[53] Aside from this, the SEC also fails to discern how any of the postulated benefits are derived from the Proposal as opposed to already existing. For example, the Proposing Release states that:

> Advisers who use service providers, whether a related-person or third-party service provider, may currently conduct activities related to each of the proposed obligations, such that varying degrees of due diligence, risk mitigation and management, monitoring, recordkeeping, and other oversight-related activities may already occur in the marketplace. Certain advisers may currently conduct some or all of the proposed activities to satisfy a variety of legal requirements.[54]

Statements like these beg the question that, if advisers are already performing due diligence, what is the purpose and need for this highly prescriptive, burdensome, and costly Proposal? The SEC argues that the costs of this Proposal will be mitigated because "some advisers may already meet certain portions of the obligations that would be required under the proposed rules in the course of complying with existing legal obligations and their costs would only include the costs associated with obligations they do not already meet."[55] This reasoning is faulty. First, the SEC cannot claim that costs will be mitigated because advisers already perform the proposed functions as this rule has new and different prescriptive requirements, along with vague definitions. For example, the analysis fails to recognize that, by being so prescriptive, the Proposal likely will require advisers that currently have effective vendor oversight programs in place to deconstruct and then reconstruct such programs solely to satisfy new and different requirements even if doing so would have no concomitant benefits. Second, the benefits are unclear. By the SEC's own admission, many advisers are performing some of the proposed functions, meaning benefits from a new rule would be limited. The Proposing Release's

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[52] Proposing Release at 145.

[53] *See* Proposing Release at 99 ("Even if it were possible to calculate a range of potential quantitative estimates, that range would be so wide as to not be informative about the magnitude of the benefits or costs associated with the proposed rule. Many parts of the discussion below are, therefore, qualitative in nature."). The SEC then provides examples of those hypothetical qualitative benefits at Proposing Release 131-35.

[54] Proposing Release at 115.

[55] Proposing Release at 129.

economic analysis fails to adequately consider, reflect, analyze, and quantify these considerations.

Conclusion

For all the reasons discussed in this letter, the ICI strongly opposes the Commission adopting this Proposal. The Commission's attempt to prescriptively regulate advisers' relationships with their service providers with a new anti-fraud rule is unnecessary and flawed. Should the Commission believe there are aspects of advisers' relationships with their service providers that warrant attention, the Commission should further study and assess those concerns and then, consistent with the Commission's mission and authority, consider the most effective ways to address any such areas. Further, notwithstanding the issues with the Proposal, we note that neither this Proposal nor any other recent proposed rulemaking acknowledges the totality and cumulative effect of collective costs and burdens, including the regulatory complexity, that will result and will ultimately be borne by retail investors.[56] Of the 34 rule proposals issued or reopened for comment by the SEC this year,[57] both the market and investors would be well served by an economic analysis that acknowledges the interplay between these proposals.

If you have any questions or require further information regarding our comments, please do not hesitate to contact either me at solson@ici.org, Kevin Ercoline, Assistant General Counsel, at kevin.ercoline@ici.org, or Tamara Salmon, Associate General Counsel, at tamara@ici.org.

Sincerely,

/s/ Susan M. Olson
Susan M. Olson
General Counsel

cc: The Honorable Gary Gensler
The Honorable Hester M. Peirce
The Honorable Caroline A. Crenshaw
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[56] Joint Trade Letter to Chair Gensler, Importance of Appropriate Length of Comment Periods (April 5, 2022), *available at* https://www.ici.org/system/files/2022-04/22-ici-letter-to-sec-chair-gensler.pdf.

[57] *See* The Inspector General's Statement of the SEC's Management and Performance Challenges, *supra* note 17, at 2. The Inspector General noted that as of August 29, 2022, 26 rule proposals had been issued or reopened for comment. Since then, the SEC has issued or reopened for comment, excluding reopening due to technical glitches, eight more rule proposals.