Schulte Roth&Zabel LLP

919 Third Avenue
New York, NY 10022
212.756.2000
212.593.5955 fax

www.srz.com

Marc Elovitz
[redacted]

E-mail Addresses
[redacted]

December 27, 2022

**Submitted via Email to: rule-comments@sec.gov**

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Outsourcing by Investment Advisers (File No. S7-25-22)

Dear Ms. Countryman:

We are writing in response to the request of the Securities and Exchange Commission ("SEC" or the "Commission") for comments to the proposed rule related to outsourcing by registered investment advisers (the "Proposed Rule"). We recognize the time and effort invested by the Commission and the staff of the Division of Investment Management (the "Staff") in formulating the Proposed Rule and appreciate the opportunity to comment.

Schulte Roth & Zabel LLP is an international law firm with offices in New York, London and Washington, D.C. Our clients include many investment advisers that may be directly affected by the Proposed Rule as well as institutional investors and limited partners. These comments, while informed by our experience in representing these clients, represent our own views and are not intended to reflect the views of the clients of the firm.

On October 26, 2022, the Commission proposed a new rule and rule amendments under the Investment Advisers Act of 1940 (the "Advisers Act") creating new due diligence and oversight requirements with respect to certain service providers engaged by investment advisers. We appreciate the Commission's concerns with respect to due diligence and oversight of service providers engaged by investment advisers and agree that it is important that advisers carefully evaluate and oversee their use of service providers. In our experience, however, that due diligence and oversight is often effectively conducted using a risk-based approach tailored to the particular adviser, client, service provider and circumstances. We believe the Proposed Rule is

overly broad in coverage, would impose a standardized approach to a wide range of facts and circumstances and would potentially discourage advisers from using service providers despite the benefits that can come from their specialized areas of expertise. We also believe that the Commission's existing rules are sufficient to address circumstances where an adviser is deficient in its due diligence and oversight of service providers. We are therefore unable to support the Proposed Rule. Specific issues are noted below.

1. **Lack of Need for Rulemaking**. The Proposed Rule is not supported by evidence of significant investor harm caused by a lack of service provider due diligence and oversight such that new rulemaking is necessary. Notably, there are only three incidents cited by the Commission in support of the Proposed Rule all of which could be sufficiently addressed – and are sufficiently addressed – by existing Commission rules. The first incident involved a subadviser that licensed faulty models. In that situation, existing rules under the Advisers Act were sufficient for the Commission to charge three advisers for using the faulty models in their investment decisionmaking.[1] The second incident involved deficient services performed by an outsourced Chief Compliance Officer.[2] Not only were the existing rules sufficient for the Commission to bring charges, the issue also was addressed in the subsequent amendment to Form ADV requiring disclosure of such outsourced arrangements.[3] The third incident alleged violations of Regulation S-P for failure of a broker-dealer and investment adviser to safeguard personally identifiable information provided to a vendor.[4] Not only is Regulation S-P well-suited to address this type of violation, the Commission's proposed new cybersecurity rule also would require advisers to adopt policies and take steps to protect confidential information.[5] In these circumstances we respectfully suggest that the Commission study the use of service providers by investment advisers to identify specific risks of harm to investors, which can then be addressed by Risk Alerts or by tailored rulemaking, as the Commission deems appropriate based on such studies.

2. **Lack of Basis for Rulemaking**. The Commission identifies Sections 206(4) and 211(a)(h) of the Advisers Act as the basis for the Proposed Rule. Section 206(4) prohibits fraud against clients, while the Proposed Rule addresses negligence in connection with an adviser's engagement and use of service providers. Section 211(a)(h) addresses the clarity of investor disclosures and restricts certain "sales

[1] In the Matter of Aegon USA Investment Management, LLC, et al., Investment Advisers Act Release No. 4996 (Aug. 27, 2018); In the Matter of AssetMark, Inc, (FKA Genworth Financial Wealth Management, Inc.), Investment Advisers Act Release No. 4058 (Aug. 25, 2016); In the Matter of Virtus Investment Advisers, Inc., Investment Advisers Act Release No. 4366 (Nov. 16, 2015).
[2] In the Matter of Aegis Capital, LLC, Investment Advisers Act Release No. 4054 (March 30, 2015).
[3] Final Rule, Form ADV and Investment Advisers Act Rule, Release No. IA-4509 (Aug. 25, 2016) (adding new Item 1.J.(2) to Part 1 of Form ADV, requiring advisers to disclose whether a Chief Compliance Officer is compensated or employed by someone other than the adviser, its related persons, or a registered investment company).
[4] In the Matter of Morgan Stanley Smith Barney LLC, Investment Advisers Act Release No. 6138 (Sept. 20, 2022).
[5] Proposed Rule, Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies and Business Development Companies, Release Nos. 33-11028, 34-94197, IA-5956, IC-34497, File No. S7-04-22 (Feb. 9, 2022).

practices, conflicts of interest, and compensation schemes", none of which relates to an adviser's due diligence and oversight of its service providers.

3. **Incomplete Economic Analysis**. The Proposed Rule lacks the support of a quantitative cost-benefit analysis. The Commission acknowledges that its economic analysis is almost entirely qualitative, explaining that advisers and service providers both vary in size, sophistication and the products and services offered. It is not apparent why these variations – which are to be expected, and which are likely similar to variations in the subjects in any economic analysis under Section 202(c) of the Advisers Act or analogous provisions in other statutes – prevent a quantitative economic analysis of the Proposed Rule. It seems to boil down to the need for more time to gather and analyze the data from a range of advisers and with respect to a range of service providers. We respectfully suggest the Commission take the time to study this issue if it is believed to be of sufficient import, and gather the data that would be necessary for a quantitative economic analysis.

4. **Unclear Scope of Coverage**. The Proposed Rule is titled "Outsourcing by Investment Advisers" but the scope of coverage goes far beyond the common understanding of the term "outsourcing". In our experience, the term "outsourcing" means delegating a function to a third-party. For example, an adviser that engages a third party to act as its Chief Compliance Officer would be viewed as having "outsourced" compliance, but an adviser that employs its own Chief Compliance Officer and engages a consultant to assist in conducting compliance testing would not be viewed as having "outsourced" compliance. Under the Proposed Rule it's not at all clear which engagements would address a "covered function" and therefore be within the scope of the Proposed Rule. A "covered function" is defined as "(1) a function or service that is necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws, and (2) 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." How central to the provision of advisory services must a function or service be in order to be "necessary" for the adviser to provide its services? How should advisers evaluate what is "reasonably" likely to cause a "material negative impact" on their clients or ability to provide advisory services? By adopting an unclear standard of coverage, the Commission would subject advisers and their compliance officers to second-guessing by SEC examination and enforcement staff. In these circumstances, advisers and their compliance officers may apply the Proposed Rule broadly, increasing the costs and decreasing the Proposed Rule's effectiveness as it moves further away from the "core" functions it is purported to cover.

5. **Form ADV Disclosure**. We believe the public disclosure of specific service provider relationships in Form ADV would create a real risk of harm to advisers and their clients and investors. Advisers invest significant resources into identifying service providers that will help their businesses provide the best services and to be competitive. Mandating public disclosure of such providers will undermine their competitive efforts. Disclosure also could reveal confidential information about

strategies, methodologies or approaches. In addition, public disclosure of specific service providers would increase cybersecurity risks. The Commission has recognized the emergence of cybersecurity risks, proposing rule amendments to increase requirements of public companies and a new cybersecurity rule imposing specific requirements on investment advisers.[6] Indeed, the Commission specifically noted the cybersecurity risks to advisers associated with service providers. In this context, it seems anomalous to adopt a new rule increasing the risk to advisers by mandating public disclosure of the identities and locations of their service providers. For example, successful phishing campaigns are often perpetuated by threat actors posing as service providers. There is no cognizable benefit from the public disclosure that justifies this risk.

* * *

We would be pleased to respond to any inquiries you may have regarding our letter or our views on the Proposed Rule more generally. Please direct any inquiries to Allison Bernbach, Marc Elovitz or Kelly Koscuiszka at [redacted].

Respectfully submitted,

SCHULTE ROTH & ZABEL LLP

cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
The Honorable Jaime Lizárraga, Commissioner
William Birdthistle, Director, Division of Investment Management

[6] Proposed Rule: Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, Release SEC Nos. 33-11038; 34-94382; IC-34529, File No. S7-09-22 (March 9, 2022); Proposed Rule: Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, Release SEC No. IA- 5956, File No. S7-04-22 (Feb. 9, 2022).