

SEC proposes new oversight requirements for certain services outsourced by investment advisers

October 26, 2022 | Client Update | 3-minute read

The SEC's proposed new oversight rule and rule amendments under the Investment Advisers Act of 1940 (Advisers Act) prohibit registered investment advisers from outsourcing certain services and functions without conducting due diligence and monitoring of the service providers.

On October 26, 2022, the Securities and Exchange Commission (SEC) proposed new rule 206(4)-11 and rule amendments under the Advisers Act that prohibit SEC-registered investment advisers from outsourcing certain services or functions to service providers and third-party recordkeepers without meeting minimum due diligence and monitoring requirements. The new requirements are designed to protect investors and ensure that the outsourcing is consistent with investment advisers' obligations to their clients.

Scope and application of the proposed rule and amendments

The proposed rule would apply to SEC-registered advisers that seek to outsource recordkeeping or functions (covered functions) that (1) are necessary to provide advisory services in compliance with the federal securities laws, and (2) 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. Clerical, ministerial, utility, and general office functions or services would be explicitly excluded from the proposed rule. The primary requirements for SEC-registered advisers introduced by the proposed rule and amendments include:

– Due diligence before retention of a service provider or third-party recordkeeper:

Prior to retaining a service provider or third-party recordkeeper to perform a covered function or recordkeeping, an advisor must perform due diligence to reasonably determine that the intended outsourcing is appropriate, considering the following factors:

- Nature and scope of the function;
- Potential risk, risk mitigation, and risk management relating to performance of the function by the service provider or third-party recordkeeper;
- Service provider's or third-party recordkeeper's competence, capacity, and resources necessary to perform the function;
- Service provider's or third-party recordkeeper's material subcontracting arrangements related to the covered function;

- Coordination with the service provider or third-party recordkeeper for federal securities law compliance; and
 - Orderly termination of the performance of the function.
- Periodic monitoring of the service provider’s or third-party recordkeeper’s performance
 - Periodic reassessment of the selection of the service provider or third-party recordkeeper under the due diligence requirements of the rule
 - Maintenance of books and records regarding service provider due diligence and monitoring performed
 - Reporting on Form ADV census-type information relating to the service providers
 - Obtaining reasonable assurances that the third-party recordkeeper will:
 - Adopt and implement internal processes and/or systems for making and/or keeping records that meet the requirements of the recordkeeping rule applicable to the books and records being maintained on behalf of the adviser;
 - Make and/or keep records that meet all of the requirements of the recordkeeping rule applicable to the adviser;
 - Provide access to electronic records; and
 - Ensure the continued availability of records if the third-party recordkeeper’s relationship with the adviser or its operations cease.

The public comment period will remain open for 60 days after October 26, 2022, or 30 days after publication in the Federal Register, whichever period is longer. If the proposed amendments are adopted, they would have a significant impact on the due diligence and monitoring obligations of SEC-registered advisers.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Sijja Cai

+1 212 450 3071
sijja.cai@davispolk.com

Jennifer Grant Cooper

+1 212 450 4492
jennifer.cooper@davispolk.com

Lee Hochbaum

+1 212 450 4736
lee.hochbaum@davispolk.com

Michael S. Hong

+1 212 450 4048
michael.hong@davispolk.com

Sarah E. Kim

+1 212 450 4408
sarah.e.kim@davispolk.com

Leor Landa

+1 212 450 6160
leor.landa@davispolk.com

Benjamin Milder

+1 212 450 3171
benjamin.milder@davispolk.com

Gregory S. Rowland

+1 212 450 4930
gregory.rowland@davispolk.com

Matthew R. Silver

+1 212 450 3047
matthew.silver@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.