

SEC Proposes New Rules on Adviser Oversight of Service Providers

15 November 2022

On October 26, 2022, the SEC proposed, by a vote of 3-2, a new rule (“Proposed Rule”) that, if adopted, would require SEC-registered advisers, including private fund advisers, to undertake due diligence assessments before engaging service providers, including affiliated service providers, for certain “core” advisory-related services or functions and to periodically monitor the service provider’s performance and reassess the appropriateness of the outsourcing arrangement.¹ This proposal continues the extensive 2022 rulemaking agenda for private fund and other advisers.²

The proposals also contain related books and records requirements, including a new provision specifically addressing the retention of outsourced recordkeepers. In addition, SEC-registered advisers would be required to disclose certain census-like information about the Covered Functions (as defined below) and outsourced service providers on Form ADV.

SEC’s Concerns and Objectives

In connection with this proposed rulemaking, the SEC noted that advisers have increasingly outsourced some of the services and functions the adviser otherwise would provide, particularly in the areas of compliance, recordkeeping, investment research and data analysis, trading and risk management, and technology platforms for offering advisory services. The SEC expressed concern about the potential risks to clients when advisers engage service providers to perform activities that form a central part of advisory services. The SEC’s objective in proposing the outsourcing rule is to establish “minimum and consistent” requirements for the oversight of outsourcing by SEC-registered advisers, in keeping with existing fiduciary duties. However, the proposing release mainly addresses risks related to outsourcing advisory

services focused on publicly traded securities while the rule proposal would apply to all SEC-registered advisers, including private equity, real estate and credit managers.

Covered Functions and Service Providers

The Proposed Rule contains a two-part definition of services and functions (“Covered Functions”) that, if outsourced by a SEC-registered adviser, would be subject to the new requirements:

1. A function or service that is necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws,³ 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.⁴

The Proposed Rule expressly excludes as “Covered Functions” clerical, ministerial, utility, or general office functions or services and defines “service provider” as a person (other than an adviser employee) or entity performing one or more Covered Functions. The Proposed Rule makes no distinction between affiliated and unaffiliated service providers and both are covered under the Proposed Rule.

Due Diligence and Monitoring

The Proposed Rule would require SEC-registered advisers to conduct a due diligence review *before* outsourcing any Covered Function, including a new Covered Function to an existing service provider. Specifically, an adviser must reasonably identify and determine that it would be appropriate to outsource the Covered Function, and that it would be appropriate to select that particular service provider, by following a due diligence process that consists of the following prescribed elements:

- Identifying the nature and scope of the Covered Function the service provider is to perform;
- Identifying potential risks to clients or to the adviser’s ability to perform its advisory services resulting from engaging a service provider (and that particular service provider) to perform the Covered Function, including how to mitigate and manage such risks;⁵
- Determining that the service provider has the competence, capacity and resources necessary to perform the Covered Function;

- Assessing the risks of any material subcontracting arrangements of the service provider related to the Covered Function;
- Obtaining reasonable assurances from the service provider regarding coordination for purposes of the adviser's Federal securities law compliance; and
- Obtaining reasonable assurances from the service provider regarding the orderly termination of its performance of the Covered Function.

In addition, the Proposed Rule would require periodic monitoring and reassessment of a service provider's performance and whether the arrangement continues to be appropriate under the due diligence requirements of the rule.

Related Books and Records Requirements

The rule proposals would also (1) amend the Advisers Act books and records rule to require SEC-registered advisers to maintain records of outsourced Covered Functions, the adviser's due diligence assessment and periodic monitoring of the service providers, and copies of written agreements with service providers regarding Covered Functions, and (2) require additional safeguards and requirements for advisers outsourcing recordkeeping functions.

Proposed Form ADV Form Amendments

The SEC also proposed amendments to Form ADV intended to provide more information about an adviser's outsourced Covered Functions to facilitate enhanced SEC oversight and allowing investors and clients to make better informed decisions about their advisers.

Comment Period; Transition and Compliance

The proposed new requirements have a public comment period of 30 days from publication in the Federal Register or until December 27, 2022, whichever period is longer.

If adopted advisers will have ten months from the effective date to comply with the Proposed Rule. Although the Proposing Release states that the Proposed Rule would be applicable only to engagements of new service providers made on or after the

compliance date, the Proposing Release (somewhat unclearly) indicates that certain monitoring and due diligence responsibilities would apply to existing agreements and that some written agreements may require amendment.

1. The proposing release is available through this link: [The Proposed Oversight Requirements for Certain Services Outsourced by Investment Advisers](#). ↩

2. See [SEC Proposes Significant Amendments to Private Fund Manager Reporting on Form PF](#), [SEC Proposes Sweeping Rule Changes for Private Fund Advisers \(Part 1 of 2\)](#), [SEC Proposes Sweeping Rule Changes for Private Fund Advisers \(Part 2 of 2\)](#), [SEC Proposes Significant New Cybersecurity Rules for Investment Advisers](#), and [SEC Proposes Enhanced Disclosure by Certain Advisers on ESG Investment Practices](#). ↩

3. While the SEC explains that the first part of the definition does not cover all services that an adviser could potentially outsource and is more narrowly aimed at the functions and services related to or directly supporting an adviser's investment decision-making process and portfolio management, the definition as proposed potentially could capture a broad range of services and functions. ↩

4. The second prong of the test depends on whether negative impact is "material." The SEC suggests that this could include a material financial loss to a client or a material disruption in the adviser's operations resulting in the inability to effect investment decisions or to do so accurately. ↩

5. According to the SEC, there is a variety of potential risks that the adviser could consider such as sensitivity of information and data, the complexity of the function being outsourced, available alternatives, speed with which a function could be moved to a new service provider, existing and potential conflicts of interest, and availability of market resources. ↩

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Related Services

Practices

- Transactional
- Investment Funds

Suggested Reading

- 03 June 2022 Kirkland AIM SEC Proposes Enhanced Disclosure by Certain Advisers on ESG Investment Practices
- 14 March 2022 Kirkland AIM SEC Proposes Significant New Cybersecurity Rules for Investment Advisers
- 18 February 2022 Kirkland AIM SEC Proposes Sweeping Rule Changes for Private Fund Advisers (Part 2 of 2)

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