Consumer Federation of America

December 24, 2022

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File Number S7-25-22
Outsourcing by Investment Advisers

Dear Secretary Countryman,

On behalf of Consumer Federation of America (CFA),[1] I write to express our support for the above captioned proposal,[2] which would establish a set of minimum and consistent due diligence and monitoring obligations for investment advisers that outsource certain functions to third-party service providers.[3] These obligations would help to ensure that advisers maintain sufficient oversight over third-parties so as to fulfill advisers' fiduciary duty, comply with the federal securities laws, and protect clients from potential harm. In particular, we commend the Commission for recognizing the fact that no reasonable investor would agree to engage an investment adviser that would not perform functions necessary to provide the advisory services for which it is hired, and instead would outsource those functions to a service provider without effective oversight over the service provider.[4] Accordingly, we urge the Commission to finalize this proposal without undue delay.

As the market for investment advisory activities has become more specialized and technology intensive, investment advisers have increasingly outsourced certain functions that are necessary for advisers to efficiently provide investment advisory services to clients in

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[1] The Consumer Federation of America is a non-profit association more than 250 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.
[2] Proposed Rule, Outsourcing by Investment Advisers, Release Nos. IA-6176, October 26, 2022, https://www.sec.gov/rules/proposed/2022/ia-6176.pdf ["Proposing Release"].
[3] This Proposed Rule would apply only to investment advisers that are federally registered or required to be federally registered with the Commission. It would not affect most small investment advisers because they are generally registered with one or more state securities authorities and not with the Commission. Under Section 203A of the Investment Advisers Act, most small advisers are prohibited from registering with the Commission and are regulated by state regulators. *Id*. at 204-205.
[4] As discussed below, we applaud the Commission for recognizing the broader principle that if no reasonable investor would consent to particular advisory conduct, including consent to suffering potential harm, that conduct should be deemed inconsistent with the adviser's fiduciary duty.

compliance with the federal securities laws. These include, for example, functions relating to portfolio management, client servicing, data analytics, cybersecurity, transaction processing, risk management, marketing, regulatory compliance, and valuation, to name a few. However, outsourcing critical advisory functions to third parties raises investor protection concerns, including whether advisers are exercising appropriate oversight of those third parties in order to ensure that such activities comply with the securities laws, including an adviser's fiduciary duty.

As the Proposing Release states, "without a minimum and consistent framework for identifying, mitigating, and managing risks to clients, outsourcing can lead to client harm…such as clients being misled, their adviser making investment decisions based on incorrect data, having sensitive information misappropriated, potential or actual conflicts of interest, or failures to provide records for regulatory oversight."[5] Indeed, Commission staff have observed instances when not all advisers provided a sufficient level of oversight with respect to their service providers, despite these advisers' existing fiduciary duty and other legal obligations.[6]

In light of these developments in the market for advisory services, we strongly support requiring investment advisers to comply with an oversight framework when outsourcing functions or services that are necessary for the investment adviser to comply with the federal securities laws. Specifically, we support this proposed rule to require investment advisers to comply with a due diligence and monitoring process to oversee the provision of covered functions by third-party service providers.

The proposal would include four requirements for investment advisers who outsource advisory functions, including:

- Conducting due diligence prior to outsourcing a "covered function,"[7] as well as periodically monitoring third-party service providers' performance;
- Maintaining books and records related to the oversight of third-party service providers;
- Reporting census-type information about third-party service providers to the public and the Commission; and
- Conducting due diligence and monitoring for third-party recordkeepers and obtaining reasonable assurances that the third-party recordkeepers will meet certain standards.

Individually and collectively, these requirements would help to promote meaningful oversight over third-party service providers whose functions are necessary for advisers to comply with the federal securities laws. If implemented, these requirements would reduce the risks that third parties may not perform their intended functions or may perform such functions negligently, which could undermine an adviser's ability to provide effective advisory services to clients, which in turn could harm the adviser's clients. For example, these requirements would reduce potential risks to investors associated with outsourcing, such as operational failures that impact investors' accounts, fraud, conflicts of interest, and other compliance deficiencies. These

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[5] Proposing Release at 122.
[6] *Id*. at 12.
[7] "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.

requirements are also designed to give the Commission and advisers' clients better information for oversight of advisers' use of third-party service providers, which in turn would help to promote regulatory compliance.

Ultimately, an adviser that outsources advisory functions remains liable for those functions and cannot waive or disclose away their fiduciary duty generally or with regard to outsourced functions. As the Proposing Release states, "We do not believe any reasonable investor would agree to engage an investment adviser that would not perform functions necessary to provide the advisory services for which it is hired, and instead would outsource those functions to a service provider without effective oversight over the service provider."[8] We strongly agree with this statement and commend the Commission for recognizing the broader principle that if no reasonable investor would consent to particular advisory conduct, including consent to suffering potential harm, that conduct should be deemed inconsistent with the adviser's fiduciary duty.[9]

For the reasons discussed above, as well as those discussed in the Proposing Release, we urge the Commission to finalize this proposal without undue delay.

Respectfully submitted,

Dylan Bruce
Financial Services Counsel

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[8] Proposing Release at 14.

[9] Under its duty of loyalty, an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser— consciously or unconsciously—to render advice which is not disinterested, such that a client can provide informed consent to the conflict. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, June 5, 2019, https://www.sec.gov/rules/interp/2019/ia-5248.pdf. According to this Interpretation, informed consent is generally considered on an objective basis. *See Id*. at note 24. Thus, if no reasonable investor would consent to certain advisory conduct, it would not be reasonable to infer that any particular client would provide informed consent to such conduct.