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SEC Proposes RIA Outsourcing Rule

On October 26, the SEC proposed a new Advisers Act rule (the “Proposed Rule”) that would establish specific obligations for Registered Investment Advisers¹ with respect to outsourcing of “Covered Functions”, as that term is defined in the Proposed Rule and further described below.² Under the Proposed Rule, RIAs would be required to, among other obligations:

- **Initial diligence.** Before retaining a service provider that will perform a Covered Function, satisfy certain initial due diligence requirements.
- **Periodic monitoring.** After retaining a service provider that performs a Covered Function, carry out periodic monitoring and reassessment of the service provider with respect to the initial due diligence requirements.
- **Form ADV Part 1A.** Disclose certain information regarding outsourced Covered Functions in new Form ADV Part 1A Item 7.C.
- **Recordkeeping.** Create and maintain certain records in respect of the Covered Functions that the adviser outsources, including (i) a list of the outsourced Covered Functions (along with a record of the factors that led the adviser to list it as a Covered Function), (ii) documentation of the initial due diligence assessment, and (iii) documentation of periodic monitoring.

The comment period expires on December 27, 2022.

I. SCOPE OF THE PROPOSED RULE

1.1 What is a Covered Function?

The definition of “Covered Function” has two elements, each of which must be met for the service provided to constitute a Covered Function:

- “a function or service that is necessary for the adviser to provide its investment advisory services in compliance with the Federal securities laws”; **and**



- “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.”

The Proposed Rule expressly states that clerical, ministerial, utility, or general office functions or services are not Covered Functions.³ Likewise, the proposing release notes that marketing and solicitor functions would not be Covered Functions, because such services are not used by an adviser to provide investment advice to its clients.⁴

In discussing the first element of the Covered Function definition, on the other hand, the proposing release states that the SEC generally would consider functions or services that are related to an adviser’s investment decision-making process and portfolio management to meet the element. With respect to the second element, the proposing release states: “[d]etermining what is a material negative impact would depend on the facts and circumstances, but it 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

Other guidance as to what may (or may not) constitute a Covered Function includes:

- Valuation services/performance measurement. In respect of valuation services, the proposing release states that an adviser that uses valuation service providers to assist in fair value determinations outsources a Covered Function, but that, on the other hand, a common market data provider providing publicly available information would not be a Covered Function.⁶ The proposing release also describes “pricing or valuation services” and “performance measurement” among examples of functions “essential to asset management.”
- The release goes on to note, in contrast, “custodians that are independently selected and retained through a written agreement directly with the client would not be covered by the proposed rule because the adviser is not retaining the service provider to perform a function that is necessary for the adviser to provide its advisory services.”
- Service classifications may differ among advisers. The proposing release states that because the Proposed Rule is meant to encompass functions or services that are necessary for a particular adviser to provide its investment advisory services, certain functions may be Covered Functions for one adviser but not for another.⁷

1.2 **What is a Service Provider?**

“Service Provider” is defined in the Proposed Rule as a person or entity that: (a) performs one or more Covered Functions, and (b) is not a “supervised person” of the adviser, as that term is defined for purposes of the Advisers Act.

The Proposed Rule does not make a distinction between unaffiliated and affiliated service providers.

II. OBLIGATIONS IN RESPECT OF OUTSOURCED COVERED FUNCTIONS

2.1 **Initial Due Diligence**

Under the Proposed Rule, it would be prohibited to outsource a Covered Function, unless the adviser reasonably identifies, and determines that it would be appropriate to outsource the Covered Function and that it would be appropriate to select that Service Provider, by:

- (i) identifying the nature and scope of the Covered Function the Service Provider is to perform;
- (ii) identifying, and determining how the adviser will mitigate and manage, the potential risks to clients or to the adviser’s ability to perform its advisory services resulting from engaging a Service Provider to perform the Covered Function and engaging that Service Provider to perform the Covered Function;



- (iii) determining that the Service Provider has the competence, capacity, and resources necessary to perform the Covered Function in a timely and effective manner;
- (iv) determining whether the Service Provider has any subcontracting arrangements that would be material to the Service Provider's performance of the Covered Function, and identifying and determining how the adviser will mitigate and manage potential risks to clients or to the adviser's ability to perform its advisory services in light of any such subcontracting arrangement;
- (v) obtaining reasonable assurance from the Service Provider that the Service Provider is able to, and will, coordinate with the investment adviser for purposes of the adviser's compliance with the Federal securities laws, as applicable to the Covered Function; and
- (vi) obtaining reasonable assurance from the Service Provider that is able to, and will, provide a process for orderly termination of its performance of the Covered Function.

2.2 Monitoring

Under the Proposed Rule, the adviser is also obligated to conduct periodic monitoring of the Service Provider.

Specifically, paragraph –(a)(2) would require that the adviser periodically monitor the Service Provider's performance of the Covered Function and reassesses the retention of the Service Provider in accordance with the initial due diligence requirements.

While the Proposed Rule does not specify a particular cadence for the periodic monitoring; it provides that it must be conducted at such a manner and frequency that the adviser reasonably determines that it is appropriate to continue to outsource the Covered Function and that it remains appropriate to outsource such Covered Function to the Service Provider.

2.3 Recordkeeping

The Proposed Rule would amend the Advisers Act Recordkeeping Rule (204-2) to require advisers to make and retain specific records related to their due diligence assessment:

- the name of each Service Provider, along with a record of the factors, corresponding to each listed function, that led the adviser to list it as a Covered Function;
- records documenting the due diligence assessment conducted, including any policies and procedures or other document as to how the adviser will comply with the obligation to identify and determine how it will mitigate and manage the potential risks to clients or to the adviser's ability to perform its advisory services resulting from outsourcing a Covered Function;
- copy of any written agreement, including any amendments, appendices, exhibits, and attachments, entered into with a Service Provider regarding Covered Functions;
- records documenting the periodic monitoring of a Service Provider.

III. THIRD-PARTY RECORDKEEPING

The Proposed Rule would add a new provision to the Recordkeeping Rule that would require every adviser that relies on a third party to make and/or keep books and records required by the Recordkeeping Rule to:

- (i) conduct initial due diligence and periodic monitoring of that third party consistent with the requirements under the Proposed Rule;⁸ and



- (ii) obtain reasonable assurances from the third party that such third party has and will continue to have to the ability to:
- a. 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 adviser in providing services to the adviser;
 - b. make and/or keep records that meet all of the requirements of the recordkeeping rule applicable to the adviser;
 - c. provide access to electronic records; and
 - d. ensure the continued availability of records if the third party's operations or relationship with the adviser cease.

IV. NEW FORM ADV PART 1A ITEM REGARDING OUTSOURCING

The Proposed Rule would add new item 7.C. in Form ADV Part 1A to provide “census-type” information about service providers that perform Covered Functions for the adviser.

In Item 7.C., the adviser will be required to indicate “yes” or “no” to the question of whether it outsources a Covered Function to a Service Provider. For each Service Provider, the adviser will need to complete new Section 7.C. on Schedule D, noting the legal name of the Service Provider, the date it was first engaged with respect to a Covered Function, and the category of Covered Function, among other information.

The new Form ADV item will note the following categories of Covered Functions.

- Adviser / Subadviser;
- Client Servicing;⁹
- Cybersecurity;
- Investment Guideline / Restriction Compliance;
- Investment Risk;
- Portfolio Management (excluding Adviser / Subadviser);
- Portfolio Accounting;
- Pricing;
- Reconciliation;
- Regulatory Compliance;
- Trading Desk;
- Trade Communication and Allocation;
- Valuation; and
- Other.



V. NEXT STEPS

If adopted, the Proposed Rule would require advisers to comply with the Proposed Rule **ten months** from the rule's effective date (such latter date, the "compliance date"). The initial diligence requirements would apply to engagement of Service Providers of Covered Functions after the compliance date, but the ongoing monitoring requirements would apply to existing engagements.

Although the Proposed Rule does not expressly impose policy-and-procedure requirements, the proposing release notes that advisers would be required under existing rule 206(4)-7 to have policies and procedures reasonably designed to prevent violations of the Proposed Rule, if adopted. Should the Proposed Rule be adopted, advisers will need to consider which outsourced functions constitute Covered Functions.

Our team would be glad to discuss any items of interest for your team in respect of the Proposed Rule.

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¹ The Proposed Rule would not apply to exempt reporting advisers. On the other hand, parts of the SEC's recent private funds rule proposal would apply to exempt reporting advisers: please see our [February 2022 client alert](#) (or [pdf](#)) for further information. References in this client alert to "advisers" should be understood to be limited to investment advisers that are registered with or required to be registered with the SEC.

² The proposing release is available at <https://www.sec.gov/rules/proposed/2022/ia-6176.pdf>.

³ The proposing release further notes: "[f]or example, covered functions would not include the adviser's lease of commercial office space or equipment, use of public utility companies, utility or facility maintenance services, or licensing of general software providers of widely commercially available operating systems, word processing systems, spreadsheets, or other similar off-the-shelf software."

⁴ The new Marketing Rule does require RIAs to have a reasonable basis to believe that the communications of placement agents and other promoters comply with the Marketing Rule's requirements. Please see our [March 2022 client alert](#) (or [pdf](#)) for further information, at Part III.

⁵ The proposing release continues: "[a]n adviser would consider a variety of factors when determining what would be reasonably likely to have a material negative impact, such as the day-to-day operational reliance on the service provider, the existence of a robust internal back up process at the adviser, and whether the service provider is making or maintaining critical records, among other things."

⁶ See the proposing release at footnote 39.

⁷ The following is an example cited in the proposing release: "[f]or example, an adviser may choose to engage an index provider for the purposes of developing an investment strategy for its clients, which would be a covered function under the proposed rule, while another may license a widely available index from an index provider to use as a performance hurdle, in which case the proposed rule would not apply."

⁸ The SEC noted, with respect to diligence of cloud service providers: the adviser "may not need to understand the intricacies of the cloud service's operations", but "generally should have a reasonable understanding of the cloud service and the risks of the service, and be able to conclude that it can mitigate and manage those risks", and set forth certain factors the adviser might consider.

⁹ This and other categories are broad in scope and are not further defined in the new form ADV item 7.C.