



Schulte Roth&Zabel

SEC Proposed Rule:
(Release No. IA-6176)

**Service Provider Due Diligence & Monitoring for
Registered Investment Advisors**

Webinar

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Our Speakers Today



John Phinney

Chairman/CEO – Convergence Inc
email: jphinney@convergenceinc.com
phone: 203-956-4824

John spent his entire career as a C-Suite Executive at JPMorgan, Fidelity Investments, TRG Asset Management and Apollo Global Management developing and managing the infrastructure needed to increase revenues, improve efficiency and manage investment and non-investment risk. He is a proven thought leader who has designed and developed several first-ever initiatives, including being a named inventor for a patent for a Tier 1 multinational bank.



Carl J. Versella

Managing Director of Capital Markets and Head of Management Consulting – Convergence Inc
email: cversella@convergenceinc.com
phone: 917-232-0750

Carl is a C-Suite executive with a successful track record of launching and managing advisory practices (HC Associates, Rothstein Kass, KPMG, Double N Advisors) for middle market and bulge bracket Financial Services companies. He was a key member in the development of Correspondent Clearing and Prime Brokerage businesses for Goldman Sachs, Credit Suisse, and Morgan Stanley.



Christopher S. Avellaneda

Partner – Schulte Roth & Zabel
email: christopher.avellaneda@srz.com
phone: 212-756-2028

Christopher S. Avellaneda advises hedge funds, private equity funds and funds of funds on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements. Chris has extensive experience providing guidance to clients on establishing compliance programs, registering with the SEC, complying with U.S. securities trading rules and handling SEC examinations.

After brief introductions, the following topics will be discussed:

Purpose & Reasons for the Rule

- Recent SEC staff focus on Service Providers
- Growth Trends
- Legislation

Definitions of the rule

- Outsourced Covered Functions
- Potential Impacted Covered Functions
- Service Provider definition

Questions for the Audience

- Questions #1: Pre-Selection Due Diligence
- Questions #2: Post Selection Monitoring
- Questions #3: Recordkeeping

Key aspects of the rule

- Overview of the proposed rule
- Legal overview of key rule provisions
- Monitoring of service providers
- Monitoring of Covered Functions
- Recordkeeping of Covered Functions
- Amendments to Advisors Act – Books & Records
- Key challenges to the Industry

Questions for the Panel

- Open to all attending
- Pose questions throughout the webinar
- Answer the most-asked questions

The SEC closely monitoring these events:

Recent SEC staff focus on service providers

Growth in advisers' reliance on outsourcing to service providers

- **Material % increases** for all fund types naming service providers

Growth in the number of service providers (since 2015)*

- **20% To 56%** increase in key industry segments; Fund Admin, Fund Auditors, Prime Brokers, Custodians, Marketers, Compliance firms

Regulatory Assets Under Management (RAUM) Growth over the last 10 years

- **\$47 trillion to \$128 trillion**

Investor access to alternative assets

- Pension Plans at **18%**, projected increase to **27%** by 2024

Legislative actions

- Proposed Retirement Savings Modernization Act
- **Advisers and service providers stand to benefit from this proposed legislation**

*Based on data sourced from Form ADV – 2015–2021 and curated and enriched by Convergence

Outsourced Covered Functions – Currently Defined

- Investment decision-making process and portfolio management functions or services outsourced to a service provider
- Any functions or services 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
- Disruption in the Advisor's operations – Material negative impact or its inability to effect investment decisions or to do so accurately
- Not considered Covered Functions – clerical, ministerial, utility, or general office functions or services, 3rd Party Marketers and solicitors

Potential Impacted Covered Functions

These functions have the potential to be part of the proposed rule if outsourced to a service provider:

Investment Functions/Activities

- Portfolio Construction
- Investment & Deal Sourcing
- Deal Negotiation
- Pre-Investment research analysis
- Post-Investment research analysis
- Post Investment Monitoring
- Investment Risk Management
- Outsourced Trading Desk
- Investment Banking
- Financing Activities

Non-Investment Functions/Activities

- Investment Support Operations (MO/BO)
- Portfolio & Management Company Accounting
- Pricing & Valuation
- Investment Compliance
- Regulatory Compliance
- Tax Preparation
- Client Management/Investor Services
- Network (cloud) & Security Services
- Data Management/Data Content
- Human Resources
- Facilities & Vendor Management

Service Provider is defined as a person or entity that:

1. Performs one or more covered functions and;
 2. is not a supervised person of the adviser
- Excludes supervised persons of an adviser since such persons are already directly overseen by the adviser
 - The proposed rule **does not** make a distinction between third-party providers and affiliated service providers

Due Diligence on Service Providers for Outsourced Covered Functions

Requires:

- Due diligence prior to engaging a service provider
- Periodic due diligence monitoring of the performance of each service provider
- Periodic reassessment of each service provider in accordance with due diligence requirements

Amendments to:

- Investment Adviser registration form to collect census-type info about service providers
- Advisers Act books and records rule, including a new provision to keep books & records for conducting due diligence and monitoring on service providers
- Requires outsourced books and records providers to comply with Advisers Act requirements.

Pre-selection Elements of Compliance:

1. **Nature and Scope** of the services
2. **Subcontracting arrangements** related to the covered function
3. **Orderly termination** of the covered function by the service provider
4. **Coordination** with the service provider for federal securities law compliance
5. **Risks** resulting from the service provider performing the covered function
6. **Competence, capacity, and resources** of the service provider to perform the covered function

Expect scrutiny in SEC examinations, as a continuation of SEC exams focusing on due diligence and service provider relationships

- Pay attention to the **fiduciary duties** in the context of the service provider relationship
- Advisers need to determine whether outsourcing the function at all is **consistent with its fiduciary duties**
- The proposal continues the SEC's approach in other recent rulemakings of **applying elements of the Advisers Act to third party service providers**
- Compliance with the rule **10-months post the final rule**

Question # 1: Pre-Selection Due Diligence

What are the top three important aspects of your initial due diligence before selecting a service provider?

- a) Product Technology
- b) Staff & product expertise
- c) Client retention rates
- d) Price
- e) Financial sustainability
- f) Cyber security platform

Any change in the risk profile of the covered function or the service provider would need monitoring such as:

- Service provider layoffs of personnel
- New laws or regulations implemented affecting a specific function
- M&A activity between two service providers
- Change in business conditions (capacity challenges, loss of business)

Question # 2 – Post Selection Monitoring

How often do you monitor changes to the information obtained about the service provider during due diligence?

- a) Once per quarter
- b) Once per year
- c) When a significant change occurs
- d) Never

Revision of the Advisers Books & Records Rule:

- Requires an adviser to **record covered functions** the adviser has outsourced to a service provider
- A **record of the factors**, corresponding to each function that led the adviser to list it as a covered function
- A **written agreement** between the adviser and service provider, explicitly stating the function or service provided is a covered function

Service Provider Information to potentially include:

- Performance reports
- Summary of financial, operational, or third-party assessments
- Identification of service provider risks and mitigation/management those risks
- Amendments to written agreements with a service provider
- A record of changes to the nature and scope of the covered function
- A record of inadequate or failed performance by a service provider of a covered function and responses from the adviser

Question # 3 – Recordkeeping

How are service provider choices documented to justify selection?

- a) A formal DDQ is created for each service provider
- b) An informal discussion with investors takes place, if asked
- c) Refer to email traffic for reference
- d) No formalized process in place currently

Key Challenges – Due Diligence

Investment Advisers

- Analysis of the facts and circumstances
- Time and personnel costs
- Advisers' current process changes
- Subcontractors for service providers
- Compliance coordination
- Increased cost for compliance

Service Providers

- Service Provider cost increases
- Increased demands on personnel time to verify adviser compliance
- Difficulty to assess risk for service providers who utilize subcontractors

Q&A



Schulte Roth&Zabel

Thank you for attending!
Additional Information

Webinar

February 15, 2023

<https://www.convergenceinc.com>

<https://www.srz.com>

Convergence has been providing data-driven insights and implementation services to service providers, advisers, and institutional investors for over 10 years supporting business development, risk management, and product management.

Founded in 2013 by “C-Suite” Executives who had successful track records at Apollo Global Management, JPMorgan, GlobeOp Financial, BISYS, Fidelity, Bank of America, Arthur Andersen, KPMG, and MFS Investments. Personnel has since expanded to encompass “buy” and “sell” side “C-Suite” executives with consulting experience and pedigree from various bulge-bracket firms such as Morgan Stanley, Goldman Sachs, Credit Suisse and Tiger Management.

Our database houses over 46,000 private and public investment advisers in 67 countries, over 238,000 active funds with proprietary risk analytics created on each, along with 15,000+ services providers with advanced metrics and a complete book of business for each service provider.

We maintain 10+ years of clean, structured and enriched time series data with a 95% confidence factor for all data sources. With over 2,000 proprietary enriched artifacts per entity, our data is shaped and highly curated for each client.

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About Schulte Roth & Zabel, LLC



Founded in 1969, Schulte Roth & Zabel is a multidisciplinary firm with international clientele, serving our clients from strategically located offices in New York, London and Washington, DC. Over time, we have become known for two things: doing great work in the financial services sector and doing things a little differently than many of our peers. Instead of trying to be everything to everybody, we've grown organically, in ways that make sense for our clients' industry demands and evolving needs. As one of the leading law firms serving the financial services industry, the firm regularly advises clients on corporate and transactional matters and provides counsel on regulatory, compliance, enforcement and investigative issues.

The firm's practices include: bank regulatory; bankruptcy & creditors' rights litigation; blockchain technology & digital assets; broker-dealer regulatory & enforcement; business reorganization; complex commercial litigation; cybersecurity; distressed debt & claims trading; distressed investing; education law; employment & employee benefits; energy; environmental; finance & derivatives; financial institutions; hedge funds; individual client services; insurance; intellectual property, sourcing & technology; investment management; litigation; litigation finance; mergers & acquisitions; PIPEs; private equity; real estate; real estate capital markets & REITs; real estate litigation; regulated funds; regulatory & compliance; securities & capital markets; securities enforcement; securities litigation; securitization; shareholder activism; tax; and white collar defense & government investigations.

<https://www.srz.com>

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Material growth in the industry since 2015*

Investment Advisers growth on the reliance of outsourcing

- Steady # increase of unregulated funds
- Material # increases of individual & high-net worth investors
- Material % increases for all fund types for naming service providers

Significant increase in the number of Service Providers

- 56% increase in Fund Admin
- 27% increase in Fund Auditors
- 21% increase in Prime Brokers
- 31% increase in Custodians
- 32% increase in Marketers
- 30% increase in Compliance firms

*Based on data sourced from Form ADV – 2015–2021 and curated and enriched by Convergence

Material Growth: Investors

Regulatory Assets Under Management (RAUM) growth over the last 10 years

- \$47 trillion to \$128 trillion

US Retirement Asset & Funding (June 2022)

- Total US retirement entitlements were \$40.4 trillion, including \$33.7 trillion of retirement assets and another \$6.7 trillion of unfunded liabilities
- North American pension plans allocated **18% of assets** to alternative assets, the lowest allocation to alternative investments compared to all other developed geographic regions and its allocations to alternatives are expected to increase to **27% by 2024**
- The reasons for the projected increase include: 1) alternative investments act as hedges against inflation and 2) provide higher returns for institutional and high net worth investors

Legislative Action

On September 28, 2022, Congress proposed the Retirement Savings Modernization Act which amends ERISA:

- Retirement plan sponsors may offer DC or DB plans that are prudently diversified across all asset classes, including both traditional and alternative assets.
- *Advisers and service providers stand to benefit from this proposed legislation.* Encourages DC plan sponsors to offer alternative investment options to 401k holders. DB plans put one of every five dollars in alternative asset classes like private equity.

The Act:

- Clarifies that plan fiduciaries may select investment options that include a range of asset classes, including private equity
- Protects ERISA's fiduciary standard
- Promotes the prudent diversification of retirement savings plans

www.banking.senate.gov/imo/media/doc/retirement_savings_modernization_act1.pdf#:~:text=The%20Retirement%20Savings%20Modernization%20Act%20amends%20ERISA%20to,assets.%20More%20specifically%2C%20the%20Retirement%20Savings%20Modernization%20Act%3A

The public comment period ended on December 27, 2022

☐ 88 public comments were received:

- 21 from Registered Investment Advisers (24%)
- 20 from Industry Groups (23%)
- 14 from Service Providers (16%)
- 9 from Law Firms (10%)
- 19 from Unaffiliated Individuals (22%)
- 2 from Political Groups
- 1 from Academic Groups
- 1 from Investment Consultants (1%)
- 1 from and Exchange (1%)

☐ No public comments were made directly by Institutional Investors

☐ General Themes

- SEC has not established a need
- Redundant with current fiduciary obligations
- Extend the comment period
- Not within the SEC's statutory authority
- Generally opposed to the rule