HOULIHAN LOKEY

December 27, 2022

Via email: rule-comments@sec.gov

Securities and Exchange Commission
450 Fifth Street NW
Washington, D.C. 20549-0609
Attention: Vanessa A. Countryman, Secretary

Re: File No: S7-25-22; Release No. IA- 6176 – Regarding Outsourcing by Investment Advisers

Ladies and Gentlemen:

This letter is submitted by Houlihan Lokey, Inc. ("Houlihan Lokey") in response to the request for comments by the Securities and Exchange Commission (the "Commission") on File No: S7-25-22; Release No. IA-6176 (the "Release").

Houlihan Lokey shares the Commission's view that the use by registered investment advisers ("advisers") of service providers can be beneficial to advisers and their clients, such as by giving the adviser access to certain specializations or areas of expertise and the benefit of independent, third-party advice and analysis. However, we are concerned that the new rule proposed in the Release (the "Proposed Outsourcing Rule") requiring advisers to engage in due diligence, monitoring and record-keeping and to disclose publicly the identity of service providers could significantly increase costs to advisers, clients and service providers and could discourage or reduce the use of service providers to the detriment of advisers and their clients. Houlihan Lokey very much appreciates the opportunity to comment on the Proposed Outsourcing Rule. Per the Commission's request, our goal is to provide insight and input on the Proposed Outsourcing Rule from a service provider's perspective.

Established in 1972, Houlihan Lokey is a leading global investment bank with deep experience in mergers and acquisitions, capital markets, financial restructurings, and financial and valuation advisory services. Houlihan Lokey's Portfolio Valuation and Fund Advisory Services practice ("Portfolio Valuation") is a leading advisor to many of the world's largest asset managers. The Houlihan Lokey Portfolio Valuation group is at the forefront of evolving trends in portfolio valuation best practices and provides valuation and advisory services to hundreds of hedge funds, private equity firms, financial institutions, corporations, other investment managers and investors. As a consequence, Houlihan Lokey is intimately familiar with the valuation and advisory services provided to advisers and the diligence and monitoring already being conducted by advisers in relation to those services and is therefore highly qualified to comment on the Proposed Outsourcing Rule. We have organized our comments by responding to selected questions posed by the Commission in the Release.

Questions 4 and 15: Is the proposed definition of "covered function" clear? Why or why not? In what ways, if any, could the proposed definition be made clearer? Is "necessary for the adviser to provide

its advisory services in compliance with the Federal securities laws" sufficiently clear? Is the term "necessary" too restrictive and, if so, should alternate language be used, such as "supports the adviser in making investment selections and otherwise providing its advisory services in compliance with the Federal securities laws"? Should the proposed rule be limited to providing its advisory services in compliance with obligations only under the Advisers Act?

It is unclear to us what it means for a function or service to be "necessary" for the adviser to provide investment advisory services in compliance with the Federal securities laws. As currently drafted, the definition of "covered function" could be interpreted so broadly that nearly any service provided by a service provider to an adviser could be captured, even if such service is intended to be advisory in nature only and is not intended to be "outsourced" in the traditional sense of the word. For example, as applied to Houlihan Lokey's Portfolio Valuation group, many of our adviser clients have the internal capability of valuing illiquid securities held by their clients. However, as a best practice, our adviser clients choose to engage a third-party valuation firm to provide advice to assist them in their determination of fair value. An adviser could already have its own view as to value and is merely looking for a third party review of their internal valuation determination. The valuations we and other valuation firms provide in these settings are not dispositive of the valuation determined by the adviser. Instead, they are intended to be but one of a number of factors that the adviser may consider in its determination of fair value. We note that a decision by an adviser not to engage a service provider to provide these valuation advisory services would not prevent the adviser from complying with its obligations under the Federal securities laws. In such context, our adviser clients have not "outsourced" their valuation function to us but are merely obtaining advice from us in order to bolster their confidence in their own internally determined marks. We believe that categorizing advisory services such as these as an outsourced covered function subject to the due diligence, monitoring, and recordkeeping requirements of the proposed rule could dissuade advisers from obtaining beneficial third-party advice from service providers, which would ultimately prevent clients from receiving the benefit of such advice, given the additional obligations associated with obtaining such advice. Therefore, we would agree with certain other commenters' suggestion that the Commission limit any rule's applicability to instances where an adviser has fully delegated the performance of a covered function to a service provider.

In addition, we do not think it would be appropriate to characterize valuation advisory services as assisting the adviser in its compliance with the Federal securities laws. Valuation advisory services are not legal advice, nor are they an audit or any form of assurance, as valuation firms rely without independent verification on the accuracy and completeness of the information made available by the adviser and the adviser remains responsible for the ultimate determination of value.

Finally, the Commission's proposal to require advisers to disclose in Form ADV the identity of providers of "outsourced" functions could be misleading to investors. We do not think the portfolio valuation and advisory services we provide constitute an "outsourced" function of the adviser, at least not under the plain meaning of the word "outsourced." As noted above, our adviser clients make their own determination of value; they do not delegate that function to a third party, nor are they bound by our advice. As a result, we do not think it would be appropriate or accurate for a valuation firm to be specifically identified publicly as the party to which its adviser clients have outsourced their valuation responsibility.

Question 20. The proposed rule does not specify how an adviser would "retain" a service provider in compliance with the proposed rule. Should we require a written agreement or some other written documentation between the adviser and service provider to perform a covered function under the proposed rule? If so, what provisions should we require? For example, should certain elements of the proposed rule's due diligence requirements instead be required in a contract between the adviser and service provider?

We would not object to a rule requiring a contract between advisers and service providers. However, the Commission should not prescribe any particular contract terms. Instead, advisers and service providers should be free to negotiate the contract terms that best fit the circumstances of the service being provided. Requiring advisers to obtain particular contractual terms from services providers would increase costs to service providers, costs that would be passed on to the adviser and ultimately borne by clients or even potentially cause such service providers to refuse to contract with advisers, thus denying clients the indirect benefits that could be obtained through advisers' engagement of service providers.

Question 32. Should we require advisers to obtain third-party experts, audits, and/or other assistance to oversee a service provider when the adviser is outsourcing a function that is highly technical, or the oversight requires expertise or data the adviser lacks? For example, if an adviser is outsourcing to a service provider that provides valuation or pricing of complex or private securities, or a service provider that incorporates artificial intelligence into its services, should that adviser be required to confirm it has sufficient internal expertise to effectively oversee the service provider, and if not, obtain a third-party expert to provide such oversight?

We do not believe the Commission should require advisers to obtain third-party experts, audits, and/or other assistance to oversee service providers when the adviser is outsourcing a function the Commission considers highly technical. Instead, advisers should be free to retain additional service providers to assist with oversight when the adviser determines additional assistance would be necessary or appropriate under the particular facts and circumstances. As described above, with respect to Houlihan Lokey's Portfolio Valuation group, many of our adviser clients have the internal capability of valuing illiquid securities held by their clients, and therefore have the internal capability to oversee our services without the assistance of another service provider. Requiring advisers to retain third parties to assist in the oversight of other service providers when that additional assistance is unnecessary would unnecessarily increase costs to advisers and could discourage advisers from using service providers to the detriment of advisers and their clients.

Question 46. Is the provision requiring the adviser to obtain reasonable assurance from the service provider that it is able to, and will, coordinate with the adviser for purposes of compliance with the Federal securities laws, as applicable to the covered function, appropriate?

We do not think the provision requiring the adviser to obtain reasonable assurance from its service provider that it is able to, and will, coordinate with the adviser for purposes of compliance with the Federal securities laws is appropriate. This provision is vague and ambiguous, and it is not clear what it requires, either from advisers or service providers. As applied to the services Houlihan Lokey's Portfolio Valuation group provides to its adviser clients, our engagement letters with our adviser clients make clear that we are not undertaking to provide legal, regulatory or other similar advice. This allocation of responsibility is the norm among portfolio valuation firms and their adviser clients. In addition, as noted above, our services are intended to be advisory in nature: whether or not an adviser client agrees with or adopts our advice is solely at the discretion of the adviser. It is unclear what, if any, assurance we could provide in the context of valuation advisory services that we would coordinate with the adviser for purposes of its compliance with Federal securities laws. Altering typical industry practice in this regard would be disruptive, would distract from the services being provided and would impose risks and uncertainties on service providers that would lead to increased costs to advisers and, ultimately, their investor clients.

Question 47. Is the proposed requirement to obtain reasonable assurance that the service provider is able, and will, provide a process for orderly termination appropriate? Is it clear what we mean by "orderly?" Should we define what "orderly" means instead? If so, how should we define it?

The circumstances under and manner in which a service provider may stop providing services should be determined on the basis of the relevant facts and circumstances, including the nature of the services being provided and the facts leading to the termination. A provider may have an immediate and legitimate need to terminate service under certain circumstances, such as the breach by the adviser of a material term of the services agreement, the nonpayment of fees, fraud or other improper conduct by the adviser, or other similar issues.

Question 51. Should we prescribe the frequency of monitoring instead of requiring an adviser to monitor its service providers with a manner and frequency such that the adviser reasonably determines that it is appropriate to continue to outsource the covered function and to outsource to the service provider, as proposed? Or should we prescribe a minimum frequency of monitoring? For example should we require that monitoring of service providers be conducted monthly? Quarterly? No less than annually? Why or why not?

Advisers and service providers should be able to come to reasonable agreement and cadence of monitoring, as appropriate for the type of services involved. A rule prescribing a minimum frequency of monitoring is unnecessary, inappropriate and could even be detrimental. In our experience, responding to inquiries related to compliance monitoring or diligence necessarily requires input and assistance from the very people responsible for providing the relevant service. As such, a rule requiring compliance activity at year-end or quarter-end or during other similarly busy periods, or a rule creating a uniform compliance schedule applying across hundreds or thousands of customers, would divert the attention of these people away from providing services, which could compromise the timeliness and/or quality of the services.

Question 54. Should we prescribe the manner in which monitoring is conducted? For example, should we require that advisers conduct onsite visits of service providers on a periodic basis, or that advisers require periodic written certifications of compliance on a periodic basis, or engage third-party experts to conduct formal reviews? Why or why not? Are there any other monitoring actions that we should require?

We do not think the Commission should prescribe the manner in which monitoring is conducted. Advisers should have the flexibility to determine alongside service providers what is appropriate for purposes of achieving monitoring, taking into account the nature of the services and other applicable facts and circumstances. Prescriptive requirements would increase costs to service providers, which would be passed on to the adviser and ultimately borne by clients.

Question 57. Do the proposed categories adequately capture the range of covered functions? Are the categories understandable? If not, which categories require additional explanation? Should we add or remove any categories? If so, please identify the category and explain why the change is appropriate. For example, should we include additional categories relating to investment data/analytics, information technology (e.g., IT infrastructure or application software and support), or middle and back office functions (e.g., client reporting and/or billing, performance measurement, collateral management, post-trade processing, etc.)? Alternatively, should the categories be consolidated (e.g., pricing and valuation), retitled or otherwise revised?

We believe the Commission's proposal to require advisers to disclose in Form ADV the identity of providers of "outsourced" functions could be misleading to investors, because in many cases, the services being provided are a supportive of, rather than a replacement for, the relevant internal function. The proposed categories do not address this distinction and could imply there is a uniform, fixed approach to the nature and scope of the services provided, the adviser's reason for obtaining the service and the adviser's

use of the services, when in reality, each of these items will vary depending on individual facts and circumstances of the individual adviser and service provider.

As noted above, the valuations we and other valuation firms provide are not dispositive of the valuations determined by the adviser. Instead, they are intended to be but one of a number of factors the adviser may consider in its determination of fair value. In addition, we and other valuation firms rely without independent verification on the accuracy and completeness of the information made available by the adviser. Public disclosure, in Form ADV or otherwise, that a valuation firm was providing a valuation as an "outsourced" function could incorrectly suggest to the adviser's clients that the valuation firm's determination of value was dispositive or that the valuation firm provided some verification or audit of the information provided to it. Furthermore, disclosure of a valuation firm's name as the provider of "outsourced" valuation services could instill false confidence in an adviser's clients, particularly where the valuation mark determined and disclosed by the adviser is inconsistent with the valuation advice of the service provider. For these reasons and the reasons discussed below, we do not believe a rule requiring public disclosure of a valuation firm as an outsourced service provider would be in the best interest of advisers or their clients.

Question 59. Do advisers have concerns with the public disclosure of service providers that perform covered functions? If so, what are those concerns? For example, are there categories of service providers that should not be disclosed publicly due to competitive, trade secret, compliance, or other risks? Should we require such disclosure to be reported non-publicly to the Commission in a format other than the Form ADV? If so, how?

Requiring public disclosure of service providers performing covered functions would bring unnecessary risk and exposure to advisers and service providers, which could increase costs to advisers that would ultimately be passed on to and borne by their clients. For example, the disclosure of certain service providers as parties fulfilling "outsourced functions" could mislead investors as to the contractually agreed role of the service provider. As noted above, our services are intended to be advisory in nature: whether or not an adviser client agrees with or adopts our advice is solely at the discretion of the adviser. For that matter, our valuation and advisory services engagement letters provide that the adviser remains responsible for the ultimate determination of value and our advice is to be just one of a number of factors considered by the adviser in its determination of fair value, that we are not providing legal advice, and that we are entitled to rely without independent verification on the accuracy and completeness of information made available to us by the adviser.

In addition, as some other commentators have stated, public disclosure poses additional cybersecurity concerns and risks. For example, an unsavory actor could learn the identity of a service provider's clients based upon publicly available data and use that information in spear phishing attacks on the service provider, or learn the identity of an adviser's service providers to impersonate those service providers in spear phishing attacks on the adviser.

Public disclosure is also unnecessary. Investors have the ability to seek information regarding service providers on a confidential basis in connection with ordinary course due diligence and vendor due diligence questionnaires. If the Commission were to move forward with a rule requiring disclosure, it could consider a rule making clear that investors can seek information regarding service providers from advisers on a confidential basis. The Commission could also accomplish its goal of insight into advisers' critical service providers by leveraging information received in connection with its routine audits and examinations of advisers.

Question 84. Under our current proposal, all current applicable adviser engagements with service providers would fall within the purview of the proposed rule and would be subject to the due diligence and monitoring requirements as outlined within the proposal as of the compliance date. We understand that this requirement may result in advisers having to revisit existing arrangements with service providers to review for compliance and perhaps even requiring advisers to amend current contracts to satisfy the requirements of the proposed rule. We request comment on whether the rule should include a provision that excludes an adviser's existing engagement with a service provider that occurred prior to any compliance date of the proposed rule.

Any rule promulgated by the Commission should allow advisers and their service providers the flexibility to determine and agree upon the nature, scope, manner and timing of diligence or monitoring that is appropriate under their particular facts and circumstances, and should refrain from requiring parties to adopt particular provisions in their contracts regarding diligence or monitoring through other prescriptive measures. Requiring advisers and service providers to agree to particular contractual terms or amend existing agreements to comply with overly prescriptive rules would increase costs to advisers and service providers, which costs would ultimately be borne by clients. In addition, certain contractual terms could prove to be unacceptable to some service providers. If the Commission were to mandate such terms nevertheless, those service providers may opt to discontinue offering their services to advisers, resulting in fewer available providers, potentially impacting the quality of available services and further increasing costs.

As described above in our answers, various aspects of the Proposed Outsourcing Rule would likely significantly increase costs to service providers, which costs would likely be passed on to advisers and, ultimately, clients. We already respond to appropriately thorough diligence and oversight from our clients, addressing matters that include the experience and qualifications of our valuation professionals, cybersecurity measures, data analytics and other IT matters. We nevertheless estimate that were the proposed rule to be implemented in its current form, we would need to retain two or three additional full-time compliance professionals and, on top of that, our valuation professionals would need to spend significantly more time responding to diligence and oversight inquiries, which would further increase the cost of providing services to advisers.

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We hope the Commission finds these views and suggestions helpful. We would be happy to discuss any questions the Staff or the Commission may have with respect to this letter. Please do not hesitate to contact us at SECCommentLetter@hl.com with any questions regarding the foregoing.

Respectfully submitted,

/s/ Houlihan Lokey, Inc.

Houlihan Lokey, Inc.