Via Electronic Filing

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Outsourcing by Investment Advisers, Securities and Exchange Commission Release No. IA-6176 (October 26, 2022); File No. S7-25-2

Dear Ms. Countryman,

Lincoln International LLC ("Lincoln International" or "we") welcomes the opportunity to provide comments on the Securities and Exchange Commission's (the "Commission") proposed rule 206(4)-11 [1] (the "Proposed Rule") under the Investment Advisers Act of 1940, as amended ("Advisers Act"), addressing outsourcing by registered investment advisers. Lincoln International is a leading global investment banking advisory firm registered with the Commission as a broker-dealer and is a member of both the Financial Industry Regulatory Authority and the Securities Investor Protection Corporation. Serving leading investment advisers, including private equity and other alternative asset managers, private and public corporations and private business owners, Lincoln International, together with its affiliates, offers a range of advisory services including mergers and acquisitions, capital and private equity advisory and valuations. Lincoln International advised on over 400 global transactions in 2021 and, through affiliated entities, conducts approximately 15,000 portfolio company valuations annually. As a trusted advisory provider to registered investment advisers, Lincoln International believes it is highly likely that it will be considered by advisers as potentially a service provider providing a covered function in the scope of the Proposed Rule. For that reason, Lincoln International provides below its views on certain aspects of the Proposed Rule and its suggestions as to how specific elements of the Proposed Rule might be enhanced to provide further clarity to investment advisers, service providers and other industry participants and avoid imposing unnecessary burdens and costs on service providers and advisers, as well as funds and their investors.

1. <u>If enacted, the Proposed Rule will unduly increase costs for service providers and, indirectly, for investment advisers and investors.</u>

If enacted, the Proposed Rule would require investment advisers, prior to engaging a service provider to perform a covered function, to comply with six specific elements of due diligence. These include that an adviser must (i) identify the nature and scope of the covered function the

[1] *See* Proposed Rules for Outsourcing by Investment Advisers 87 Fed. Reg. 68816 (Nov. 16, 2022) ("Proposed Rule").

service provider is to perform, (ii) identify and determine how it would mitigate and manage the potential risks to clients or the investment adviser's ability to perform its advisory services, (iii) determine that the service provider has the competence, capacity, and resources necessary to perform the covered function, (iv) determine if the service provider has any subcontracting arrangements, (v) obtain reasonable assurance from the service provider that it is able to and will coordinate with the adviser for purposes of the adviser's compliance with the Federal securities laws, and (vi) obtain reasonable assurance from the service provider that it is able to and will provide a process for orderly termination of its performance of the covered function.[2]

In the proposing release, the Commission indicates that service providers would face increased costs because of this due diligence that may be partially or fully passed on to advisers.[3] It notes that these costs would include those for responding to requests from advisers for information or otherwise participating in the adviser's due diligence, updating or reforming their operations, as well as negotiating or renegotiating service arrangements. The Commission also notes that these costs would involve senior business, legal, and compliance personnel, external costs for counsel, and potential costs for hiring additional personnel to help with these burdens, and that any portion of the resulting costs that is not borne by service providers would ultimately be passed on to advisers, and may in turn be passed on to clients and investors.[4]

Lincoln International agrees with the Commission's analysis that service providers would face increased costs based on the required adviser due diligence. Lincoln International already spends a significant amount of time and effort responding to diligence and related requests from its clients. Lincoln International currently employs one full-time person dedicated to responding to due diligence requests from valuation clients. Responding to such requests also requires the efforts of multiple individuals within Lincoln International such as legal, compliance, human resources, information technology, accounting and other related services. While difficult to quantify, due diligence represents a significant time commitment. These costs will inevitability increase as a result of the Proposed Rule. Lincoln International may need to raise its fees to cover the additional costs, making its services more expensive for advisers, and ultimately their funds and investors. This could be particularly problematic for small advisers, which may be excluded from valuation services that would benefit their funds and investors but would become too costly for them. This increased cost is unwarranted, as many of Lincoln International's clients already perform due diligence on its valuation services as appropriate, including pursuant to 17 C.F.R. Section 270.2a-5 ("Rule 2a-5"), which permits advisers to assign a valuation designee to reasonably segregate fair value determinations from the portfolio management of the fund and implement oversight for outsourced pricing services impacting the fund's valuation. The additional requirements included in the Proposed Rule would not only be unnecessary, unduly burdensome, and duplicative, they would lead to confusion, because advisers and service providers would have to complete various versions of due diligence and related items that in many cases would be focused on the same practices.[5]

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[2] *See* Proposed Rule, 87 Fed. Reg. 68816 at 40-41.
[3] *Id.* at 136.
[4] *Id.*
[5] We note that the proposing release includes potential additional oversight over sub-contractors. With respect to oversight of sub-contractors, Lincoln International makes the same points regarding service provider diligence and oversight generally. In addition, Lincoln International requests that the Commission omit specific requirements from

In addition, we note the proposing release considers that costs from the Proposed Rule would decline over time as advisers develop their due diligence systems.[6] This may potentially be the case for specific advisers, but considering our experience, we do not expect this would be the case for costs incurred by a service provider in connection with the processes outlined in the Proposed Rule. Our costs in connection with diligence, oversight, contract negotiation and related items generally increase year over year, and we anticipate that they would continue to increase as advisers implement new and varying programs to comply with obligations under the Advisers Act.

We believe that the Commission should not move forward with the Proposed Rule and instead continue to allow advisers and service providers to tailor due diligence to the needs of each relationship without the imposition of undue burdens. We note that many due diligence requests and related items currently are already designed considering regulatory obligations and an adviser's duties. Should the Commission decide to move forward in prescribing certain items and processes as described in the proposing release, we believe there are ways that the Commission could mitigate the significant burdens that the requirements would cause. First, a streamlined list of standardized requests would ensure that service providers are not required to manage a variety of additional diligence requests from their clients. If diligence programs are customized by advisers, Lincoln International would be required to respond to each adviser's diligence program separately on an annual basis (with some advisers requiring quarterly diligence responses) over its more than 125 current clients, which client base is only expected to grow. Creating a standardized list could allow the Commission to ensure advisers are taking steps to diligence their service providers while attempting to minimize costs and expenses. Second, if the Commission decides to move forward with this requirement, we request that it allow advisers to rely on other regulatory obligations, such as those related to Rule 2a-5, in connection with diligence and monitoring. Information and processes designed to comply with regulatory obligations comparable to the Proposed Rule should be able to be utilized for compliance under the Proposed Rule. This approach would minimize burdens on advisers and service providers, by limiting duplicative information and requests, as well as providing more clarity for what would be sufficient under a final rule with respect to information provided regarding the same services. Third, Lincoln International believes that any final rule should provide for an exception for confidential or proprietary information. A service provider should not be required to provide information that is confidential or that could negatively affect its business if provided.

The Commission should not expand the proposed requirements. The Commission has asked through certain questions, such as questions 32 and 37 on pages 62-63 of the proposing release,[7] whether diligence should be further expanded, such as to confirm the financial stability of a service provider through the review of audited financials, costly SOC-1 reports or mandated insurance levels. Lincoln International does not believe that further expansion would be appropriate, as it would increase the burdens and costs discussed above. In addition, mandating insurance levels would likely lead to insurance rates increasing for service providers as the insurance industry would know that purchasing certain levels is not optional for these providers. With regard to

any final rule regarding sub-contractors such as separate audits and permit advisers and service providers to address sub-contractor oversight depending on the relationship and scope of services.

[6] *See* Proposed Rule, 87 Fed. Reg. 68816 at 137.

[7] *Id.* at 62-63.

question 32 specifically, it is unclear how requiring 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 when the oversight requires expertise or data the adviser lacks would be beneficial. If the adviser is not qualified to diligence a service provider, it is unclear to Lincoln International how the adviser would interpret information provided to the adviser about that function from a third party that evaluates the adviser or ensure that the third party evaluating the service provider were doing so properly. Instead, the requirement would add further burdens and costs without benefit. The Commission should reconsider the Proposed Rule, as it will impose undue burdens on service providers and advisers and their funds and investors as a whole and, at a minimum, consider mitigating those burdens.

2. The Proposed Rule would indirectly regulate entities over which the Commission does not have jurisdiction.

The Proposed Rule would indirectly regulate and significantly affect service providers, many of which are entities not under the Commission's jurisdiction. Under the Proposed Rule, to avoid damaging the relationship with their clients or even losing such clients, service providers that provide covered functions as well as their subcontractors would be expected to cooperate in the provision of significant due diligence and with monitoring as well as form agreements with their clients to support them in compliance with the proposed rule.[8] The Commission appears to recognize this concern in its proposal. For example, the Commission asks whether 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, is appropriate.[9] Lincoln International believes that it is not. This is only one instance in which, effectively, service providers would need to commit to compliance with the final rule in their efforts to coordinate with the adviser in the interest of compliance. As the Commission does not oversee service providers in this capacity, effectively causing them to comply with the rule would be inappropriate.

3. The Commission should not include data providers explicitly within the scope of the rule.

The Commission has asked whether data providers should explicitly be within the scope of the final rule.[10] As with all outsourced services, there is a range in the depth and variety of services that service providers provide to advisers and their funds, such that Lincoln International does not believe that data providers should explicitly be within the scope of the rule. In fact, the Commission notes that common market data providers providing publicly available information would not meet the definition of a covered function. Lincoln International provides a variety of data-related services to its clients, including through quarterly valuation assumptions, market insights, webinars and private market indices. These services should not *de facto* meet the definition of a covered function. Instead, the Commission should allow advisers to consider in good faith and on

[8] *Id.* at 141.
[9] *Id.* at 65.
[10] *Id.* at 33.

a case-by-case basis whether data providers meet the definition of a covered function to ensure that they are accounted for within the rule only as appropriate.[11]

4. The Commission should clarify certain terms included in any final rule.

Lincoln International believes that certain of the terms included in the Proposed Rule that are relevant to its services are vague, which would make it challenging for advisers to comply and service providers to support advisers in that compliance. In particular, Lincoln International suggests that the Commission clarify the terms "pricing service," "pricing provider," "valuation," "valuation agent," and "valuation specialist." The Commission provides some limited explanation as to the definitions of these terms, but not enough for them to be properly applied. For example, the Commission refers to both pricing and valuation services, but it does not clearly describe the difference. In fact, it asks whether these services should be considered in a consolidated manner. Moreover, there is inconsistency between the Commission's definitions and those offered by the Public Company Accounting Oversight Board ("PCAOB"), in that the PCAOB refers to firms that value illiquid securities as valuation specialists, adding to the potential for further confusion. The Commission should engage with those involved in the industry and look to industry standards, including those offered by the PCAOB, in clarifying these terms.

5. The Commission should include a specific presumptive materiality threshold.

The Commission also has asked about the appropriate percentage of measurement for determining whether a service provider's functions should be considered "core" to an adviser if they could have an impact on a certain minimum percentage of the adviser's clients or regulatory assets under management.[12] We believe that providing for guidance of a presumptive threshold is beneficial and suggest a 20% threshold above which an adviser, subject to the particular facts and circumstances of the relationship, would likely consider the service provider relationship material for purposes of the final rule. This would provide helpful guidance on materiality determinations and the decisions that would flow from that including diligence and monitoring processes. In calculating whether or not the threshold would be met, however, only the relevant services should be included; for example, if the service provider offers various functions including mergers and acquisitions and valuation support, but the covered function is only valuation services, the valuation services should be included in the threshold, but the mergers and acquisitions services should not be.

6. Any future rule should either not require disclosure of service providers on Form ADV Part 1A or take steps to limit unintended effects that may come from their inclusion.

In addition to the Proposed Rule, the Commission is proposing to amend Form ADV Part 1A to require registered advisers to identify their service providers that perform covered functions, provide the location of the office principally responsible for the covered functions, provide the date on which they were first engaged to provide covered functions, and state whether they are

[11] Lincoln International notes, as a general matter, it believes that the Commission should consider a safe harbor for advisers that make good-faith determinations as to which of their service providers fall within the scope of the final rule such that they will not be second-guessed by the Commission on future examinations or otherwise.
[12] *See* Proposed Rule, 87 Fed. Reg. 68816 at 33.

related persons of the adviser.[13] The Form ADV Part 1A would also require, for each service provider, specific information that would clarify the services or functions it provides. Lincoln International requests that the Commission remove this requirement to prevent confusion about an adviser's responsibilities. For example, a disclosure could result in a mistaken belief among investors that a service provider is ultimately responsible for the determination of value. For its engagements, Lincoln International does not determine final valuations.[14] Valuation providers generally offer their professional views on ranges of value, and advisers have no obligation to accept those views or choose a value within the valuation providers' range. Valuation providers also often have no insight into whether an adviser ultimately chooses to select a final valuation within that range. Making these service providers' information public may give the opposite impression, that valuation providers have the final say and are responsible for the ultimate valuations, but this would be inaccurate.

While we believe this requirement should not be instituted, if it is, we recommend that such disclosure be anonymous, which could be done through Form ADV Part 1A with the service provider information included in the Form but not displayed publicly. As referenced above, public disclosure of service providers may confuse investors as to where responsibility for determination of value lies. There are also other methods by which the Commission could accomplish its goal of obtaining the relevant service provider information without exposing it publicly in a manner that could reduce negative impacts and confusion. The Commission could request such service provider lists through its regular exam and request processes to the extent not already done so currently. Lincoln International understands that, under the Proposed Rule, investment advisers would be required to maintain additional books and records with respect to relevant service providers that could provide the relevant information as requested by the Commission. Alternatively, the Commission could request, in the Form ADV Part 1A, similar information as provided in the Proposed Rule but only require that service providers be publicly identified in the case of service providers that are related persons or that are otherwise affiliated with the registered investment adviser.

If the Commission intends to proceed with a public disclosure requirement, Lincoln International requests that the Commission clarify that being listed in Form ADV Part 1A as a service provider does not, in and of itself, imply that the entity so named is an investment adviser or has any responsibilities under the Advisers Act, including its Rule 206, to avoid confusion to the investors and the public as to the roles of service providers.

7. <u>If enacted, any final rule should include a grandfathering provision for existing service provider outsourcing agreements.</u>

Service provider integration and engagement is complex, and many existing service provider agreements extend well into the future with substantial time and resources already spent diligencing and negotiating the agreements. The Proposed Rule creates a likelihood that many service provider agreements would need to be renegotiated, potentially placing a burden on

[13] *Id.* at 72.

[14] *See* Final Rule on Good Faith Determinations of Fair Value, 86 Fed. Reg. 748 (Mar. 8, 2021) at 52 ("[I]n seeking the assistance of others, the entity or officer designated to perform the fair value determination remains responsible for that determination and may not designate or assign that responsibility to the third party. . . .").

advisers and service providers. Lincoln International would be required to renegotiate over 100 agreements with advisers to maintain its relationships with them, and we understand that certain service providers could be required to renegotiate as many as thousands of these agreements. Failure to renegotiate could also cause a disruption for funds or investors, as advisers could be forced to find other service providers that might be more readily able to comply with the requirements of the rule but are not necessarily as capable of providing the services, either because of expertise or experience with the relevant adviser and funds. It is also possible that this could result in the consolidation of service providers that are willing and able to cooperate and the inefficient in-sourcing of services by advisers.

Renegotiating existing agreements would place a significant burden on advisers and service providers such that any final rule should include a grandfathering provision for existing service provider agreements. This would avoid any disruption to clients and investors that would result from advisers having to renegotiate service provider agreements and provide the industry with time to adjust.

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Again, we thank you for the opportunity to provide these comments. If you have any questions regarding our comments, please feel free to contact Troy Peters, General Counsel of Lincoln International at [redacted] and [redacted]. We would welcome the opportunity to meet with the Commission as it considers the comments offered and drafts a final rule.

Troy Peters