December 27, 2022

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

Re: File Number S7-25-22

Dear Commissioners and Staff,

We are pleased to provide comments on the Commissions proposed new rule under the Investment Advisers Act of 1940 ("Advisers Act") to prohibit registered investment advisers ("advisers") from outsourcing certain services or functions without first conducting minimum due diligence requirements prior to engaging a service provider to perform certain services or functions and requiring advisers to periodically monitor the performance and reassess the retention of the service provider; and corresponding amendments to the investment adviser registration form.

Kroll provides proprietary data, technology, and insights to help our clients stay ahead of complex demands related to risk, governance, and growth. Our solutions deliver a powerful competitive advantage, enabling faster, smarter. and more sustainable decisions. With more than 6,000 experts around the world, we create value and impact for our clients and communities. To learn more, visit www.kroll.com.

Kroll is the premier global valuation and corporate finance advisor with expertise in valuations for financial reporting and tax, complex valuation, dispute and legal management consulting, M&A, restructuring, cybersecurity, and compliance and regulatory consulting. Our valuation business was formerly branded and formerly known as Duff & Phelps, but after a recent re-branding, we now operate the business under the name Kroll. Our personnel support industry efforts to enhance consistency and transparency, including participation in various AICPA and TAF (The Appraisal Foundation) task forces and committees, and other industry bodies such as the International Private Equity and Venture Capital Valuations Board, and the IVSC (International Valuation Standards Council). Our advice is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions.

Our role in the financial statement preparation process is distinctive. We support boards and managers (fund advisers) by enhancing their internal control process as it relates to estimating fair value, regulatory compliance, and other agreed upon services. Given our deep expertise working with Private Funds and with investments that are infrequently traded or not traded, we have routinely provided our insights with respect to the Commissions rule making, FASB and PCAOB proposals, and other applicable global regulations.

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Boards and Advisers are responsible for the assertions contained in financial statements; they cannot abdicate this role or outsource it to a third-party. However, they can enhance their operations and governance by obtaining support from experienced qualified service providers.

While there is no question that Advisers should carefully vet the third-party service providers who assist them in performing their non-delegable fiduciary duties, the proposed rule is—for the reasons detailed in our formal comments that follow—neither necessary nor beneficial. If the Commission nonetheless decides to proceed with the rulemaking, it should at minimum revise the proposed rule to mitigate the harmful, unintended consequences that would flow from its overly broad definition of Covered Functions and the expanded ADV disclosures it mandates. We are concerned that the proposed rule and disclosure amendment will mislead investors, adversely impact the public trust, and reduce the quality and availability of key expertise to Advisers.

We would be pleased to discuss our comments with the SEC staff. Please reach out to David Larsen at [redacted] or Miriam Strauss at [redacted] with any questions.

Sincerely,

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Comments of Kroll LLC on
Proposed Rule 206(4)-11 Regarding Outsourcing by Investment Advisers
(File Number S7-25-22)

Kroll believes that the proposed rule is unnecessary. But even if additional regulation were needed, the proposed rule as currently drafted would neither benefit investors nor assist the Commission in its work.

Kroll has three interrelated concerns with the proposed rule as currently drafted: that the rule's imprecise definition of covered functions could be read as encompassing more service providers than is appropriate; that the failure to define "outsourcing" risks over-application of the rule; and, that the rule's potentially over-inclusive scope could impair rather than enhance investor protection.

Because multiple questions posed by the Commission implicate these overarching issues, we have structured our responses thematically rather than on a question-by-question basis to minimize repetition.[1]

I. The proposed rule is unnecessary and counterproductive.

There is no need for the proposed rule. As Commissioner Peirce recently asked, "What precisely is the problem" that the proposed rule "is trying to correct?" H.M. Peirce, Outsourcing Fiduciary Duty to the Commission: Statement on Proposed Outsourcing by Investment Advisers (Oct. 26, 2022), *available at* https://www.sec.gov/news/statement/peirce-service-providers-oversight-102622. It is, as Commissioner Uyeda observed, unclear whether "there is any observable problem related to investment advisers' oversight of service providers that necessitates" adoption of the proposed rule. M.T. Uyeda, Statement on Proposed Rule Regarding Outsourcing by Investment Advisers (Oct. 26, 2022), *available at* https://www.sec.gov/news/statement/uyeda-statement-service-providers-oversight-102622. Indeed, given that 17 C.F.R. § 275.206(4)-7 already requires advisers to "[a]dopt and implement written policies and procedures reasonably designed to prevent violation" of the Investment Advisers Act of 1940, as amended, and that 17 C.F.R. § 270.2a-5(b)(i)(B) already requires boards to oversee advisers acting as valuation designees, there is no reason to think that any of the "service provider failures" cited by the Commission when proposing the rule "would have been prevented had the rule been in effect." *Id.*[2]

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[1] This discussion below is responsive to Questions 1, 4, 6, 8, 9, 13, 27, 56, 57, 58, 59, 86 and 99, among others.

[2] *See also* 17 C.F.R. § 270.38a-1 (requiring "[e]ach registered investment company and business development company" to "[a]dopt and implement written policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by the fund").

The proposed rule is neither needed nor helpful. As explained in greater detail in the sections that follow, the proposed rule would mislead investors, spark meritless litigation, reduce advisers' access to important services, and not help the Commission in its oversight work. The public disclosure of third-party service providers on Form ADV would cause investors to falsely believe that each identified service provider is—regardless how limited its engagement—responsible for investment advice that is both in fact and as a matter of law solely attributable to the adviser. That confusion and the undue reliance it generates will not only distort investors' investment decisions but lead them to file unfounded suits against service providers. The threat of expensive litigation and potential liability will drive at least some service providers from the market and thereby reduce advisers' access to qualified, experienced third-party service providers whose services indirectly benefit investors. Furthermore, collecting the information that would have to be provided on the proposed amended Form ADV would not assist the Commission in its oversight activities. Because determining whether certain services are covered would be fact-dependent and services might be covered when provided to one adviser but not another, advisers' disclosures will be inconsistent, confusing investors and leaving the Commission with fundamentally flawed data. And because the services rendered by service providers would be identified under the proposed rule using overly broad categories that do not convey the actual scope and limitations of a service provider's engagement, the data that would be collected would not provide the Commission an accurate picture of advisers' third-party relationships. Regardless, even if the information did aid the Commission's work, there is no need for public disclosure of third-party service providers when confidential disclosure to the Commission would yield the same information but without the investor confusion, unnecessary litigation, and ensuing market exit that public disclosure would cause.

If the Commission chooses to proceed with the rulemaking, which Kroll believes to be unwarranted, it should at the very least revise the proposed rule to mitigate the harms identified above and detailed below.

II. The proposed rule's imprecise definition of "Covered Function" could be read as encompassing more service providers than is appropriate.

The proposed rule as currently drafted does not clearly define the advisory functions that it covers—and thus does not clearly identify the service providers to whom it applies. As currently drafted, the proposed rule might be interpreted as applying to third-party vendors retained by registered investment advisers for limited purposes that do not affect the adviser's investment decisions. Read in such an expansive manner, the proposed rule would apply to more service providers than is appropriate.

The Commission has proposed defining "Covered Function" to "mean[] a function or service that is necessary for the investment adviser to provide its investment advisory services in compliance with the Federal securities laws, and 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." Outsourcing by Investment Advisers, 87 Fed. Reg. 68816, 68879 (Nov. 16, 2022) (proposed Rule 206(4)-11(b)).

The Commission has explained that it would as a general matter "consider functions or services that are related to an adviser's investment decision-making process and portfolio management to meet the first element" of the proposed definition of "Covered Function." 87 Fed. Reg. at 68821. Examples of "functions and services" that the Commission "believes would be covered" under the proposed definition include "those related to providing investment guidelines (including maintaining restricted trading lists), creating and providing models related to investment advice, creating and providing custom indexes, providing investment risk software or services, providing portfolio management or trading services or software, providing portfolio accounting services, and providing investment advisory services to an adviser or the adviser's clients." *Id.*

Viewed together, the examples given suggest that the Commission intends the term "Covered Function" to signify only services that are directly related to providing investment advice with respect to the purchase or sale of securities. This focus should be made explicit if the Commission adopts a new rule. As explained in Section I above, there is no need for any new rule and the rule as proposed would harm investors without assisting the Commission. But if some version of the rule were nonetheless adopted, it should be unambiguously limited to services directly involving the provision of investment advice.

Unfortunately, the definition of "Covered Function" as currently drafted might be construed as encompassing services other than those directly involving the provision of investment advice with respect to the purchase or sale of securities. The risk of an overly expansive reading is attributable to the vagueness of the phrase "necessary for the investment adviser to provide its investment advisory services." 87 Fed. Reg. at 68879. If it decides to proceed with the rulemaking, the Commission should revise the definition of "Covered Function" so that the term is expressly limited to services directly involving the provision of investment advice.

The Commission's discussion of the scope of the proposed rule illustrates the risk that the term "Covered Function" might be interpreted in an unintended, unduly expansive manner. When divorced from the other examples given by the Commission, the example of "portfolio accounting services" could be taken as referring to something more than the services necessary for the accurate posting of investment transactions to investors' accounts. It could, for instance, be misconstrued to include services related to the preparation of financial statements or tax forms—services that are not related to the investment decision-making process.

The danger that the term "Covered Function" might be misinterpreted in precisely this way is exacerbated by the Commission's proposed amendments to Form ADV. One of the "covered function categories" that it proposes including in Item 7.C of Schedule D is "Valuation." 87 Fed. Reg. at 68835. The proposed rule does not define "Valuation" even though

the term can refer to a broad spectrum of services performed for a variety of purposes, many of which—including valuation for GAAP and tax purposes—do not directly involve the provision of investment advice.[3]

To avoid such misinterpretation, the Commission should, if it proceeds with the rulemaking, rewrite the proposed rule's definition of "Covered Function" to make clear that it covers only those services that directly involve the provision of investment advice.

III. The failure to define "outsourcing" risks over-application of the proposed rule.

As the title of the Federal Register announcement indicates, the proposed rule is meant to address "outsourcing" by investment advisers. The proposed rule, however, does not define that critical term, which can encompass a broad array of relationships. The failure to do so increases the risk that the rule will be interpreted more broadly than intended and more broadly than is appropriate. To reduce that risk, the proposed rule should be revised to include an appropriately circumscribed definition of "outsourcing."

At the highest level of generality, "outsourcing" refers to a company's procurement of any goods or services from an outside source. The term could thus include everything from hiring an information technology company to design, construct, and operate the company's communications, data-processing, and compliance systems to hiring a graphic artist to design the company's logo.

Given the breadth of what might in some sense be considered "outsourcing," it is important that term be clearly defined in any rule ultimately adopted. The definition should distinguish between situations in which a function is performed substantially or entirely by the external service provider versus those in which a vendor supplies only a discrete input that the adviser then uses to perform the function itself. The definition should make clear that the rule, if adopted, applies to the former situation but not the latter.[4]

To properly cabin the "outsourcing" covered by the proposed rule, the Commission should not only define the term in the manner set forth immediately above but also adopt a provision explicitly excluding from the rule's scope of services that are provided through short-term engagements—those that are less than one year in duration. This too would help draw the

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[3] The problem is not limited to "Valuation." Other "covered function categories" that would appear on the proposed amended Form ADV—"Cybersecurity" and "Regulatory Compliance," for example—also are broad, undefined terms that could subsume a wide range of services.

[4] A definition that distinguished between the two situations would ensure, consistent with the Commission's intent, that the rule applied to "a valuation provider" hired "to value all of [an adviser's] clients' fixed income securities" on an on-going basis but not to a service provider hired to value a single illiquid position. 87 Fed. Reg. at 68821.

proper distinction between situations in which a function is performed substantially or entirely by the external service provider versus those in which a vendor supplies only a discrete input that the adviser then uses to perform the function itself.

IV. The proposed rule's potentially expansive application would have deleterious consequences.

If not revised to clearly limit its application to the complete or substantial outsourcing of investment-related functions, the proposed rule would have several undesirable consequences.

As an initial matter, the rule would increase advisers' compliance costs unnecessarily. Because compliance is an important function that protects the investing public, the fact that compliance costs money is not by itself reason to forgo adoption of a rule. There is, however, no reason to increase compliance costs unnecessarily. Yet the rule as proposed by the Commission would do exactly that. As explained above, the proposed definition of "Covered Function" could be misinterpreted in an overly expansive manner. The resulting uncertainty as to the rule's scope—exacerbated by the rule's failure to offer a limiting definition of "outsourcing"—would force advisers to do either of two things to ensure their compliance with the rule. Advisers would either have to invest significant resources determining which of their service providers perform "Covered Functions," a difficult exercise given that "[t]he determination of what is a covered function" under the proposed definition "would depend on the facts and circumstances" of each case (87 Fed. Reg. at 68821), or, in the alternative, have to invest significant resources conducting due diligence on an over-inclusive set of service providers. Clearly specifying the rule's reach would eliminate the need for such wasteful expenditures while still allowing the Commission to accomplish its stated goals.

Although certainly problematic, unnecessary compliance costs are perhaps the least worrisome of the proposed rule's detrimental consequences. Far more concerning is the rule's potential to mislead investors.

The proposed rule would "amend Form ADV to require advisers to identify their service providers that perform covered functions as defined in proposed rule 206(4)-11." 87 Fed. Reg. at 68859; *accord id.* at 68834. The amended Form ADV "would also require specific information that would clarify the services or functions" performed by each such service provider. 87 Fed. Reg. at 68859; *accord id.* at 68834.

The proposed disclosures are intended to assist the Commission in its oversight of investment advisers and to "provide public information about advisers' use of third party service providers." 87 Fed. Reg. at 68835. But public disclosure of the information that would be required under the proposed amendments to Form ADV will not assist the Commission in its work. It would, however, mislead investors—and send the wrong signal to advisers.

As proposed, the amended Form ADV would demand that advisers supply the required information in a "structured" format. 87 Fed. Reg. at 68859. In other words, the proposed Form

ADV would force advisers to choose from a limited, predetermined list of services and functions when identifying the service or function performed by a particular service provider.

The proposed disclosure regime would mislead investors, leading them to mistakenly think that a certain third-party service provider plays a greater role in an adviser's investment advice than is the case. An example illustrates the point. One of the "covered function categories" that the Commission proposes including in Item 7.C of Schedule D is "Valuation." 87 Fed. Reg. at 68835. But, as noted above, the term 'valuation' encompasses disparate activities, many of which—such as valuation for purposes of financial statements and tax forms—are not directly related to providing investment advice to clients. Moreover, a service provider who provides valuation services might do so on a very limited basis—valuing, for example, a single, infrequently traded asset that constitutes only a very small fraction of the assets managed by the adviser. If both service providers who value single positions for non-investment purposes and service providers who either "create[e] and provid[e] models related to investment advice" or "value all of [an adviser's] clients' fixed income securities" are all publicly identified on Form ADV as providing 'valuation' services, investors (and the Commission) will be confused as to the actual role played by any given service provider.[5]

The prospect of investor confusion over the services provided by a particular service provider is compounded by the fact that, under the proposed rule, "certain functions may be covered functions for one adviser but not for another adviser, and so certain persons or entities that perform functions on behalf of advisers may be a service provider in the scope of the rule with respect to one adviser but not for another adviser." 87 Fed. Reg. at 68821. This could cause investors to make false comparisons between competing advisers, erroneously believing that one uses a particular service provider while another does not. This would, in turn, inhibit rather than promote the Commission's goal of "enabling clients to make better informed decisions about the retention of an adviser." *Id.* at 68820–21.

Confusion over the role actually played by a service provider could give investors a false sense of security. For example, if a well-respected, highly qualified provider of valuation

[5] Other undefined "covered function categories" on the proposed amended Form ADV—the "Cybersecurity" and "Regulatory Compliance" categories, for example—create similar risks of confusion as to the actual role of third-party service providers. 87 Fed. Reg. at 68835. Both a computer expert hired to design, build, and constantly monitor an adviser's communication systems and an educational consultant hired to give a one-hour presentation on phishing could be said to provide 'cybersecurity' services. Likewise, both a third-party compliance consultant hired on a long-term basis to implement all aspects of an adviser's compliance program and a third-party compliance consultant occasionally hired to conduct an annual compliance review or other periodic compliance services could be said to provide 'regulatory compliance' services. By lumping together such disparate third-party engagements, the proposed amended Form ADV would mislead investors as to the nature and significance of an adviser's third-party relationships.

services is identified on a Form ADV as providing 'valuation' services to an adviser, investors might wrongly believe that the service provider plays a significant role in the adviser's investment advice when in fact it does nothing more than value one asset for non-investment purposes. The false belief would be particularly acute when, as is often the case, the service provider does nothing more than supply the adviser with information that is intended to be used as merely one among many possible inputs that the adviser might consider—or disregard—when exercising its own independent judgment. Ultimately, regardless what assistance an adviser might receive from third-party service providers, it is the adviser who is solely responsible for determining value and delivering investment advice after assessing whatever factors they believe relevant to the determination of value.

Investors are likely to be misled by the proposed Form ADV disclosures because a service provider often is hired to perform only a narrowly circumscribed role. A provider of valuation services, for example, may be hired only to perform certain limited procedures and only in reliance on information provided by the adviser. In such cases, the service provider is not tasked with independently verifying the accuracy of information provided by the adviser (and upon which the service provider relies in performing its work). Limited in scope, such work does not constitute an audit or a comprehensive review of all possible considerations that may affect value, and it is not intended to be relied upon by the adviser as such. Thus, it would be highly misleading to investors for an adviser to simply state in a Form ADV that a certain service provider was hired to perform "[v]aluation" services when the scope of services performed by such service provider was confined to certain limited procedures, the service provider depended entirely on information provided by the adviser, the service provider's work related to only a single investment or small subset of investments, or the service provider's work-product was to assist the adviser in its determination of fair value strictly for financial reporting—not investment decision—purposes. Identification of the service provider as having provided 'valuation' services would only mislead the public into thinking that (i) the scope of the services rendered was broader and more comprehensive than it was; (ii) that the service provider valued all investments; (iii) that the adviser has accepted all of the advice provided by the service provider; and (iv) that the service provider had ultimate decision-making authority. Any of these outcomes would adversely affect the public.

Public identification of service providers on Form ADV is likely to spur meritless but costly litigation against service providers. Dissatisfied investors, particularly those dissatisfied with a small advisory firm that lacks the wherewithal to pay large damages, tend to sue every entity that they can somehow link to their alleged losses. Naming outside service providers on Form ADV will place them in plaintiffs' crosshairs, even when they provide narrowly circumscribed services that have nothing to do with the advisers' investment advice.

Although service providers who provide advisers such limited services could eventually prove their lack of culpability, the mere threat of liability—and the attendant costs of litigation—could drive qualified service providers from the market. That would negatively impact the public, which indirectly benefits from the assistance rendered by service providers, by leaving

advisers with fewer service providers to choose from. The reduction in the number of available service providers would not only increase the cost of obtaining services and reduce access to quality services of the type contemplated but would also increase the risk that the "failure" of a single service provider would have destabilizing repercussions throughout the industry. 78 Fed. Reg. at 68859.

Requiring advisers to publicly disclose their service providers could convey the misimpression—to advisers and investors—that advisers are not solely responsible for investment decisions. The Commission rightly recognizes that "[o]utsourcing a particular function or service does not change an adviser's obligations under the Advisers Act and the other Federal securities laws." 87 Fed. Reg. at 68819. Still, requiring public identification of service providers used by advisers implies that service providers rather than advisers bear responsibility for certain functions notwithstanding the adviser's non-delegable duties. By shifting perceived responsibility for certain functions away from advisers, the proposed rule could cause advisers to pay less rather than more care to the performance of their fiduciary duties. Stated differently, the proposed rule could, contrary to the Commission's intent, induce advisers to "just 'set it and forget it' when outsourcing." *Id.*

Each of these undesirable consequences can be avoided by not requiring public disclosure of service providers.

According to the Commission, requiring the identification of service providers is meant to "facilitat[e] the Commission in its oversight role." 87 Fed. Reg. at 68859.

It is questionable whether collecting the information called for under the proposed amendments to Form ADV will enable the Commission to conduct the oversight it envisions. As proposed, the amended Form ADV would gather no detail regarding the scope or precise nature of the service rendered by a service provider. Rather, the services rendered by a service provider would be described using only a broad, undefined "covered function categor[y]." 87 Fed. Reg. at 68835. As a result, the information called for under the proposed rule will not help the Commission to "target" its examinations by distinguishing between advisers who outsource entire functions and those who use third parties for discrete tasks. *Id.* at 68859. Nor will it help the Commission "identify … particular service providers … who may pose a risk to clients and investors" by distinguishing between service providers with day-to-day responsibility for critical functions and those who only perform discrete, ancillary tasks on an episodic basis. *Id.*

And even if the called-for information would facilitate oversight by the Commission, public disclosure of the service provider's identity is unnecessary to the Commission's work. Confidential rather than public disclosure would be sufficient. So long as the Commission receives the information, it can use the information in its work.

Finally, public disclosure would violate the confidentiality provisions found in all or nearly all service agreements. The overwhelming majority of service agreements contain a

provision that prohibits reference to or the naming of the service provider. Such clauses are a critical element of service agreements because they directly affect the allocation of risk between the parties.

For each of these reasons, the Commission should not require public disclosure of service providers.

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