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SEC Update

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SEC Proposes Rule Requiring Investment Advisers to Adopt Business Continuity and Transition Plans

On June 28, 2016, the US Securities and Exchange Commission (the SEC) proposed new Rule 206(4)-4 (the Rule) under the Investment Advisers Act of 1940 (the Advisers Act) that would require an investment adviser registered with the SEC (an Adviser) to, among other things: (i) adopt and implement business continuity and transition plans; (ii) conduct an annual review of those plans; and (iii) comply with corresponding recordkeeping requirements.[1]

Underlying the Rule is the SEC's view that an Adviser's fiduciary duty obligates it to take steps to protect its clients' interests from the potential ramifications of the Adviser's temporary or permanent inability to provide advisory services. In proposing the Rule, the SEC sought to protect clients of an Adviser from the effects of temporary or permanent operational risks to the Adviser such as natural disasters, cyber-attacks, acts of terrorism, technology failures, and the departure of key personnel. The Rule also seeks to protect clients from operational risks associated with events such as a sale, asset transfer, or wind-down of the Adviser's operations. The SEC has acknowledged that the scope of an Adviser's policies and procedures under the Rule will depend on the size and nature of an Adviser's business; the Rule nonetheless establishes a set of specific elements that must be included in an Adviser's business continuity and transition plan. In setting out greater specificity for policies and procedures covering business continuity and transition plans, the SEC appears to have concluded that the requirements of Rule 206(4)-7 under the Advisers Act (the Compliance Program Rule) are not sufficient with respect to those plans.[2] In this regard, the SEC noted the observations of its examination Staff that existing plans undertaken in accordance with the Compliance Program Rule are "uneven and, in some instances, may not be sufficiently robust to mitigate the potential adverse effects of a significant business disruption on clients."[3]

Business Continuity and Transition Plans Under the Rule

Under the Rule, an Adviser's business continuity and transition plan must include policies and procedures concerning: (i) business continuity after a significant business disruption; and (ii) business transition in the event that the Adviser is unable to continue providing investment advisory services to its clients. The content of a business continuity and transition plan is to be based on the risks associated with the Adviser's operations and must include

policies and procedures designed to minimize material service disruptions, including policies and procedures that address the following:

- **Maintenance of critical operations and systems and the protection, backup and recovery of data**
  In its discussion of the Rule, the SEC said that, in determining which operations and systems are critical, an Adviser should consider those that are utilized for prompt and accurate processing of portfolio securities transactions on behalf of clients (including the management, trading, allocation, clearance, and settlement of those transactions), as well as those operations and systems that are material to the valuation and maintenance of clients' accounts, access to clients' accounts, and the delivery of funds and securities. An Adviser should also identify key personnel whose temporary or permanent loss would disrupt the Adviser's ability to provide services to its clients.

  According to the SEC, an Adviser's plan with respect to data protection, backup and recovery should address both hard copy and electronic backup, focusing in particular on risks related to cyber-attacks.[4] Moreover, an Adviser should prepare an inventory of key documents, including the location and description of the documents and a list of the Adviser's service providers that are necessary to maintain functional operations.
- **Pre-arranged alternate physical locations of the Adviser's offices and/or employees**
  According to the SEC, an Adviser should consider the geographic diversity of its offices or remote sites and employees, as well as access to the systems, technology, and resources necessary to continue operations at different locations in the event of a disruption.
- **Communications with clients, employees, service providers and regulators**
  The SEC is of the view that an Adviser's communication plan should generally cover, among other things, (i) the methods, systems, backup systems and protocols that will be used for communications; (ii) the way in which employees are informed of a significant business disruption; (iii) the way in which employees should communicate during such a disruption; (iv) contingency arrangements communicating who would be responsible for taking on other responsibilities in the event of loss of key personnel; and (v) employee training.

  In the SEC's view, an Adviser should also consider when and how it is in its clients' best interests to be informed of the occurrence and/or the effect of significant business disruption, how service providers will be notified of a significant business disruption at the Adviser and vice versa, and under what circumstances regulators will be notified of the disruption.
- **Identification and assessment of third-party services critical to the operation of the Adviser**
  In elaborating on this element of the Rule, the SEC noted that an Adviser should identify critical functions and services provided by the Adviser to its clients, and third-party vendors supporting or conducting critical functions or services for the Adviser and/or on the Adviser's behalf. The SEC went on to say that, in determining which service providers should be deemed critical, an Adviser should consider, among other things, the day-to-day operational reliance on the service provider and the existence of a backup process or multiple providers, regardless of whether the service provided includes direct contact with clients or investors and whether the service provider is maintaining critical records or is able to access personally identifiable information. Once an Adviser identifies its critical service providers, it should review and assess how these service providers plan to maintain business continuity when faced with significant business disruptions and consider how this planning will affect the Adviser's operations.[5]

- **Transition plan**
  Under the Rule, an Adviser's business continuity and transition plan must include a specific plan of transition that accounts for the possible winding-down of the Adviser's business or the transition of the Adviser's business to others if the Adviser is unable to continue providing advisory services. The SEC's view is that an Adviser's plan of transition should include (i) policies and procedures intended to safeguard, transfer, and/or distribute its clients' assets during transition; (ii) policies and procedures facilitating the prompt generation of any client-specific information necessary to transition each client account; (iii) information regarding the corporate governance structure of the Adviser; (iv) the identification of any material financial resources available to the Adviser; and (v) an assessment of the applicable law and contractual obligations governing the Adviser and its clients, including pooled investment vehicles, affected by the Adviser's transition.

According to the SEC, the degree to which an Adviser's business continuity and transition plan addresses a required component under the Rule will depend upon the size and nature of the Adviser's business, consistent with the Adviser's fiduciary duty to protect its clients' interests from risks of business disruption generally. In that regard, the SEC noted that business continuity and transition plans must address all components set out in the Rule, but that plans need only take into account the risks associated with an Adviser's operations, including the nature and complexity of its business, clients, and key personnel.

Implications for Advisers

The obligation imposed on an Adviser to address business continuity considerations has been identified by the SEC for some time. Nonetheless, the Rule, if adopted in its current form, could have significant consequences. Five potential consequences are of particular note.

Potential Liability

The SEC, in proposing the Rule, noted clearly that it "would be fraudulent and deceptive [within the meaning of Section 206, the [Advisers] Act's antifraud provision] for an [Adviser] to hold itself out as providing advisory services unless it has taken steps to protect clients' interests from being placed at risk as a result of the [Adviser]'s inability (whether temporary or permanent) to provide those services."[6] Thus, the Rule contemplates the possibility, among other things, that an Adviser following a business continuity plan but experiencing service disruptions following, for example, a natural disaster or other unforeseen event, could face liability for fraud under Section 206 of the Advisers Act.[7]

Need to Consolidate Business Continuity Requirements

The SEC has recognized that certain Advisers are "subject to other regulatory requirements as to business continuity and/or transition planning."[8] The SEC in proposing the Rule cited, in particular, the business continuity rules that are already mandated by FINRA[9] and the CFTC,[10] as well as model rules promulgated by the North American Securities Administrator Association.[11] An Adviser subject to these rules should consider consolidating business continuity requirements into a comprehensive plan in seeking to ensure that its plan works effectively and efficiently and meets all applicable requirements.

Disclosure

Historically, Advisers often addressed the potential consequences of natural disasters and other unexpected service disruptions by engaging in prior planning and providing disclosures to clients about those risks. An Adviser should, when determining how to meet the Rule's terms and conditions, consider not only additional planning steps, but also the potential need for enhanced

disclosures to its clients. An Adviser might, for example, choose to include disclosure to its clients to the effect that, despite its best efforts, business continuity and transition planning efforts cannot guarantee that all service disruptions will be prevented.

The Rule's Applicability to Different Types of Advisers

Requiring an Adviser to develop and maintain transition plans marks a new obligation under SEC regulations. Under the Rule, an Adviser's plan of transition must account for the possible winding-down of the Adviser's business or the transition of the Adviser's business to another Adviser.[12] The type of transition policy that is appropriate for an Adviser will vary based on the size and nature of the Adviser's business. The Rule, as proposed, would be applicable to Advisers regardless of the extent of assets under management. When proposing the Rule, the SEC highlighted the potential ramifications of an Adviser's dissolution on broader market conditions,[13] suggesting that the primary focus for the transition plan requirement is an Adviser with significant levels of assets under management, the dissolution of which could affect financial markets if handled inappropriately. Making clear, however, that the Rule is not limited to larger Advisers, the SEC noted the importance of an Adviser's attending to individual (retail) clients in connection with the transition and winding-down of its affairs.

The Rule would appear to have special consequences for an Adviser managing private funds not registered under the Investment Company Act of 1940. By its terms, the Rule would require an Adviser's transition plans to include an assessment of contractual obligations governing the Adviser and its clients. This requirement would seem to implicate, among other things, contractual provisions of private funds involving key persons and the removal or replacement of the general partner, which have typically been addressed through negotiated arrangements with limited partner investors. The SEC seemed to have contractual provisions of this sort in mind when it noted that an Adviser, in meeting its obligations under the Rule, must "consider the unique attributes of each type of the [Adviser's] clients"[14] and must analyze the types of assets that are held in each client's account[15] with respect to the merger or acquisition of an Adviser.

Economic Effects

The Rule would require an Adviser to analyze third-party service providers' plans to maintain business continuity in the face of a significant business disruption and to review all contractual obligations and clients' attributes to prepare for a transition. Meeting this requirement could result in additional costs for Advisers. The SEC has said that an Adviser should "generally consider [in connection with the Rule's requirements] alternatives for such critical services, which may include other service providers or internal functions or processes that can serve as a backup or contingency for such critical services."[16] The SEC acknowledged that it may be costly for an Adviser to establish backup relationships with multiple third-party service providers. In the SEC's view, however, those costs are outweighed by the need for an Adviser "to address how [the Adviser] will manage the loss of a critical service."[17] The SEC has recognized that Advisers would likely not be in a position to absorb all the costs resulting from the Rule and that the Rule, if implemented as proposed, may result in Advisers' passing these costs on to clients and fund investors through higher fees.[18]

Public Comments

The SEC requested public comment on a number of aspects of the Rule including, among others: whether all Advisers, or only a subset of Advisers such as those with assets under management over a specific threshold, should be required to meet the Rule's provisions; whether the SEC Staff should, as an alternative to the Rule, issue guidance under the Compliance Program Rule addressing business continuity and transition plans; whether the SEC should

adopt a more prescriptive rule that resembles the "Living Wills" required by the Federal Reserve Board and the Federal Deposit Insurance Corporation for large banks and systemically important non-bank entities; and whether the SEC should, instead of mandating the components of business continuity plans of Advisers, enable each Adviser to determine those components.

In response to these requests and a more general one seeking comment on the Rule, the SEC received support for its goal of seeking to mitigate the risks resulting from a business disruption to an Adviser. Commentary about the Rule's operation, however, was largely negative. Some commenters suggested, for example, that the interrelationship between the Rule and the Compliance Program Rule is unclear and expressed concern that the same conduct could be deemed to violate both rules. Other commenters articulated the view that the interrelationship could be clarified by the SEC's adopting principles-based guidance regarding the business continuity obligations of Advisers. Still other commenters voiced concern about the Rule's having been adopted as an anti-fraud provision. As one commenter noted "[h]istorically, fraud generally has been understood to mean an intentional act to deceive others for personal gain. By adopting this [Rule], the SEC would attach a concept of deceit or manipulation to circumstances, including temporary outages, where no such motivation exists."[19] The commenter went on to say that "independent external events, such as a natural disaster or homeland security event, could lead to a finding of fraud liability for an adviser. Further, liability could arise despite an adviser's good faith business continuity planning efforts, even in the absence of any actual disruptive event, if the SEC decides (with the benefit of hindsight) that the planning was insufficient to deal with a particular exigency."[20] Another commenter pointed out the implications for Advisers that rely on service providers and stated that "[Advisers] should not be insurers against all disruptions or guarantors of third-party performance."[21]

The potential costs of compliance with the Rule was cited by some commenters as a flaw of the Rule as proposed. Some commenters noted that the Rule, if adopted as proposed, would be cost prohibitive for smaller Advisers, which according to those commenters, lack the resources to comply with all components of the Rule;[22] these commenters suggested limiting the application of the Rule to Advisers having assets under management higher than a specified threshold or having more employees than a specified amount.

A final set of commenters focused on the Rules' provision dealing with succession and transition planning. Those commenters asked the SEC to provide detailed guidelines for succession and transition planning (i) in connection with changes in an Adviser's senior leadership; and (ii) applicable to Advisers forced to wind-down their advisory businesses.

Conclusion

The unanimous approval of the Rule by the SEC's commissioners, together with the previous initiatives by the SEC and other federal regulators relating to systemic risk initiatives, illustrates that business continuity and transition plans will continue to be a focal point for regulators. Advisers should review the Rule if and as finalized and be prepared in advance to address the specific requirements relating to business continuity, potential disruptions, and transition planning.

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NOTES

1 *See Adviser Business Continuity and Transition Plans*, Advisers Act Release No. 4439 (June 28, 2016).

[2] *Id*. (SEC stating in this regard that in adopting the Compliance Program Rule it did not "define, and prescribe means reasonably designed to prevent, such acts, practices and courses of business as are fraudulent, deceptive, or manipulative.").

[3] *Id*.

[4] *See also Cybersecurity Guidance*, SEC Division of Investment Management, IM Guidance Update No. 2015-02 (April 2015) (noting that an Adviser should create a strategy that is designed to prevent, detect, and respond to cybersecurity threats including, among others, controlling access to various systems and data; data encryption; and data backup and retrieval); *National Exam Program Examination Priorities for 2016*, SEC Office of Compliance Inspections and Examinations (2016) (identifying cybersecurity and regulation systems compliance and integrity as examination priorities).

[5] *Id.* (noting that Advisers "should consider assessing whether protective cybersecurity measures are in place at relevant service provider" since Advisers rely on service providers to carry out their own operations).

[6] *Adviser Business Continuity and Transition Plans*, *supra* n.1 (asserting that advanced "planning and preparation may minimize an [Adviser]'s exposure to operational and other risks and, therefore, lessen the possibility of a significant disruption in its operations, and also may lessen any potential impact on the broader financial markets.").

[7] *Id*.

[8] *Id.* (inquiring whether the Rule would "be inconsistent with an [Adviser's] obligations under other regulatory regimes.").

[9] *See Business Continuity Plans and Emergency Contact Information*, FINRA Rule 4370 (as amended on Feb. 12, 2015) (requiring that broker-dealers' business continuity plans address certain elements, including data backup and recovery, all mission critical systems, alternate communications, alternate physical location of employees, and critical business constituents).

[10] *See Business Continuity and Disaster Recovery*, 17 CFR Part 23.603(a) (requiring swap dealers and major swap participants to establish and maintain business continuity plans that address data backup, systems maintenance, communications, geographic diversity, and third parties).

[11] *See NASAA Model Rule 203(a)(1)-1A* (requiring state-registered advisers to have continuity and succession plans to minimize "service disruptions and client harm that could result from a sudden significant business disruption").

[12] *Adviser Business Continuity and Transition Plans*, *supra* n.1 (noting that Advisers "facing the decision to exit the market commonly do so by: (1) selling the [Adviser] or substantially all of the assets and liabilities of the [Adviser], including the existing advisory contracts with its clients, to a new owner; (2) selling certain business lines or operations to another [Adviser]; or (3) the orderly liquidation of fund clients or termination of separately managed account relationships").

[13] *Id*. (providing that an Adviser's insolvency or termination could have far-reaching consequences such as triggering a termination clause in a client's derivative contract or requiring regulators in multiple jurisdictions to approve certain acts such as the assignment of an advisory contract).

[14] *Id.* (identifying the complexities associated with transferring client information of multiple clients with respect to registered investment companies and private funds compared to transferring client information of a single client with respect to separately managed accounts).

[15] *Id.* (observing that "when transitioning accounts from one [Adviser to another, derivatives positions require special treatment in that they are typically unwound rather than transferred to the new [Adviser] and that the terms of the derivatives instrument may dictate whether and how such unwinding takes place.").

[16] *Id*.

[17] *Id.* (noting that "it may not be feasible or may be cost prohibitive for an [Adviser] to retain backup service providers, vendors, and/or systems for all critical services.")

[18] *Id.* (recognizing that the SEC does not "have data or other information concerning individual

investor fee sensitivities, how [A]dvisers take these into account, or the extent to which [A]dvisers prefer to keep fees constant [so] the potential shift in the supply of advisory service and its impact on fees is unknown.").

19 Comment Letter from the Securities Industry and Financial Markets Association to Brent J. Fields, Secretary SEC 7–8 (Sept. 2, 2016).

20 *Id*. (noting that "a 'fraud' implication is particularly inappropriate for expectations under the [Rule] that will turn on subjective interpretations examined with the benefit of hindsight.").

21 Comment Letter from The Vanguard Group, Inc. to Brent J. Fields, Secretary SEC 2 (Sept. 6, 2016).

22 *E.g.*, Comment Letter from the Mutual Fund Directors Forum to Brent J. Fields, Secretary SEC 2 (Sept. 6, 2016) (providing that the Rule "may impose rigidity and additional costs on [A]dvisers."); Comment Letter from the Investment Adviser Association to Brent J. Fields, Secretary SEC 11 (arguing that the SEC "should stress that a small firm with limited resources should not be expected to address every component at the same level of a very large firm.").