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SEC Proposes Rules on Business Continuity and Transition Plans for Investment Advisers

On June 28, 2016, the Securities and Exchange Commission (the “SEC”) proposed a new rule¹ requiring SEC registered investment advisers (“advisers”) to adopt and implement a business continuity and transition plan (a “BCTP”) to address risks of a significant disruption in the operations of the adviser. In the release, the SEC confirms its previously stated position that an adviser’s fiduciary obligation to its clients includes the obligation to take steps to protect its clients’ interests from being placed at risk as a result of the adviser’s inability to provide advisory services. While the SEC recognizes that many advisers may already have business continuity plans in place pursuant to Rule 206(4)-7² of the Investment Advisers Act of 1940, as amended (the “Advisers Act”), the proposed rule seeks to specify various components of a BCTP that the SEC considers necessary to ensure critical operations are functional during a significant disruption of an adviser’s operations. For example, the proposed rule would require an adviser to develop, among other things, contingency and succession plans to address the departure of managing partners and other key personnel, whether arising from temporary or permanent loss of such persons.

The SEC is proposing the following rules under the Advisers Act:

- **Proposed Rule 206(4)-4** would prohibit an adviser from providing investment advice unless it has adopted and implemented a written BCTP and reviews such BCTP at least annually.
- **Proposed Amendments to Rule 204-2** would require advisers to keep copies of all written BCTPs that are in effect or were in effect at any time during the last 5 years and to retain records documenting the adviser’s annual review of its BCTP.

Under the proposed rule, a BCTP must address both (i) business *continuity* after a significant business disruption (such as the unexpected loss of key personnel, a natural disaster, an act of terrorism, a cyber-attack, equipment or system failure, or the unexpected loss of a service provider or facilities); and (ii) business

¹ Adviser Business Continuity and Transition Plans, Proposed Rule, Securities and Exchange Commission Release No. IA-4439 (June 28, 2016). Available at: <https://www.sec.gov/rules/proposed/2016/ia-4439.pdf>

² On February 5, 2004, the SEC adopted Rule 206(4)-7 which requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations by the adviser and its supervised persons of the Advisers Act and rules thereunder. In the rule’s adopting release, the SEC stated that an adviser’s compliance policies and procedures should address business continuity plans to the extent that they are relevant to an adviser. However the SEC did not offer guidance on the specific components of such a plan. See Rule 206(4) – 7, Investment Advisers Act of 1940 (54 Stat. 847, 15 U.S.C. 80b-1 - 80b-2). Also see Compliance Programs of Investment Companies and Investment Advisers, Final Rule, Securities and Exchange Commission Release Nos. IA-2204; IC-26299 (February 5, 2004). Available at: <https://www.sec.gov/rules/final/ia-2204.htm>

transition in the event the adviser is unable to continue providing investment advisory services to clients (including as a result of exiting the market, merger with another adviser or a sale of its business). The proposed rule would not require an adviser to deliver its BCTP to investors or file it with the SEC.

Components of a Business Continuity and Transition Plan

The SEC has identified certain key components to facilitate adoption and implementation of a robust BCTP by all advisers. However, the SEC recognizes that the degree to which an adviser's plan addresses a required component will depend on the nature of that adviser's business. Therefore, the proposed rule would require that the BCTP be *reasonably* designed to address risks of an adviser bearing in mind such adviser's operations, complexity of business, clients and key personnel. Under the proposed rule, an adviser's BCTP would be required to address the following:

- (i) **Maintenance of Critical Operations and Systems, and the Protection, Backup, and Recovery of Data.** The BCTP should identify and prioritize critical functions, operations and systems and consider alternatives to help continue operations in case of any significant business disruption. In evaluating which operations and systems are critical, advisers should consider those that are utilized for prompt and accurate processing of portfolio securities transactions, including but not limited to, management, trading, and settlement; systems critical to valuation of, maintenance of and access to client accounts; delivery of funds and securities; data protection, backup and recovery; and key personnel whose absence would disrupt critical functions.
- (ii) **Pre-Arranged Alternate Physical Location(s).** The BCTP should describe how and where the adviser would continue operations in the event that physical access to one or more of its office locations is unavailable. When developing the BCTP, advisers should consider the geographic diversity of their offices, remote sites and employees, as well as the ability to access systems, technology and resources required to continue operations at alternate locations in the event of a business disruption.
- (iii) **Communications with Clients, Employees, Service Providers, and Regulators.** The BCTP should contain a communication plan that addresses, among other things, methods, systems and protocols used for communications with various persons necessary for operations, how employees will be informed of a significant business disruption and how and when employees will communicate with each other, clients, service providers and regulators during a disruption, and contingency arrangements communicating who would be responsible for taking on other responsibilities in the event of loss of key personnel. Advisers should also ensure that the BCTP covers employee training so that employees understand their specific roles during a disruption and are able to promptly implement the BCTP.
- (iv) **Identification and Assessment of Third-Party Services Critical to the Operation of the Adviser.** A BCTP should identify critical service providers and assess how their services would be covered in the event of a business disruption at the service provider. In identifying which outsourced services are critical to operations, advisers should consider factors such as day-to day operational reliance, existence of a backup process or availability of multiple providers, whether the service provider maintains the critical records of the adviser or is able to access personally identifiable information and other factors. The SEC considers "critical service providers" to at least include service

providers related to portfolio management, custody of client assets, trade execution and related processing, pricing, client servicing and/or record keeping.

- (v) **Transition Plan.** The BCTP should include a transition plan in case of a winding down of the adviser's business or when the adviser is unable to continue providing advisory services. Such a plan should provide for transitions under both normal and stressed market conditions and consider contractual obligations to clients, counterparties and service providers, as well as relevant regulatory regimes. The proposed rule would require that transition plans in the BCTP include: (a) policies and procedures to safeguard or transfer client assets; (b) policies and procedures to facilitate prompt generation of any client specific information necessary to transition; (c) information regarding the corporate governance structure of the adviser; (d) identification of any material financial resources available to the adviser; and (e) assessment of applicable law and contractual obligations. When designing transition plans, advisers should also carefully consider the consequences of assignment provisions in existing investment management agreements, as well as contractual obligations under any "key person" provisions often contained in the operative documents of private funds and/or side letters with private fund investors. Such advance 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.

Succession Planning

In its discussion of the components summarized above, the SEC states in the release that an adviser's BCTP "generally should include short-term arrangements, such as which specific individuals would satisfy the role(s) of key personnel when unavailable, and long-term arrangements regarding succession planning and how an adviser will replace key personnel." Accordingly, if the proposed Rule 206(4)-4 is adopted, advisers will be required to address succession planning in the event of the death, disability or other unavailability of a managing partner or other key personnel, with a focus on minimizing the disruption of such departures on the adviser's ability to continue to provide services to its clients.

Next Steps

Comments on the proposed rules must be submitted to the SEC on or before September 6, 2016. In the meantime, advisers with business continuity plans already in place should review and consider improvements to such plans in light of this latest guidance on SEC expectations, and advisers that currently do not have formal business continuity plans should begin the process of developing one by assessing the different aspects of their business taking into account the components set forth in the proposed rule.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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