ALERT MEMORANDUM

SEC Proposes Rules to Require Business Continuity and Transition Plans for Registered Investment Advisers

July 7, 2016

On June 28, 2016, the Securities and Exchange Commission (the "SEC") released proposed rules under the Investment Advisers Act of 1940, as amended (the "Advisers Act") to require all investment advisers that are registered with the SEC to adopt and implement business continuity plans ("BCPs") and transition plans (the "Proposed Rule"). Under the Proposed Rule, registered investment advisers would be required to include certain specific components in the plans with the emphasis and focus of each component tailored to the circumstances of an adviser's business, operations, and risks. This memorandum highlights notable aspects of the SEC's approach and the key requirements under the Proposed Rule.

The Proposed Rule diverges from the SEC's typical approach to regulation under the Advisers Act. The SEC generally adopts principles-based rules under the Advisers Act that give an investment adviser substantial flexibility to determine the appropriate way to meet the requirements in the context of its business. By going beyond the existing general rule[1] requiring advisers to have a BCP to prescribing a number of specific components to be included, the Proposed Rule is likely more burdensome than most investment advisers might expect.

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[1] See Compliance Programs of Investment Companies and Investment Advisers, Rel. No. IA-2204 (Dec. 24, 2003), nn. 22 and accompanying text, available at https://www.sec.gov/rules/final/ia-2204.htm.

Key Observations

— As with the code of ethics requirement of Rule 204A-1 under the Advisers Act, the Proposed Rule requires an adviser to include specific components in its plans, but the requirements for the components under the Proposed Rule are significantly more detailed and likely more burdensome, because of the Proposed Rule's one-size-fits-all approach.

— The proposing release cites weaknesses in advisers' existing BCPs revealed in natural disasters and the 2008 financial crisis as justification for the Proposed Rule's specific requirements for BCPs. In contrast, current Rule 206(4)-7, which requires that advisers maintain written compliance policies and procedures that "should" include BCPs as one of numerous topics that were neither exclusive nor mandated.[2]

— The Proposed Rule does not address its potential impacts on foreign SEC-registered advisers.

— Many registered investment advisers have regulated affiliates and are often able to utilize the affiliate's compliance programs and policies with only modest changes to meet the Advisers Act's principles-based requirements. The Proposed Rule is likely to create additional burdens on advisers whose current BCPs reflect that approach and have now been questioned by the Staff or who will now need to carefully consider modifications to an affiliate's BCP to address the Proposed Rule's specific requirements.

Summary of Proposed Rule

Required Components of BCPs

The Proposed Rule 206(4)-4 requires the following components for BCPs:

— Maintenance of critical operations and systems.

- Which operations and systems are "critical" will vary, but the SEC suggests prioritizing systems for processing client transactions and maintaining client accounts.
- Advisers should plan for consequences of a disruption of services provided by third parties.
- Plans must account for key personnel.

— Protection,[3] backup, and recovery of data.

- The plan should take into account disruptions of access to hard copy records, electronic records or both.
- Advisers would be required to maintain lists of key documents and service providers.
- Advisers should consider risks related to cyber-attacks in particular.[4]

— Pre-arranged alternate physical locations for the adviser's office(s) and/or employees.

- The staff suggests establishment of a satellite office or a plan to use a remote site in another location or geographic region.
- This requirement could be particularly burdensome for small advisers with only one location or a limited number of locations in

[2] The Proposed Rule is proposed under Section 206 and, like the compliance program rule, relies on the fiduciary duty imposed on investment advisers. The release goes to great lengths to cite the importance of the adviser's fiduciary duty in times of stress as the justification for the Proposed Rule; in addition, the SEC staff spends a considerable amount of time explaining the burdens and costs of these rules, potentially anticipating challenges to the proposed approach.

[3] Under Regulation S-P, registered investment advisers must maintain the privacy of customer data and provide notices to customers for any data sharing. The Proposed Rule could present difficulties in the context of an adviser coordinating its plan with those of third-party service providers.

[4] The SEC has been increasingly focused on the importance of cybersecurity as a compliance matter for investment advisers. See, for example, SEC Division of Investment Management, Cybersecurity Guidance, IM Guidance Update 2015-02 (April 2015), available at https://www.sec.gov/investment/im-guidance-2015-02.pdf.

close proximity, as well as for SEC-registered foreign advisers.

— Communications with clients, employees, service providers, and regulators.
  - This requirement includes maintaining up-to-date client and investor contact information, providing for contingency operations for unavailable personnel and employee training.

— Identification of third-party services critical to the operation of the adviser.
  - An adviser's plan should include a process for how an adviser and service provider will communicate with each other in a disruption.
  - To identify a third-party service provider as critical, an adviser must consider its reliance on the service, whether alternatives are available, and how the service directly impacts clients.
  - Advisers should conduct due diligence on their services providers, including on the service providers' own BCPs.

The SEC has requested comment on whether (a) the list of components are over- or under-inclusive, (b) the components should be mandatory or a safe harbor, and (c) whether advisers should be able to determine the appropriate components of the plans for themselves.

Required Components of Transition Plans

The Proposed Rule requires the following components for transition plans to deal with situations where an adviser exits the business:

— Policies and procedures that would safeguard, transition, and/or distribute client assets, as applicable, tailored by client type;

— Policies and procedures to allow prompt generation of necessary client information, including:
  - Contact information for investors in private funds and RIC clients, which could add complexity in complying with this component for advisers to these entities; and
  - Information needed to transition a client account to another adviser or a successor entity;

— The corporate governance structure of the adviser, including: an organizational chart, identity and contact information for key personnel, and identification of affiliates whose dissolution or distress could materially impact the adviser;

— Identification of any material financial resources of the adviser, which would include sources of funding, liquidity, or capital the adviser would seek to access in periods of stress; and

— An assessment of applicable law and any contractual obligations implicated by transition, including termination clauses in derivative contracts, provisions related to assignment of advisory contracts, and any regulatory approvals required under other regulatory regimes.

Under the Proposed Rule, transition plans should account for transitions taking place in both normal and stressed market conditions, be tailored to the adviser's circumstances, and be able to be executed quickly. The SEC staff indicated that a transition plan should deal with different scenarios under which an adviser might exit the market, whether by merger, sale of all or part of its business, or by entering bankruptcy proceedings.

The SEC has requested comment on whether there is a subset of advisers for whom a transition plan would not be beneficial and how to identify the subset.

Annual review

At least annually, each adviser would be required to review its business continuity and transition plans for

their adequacy in protecting client interests.[5] The review should also take into account any changes in the adviser's operations, structure, service providers, client types, regulatory environment, and any other factor that might suggest the plan needs to be updated. It should also take into account the results of any testing or use of the plans.

The SEC has requested comment on whether review should be required more or less frequently, or in the event of certain triggers, such as any instance of the adviser having to rely on or use its business continuity or transition plan.

Disclosure and Filing

The Proposed Rule does not require that investment advisers disclose their business continuity or transition plans to clients, investors or the SEC. Rather, and similar to the compliance rule, advisers are required to adopt the mandated policies and procedures, which are subject to review by the SEC during examinations, but not approval. Unlike with the adviser's code of ethics, the Proposed Rule does not require that advisers disclose their plans to clients in their Forms ADV.[6]

The SEC has requested comment on whether there should be a requirement for disclosure and/or filing of plans or the use of the plans.

Related Release for Investment Companies

Contemporaneously with the Proposed Rule, the SEC's Division of Investment Management issued an IM Guidance Update, "Business Continuity Planning for Registered Investment Companies".[7] With respect to Registered Investment Companies ("RICs"), the SEC took the approach of issuing guidance under its current Rule 38a-1 (the "RIC Guidance") rather than issuing a new proposed rule for RICs. More importantly, the RIC Guidance has substantive differences from the Proposed Rule; potentially because all RICs are managed by registered advisers that will be subject to the Proposed Rule.[8] The RIC Guidance notes that "business continuity planning generally is conducted at the fund complex level and typically business continuity plans […] address fund activities in conjunction with the activity of the primary investment adviser and other service providers that are part of the fund complex."[9]

— The RIC Guidance includes a number of policies and practices that funds and fund complexes "should consider" in creating a BCP, rather than listing required components of such plans. Items that the RIC Guidance suggests funds consider include:

  - Generally, mitigating risk through business continuity planning and potential disruption of services internally and at critical services providers, and under multiple scenarios;

[5] Under the Proposed Rule, this annual review would not be part of the annual compliance program review required under Rule 206(4)-7, though for efficiency investment advisers might choose to conduct them at the same time as part of the same process.

[6] Rule 204A-1(a) (requiring registered investment advisers to adopt codes of ethics); Form ADV Part 2a Item 11 (requiring a filer to summarize its code of ethics on Form ADV and to provide its full code of ethics to clients or prospective clients upon request).

[7] SEC Division of Investment Management, Business Continuity Planning for Registered Investment Companies, IM Guidance Update 2016-04 (June 2016), available at https://www.sec.gov/investment/im-guidance-2016-04.pdf.

[8] While the RIC Guidance is focused largely on a fund's review of its service providers' BCPs, the Proposed Rule emphasizes required elements of investment advisers' own plans. The SEC might consider less stringent requirements to be appropriate for funds than for investment advisers because the funds will be protected by BCP requirements imposed on their service providers. See n. 9 and accompanying text. But investment advisers may also benefit from similar protection; for instance, from broker-dealer service providers subject to BCP requirements.

[9] RIC Guidance at 2.

- Conducting due diligence on third party service providers, including on those providers' own BCPs;
- Understanding how the fund's BCP addresses disruptions related to critical service providers;
- Considering how to monitor whether a critical service provider has experienced a significant disruption;
- Communications policies:
  - Internally with management, employees, and the fund board;
  - Externally with service providers, intermediaries, investors, regulators, and the public;
  - Maintaining updated and accessible contact information for communication; and
- Considering how the BCPs of service providers relate to each other.

— The RIC Guidance does not include any requirement for a transition plan for RICs, unlike the Proposed Rule, which requires a transition plan for registered investment advisers.

The SEC has requested comment on whether instead of the Proposed Rule, it should issue guidance on business continuity and transition plans under rule 206(4)-7.

Other Items of Note

Applicability to All Registered Advisers

The Proposed Rule would apply to all registered investment advisers. The SEC considered and rejected variances based on the size of the adviser, but acknowledged by requesting comment that other characteristics could provide an appropriate subset of advisers to whom the Proposed Rule's application could be considered. For instance, advisers that are small or of limited complexity, or that have a limited nexus to the United States, might not achieve sufficient benefits through meeting the requirements of the Proposed Rule to justify the cost of preparing BCPs and transition plans with the required components. Furthermore, while the Advisers Act's compliance rule itself applies to foreign SEC-registered investment advisers only with respect to activities with U.S. clients,[10] the release is silent on applicability of the Proposed Rule to, for instance, foreign SEC-registered advisers with no U.S. clients. Although it would be logical to infer that the Proposed Rule would have similar limits on extraterritorial application, the SEC staff should clarify the impact of the Proposed Rule, if adopted, on foreign advisers.

The SEC has requested comment on whether the Proposed Rule should apply only to a subset of advisers, and which subset.

BCP Best Practices

In preparing the Proposed Rule (and the RIC Guidance), the SEC attempted to discern best practices in the market by means of its own exams and also through responses provided to a request for comment by the Financial Stability Oversight Council (the "FSOC").[11] In the Proposed Rule, the SEC recognized that BCPs are a best practice in the market: "[M]any investment advisers, like other financial services firms, already have taken critical steps to address and mitigate the risks of business disruption, regardless of the sources, as a prudent business measure."[12]

In the FSOC notice, comments were requested from the asset management industry about four topics: Liquidity and Redemptions, Leverage, Operational Risk, and Resolution. The Proposed Rule addresses

[10] See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Rel. No. IA-2333 (Dec. 10, 2004), nn. 211-222 and accompanying text, available at https://www.sec.gov/rules/final/ia-2333.htm.

[11] FSOC, Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77488 (Dec. 24, 2014).

[12] Proposed Rule at 7.

certain operational risks through the BCP requirement, and resolution through the transition plan requirement.

Other Regulatory Regimes' Business Continuity Requirements

The Proposed Rule release refers to a number of other regulatory regimes that impose BCP requirements, including:

— FINRA Rule 4370 (for broker-dealers);

— CFTC regulations[13] (for swap dealers and major swap participants);

— NASAA Model Rule 203(a)-1A[14] (for state-registered advisers in states that have adopted the NASAA model rule related to BCPs); and

— Regulation SCI (for self-regulatory organizations and alternative trading systems, among other entities).

The SEC "modeled the proposed rule on [BCP] requirements for other financial services firms that [it] believe[s] share similar vulnerabilities as investment advisers."[15]

The NASAA model rule may have been a motivating factor behind the Proposed Rule in an effort to ensure that SEC-registered advisers are regulated no less stringently than state-registered advisers, at least in states that adopt the model rule.

The fact that other regulatory regimes impose similar requirements on a number of entities—for example, broker-dealers, under FINRA—argues against imposing requirements for investment advisers to conduct detailed due diligence of third-party service providers who are already subject to business continuity planning requirements through these other regimes. Also, in the context of dual-registrants (i.e., those SEC-registered investment advisers that are also registered broker-dealers) specifically, meeting two independent BCP requirements (FINRA Rule 4370 and the Proposed Rule) could be more burdensome than beneficial; although the SEC staff notes the rules are largely complementary. The Proposed Rule does not address how (or if) an investment adviser can rely on another service provider's BCP or how advisers may interact with other advisers that have BCPs.

The SEC has requested comment on the implications of the Proposed Rule for advisers already subject to another regulatory regime's business continuity or transition plan requirement and whether other rules or guidance addressing similar plans should be considered.

Transition Plans

The Proposed Rule release explicitly provides that the transition plan requirement is not a resolution plan or living will as required for certain financial institutions by the Federal Reserve and Federal Deposit Insurance Corporation ("FDIC"); nor is it intended to be "similar" to these resolution plans.[16]

The SEC has requested comment on whether a more prescriptive rule like the Federal Reserve and FDIC's resolution plans should be adopted for advisers instead.

However, several key components of the transition plans in the Proposed Rule are also requirements of resolution plans.

Feedback received by the "first wave" resolution plan filers in March 2016 included shortcomings for a number of these large banks in the area of assessing potential legal challenges that would result in a transition.[17] While a typical investment adviser might

[13] 17 C.F.R. §23.603.

[14] Available at http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Model-Rule-on-Business-Continuity-and-Succession-Planning-with-gu....pdf.

[15] Proposed Rule at 27 n. 62.

[16] See Proposed Rule at 19 n. 40.

[17] See, e.g., Cleary Gottlieb, Judgment on 2015 Domestic First Wave Resolution Plans (April 29, 2016), available at https://www.clearygottlieb.com/~/media/cgsh/files/2016-rp-feedbackalert-memo.pdf.

be smaller, or at the very least have a more limited range of business activities, and therefore be less complex than these institutions, the experience of the resolution plan process suggests that the burden of producing transition plans could be greater than the Proposed Rule implies.

Also, some of the transition plan components are not necessary for investment advisers. For example, the contractual provision that is most likely to be in play in a transition is the anti-assignment provision that is already required under the Advisers Act,[18] though the SEC notes a few other examples. Requiring as a component to the transition plan an assessment of contractual provisions for all registered advisers would amount to engaging in a mergers-and-acquisitions-style diligence review of all their advisory contracts to evaluate the anti-assignment provisions. For fund advisers, especially, where the fund's consent process can be an analytic issue, this requirement could be unduly burdensome, at the expense of devoting compliance resources to anticipate events that may never come to pass.

Conclusion

The Proposed Rule is likely to generate substantial comment from the investment management industry. If adopted as proposed, registered investment advisers will need to revise existing BCPs. They may not be able to rely on BCPs and transition plans of any regulated affiliates, because of the prescriptive nature of the required components of the plans.

Link to the Proposed Rule:
https://www.sec.gov/rules/proposed/2016/ia-4439.pdf

Link to the RIC Guidance:
https://www.sec.gov/investment/im-guidance-2016-04.pdf

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[18] Advisers Act, §205(a)(2).