

Stradley Ronon Stevens & Young, LLP  
Philadelphia, Pa.  
2005 Market Street, Suite 2600  
Philadelphia, PA 19103-7018  
215.564.8000 Telephone  
215.564.8120 Facsimile

Washington, D.C.  
1250 Connecticut Avenue, N.W., Suite 500  
Washington, DC 20036  
202.822.9611 Telephone  
202.822.0140 Facsimile

With other offices in:  
New York  
Illinois  
New Jersey  
Delaware

[www.stradley.com](http://www.stradley.com)

## What You Need to Know About the SEC's New Proposal on Investment Adviser Business Continuity and Transition Plans

by Joel D. Corriero

On June 28, 2016, the U.S. Securities and Exchange Commission (the SEC) proposed new rule 206(4)-4 under the Investment Advisers Act of 1940 (the Advisers Act), which would require registered investment advisers to adopt and implement written business continuity and transition plans that include certain specified components (the Proposal).<sup>1</sup> The Proposal is designed to ensure that investment advisers have plans in place to address operational and other risks related to significant disruptions and transition events in the advisers' operations in order to minimize client and investor harm.<sup>2</sup> Although the SEC recognizes that advisers may not be able to prevent significant disruptions or transition events, it believes that robust planning across all SEC-registered advisers can help mitigate the effects and, in some cases, minimize the likelihood of reoccurrence.<sup>3</sup>

Proposed rule 206(4)-4 comes under the SEC's authority in Section 206(4) of the Advisers Act to adopt rules and regulations that "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."<sup>4</sup> In the Proposal, the SEC states that investment advisers, as fiduciaries, owe their clients the duties of care and loyalty, which require advisers to take appropriate steps to protect their clients' interests from being placed at risk as a result of the advisers' business continuity and transition events.<sup>5</sup> Because this fiduciary duty "fosters trust between the client and its adviser,"<sup>6</sup> the SEC states that it would be "fraudulent and deceptive 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."<sup>7</sup>

The Proposal is the fourth in a series of SEC proposals designed to address the impact of investment activities on investors and the financial markets, and the risks associated with the increasingly complex portfolio composition and operations of the asset management industry.<sup>8</sup>

<sup>1</sup> Adviser Business Continuity and Transition Plans, SEC Release No. IA-4439 (June 28, 2016), 81 Fed. Reg. 43530 (July 5, 2016), available at <https://www.gpo.gov/fdsys/pkg/FR-2016-07-05/pdf/2016-15675.pdf> (the Proposing Release). As an alternative to adopting proposed rule 206(4)-4 under the Advisers Act, the SEC has requested comment on whether it should issue guidance under rule 206(4)-7 of the Advisers Act (relating to Compliance Procedures and Practices) addressing business continuity and transition plans. *Id.* at 43543.

<sup>2</sup> The Proposal notes that such disruptions may put clients' and investors' interests at risk if, for example, an adviser lacks the ability to make trades in a portfolio or is unable to receive or implement directions from clients, or its clients are unable to access their assets or accounts. *Id.* at 43531.

<sup>3</sup> *Id.* at 43534.

<sup>4</sup> *Id.* at 43532.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 43534.

<sup>7</sup> *Id.* at 43532.

<sup>8</sup> See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release Nos. 33-9922, IC-31835 (Sept. 22, 2015), 80 Fed. Reg. 62274 (Oct. 15, 2015), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf>

Information contained in this publication should not be construed as legal advice or opinion or as a substitute for the advice of counsel. The enclosed materials may have been abridged from other sources. They are provided for educational and informational purposes for the use of clients and others who may be interested in the subject matter.

Copyright © 2016  
Stradley Ronon Stevens & Young, LLP  
All rights reserved.

## SUMMARY

The Proposal has three main components:

1. **Adopt and implement** business continuity and transition plans, which may be separate plans or a single consolidated plan, that are reasonably designed to address operational and other risks attributable to significant disruptions in an adviser's operations;
2. **Review**, no less frequently than annually, the adequacy of the plans and the effectiveness of their implementation; and
3. **Maintain** relevant records.



If you would like more information, contact Joel D. Corriero at 215.564.8528 or [jcorriero@stradley.com](mailto:jcorriero@stradley.com).

Comments on the Proposal are due by or before Sept. 6, 2016.

## DETAILED DISCUSSION

### I. Adopt and Implement Business Continuity and Transition Plans

Pursuant to proposed rule 206(4)-4, it shall be unlawful for SEC-registered investment advisers (or those required to be registered pursuant to section 203 of the Advisers Act) to provide investment advice to clients unless they adopt and implement a written business continuity and transition plan (a Plan or Plans).<sup>9</sup> These Plans must include policies and procedures concerning business continuity after a significant business disruption, and business transition in the event the investment adviser is unable to continue providing investment advisory services to clients.<sup>10</sup> Although similarly formulated to rule 206(4)-7, which requires advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder, proposed rule 206(4)-4 also includes specified components detailing the information that must be included in the Plan.

Pursuant to the Proposal, significant business disruptions generally include natural disasters; acts of terrorism; cyberattacks; equipment or system failures; and/or unexpected loss of a service provider, facilities, or key personnel.<sup>11</sup> Business transitions generally include situations in which the adviser exits the market and is no longer able to serve clients, such as when it merges with another adviser or sells all or part of its business.<sup>12</sup>

Because the proposed rule requires that these policies and procedures be *reasonably* designed to address risks related to significant disruptions in operations,<sup>13</sup> the Proposal suggests that an adviser should only be required to “take into account the risks associated with its particular operations, including the nature and complexity of the adviser’s business, its clients, and its key personnel.”<sup>14</sup> For example, Plans of larger advisers would likely differ from those of smaller advisers with fewer resources and employees, and Plans of advisers with complex internal technology infrastructure would likely differ from those of advisers that use third-party providers to perform various middle- and back-office functions.<sup>15</sup>

---

Investment Company Reporting Modernization, SEC Release Nos. 33-9776, 34-75002, IC-31610 (May 20, 2015), 80 Fed. Reg. 33590 (June 12, 2015), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2015-06-12/pdf/2015-12779.pdf>; and Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC-31933 (Dec. 11, 2015), *available at* <http://www.sec.gov/rules/proposed/2015/ic-31933.pdf>.

<sup>9</sup> Proposed rule 206(4)-4(a)(1). We note that this formulation is similar to rule 206(4)-7 under the Advisers Act, which makes it unlawful for an adviser to provide investment advice to clients if, among other things, it has not adopted compliance policies and procedures.

<sup>10</sup> Proposed rule 206(4)-4(b)(1). Note that “unable to continue providing investment advisory services” is not a defined term in proposed rule 206(4)-4, and the SEC has requested comment on whether such term should be defined. See Proposing Release, *supra* note 1, at 43544.

<sup>11</sup> Proposing Release, *supra* note 1, at 43537. Note that “significant business disruptions” is not a defined term in proposed rule 206(4)-4, and the SEC has requested comment on whether such term should be defined. *Id.* at 43544.

<sup>12</sup> *Id.* at 43537.

<sup>13</sup> Proposed rule 206(4)-4(b).

<sup>14</sup> Proposing Release, *supra* note 1, at 43538.

<sup>15</sup> *Id.*

Under the proposed rule, the content of an adviser's Plans must be based on the risks associated with the adviser's operations, and include policies and procedures designed to minimize material service disruptions. These policies and procedures must address the following specified components (the Plan Components):<sup>16</sup>

- Maintenance of critical operations and systems, and the protection, backup, and recovery of data, including client records (Maintenance and Backup);
- Pre-arranged alternate physical location(s) of the adviser's office(s) and/or employees (Alternate Locations);
- Communications with clients, employees, service providers, and regulators (Communication Plans);
- Identification and assessment of third-party services critical to the operation of the adviser (Third-Party Service Providers); and
- A plan of transition that accounts for the possible winding down of the investment adviser's business or the transition of the investment adviser's business to others in the event the investment adviser is unable to continue providing investment advisory services (the Transition Plan).

The following discussion provides additional information about the Plan Components:

#### **A. Maintenance and Backup**

The Proposal requires that an adviser's Plan generally should identify and prioritize critical functions, operations and systems, and consider alternatives and redundancies to help maintain the continuation of operations in the event of a significant business disruption.<sup>17</sup> When evaluating which operations and systems are "critical," advisers generally should:

- i. Consider those operations and systems 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 such transactions;<sup>18</sup> and
- ii. Identify which key personnel (a) provide critical functions to the adviser, or (b) support critical operations or systems of the adviser, such that the temporary or permanent loss<sup>19</sup> of those individuals would disrupt the adviser's ability to provide services to its clients.<sup>20</sup>

When considering alternatives and redundancies to help maintain the continuation of operations in the event of a significant business disruption, advisers should:

- i. Generally consider circumstances in which a service provider (or another investment adviser that provides operations or systems to the adviser) is permanently unable to provide the adviser with critical operations or systems;<sup>21</sup>
- ii. Include short-term arrangements, such as which specific individuals would satisfy the roles of key personnel when key personnel are unavailable, and long-term arrangements regarding succession planning and how an adviser will replace key personnel over time;<sup>22</sup> and

<sup>16</sup> Proposed rule 206(4)-4(b)(2). The SEC modeled the Plan Components on certain provisions in disaster recovery plans that appeared to be effective based on the SEC staff's review of such plans, as noted in the SEC's June 2007 Compliance Alert, *available at* <https://www.sec.gov/about/offices/ocie/complialert.htm>.

<sup>17</sup> Proposing Release, *supra* note 1, at 43538.

<sup>18</sup> *Id.* This typically will include identification and assessment of third-party service providers that support certain functions (as discussed below under Third-Party Service Providers).

<sup>19</sup> The SEC believes that contingency plans should address both temporary and permanent loss of key personnel. *Id.* at 43539.

<sup>20</sup> *Id.* at 43538.

<sup>21</sup> *Id.* at 43538, n.73.

<sup>22</sup> *Id.* at 43539.

- iii. Consider whether the departure of key personnel may trigger contractual obligations with clients, investors or counterparties.<sup>23</sup>

A Plan generally should also address backup through both hard copy and electronic mediums, as significant business disruptions may prevent access to one or both (*e.g.*, the inability to access a building where data is located or a power outage). In addition, a Plan generally should include an inventory of key documents (*e.g.*, organizational documents, contracts, policies, and procedures), including the location and description of the item, and a list of service provider relationships that are necessary to maintaining functional operations of the adviser. This documentation generally should include details of the adviser's management structure, risk management processes, and financial and regulatory reporting requirements.<sup>24</sup> Further, the Proposal notes that the backup portion of the Plan Components should also consider and address operational and other risks related specifically to cyberattacks.<sup>25</sup>

## B. Alternate Locations

According to the Proposal, "alternate or remote locations are *essential* for an adviser to continue providing services during a significant business disruption."<sup>26</sup> Therefore, when developing Plans, the Proposal suggests that advisers generally should consider the geographic diversity of their 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.<sup>27</sup>

## C. Communication Plans

The SEC believes that "communication plans are an essential element of effective business continuity and transition plans and generally should cover communications with parties involved in the critical aspects of the adviser's operations."<sup>28</sup> Pursuant to the Proposal, an adviser's Communication Plans generally should cover, among other matters:

- i. The methods, systems, backup systems, and protocols that will be used for communications;
- ii. How employees are informed of a significant business disruption;
- iii. How 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, so that in the event of a significant business disruption employees understand their specific roles and responsibilities and are able to carry out the Plan.<sup>29</sup>

In addition, Communication Plans with clients should consider, among other matters:

- i. When and how it is in the adviser's clients' best interests to be informed of a significant business disruption and/or its impact;

<sup>23</sup> Proposing Release, *supra* note 1, at 43539, n.75. For example, private funds may contain redemption rights for their investors upon the departure of specified investment personnel.

<sup>24</sup> *Id.* at 43539.

<sup>25</sup> *Id.*, citing the SEC's Cybersecurity Guidance, IM Guidance Update (April 2015), available at <http://www.sec.gov/investment/im-guidance-2015-02.pdf>, which "highlighted a number of measures for advisers to consider in the context of cybersecurity." *Id.* at 43539, n.77.

<sup>26</sup> *Id.* at 43539 (emphasis added).

<sup>27</sup> *Id.* The Proposal does not require an alternative location at a specified distance away from the adviser's primary location; rather, it requires consideration of whether the adviser's alternative locations and/or primary location are in such close proximity to one another that they may share common infrastructure providers and, therefore, be similarly affected by the same external event. *Id.* at 43539, n.80.

<sup>28</sup> *Id.* at 43540.

<sup>29</sup> *Id.*

- ii. The process by which the adviser would have prompt access to client records that include the name and relevant contact and account information for each client, as well as investors in private funds sponsored by the adviser; and
- iii. How clients will be made aware of and updated about a significant business disruption that materially impacts ongoing client services and, when applicable, how clients will be contacted and advised if account access is impacted during such a disruption.<sup>30</sup>

Communication Plans with service providers should consider, among other matters:

- i. How the service provider will be notified of a significant business disruption at the adviser;
- ii. How the adviser will be notified of a significant business disruption at the service provider; and
- iii. How the entities will communicate with one another, and with clients or investors, during a disruption.<sup>31</sup>

Lastly, Communication Plans with regulators should include the contact information for all relevant regulators, identify the personnel responsible for notifying regulators, and identify the circumstances in which regulators should be notified of a significant business disruption.<sup>32</sup>

#### **D. Third-Party Service Providers**

Third-party service providers that support or conduct critical functions or services for an adviser and/or on the adviser's behalf should be identified in a Plan.<sup>33</sup> When identifying and prioritizing which service providers should be deemed "critical," advisers should consider a variety of factors, including, among others:

- i. The day-to-day operational reliance on the service provider and the existence of a backup process or multiple providers;
- ii. Whether the service provided includes direct contact with clients or investors; and
- iii. Whether the service provider is maintaining critical records or is able to access personally identifiable information.<sup>34</sup>

Under the Proposal, "critical service providers" should at least include those providing services related to portfolio management; custody of client assets; trade execution and related processing, pricing, client servicing, and/or recordkeeping; and financial and regulatory reporting.<sup>35</sup>

Service providers for which an adviser plays a key role in *identifying, arranging for, and overseeing as part of its sponsoring role* should also be identified in the Plan if they are deemed "critical service providers."<sup>36</sup> This would include, for example, situations in which an adviser arranges for a particular administrator or pricing vendor for a registered investment company.<sup>37</sup> It is important to note that the proposed rule would apply to all critical service providers that the

<sup>30</sup> Proposing Release, *supra* note 1, at 43540.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 43541.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*; *see also id.* at 43541, n.92, citing n.85 ("pooled investment vehicles generally rely on their investment advisers to arrange for and interact with fund service providers.").

adviser has identified, arranged for, and oversees as part of its “sponsoring role,” not just those with which the adviser has contracted directly.

Once critical service providers are identified, an adviser should review and assess how these service providers plan to maintain business continuity when faced with significant business disruptions,<sup>38</sup> and consider how this planning will affect the adviser’s operations. The adviser should also consider alternatives for such critical service providers, such as other service providers or its own internal functions or processes, to the extent the service provider does not have a business continuity plan or its plan does not provide for backup plans during significant business disruptions.<sup>39</sup> In this regard, the Proposal cites to the August 2015 Bank of New York Mellon pricing system failure, which resulted in the Bank of New York Mellon being unable to timely calculate net asset values for its clients.<sup>40</sup>

The Proposal, referring to a Joint Report of the Federal Reserve, Office of the Comptroller of the Currency, and SEC, notes that while advisers can use service providers to perform various functions, they cannot shift responsibility for compliance with the federal securities laws to those service providers.<sup>41</sup> “Should a service provider not have the appropriate level of resilience, a financial institution *would be required to move* to a provider that can demonstrate an appropriate level of resilience.”<sup>42</sup> Based on the foregoing, the SEC encourages advisers to be familiar with the terms of their contracts with critical service providers, including provisions regarding termination or assignment of a contract and any related notice requirements.<sup>43</sup> The SEC did not provide details of the time frame in which such a move would be required to take place. The SEC did recognize, however, 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.”<sup>44</sup> In such cases, the SEC suggests that “an adviser should consider backup plans, functions and/or processes to address how it will manage the loss of a critical service.”<sup>45</sup>

## E. Transition Plan

Under the proposed rule, an adviser’s Plan would have to include a Transition Plan that accounts for the possible winding down of the adviser’s business or the transition of the business to others in the event the adviser is “unable to continue providing investment advisory services.”<sup>46</sup> The Transition Plan should account for transitions in both normal and stressed market conditions, and generally should consider each type of advisory client; the adviser’s contractual obligations to its clients, counterparties and service providers; and relevant regulatory regimes under which the adviser operates.<sup>47</sup> Proposed rule 206(4)-4(b)(2)(v) provides that the Transition Plan must include the following components:

- i. Policies and procedures intended to safeguard, transfer, and/or distribute client assets during a transition;<sup>48</sup>

<sup>38</sup> In determining what steps are appropriate to understand the operational and other risks of service providers, an adviser should consider the significance of the service provider to the adviser’s advisory operations, the type of services provided, and the adviser’s ability to require or request actions of the service provider. These steps may include review of a service provider’s business continuity plans, due diligence questionnaires, certifications, or onsite visits, among others. Proposing Release, *supra* note 1, at 43541.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 43541, n.90.

<sup>41</sup> *Id.* at 43540-41, n.89, citing the Federal Reserve, Office of the Comptroller of the Currency, and SEC’s Joint Report on Efforts of the Private Sector to Implement the Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System (April 2006) at 3, *available at* <https://www.sec.gov/news/press/studies/2006/soundpractices.pdf> (the Joint Report).

<sup>42</sup> *Id.* (emphasis added).

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* 43541, n.91.

<sup>45</sup> *c*

<sup>46</sup> *Id.* at 43541; *see also* proposed rule 206(4)-4(b)(2)(v). As noted above, “unable to continue providing investment advisory services” is not a defined term in proposed rule 206(4)-4, and the SEC has requested comment on whether such term should be defined. *See* Proposing Release, *supra* note 1, at 43544.

<sup>47</sup> *Id.* at 43542.

<sup>48</sup> These policies and procedures should consider the unique attributes of each type of client (e.g., registered investment companies, private funds, separately managed accounts) and how the adviser plans to transfer accurate client information to other advisers or their service providers. If a client account holds assets that would require special instruction or treatment in the event of transition (such as certain derivative instruments), these policies and procedures generally should address those instructions or treatments. *Id.*



- ii. Policies and procedures facilitating the prompt generation of any client-specific information necessary to transition each client account;<sup>49</sup>
- iii. Information regarding the corporate governance structure of the adviser;<sup>50</sup>
- iv. 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, implicated by the adviser's transition.

The Proposal notes that, because “advisers manage a variety of products and security types, with investments in and investors from various jurisdictions and are subject to a variety of contractual and legal obligations and regulatory regimes,”<sup>51</sup> Transition Plans should include an assessment of *all* applicable laws from such various jurisdictions, and *all* contractual obligations that would be implicated by an adviser's transition. Such laws and contracts could relate to a number of different occurrences, such as the sale of the adviser's assets and liabilities, business lines, or operations; liquidation of fund clients; or termination of the advisory relationship.<sup>52</sup>

## II. Review

Pursuant to proposed rule 206(4)-4, the adequacy of a Plan and the effectiveness of its implementation must be reviewed no less frequently than annually.<sup>53</sup> The Proposal notes that, during the review, an adviser generally should consider any changes to its products, services, operations, critical third-party service providers, structure, business activities, client types, and location, and any regulatory changes that might suggest a need to revise the Plan. The Proposal also provides that the adviser should address weaknesses identified during any testing or assessments, and any lessons learned if an event required the Plan to be implemented during the previous year, including any changes made or contemplated as a result of the event.<sup>54</sup>

## III. Recordkeeping Requirements

The Proposal would amend rule 204-2 under the Advisers Act to require SEC-registered advisers to maintain copies of all Plans that are in effect, or were in effect at any time during the last five years, after the compliance date.<sup>55</sup> Advisers would also be required to maintain records documenting the annual review of the Plans in accordance with the recordkeeping requirements of rule 204-2(e)(1).<sup>56</sup>

## IV. Proposed Implementation Costs to Advisers and Clients

---

<sup>49</sup> Such information may include the identity of custodians, positions, counterparties, collateral, and related records of each client. Proposing Release, *supra* note 1, at 43542.

<sup>50</sup> With respect to this factor, the Transition Plan generally should include an organizational chart and other information about the adviser's ownership and management structure, including the identity and contact information for key personnel, and the identity of affiliates (both foreign and domestic) whose dissolution or distress could lead to a change in or material impact to the adviser's business operations. *Id.*

<sup>51</sup> *Id.* at 43542.

<sup>52</sup> *Id.* at 43541-42.

<sup>53</sup> Proposed rule 206(4)-4(a)(2).

<sup>54</sup> Proposing Release, *supra* note 1, at 43544.

<sup>55</sup> Proposed rule 204-2(a)(20)(i).

<sup>56</sup> Proposed rule 204-2(a)(20)(ii). Rule 204-2(e)(1) would require annual review records to be maintained and preserved in an easily accessible place for at least five years from the end of the fiscal year during which the last entry was made on such records, with the first two years in an appropriate office of the adviser.

The SEC believes that an adviser would experience an initial cost associated with developing and implementing its Plans of between \$30,000 and \$1.5 million, depending on the facts and circumstances of the adviser's operations.<sup>57</sup> These costs include a range of \$5,000 to \$50,000 for third-party oversight, as described in Section I.D. above, which would include due diligence reviews of third-party service providers.<sup>58</sup> This estimate, however, does not appear to take into account the potential costs associated with issues arising outside of the due diligence review, such as the costs of replacing service providers that "no longer have the appropriate level of resilience."<sup>59</sup> Annual costs thereafter are estimated to range from \$7,500 to \$375,000, which is calculated based on a percentage (25 percent) of the initial costs. The Proposal acknowledges that some of these costs could be passed on to clients and fund investors through higher fees.<sup>60</sup>

---

<sup>57</sup> Proposing Release, *supra* note 1, at 43548.

<sup>58</sup> *Id.* at 43549, n.129.

<sup>59</sup> Joint Report, *supra* note 43.

<sup>60</sup> Proposing Release, *supra* note 1, at 43549.