July 6, 2016

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

On June 28, 2016, the SEC published a release (the "Release") proposing new Rule 206(4)-4 under the Advisers Act (the "Proposed Rule"). If adopted, the Proposed Rule would require every SEC-registered investment adviser (an "Adviser") to adopt and implement a written business continuity and transition plan reasonably designed to address operational risks related to a significant disruption in the Adviser's business.

- The **business continuity portion** of the required plan must be based upon the risks associated with an Adviser's operations, and would be required to consist of policies and procedures reasonably designed to minimize material service disruptions after a significant business disruption.

- The **transition portion** of the required plan also must be based upon the risks associated with an Adviser's operations, and would be required to consist of policies and procedures reasonably designed to minimize material service disruptions if the Adviser's business is wound down or transitioned to others.

The Proposed Rule also would require an Adviser to review, at least annually, the adequacy of its business continuity and transition plan and the effectiveness of its implementation. Finally, the Release also proposes changes to Adviser record-keeping requirements that correspond to the requirements of the Proposed Rule.

The Proposed Rule is described in detail below. Comments on the Release must be filed no later than September 6, 2016.

On the same date that the Release was published, the SEC's Division of Investment Management published a Guidance Update titled, *Business Continuity Planning for Registered Investment Companies* (available here). The Guidance Update is the subject of a separate Ropes & Gray Alert (available here).

**Business Continuity Planning.**[1] In 2003, in the adopting release for Rule 206(4)-7 under the Advisers Act (the "Compliance Program Rule"), the SEC stated that Advisers should adopt business continuity plans ("BCPs"). The Release states that, in 2003, the SEC did not "identify critical components of a BCP or discuss specific issues or topics that advisers should consider in developing such plans." Based on the SEC examiners' subsequent reviews of Advisers' responses to weather-related events and other observations of the examination staff concerning the operation of BCPs, as well the increasing operational complexity of many Advisers' operations, the SEC now believes that BCPs must expressly address the issues and topics set forth in the Proposed Rule.

The Proposed Rule provides that a BCP must be based upon the risks associated with an Adviser's operations, and would be required to consist of policies and procedures reasonably designed to minimize material service disruptions after a significant business disruption. These policies and procedures must address the following issues and topics, some or all of which may already be addressed by many Advisers' current BCPs:

[1] Throughout the Release, the SEC refers to an Adviser adopting a "business continuity and transition plan." However, in a footnote, the SEC states that it recognizes that business continuity planning and transition planning address different circumstances and, further, that the Rule would not require an Adviser to consolidate a business continuity plan and a transition plan into one document. Accordingly, the remainder of this Alert refers to business continuity plans and transition plans as separate plans.

1. Maintenance of critical operations and systems, and the protection, backup, and recovery of data, including client records.

2. Pre-arranged alternate physical location(s) of the Adviser's office(s) and/or employees;

3. Communications with clients, employees, service providers, and regulators; and

4. Identification and assessment of third-party services critical to the operation of the Adviser.

**Transition Planning.** The Release does not point to any specific rulemaking or guidance that would currently require Advisers to have transition plans. Instead, the Release notes the failure of multiple large financial services firms in the 2008 financial crisis, but without any discussion of the failed firms' subsidiary Advisers.

The Proposed Rule provides that a transition plan must be based upon the risks associated with an Adviser's operations, and would be required to consist of policies and procedures reasonably designed to minimize material service disruptions if the Adviser's business is wound down or transitioned to others. These policies and procedures must include the following elements:

1. Policies and procedures intended to safeguard, transfer, and/or distribute client assets during a transition;

2. Policies and procedures to facilitate the prompt generation of client-specific information necessary to transition each client account;

3. Information regarding the corporate governance structure of the Adviser;

    a. The SEC believes that identification of an Adviser's important decision-makers is required because these individuals understand the relationships between the Adviser and any affiliated entities and, therefore, are the persons required to assess whether and how issues at an affiliate may affect the Adviser.

    b. In turn, understanding the relationships between the Adviser and any affiliated entities is necessary for the Adviser to assess the manner in which it can exit the market with minimal adverse effect on its clients, and for the Adviser to protect itself from any issues that arise from any affiliated entities.

4. The identification of any material financial resources available to the Adviser (because a strategy either to avoid or facilitate a transition of the Adviser's business due to the Adviser's financial distress requires considering such resources); and

5. 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 (because knowledge of legal impediments – *e.g.*, the requirement that shareholders or clients must approve the assignment of advisory contracts – affects the Adviser's ability to transition its business).

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Announced in a speech by Chair White in December 2014, the Proposed Rule is the fourth of five elements of the SEC's regulatory agenda to address systemic risks posed by asset managers.[2] The Proposed Rule is proposed as an anti-fraud provision and, consequently, the Proposed Rule would apply to all Advisers, other than exempt reporting advisers, regardless of the Adviser's size.

[2] The fifth element, annual stress testing by large Advisers and large funds, has not yet been proposed.

We expect a significant number of comments on the Proposed Rule from various industry participants and other interested parties. As noted above, comments on the Release must be filed with the SEC no later than September 6, 2016.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.