

Client Update

“Living Wills” for Private Fund Sponsors? Proposed Rule Requiring Investment Adviser Business Continuity and Transition Plans

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On June 28, the U.S. Securities and Exchange Commission (the “SEC”) proposed a new rule under the Investment Advisers Act of 1940 (the “Advisers Act”) that would require SEC-registered investment advisers (“advisers”) to adopt and implement written business continuity and transition plans (“BCTPs”) reasonably designed to address operational and other risks related to a significant disruption in the adviser’s operations.¹

Most advisers currently have business continuity plans that are designed to address business disruptions that might be caused by natural disasters, acts of terrorism, cyber-attacks, equipment or system failures, or the unexpected loss of a service provider, facilities, or key personnel. The proposed rule would also require these plans to address transition issues – that is, situations where the adviser exits the market and thus is no longer able to serve its clients, including when it merges with another adviser or sells its business.

Private fund managers and other advisers should review their existing business continuity plans to determine whether they address the issues raised by the SEC in the Proposing Release, as well as begin to develop the types of transition plans that would be required by the proposed rule.

¹ Adviser Business Continuity and Transition Plans, Advisers Act Release No. IA-4439 (Jun. 28, 2016), available at <https://www.sec.gov/rules/proposed/2016/ia-4439.pdf> (the “Proposing Release”). Concurrently with the publication of the Proposing Release, the SEC’s Division of Investment Management issued guidance concerning business continuity planning for registered investment companies. See “Business Continuity Planning for Registered Investment Companies,” Division of Investment Management Guidance Update (Jun. 2016), available at: <https://www.sec.gov/investment/im-guidance-2016-04.pdf>.

BACKGROUND

The proposed rule grows out of a set of initiatives that SEC Chair Mary Jo White announced at the end of 2014 as SEC priorities designed to modernize certain aspects of investment management regulation.² Focusing in particular on “the impact on investors . . . when an investment adviser is no longer able to serve its clients” she stated that the SEC staff was “developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business.” Chair White specifically noted “...we must take steps to ensure that firms have a plan for transitioning their clients’ assets when circumstances warrant. If we have learned nothing else from the financial crisis, it is that we must test and plan for the worst.”

The SEC has also been following the lead of other financial regulators in addressing these types of issues. Following the 2008 financial crisis, Congress addressed the need for this type of advance planning for certain financial institutions by requiring that they adopt resolution plans. Although the SEC notes that it is not proposing that advisers adopt plans that are on par with “living wills” for banks, the Proposing Release indicates that “a reasonably designed plan assessing various risks related to a business transition . . . and how to react to transition events should ameliorate the impact of transitions on clients.” The Proposing Release notes that the SEC is concerned about the adequacy of certain advisers’ business continuity plans because clients of advisers without robust plans are at greater risk of harm during a significant disruption.

The Advisers Act does not provide the SEC with explicit rulemaking authority to address these types of risks. Nevertheless, the SEC has determined that it has the authority to address business continuity and transition risks based on its authority to adopt rules designed to “define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business” that it determines are “fraudulent, deceptive, or manipulative.” In this connection, the Proposing Release asserts:

As part of their fiduciary duty, advisers are obligated to take steps to protect client interests from being placed at risk as a result of the adviser’s inability to provide advisory services. . . . Because an adviser’s fiduciary duty obligates it to take steps to protect client

² SEC Chair Mary Jo White, “Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry”, (Dec. 11, 2014) *available at* <https://www.sec.gov/News/Speech/Detail/Speech/137054367722>.

interests from being placed at risk as a result of the adviser's inability to provide advisory services, clients are entitled to assume that advisers have taken the steps necessary to protect those interests in times of stress, whether that stress is specific to the adviser or the result of broader market and industry events. We believe 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.

Thus, the proposed rule would provide that it would be unlawful for an adviser to provide investment advice to its clients unless, among other things, the adviser has adopted and implemented a written BCTP. The language of the Proposing Release, however, suggests that an adviser should take the steps outlined by the proposed rule regardless of whether it is adopted.

COMPONENTS OF BCTPS

The SEC appears to recognize that advisers' business models and operations vary and that an adviser should tailor its BCTP to the specific risks of its business. The proposed rule, however, would require that a BCTP address specified key issues with respect to business disruptions and transitions. These components include the following.

- *Maintenance of Critical Operations and Systems, and Protection of Data.* An adviser should identify systems critical to client transactions and alternatives for ensuring continued operations during a significant disruption. The adviser should:
 - consider systems that are critical to the valuation and maintenance of client accounts and the delivery of funds and securities;
 - identify key documents, such as organizational documents, contracts, policies and procedures, and a list of service providers necessary to maintaining operations;
 - plan for risks resulting from cyber-attacks; and
 - identify key personnel and make both short-term arrangements for when key personnel are unavailable and long-term arrangements for succession planning.

Advisers to private funds should additionally consider whether the departure of key personnel may trigger contractual obligations, such as redemption rights for investors upon the departure of specified investment personnel.

- *Pre-arranged Alternate Physical Locations of the Adviser's Offices and Employees.* A BCTP should also include arrangements for remote access to the technology necessary to continue operations.
- *Communications with Clients, Employees, Service Providers, and Regulators.* Communication plans should cover the systems and protocols that will be used to send out communications and employee training on responses to business disruptions. An adviser should consider when it is in its clients' best interests to be informed of business disruptions.

A BCTP should include the process by which the adviser would have prompt access to client records, including the contact and account information for each client, as well as investors in private funds sponsored by the adviser. The SEC notes that, in order to rely on exclusions from registration as investment companies, private fund sponsors are already required to have detailed contact information available regarding beneficial owners that are U.S. persons, but may not have such detailed information about non-U.S. person beneficial owners.

- *Identification and Assessment of Critical Third-party Service Providers.* In determining which third-party service providers are critical, an adviser should consider the existence of a backup process, whether the service includes direct contact with investors, and whether the service provider maintains critical records. The adviser should consider the business continuity plans of its critical service providers as well.

The Proposing Release notes that a private fund sponsor may play a key role in identifying service providers for the funds that it manages, for example, arranging for particular administrators or pricing vendors for private fund clients. Therefore, a private fund sponsor should consider how business disruptions at these service providers will affect fund operations.

- *Plan of Transition.* Developing a transition plan will be a new undertaking for most advisers. A BCTP would be required to address the possible winding down of the adviser's business or the transition of the adviser's business to others in the event the adviser is unable to continue providing advisory services. An adviser should consider plans for exiting the market under normal and stressed conditions and should consider its contractual obligations to clients, counterparties, and service providers, and relevant

regulatory requirements. A transition plan would be required to address the following issues:

- *Safeguarding Client Assets.* A BCTP should address how the adviser intends to safeguard, transfer, and/or distribute client assets in the event of a transition and should consider the unique attributes of each type of client, and how the adviser plans to transfer accurate client information to another adviser. Because private funds typically have multiple investors, private fund sponsors should consider the complexity of transferring their clients' information. Private fund sponsors should also consider whether a client account holds any assets, such as derivatives, that would require special instructions in the event of a transition.
- *Generating Necessary Information.* A BCTP should also address how client-specific information, such as the identity of custodians, positions, counterparties, collateral, and other related records would be transitioned.
- *Corporate Governance and Structure.* A BCTP should include an organizational chart and other information about the adviser's ownership and management structure, including contact information for key personnel and the identity of affiliates whose financial distress could lead to a change in or material impact to the adviser's operations. The SEC indicates that this form of preparation will allow senior executives to quickly identify important decision-makers in the organization and any affiliated entities that may be impacted in times of distress.
- *Identification of Material Financial Resources.* The Proposing Release notes that an adviser should consider in advance its strategy for avoiding or facilitating a transition if it is in financial distress such that its ability to provide investment advisory services or otherwise serve its clients' best interests is impacted. A BCTP should therefore include a consideration of financial resources available to the adviser, such as any material sources of funding or liquidity it would seek in times of stress or ways to reduce expenses to facilitate continued operations.
- *Legal Assessments Governing the Adviser and its Clients.* A BCTP should include an assessment of applicable law and contractual obligations relating to the various products and security types that the adviser manages (for example, provisions requiring client consent to the assignment of the management contract). Private fund sponsors should also consider the complexities of navigating various legal and regulatory regimes if the adviser's investment vehicles are domiciled in different jurisdictions.

ANNUAL REVIEW; RECORDKEEPING

The proposed rule would require an adviser to review the adequacy and effectiveness of its BCTP at least annually. This review generally should consider any operational or regulatory changes that might require revisions to the plan.

The SEC is also proposing rule amendments that would require advisers to maintain a copy of its BCTP for five years. Proposed rule amendments would also require advisers to keep any records documenting its annual review.

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Comments on the proposed rule are due on September 6, 2016. Private fund sponsors should begin refining their business continuity plans and developing transition plans to meet the proposed requirements.

Please do not hesitate to contact us with any questions.