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SEC proposes rule 206(4)-4

Adviser business continuity
and transition plans

Proposed rule related to business continuity and transition plans for investment advisers

The Securities and Exchange Commission (SEC) proposed a new rule 206(4)-4¹ under the Investment Advisers Act of 1940 (Advisers Act), which if adopted, would have a significant impact on the investment management industry including investment advisers and service providers to the industry. The Adviser Business Continuity and Transition Plans Rule (the Rule) would require the industry's 12,000+ registered investment advisers (advisers) to adopt and implement written business continuity and transition plans reasonably designed to address operational risks related to significant disruption in the adviser's operations. In conjunction with the proposal, the SEC's Division of Investment Management also issued guidance² addressing business continuity planning for registered investment companies (funds), including the oversight of the operational capabilities of fund service providers by the fund complex's sponsor, chief compliance officer, and boards. The guidance suggests that many of these matters already apply to funds based on SEC staff's interpretation of 38a-1.³

Building upon the trend seen in the banking and securities sectors, the Rule shows that financial services regulators continue to apply pressure on covered organizations to further mitigate risks of service disruption. SEC Chair White indicated that the Rule is the Commission's latest effort to modernize and enhance regulatory safeguards for the investment management industry.⁴ Recent events such as natural disasters (e.g., Hurricanes Katrina and Sandy), operational failures, evolving threats of cyberattacks, increasing complexity of portfolios and strategies, growing reliance on technology and third-party service providers, as well as poor examination results when reviewing advisers' business continuity plans moved the SEC to take action.

Key components

The Rule would require an adviser's plan to include written policies and procedures addressing the following:

- 1 Maintenance of critical operations and systems and protection of data.
- 2 Pre-arranged alternative physical locations.
- 3 Communication plans.
- 4 Review of third-party service providers.
- 5 A plan of transition in the event the adviser needs to wind down its operations if it is unable to continue providing advisory services.

Advisers would be permitted to tailor the detail of their plans based upon the complexity of their business operations and the risks presented by their particular business models and activities.

1 <https://www.sec.gov/rules/proposed/2016/ia-4439.pdf>

2 <https://www.sec.gov/investment/im-guidance-2016-04.pdf>

3 https://www.sec.gov/rules/final/ia-2204.htm#P277_108280

4 <https://www.sec.gov/news/pressrelease/2016-133.html>

What's new under the proposed Rule?



More prescriptive: Unlike previous guidance,⁵ the Rule would be more prescriptive in its requirements. Plans would need to be more comprehensive in scope and address the key components noted earlier. Plans will need to have the agility and sustainability to adapt to evolving issues. Organizations will also need to evaluate plans at least annually and be able to demonstrate effectiveness. This may require greater levels of assurance over capabilities especially with respect to the use of third parties, driving the development of new scenario planning, attestations, or plan testing techniques that incorporate service providers along with the business.



Inclusion of transition plans: The Rule would require a transition plan in the event an adviser needed to wind down its operations and transition services to another adviser. These plans would need to contain adequate information to guide the wind down while addressing issues relating to the safeguarding of client assets and records, legal considerations affecting the adviser and its clients during transition, identification of financial resources to support the transition, and information related to corporate governance structure.



Third-party oversight: Oversight of third parties is a repeated focus under the Rule. Adviser organizations often rely on an interconnected web of third parties including custodial services, pricing vendors, transfer agents, broker-dealers, administrators, portfolio accountants, sub-advisers, and technology providers. Advisers need to assess relevant risks within this ecosystem known as the "extended enterprise" including financial, operational, security risks, etc. Advisers should design adequate, risk-based mitigation strategies across the third-party lifecycle⁶. Since third parties also rely on service providers, understanding critical "fourth parties" in the extended enterprise will be necessary. Advisers will also need to evaluate whether their providers' plans are adequate to ensure continuity of services during a significant disruption or establish contingencies.



Data security: Due to the evolving threats to key data such as customer records, advisers will need to have appropriate controls in place to protect, backup and recover information. Advisers will also need to gain assurance on data security capabilities at third-party service providers.



Effective communication plans: Advisers would need to have a documented, actionable communication plan to interact with clients, employees, service providers, and regulators during a disruption event. Stakeholders must understand their specific roles and responsibilities in carrying out the plan.



Moving towards "resiliency": While the investment management industry has increased its focus on protection against threats such as cyber-attacks, many organizations do not adequately stress test or scope their plans, therefore providing little confidence in actual results. Advisers should focus on moving towards an approach focused on resiliency which includes a) clearly defining recovery capabilities, b) using data to help predict potential disruptions, and c) using severity thresholds and systems to make proactive decisions during business disruptions.

⁵ Including the adopting release to Rule 206(4)-7 under the Advisers Act

⁶ The Third-Party Lifecycle includes the following four phases: 1) Evaluation & Selection, 2) Contract & On-boarding, 3) Ongoing monitoring and 4) Termination & Off-boarding

What's next?

Advisers and funds should review the Rule and SEC staff guidance to assess potential impact of the proposed requirements on their business and consider responding to the SEC's requested comments by September 6, 2016. Next, take appropriate actions to assess strategies for addressing the requirements which would include the following measures:

- Assign ownership and overall governance for the program; involve senior management and boards
- Assess relevant risks including impact and likelihood of disruption and determine severity threshold
- Benchmark existing continuity plan against the requirements
- Create and document a transition plan
- Compile an inventory of third-party service providers and their critical service providers (fourth parties); assess relevant risks and design due diligence and ongoing oversight practices
- Develop a testing strategy and schedule to validate program effectiveness
- Enable a change control process to create a dynamic program which can adapt to ongoing changes (e.g. new products, counterparties, vendors and acquisitions)

Get ready

Deloitte has the deep industry knowledge, tools and experience necessary to guide advisers through the multiple operational and risk dimensions posed by the Rule. Our wide range of existing solutions and experience align across the various disciplines called upon by the Rule including regulatory and compliance assistance, business resiliency, transition planning, extended enterprise risk management and cyber security. We are prepared to support our clients across each aspect of implementation including strategy, assessments of existing capabilities, design of plans and target state operating models, and assisting in the implementation of oversight models to optimize operational performance and regulatory compliance.

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