

SEC issues guidance on business continuity planning for registered investment companies

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Abstract

Purpose – To explain guidance from the US Securities and Exchange Commission (SEC) Division of Investment Management concerning registered investment companies' business continuity and transition plans (BCPs).

Design/methodology/approach – Discusses the SEC's concerns with fund complexes' operational complexity and reliance on technology and third-party service providers, lists notable practices in the BCPs of some registered fund complexes, and addresses practical considerations.

Findings – While the SEC staff recognizes that it is not possible for a fund complex to anticipate or prevent every business continuity event, the staff also believes that fund complexes' preparedness would be enhanced if in addition to complying with the federal securities laws, fund complexes and their advisers consider additional factors related to BCPs discussed in the Guidance.

Practical implications – It would be prudent for the fund boards to consider discussing the Guidance with fund investment advisers and fund CCOs to determine the status of fund complex BCPs and any gaps related to the Guidance. Boards may also want to review with their counsel the current BCP reporting framework and any enhancements needed in light of the Guidance.

Originality/value – Practical guidance from experienced securities, fund management, regulatory and compliance lawyers.

Keywords Business continuity and transition plan (BCP), Division of Investment Management, Registered investment company, US Securities and Exchange Commission (SEC)

Paper type Technical paper

The Securities and Exchange Commission's (SEC's) recently proposed new rule, Rule 206(4)-4, sets a new compliance standard for investment advisers in the area of business continuity and transition plans (BCPs)[1]. The rule, applying to all SEC-registered investment advisers, would require advisers to adopt and implement written BCPs designed to address risks related to a significant disruption in the investment adviser's operations. Importantly, in a simultaneous but separate Guidance[2], the SEC Division of Investment Management has highlighted its additional concerns and articulated additional standards in this area specifically applicable to investment advisers managing assets of registered investment companies and investment companies' boards. It is, therefore, appropriate to view the Guidance as an indication of the SEC's heightened attention to this area as relating to registered investment companies.

The Guidance emphasizes the importance of mitigating operational risks of significant business disruptions through proper business continuity planning for registered investment companies. The Guidance also reflects the staff's concerns about the ability of fund complexes to ensure comprehensive business planning and continuity given their increasing use of technologies and services provided by third parties to conduct daily fund operations[3]. The SEC believes that the operational complexity of advisers has increased over the years and many advisers' operations are highly dependent on technology, including investment processes (e.g., trading, risk management operations) and client

services[4]. Accordingly, the Guidance discusses measures that the staff believes funds should consider as they evaluate their BCPs in light of the existing requirements including Rule 38a-1 under the Investment Company Act of 1940 (1940 Act)[5] and the Proposed Rules.

The Guidance states that fund complexes should ensure that their compliance policies and procedures address business continuity planning and potential disruptions in services provided internally and externally by critical third-party service providers, such as in the area of processing shareholder transactions. Additionally, according to the Guidance, fund complexes should conduct thorough initial and ongoing due diligence of third parties to which fund complexes outsource any of their functions, including due diligence of their service providers' BCPs. Critical fund service providers include each named service provider under Rule 38a-1 (*i.e.*, each investment adviser, principal underwriter, administrator, and transfer agent), as well as each custodian and pricing agent[6].

The Guidance also lists some of the notable practices observed by the staff in BCPs of some of the registered fund complexes, including:

- Covering the facilities, technology/systems, employees, activities and services providers of the adviser;
- Involving a broad cross-section of employees from key functional areas;
- The chief compliance officer (CCO) participating in the fund complex's third-party service provider oversight process;
- The adviser and other critical service providers presenting BCPs to fund boards of directors, with CCO participation, on an annual basis;
- Conducting some form of annual BCP testing, with the results shared in updates to fund boards; and
- The CCO monitoring business continuity outages and reporting them to the fund board.

The Guidance invites fund complexes to consider how they can best assess and monitor whether a critical service provider has experienced a significant disruption (such as a cybersecurity breach or other continuity event), the potential impacts these events may have on fund operations and investors, and the communication protocols and steps that may be necessary for the fund complex to successfully navigate these events. These protocols and steps may include policies and procedures for internal communications across the fund complex (*e.g.*, involving senior management, legal, compliance, risk management, technology, information security, operations, human resources, and communications staff), as well as with fund boards; a consideration of back up processes of critical service providers; and scenario analyses of such service providers' potential disruptions. According to the Guidance, it is also important to consider how the BCPs of a fund's critical service providers relate to each other to better ensure that funds can continue operations and/or promptly resume operations during a significant business disruption.

Practical considerations

In light of the above, it would be prudent for fund boards to consider discussing the Guidance with fund investment advisers and fund CCOs to determine the status of fund complex BCPs and any gaps related to the Guidance. Boards may also want to review with their counsels the current BCP reporting framework and any enhancements needed in light of the Guidance. While the SEC staff recognizes that it is not possible for a fund complex to anticipate or prevent every business continuity event, the staff also believes that fund complexes' preparedness would be enhanced if in addition to complying with the federal securities laws, fund complexes and their advisers consider additional factors discussed in the Guidance.

Notes

1. See Adviser Business Continuity and Transition Plans, Advisers Act Rel. No. 4439 (June 28, 2016). The proposed rules (the Proposed Rules) for investment advisers are discussed in a separate article on [page [INSERT] of this issue] entitled "SEC Proposes Rules on Adviser Business Continuity and Transition Plans".
2. IM Guidance Update No. 2016-04: Business Continuity Planning for Registered Investment Companies (June 2016) (the Guidance).
3. As mentioned in the Guidance, in August 2015, hundreds of mutual funds and exchange-traded funds (ETFs) experienced a business continuity event when a systems malfunction at a financial institution prevented it from calculating accurate NAVs for these funds. See, e.g. [Foley \(2015\)](#), [Toonkel and McLaughlin \(2015\)](#); Barrington Partners White Paper, An Extraordinary Week: Shared Experiences from Inside the Fund Accounting System Failure of 2015, available at: www.mfdf.org/images/uploads/blog_files/SharedExperiencefromFASystemFailure_2015.pdf (November 2015); Transcript of the BNY Mellon Teleconference Hosted by Gerald Hassell on the Sungard Issue, available at: www.bnymellon.com/_global-assets/pdf/events/transcript-of-bny-mellonteleconference-on-sungard-issue.pdf. See also In the Matter of The Reserve Fund, *et al.*, Investment Company Act Rel. No. 28386 (September 22, 2008) (finding that the temporary suspension of the right of redemption and postponement of payment for shares which had been submitted for redemption but for which payment had not been made was necessary for the protection of shareholders); see also [MFWire.com \(2008a, 2008b\)](#).
4. See Adviser Business Continuity and Transition Plans, Advisers Act Rel. No. 4439 (June 28, 2016) citing [Blackrock \(2014\)](#). The paper also notes that a robust asset management process requires both experienced professionals and technology, and that integrated investment technology enhances the quality of large volumes of data, supports consistent investment workflows and enables timely communications for both internal functions and with external parties.
5. See 17 CFR 270.38a-1(a)(1).
6. Rule 38a-1 requires a fund's compliance policies and procedures to provide for the oversight of compliance by the fund's advisers, principal underwriters, administrators, and transfer agents (collectively, named service providers), and that the fund's board of directors approve, and review annually, the compliance policies and procedures of the fund and each of its named service providers. See 17 CFR 270.38a-1(a)(1)-(3). The Guidance also stated that "the staff recognizes that not all fund service providers provide critical services to a fund. In determining whether a service provider is critical, fund complexes may wish to consider the day-to-day operational reliance on the service provider and the existence of backup processes or multiple providers." See, the Guidance, Fn. 17. See also See 17 CFR 275.206(4)-7(a) at n.28 (noting that limiting the service providers named in rule 38a-1 did not lessen a fund's obligation to consider compliance as part of its decision to employ other entities, such as pricing services, auditors, and custodians).

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