September 6, 2016

Via Electronic Filing

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Adviser Business Continuity and Transition Plans; File No. S7-13-16

Dear Mr. Fields:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed new rule that would require SEC-registered investment advisers to adopt and implement written business continuity and transition plans.[2] This important Proposal is the fourth in a series of rulemakings designed to enhance the Commission's risk monitoring and regulatory safeguards for the asset management industry.

We understand and appreciate the goals underlying the Proposal. Investment advisers, as fiduciaries, take protecting the interests of advisory clients very seriously, including by taking steps to address and mitigate the risks of business disruptions. As the Commission notes, most SEC-registered investment advisers already have business continuity plans ("BCPs") in place as part of their compliance policies and procedures and some have considered elements of transition planning as well. We recognize that the Commission has seen a wide variation of practices across the industry, however, and we agree that more can be done to encourage advisers to thoughtfully plan for potential significant business disruptions. The Proposal will foster an important dialogue in this regard.

We also appreciate that the Commission intended to propose a principles-based rule that would allow advisers to tailor their business continuity and transition planning to the unique attributes of their businesses. As the Commission knows, there are literally thousands of SEC-registered investment advisers with a myriad of business models and client bases. Some are very large and quite complex, but many are small firms with relatively simple and straightforward businesses. In fact, of the 11,847 firms in our recently published *Evolution Revolution* report,

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[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. The IAA has approximately 600 member firms that collectively manage nearly $20 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

[2] *Adviser Business Continuity and Transition Plans*, SEC Rel. IA-4439 (June 28, 2016) ("Proposal"), available at https://www.sec.gov/rules/proposed/2016/ia-4439.pdf.

10,404 (87.8 percent) have fewer than 50 non-clerical employees and 6,725 (56.8 percent) have fewer than ten.[3] It will be extremely important that each adviser has the flexibility to satisfy the principles in the rule in ways that make sense given its unique business model.

To better effectuate the Commission's goals and the critical principles-based approach to BCPs, we recommend that the Commission use a different vehicle than a new anti-fraud rule. Rule 206(4)-7, the Compliance Program Rule, provides the Commission with an appropriate and well-established framework to mandate and evaluate business continuity and transition planning. We strongly recommend that the Commission issue interpretive guidance under the Compliance Program Rule that covers BCPs and, subject to our comments below, transition planning for reasonably foreseeable disorderly events.[4]

Business continuity and transition planning are inherently more operational in nature than conduct typically governed by anti-fraud rules. Advisers that are faced with the potential for an inadvertent violation of an anti-fraud rule may go to great (and potentially unnecessary) lengths to satisfy the perceived intent of the rule and avoid the potential of a fraud charge. In this respect, we are concerned that, although intended to be principles-based, the rule and some of the statements in the release could be interpreted in a more prescriptive way—to suggest that all investment advisers are required to develop and implement detailed policies and procedures on each of the areas covered by the rule, whether germane to their business model or not. Given these concerns, the Commission's statements in the release implying that perceived inadequacies in this type of planning constitute fraud are particularly troubling.[5] We strongly submit that a deficiency in business continuity and transition planning should not be considered *per se* fraud.

Thus, we believe that the adoption of a new anti-fraud rule, as proposed, is unnecessary and in fact could become counterproductive. New guidance under the Compliance Program Rule would be preferable, both because it would be inherently more flexible than a new rule and because it would allow the Commission to more appropriately characterize deficiencies in business continuity and transition planning as a breakdown of the firm's compliance program rather than as fraud.

This overarching recommendation is explained below. In addition, we offer comments and seek clarification on several specific aspects of the Proposal, including on the substantive

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[3] *2016 Evolution Revolution*, available at https://www.investmentadviser.org/eweb/docs/Publications_News/EVREV/evolution_revolution_2016.pdf.

[4] We do not believe that transitions that occur in the ordinary course of business, such as mergers or general succession planning, present the same sorts of risks to clients that need to be addressed by a rule or new guidance.

[5] *See, e.g.*, Proposal at 10 ("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"); *see also* Proposal at 23 ("an adviser's fiduciary duty obligates it to take steps to protect client interests from being placed at risk as a result of the adviser's inability to provide advisory services and, thus, it would be fraudulent and deceptive for an adviser to hold itself out as providing advisory services unless it has taken such steps").

requirements for BCPs and transition plans and on the annual review and recordkeeping provisions.

I. Recommendation for Guidance Rather than an Anti-Fraud Rule

We support the principle that an adviser should have reasonably designed policies and procedures to address operational risks and preserve the continuity of critical advisory services to clients in the event of a significant business disruption. In addition to being part of an adviser's fiduciary duty, business continuity planning is already effectively required under the Compliance Program Rule[6] and is a prudent practice as a business matter.

While we agree that advisers should have robust BCPs, we strongly believe that business continuity—and to a limited extent, transition planning—is more suitably addressed as an interpretation of or guidance under the existing Compliance Program Rule framework than as a separate, new anti-fraud rule. The Commission appears to recognize the feasibility of this approach in asking whether it should issue guidance under Rule 206(4)-7 instead of the proposed anti-fraud rule. We think it should, for three principal reasons.

First and foremost, business continuity and transition planning requires advisers to take current action in the face of varied and unknown potential events. There is no such thing as a perfect BCP, and imperfections—likely assessed in hindsight—may not reflect fraudulent or deceptive conduct, but rather decisions made in good faith that were rendered inadequate by unforeseen events. For example, the Proposal states that "with respect to alternative locations, examination staff noted that some advisers did not have geographically diverse office locations, even when they recognized that diversification would be appropriate."[7] An adviser may reasonably believe that an alternative location is sufficiently geographically diverse only to experience a once-in-a-century event that makes both the primary and alternative locations unusable. Or a smaller adviser may recognize that diversification would be appropriate under an unlikely circumstance but resource constraints may compel it on balance to choose an alternative location that is closer to its primary location, easier to maintain, and more likely to be used. In each case, the adviser's good faith planning and balancing of factors in the face of such varied and unknown potential events should be respected. A divergence from the plan may be prudent and should not be judged or otherwise wrongly scrutinized after the fact.

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[6] *See Compliance Programs of Investment Companies and Investment Advisers*, SEC Rel. IA-2204 (Dec. 17, 2003), at n.22, *available at* https://www.sec.gov/rules/final/ia-2204.htm ("We believe that an adviser's fiduciary obligation to its clients includes the obligation to take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel. The clients of an adviser that is engaged in the active management of their assets would ordinarily be placed at risk if the adviser ceased operations.").

[7] Proposal at 17.

As the Commission explicitly emphasizes,[8] proposed Rule 206(4)-4 is an anti-fraud rule, and the failure of an adviser to have the required plan and review it at least annually could constitute an "act, practice, or course of business which is fraudulent, deceptive, or manipulative" within the meaning of the anti-fraud rule.[9] Therefore, an adviser could be found to have violated the fraud section of the Advisers Act without having committed any substantive violation that harmed or even impacted clients. For example, suppose an adviser failed to include what the Commission deemed to be an adequate discussion of the corporate governance structure of the adviser in its plan. It seems fundamentally unfair to attach a fraud label to that firm's conduct, potentially misleading clients and the general public as to the severity of the violation and causing the adviser significant reputational and financial harm, based on a drafting decision in developing policies and procedures intended to prevent or mitigate risk. This deficiency would be much better characterized as a violation of the Compliance Program Rule.

Second, an anti-fraud rule also has the potential to be interpreted more prescriptively and thus be counterproductive, as it could cause advisers to devote enormous resources in order to fend off a potential fraud claim for relatively minor risks or risks unrelated to their business. Guidance would be inherently more flexible.

We recognize that the Commission intended the Proposal to be principles-based to give each adviser flexibility to tailor its BCP and transition plan to its business. The proposing release speaks in terms of a plan that is "reasonably designed" to address operational risks and notes that "advisers need only take into account the risks associated with its particular operations."[10] We agree that overly prescriptive rules will not achieve the Commission's overall goals; a principles-based approach that allows for maximum flexibility consistent with an adviser's fiduciary duty and regulatory obligations is more in keeping with the Commission's intent. The level of detail and prescriptive language in the release, however, suggests a more particular set of regulatory expectations that is seemingly inconsistent with that intent. For instance, the text of the proposed rule specifies five elements, with the last element broken into five subparts, that every plan must include. In addition, the proposing release contains dozens of specific examples of issues and areas that an adviser's plan "should" or "must" consider, include, address, cover, identify, review and/or assess. This leaves advisers uncertain as to whether these provisions are suggestions or are meant to be binding, and makes it difficult for advisers to operationalize the new requirements.

Guidance may afford the Commission and SEC staff more flexibility to establish clear regulatory expectations while also giving an adviser discretion to determine which elements are relevant to its business and which are not necessary or appropriate—something that is critical to mitigate the considerable costs involved.

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[8] *Supra*, note 5.

[9] §206(4), Investment Advisers Act of 1940.

[10] *See, e.g.,* Proposal at 28.

And third, the existing Compliance Program Rule already provides an appropriate and well-established framework for the Commission to mandate and evaluate BCPs, preserving the Commission's power to address poorly constructed or maintained plans. As a result, additional guidance under that rule would address many, if not all, of the Commission's concerns and encourage good faith efforts to prepare for material service disruptions, making a new anti-fraud rule unnecessary.

In interpreting Rule 206(4)-7, the Commission has already stated that a registered investment adviser's compliance policies and procedures should include business continuity planning to the extent it is relevant to the adviser's business, recognizing that the operational and risk-based nature of that planning fits well within the types of activity governed by that rule.[11] We recognize that Rule 206(4)-7 itself does not specify the content of a BCP and SEC staff has observed "weaknesses" and divergent practices in how advisers implement BCPs.[12] But rather than adopting a redundant requirement as a new anti-fraud rule, staff guidance or a Commission interpretive release could state that under Rule 206(4)-7, a plan is expected to include certain elements to the extent they are relevant to the adviser's business. When a plan is found to be deficient or an annual review is not conducted properly, the violation would then be cast more appropriately as a breakdown of the firm's compliance program, not as a separate fraud. This approach would also avoid confusion about whether advisers are subject to different requirements under Rule 206(4)-7 and Rule 206(4)-4, as well as subject to potential violations under two separate rules for the same deficiency.

For all of these reasons, we strongly recommend that the Commission address this topic through additional guidance, rather than a new rule. If, however, the Commission ultimately determines to address this topic through a new rule, at a minimum, we urge it to remove from the adopting release the statements about violations constituting fraud and confirm that it would not characterize a technical finding of a deficiency in a plan, or the mere fact that an adviser experiences a business disruption, as "fraudulent and deceptive."

II. Specific Requirements for BCPs and Transition Plans

Although we favor guidance rather than the proposed rule, we offer comments on the Proposal below, many of which will be relevant whether the Commission moves forward with a rule or issues guidance instead.

As proposed, Rule 206(4)-4(b)(2) contains five specific areas that must be addressed in an adviser's business continuity and transition plan. We recognize that the Commission did not propose to require advisers to have separate BCPs and transition plans, and uses the term "business continuity and transition plan" in the text of the rule to refer to one or more sets of policies and procedures that would cover these areas. However, business continuity planning

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[11] *See Compliance Programs of Investment Companies and Investment Advisers, supra* note 6.

[12] *See* Proposal at 9.

(how to keep the business going) is a very different concept from transition planning (how to wind the business down). For purposes of this letter, therefore, we are separating proposed Rule 206(4)-4(b)(2) into two distinct sections—addressing subsections (i) through (iv) as primarily relating to BCPs and subsection (v) as primarily relating to transition plans.

A. BCP-Related Policies and Procedures

(i) General Comments

As noted above, we support the principle that advisers should have reasonably designed policies and procedures to address operational risks and preserve the continuity of advisory services to clients in the event of a significant business disruption. Consistent with the Commission's interpretation of Rule 206(4)-7, we understand that most advisers have BCPs in place. Nevertheless, we have several specific comments on these sections, which we address in the order they appear in the proposed rule.

As a preliminary matter, we ask the Commission to confirm that organizations composed of multiple affiliated advisers may implement BCPs at an organizational level. For many larger organizations, maintaining individual plans at the level of each adviser would be impractical and would not reflect the reality that their business continuity activities are considered and implemented at higher organizational levels.

(ii) Proposed Rule 206(4)-4(b)(2)(i) – Maintenance of critical operations and systems, and the protection, backup, and recovery of data, including client records

The proposed rule states that advisers "shall include policies and procedures…that address…maintenance of critical operations and systems, and the protection, backup, and recovery of data, including client records." The release contemplates that advisers will "consider alternatives and redundancies to help maintain the continuation of operations in the event of a significant business disruption."[13]

We believe that the Commission has inadvertently created considerable uncertainty in the Proposal in discussing backups and redundancies. We appreciate that the Commission recognizes "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. In such cases, an adviser should consider backup plans, functions and/or processes to address how it will manage the loss of a critical service."[14] We agree with these statements; the degree to which a plan should address a required component should depend upon the nature of each particular adviser's business.

[13] Proposal at 29.

[14] Proposal at n.91.

But the Commission in other places appears to suggest that advisers are expected to maintain duplicate functions for a wide variety of tasks normally performed by the adviser itself, its parent, its affiliate, or its service provider. In particular, the release suggests that critical operations and systems requiring backup include the "management, trading, allocation, [and] clearance and settlement" of portfolio securities transactions,[15] including "post-trade processing, corporate actions, reconciliation, etc."[16] This could be interpreted, for example, to mean that an adviser would have to go so far as to retain a second fund administrator to maintain shadow net asset values for the mutual funds it advises. There should not be an implication that the adviser is responsible for having a redundant service provider "ready to go" in the event of a business disruption. We ask the Commission to clarify that this duplication of function is not what was intended, as it would be both impractical and entirely cost prohibitive for the vast majority of advisers to satisfy such a requirement, in particular for smaller advisers.

Business continuity and transition planning is expensive, and the cost of implementing a transition plan from the ground up would be sizeable. The Commission's own analysis estimates that one-time costs necessary to adopt and implement a business continuity and transition plan would range from approximately $30,000 to $1.5 million per SEC-registered adviser, and ongoing costs would range from approximately $7,500 to $375,000. These figures would grossly underestimate costs if duplicative service providers are required.

Given these substantial initial and ongoing costs, it is critical that the Commission allow advisers to conduct reasonable cost-benefit analyses and manage the potential for a disruption in ways other than maintaining redundant backup service providers, vendors, and/or systems. We ask that the Commission confirm even more clearly that an adviser need not arrange for backups if it concludes from its risk assessment that those backups are not critical, the likelihood of needing them is remote, or it takes other steps to address the potential risk.

(iii) Proposed Rule 206(4)-4(b)(2)(ii) – Pre-arranged alternate physical location(s) of the adviser's office(s) and/or employees

The Proposal would require each adviser to "include" in its plan one or more pre-arranged alternate physical locations of the adviser's offices and/or employees. It is not clear whether the Commission intended this to mean that every adviser must have an actual alternate physical location, access to an alternate physical location, or merely plans to allow employees to work remotely as necessary to maintain operations.

We would oppose a blanket requirement that advisers establish an actual pre-arranged alternate physical location. As the Commission recognizes, "a smaller adviser with minimal employees may be able to function by enabling its employees to telework and access the

[15] Proposal at 30.

[16] Proposal at 30-31.

adviser's systems remotely instead of requiring formal meeting space."[17] We agree. For many advisers, an alternate physical location would add substantial cost with no commensurate benefit. As the staff has acknowledged, many advisers store duplicate copies of their advisory records in a location separate from their principal office in order to ensure the continuity of their business in the case of a disaster.[18] And technology continues to improve, allowing for efficient and reliable remote connectivity. Advisers equipped to operate without a redundant physical office should not be artificially required to secure one.

Accordingly, the Commission should confirm that advisers have full discretion to determine the degree to which they need alternate physical sites; advisers (regardless of size) are not required to rent commercial space and can use a personal residence as a secondary location;[19] and using a personal residence on a temporary basis for these purposes would not subject that space's records to SEC oversight and examination.

(iv) Proposed Rule 206(4)-4(b)(2)(iii) – Communications with clients, employees, service providers, and regulators

Under the Proposal, a business continuity plan would need to address communications with clients, employees, service providers, and regulators. We strongly support the Commission's decision not to propose a requirement that advisers provide disclosure to their clients about their plans. The extent of any such disclosure should be at the adviser's discretion. For instance, while discussions about overall concepts and protocols of BCPs with clients may be appropriate, providing detailed information about the plan or copies of plans to clients, fund investors, or the general public may not be. It would not provide meaningful information about the merits of a particular advisory firm and might in fact risk revealing confidential information. The information contained in a BCP is often very granular (*e.g.*, contact telephone numbers of staff) and includes confidential or secure information that, if made public, could expose the adviser to additional risks such as providing a road map for bad actors to conduct cyber attacks or otherwise disrupt operations. Specific elements (such as the identity of certain individuals and other succession planning details) could be highly sensitive and making them known (even internally) could create disruption in the adviser's business.

The Commission asks for comment on whether to require advisers to disclose to clients or regulators incidents where they relied on or activated their plans. Advisers should be permitted to maintain discretion as to when and how they notify clients, regulators, or other parties about their reliance on their BCPs. Advisers need flexibility in this regard, as each

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[17] Proposal at n.127.

[18] *See Information for Newly-Registered Investment Advisers*, available at https://www.sec.gov/divisions/investment/advoverview.htm.

[19] "Larger advisers with many employees, on the other hand, may need to rent office space on a temporary basis or establish co-locations where employees necessary to the operations of an adviser may congregate." Proposal at n.127.

incident is unique and it would be impractical to attempt to identify the materiality of a particular type of incident in advance. Further, it would not be feasible to outline in advance each specific circumstance under which an adviser would notify regulators of a disruption. Instead, an adviser could include in a plan the types of factors that it will consider in deciding whether to notify regulators, such as the severity of the event, whether clients are impacted, and the length of the disruption. Moreover, reporting every incident where an adviser has relied on its BCP to the Commission would not be particularly meaningful; in fact, more instances of a plan being activated could indicate that an adviser merely has more comprehensive plans to identify and remedy events. We also note that advisers would generally maintain a record of incidents where they rely on their BCPs and make such records available to the Commission during an examination.

Also with respect to regulators, the release notes that a plan generally should include "the contact information for relevant regulator(s), and identify the personnel responsible for notifying, as well as under what circumstances it would notify, such regulator(s) of a significant business disruption."[20] Because contact information for regulators is readily available on regulators' websites, it is not necessary to require its inclusion in a plan.

(v) Proposed Rule 206(4)-4(b)(2)(iv) – Identification and assessment of third-party services critical to the operation of the adviser

The Proposal would require an adviser's BCP to include the identification and assessment of third-party services critical to the operation of the adviser. We appreciate that the Commission appears to recognize that only "critical" third-party functions and services would be subject to this identification and assessment element of the rule, and also appreciate that an adviser could determine for itself which service providers should be deemed critical. We strongly recommend that the Commission maintain this flexibility in any final rule or guidance. To that end, we would suggest that the Proposal's list of service providers that the Commission generally would consider to be critical[21] appears to be over-broad. We ask that the adopting release or guidance focus more on the factors to be considered in determining whether third-party services are critical and refrain from drawing conclusions as to which service providers are likely to be critical.

With respect to assessments of service providers, we also, in particular, appreciate that the Commission recognizes that "the adviser's ability to require or request actions of its service providers will impact the steps that advisers should consider taking."[22] Most advisers already conduct due diligence and oversee third-party service providers that are critical to an adviser's

[20] Proposal at 36.

[21] "We would generally consider critical service providers to at least include those providing services related to portfolio management, the custody of client assets, trade execution and related processing, pricing, client servicing and/or recordkeeping, and financial and regulatory reporting." Proposal at 38.

[22] Proposal at 40.

operations, but service providers sometimes resist giving detailed information about their BCPs to advisers and only provide a general overview of their plans. The assessment of BCPs of third-party service providers is thereby limited by the information provided. Smaller advisers in particular lack the bargaining power to demand such access, and should not be held to unreasonable expectations with respect to their due diligence. We ask that the Commission clarify that it would be reasonable, in assessing a critical third-party service provider, to document the adviser's reasonable belief that the third party is adequately prepared for its own business continuity events.

The Commission also asks whether it should explicitly require advisers to annually review the business continuity and transition plans of their critical third-party service providers. We strongly recommend that this not be required but that advisers maintain flexibility as to the frequency, scope, and methods of such reviews.

B. Transition Plan-Related Policies and Procedures

Proposed Rule 206(4)-4(b)(2)(v) lists five elements that every transition plan must include: (A) policies and procedures intended to safeguard, transfer, and/or distribute client assets during transition; (B) policies and procedures facilitating the prompt generation of any client-specific information necessary to transition each client account; (C) information regarding the corporate governance structure of the adviser; (D) identification of any material financial resources available to the adviser; and (E) 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.

We have a number of comments and concerns about these provisions. First, taken together, the five specific elements of this part of the rule, along with the accompanying discussion in the proposing release, may be interpreted as overly prescriptive. Not all of these elements would apply to all advisers in all circumstances, and many of them are particularly inapt for smaller advisers. Advisers should be given greater flexibility with respect to transition planning. Second, the key elements of transition plans can be addressed appropriately without highly detailed transition plan provisions. Third, the object of the proposed transition plans should be reasonably foreseeable or likely potential disorderly events—normal corporate transactions or wind-downs do not raise the same sort of client protection concerns. Finally, we request clarification with respect to some of the specific components of the proposed transition plan requirement.

(i) The Need for Sufficient Flexibility in Transition Planning

There is a significant risk that this part of the rule will be interpreted in an overly prescriptive way. Because the Commission has listed five specific elements, advisers will feel compelled to address each one despite the Commission's own affirmation that each adviser has the flexibility to tailor its program to fit its business, taking into account factors such as "the adviser's assets under management, number of employees, number of offices, number and types of clients (e.g., high net worth individuals, private funds, or registered investment companies), types of advisory activities, other business activities or lines of business which may affect the adviser's advisory business, types of investment strategies pursued, and the extent of reliance on service providers (in-sourced vs. out-sourced models)."[23]

Despite the Commission's own affirmation that each adviser has the flexibility to tailor its program to fit its business, the level of detail in both the text of the proposed rule and the proposing release may create regulatory expectations that could require advisers to develop a detailed set of policies and procedures to guide them through almost any event, covering each of these five areas. This would impose a significant new burden on investment advisers of all sizes that is neither appropriate nor practical. Attempting to establish a highly detailed plan with specific components when the nature of the event, the products, clients, counterparties and vendors involved are unknown would be unrealistic and not a useful exercise. And the task of developing these comprehensive detailed policies would undoubtedly fall primarily to chief compliance officers, who are already subject to escalating burdens and expectations and understandably concerned about potential liability for a breakdown in planning that will be evaluated in retrospect.

We do not believe such a prescriptive standard was intended. In any final rule or guidance, however, the Commission should make it absolutely clear that advisers have the flexibility to exercise judgment as to which elements to include in a plan, the extent to which those elements are addressed, and the types of potential events to cover.

In particular, the Commission should stress that a small firm with limited resources should not be expected to address every component at the same level of a very large firm. Instead, a plan should be proportionate to the size and nature of the business. For example, Proposed Rule 206(4)-4(b)(2)(v)(C) on the corporate governance structure of the adviser and (D) on the identification of any material financial resources available to the adviser may be particularly inapt for smaller advisers. A sole proprietor should not need to reduce to writing information regarding his corporate governance structure or the location of his backup systems, if they are at his house. A sole proprietor who wishes to close her business upon her death would not need all of the transition elements contemplated in the Proposal, but rather would simply have to make sure the records were in good order and leave directions on how to transfer trading authority over accounts, subject to the client's consent.

As noted above, the vast majority of investment advisory firms are quite small.[24] They tend to employ a few highly educated professionals who generally work together in intimate, collegial settings. More than 6,500 firms or 56.8 percent of all SEC-registered advisers have ten or fewer employees performing investment advisory functions. And more than 10,000 firms or 87.8 percent of advisers employ 50 or fewer non-clerical employees. We believe the Commission should continue to foster an environment that is conducive to supporting the robust

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[23] Proposal at 62.

[24] *2016 Evolution Revolution*, *supra* note 3.

and dynamic population of relatively small businesses that dominate the U.S. investment advisory profession, rather than imposing burdensome requirements that likely won't be useful. Therefore, it is critically important that the Commission treat the proposed components with sufficient flexibility for advisers to determine whether or not to address as appropriate to their businesses.

(ii) Transition Planning as a Separate Concept

Unlike the BCP portions of the Proposal, the idea of a plan of transition—a plan that accounts for 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—is new for investment advisers (other than some dual registrants)[25] outside of routine succession planning. That is not surprising, given the nature of advisory services and the regulation of the investment advisory industry. As we have highlighted in numerous comment letters, in the terminology of the systemic risk debate, advisers are "highly substitutable," meaning that client accounts are easily transitioned in the ordinary course of business. In both business continuity and transition types of events, the same regulatory concerns—protecting client interests from being placed at risk as a result of the adviser's inability to provide advisory services—are prompted at the outset of an event. In one case, the business continues, and in the other case, the business winds down. As a result, we believe that the Commission's concerns about client protection in transition types of events involve the same operational issues that can be largely addressed as part and parcel of a BCP, without the need for highly detailed transition plan-specific elements in the new rule.

In considering the need to identify transition planning elements, our starting point, like the Commission's, is to understand the fundamental distinction between investment advisers and banks, broker-dealers, and insurance companies. We appreciate that the Commission states that it is "not proposing that advisers adopt resolution plans or 'living wills' similar to that which certain financial institutions must now adopt under FDIC and Federal Reserve rules because investment advisers do not interact with the government in the same way as banks."[26] As the Commission points out:

> In the normal course of business, it is our understanding that advisers routinely transition client accounts without a significant impact to themselves, their clients, or the financial markets. We believe that much of this is largely attributable to the agency relationship of advisers managing the assets on behalf of their clients and

[25] *See, e.g.*, FINRA Rule 4370 (requiring a business continuity plan to address "[h]ow the member will assure customers' prompt access to their funds and securities in the event that the member determines that it is unable to continue its business").

[26] Proposal at n.40. We would oppose the Commission's adoption of a more prescriptive rule that calls for a more specific transition plan similar to the "living wills" required by the Federal Reserve Board and the FDIC for large banks and systemically important non-bank entities. While a living will may be appropriate for a bank, it is not appropriate for an investment adviser.

> the regulatory framework supporting this relationship whereby advisory client assets for which the adviser has custody are required to be held at a qualified custodian, such as a bank or broker-dealer. Because client assets custodied by an adviser must be held at a qualified custodian and segregated from the adviser's assets, we have observed that transitioning accounts from one adviser to another can largely be a streamlined process that in many cases may not involve the physical movement or sale of assets. Pooled investment vehicle clients generally have the ability to terminate the advisory contract of the adviser or remove the governing body that may provide advisory services (*e.g.*, general partner or managing member) and appoint a new adviser or governing body if they so desire, while separate account clients can generally terminate the advisory contract and appoint a new adviser to manage their assets, all while their assets are typically maintained at a qualified custodian.[27]

All of this is exactly right. An investment adviser acts merely as an agent in managing assets on behalf of clients and clients' interests are protected even if the adviser becomes unable to provide services. Investment advisers must generally use qualified custodians to hold client assets, as required by regulation, which facilitates the substitution of investment advisers and reduce the risk. The qualified custodian keeps a separate accounting for the client under its books and records obligations. The vast majority of advisers—more than 96 percent[28]—have independent qualified custodians that are unaffiliated with the adviser. Advisers that have an affiliated qualified custodian are subject to additional requirements in order to safekeep client assets.

As a result, in the ordinary course, clients may easily transfer advisory authority over separately managed accounts to another investment adviser simply by removing trading discretion from one adviser and granting it to another. Based upon the client's direct contractual relationship with the custodian, the client would have control over how its assets are handled in the event of an adviser's material business disruption. Accounts either remain at the same custodian with a different adviser, or are transferred to a different custodian and different adviser.

This high degree of substitutability does not mean that firms do not fail. Like all businesses, investment advisers fail or close from time to time, but those failures do not deprive clients of essential or irreplaceable services or access to essential records.

For all of these reasons, we believe that the Commission can and should address its concerns about client protection during an adviser's transition—limited in scope to planning for

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[27] Proposal at 19-20.

[28] *See 2016 Evolution Revolution, supra* note 3, at 25 (only 74 advisers reported acting as a qualified custodian in connection with their advisory services and 384 advisers reported that a related person acts as a qualified custodian).

reasonably foreseeable disorderly events as discussed below—without a highly detailed provision in the new rule.

(iii) Limiting Transition Planning to Reasonably Foreseeable Disorderly Events

The Commission states that "a plan of transition generally should account for transitions in both normal and stressed market conditions."[29] But the Commission also states that the components of the rule are designed to help advisers be well prepared so they "can act *quickly*"[30] (emphasis added). In our view, the latter statement is more correct—transition planning is meant to prepare advisers for unanticipated/unplanned events. As a result, we fundamentally disagree that a plan of transition needs to address an orderly event that occurs in the normal course of business, such as succession planning, a merger or acquisition, liquidation of a pooled investment vehicle, or partial transition of an adviser's business. In planning for such a transaction, an adviser necessarily contemplates taking steps to protect its clients' interests from being placed at risk as a result of the event. These types of orderly transitions do not require a rule or advance plan and should be treated as distinct from unexpected situations that could cause a sudden suspension of advisory services.

On the other hand, advisers also should not be required to catalogue every potential highly unlikely event that could conceivably occur. We understand the Commission's heightened concern about protecting client interests in times of stress or during disorderly events, but we think that the Commission should clarify that it does not expect advisers to identify and address in advance all "black swan" events. An adviser does not guarantee uninterrupted service, and it would be unreasonable to expect it to be able to plan for events that are very rare and potentially only apparent in hindsight. Rather, a transition plan should be expected to generally identify only reasonably foreseeable events.

Even with respect to reasonably foreseeable events, any transition planning guidance or new rule should avoid suggesting that the plan should be set in stone. Even if a great amount of detail were included in a plan, when faced with a real crisis, it is likely that some or all pre-planned steps might need to be changed or abandoned. Advisers need to have discretion to make decisions at the time that actual situations arise and adjust their plans accordingly in the best interests of clients without fear of incurring regulatory liability for not following the pre-determined plans.

[29] Proposal at 41.

[30] *Id*.

(iv) Specific Comments on the Five Proposed Elements in Proposed Rule 206(4)-4(b)(2)(v)

Subsections (A) and (B). The first two subsections of the proposed rule would require policies and procedures intended to safeguard, transfer, and/or distribute client assets during a transition and policies and procedures facilitating the prompt generation of any client-specific information necessary to transition each client account. We support the substance of both of these proposed elements.

Subsection (C) on Corporate Governance. The Proposal states, "We believe senior executives at an investment adviser generally, and especially in times of stress, should be able to quickly identify the important decision-makers within the organization and understand the inter-relationships between the adviser and any affiliated entities to be able to assess whether and how issues at an affiliate may affect the advisory entity."[31] These justifications are clearly aimed at large, complex investment advisers with multiple affiliates. Smaller firms do not need to formally make organizational charts or information about the adviser's ownership and management structure part of their transition plan. For most firms, this would not add any value to the firm's readiness for disorderly events. Accordingly, the Commission should make clear that this is not a required element, but simply a factor to be considered as necessary or appropriate depending on the characteristics of each firm.

Subsection (D) on Identifying Material Financial Resources. Proposed Rule 206(4)-4(b)(2)(v)(D) would require advisers to identify any material financial resources available to the adviser. We request clarification on what this means, such as whether advisers are required to simply identify potential resources or to assess the availability or amounts of these resources. The latter, which the Proposal could be interpreted to imply, would be difficult, if not impossible, to do in advance.

Subsection (E) on Assessing Contractual Obligations. Proposed Rule 206(4)-4(b)(2)(v)(E) would require advisers to assess the applicable law and contractual obligations governing the adviser and its clients, including pooled investment vehicles, implicated by the adviser's transition. As with any risk assessment, certain contractual obligations carry more weight than others. An adviser should not have to create an inventory of every legal and contractual obligation to a level of granularity and detail that does not currently exist and would be logistically infeasible to maintain and keep current. Instead, this element should be limited to appropriate counterparties, such as counterparties to derivative contracts, and critical service providers, as determined by the adviser for purposes of its business continuity plan pursuant to Proposed Rule 206(4)-4(b)(2)(iv).

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[31] Proposal at 43.

III. Other Aspects of the Proposal

A. Annual Review

The Commission proposes that advisers review their plans annually and seeks comment on whether it should require more frequent reviews. Given our overarching recommendation to address this topic as guidance under Rule 206(4)-7, we support the idea of an annual review, consistent with the required annual review of an adviser's compliance program. As a practical matter, consistent with the requirements of the compliance program rule, as businesses evolve, as regulations are interpreted, and as practices and services change, most firms annually reconsider their BCPs as a matter of course to evaluate whether they work as designed and whether changes are necessary to assure their continued effectiveness.[32] Further, because their operations can be quite complex, large firms already review their plans on a continuing basis to keep pace with internal changes. An annual review would serve as a useful check on these systems to ensure that appropriate steps have been taken during the year. We would oppose any formal requirement for firms to review their plans more frequently than annually. A formal quarterly review requirement would add extra cost without adding commensurate benefit to clients or advisers.

The Commission states that "annual reviews generally should address weaknesses an adviser may have identified in any testing it has done or assessments that have been performed to address the adequacy and effectiveness of its business continuity and transition plan."[33] While advisers are familiar with how to test a BCP, it is not immediately clear to us how a plan of transition can be tested. We request that any final guidance or the adopting release provide examples of how a plan of transition can be tested.

The Commission also seeks comment on whether it should require advisers to report to the Commission regarding the annual review of their business continuity and transition plans. We do not believe that this would provide particular value to the Commission. Consistent with the Compliance Program Rule, this type of review would best be documented by the adviser and provided for inspection as part of an SEC examination.

B. Recordkeeping

(i) BCP and Transition Planning as Living Documents

While we agree that advisers would have to keep records relating to their business continuity and transition planning, we note that the Proposal appears to contemplate a plan that is

[32] An annual review is the standard recommended by the Board of Governors of the Federal Reserve System (FRB) and the Federal Financial Institutions Examination Council (FFIEC).

[33] Proposal at 50.

maintained as a single record and easily produced.[34] In reality, many advisers are large and have complex business structures operating in multiple jurisdictions across multiple business lines, and the multiple policies and procedures comprising a plan are "living" documents. These multiple policies and procedures may be dispersed throughout many different areas of an organization and could frequently change and be updated in various bits and pieces on an ongoing basis in response to events. This is perfectly appropriate; a single static plan that is updated infrequently most likely would be inappropriate and insufficient for a large and complex firm. We therefore request the Commission to confirm that it does not expect to see a single comprehensive "playbook" but rather expects an adviser to produce the same types of records relating to this planning as it does for its compliance program generally.

We are also concerned about the proposed requirement to maintain a copy of the adviser's plan that was in effect at any time within the past five years. As noted above, many advisers frequently update their plans as needed. It might be as simple as changing a name, system name, or IP address. A requirement to produce a snapshot of "a plan" from any day in the past five years would be a significant undertaking, logistically challenging, impractical, of limited use to the Commission, of limited value to the adviser (because an old version of a plan would not be used), and would not provide any meaningful benefit or protection to clients. Even if an adviser has a system that tracks changes to each field in a document, an adviser cannot recreate a given plan as of a given point in time. Also, a large firm with many BCPs, disaster recovery plans, and crisis management plans for each of its affiliates would generate hundreds of snapshots of plans over a five-year period.

As an alternative, we suggest that recordkeeping requirements should be limited to an annual summary of the plan, the plan as of the date of the most recent annual review (or as of year end) and evidence of the annual review for each of the past five years. An adviser would be expected to produce each summary over the past five years, and the current version of the plan, during an SEC examination.

(ii) Filing Plan with the Commission

We support the Commission's decision not to require advisers to file their business continuity and transition plans with the Commission, which even on a non-public basis would have a number of drawbacks. For larger advisers, the significant costs of compiling and filing a large and disparate plan (as discussed above) would far outweigh any benefit to the Commission.[35] And for all advisers, parts of the planning would necessarily contain highly proprietary and sensitive information, such as succession plans and information about the firm's

[34] Rule 204-2 is proposed to be amended to require an adviser to maintain "[a] copy of the investment adviser's business continuity and transition plan formulated pursuant to §275.206(4)-4 that is in effect, or at any time within the past five years was in effect."

[35] There is a risk to the Commission as well, inasmuch as it would be receiving filings from all 11,847 SEC-registered advisers—some of which could be quite lengthy—which it would then have to receive, store, protect, and substantively analyze. This would not be the most beneficial use of the Commission's resources.

systems, structure, possible points of entry, and key personnel. Firms take great steps to guard against accidental public disclosure of this type of information, and would be naturally wary of including it in a regulatory filing, even if that filing were confidential.

The Commission's proposal to simply rely upon the recordkeeping requirement is a far more practical approach. This would make the plan available to the Commission and its staff upon request and would maintain the confidentiality of that information pursuant to the Commission's examination authority.

(iii) Application of the Proposal to Non-Resident Advisers with respect to their Non-U.S. Clients

Because the general position taken by the staff is that investment advice provided by non-resident advisers to non-U.S. clients should not be governed by the substantive provisions of the Advisers Act, we would expect that principle to be followed under the Proposal. However, to the extent that the final rule contains precise prescriptive requirements, the Commission should confirm that these should not apply to non-U.S. clients of non-U.S. advisers and that, to the extent that there are any purely local plans, a non-resident adviser should not have to comply with the Proposal's books and records obligations with respect to its non-U.S. clients (similar to no-action letters on other records).

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We appreciate the opportunity to provide comments on the Proposal and would be pleased to meet with the Commission and its staff regarding our comments and to provide any additional information. Please contact Laura Grossman, IAA Assistant General Counsel, or me at [redacted] with any questions regarding these matters.

Respectfully submitted,

Robert C. Grohowski
General Counsel