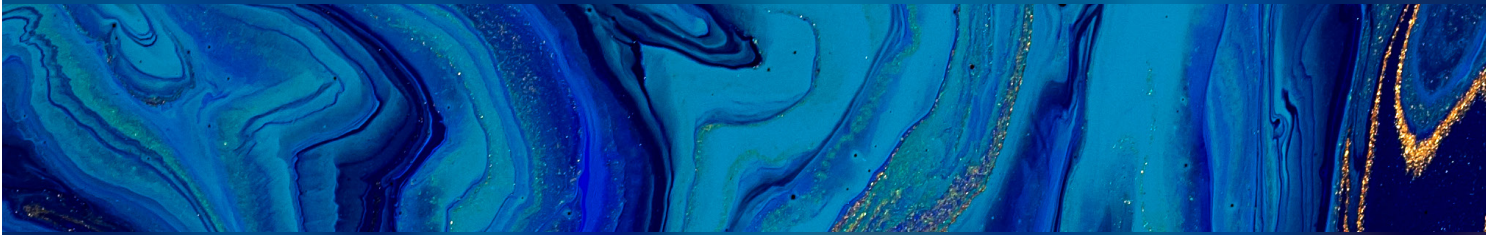


C L I F F O R D
C H A N C E



CORONAVIRUS:
OPERATIONAL AND REGULATORY RISK-OFF
STRATEGIES FOR SEC-REGISTERED
INVESTMENT ADVISERS
MARCH 24, 2020

CORONAVIRUS: OPERATIONAL AND REGULATORY RISK-OFF STRATEGIES FOR SEC-REGISTERED INVESTMENT ADVISERS

As the impact from the spread of the novel coronavirus (“**COVID-19**”) continues to affect the global economy and disrupt business operations, investment advisers should be focusing on the short- and long-term operational and regulatory risks to their firms. While the U.S. Securities and Exchange Commission (the “**SEC**”) has acknowledged the challenges that advisers confront under the present circumstances, the agency has also reminded advisers to continuously evaluate their obligations under the Federal securities laws, including their fiduciary duty to clients.¹ Advisers must also ensure that business continuity and operational resilience planning can guarantee the adviser’s ability to meet client obligations and expectations. This briefing discusses key operational and regulatory risks to advisers presented by the ongoing COVID-19 emergency and offers suggestions on how advisers should address these risks.

Business continuity and operational resilience

The SEC has explicitly stated 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.”²

The SEC has been clear that, in furtherance of this fiduciary obligation, it expects an adviser to have developed a business continuity plan (“**BCP**”) as part of its policies and procedures.³ While the SEC may demonstrate a degree of flexibility at this time and work with advisers in relation to specific COVID-19 related issues, advisers should expect that the agency will take a strong interest in an adviser’s BCP and operational resilience planning both during and after the crisis.

1. See U.S. Securities and Exchange Commission, Order Under Section 206A of the Investment Advisers Act of 1940 Granting Exemptions from Specified Provisions of the Investment Advisers Act and Certain Rules Thereunder, Release No. IA-5463 (March 13, 2020), <https://www.sec.gov/rules/other/2020/ia-5463.pdf>
2. See U.S. Securities and Exchange Commission, Proposed Rule: Adviser Business Continuity and Transition Plans, Release No. IA-4439 (June 28, 2016), <https://www.sec.gov/rules/proposed/2016/ia-4439.pdf>
3. See U.S. Securities and Exchange Commission, Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-4439 (February 5, 2004), <https://www.sec.gov/rules/final/ia-2204.htm>

Accordingly, advisers should:

- Keep records of steps taken in relation to the development and execution of their BCP in order to demonstrate responsiveness to identified issues and compliance with regulatory obligations.
- Review their BCP and ensure that it appropriately addresses, at a minimum:
 - Maintenance of critical operations and systems.
 - Protection, backup and recovery of data.
 - Alternate physical location(s) of the adviser's office(s) and/or employees, including consideration of the need for back-up sites and systems and appropriate supervisory controls.
 - Communications with clients, employees, service providers and regulators.
 - Identification and assessment of third-party services critical to the operation of the adviser.
 - A transition 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.
- Recognize how COVID-19 may directly or indirectly impact the implementation of the BCP, including identifying those services that could be affected and alternative measures that can be taken, if necessary, to ensure continuity of service.
- Ensure that any BCP review involves both senior management and a broad cross-section of employees of the adviser from key functional areas (Finance, IT, etc.).
- Consider establishing a team specifically dedicated to managing the impact of COVID-19 on the firm, including developing action plans and acting with proper authority in specific situations that may arise.
- Identify which personnel are responsible for executing and implementing the various portions of the BCP (and which other personnel could fill such roles in an emergency).
- Test their BCP to confirm that operations are working as required, document the testing, and, if issues are identified, document how such issues are being addressed.
- Communicate with key third-party service providers to assess their vulnerabilities as a result of COVID-19 and evaluate how their BCPs work alongside the adviser's.
- If necessary, conduct connectivity and stress testing of service provider processes, as well as appropriately update or modify existing plans and procedures governing relationships with service providers.
- Consider drawing on existing⁴ guidance⁵ from the SEC and other regulators around BCPs developed in the wake of Hurricane Sandy.

4. See U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, National Exam Program Risk Alert: SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year (August 27, 2013), <https://www.sec.gov/about/offices/ocie/business-continuity-plans-risk-alert.pdf>

5. See U.S. Securities and Exchange Commission, Commodity Futures Trading Commission and Financial Industry Regulatory Authority, Inc., Joint Review of the Business Continuity and Disaster Recovery Planning of Firms: Business Continuity Planning (August 7, 2013), <https://www.sec.gov/about/offices/ocie/jointobservations-bcps08072013.pdf>

We are available to assist advisers with the drafting and/or review of BCP provisions to ensure they adequately address operational risks and facilitate compliance with applicable regulatory obligations.

Regulatory compliance

While recognizing that “there may be temporary disruptions” outside of their control, the SEC expects that advisers will continue to comply with their regulatory obligations during the COVID-19 crisis. Advisers should consider which such obligations under the Investment Advisers Act of 1940, as amended (the “**Advisers Act**”) and the rules and regulations thereunder, as well as other applicable laws and regulations, may be affected by the disruption in business operations caused by COVID-19.

Form ADV

The SEC has issued an order⁶ providing temporary exemptive relief from an adviser's requirement to file its Form ADV and Form PF, if applicable, in a timely manner, as well as the timing of the delivery, if required, of the adviser's (i) Form ADV Part 2; (ii) Form ADV Part 2 supplement; or (iii) summary of material changes to its Form ADV Part 2 (collectively, the “**Brochure**”).

The order sets out the following requirements, which must be satisfied in order to rely upon the relief:

- The adviser is unable to meet a filing deadline or delivery requirement due to circumstances related to current or potential effects of COVID-19; and
- The adviser promptly notifies the SEC via email at IARDLive@sec.gov (or, with respect to Form PF, via email at FormPF@sec.gov) and discloses on its public website (or, if it does not have a public website, notifies its clients and/or private fund investors of) that it is relying on the order.

The exemptive relief under the order is only applicable to filing or delivery obligations that are due on or before June 30, 2020. An adviser that is relying on the exemptive relief provided by the order must file its Form ADV and Form PF, if applicable, and/or deliver its Brochure as soon as practicable, but not later than 45 days after the original due date for filing or delivery.

Questions have arisen regarding how COVID-19 will affect the information required to be reported on Form ADV. Advisers should note the following:

- An adviser does not need to update either Item 1.F. of Part 1A (relating to the adviser's principal office and place of business) or Section 1.F. of Schedule D (relating to each office at which the adviser conducts advisory business) to account for employees working remotely as a result of COVID-19, *if such teleworking arrangement is part of the adviser's BCP*.⁷

6. See U.S. Securities and Exchange Commission, *supra* note 1. See also U.S. Securities and Exchange Commission, Order Under Section 206A of the Investment Advisers Act of 1940 Granting Exemptions from Specified Provisions of the Investment Advisers Act and Certain Rules Thereunder, Release No. IA-5469 (March 25, 2020), <https://www.sec.gov/rules/other/2020/ia-5469.pdf> (making certain revisions to the prior order).

7. See U.S. Securities and Exchange Commission, Frequently Asked Questions on Form ADV and IARD, <https://www.sec.gov/divisions/investment/iard/iardfaq.shtml> (last updated March 16, 2020)

- Advisers filing a Form ADV Part 2A should strongly consider whether the risk factors discussed in Item 8 account for the actual and/or potential effects of COVID-19 on the adviser's business and investment strategies. While general references to pandemics and global business disruptions may be sufficient, clients may expect a direct reference to COVID-19, and many advisers have anticipated this in their annual filings.

We are available to assist advisers with questions relating to their Form ADV filing, as well as drafting and/or reviewing communications with the SEC regarding the potential need for relief from filing and/or delivery obligations.

Custody Rule

Advisers subject to Rule 206(2)-4 of the Advisers Act (the "**Custody Rule**") may have concerns regarding the ability to comply with the requirements to (i) if applicable, deliver audited financial statements to clients within 120 days of the end of the adviser's fiscal year⁸ and (ii) return client assets (such as checks or securities) within 3 days of receipt (or else be deemed to have custody and be in violation of the "qualified custodian" requirement of the Custody Rule).

- **Delivery of an audited financial statement.** The SEC has not explicitly modified the 120-day requirement under the Custody Rule to provide an audited financial statement in light of the challenges presented by COVID-19. However, the SEC has provided guidance that it would not enforce the requirement if (i) the adviser reasonably believed that audited financial statements would be distributed within the 120-day deadline and (ii) the statements were not distributed in time due to "certain unforeseeable circumstances".⁹ It is likely that the SEC will consider the outbreak of COVID-19 to constitute such circumstances.
- **Receipt of client assets.** The SEC has confirmed that it would not consider an adviser to have received client assets at an office location that cannot be accessed by adviser personnel due to the activation of the adviser's BCP, *until such time as personnel are able to access the mail or deliveries at that office location*.¹⁰ Advisers should therefore ensure that (i) the BCP properly accounts for remote work under circumstances such as those presented by COVID-19 and (ii) any employee of the adviser who may, at some point, gain access to mail or deliveries at the adviser's office is aware of the requirement and immediately notifies the appropriate personnel upon accessing client mail or deliveries.

Advisers are encouraged to reach out to us with any questions or concerns relating to compliance with the Custody Rule.

8. A fund of funds has 180 days from the end of their fiscal year to deliver an audited financial statement. See U.S. Securities and Exchange Commission, Staff Responses to Questions About the Custody Rule https://www.sec.gov/divisions/investment/custody_faq_030510.htm (last updated March 16, 2020)

9. Id.

10. Id.

Recordkeeping

Advisers should be aware of their continued obligations to comply with Rule 204-2 of the Advisers Act (the “**Recordkeeping Rule**”) as personnel work from remote locations and, potentially, on personal equipment. These include the requirements to (i) maintain electronic storage media “so as to reasonably safeguard them from loss, alteration, or destruction” and (ii) “limit access to the records to properly authorized personnel”.

Advisers should therefore consider:

- Permitting only those forms of electronic communication for business purposes that the adviser determines can be used in compliance with the Recordkeeping Rule.
- Prohibiting the use of applications and other technologies that can be readily misused through the ability of an employee to send messages or otherwise communicate anonymously or to automatically destroy messages.
- Developing, implementing, and specifically instructing employees on procedures for employees to move messages received from a prohibited electronic system to another electronic system that the adviser determines can be used in compliance with the Recordkeeping Rule.
- If the use of personal email accounts for business purposes is permitted, reviewing and implementing policies and procedures for the monitoring, review, and retention of electronic communications.
- Requiring personnel to complete training and/or providing ongoing reminders on the adviser’s policies and procedures regarding record retention in relation to the use of electronic messaging and electronic applications.
- If the adviser permits the use of social media, personal email or personal websites for business purposes, contracting with a third-party vendor to enable the archiving of such communications as necessary to comply with the Recordkeeping Rule.

We are available to draft and/or review recordkeeping policies and procedures to ensure compliance with the requirements of the Recordkeeping Rule, as well as to provide ongoing advice about related issues that may arise from the transition to offsite, remote work.

State Registration

With many employees likely working from home in states other than the state in which the adviser’s office is located, advisers are understandably concerned that this may trigger registration requirements in those states. Given the SEC’s position described above regarding the reporting of remote offices on the Form ADV, we do not expect that states will require registration where an adviser’s employee is working from home pursuant to the adviser’s BCP. Nonetheless, we will monitor state guidance on an ongoing basis and are available to address questions and concerns that may arise.

Disclosure and communications

Advisers will need to consider how proper communication will be maintained with regulators, clients, service providers and employees during the period where operations are impacted by COVID-19. The SEC expects that firms will “provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus to the fullest extent practicable to keep investors and markets informed of material developments”.¹¹ Advisers should therefore think about coordinating communications through a central person/team to make certain that messaging is consistent and appropriate given market and regulatory expectations.

Communications with Regulators

Advisers should:

- Develop (if they have not already done so) a communications strategy to keep the SEC and other regulators appropriately updated on material business and regulatory risks.
- Identify contacts (both primary and emergency) at regulators for the purpose of providing such updates.
- Identify the adviser’s personnel responsible for interfacing with regulatory bodies and creating a plan to maintain responsive communication if such person(s) becomes unavailable.
- Review their BCPs to determine, what, if any, notifications to regulators are required as a result of activating the BCP (such as notification of teleworking arrangements).
- Keep an open line of communication with regulators regarding any issues resulting from COVID-19 impacts. Advisers should contact the SEC at IM-EmergencyRelief@sec.gov with any questions or concerns.

We can provide ongoing support to advisers in responding and reporting to regulators as necessary, as well as providing continuing advice about how regulators are responding to the situation as it continues to evolve.

Communications with Clients

Advisers should:

- If becoming aware of a risk related to COVID-19 that would be material to clients, appropriately inform clients and ensure that the adviser refrains from engaging in any activities that could conflict with the interests of clients until such clients have been so appropriately informed of material risks.
- If disclosing material information related to the impacts of COVID-19, take the necessary steps to avoid selective disclosures and disseminate such information broadly to clients.

11. See U.S. Securities and Exchange Commission, Press Release: SEC Provides Conditional Regulatory Relief and Assistance for Companies Affected by the Coronavirus Disease 2019 (COVID-19), Release No. 2020-53, <https://www.sec.gov/news/press-release/2020-53>

- Regularly consider the need to revisit, refresh, or update previous disclosures to the extent that the information becomes materially inaccurate as the situation evolves. Such disclosures include not only those related to the adviser's business, but also particular aspects of the adviser's investment strategy to which COVID-19 may pose a risk.
- Communicate regularly with clients regarding the adviser's operations and practices being put into place pursuant to the adviser's BCP.

We are ready to assist advisers in the drafting and/or review of client communications to ensure compliance with applicable regulatory requirements and best business practices.

Communications with Service Providers

Advisers should:

- Identify key service providers and the appropriate contact person (or backup contact person) at each.
- Communicate with service providers and conduct initial and ongoing due diligence, particularly with respect to the service provider's implementation of their BCP.
- Encourage service providers to notify the appropriate personnel of the adviser in a timely manner of any issues or concerns that emerge.

Communications with Employees

Advisers should:

- Review existing employee communications policies to ensure they can be implemented effectively in light of the challenges presented by potentially long-term remote working.
- Maintain consistent, ongoing communication with employees to inform them of how the firm is responding to changing circumstances, including ongoing modifications to policies and procedures, and any new limitations/restrictions in place related to remote work.
- Ensure that such communications reflect the latest government and medical guidelines, as appropriate.

Cybersecurity and data privacy

Cybersecurity continues to be a significant focus of the SEC, and the agency has specifically commented that a firm's compliance program should address cybersecurity risk as it relates to business continuity.¹² As employees of investment advisers work from home, advisers must also consider the cybersecurity issues presented by the use of technology to work remotely. Advisers should review their related policies and procedures to ensure that they properly account for the risks presented by remote work, such as the use of mobile devices and/or personal technology. Advisers will also need to make certain that employees safeguard confidential and sensitive data of both the firm and its clients.

12. See U.S. Securities and Exchange Commission, IM Guidance Update: Cybersecurity Guidance, No. 2015-02 (April 2015), <https://www.sec.gov/investment/im-guidance-2015-02.pdf>

Advisers should:

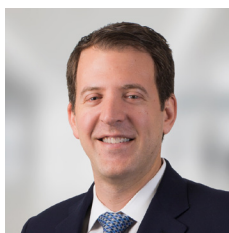
- Review their compliance policies and procedures and ensure that such policies and procedures adequately address matters as identity theft, data protection, and fraud, and consider whether additional policies or protocols need to be put into place.
- Review access controls and confirm that such controls can discern the location of data (including client information) through periodic reviews performed by adviser personnel.
- Address any gaps in information management that may compromise client confidentiality or risk dissemination of inside information.
- Consider prohibiting third-party viewing or back-up of data and information.
- Ensure that systems and data are restricted to authorized users, including implementing any controls as necessary.
- Monitor systems and data for unauthorized access on an ongoing basis.
- Consider allowing employees to access the adviser's email servers or other business applications only by virtual private networks or other security applications to segregate remote activity and help protect the adviser's servers from hackers or malware.
- Consider loading security applications or other software on company-issued or personally owned devices before allowing them to be used for business communications.
- Review and remind all personnel of the firm's policies and procedures governing the use of mobile applications and devices.
- If a service provider of the adviser possesses client information, assess the risks to that provider on an ongoing basis, including having a clear understanding of how such information is being secured by the provider.

We are available to review cybersecurity policies and procedures, as well as provide ongoing advice to advisers regarding cybersecurity issues and address any operational or regulatory questions or concerns.

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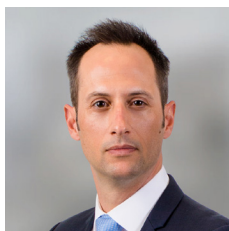
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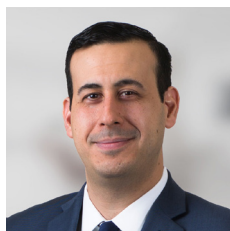
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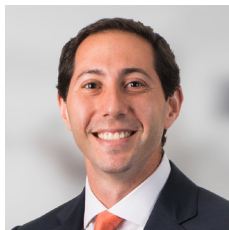
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