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SEC Proposes RIA Succession Requirements

If a client's portfolio manager dies or abruptly retires, who will be in charge of the client's money, and what will happen to the practice the client has relied on? Will there be a hurried merger with another firm? Alternatively, will there be others in the firm who can step up?

Advisory firms have wrestled with succession planning for years. According to industry sources, more than one in three investment firm owners are planning to exit the business by 2025.[1] Although succession planning has become more common within advisory firms in recent years, industry sources suggest that only 40 percent of firms either have a succession plan in place or are prepared to implement a plan.[2] However, forward-thinking investment advisers have been planning for succession and adopting tailored succession plans. A recent Securities and Exchange Commission (SEC) proposal attempts to make this trend toward forward thinking a requirement for all SEC-registered investment advisers (RIAs).

On June 28, the SEC issued a proposal that would require RIAs to adopt and implement a plan designed to address business transition risks, and would require more comprehensive plans to cover other contingencies. As interpreted by the SEC, Rule 206(4)-7 of the Investment Advisers Act of 1940 (the "Compliance Program Rule") already requires RIAs to have business continuity plans, but currently is not specific as to what needs to be included in those plans. If adopted, the SEC's proposal would establish new rule 206(4)-4, which would expand on the requirements of the existing Compliance Program Rule, with the effect that RIAs would be required to reasonably document a plan covering both business continuity and business transition and to have that plan cover certain specified topics.

In particular, the SEC stated:

> [W]e believe that contingency plans with respect to key personnel generally should address both the temporary or permanent loss of such personnel. For example, loss of key personnel could result from an employee's sudden departure from the adviser or could be due to a weather related event that renders the employee temporarily unavailable. Accordingly, an adviser's business continuity plan generally should include short-term arrangements, such as which specific individuals would satisfy the role(s) of key personnel when unavailable, and long-term arrangements regarding succession planning and how an adviser will replace key personnel.

And in a footnote, the SEC added:

> An adviser should also consider whether the departure of key personnel may trigger contractual obligations with clients, investors, or counterparties. For example, private funds clients may contain redemption rights for its investors upon the departure of specified investment personnel.

Proposed rule 206(4)-4 would make it unlawful for an RIA to provide any investment advice unless the RIA adopts and implements a written business continuity and transition plan and reviews the plan annually. The proposal would also require RIAs to create and keep copies of all written plans that are currently in effect or have been in effect at any point in the past five years. Each RIA would also have to keep copies of any records documenting the annual review of its continuity and transition plan and review and, if appropriate, update that plan at least annually.

Under the proposal, RIAs would be required to create and maintain a business continuity and transition plan that includes policies and procedures that address:

- Maintenance of critical operations and systems, and the protection, backup, and recovery of data
- Prearranged alternate physical location(s) of the adviser's office(s) and/or employees

- Communications with clients, employees, service providers, and regulators
- Identification and assessment of third-party services critical to the operation of the adviser
- 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, including:
    - Policies and procedures to safeguard, transfer, and/or distribute client assets during a transition
    - Procedures for facilitating the prompt generation of any client-specific information necessary to transition each client account
    - Information regarding the corporate governance structure of the adviser
    - Plans for the identification of any material financial resources available to the adviser
    - An assessment of the applicable law and contractual obligations governing the adviser and its clients

The SEC estimates the cost per RIA for implementing the proposal would be between $30,000 and $1.5 million. The projected cost is dependent on the size and circumstances of each advisory practice. According to the SEC, the majority of these costs are associated with the initial development and implementation of the plan. After the plan is implemented, the projected maintenance costs are expected to be minimal.

In releasing this proposal, the SEC states that the transition aspects of the required plan are meant to safeguard investors and provide for a seamless transition between RIAs, if needed. A business continuity and transition plan can serve as a road map to help firms navigate difficult times by assigning responsibilities to those who can help fulfill client needs and, it is hoped, keep the practice afloat. If adopted, the proposal will take a significant step toward more widely protecting the interests of RIA clients in the event of an abrupt or unforeseen personnel change or other negative contingencies impacting RIAs and their operations.

Day Pitney's Investment Management and Private Funds group guides investment advisers and broker-dealers through mergers, acquisitions, restructurings, succession planning, and changes in ownership, operations, and management. Our knowledge of our clients' businesses and the changing regulatory environment informs our approach to effectively representing RIAs in planning for the future. The Day Pitney attorneys listed to the right are available to discuss any issues you may have regarding RIA compliance matters.

Summer associate Jeffrey Kole contributed to this alert.

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[1] *See* More Than One in Three Firm Owners are Planning to Exit the Business in the Next 10 Years, According to Fidelity, *Fidelity*, December 17, 2015.

[2] *Id.*

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