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# Legal Update

## Investment Management Survival Tips in the COVID-19 Environment

Historically, we have viewed business continuity plans (or BCPs) as emergency planning for short-term internal disruptions (such as a power blackout or natural disaster) and the occasional short-term market disruption to normal operations. This was the lesson offered by the market volatility and uncertainty in the aftermath of September 11, 2001, and the global financial crisis of 2008.

Recent events, however, have reminded us of the need for implementing robust playbooks that address not only short-term disruptions but also longer-term disruptions. We are taking this opportunity to provide investment advisers with a high-level outline of considerations as part of a broader risk assessment for their businesses as they address in real time the market, business, portfolio and personnel disruptions caused by COVID-19.

### Internal Impact Analysis of Advisory Operations

The Securities and Exchange Commission ("SEC") has stated that investment advisers, as fiduciaries, have an obligation to mitigate and seek to protect client interests from being placed at risk due to the adviser's inability to provide advisory services.[1] Advisers should review whether their BCPs identify and prioritize critical systems necessary to conduct their advisory operations and to evaluate whether sufficient alternatives and redundancies are in place or need to be put in place to maintain operations in this disruption. Key risk areas include:

**People and Advisory Operations.** Which personnel are critical to business operations, and is there a succession plan in place? Will these persons be able to effectively perform critical advisory functions remotely during a disruption?

- If a significant number of advisory (or operations) staff are required to work remotely, will they be able to effectively access the adviser's critical systems and continue operations as usual? Does the adviser's existing infrastructure have sufficient capacity to support a secure and effective wide-scale remote operation such that advisory personnel will be able to communicate with each other, clients and third parties securely?
- In light of remote work or other arrangements, do any existing practices need to be modified (e.g., transitioning to electronic communications) and how?

- What short-term succession arrangements are in place in the event that key advisory and operational personnel are or become unavailable? For example, are there appropriate alternates for key portfolio managers, as well as executive, finance, compliance, technology/cybersecurity, risk and operations chiefs?
- Advisers should review their existing advisory agreements to determine if they contemplate or permit firms to temporarily delegate critical operations to an affiliate, or even an unaffiliated vendor, in an unaffected region, including temporarily assuming certain advisory or operational functions.

**Cybersecurity.** Will remote, electronic systems be able to handle potential cybersecurity threats and protect non-public client information?

- The SEC's exam program has focused on cybersecurity every year since 2014. Under current circumstances, the SEC will expect advisers to tailor their cybersecurity controls to address threats that may emerge during the current environment.
- Potential operational disruptions could lead to, or be caused by, a rise in external threats, such as increased cybersecurity breaches. The SEC's Office of Compliance Inspections and Examinations ("OCIE") has provided guidance with respect to cybersecurity practices, covering (among other things) remote access controls; critical data and client nonpublic customer information; intrusion monitoring; incident response; and due diligence performed on the cybersecurity controls of critical third-party vendors.[2]
- Advisers should pay particular attention to cybersecurity and other protective measures for employees working remotely and train employees on phishing scams that try to capitalize on employees being less vigilant when working from home.
- Cybersecurity policies and procedures should also include performing due diligence on the cybersecurity controls of critical third-party vendors.

**Client Communications.** Does the adviser's BCP include communication plans to clients and investors in the event of a disruption?

- In times of crisis, clients and investors may seek to communicate more often with the firm. Are existing and remote systems and personnel able to handle such communications?
- Has the firm established a clear communication plan to provide regular updates to clients and investors regarding the status of advisory operations, including how they can communicate with advisory staff, obtain account information, and receive market commentaries?

**Third-Party Vendors.** Are third-party service providers (such as custodians, administrators, counterparties, trading systems and IT/software providers) similarly prepared with alternatives and redundancies?

- Has the firm reviewed existing vendors and established risk-based protocols for each?
- Has the firm reached out to its third-party vendors to test and confirm their ability to continue operations?
- What protections and remedies does the firm have, and what conditions must it satisfy in order to protect itself and its clients should a third-party vendor's services become unavailable or compromised? Are third-party service providers still able to provide portfolio management assistance in a changing, volatile market, including through backup or other mitigating procedures? This is of particular importance to advisers of

registered funds who may rely on particular third-party service providers with respect to certain critical functions of the fund (such as, for example, the calculation of the fund's net asset value (NAV) or the valuation of fund portfolio assets).[3]

**Regulatory Requirements.** Are advisers able to continue to comply with their regulatory obligations and filing requirements under the Advisers Act and, for advisers to registered funds, the Investment Company Act of 1940 (the "Investment Company Act"). In an effort to address certain challenges that advisers may face from COVID-19, the SEC recently has granted certain temporary conditional relief with respect to certain Advisers Act and Investment Company Act requirements through two exemptive orders.

- *Form ADV and Form PF Filings.* The SEC has provided temporary relief from the Form ADV amendment and delivery requirements and the Form PF filing requirements through a March 13 Advisers Act exemptive order, provided that such advisers complied with three specified conditions in such order. This relief is limited to filing or delivery obligations for which the original due date is on or after the date of the SEC's order (March 13, 2020) but on or prior to April 30, 2020.[4]
- *In-Person Meeting Requirements under the Investment Company Act for Registered Funds.* Under normal circumstances, the Investment Company Act requires that a registered fund's board of directors vote to approve investment advisory agreements and principal underwriting agreements as well as the annual selection of the fund's independent accountant at an in-person meeting. In recognition of the potential challenges of this requirement in the wake of COVID-19, the SEC, through a March 23 Investment Company Act order (the "March 2020 Order"), granted relief from this in-person requirement provided that fund boards comply with three specified conditions in that order. This relief is limited to the period from and including the date of the order (March 13, 2020) to June 15, 2020.[5]
- *Form N-PORT and Form N-CEN Filings and Transmittal of Annual/Semi-Annual Shareholder Reports.* The March 2020 Order also granted temporary relief with respect to the filings of Form N-PORT and Form N-CEN as well as the requirement to transmit annual or semi-annual shareholder reports to investors, provided that, registered funds comply with certain specified conditions under the Order. This relief is limited to transmittal obligations for which the original due date is on or after the date of the order but on or prior to April 30, 2020.[6]

## Impact Assessment of Client Portfolios

Advisers should consider establishing or enhancing their portfolio review protocols, including a focus on the following areas:

**Portfolio Risks and Compliance.** Client portfolios should be evaluated for both short term and potential longer term risks, in light of current conditions and the specific client at issue, and determine whether any responsive action should be taken. In addition, advisers should identify their on-going portfolio compliance limits and requirements under their advisory contracts, client investment guidelines, fund registration statements and offering memoranda, Form ADV disclosures, the firm's own compliance policies and procedures, client contractual obligations (e.g., credit agreements, subscription lines), the Advisers Act and, as applicable, the Investment Company Act.

- Advisers will want to ensure that any changes in portfolio management to

address market volatility are supported by the relevant documents describing the strategy (see above). In some cases, the adviser has the freedom to deviate from the stated investment objective and/or strategy for temporary defensive purposes. In some cases, investor notice or consent is required to make material changes to the principal investment strategy. Advisers should determine exactly what steps portfolio managers can take under existing documents and what steps must be taken before they can modify their practices.

- Advisers should create a list of obligations or consequences that may be triggered by market volatility or other impact of COVID-19 and further identify the permissible steps that could be taken in response. For example, will payments under financing arrangements become accelerated? Will leverage limits or asset coverage requirements continue to be met?

**Valuation.** The proper valuation of assets affects net asset value calculations, fee calculations and performance.

- For commingled investment vehicles, are current valuation procedures capable of incorporating new events quickly or does trading need to be restricted or deferred until such changes can be assessed and incorporated?
- Extreme care should be taken when contemplating a change to valuation procedures in the midst of a crisis. Sometimes events require changes in valuation procedures and should they become necessary, such changes need to be fully documented (and if applicable approved by the relevant body) . However, there should be no doubt that if changes to valuation procedures result in improved fee revenue or better performance, they will be closely scrutinized and challenged in the next regulatory examination.
- Third-party valuation experts may need to be retained depending on the types of assets held in portfolios. Valuation is one of the most conflicted processes that advisers perform and if an illiquid asset with no available market quotation is to be valued, removing the conflict by retaining a third-party valuation expert might be appropriate.

**Liquidity.** Client portfolios may experience greater liquidity risks due to client withdrawals/investor redemptions and reduced market liquidity.

- As noted above, it is important to be mindful of permissible and prohibited liquidity options, as written in constituent documents of funds and accounts. For example, these documents typically address limitations on withdrawals and suspensions of redemptions. In addition to assessing what is permitted or prohibited by governing documents, advisers also need to take into account market accessibility and where and how liquidity can be accomplished. This assessment may prompt client/investor communications, particularly if suspensions of redemption and withdrawal requests will be invoked.
- Significant and sudden redemptions or withdrawals from funds have occurred during other market dislocations. It will always be crucial to consider the potential impact on remaining investors and other clients. Advisers to registered mutual funds must also be mindful of the liquidity restrictions and related portfolio reporting obligations imposed under the Investment Company Act.[7] Registered closed-end funds and business development companies ("BDCs") that wish to call or redeem their securities in accordance with their respective governing instruments are

subject to certain requirements under Sections 23(c) and 63, as applicable, and Rule 23c-2 under the Investment Company Act, which (among other things) imposes a 30-day advance notice filing requirement with the SEC. A March 2020 Order granted closed-end funds and BDCs temporary relief from this advance notice requirement provided that such registrant complies with three specified conditions laid out in such order. This relief is limited to the period from and including the date of the order to June 15, 2020.[8]

**Conflicted Transactions.** Investment advisers may experience greater pressure to develop novel solutions in light of market volatility or other disruptions, which may increase the potential for conflicted transactions. Such transactions may be subject to greater scrutiny by regulators and investors without a robust conflicts management process.

- Consider whether existing conflicts review and resolution processes need to be enhanced. In a volatile environment, it is important to have a process in place so that transactions can proceed quickly, while mitigating risks.
- In times of crisis, some clients may force full liquidations of their account, prompting the adviser to effect cross trades of illiquid securities/assets between advisory accounts. This raises Advisers Act concerns and, as applicable, certain Investment Company Act prohibitions (such as, but not limited to, the prohibitions with respect to certain affiliated transactions with registered funds). Some accounts, generally retirement accounts such as those governed by the Employee Retirement Income Security Act of 1974 (ERISA) and Individual Retirement Accounts (IRAs), cannot participate in cross trades (or principal transactions for that matter).

**Disclosure to Clients and Investors.** Investment advisers should evaluate whether any new disclosures should be made in light of increased market risks, changes to an adviser's practices (such as those identified above) and other risks that have come to light in the wake of the COVID-19 situation. Advisers should also be sure to comply with "key man" disclosure requirements in fund documents in the event that key personnel become incapacitated. More generally, Form ADV and fund offering document risk updates for COVID -19 have already started to appear.

- Consider updates to offering materials and Forms ADV to reflect the new market risks.
- Advisers should carefully review disclosures in fund documents as well as in their Form ADV and brochure.
- As was the case following the 2008 financial crisis, the SEC will be looking for undisclosed conflicts of interest relating to liquidity, valuation, and redemptions, including preferential redemptions, limitations on withdrawals, and other practices that may favor some investors or the adviser over others.

## Shifting OCIE Priorities and Increased Enforcement or Litigation Risks

Advisers should be prepared for OCIE to alter its examination priorities. OCIE previously published its examination priorities for 2020 on January 7th, well before the events of the last few weeks. OCIE's Director stated that the published priorities are not exhaustive and explained that: "as markets evolve, so do risks and potential harm to investors. OCIE continually works to adjust its examination focus areas to target these risks. . . ." Consistent with this approach, OCIE will likely shift its examination priorities to address risks

to investors that have recently arisen in the current climate.

Although the SEC reports that OCIE and the Division of Enforcement "remain fully operational," the agency also announced that it has "transitioned to a full telework posture with limited exceptions."[9] Thus, advisers should expect that OCIE will continue to conduct examinations of investment advisers but will likely do so remotely rather than at the adviser's premises. OCIE may also limit its examinations for the time being to those advisers it considers to be at particularly high risk of committing violations and to completing examinations that are already underway. However, OCIE will undoubtedly return to regular onsite examinations once the threat of COVID-19 has receded. New areas of examination focus may include the following:

**Business Continuity Plans.** Every adviser should have a BCP, and be ready for OCIE to examine both the plan itself and its implementation in response to COVID-19 or other disruptive event.

- A BCP should be tailored to the specific risks of each adviser's business and address the issues identified above including succession planning and remote access to critical systems.
- To the extent an adviser identifies deficiencies in or needed enhancements to its BCP, OCIE will expect the adviser to take prompt action to address those deficiencies and improve its plan.
- The BCP should include policies and procedures for continuing to preserve required books and records during a business disruption.

**Liquidity, Redemptions, Valuation, and Key Personnel.** Advisers should be prepared for OCIE to examine carefully disclosures, procedures and practices relating to liquidity, redemptions, and valuation as well as compliance with those disclosures.

Advisers also face an increased likelihood of regulatory enforcement action and civil litigation in the current environment.

**Whistleblower Complaints to the SEC**. Advisers must respond in a timely and appropriate manner to investor complaints notwithstanding the important competing demands of implementing BCPs, dispersing employees to work remotely, and preparing to deal with employees who may become ill or incapacitated. Otherwise, employees and investors may conclude that the only way to resolve complaints is by making a report to the SEC Office of the Whistleblower or through civil litigation.

**Litigation.** Depending on the severity of quarantine protocols, the progression of ongoing litigation may slow significantly. Advisers involved in or contemplating significant litigation should consider the impact of such a slowdown in light of their own situation and goals.

We are here to help evaluate the prudence of actions under consideration. We think that we are well-suited to assess risk, convey best practices, and advise on what others similarly situated are doing and how regulators might evaluate decisions made during these times.

These investment management survival tips in the COVID-19 environment are part of an evolving COVID-19 response that is moving across regulatory agencies. Please visit our dedicated COVID-19 website to learn more.

Take care and stay well!

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## Endnotes

[1] In the adopting release to Rule 206(4)-7, the SEC emphasized that BCPs are critical components of advisers' compliance policies and procedures. The SEC also 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." Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Release No. 2204 (Dec. 17, 2003). The SEC's staff also has issued BCP-related guidance and observations following major disruptions to remind advisers of their fiduciary responsibilities to safeguard client interests in the wake of such disruptions. *See* SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year, OCIE National Exam Program Risk Alert (August 27, 2013) (covering observations of investment adviser BCPs following significant disruptions caused by Hurricane Sandy). SEC examinations and deficiency letters further make clear that the SEC expects all investment advisers to have BCPs.

[2] For example, OCIE released in late January 2020 a 13-page report of observations from its examinations of cybersecurity and operational resiliency practices of market participants (including registered investment advisers) in an effort "to allow organizations to reflect on their own cybersecurity practices." SEC OCIE Publishes Observations on Cybersecurity and Resiliency Practices (Jan. 27, 2020). *See* the Mayer Brown Legal Update SEC's OCIE Publishes Observations on Cybersecurity and Resiliency Practices (February 25, 2020).

[3] *See* SEC IM Guidance Update No. 2016-04: Business Continuity Planning for Registered Investment Companies (June 2016).

[4] *See* 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, Investment Company Act Release No. 33817 (March 13, 2020). For a summary of the relief and the required conditions, see the Mayer Brown Legal Update COVID-19: US SEC Provides Temporary, Conditional Relief to Funds and Advisers (the "Mayer Brown Temporary Relief Order Legal Update").

[5] *See* Order under Section 6(c) and Section 38(a) of the Investment Company Act of 1940 Granting Exemptions from Specified Provisions of the Investment Company Act and Certain Rules Thereunder, Commission Statement Regarding Prospectus Delivery, Investment Company Act Release No. 33817 (March 13, 2020). For a summary of the conditions imposed under that Order, see the Mayer Brown Temporary Relief Order Legal Update.

[6] March 2020 Order. For a summary of the conditions imposed under that Order, see the Mayer Brown Temporary Relief Order Legal Update.

[7] Generally, mutual funds (other than money market funds, which are subject to separate requirements) are required to establish liquidity risk management programs and are subject to a 15 percent illiquid investments limitation. *See*

Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32,315 (October 13, 2016) and Investment Company Liquidity Disclosure, Investment Company Act Release No. 33,142 (June 28, 2018). *See also* previous discussion for a description of the temporary relief granted by the SEC with respect to Forms N-PORT and N-CEN (filings which, among other things, include certain information about fund portfolio liquidity). March 2020 Order.

[8] March 2020 Order. For a summary of the conditions imposed under that Order, see the Mayer Brown Temporary Relief Order Legal Update.

[9] *See* SEC Website on COVID-19 Response.