

BUSINESS CONTINUITY PLANNING FOR REGISTERED INVESTMENT COMPANIES

In this guidance update, the staff of the Division of Investment Management (the “Division”) underscores the importance of mitigating operational risks related to significant business disruptions, particularly through proper business continuity planning for registered investment companies (“funds”). Rule 38a-1 under the Investment Company Act of 1940 (“Investment Company Act”) requires funds to adopt and implement written compliance policies and procedures reasonably designed to prevent violation of the federal securities laws.¹ In the staff’s view, fund complexes² should consider their respective compliance obligations under the federal securities laws when assessing their ability to continue operations during a business continuity event.

As discussed below, the importance of proper business continuity planning was highlighted in August of 2015 when a systems malfunction at a financial institution prevented it from calculating accurate net asset values (“NAVs”) for hundreds of mutual funds and exchange-traded funds. Because fund complexes increasingly use technologies and services provided by third parties to conduct daily fund operations, the staff believes such dependencies and arrangements should be considered as part of comprehensive business continuity planning. This guidance update discusses a number of measures that the staff believes funds should consider as they evaluate the robustness of their fund complex’s plan in order to mitigate business continuity risks for funds and investors.



Background

Funds are generally externally managed and do not have employees of their own; they typically are organized by their primary investment advisers (also known as the funds' "sponsors"), who often manage a number of funds within a fund complex and coordinate the activities of other fund service providers. Due to this structure, we understand that business continuity planning generally is conducted at the fund complex level and typically business continuity plans ("BCPs") address fund activities in conjunction with the activities of the primary investment adviser and other service providers that are part of the fund complex.³

Business continuity planning is critical to a fund complex's (or any business entity's) ability to continue operations during, and recover from, a significant business disruption. The development of policies and procedures reasonably designed to ensure that an entity's critical functions and business activities can continue to operate in the face of a significant business disruption has long been considered an essential aspect of operational risk management.⁴ For decades, fund complexes and their service providers have continued to build and improve practices to create resiliencies designed to mitigate the consequences of disruptive events.⁵ BCPs are important tools used by fund complexes and other service providers to prepare for significant business disruptions and to address fund compliance obligations during such disruptions.⁶

In recent history, significant business disruptions have impacted the financial services industry and, as a result, business continuity and disaster recovery practices have appropriately taken on more importance in the industry and have been subject to increased focus by regulators.⁷ In the years since September 11, 2001, the Securities and Exchange Commission ("Commission" or "SEC") has taken numerous steps to address business continuity practices in the financial services industry and the ability of market participants to continue operations during times of crisis.⁸ For example, in 2003, the Commission adopted rule 38a-1 under the Investment Company Act,⁹ which, as discussed above, requires funds to adopt and implement written compliance policies and procedures.¹⁰ In the context of the expected elements of a fund's compliance program, the Compliance Program Adopting Release states that funds' or their advisers' policies and procedures should address the issues identified in that release, including BCPs.¹¹ Additionally, in the wake of Hurricanes Katrina and Sandy, Commission staff reviewed, observed, and addressed business continuity practices and issued alerts reflecting their observations and describing notable practices.¹²

As noted above, in August 2015, hundreds of mutual funds and exchange-traded funds (“ETFs”) experienced a business continuity event when a systems malfunction at a financial institution prevented it from calculating accurate NAVs for these funds.¹³ As a result of this malfunction, the critical third-party provider was unable to deliver timely system-generated NAVs or to publish current ETF baskets for certain clients for several days.¹⁴ Had this outage persisted, the magnitude of this event could have been much greater.¹⁵ Staff in the Division’s Risk and Examinations Office and the Commission’s Office of Compliance Inspections and Examinations conducted outreach to the third-party provider, fund and ETF complexes, and select intermediaries during the course of the outage and after the incident. The outreach revealed that some funds could have been better prepared for the possibility that one of their critical service providers would suffer an extended outage.¹⁶ This outreach also highlighted the importance of robust business continuity planning for fund complexes, particularly the need to understand the business continuity and disaster recovery protocols of critical fund service providers, and how the fund complex’s own BCP addresses the risk that a critical third-party provider could suffer a significant business disruption.

Fund Compliance

In the staff’s view, fund complexes should consider how to mitigate exposures through compliance policies and procedures that address business continuity planning and potential disruptions in services (whether provided internally at the fund complex or externally by a critical third-party service provider) that could affect a fund’s ability to continue operations, such as processing shareholder transactions. Because fund complexes vary in activities and operations, the staff believes that their policies, procedures, and plans generally should be tailored based on the nature and scope of their business. Additionally, because fund complexes also outsource critical functions to third parties, the staff believes that they should consider conducting thorough initial and ongoing due diligence of those third parties, including due diligence of their service providers’ business continuity and disaster recovery plans.

Notable Practices for Fund Complexes

The Division recently conducted outreach to a number of fund complexes and their advisers regarding business continuity planning generally. The staff recognized many similarities among fund complexes, including that most funds rely on fund complex or enterprise-wide business continuity and disaster recovery plans that incorporate, among other things, the critical functions performed on behalf of funds.

In the staff's view, critical fund service providers likely would include, but would not be limited to, each named service provider under rule 38a-1 (*i.e.*, each investment adviser, principal underwriter, administrator, and transfer agent), as well as each custodian and pricing agent.¹⁷

Although the types of funds and fund complex business models may vary significantly, they generally share certain fundamental operational risks, including their ability to continue operations and service investors during business disruptions, regardless of the cause. The staff observed the following notable practices in recent discussions with fund complexes:

- Plans typically cover the facilities, technology/systems, employees, and activities conducted by the adviser and any affiliated entities, as well as dependencies on critical services provided by other third-party service providers.
- A broad cross-section of employees from key functional areas are involved in BCP programs at the fund complex typically including, but not limited to, senior management (including officers of the fund), technology, information security, operations, human resources, communications, legal, compliance, and risk management to assist in efforts to ensure continuity and resiliency when events occur.
- The fund's Chief Compliance Officer ("CCO") and/or the CCO of other entities in the fund complex typically participate in the fund complex's third-party service provider oversight process as conducted by key personnel. Service provider oversight programs generally incorporate both initial and ongoing due diligence processes, including review of applicable business continuity and disaster recovery plans for critical providers. The fund complex typically seeks a combination of information to conduct its oversight, including, but not limited to, service provider presentations, on-site visits, questionnaires, certifications, independent control reports,¹⁸ and summaries of programs and testing, where appropriate, including with respect to BCPs.¹⁹
- Although practices vary, BCP presentations are typically provided to fund boards of directors, with CCO participation, on an annual basis and are given by the adviser and/or other critical service providers. These presentations may be provided separately, as part of periodic presentations related to contractual arrangements (including as part of the annual section 15(c) process),²⁰ or as part of the CCO's annual update to the board.²¹

- For many fund complexes, some form of BCP testing for their plan occurs at least annually, and the results of the fund complex's tests may be shared in updates to fund boards.
- Business continuity outages, including those incurred by the fund complex or a critical third-party service provider, are monitored by the CCO and other pertinent staff and reported to the fund board as warranted.²²

Additional Considerations Regarding Critical Service Providers

As described above, advisers of fund complexes, CCOs, and the fund board play a key role in the selection and ongoing oversight of critical fund service providers. Key business functions and related activities may be performed by an affiliate of the fund complex, a third-party service provider, or some combination thereof. In the staff's view, a fund complex's BCP should contemplate such arrangements, and consider the following lessons learned from past business continuity events and our outreach efforts when formulating fund complex BCPs as they relate to critical service providers.

- ***Back-Up Processes and Contingency Plans.*** The staff believes that fund complexes should consider examining critical service providers' backup processes and redundancies, the robustness of the provider's contingency plans, including reliance on other critical service providers, and how these providers intend to maintain operations during a significant business disruption. Fund complexes generally should understand how their own BCP addresses the risk that a critical service provider could suffer a significant business disruption and how the provider and the fund complex might respond under certain scenarios.²³
- ***Monitoring Incidents and Communications Protocols.*** The staff believes that fund complexes should consider how they can best monitor whether a critical service provider has experienced a significant disruption (such as a cybersecurity breach²⁴ or other continuity event) that could impair the service provider's ability to provide uninterrupted services, the potential impacts such events may have on fund operations and investors, and the communication protocols and steps that may be necessary for the fund complex to successfully navigate such events. Such protocols might include:
 - Policies and procedures for internal communications across the fund complex (e.g., involving senior management, legal, compliance, risk management, technology, information security, operations, human resources, and communications staff), as well as with fund boards.

- External communications plans that address ongoing discussions with the affected service provider, as well as other providers as warranted, and intermediaries, investors, regulators, and the press, as appropriate.
 - Maintaining updated and accessible contact information for essential communications with various constituents during an event.
 - Providing timely communications that report progress and next steps, which may include posting updates to websites or portals to facilitate accessibility and broad dissemination of information.
- ***Understanding the Interrelationship of Critical Service Provider BCPs.*** The staff believes that fund complexes should consider how the BCPs of a fund's critical service providers relate to each other to better ensure that funds can continue operations and/or promptly resume operations during a significant business disruption. For example, if the fund complex relies on a particular third-party service provider to calculate its NAV on a daily basis, has the fund complex discussed with the service provider any redundancies and backup plans the service provider has in the event it experiences a significant business disruption? Additionally, does the fund complex also have backup procedures that address the steps that would need to be taken to successfully navigate through the service provider disruption in order to mitigate potential risks to impacted funds and investors?
 - ***Contemplating Various Scenarios.*** The staff believes that fund complexes should consider how a critical service provider disruption could impact fund operations and investors, and generally have a plan for managing the response to potential disruptions under various scenarios, whether such disruptions occur internally or at a critical third-party service provider.

In the staff's view, to assist fund boards in providing appropriate oversight, boards generally should discuss with the fund's adviser and other critical (affiliated and/or third-party) service providers the steps being taken to mitigate the risks associated with business disruptions and the robustness of their business continuity planning, including how the fund complex's own BCP addresses the risk that a critical third-party service provider could suffer a business disruption.²⁵

Conclusion

The staff believes that funds will be better prepared to deal with business continuity events, if and when they occur, if fund complexes consider the robustness of their BCPs as well as those of their critical third-party service providers. The staff also believes that fund complexes' preparedness likely would be enhanced if they consider their service providers' interrelationships to one another and how the fund complex will respond to significant business disruptions that may impact their internal operations and/or a critical third-party service provider of the fund. The staff recognizes that it is not possible for a fund or fund complex to anticipate or prevent every business continuity event. However, the staff believes appropriate planning includes consideration of these issues and various scenarios in advance of a significant business disruption. We believe such planning will assist funds and fund complexes in mitigating the impact of significant business disruptions on operations and in servicing investors, as well as in complying with the federal securities laws throughout business continuity events.

Endnotes

- 1 See 17 CFR 270.38a-1(a)(1).
- 2 For purposes of this guidance update, we use the term "fund complex" to mean funds, their primary investment adviser, and other fund service providers that are affiliated with the funds or their primary investment adviser. See section 2(a)(3) of the Investment Company Act (defining "affiliated person").
- 3 We recognize that some funds do not have a traditional "sponsor" and instead use a turnkey service provider or third-party administrator to conduct all or most of the activities of running the fund. Like with other critical service providers, the staff believes that such funds should consider the BCP of their turnkey service provider or third-party administrator as it affects the fund. See Additional Considerations Regarding Critical Service Providers in this guidance update.
- 4 See, e.g., Summary of "Lessons Learned" from Events of September 11 and Implications for Business Continuity, Discussion Note Prepared by Staffs of the Federal Reserve, the New York State Banking Department, the Office of the Comptroller of the Currency, and the SEC, for discussion at a meeting on February

26, 2002 at the Federal Reserve Bank of New York (Feb. 13, 2002), *available at* <https://www.sec.gov/divisions/marketreg/lessonslearned.htm>; Interagency Paper on the Sound Practices to Strengthen the Resilience of the Financial System, Securities Exchange Act Rel. No. 47638 (April 7, 2003) [68 FR 17809 (Apr. 11, 2003)] (setting forth business continuity objectives for all financial firms and the U.S. financial system as a whole); Policy Statement: Business Continuity Planning for Trading Markets, Securities Exchange Act Rel. No. 48545 (Sept. 29, 2003) [68 FR 56656 (Oct. 1, 2003)].

- 5 *See supra* note 4; *see also* Comment Letter of Investment Company Institute on the Financial Stability Oversight Council's ("FSOC") Notice Seeking Comment on Asset Management Products and Activities (Mar. 25, 2015) ("ICI FSOC Comment Letter") at 68 ("Over the past several decades, the fund industry has confronted and worked through a variety of emergencies In addition, since September 11, 2001, the nature and scope of business continuance has changed significantly, making fund complexes and their critical service providers more resilient to unexpected business interruptions.").
- 6 *See* Comment Letter of BlackRock, Inc. on the FSOC Notice Seeking Comment on Asset Management Products and Activities (Mar. 25, 2015) at 10 ("In the normal course of business, asset managers implement measures to mitigate the impact of potentially disruptive events through operational risk management programs, including maintaining business continuity plans"); Comment Letter of The Capital Group Companies to the FSOC Notice Seeking Comment on Asset Management Products and Activities (Mar. 25, 2015) at 11 ("Regulatory compliance and operational risk management are well-developed areas within [the asset management] industry Consequently, asset managers invest significant resources and employ various tools to avoid operational issues that could adversely affect their clients or the assets they manage."); ICI FSOC Comment Letter, *supra* note 5 at 69 ("[F]unds and key service providers to the industry have robust plans and strategies in place to facilitate the continuation or resumption of business operations in the event of an emergency....").
- 7 *See, e.g., supra* note 4; *see also* FSOC Notice Seeking Comment on Asset Management Products and Activities, *available at* <http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf>, [79 FR 77488 (Dec. 24, 2014)] (requesting public comment on, among other things, operational risks and transition planning as it relates to the asset management industry).

- 8 See, e.g., *infra* notes 9 and 12; see also FINRA rule 4370 (requiring broker-dealers to have BCPs that address certain required elements); SEC Approves NASD and NYSE Business Continuity Rules (Apr. 2004), available at <https://www.sec.gov/news/press/2004-53.htm>. More recently, in 2014, the Commission adopted Regulation Systems Compliance and Integrity, or Regulation SCI, which, among other things, requires certain entities to establish, maintain, and enforce written policies and procedures, including business continuity and disaster recovery plans that include maintaining backup and recovery capabilities sufficiently resilient and geographically diverse and that are reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption. See Regulation Systems Compliance and Integrity, Securities Exchange Act Rel. No. 73639 (Nov. 19, 2014) [79 FR 72251 (Dec. 5, 2014)]; 17 CFR 242.1001(a)(2)(v).
- 9 See Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Rel. No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] (“Compliance Program Adopting Release”). In 2003, the Commission also adopted rule 206(4)-7 under the Advisers Act, which makes it unlawful for a registered investment adviser to provide investment advice unless the adviser has adopted and implemented written policies and procedures that are reasonably designed to prevent violation by the adviser and its supervised persons of the Advisers Act and the rules thereunder. See 17 CFR 275.206(4)-7(a). In addition, today the Commission proposed a new rule under the Advisers Act that would require SEC-registered investment advisers to adopt and implement business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in the investment adviser’s operations and that also address certain components. See Adviser Business Continuity and Transition Plans, Advisers Act Rel. No. 4439 (June 28, 2016).
- 10 Rule 38a-1 also requires a fund’s compliance policies and procedures to provide for the oversight of compliance by the fund’s advisers, principal underwriters, administrators, and transfer agents (collectively, “named service providers”), and that the fund’s board of directors approve, and review annually, the compliance policies and procedures of the fund and each of its named service providers. See 17 CFR 270.38a-1(a)(1)-(3).
- 11 In the Compliance Program Adopting Release, the Commission stated that it expected that an adviser’s policies and procedures, at a minimum, should address (among other things) BCPs to the extent that they are relevant to that adviser. In

the context of the expected elements of a fund's compliance program, the release states that "[f]unds' or their advisers' policies and procedures should address the issues ... identified for investment advisers...." See Compliance Program Adopting Release, *supra* note 9.

- 12 See Compliance Alert, June 2007, available at <https://www.sec.gov/about/offices/ocie/complialert.htm>; National Exam Program Risk Alert, SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year (Aug. 27, 2013), available at <https://www.sec.gov/about/offices/ocie/business-continuity-plans-risk-alert.pdf>. The 2012 examination was part of a joint review by the Commission's Office of Compliance Inspections and Examinations, the Financial Industry Regulatory Authority, and the Commodity Futures Trading Commission of relevant firms' business continuity and disaster recovery planning in the wake of Hurricane Sandy. Together, these entities also issued a joint statement setting forth best practices and lessons learned as a result of their review. See Joint Review of Business Continuity and Disaster Recovery of Firms by the Commission's National Examination Program, the Commodity Futures Trading Commission's Division of Swap Dealers and Intermediary Oversight and the Financial Industry Regulatory Authority (Aug. 16, 2013), available at <http://www.sec.gov/about/offices/ocie/jointobservations-bcps08072013.pdf>.
- 13 In late August 2015, Bank of New York Mellon ("BNY Mellon"), a service provider that provides custodial and administrative services to mutual funds, closed-end funds, and exchange-traded funds, experienced a breakdown in one of its third-party systems (SunGard's InvestOne) used to calculate numerous client funds' NAVs. See, e.g., Stephen Foley, BNY Mellon Close to Resolving Software Glitch, Financial Times (Aug. 31, 2015), available at <http://www.ft.com/intl/cms/s/0/47d5860a-4f2b-11e5-b029-b9d50a74fd14.html>; Jessica Toonkel & Tim McLaughlin, BNY Mellon Pricing Glitch Affects Billions of Dollars of Funds, Reuters (Aug. 26, 2015), available at <http://www.reuters.com/article/bnymellon-funds-nav-idUSL1N111QY20150826>; Barrington Partners White Paper, An Extraordinary Week: Shared Experiences from Inside the Fund Accounting System Failure of 2015 (Nov. 2015), available at http://www.mfdf.org/images/uploads/blog_files/SharedExperiencefromFASystemFailure2015.pdf; Transcript of the BNY Mellon Teleconference Hosted by Gerald Hassell on the Sungard Issue, available at https://www.bnymellon.com/_global-assets/pdf/events/transcript-of-bny-mellon-teleconference-on-sungard-issue.pdf.

- 14 This situation resulted in certain clients pricing their shares using stale or manually calculated NAVs and certain ETFs using stale baskets. Once the automated system was restored, ETF baskets were updated and certain funds had to review the NAVs used while the automated system was down and make any necessary corrections. See *supra* note 13.
- 15 See Remarks to the Investment Company Institute's 2016 Mutual Funds and Investment Management Conference, David W. Grim (Mar. 14, 2016), available at <http://www.sec.gov/news/speech/david-grim-remarks-to-ici-2016-mutual-funds-and-invest-mgmt-conf.html> (“[L]ast August, a computer malfunction at one financial institution prevented it from calculating accurate net asset values for hundreds of mutual funds and exchange traded funds. The situation could have been far worse had the outage persisted.”).
- 16 See *id.*
- 17 See, e.g., ICI FSOC Comment Letter, *supra* note 5 at 59-61 (discussing key service providers for funds); see also Compliance Program Rule Adopting Release, *supra* note 9 at n.28 (noting that limiting the service providers named in rule 38a-1 did not lessen a fund’s obligation to consider compliance as part of its decision to employ other entities, such as pricing services, auditors, and custodians). The staff recognizes that not all fund service providers provide critical services to a fund. In determining whether a service provider is critical, fund complexes may wish to consider the day-to-day operational reliance on the service provider and the existence of backup processes or multiple providers.
- 18 We understand that many fund complexes review Service Organization Control (“SOC”) reports, such as SSAE 16 reports that are prepared by an independent public accountant in accordance with the American Institute of CPAs’ Auditing Standards Boards’ Statement on Standards for Attestation Engagements No. 16, Reporting on Controls at a Service Organization. These reports provide assurances that the service provider has established a system of internal controls, that the internal controls are suitably designed to achieve specified objectives, and that the internal controls are operating effectively. See <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AT-00801.pdf>.

- 19 Service provider oversight programs also may include the review of a service provider's financial condition and resources, insurance arrangements, and any indemnification provisions covering the service provider and its activities. See, e.g., Board Oversight of Certain Service Providers, Independent Directors Council, Task Force Report (June 2007) ("IDC Report") at 4-5, available at <https://www.idc.org/pdf/21229.pdf>.
- 20 Section 15(c) of the Investment Company Act requires fund boards to approve and renew a fund's investment advisory agreements and principal underwriting agreements. We understand that fund boards may consider an adviser's or principal underwriter's BCP in connection with its annual section 15(c) renewal process.
- 21 See *supra* note 9 and 10, and accompanying text (discussing rule 38a-1 under the Investment Company Act).
- 22 Such reports may include, among other things, periodic updates on progress, resumption, recovery, and remediation efforts during and after such events.
- 23 See, e.g., Comment Letter of Securities Industry and Financial Markets Association (Asset Management Group) and Investment Advisers Association to the FSOC Notice Seeking Comment on Asset Management Products and Activities (Mar. 25, 2015) at 138 ("Typical business-continuity planning and disaster relief programs articulate the importance of back-ups and explicitly lay out contingency plans around service providers."); The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference, Chair Mary Jo White (Mar. 29, 2016), available at <https://www.sec.gov/news/speech/chair-white-mutual-fund-directors-forum-3-29-16.html> (discussing back-up plans and redundancies in the context of service providers).
- 24 Our staff recently addressed the importance of cybersecurity for funds and investment advisers. See Cybersecurity Guidance, IM Guidance Update (Apr. 2015), available at <http://www.sec.gov/investment/im-guidance-2015-02.pdf>.
- 25 Fund boards oversee the activities of their funds, including the hiring and continued retention of critical service providers, but they are not involved in the day-to-day management and business activities conducted by the fund complex. Rather, they rely on the fund's adviser and other service providers to perform necessary day-to-day functions on behalf of the fund. See Compliance Program Adopting Release, *supra* note 9 at 29 ("Most of the operations of funds are carried out by service providers..."); IDC Report, *supra* note 19 at 1 ("Service providers play a significant role in the day-to-day operations of a fund....").

IM Guidance Updates are recurring publications that summarize the staff's views regarding various requirements of the federal securities laws. The Division generally issues *IM Guidance Updates* as a result of emerging asset management industry trends, discussions with industry participants, reviews of registrant disclosures, and no-action and interpretive requests.

The statements in this *IM Guidance Update* represent the views of the Division of Investment Management. This guidance is not a rule, regulation or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved its content. Future changes in rules, regulations, and/or staff no-action and interpretive positions may supersede some or all of the guidance in a particular *IM Guidance Update*.

The mission of the Securities and Exchange Commission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

If you have any questions about this IM Guidance Update, please contact:

Andrea Ottomanelli Magovern
Kathleen Joaquin
Investment Company Rulemaking Office
Phone: 202.551.6792