

Pensions & Investments

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Commentary: Investment management survival tips in the COVID-19 environment

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Recent events demonstrate the need for implementing playbooks that address business interruptions like those associated with COVID-19.

Historically, investment advisers have viewed business continuity plans as emergency planning for short-term disruptions. However, recent events demonstrate the need for implementing robust playbooks that also address longer-term business interruptions like the disruption associated with COVID-19.

In the current environment, investment advisers should take into account the high-level considerations discussed below as they address in real time the disruptions caused by COVID-19.

1. Internal impact analysis of advisory operations

The Securities and Exchange Commission has said 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. Accordingly, advisers should review whether their business continuity plans identify and prioritize critical systems necessary to conduct advisory operations and evaluate whether sufficient alternatives are in place to maintain operations in this disruption. Key risk areas include people and advisory operations; cybersecurity; third-party vendors; and continued compliance with regulatory requirements.

People and advisory operations

Which personnel are critical to business operations, and is there a succession plan in place? Staff working remotely must be able to effectively access the adviser's critical systems and continue operations. They must also be able to communicate securely with each other, clients and third parties. A communication plan should be implemented for providing regular updates to clients and investors regarding the status of advisory operations, including how to communicate with advisory staff, obtain account information and receive market commentaries. Advisers also need to determine what succession arrangements are in place in the event key personnel become unavailable. Similarly, advisers should evaluate whether they have the authority to delegate critical operations to vendors unaffected by the disruption.

Cybersecurity

Are remote systems able to handle cybersecurity threats? Disruptions could lead to, or be caused by, cybersecurity threats. Thus, advisers should review the recent cybersecurity guidance from the SEC's office of compliance inspections and examinations. It is particularly important in the current environment that an adviser's cybersecurity plan include protective measures for employees working remotely, including training on phishing scams.

Third-party vendors

Are third-party service providers prepared with alternatives and redundancies? As part of vendor due diligence, investment advisers should test their vendors' ability to continue operations in the current environment. The adviser should also have protocols in place to protect itself and clients if a vendor is compromised.

Regulatory requirements

Are advisers able to continue to comply with their applicable regulatory obligations under the Advisers Act and Investment Company Act of 1940? The SEC recently granted temporary conditional relief for certain of these requirements.

2. Impact assessment of client portfolios

Advisers should evaluate their portfolio review protocols, including a focus on portfolio risks and compliance, valuation, liquidity, conflicted transactions and disclosures to clients.

Portfolio risks and compliance

Client portfolios should be evaluated to determine whether any responsive action should be taken. Advisers should identify their ongoing portfolio compliance limits and requirements under client investment guidelines, registration statements, offering memorandums, Form ADV disclosures, compliance policies, contracts and applicable law. Advisers should also ensure that any changes in portfolio management to address market volatility are

permissible under relevant documents. In addition, advisers should create a list of consequences that may be triggered by market volatility or other impacts of COVID-19 and identify permissible steps that could be taken in response. Such potential consequences may include whether payments under financing arrangements become accelerated and whether leverage limits or asset coverage requirements will continue to be met.

Valuation

The proper valuation of assets affects net asset value calculations, fee calculations and performance. Important valuation considerations include:

- Are current valuation procedures capable of incorporating new events quickly or does trading need to be restricted until changes can be assessed?
- Are changes in valuation procedures fully documented (and if applicable approved by the relevant body)? Regulators will scrutinize changes resulting in increased fees or better performance.
- Third-party valuation experts may need to be retained to minimize conflicts associated with valuation of illiquid assets.

Liquidity

Client portfolios may experience greater liquidity risks due to withdrawals and reduced market liquidity. Advisers must recognize permissible liquidity options in fund and account documents that typically address limitations on withdrawals and redemptions.

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It is crucial to consider the impact of sudden or significant fund redemptions on remaining investors and clients. Advisers to registered mutual funds must also be mindful of liquidity restrictions and related portfolio reporting obligations under the Investment Company Act. Registered closed-end funds and business development companies that wish to call or redeem their securities in accordance with governing instruments are subject to specified requirements under certain provisions of the Investment Company Act, which (among other things) imposes a 30-day advance notice filing requirement with the SEC. The SEC recently granted limited relief from this advance notice requirement.

Conflicted transactions

Investment advisers may experience greater pressure to develop novel solutions in light of market volatility, investor demands for liquidity or other disruptions, which may increase the potential for conflicted transactions. Advisers should consider whether existing conflicts protocols need to be enhanced so transactions can proceed quickly, while mitigating risks. Some clients may force full liquidations of their account, prompting the adviser to effect

cross trades of illiquid assets between advisory accounts. This raises Advisers Act concerns and Investment Company Act prohibitions (such as 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 and individual retirement accounts, cannot participate in cross trades (or principal transactions for that matter).

With respect to disclosure to clients and investors, investment advisers should evaluate whether new disclosures should be made in light of increased risks or changes to adviser practices or client portfolios.

3. Shifting OCIE priorities

Advisers should be prepared for the SEC's office of compliance inspections and examinations to shift its examination priorities and procedures 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." Thus, advisers should expect that OCIE will continue to conduct examinations of investment advisers but will likely do so remotely. Areas of examination focus may include business continuity plans; disclosures, procedures, practices, and undisclosed conflicts relating to liquidity, redemptions, and valuation; and cybersecurity.
