Blogs
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Should Failure to Plan Constitute Fraud?

I have spoken for years about the importance of contingency planning for money market funds. So I understand why business continuity and transition planning is a great idea for investment advisers. I'm troubled, however, by the SEC's recent proposal to require advisers to maintain such plans. My troubles lie more with their means than with their ends. **The Proposed Rule** Proposed Rule 206(4)-4 would require all SEC registered investment advisers to adopt, implement and annually review a business continuity and transition plan ("BCTP"). The BCTP must address:

- Maintenance of critical operations and systems, and the protection, backup, and recovery of data, including client records;
- A pre-arranged alternate physical location of the adviser's office and employees;
- Communications with clients, employees, service providers, and regulators;
- Identification and assessment of third-party services critical to the operation of the adviser; and
- A plan of transition that accounts for the possible winding down of the adviser's business or the transition of the adviser's business to others.

The rule would be promulgated under Section 206(4) of the Investment Advisers Act, which makes it unlawful "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." Granting that planning is a sound practice, why would a failure to plan be "fraudulent, deceptive, or manipulative?" **Can Fiduciaries Negotiate Risks with their Clients?** The SEC offers the following justification for requiring BCTPs under Section 206(4):

> As fiduciaries, investment advisers owe their clients a duty of care and a duty of loyalty, requiring them to put their clients' interests above their own. As part of their fiduciary duty, advisers are obligated to take steps to protect client interests from being placed at risk as a result of the adviser's inability to provide advisory services.… [C]lients are entitled to assume that advisers have taken the steps necessary to protect those interests in times of stress …. We believe it would be fraudulent and deceptive for an adviser to hold itself out as providing advisory services unless it has taken steps to protect clients' interests from being placed at risk as a result of the adviser's inability … to provide those services.

I detect some legal legerdemain here. It is one thing to say that an adviser must place the client's interest first when managing the client's assets; it's quite another thing to say that client interests must come first in the management of the adviser's business. Moreover, by decreeing what "clients are entitled to assume," the SEC would prevent advisers from negotiating their clients' expectations. Before the proposed rule, I would have thought an adviser might disclose to clients that he or she may not always be available during "times of stress" and that clients could accept this risk. The SEC's proposal now suggests this would be a deceptive practice. **Paths Not Taken** Section 204(a) of the Investment Advisers Act requires advisers to "make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, may prescribe …." The SEC could get much, although not all, that it is looking for by defining recordkeeping to include planning for accessing, updating and transferring client records in the event of a business disruption. The SEC could also require advisers to disclose whether they have a BCTP and summarize any plan in their brochure, so that clients could gauge the adviser's preparedness themselves. We would then complain about regulation through disclosure. But I would prefer to risk a fraud charge due to an actual misstatement, rather than due to disappointing expectations the SEC has created on the clients' behalf.

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