

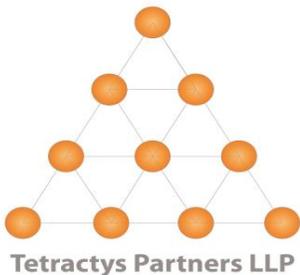
TTRACTYS PARTNERS

BRIEFING NOTE

PRACTICAL GUIDANCE ON OUTSOURCING ARRANGEMENTS

BRIEFING 03, DECEMBER 2013

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INTRODUCTION

Following our Briefing Note 1 on the Financial Conduct Authority's (**FCA**) thematic work on outsourcing, we thought it might be helpful to set out the basics of a sound, compliant framework for any outsourcing arrangements our clients might contemplate.

It should be stressed that this is an indicative guide to what are regarded as benchmark practices and requirements. Any legal agreements will need input from Counsel, and it can also be helpful to seek external help with ensuring that the regulatory aspects are being dealt with in a manner which works best for the firm, as formulaic approaches are not necessarily helpful.

This Note deals primarily with the requirements of SYSC 8 of the FCA Rules, which apply to all firms, but it also contains some additional thoughts on compliance with the outsourcing provisions of the new FUND sourcebook for alternative investment managers (found at FUND 3.10)

The most important thing for firms to remember about delegation is the general legal point which SYSC 8 of the FCA Rules aims to bring to life – namely that a firm can delegate the performance of a function to a third party, but the firm and its management cannot delegate the responsibility for the proper performance of the delegated function.

The FCA has spent considerable attention on outsourcing and sees it as a key source of potential weakness in the financial system, where control and accountability become distanced from the performance of the function, and senior management focuses more on cost reduction rather than control.

Indeed there are even questions as to whether some third party administrators would have a systemic impact on the financial system were they to fail.

The FCA is concerned to ensure that:

- The regulated firm and its senior management remain responsible and accountable for all the functions of the firm, whether undertaken in-house or outsourced to a third party;
- The firm keeps the FCA informed in advance about its outsourcing intentions (remember the outsourcing of some functions such as portfolio management might require prior approval – and in other jurisdictions this may be mandatory);
- Resilience to systemic or operational shocks is not diminished as a result of the outsourcing arrangement; and
- Investor protection is not disadvantaged by any potential dilution of control caused by the outsourcing, including outsourcing to third countries where physical distance, time zones and different regulatory standards might affect oversight or the performance of the function.

With this in mind, firms need to ensure they revisit SYSC 8 of the FCA Handbook and ensure that they have appropriate contractual arrangements in place, including detailed service level agreements at an appropriately granular level.

Firms should also ensure:

- Sufficient records to demonstrate the probity of the process for choosing the best provider on objective criteria, and that there were no conflicts of interest inherent in the selection process.
- Sufficiently senior and skilled resources are retained internally to monitor the conduct of the service provider. Such staff must engage with the service provider on a regular, documented basis following a specific agenda which includes interrogation of the metrics showing the provider's performance against service levels. Firms should also remember to document clearly, in a job description, the person who has responsibility for fulfilling this oversight task.
- Regular reports on the performance of the outsourced functions reach the governing body of the regulated firm, which actually reviews and interrogates the data.
- A written contract exists covering all the requirements of SYSC 8 and FUND 3.10, especially around obligations to notify the regulated firm when things are going wrong or service standards are not being met.
- Granular service level agreements setting out the service standards to be met by the service provider for all the key tasks it performs. These should be sufficiently granular to form the basis of meaningful management information for the regular oversight meetings and the governing body.
- Appropriate documented consideration exists of the extent to which the service provider's internal controls over such issues as insider dealing and financial crime and associated training are of the right standard. This is particularly relevant where the service provider is based in a different jurisdiction where standards may be lower than those of the UK. Where standards are lower, firms will need to insist contractually on the service provider meeting UK standards before continuing with the outsourcing arrangement.
- Clarity over the notification obligations of the service provider. It is particularly important to consider the extent to which the service provider has any discretion to raise external notifications (e.g. financial crime issues) without communicating these to the regulated firm. This might be made more complex where there is a conflict of laws between the UK requirements binding on the firm, and any local legal requirements binding on the service provider.
- Clear escalation protocols for internal issues – it is very important that service providers are not permitted to conceal issues in the hope they can resolve them before they blow up, rather than engaging constructively with the regulated firm at an early stage.
- Clarity over access rights to inspect the records of the provider (for the firm, its auditors and regulators).



- Clarity over disaster recovery/business continuity obligations and communication – also a requirement for the provider to participate as necessary in disaster recovery/business continuity testing.

Firms also need to ensure that they have a thorough understanding, not just of the service provider's internal processes, but also its resilience arrangements in the event of any major service disruption. These arrangements should be mapped by the firm against the minimum requirements of its clients to ensure that basic levels of service can be maintained during a period of business disruption. Mapping is essential as it documents the thought processes of management which, in turn, provides documentary evidence for the FCA that the necessary thought has been put into the process by senior management of the regulated firm.

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KEY MESSAGES AND NEXT STEPS

Firms should consider scheduling regular periodic reviews of their outsourcing arrangements to ensure that all arrangements are captured and properly managed. External review by a competent third party adds an extra layer of assurance.

The first steps are to identify all arrangements where functions that would normally be undertaken by the firm which are outsourced to third parties and then to identify whether these arrangements are material or immaterial as defined by the FCA.

Essentially, an arrangement is material, if its performance is critical to the delivery of investment services to clients, or the firm ensuring it remains in compliance with the requirements of the regulatory system. Therefore arrangements such as the outsourcing of payroll etc are not normally considered "material" for this purpose.

"Immaterial" outsourcing arrangements still require there to be a contract in place covering the provision of the services.

Once the list of outsourcing functions and their materiality has been determined, firms can check for evidence of beauty parades, FCA notifications, regular meetings, contracts etc. This is not just a "tick box" exercise. Contracts should be reviewed to ensure they remain relevant and adequate in a changing legal environment, the service level agreements need to be comprehensive and relevant and the documentation of the governance process needs to demonstrate that there is meaningful scrutiny taking place. Often, the objective view of a third party can genuinely add value here.

Where there has been a lack of demonstrable oversight, firms may need to take retrospective action to review data and follow up issues in order to demonstrate that they have taken all reasonable steps to ensure that there has been no investor disadvantage as a result of any failures on the part of the provider. On a less comfortable note, it may be that the issue is serious enough to require reporting to the FCA under the provisions of Principle 11 and SUP 15.

It is important to remember that the FCA requires prior notification ahead of any material outsourcing taking place. Aside from the requirements of SYSC 8, Principle 11 would demand that such prior notification be made, especially where such outsourcing was to take place with an overseas service provider. In the interests of transparency and in preparation for any FCA visit, thematic or otherwise, firms should review their applications to the FCA and subsequent correspondence in order to ensure that all outsourcing arrangements have been subject to such a notification. It should be remembered that this is not a mere formality – the FCA will expect to have the opportunity to comment ahead of the outsourcing being implemented, and it will expect its comments to be acted upon. Firms will need to find the original notifications or ensure they make a Principle 11 notification to bring the FCA up to date with their arrangements.

It is of particular relevance for investment managers applying to the FCA for their AIFMD Variation of Permission that they ensure:

- (a) That entities are not delegating so much risk management and/or investment management activity away that they become “letterbox entities” as this has an impact on the entity which has to be regulated under AIFMD; and
- (b) That where they are delegating activities overseas, they do not let the physical separation become an excuse for reduced oversight standards. Site visits might be necessary and this is a potential cost factor to be considered.

This is in addition to the general requirements of SYSC 8 which are not removed by the existence of FUND 3.10.

HOW TETRACTYS CAN HELP YOU

Tetractys has extensive experience of setting up outsourcing arrangements and associated controls. We can review any existing arrangements and benchmark them against FCA expectations, as well as support the development of effective controls and governance to evidence effective adherence to these requirements. We can also help to structure the process of beauty parades of potential suppliers and the deeper due diligence process that needs to be undertaken. For a no-obligation discussion, please call Gary Pitts on 07795 830 636 or email gary.pitts@tetractyspartners.com.