

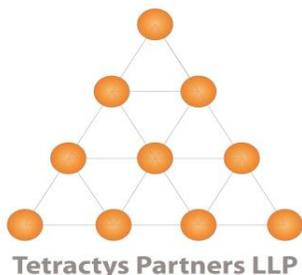
# TTRACTYS PARTNERS

## BRIEFING NOTE

### TR13/10, OUTSOURCING IN ASSET MANAGEMENT

BRIEFING 01, NOVEMBER 2013

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#### INTRODUCTION

On 4<sup>th</sup> November 2013, the Financial Conduct Authority (the **FCA**) published the findings of its thematic review of outsourcing in the asset management industry. This follows its previous work which led to the publication of a “Dear CEO” letter on outsourcing in December 2012. The basic message is encouraging. Firms, industry associations and service providers have been working together to set standards and address the FCA’s concerns without the FCA needing to intervene to make further rules over and above the provisions of SYSC 8. In particular the FCA seems heartened by the work of the Outsourcing Working Group and it seems likely that the work of this Group will become the benchmark the FCA uses to assess industry standards of outsourcing controls in the future.

It should be noted that only three of the seventeen asset managers reviewed were hedge fund managers, therefore this small sample is unlikely to be representative of the levels of compliance within the hedge fund industry, particularly at the smaller manager end of the scale.

The FCA commented that the effectiveness of the measures being taken remained patchy and there was a clear warning for hedge fund managers who delegate functions to offshore providers that, while distance might dilute the manager’s control over the outsourcing arrangement, the FCA’s expectations remain the same as if the outsourcing took place onshore. This may present a particular challenge for smaller managers.

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*“Some of the asset managers in our sample used service providers that off-shore part of the service they provide. In these situations, we found that most asset managers maintained a reduced level of oversight of the offshored activity. Where the operational chain gets longer with a greater number of parties involved, the asset manager’s oversight is diluted, but our requirements remain the same. This results in additional challenges for the asset manager.”*

– TR 13/10 page 15.



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## FCA FOCUS AND CONCERNS

The FCA focused on the resilience of the arrangements in place if a service provider were to cease operating, and the effectiveness of firms' arrangements for monitoring outsourced relationships.

While recognising that the failure of an administrator was a low probability event, the FCA believes such a failure would be a high impact failure – hence the FCA believes firms should have detailed plans in place to deal with the corporate failure of an administrator.

The FCA is concerned that firms significantly under-estimate the complexity and time involved in transferring from one service provider to another, particularly where one provider is in a stressed situation. The complexity of any transfer will, of course, be affected by the types of instrument involved in the transfer and it is essential that firms understand the basic minimum service that will be required to safeguard the interests of investors.

In terms of monitoring the effectiveness of the service provider in the outsourced relationships, the FCA's main finding was that firms might lack personnel with sufficient experience to monitor the arrangement effectively. The FCA was particularly focused on administration issues such as corporate actions, reconciliations, trade processing and valuation which have the potential to affect large numbers of investors. The FCA indicates it had found a number of instances where the firm had insufficiently skilled internal resource to monitor the service provider adequately.

FCA's expectation, stated here and flowing from the SYSC sourcebook, is that the person with responsibility for oversight must be:

- (a) Of sufficient seniority to ensure that the firm's interests are protected and who can make appropriate on the spot decisions for the firm;
- (b) Someone with sufficient technical expertise in the area subject to the outsourcing to enable them to challenge the service provider effectively over its management information and any service failings; and
- (c) Someone able to devote sufficient time and resources to the oversight role in order to undertake it effectively.

Of course, all this needs to be evidenced properly with proper records of calls and meetings between the firm and its service provider, preferably in the form of minutes of the meeting. Ideally such meetings would run to a fixed agenda to ensure that nothing was missed and that there was consistency of oversight. In our experience, calls and meetings are often very informal with limited evidence as to the substance of what has been discussed, which would be unlikely to meet the standards envisaged by TR13/10.

## KEY MESSAGES AND NEXT STEPS

The key messages are no different from earlier FCA and FSA pronouncements on the subject of outsourcing.

Firms need to be able to demonstrate that they understand their service provider and its arrangements thoroughly, including their resilience arrangements, and have contingency plans for a rapid move to another provider in the event of serious issues. Transferring from one service provider to another is logistically complex and time-consuming to an extent often not recognised by firms – which could put the fund, its investors and the firm itself at risk.

Firms should consider reviewing agreements, putting in place backup arrangements and ensuring they understand the logistics of a transfer from one provider to another and have a plan in place for such a transfer which is kept fresh.

Firms also need to ensure that they have the capability to monitor the service provider effectively. This last point is particularly important as the delegation of the performance of a function does not mean that the responsibility for the proper performance of the function can be delegated away. **This is a key risk for any firm that outsources, as outsourcing exposes the firm to the risk of litigation or regulatory action for failures by its service provider.** For hedge funds delegating to overseas administrators there is a clear warning that the FCA expects no less a standard of monitoring, which could be costly to smaller firms if periodic onsite visits to test controls and procedures are required.

In assessing the appropriateness of their resource for oversight, firms should ensure that the oversight role is documented in a job description and that there is some objective documented assessment of the competence of the individual to exercise oversight. They should also ensure that there are appropriate contractual provisions with the service provider to facilitate oversight (including onsite access), a service level agreement and a proper governance structure for the relationship.

## HOW TTRACTYS CAN HELP YOU

Tetractys's Managing Partner, Gary Pitts, has extensive experience of managing outsourcing relationships across multiple jurisdictions. Gary can review your existing arrangements and benchmark them against FCA expectations, support the development of service level agreements and management information and help to ensure that oversight and resilience arrangements are appropriate. For a no-obligation discussion, please call Gary on 07795 830 636 or email [gary.pitts@ttractyspartners.com](mailto:gary.pitts@ttractyspartners.com).