

MiFID Connect

GUIDELINE ON THE APPLICATION OF THE OUTSOURCING REQUIREMENTS UNDER THE FSA RULES IMPLEMENTING MIFID AND THE CRD IN THE UK

This Guideline does not purport to be a definitive guide, but is instead a non-exhaustive statement of the measures that common platform firms may adopt in complying with some of the requirements relating to outsourcing under the FSA Rules implementing MiFID in the UK. This Guideline focuses only on the UK's implementation of MiFID requirements relating to outsourcing.

This Guideline is directed at "common platform firms"; in summary those firms that are subject to either MiFID or CRD, or both, and are therefore subject to the FSA's common platform of systems and controls requirements set out in the FSA's SYSC Handbook.

Please note that this Guideline does not cover the requirements contained in SYSC 8.2 and SYSC 8.3 on the outsourcing of retail portfolio management to certain third country firms. In addition, this Guideline does not cover some of the wider aspects of the FSA's regime applicable to outsourcing. For example, it does not discuss the application of the approved persons regime where individuals employed by a third party service provider perform controlled functions.

This Guideline is up to date as at 16 May 2007. It may be revised from time to time in the light of any relevant changes to the FSA Handbook. If you intend to place significant reliance on it, it would be sensible to check whether there have been any such changes to the FSA Handbook.

This Guideline has taken account of "FSA Confirmation of Industry Guidance"(DP 06/5).

This Guideline does not alter the meaning of any relevant FSA Rule, nor should it be interpreted as doing so.

The FSA has reviewed this Guideline and has confirmed that it will take it into account when exercising its regulatory functions. This Guideline is not mandatory and is not FSA guidance. This FSA view cannot affect the rights of third parties.

<i>Structure of this document:</i>	<i>Page:</i>
<i>Section 1</i> - Introduction to outsourcing including an overview of the new obligations relating to outsourcing	<i>2</i>
<i>Section 2</i> - Guidelines to help firms understand when the outsourcing obligation will apply to them	<i>3</i>
<i>Section 3</i> - Guidelines to help firms understand the nature of the outsourcing obligation and how this will vary depending on the type of arrangement	<i>5</i>
<i>Section 4</i> - Guidelines to help member firms understand the detailed requirements	<i>9</i>
<i>Appendix 1</i> - Outsourcing under MiFID and CRD - Level 1 and 2 Text	<i>19</i>
<i>Appendix 2</i> - Glossary	<i>24</i>

C L I F F O R D C H A N C E

SECTION ONE

1. INTRODUCTION TO CHANGES

This section summarises the effect of the new FSA Rules implementing the outsourcing requirements of both MiFID and the CRD (the "**Implementing Rules**").

Outsourcing under the Implementing Rules

The requirements imposed under the pre-MiFID FSA regime relating to outsourcing and the requirements imposed under the Implementing Rules are not significantly different. The Implementing Rules are, in many ways, simply a codification of good market practice that existed before MiFID. The key difference is that the Implementing Rules contain specific detailed rules, as there were previously no detailed FSA rules on outsourcing by investment firms in the UK (although guidance has been in place for banks and insurance companies for some time).

While the definition of outsourcing under MiFID is potentially very wide, it is only applicable to arrangements regarding the outsourcing of "critical or important" functions and investment services and activities and, consequently, what is caught within the definition under the Implementing Rules does not differ considerably from what was caught under the pre-MiFID FSA regime.

MiFID applies detailed requirements regarding the measures firms must take to manage the risks associated with outsourcing "critical or important" functions or investment services or activities (the "**Outsourcing Obligation**"). The FSA applies the Outsourcing Obligation to all firms carrying out MiFID and/or CRD business ("common platform firms") and also applies it as guidance for outsourcing that does not involve "critical or important" functions or investment services or activities. The requirements apply to a common platform firm's material outsourcing in relation to: (i) UK regulated activities whether MiFID business or not (e.g. deposit taking activities as well as MiFID investment services and activities), (ii) listed activities under the BCD (e.g. lending activities), and (iii) ancillary services under MiFID (e.g. provision of investment research).

However, the FSA recognises that outsourcing of certain functions in certain circumstances may carry lower risks than others and so provides that where a firm relies on a third party to perform operational functions which are not "critical or important" for the performance of relevant services or activities ("non-material outsourcing") it is able to take into account the detailed MiFID requirements in a proportionate manner. This means that firms may have more flexibility when carrying out "non-material outsourcing" than when outsourcing critical or important functions.

What is considered as a "critical or important" function varies according to the nature and circumstances of each firm and the specific arrangements contemplated. What is critical or important for one firm may not be critical or important for another.

Firms should note that the requirement under SUP 15.3.1R and SUP 15.3.8G(1)(e) to notify proposed outsourcing arrangements and significant changes to outsourcing arrangements to the FSA is unaffected by the Implementing Rules.

Please see Appendix 1 for full text of the relevant provisions of MiFID and the CRD.

C L I F F O R D C H A N C E

SECTION TWO

2. APPLICATION OF THE OUTSOURCING OBLIGATION UNDER THE IMPLEMENTING RULES

2.1 *Definition of Outsourcing for Common Platform Firms*

Glossary

Outsourcing: means an arrangement of any form between a *firm* and a service provider by which that service provider performs a process, a service or an activity which would otherwise be undertaken by the *firm* itself.

[Note: article 2(6) of the *MiFID Implementing Directive*]

The definition of "outsourcing" under the Implementing Rules is very broad and it is not possible to describe a simple test or a clear dividing line to determine whether an arrangement falls within the definition of outsourcing or not. Firms should exercise judgement in determining whether borderline arrangements should be considered as outsourcing. However, some general principles can be identified which may help firms to determine whether arrangements are inside or outside the definition of outsourcing.

- (a) In circumstances where a firm provides investment services to its clients and certain elements of the delivery of those services are contracted to a third party:
- Where there is a direct contractual relationship for the delivery of these services between the third party and the client the arrangement should not fall within the definition of outsourcing;
 - Where there is no contract between the third party and the client and the firm chooses to enter into the arrangement with the third party (i.e. it would otherwise carry out those elements of the service itself) the arrangement may fall within the definition of outsourcing.
- (b) If a firm arranges for the provision by a third party of a particular process, service or activity that does not fall within part of the service offering of the firm, as opposed to simply delegating the provision of a process, service or activity that is part of the firm's service offering to another entity, this will not fall within the definition of outsourcing under the Implementing Rules.
- For example, where a global custodian puts in place sub-custodian arrangements (it being generally implied and understood as part of such an arrangement that a global custodian is not expected to hold assets directly in every jurisdiction in the world), this will not constitute an outsourcing. This can be contrasted with the case in which a global custodian delegates its central custody functions, for example by appointing a global sub-custodian, which will constitute an outsourcing.
 - As a further example, if a firm engages a third party to provide execution services for its clients, whether or not this constitutes an outsourcing will depend on the nature of the service offered by the firm. If it does offer an execution service, delegating execution may be an outsourcing. In contrast, if the relevant service offered by the firm is simply the receipt and transmission of orders, transmitting orders for execution to a third party broker will not constitute outsourcing.

C L I F F O R D

C H A N C E

- (c) Where specialist consultants are hired to provide technical advice on operations managed by the firm or to prepare and install a service (for example, an execution service) this will not fall within the definition of outsourcing as provided under the Implementing Rules. However, if once installed and fully operational the service is managed by a service provider, provision of the service will fall within the definition of outsourcing as provided under the Implementing Rules.

Any other substantial activity which is carried on by a third party would, depending on its relative importance to the firm, be likely to fall within the scope of the Outsourcing Obligation.

SECTION THREE

3. NATURE OF THE OUTSOURCING OBLIGATION

3.1 Introduction

SYSC 8.1.1R

A *common platform firm* must:

(1) when relying on a third party for the performance of operational functions which are critical for the performance of *regulated activities*, *listed activities* or *ancillary services* (in this chapter "relevant services and activities") on a continuous and satisfactory basis, ensure that it takes reasonable steps to avoid undue additional operational risk;

(2) not undertake the *outsourcing* of important operational functions in such a way as to impair materially:

(a) the quality of its internal control; and

(b) the ability of the *FSA* to monitor the *firm's* compliance with all obligations under the *regulatory system* and, if different, of a *competent authority* to monitor the *firm's* compliance with all obligations under *MiFID*.

[Note: article 13(5) first paragraph of *MiFID*]

SYSC 8.1.3G

SYSC 4.1.1R requires a *common platform firm* to have effective processes to identify, manage, monitor and report risks and internal control mechanisms. Except in relation to those functions described in *SYSC 8.1.5R*, where a *firm* relies on a third party for the performance of operational functions which are not critical or important for the performance of relevant services and activities (see *SYSC 8.1.1R(1)*) on a continuous and satisfactory basis, it should take into account, in a manner that is proportionate given the nature, scale and complexity of the *outsourcing*, the *rules* in this section in complying with that requirement.

The Outsourcing Obligation applies to all new and existing outsourcing arrangements from 1 November 2007 (see section 3.5 below). The application of the detailed outsourcing rules will vary depending on the function to be outsourced.

Note that the Implementing Rules extend the application of the detailed MiFID outsourcing requirements so that in complying with *SYSC 4.1.1R* firms are required to take them into account in a proportionate manner when conducting non-material outsourcing (i.e. outsourcing of non-critical or non-important business functions). This means that firms have a certain amount of flexibility when carrying out non-material outsourcing.

C L I F F O R D

C H A N C E

3.2 *Critical and important functions*

SYSC 8.1.4R

For the purposes of this chapter an operational function is regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of a *common platform firm* with the conditions and obligations of its *authorisation* or its other obligations under the *regulatory system*, or its financial performance, or the soundness or the continuity of its relevant services and activities.

[Note: article 13(1) of the *MiFID implementing Directive*]

SYSC 8.1.5R

Without prejudice to the status of any other function, the following functions will not be considered as critical or important for the purposes of this chapter:

(1) the provision to the *firm* of advisory services, and other services which do not form part of the relevant services and activities of the *firm*, including the provision of legal advice to the *firm*, the training of personnel of the *firm*, billing services and the security of the *firm's* premises and personnel;

(2) the purchase of standardised services, including market information services and the provision of price feeds.

[Note: article 13(2) of the *MiFID implementing Directive*]

What will be considered as a critical or important function will vary according to the nature and circumstances of each firm and the specific arrangements contemplated. What is critical or important for one firm may not be critical or important for another. Reference to "critical or important" is a single concept and where a function is identified as one part (i.e. critical) it will also tend to be the other (i.e. important). There is not likely to be any difference between the two terms.

Outsourcing of the operation, maintenance or management of those key systems without which a firm would be unable to deliver services to its clients would be considered critical. For example, where the sole means of providing a service is outsourced (e.g. where all customer orders are taken by a call centre provided by an outsource service provider) this is likely to be considered critical outsourcing. However, where the outsourced function is only one of many ways in which the service is or can be provided this may not be considered critical where a failure in relation to one system would not affect the firm's ability to provide the service by other means. For example, where a firm decides to outsource its execution services to four different service providers, a failure by one service provider would not affect the firm's ability to provide the execution services as it may do so through the other three service providers. However, the arrangement could still involve the outsourcing of critical and important functions because the fact that the other brokers could step in does not mitigate the risk that a broker could continue to deal but do so in a defective way that might lead the firm to no longer comply with its execution obligations.

Where a firm has more than one means of providing a service which are not substantially interchangeable (for example, it takes customer orders via telephone calls, over the internet and through a sales team) but places significant reliance on any one or more one of those means (e.g. due to high order flow through this means), outsourcing of this means will constitute critical outsourcing.

3.3 *Some practical examples*

C L I F F O R D

C H A N C E

Bearing in mind the general principles described above in section 2.1 and section 3.2, it is possible to categorise the following common arrangements or activities as unlikely to constitute outsourcing or, if they do constitute outsourcing, as unlikely to constitute outsourcing of critical and important functions:

- (a) Appointment of sub-custodians;
- (b) Participation in securities settlement systems and payment systems;
- (c) Provision of one-off, expert assistance with compliance, internal audit, accounting or risk management issues;
- (d) Provision of logistical support, e.g. cleaning, catering and procurement of basic services/products;
- (e) Provision of human resources support, e.g. sourcing of temporary employees and processing of payroll;
- (f) Buying standard software "off-the-shelf" or engaging a software designer to develop bespoke software; and
- (g) Reliance on software providers for ad-hoc operational assistance in relation to off-the-shelf systems.

And bearing in mind the general principles described in section 2.1 and section 3.2, it is possible to categorise the following common arrangements or activities as likely to constitute outsourcing - potentially of critical and important functions:

- (a) Provision of regular or constant compliance, internal audit, accounting or risk management support;
- (b) Provision of credit risk control and credit risk analysis;
- (c) Portfolio administration or portfolio management by a third party;
- (d) Provision of data storage (physical and electronic);
- (e) Provision of ongoing, day-to-day systems maintenance/support; and
- (f) Provision of ongoing, day-to-day software/systems management (e.g. where third party carries out day-to-day functionality and/or runs software or processes on its own systems).

3.4 *What is outsourcing of relevant services or activities?*

SYSC 8.1.6R

If a *common platform firm* outsources critical or important operational functions or any relevant services and activities...

[Note: article 14(1) of the *MiFID implementing Directive*]

Outsourcing of any relevant activity or service is also subject to the specific detailed rules applicable to outsourcing as outlined at section 4. This includes outsourcing of an investment activity or service provided to a client, for example, the outsourcing to another firm of part of the investment management mandate or brokerage service for a particular type of client.

C L I F F O R D

C H A N C E

3.5 Arrangements entered into before 1 November 2007

Firms should ensure that arrangements entered into before 1 November 2007 adequately deal with the relevant risks of outsourcing. Firms should consider checking that where such arrangements are documented by written agreement, they adequately deal with the relevant risks outlined in Section 4 below and that their terms are not contrary to the Implementing Rules (e.g. they do not, for example, purport to limit the firm's responsibility for the outsourced services to its clients). While there is no specific requirement under the Implementing Rules for firms to repaper all existing arrangements following implementation of MiFID, firms should ensure that their existing arrangements are compliant with the new requirements.

Where existing arrangements do not meet the standards required by the Implementing Rules (for example, where access provisions for regulators and personal account dealing compliance within the provider are not covered within the existing contract), firms may consider that it is appropriate to enter into a side letter arrangement amending their existing contractual arrangements. The side letter must be legally equivalent to the agreement and contractually binding.

SECTION FOUR

4. CONSIDERATION OF THE DETAILED IMPLEMENTING RULES REQUIREMENTS

4.1 *Summary of Implementing Rules requirements*

SYSC 8.1.6R

If a *common platform firm* outsources critical or important operational functions or any relevant services and activities, it remains fully responsible for discharging all of its obligations under the *regulatory system* and must comply, in particular, with the following conditions:

- (1) the *outsourcing* must not result in the delegation by *senior personnel* of their responsibility;
- (2) the relationship and obligations of the *firm* towards its clients under the *regulatory system* must not be altered;
- (3) the conditions with which the *firm* must comply in order to be *authorised*, and to remain so, must not be undermined;
- (4) none of the other conditions subject to which the *firm's* *authorisation* was granted must be removed or modified.

[Note: article 14(1) of the *MiFID implementing Directive*]

SYSC 8.1.7R

A *common platform firm* must exercise due skill and care and diligence when entering into, managing or terminating any arrangement for the *outsourcing* to a service provider of critical or important operational functions or of any relevant services and activities.

[Note: article 14(2) first paragraph of the *MiFID implementing Directive*]

SYSC 8.1.8R

A *common platform firm* must in particular take the necessary steps to ensure that the following conditions are satisfied:

- (1) the service provider must have the ability, capacity, and any *authorisation* required by law to perform the *outsourced* functions, services or activities reliably and professionally;
- (2) the service provider must carry out the *outsourced* services effectively, and to this end the *firm* must establish methods for assessing the standard of performance of the service provider;
- (3) the service provider must properly supervise the carrying out of the *outsourced* functions, and adequately manage the risks associated with the *outsourcing*;
- (4) appropriate action must be taken if it appears that the service provider may not be carrying out the functions effectively and in compliance with applicable laws and regulatory requirements;
- (5) the *firm* must retain the necessary expertise to supervise the *outsourced* functions effectively and manage the risks associated with the *outsourcing* and must manage those risks and must supervise those functions and manage those risks;

C L I F F O R D C H A N C E

- (6) the service provider must disclose to the *firm* any development that may have a material impact on its ability to carry out the *outsourced* functions effectively and in compliance with applicable laws and regulatory requirements;
- (7) the *firm* must be able to terminate the arrangement for the *outsourcing* where necessary without detriment to the continuity and quality of its provision of services to *clients*;
- (8) the service provider must co-operate with the *FSA* and any other relevant *competent authority* in connection with the *outsourced* activities;
- (9) the *firm*, its auditors, the *FSA* and any other relevant *competent authority* must have effective access to data related to the *outsourced* activities, as well as to the business premises of the service provider; and the *FSA* and any other relevant *competent authority* must be able to exercise those rights of access;
- (10) the service provider must protect any confidential information relating to the *firm* and its *clients*;
- (11) the *firm* and the service provider must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities where that is necessary having regard to the function, service or activity that has been *outsourced*.

[Note: article 14(2) second paragraph of the *MiFID implementing Directive*]

The requirement in SYSC 8.1.7R to exercise due skill, care and diligence means that a firm should have one or more persons with responsibility for supervising and monitoring the outsourced function on an ongoing basis, and that the firm should have sufficient competence at a senior level in-house to enable them to resume control over the outsourced function if necessary.

It is important that a firm involves the right individuals at each stage of the outsourcing process so that the firm can meet its requirement to exercise due skill, care and diligence. The stages can be broadly summarised as:

- the decision to outsource or change an existing outsourcing arrangement (the decision making phase);
- due diligence checks on the service provider;
- drafting a written outsourcing agreement and a service level agreement (the pre-contractual drafting phase);
- the implementation, monitoring and management of an outsourcing arrangement, e.g. monitoring the performance of the service provider on an ongoing basis in terms of quality and efficiency and liaising with the service provider (the contractual phase);
- dealing with the expected or unexpected termination of a contract and other service interruptions (the post-contractual phase).

It may be that different individuals are required to be involved at different stages of the process.

The following sections give guidance on the meaning of the obligations under the Implementing Rules that are specific to the firm (Section 4.2) and those which are specific to the service provider (Section 4.3). As set out at section 4.6 below, the firm remains responsible for ensuring that the service provider provides it with a service which allows the firm to comply with its obligations under the regulatory

C L I F F O R D

C H A N C E

system. In addition, whilst there are obligations that are specific to the service provider (Section 4.3) these do not apply directly to the service provider - instead, the firm in question has responsibility to ensure that its service provider complies with the obligations.

Steps that firms might take to meet the relevant obligations are suggested below, first by reference to what the firm must do and then by reference to the arrangements a service provider must have in place. To an extent these need to be considered together, for example, where a firm identifies one individual responsible for supervision of the arrangement it would be helpful if this person were to co-ordinate with an individual within the service provider.

The suggestions provided are consistent with: (i) The International Organization of Securities Commissions' (IOSCO) Final Report on Principles of Outsourcing of Financial Services for Market Intermediaries dated February 2005; and (ii) the Committee of European Banking Supervisors' (CEBS) Guidelines on Outsourcing dated 14 December 2006. These two documents contain internationally recognised outsourcing standards.

4.2 The firm must:

- (a) establish methods for assessing the standard of performance of the service provider (SYSC 8.1.8R(2));

Steps that firms might take in complying with this requirement include:

- agreeing and documenting quantitative and qualitative service level standards/performance targets for the performance of the outsourced functions so as to ensure that the outsourced functions meet the performance and quality standard that would apply if the firm were to perform the relevant activities itself;
- putting in place procedures to continuously monitor and assess the performance of the service provider (e.g. scheduling regular update meetings with the service provider, assessing the appropriate frequency and carrying out onsite inspections);
- adopting measures to identify and report instances of unsatisfactory performance or non-compliance, such as service delivery reports, self-certification or independent review by auditors;
- imposing regular reporting obligations on the service provider and scheduling update meetings with the service provider to monitor compliance with obligations.

- (b) take appropriate action if it appears that the service provider may not be carrying out the functions effectively and in compliance with applicable laws and regulatory requirements (SYSC 8.1.8R(4));

What is considered "appropriate" will depend on the breach itself and the terms of the agreement between the parties. Steps that firms might take in complying with this requirement include:

- implementing a service credit regime for non-compliance with performance targets in order to address minor breaches;
- warning the service provider, activating step-in rights or terminating the

C L I F F O R D
C H A N C E

agreement where a significant or persistent breach is identified.

- (c) retain the necessary expertise to supervise the outsourced functions effectively and manage the risks associated with the outsourcing and supervise and manage those risks (SYSC 8.1.8R(5));

Steps that firms might take in complying with this requirement include:

- specifying individuals within the firm that are responsible for monitoring and managing the relevant outsourcing arrangement at each stage of its life-cycle (i.e. decision-making phase, pre-contractual drafting phase, contractual phase and post-contractual phase);
- ensuring that those individuals have adequate training and experience to understand the nature of the service or activity outsourced and to manage the risks associated with the outsourcing;
- putting in place procedures to continuously monitor and assess the performance of the service provider (e.g. scheduling regular update meetings with the service provider, assessing the appropriate frequency and carrying out onsite inspections);
- performing an ongoing assessment of the operational risks and concentration risks associated with all of its outsourcing arrangements;
- adopting measures to enable the firm to monitor and assess the service provider's organisational structure and ownership structure;
- documenting the ability for the firm to have access to relevant documentation and systems regularly as required to assess the quality of the outsourced function.

- (d) ensure that the arrangement for outsourcing may be terminated where necessary without detriment to the continuity and quality of its provision of services to clients (SYSC 8.1.8R(7));

- See section 4.8 below.

- (e) ensure access for the firm, its auditors and the relevant competent authorities to data related to the outsourced activities, as well as to the business premises of the service provider, and the competent authorities must be able to exercise those rights of access (SYSC 8.1.8R(9));

Steps that firms might take in complying with this requirement include:

- imposing an obligation on the service provider to provide the firm, its auditors and/or relevant competent authorities with access to premises, books, records and information relevant to the outsourced activity (and books, records and information of sub-contractors where relevant) where required. Note that providing for auditor access does not imply that there is a requirement for auditors to make additional site visits. Note also that in order to meet the requirement that competent

C L I F F O R D
C H A N C E

authorities must be able to exercise their rights of access, they may need to be given third party rights of action in any outsourcing agreement;

- imposing an obligation on the service provider to provide sufficient information to the firm to enable it to report to the relevant competent authority.

This requirement would prevent outsourcing to jurisdictions in which local legal requirements would prevent such access.

- (f) establish, implement and maintain a contingency plan for disaster recovery (which would form part of the firm's overall business continuity strategy) and periodic testing of back-up facilities, where that is necessary having regard to the function, service or activity that has been outsourced (SYSC 8.1.8R(11)).

Steps that firms might take in complying with this requirement include:

- implementing a contingency plan which addresses the possibility that one or more of the firm's service providers fails to adequately perform their contractual obligations and requiring that the service provider have a contingency plan which meets the standards required by the firm (note, firms should take this into account in developing their own business continuity arrangements);
- making arrangements for the swift transfer of the outsourced activities to another service provider or back to the firm itself;
- put in place arrangements for the periodic testing of contingency plans (the frequency of testing is likely to depend on the nature of the plans).

4.3 The firm must ensure that the service provider:

- (a) has the ability, capacity and authorisation required by law to perform the outsourced functions, services or activities reliably and professionally (SYSC 8.1.8R(1));

Steps that firms might take in complying with this requirement include:

- requiring written representations from the service provider regarding its ability capacity and authority, for example, representations that it is qualified and has adequate resources to perform the service and that it is financially sound;
- carrying out independent checks of the representations made by the service provider and carrying out additional due diligence such as obtaining publicly available information including details from online authorisation registers, carrying out site visits, obtaining and checking references and carrying out credit analysis.

- (b) carries out the outsourced services effectively (SYSC 8.1.8R(2));

- See section 4.2(a) above.

- (c) properly supervises the carrying out of the outsourced functions and adequately manages the risks associated with outsourcing (SYSC 8.1.8R(3));

C L I F F O R D
C H A N C E

Steps that firms might take in complying with this requirement include:

- requiring the service provider to have adequate systems in place to monitor internally the performance of the outsourced functions and provide regular reports of non-compliance to the firm;
- requiring the service provider to ensure that it has personnel with adequate training and experience to understand the nature of the service or activity outsourced and to manage the risks associated with the outsourcing.

- (d) discloses to it any development that may have a material impact on its ability to carry out the outsourced functions effectively and in compliance with applicable laws and regulatory requirements (SYSC 8.1.8R(6));

Steps that firms might take in complying with this requirement include:

- imposing a disclosure obligation on the service provider and monitoring the disclosure (i.e. testing that it is adequate).

- (e) cooperates with the competent authorities of the firm in connection with the outsourced activities (SYSC 8.1.8R(8));

Steps that firms might take in complying with this requirement include:

- imposing and, where relevant, enforcing an obligation on the service provider to provide to the firm, its auditors and/or its regulators with access to books, records and information relevant to the outsourced activity (and books, records and information of sub-contractors where relevant) where required and to cooperate fully with the firm, its auditors and/or its regulators.

- (f) protects any confidential information relating to the firm and its clients (SYSC 8.1.8R(10));

Steps that firms might take in complying with this requirement include:

- documenting the security requirements of systems to be used by the service provider, including the technical and organisational measures that will be taken to protect firm and customer related data;
- impose confidentiality requirements on the service provider including requirements regarding the use of sub-contractors, where relevant;
- imposing a requirement on the service provider to comply with all data protection rules.

- (g) establishes, implements and maintains a contingency plan for disaster recovery and periodic testing of back-up facilities, where that is necessary having regard to the function, service or activity that has been outsourced (SYSC 8.1.8R(11)).

Steps that firms might take in complying with this requirement include:

C L I F F O R D C H A N C E

- documenting a requirement for the service provider to put in place emergency procedures, disaster recovery and contingency plans and to comply with any contingency and disaster recovery plans of the firm;
- arranging tests and inspections of the service provider's contingency arrangements (where any security concerns allow).

4.4 *Written agreement*

SYSC 8.1.9R

A common platform firm must ensure that the respective rights and obligations of the *firm* and of the service provider are clearly allocated and set out in a written agreement.

[Note: article 14(3) of the *MiFID implementing Directive*]

The written agreement is a useful tool that firms can use to demonstrate that they have considered the relevant risks of a particular arrangement and are acting in compliance with the FSA's requirements as to outsourcing. However, in addition to having a written agreement in place, firms should consider adopting measures to ensure that any outsourcing agreement remains up-to-date and accurate and reflects the arrangements that are actually in operation. The contents of any written agreement should be proportionate to the risks involved and the size and complexity of the outsourcing.

Firms may consider setting minimum service performance standards (e.g. in the form of a service level agreement) or require the service provider to agree to certain requests. Requests might include implementation of specific systems (such as putting in place a system to capture personal account dealing records), regular monitoring and reporting on performance of systems and providing full cooperation and access for monitoring purposes. Firms may also require representations from service providers (such as the ability, capacity and authorisation of the service provider). Representations given by the service provider may be sufficient to show that the firm has obtained all relevant information and has taken the necessary steps to ensure compliance with the relevant obligation, although where appropriate, firms should verify any representations received from the service provider.

The contract is likely to include a number of core provisions such as those which:

- outline and clearly define the activities to be outsourced, the responsibilities of the firm and the service provider;
- specify the precise service and performance levels in both quantitative and qualitative terms and how these will be monitored;
- impose an obligation on the service provider to provide to the firm, its auditors and/or its regulators with rights of inspection and access to books, records and information relevant to the outsourced activity (and books, records and information of sub-contractors where relevant) where required;
- outline the agreed termination and exit management process, including exit strategies to allow for transfer of the service to another service provider or to the firm itself;
- cover the ownership of intellectual property and the protection of confidential information;

C L I F F O R D

C H A N C E

- require prior consent of the firm to the possibility and circumstances of any sub-outsourcing (i.e. where a service provider subcontracts elements of the service to other third-party providers) and ensure that any terms agreed between the service provider and any third party do not contradict the terms of the agreement between the firm and the service provider;
- require the service provider to immediately inform the firm of any material change in circumstances which could have a material impact on the provision of services by the service provider.

In addition, consideration should be given to including other elements such as those which:

- confirm the choice of law where the service provider is located abroad;
- outline the responsibilities of the service provider with regard to IT security;
- require acceptance of liability by the service provider for unsatisfactory performance or other breach of the agreement;
- outline payment processes;
- require guarantees and indemnities from the service provider;
- outline agreed mechanisms to resolve disputes;
- outline agreed business continuity measures to be taken by the service provider.

4.5 *Intra-group outsourcing*

SYSC 8.1.10R

If a *common platform firm* and the service provider are members of the same *group*, the *firm* may, for the purpose of complying with SYSC 8.1.7R to SYSC 8.1.11R and SYSC 8.2 and SYSC 8.3, take into account the extent to which the *common platform firm controls* the service provider or has the ability to influence its actions.

[Note: article 14(4) of the *MiFID implementing Directive*]

Whilst an intra-group outsourcing may be a material outsourcing, intra-group outsourcing in general is recognised as potentially posing a lower level of risk. Many firms have arrangements in place with group companies, e.g. some firms outsource IT services, data analysis or the production of research to group companies in low-cost jurisdictions.

In applying the outsourcing requirements to intra-group outsourcings, firms can take into account their ability to influence the service provider and the level of control the firm has over the service provider. In practical terms this means that whilst a written agreement must always be in place, there is considerable flexibility as to the level of detail it should contain.

4.6 *Inability to contract out of responsibility*

See SYSC 8.1.6R above.

It is not possible to contract out of the obligation to comply with these requirements even in circumstances where the client consents to the arrangements or has requested that another firm be used in a specific capacity except where the client contracts separately with the other firm. While the firm remains responsible for ensuring that its regulatory obligations are fulfilled it is not expected to be involved in the day-to-day management of the service provider.

C L I F F O R D C H A N C E

The Implementing Rules do not apply directly to service providers. However, firms must ensure that the service provider provides the firm with a service that allows it to comply with its obligations under the regulatory system.

4.7 *Monitoring of relevant persons*

Glossary

Relevant person: meansa natural person who is directly involved in the provision of services to the *firm* or its *appointed representative* (or where applicable, *tied agent*) under an *outsourcing* arrangement for the purpose of the provision by the firm of *regulated activities*.

[Note: article 2(3) of the *MiFID implementing Directive*]

The broad definition of relevant person means that those individuals directly involved in the provision of services to a firm under an outsourcing arrangement for the purpose of the provision by the firm of regulated activities are caught by a number of requirements under the Implementing Rules (but note that not all individuals providing services to a firm under an outsourcing arrangement are covered). The term relevant person is used throughout the Implementing Rules and, in practice, requires a firm to monitor and impose controls over the behaviour of its service provider's employees more closely than under the pre-MiFID rules. For example, under SYSC 7.1.5R a firm's risk management function will have to monitor the compliance of relevant persons with the firm's risk management arrangements. Under SYSC 5.1.12R, relevant persons will have to be made aware of the firm's procedures relevant to their jobs and under SYSC 6.1.3R(2) a firm's compliance function should be involved in advising and assisting relevant persons to comply with the firm's obligations under FSA Rules. In this regard it may be appropriate for a firm to provide training to relevant persons in order to ensure that they are aware of any actions that may be restricted. Firms should note that under SYSC 10.1.4R the interests of employees of service providers are relevant to their conflicts management obligations.

The Implementing Rules relating to personal account dealing (COBS 12.7) also apply by reference to the term "relevant person". Relevant persons must be made aware of the restrictions on personal transactions and of the measures established by the firm in connection with personal transactions. In relation to outsourcing arrangements, COBS 12.7.4R(2)(b) provides that a firm should ensure that its service providers maintain a record of personal transactions entered into by any relevant persons and provide that information to the firm promptly on request.

4.8 *Termination rights*

See SYSC 8.1.8R(7) above.

Firms are required to ensure that they have the ability to terminate the arrangement for outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients. In practice this means that firms should have the ability to determine the relevant notice period, including the ability to not give notice in appropriate circumstances, and should have contingency plans in place and a clearly defined exit strategy in the event of termination. Firms should agree and document termination rights with the service provider including provision for transition to another provider or to the firm itself (including exit periods) in order to ensure continuity of service and the return of customer related data. Firms should agree and document the ownership of intellectual property following termination and provide for the transfer of information back to the outsourcing firm. Firms should have the right to require cooperation of the service provider upon termination including full access to relevant systems and documentation and should ensure that they have

C L I F F O R D

C H A N C E

adequate information and knowledge regarding the outsourced activities to enable them to either bring the function in house or instruct an alternative service provider should the need arise.

Appendix 1

OUTSOURCING UNDER CRD AND MiFID (LEVEL 1 and LEVEL 2)

CRD

Article 22(1)

Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures

Article 22(2)

The arrangements, processes and mechanisms referred to in paragraph 1 shall be comprehensive and proportionate to the nature, scale and complexity of the credit institution's activities. The technical criteria laid down in Annex V shall be taken into account.

MiFID

Article 13(5)

An investment firm shall ensure, when relying on a third party for the performance of operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis, that it takes reasonable steps to avoid undue additional operational risk. Outsourcing of important operational functions may not be undertaken in such a way as to impair materially the quality of its internal control and the ability of the supervisor to monitor the firm's compliance with all obligations.

MiFID Implementing Directive

Recital 14

For the purposes of the provisions of this Directive requiring an investment firm to establish, implement and maintain an adequate risk management policy, the risks relating to the firm's activities, processes and systems should include the risks associated with the outsourcing of critical or important functions or of investment services or activities. Such risks should include those associated with the firm's relationship with the service provider, and the potential risks posed where the outsourced activities of multiple investment firms or other regulated entities are concentrated within a limited number of service providers.

Recital 18

Competent authorities should not make the authorisation to provide investment services or activities subject to a general prohibition on the outsourcing of one or more critical or important functions or investment services or activities. Investment firms should be allowed to outsource such activities if the outsourcing arrangements established by the firm comply with certain conditions.

Recital 19

For the purposes of the provisions of this Directive setting out conditions for outsourcing critical or important operational functions or investment services or activities, an outsourcing that would involve the delegation of functions to the extent that the firm becomes a letter box entity should be considered to undermine the conditions with which the investment firm must comply in order to be and remain authorised in accordance with Article 5 of MiFID.

Recital 20

The outsourcing of investment services and activities or critical and important functions is capable of

C L I F F O R D
C H A N C E

constituting a material change of the conditions for the authorisation of the investment firm, as referred to in Article 16(2) of MiFID. If such outsourcing arrangements are to be put in place after the investment firm has obtained an authorisation according to the provisions included in Chapter I of Title II of MiFID, those arrangements should be notified to the competent authority where required by Article 16(2) MiFID.

Recital 21

Investment firms are required by this Directive to give the responsible competent authority prior notification of any arrangement for the outsourcing of the management of retail client portfolios that it proposes to enter into with a service provider located in a third country, where certain specified conditions are not met. However, competent authorities are not expected to authorise or otherwise approve any such arrangement or its terms. The purpose of the notification, rather, is to ensure that the competent authority has the opportunity to intervene in appropriate cases. It is the responsibility of the investment firm to negotiate the terms of any outsourcing arrangement, and to ensure that those terms are consistent with the obligations of the firm under this Directive and MiFID, without the formal intervention of the competent authority.

Recital 22

For the purposes of regulatory transparency, and in order to ensure an appropriate level of certainty for investment firms, this Directive requires each competent authority to publish a statement of its policy in relation to the outsourcing of retail portfolio management to service providers located in third countries. That statement must set out examples of cases where the competent authority is unlikely to object to such outsourcing, and must include an explanation of why outsourcing in such cases is unlikely to impair the ability of the firm to comply with the general conditions for outsourcing under this Directive. In providing that explanation, a competent authority should always indicate the reasons why outsourcing in the cases in question would not impede the effectiveness of its access to all the information relating to the outsourced service that is necessary for the authority to carry out its regulatory functions in respect of the investment firm.

Article 13(1)

For the purposes of the first subparagraph of Article 13(5) of MiFID, an operational function shall be regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of an investment firm with the conditions and obligations of its authorisation or its other obligations under MiFID, or its financial performance, or the soundness or the continuity of its investment services and activities.

Article 13(2)

Without prejudice to the status of any other function, the following functions shall not be considered as critical or important for the purposes of paragraph 1:

- (a) the provision to the firm of advisory services, and other services which do not form part of the investment business of the firm, including the provision of legal advice to the firm, the training of personnel of the firm, billing services and the security of the firm's premises and personnel;*
- (b) the purchase of standardised services, including market information services and the provision of price feeds.*

Article 14(1)

Member States shall ensure that, when investment firms outsource critical or important operational functions or any investment services or activities, the firms remain fully responsible for discharging all of their obligations under MiFID and comply, in particular, with the following conditions:

C L I F F O R D

C H A N C E

- (a) *the outsourcing must not result in the delegation by senior management of its responsibility;*
- (b) *the relationship and obligations of the investment firm towards its clients under the terms of MiFID must not be altered;*
- (c) *the conditions with which the investment firm must comply in order to be authorised in accordance with Article 5 of MiFID, and to remain so, must not be undermined;*
- (d) *none of the other conditions subject to which the firm's authorisation was granted must be removed or modified.*

Article 14(2)

Member States shall require investment firms to exercise due skill and care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any investment services or activities.

Investment firms shall in particular take the necessary steps to ensure that the following conditions are satisfied:

- (a) *the service provider must have the ability, capacity, and any authorisation required by law to perform the outsourced functions, services or activities reliably and professionally;*
- (b) *the service provider must carry out the outsourced services effectively, and to this end the firm must establish methods for assessing the standard of performance of the service provider;*
- (c) *the service provider must properly supervise the carrying out of the outsourced functions, and adequately manage the risks associated with the outsourcing;*
- (d) *appropriate action must be taken if it appears that the service provider may not be carrying out the functions effectively and in compliance with applicable laws and regulatory requirements;*
- (e) *the investment firm must retain the necessary expertise to supervise the outsourced functions effectively and manage the risks associated with the outsourcing and must supervise those functions and manage those risks;*
- (f) *the service provider must disclose to the investment firm any development that may have a material impact on its ability to carry out the outsourced functions effectively and in compliance with applicable laws and regulatory requirements;*
- (g) *the investment firm must be able to terminate the arrangement for outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients;*
- (h) *the service provider must cooperate with the competent authorities of the investment firm in connection with the outsourced activities;*
- (i) *the investment firm, its auditors and the relevant competent authorities must have effective access to data related to the outsourced activities, as well as to the business premises of the service provider; and the competent authorities must be able to exercise those rights of access;*
- (j) *the service provider must protect any confidential information relating to the investment firm and its clients;*
- (k) *the investment firm and the service provider must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities, where that is necessary*

C L I F F O R D

C H A N C E

having regard to the function, service or activity that has been outsourced.

Article 14(3)

Member States shall require the respective rights and obligations of the investment firms and of the service provider to be clearly allocated and set out in a written agreement.

Article 14(4)

Member States shall provide that, where the investment firm and the service provider are members of the same group, the investment firm may, for the purposes of complying with this Article and Article 15, take into account the extent to which the firm controls the service provider or has the ability to influence its actions.

Article 14(5)

Member States shall require investment firms to make available on request to the competent authority all information necessary to enable the authority to supervise the compliance of the performance of the outsourced activities with the requirements of this Directive.

Article 15(1)

In addition to the requirements set out in Article 14, Member States shall require that, where an investment firm outsources the investment service of portfolio management provided to retail clients to a service provider located in a third country, that investment firm ensures that the following conditions are satisfied:

- (a) the service provider must be authorised or registered in its home country to provide that service and must be subject to prudential supervision;*
- (b) there must be an appropriate cooperation agreement between the competent authority of the investment firm and the supervisory authority of the service provider.*

Article 15(2)

Where one or both of those conditions mentioned in paragraph 1 are not satisfied, an investment firm may outsource investment services to a service provider located in a third country only if the firm gives prior notification to its competent authority about the outsourcing arrangement and the competent authority does not object to that arrangement within a reasonable time following receipt of that notification.

Article 15(3)

Without prejudice to paragraph 2, Member States shall publish or require competent authorities to publish a statement of policy in relation to outsourcing covered by paragraph 2. That statement shall set out examples of cases where the competent authority would not, or would be likely not to, object to an outsourcing under paragraph 2 where one or both of the conditions in points (a) and (b) of paragraph 1 are not met. It shall include a clear explanation as to why the competent authority considers that in such cases outsourcing would not impair the ability of investment firms to fulfil their obligations under Article 14.

Article 15(4)

Nothing in this article limits the obligations on investment firms to comply with the requirements in Article 14.

Article 15(5)

C L I F F O R D

C H A N C E

Competent authorities shall publish a list of the supervisory authorities in third countries with which they have cooperation agreements that are appropriate for the purposes of point (b) of paragraph 1.

Appendix 2

GLOSSARY

Ancillary Service: any of the services listed in Section B of Annex I to MiFID, that is: (a) safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management; (b) granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction; (c) advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings; (d) foreign exchange services where these are connected to the provision of investment services; (e) investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments; (f) services related to underwriting; and (g) investment services and activities as well as ancillary services of the type included under Section A or B of Annex I related to the underlying of the derivatives included under Section C – 5, 6, 7 and 10, that is (in accordance with that Annex and Recital 21 to, and Article 39 of, the MiFID Regulation): (i) commodities; (ii) climatic variables; (iii) freight rates; (iv) emission allowances; (v) inflation rates or other official economic statistics; (vi) telecommunications bandwidth; (vii) commodity storage capacity; (viii) transmission or transportation capacity relating to commodities, where cable, pipeline or other means; (ix) an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources; (x) a geological, environmental or other physical variable; (xi) any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred; (xii) an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation; where these are connected to the provision of investment services or ancillary services. [Note: article 4(1)(3) of MiFID]

Appointed representative: appointed representative (in accordance with section 39 of the Act (other than an authorised person) who: (a) is a party to a contract with an authorised person (his principal) which: (i) permits or requires him to carry on business of a description prescribed in the Appointed Representatives Regulations; and (ii) complies with such requirements as are prescribed in those Regulations; and (b) is someone for whose activities in carrying on the whole or part of that business his principal has accepted responsibility in writing; and who is therefore an exempt person in relation to any regulated activity comprised in the carrying on of that business for which his principal has accepted responsibility.

Authorisation: means authorisation as an authorised person for the purposes of the Act.

Client: means a person to whom a firm provides, intends to provide or has provided: (a) a service in the course of carrying on a regulated activity; or (b) in the case of MiFID business or the equivalent business of a third country investment firm, an ancillary service. See COBS 3.2 for further details.

Common platform firm: means a firm that is (a) a BIPRU firm; or (b) an exempt CAD firm; or (c) a UK MiFID investment firm which falls within the definition of 'local firm' in article 3.1P of the Banking Consolidation Directive.

Competent authority: means a competent authority for the purposes of the relevant Single Market Directive.

Control: (for a common platform firm) control as defined in article 1 of Directive 83/349/EEC.

Firm: an authorised person, but not a professional firm unless it is an authorised professional firm.(see also GEN 2.2.18 R for the position of an authorised partnership or unincorporated association which is dissolved.)

FSA: means the Financial Services Authority

Group: (in relation to a common platform firm) means the group of which the firm forms a part, consisting of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries hold a

C L I F F O R D

C H A N C E

participation, as well as undertakings linked to each other by a relationship within the meaning of article 12(1) of Directive 83/349/EEC on consolidated accounts.

Listed activity: means an activity listed in Annex 1 to the Banking Consolidation Directive.

MiFID: means Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments.

MiFID implementing Directive: Commission Directive No. 2006/73/EC implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

Outsourcing: means an arrangement of any form between a *firm* and a service provider by which that service provider performs a process, a service or an activity which would otherwise be undertaken by the *firm* itself.

Regulated activity: (in accordance with section 22 of the Act (The classes of activity and categories of investment)) any of the following activities specified in Part II of the Regulated Activities Order (Specified Activities): (a) accepting deposits (article 5); regulated activity (aa) issuing electronic money (article 9B); (b) effecting contracts of insurance (article 10(1)); (c) carrying out contracts of insurance (article 10(2)); (d) dealing in investments as principal (article 14); (e) dealing in investments as agent (article 21); (f) arranging (bringing about) deals in investments (article 25(1)); (g) making arrangements with a view to transactions in investments (article 25(2)); (ga) arranging (bringing about) regulated mortgage contracts (article 25A(1)); (gb) making arrangements with a view to regulated mortgage contracts (article 25A(2)); (h) managing investments (article 37); (ha) assisting in the administration and performance of a contract of insurance (article 39A); (i) safeguarding and administering investments (article 40); for the purposes of the permission regime, this is sub-divided into: (i) safeguarding and administration of assets (without arranging); (ii) arranging safeguarding and administration of assets; (j) sending dematerialised instructions (article 45(1)); (k) causing dematerialised instructions to be sent (article 45(2)); (l) establishing, operating or winding up a collective investment scheme (article 51(1)(a)); for the purposes of the permission regime, this is sub-divided into: (i) establishing, operating or winding up a regulated collective investment scheme; (ii) establishing, operating or winding up an unregulated collective investment scheme; (m) acting as trustee of an authorised unit trust scheme (article 51(1)(b)); (n) acting as the depositary or sole director of an open-ended investment company (article 51(1)(c)); (o) establishing, operating or winding up a stakeholder pension scheme (article 52); (oa) providing basic advice on a stakeholder product (article 52B); (p) advising on investments (article 53); for the purposes of the permission regime, this is sub-divided into: (i) advising on investments (except pension transfers and pension opt-outs); (ii) advising on pension transfers and pension opt-outs; (pa) advising on regulated mortgage contracts (article 53A); (q) advising on syndicate participation at Lloyd's (article 56); (r) managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's (article 57); (s) arranging deals in contracts of insurance written at Lloyd's (article 58); (sa) entering into a regulated mortgage contract (article 61(1)); (sb) administering a regulated mortgage contract (article 61(2)); (t) entering as provider into a funeral plan contract (article 59); (u) agreeing to carry on a regulated activity (article 64); which is carried on by way of business and relates to a specified investment applicable to that activity or, in the case of (l), (m), (n) and (o), is carried on in relation to property of any kind.

Regulatory system: the arrangements for regulating a firm or other person in or under the Act, including the threshold conditions, the Principles and other rules, the Statements of Principle, codes and guidance and including any relevant directly applicable provisions of a Directive or Regulation such as those contained in the MiFID implementing Directive and the MiFID implementing Regulation.

Relevant services and activities: means regulated activities, listed activities or ancillary services (in SYSC 8).

Rule: means (in accordance with section 417(1) of the Financial Services and Markets Act 2000 (Definitions)) a rule made by the FSA under the Act, including: (a) a Principle; and (b) an evidential provision.

C L I F F O R D

C H A N C E

Senior personnel: means those persons who effectively direct the business of the firm, which could include a firm's governing body and other persons who effectively direct the business of the firm.

Tied agent: means a person who, under the full and unconditional responsibility of only one MiFID investment firm on whose behalf it acts, promotes investment services and/or ancillary services to clients or prospective clients, receives and transmits instructions or orders from the client in respect of investment services or financial instruments, places financial instruments and/or provides investment advice to clients or prospective clients in respect of those financial instruments or investment services.