PRINCIPLES ON OUTSOURCING OF FINANCIAL SERVICES FOR MARKET INTERMEDIARIES

NOTICE OF FINAL REPORT, SURVEY AND SUMMARY OF COMMENTS

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Introduction

The IOSCO Technical Committee ("TC") released for publication a final report on *Principles on Outsourcing of Financial Services for Market Intermediaries* ("Outsourcing Principles" or "Report"). The Outsourcing Principles set forth a framework that is designed to assist regulated entities in determining the steps they should take when considering outsourcing activities. The Report also contains some broad principles to assist securities regulators in addressing outsourcing in their regular risk reviews of firms. This report by the IOSCO TC is being released in conjunction with the report of the Joint Forum (IOSCO, Basle Committee on Banking Supervision, IAIS) entitled: *Outsourcing in Financial Services.* The Joint Forum report was prepared in coordination with the IOSCO report and focuses on related cross-sector issues. In the event that further work is warranted, the IOSCO TC and the Joint Forum will continue to work together on issues related to outsourcing.

This Notice describes the background to the publication of the final TC Report, summarizes the comments received by IOSCO from the international financial community, sets out the responses to those comments and identifies changes that have been made as a result of the comments.

I. Background

In October 2003, IOSCO publicly released the *Report on Securities Activity on the Internet III.* This report recommended that the IOSCO Technical Committee review how risks relating to outsourcing should be addressed. In response to this recommendation, at a meeting of the TC held in February 2004, the TC's Standing Committee on the Regulation of Market Intermediaries ("SC3") submitted a draft project specification proposing to prepare a paper on the topic of outsourcing, and to consult with other groups on this issue. TC approved this mandate to work on the issue of outsourcing and consult with other international regulatory bodies and industry officials.

Following this TC decision, an SC3 drafting team prepared a set of principles on the issue of outsourcing and consulted with other international regulatory bodies on this issue. A Consultative Draft of the principles on outsourcing was approved by the IOSCO TC in July 2004 and published on the IOSCO website in August 2004. During the September – October 2004 period, various members of SC3 surveyed industry participants in their respective jurisdictions for information regarding current outsourcing practices. Following the receipt of comments by the public, SC3 revised the Consultation Report and the TC approved the Report during its 31 January and 1 February 2005 meeting. This paper sets forth a summary of the comments received by SC3 and the response of SC3 with respect to those comments. The TC has reviewed this summary of comments and has approved its publication concurrent with the release of the Outsourcing Principles on the same date.

II. Comments on the IOSCO Outsourcing Principles

In general, the comments were favorable. For example, a U.S. based SRO stated that the principles address the "significant regulatory concerns" raised by outsourcing, without unduly interfering with an intermediary's judgment. Nonetheless, there were specific comments on a number of areas. This report focuses on those issues where there were multiple comments on the same topic.

A. Outsourcing Definition

Comments:

A number of commenters expressed the view that the definition of outsourcing in the IOSCO principles is too broad. Some Australian firms noted that the definition could cover a wide range of activities from IT product development and support to office cleaning contracts. A number of French firms indicated that the principles should only cover functions or activities that are part of the main activity of the regulated firm, which it might otherwise do itself. These French firms commented that they also viewed the outsourcing definition as problematic, with different groupings defining the term in different ways. A Singapore firm also felt that the definition was too broad, and that it would be difficult to determine whether in fact a function had been "outsourced." A U.S. trade association asserted that the definition of "outsourcing" should be limited to the transfer of functions that directly impact the outsourcing firm's operational risks or ability to meet regulatory requirements. It felt the current definition, which covers topics as diverse as cafeteria and travel service, is too broad and are tangential to the firm's client business.

There were also some commentators who prefer the definition set forth by the Committee of European Banking Supervisors (CEBS). French firms noted that the CEBS definition excludes purchasing contracts from the definition of outsourcing, which they view as appropriate. They also propose that the term apply only to core functions.

A U.S. firm commented that the definition should not include the provision of non-customized services, particularly custodial arrangements for securities. It notes that securities custodians are regulated themselves in many jurisdictions, and that the service is mature and well understood. Moreover, the U.S. firm believes that, consistent with Basel II, there should be a recognition that outsourcing by one regulated entity to another poses less risk than outsourcing to an unregulated entity.

Similarly, the French firms would exclude custodial arrangements, along with such arrangements involving other brokerage firms or a clearing member. The French firms commented in this regard that outsourcing should only include activities where the service provider is not acting in its own name and the outsourcing firm remains fully accountable to its regulators for the delegated activities. In their view, outsourcing should not include cases where liability is transferred contractually to the service provider and the service provider acts in its own name relative to third parties, and where the service provider assumes liability, independent of the outsourcing firm, to both customers and regulators. This view is similar to the view expressed by the Australian firms (*see below*, sections on accountability and cross-border outsourcing).

Finally, a U.S. trade association stated that the report should clarify that the term "outsourcing" refers to the transfer from a regulated firm to a service provider of a function where management of the function is transferred with the function. For example, a U.S. trade industry association does not believe that the term should include arrangements where consultants are hired to provide additional resources on teams led and managed by the firm. In such cases, since the firm retains management responsibility, the risks to the firm do not change materially, regardless of whether particular outside resources are used.

Response:

The TC considered each of these comments regarding the definition of outsourcing. In general, the TC believes that a broad definition of the term outsourcing is appropriate, particularly in light of the fact that the paper expressly states that the materiality of the function being outsourced will affect the applicability of the outsourcing principles. Thus, the definition of outsourcing will continue to cover a range of functions, from relatively non-material items such as the provision of janitorial services, to material activities such as the provision of information technology and back-office services.

In light of the comments received, however, the TC has made a number of revisions in the final Report. First, the Introduction has been amended to further emphasize that the Principles should be applied according to the degree of materiality of the function being outsourced. Second, the Outsourcing Principles now explicitly state that outsourcing does not cover purchasing contracts, which is defined as the acquisition from a vendor of services, goods or facilities without the transfer of the purchasing firm's non-public proprietary or customer information. The TC believes such an exclusion is warranted, and is also aware that in providing such an exclusion, the IOSCO definition of the word "outsourcing" will be consistent with that of other international regulatory bodies, including the Joint Forum and the CEBS.

With respect to the issue of outsourcing to another registered entity, the TC determined that the issue was already adequately addressed, since the regulatory status of the service provider is already one of the materiality factors. Finally, the TC agrees with the U.S. industry association comment that the hiring of individuals to provide technical expertise on operations managed by the regulated entity does not necessarily fall within the definition of "outsourcing."

B. Intra-Group Outsourcing

Comment:

There were numerous comments on the issue of intra-group outsourcing. French firms suggested that intra-group outsourcing should not be covered by the principles, but should be considered the responsibility of the group. Hong Kong firms believe that the principles should focus on third party service providers, since outsourcing within a corporate group does not generally raise concerns or specific risks where consistent policies and procedures are applied. By contrast, a U.S. firm welcomed the inclusion of intra-group outsourcing within the definition of outsourcing, and noted that such arrangements do not necessarily reduce operational risk or cost to end-users and investors. A number of Australian firms felt there was some ambiguity in the

extent to which the principles would apply where they outsourced activities to affiliates, since the Principles indicate that not all would apply when outsourcing to an affiliate. These Australian firms also raised the issue of custodians, noting that the service provider cannot, as a practical matter, seek consent from each outsourcing firm before appointing new sub-custodians.

A U.S. trade association believes that the focus should be on the firm's global policies and management controls. This trade association suggests that, where service requirements between affiliates are established and managed, effective corporate governance will ensure that service levels are enforceable, and that therefore, the formality of a written contract adds no value in such instances.

Response:

The TC has considered the comments. In light of the fact that the Outsourcing Principles already provide that "risks may not be as pronounced within a corporate group," and the fact that affiliation between the outsourcing firm and service provider is one of the materiality factors, no further revisions to the Report are deemed necessary. Outsourcing firms may adapt these Outsourcing Principles to the extent they use an affiliated service provider.

C. Accountability and Scope of Outsourcing Principles

Comments:

Some Australian firms viewed the principles as too prescriptive. As examples they cite some of the "means for implementation," such as the list of items under Topic 2, dealing with the contract with the service provider. In general, these firms would prefer a principles-based approach, as opposed to what they see as strict rules. Some Canadian firms expressed a similar concern, expressing a desire for "flexible" principles. On the other hand, a group of French firms stated that outsourcing should be subject to strict rules, which should never be differentiated according to the location of the service provider.

Some Australian firms were also concerned about the apportionment of liability. Using as an example the case of a securities dealer who obtains expert advice from another registered entity involving a hedging strategy using derivatives, these firms contend that it is not fair that the outsourcing firms might be subject to liability, since the reason the firm outsourced this activity in the first place was because the firm believed it did not have the expertise to perform the function. In such cases, particularly taking into account the fact that the service provider is regulated, these firms do not believe the outsourcing firm should be responsible for the performance of the other regulated entity.

Response:

The TC believes that the Principles are worded in a way to allow flexibility. In this regard, the means for implementation under each Principle provides a menu of *options* for firms (and, in some cases, regulators), to consider with respect to how to adapt the Principles to particular circumstances. They are explicitly – and deliberately – worded in a non-prescriptive fashion.

With respect to the issue of liability apportionment, the TC believes this is an issue of national law, beyond the scope of this project.

D. Outsourcing on a Cross-Border Basis

Comments:

As indicated above, a group of Australian firms noted that where a global custodian appoints sub-custodians, it would be difficult to assess the entity's ability to comply with applicable laws, which is the primary reason to use sub-custodians in the first place. A U.S. firm noted that the principles should further emphasize that "off-shoring" is a means of achieving a better level of service and reducing costs to investors, whether it is an intra-group or inter-group arrangement. Similarly, some Australian firms noted the potential diversification benefit from outsourcing to overseas providers.

French firms believe that outsourcing within the EU should not be considered cross-border outsourcing, rather it should be considered as a domestic area.

Response:

The TC believes that it is appropriate that custodial services fall within the definition of outsourcing, but that the topic of materiality is applicable in this instance. In particular, it is the view of the TC that a registered, supervised entity such as a sub-custodian may require less application of these principles than other types of outsourcing. As noted above, the issue of liability apportionment with respect to the application of a particular custodial arrangement will likely remain an issue of national law, beyond the scope of these principles. The issue of whether outsourcing within EU member states should be considered outsourcing on a cross-border basis is best left to the EU countries themselves, and will depend in part on the level of integration of financial supervision on an EU-wide level.

Topic 1—Due Diligence

Comments:

A group of French firms warned that the topic should not be burdened with too many requirements on service providers, taking into account the fact that there is no guarantee that they would be selected in the end. Similarly, some Japanese firms also expressed concern about imposing too many due diligence requirements, which could increase the cost and the possible concentration risk in outsourcing.

A U.S. trade association believes that the current language suggests that an outsourcing firm is responsible for identifying where a service provider is not in compliance with laws and regulatory requirements in the service provider's home jurisdiction, even for activities not associated with the outsourcing firm. The trade association believes that the language should be

re-worded to clarify that the duty of the outsourcing firm to report violations is limited to services performed for or on behalf of the outsourcing firm.

Response:

The TC is cognizant of the concern expressed by some that outsourcing of various functions not be encumbered unnecessarily by too many requirements in order to maintain the possible cost efficiencies that might arise in a given outsourcing arrangement. It is the view of the TC that the existing principles provide sufficient flexibility to ensure that regulatory requirements can be maintained without undue burdens on firms that might wish to consider an outsourcing arrangement. However, the TC recognizes that in certain instances, the cost of meeting appropriate regulatory requirements may be a factor that an outsourcing firm should take into account when considering the feasibility of outsourcing the function.

With respect to the concern expressed by the US trade industry group, it is the view of the TC that the existing language in the Outsourcing Principles already makes clear that the Principles only address the outsourcing firm's responsibility to report to its financial regulator breaches of law or regulation by a service provider that are directly related to the outsourcing.

Topic 2 – Contract with a Service Provider

Comments:

A group of Japanese firms did not view it as practical to require the outsourcing firms to monitor the sub-contractor. A group of French firms indicated a similar concern.

A number of French firms suggested that requirements for contracts should not be so detailed as to hamper the necessary evolution of the contract over time with the service provider. An Australian trade association indicated a similar concern.

Response:

The TC notes that the existing draft does not allocate liability amongst the service provider and the sub-contractor. The TC recognizes this concern, and has therefore decided to revise the third bullet of the contract section, which previously discussed only the responsibilities of the outsourcing firm and that of the service provider. As rewritten, this bullet now clarifies that the responsibilities of sub-contractors should also be included, where relevant. In order to address the concerns of commenters from Japan, France and other jurisdictions that it is impractical to assume that the outsourcing firm imposes complete supervision over the subcontractor, the TC recognizes that the primary issue is that the outsourcing firm is responsible for assuring that its regulatory obligations are fulfilled. The outsourcing firm is not expected to be involved in day-to-day management of the service provider or the subcontractor.

Topic 3 – IT Security and Business Continuity

Comments:

One commenter noted that it is not clear which regulatory authority should be the recipient of regulatory reporting that is an option in this section, and that reporting to an overseas regulator may not be feasible due to legal provisions. French firms believe that materiality of the activities should be key to any requirements. These firms also note that the principles raise a question of compliance in instances where the outsourced service is itself IT security.

Response:

In response to the concern raised, the TC has revised the final bullet to state specifically that it is the outsourcing firm – not the service provider – that may be obligated to provide regulatory reporting to the regulator of the outsourcing firm. To be sure, the outsourcing firm may need to contractually require information from the service provider to fulfill this obligation, and the outsourcing firm may not escape its obligations based on an inability of the service provider to provide such information.

Topic 4 – Client Confidentiality

Comments:

Some U.S. firms strongly object to the statement that outsourcing firms should consider whether it is appropriate to notify customers that customer data may be transmitted to a service provider. They view the proposal as impractical, and are concerned that while framed in optional language, it may become mandatory at a later time. A U.S. trade association noted that the report seemed to be imposing requirements that went beyond what national laws required. A group of French firms noted that national laws and regulations largely subsume the principle. These French firms also stated that the notification of the client should not be a regulatory requirement as it is part of the commercial relationship of the firm with its clients, and the firm is in the best position to judge what it should tell its clients on the means put in place to offer a service.

Response:

The TC believes that the existing language asking the firms to consider regulatory requirements and whether notification of customers is appropriate does not rise to the level of a mandate, nor should it be seen as such.

Topic 5 – Concentration Risk

Comments:

A group of Australian firms expressed some concern that the principle may not be viable in smaller countries, where there is limited competition for services. Moreover, there is a concern expressed about whether it is feasible for the regulator to take appropriate actions in the case of concentration risk, as the users of the service may not have a viable alternative.

A group of French firms rejects the idea that there should be publication of client lists. These French firms take the view that concentration in the custodian industry is inevitable and it is not possible for firms to have an influence on this trend. A strict application of the recommendation that outsourcing firms should take steps to ensure that the service provider has adequate capacity to meet the needs of all outsourcing firms would require the service provider to publish list of its clients, which they view as possibly compromising confidentiality and security.

Response:

In response to the concerns raised by some that a certain degree of concentration risk may be inevitable, particularly in smaller jurisdictions, the TC has already acknowledged that there are in fact a number of reasons why a single service provider may be utilized by numerous firms in a given country or reason. The existing principle on concentration risk is not intended to prohibit concentration. Rather, it sets forth additional measures that should be undertaken where concentration risk exists (*e.g.,* measuring the capacity of the service provider to meet the needs of all outsourcing firms, even where unusual circumstances exist.) These measures do *not*, however, include a requirement that service providers make publicly available a list of their clients.

Topic 6—Termination Procedures

No Comments received

Topic 7– Books and Records

Comments:

A group of French firms noted that while outsourcing arrangements should not prevent an outsourcing firm from complying with its duties and obligations towards regulators, in practice it might be difficult for firms to have immediate access to information held by service providers in cases where there are multiple service providers. These French firms also noted cost constraints if books and records were required to be maintained in the jurisdiction of the outsourcing firm.

Response:

The TC believes there may be instances in which a potential outsourcing arrangement would make it difficult or impossible for the outsourcing firm to comply with regulatory requirements in its home jurisdiction. In such cases – for example, where regulatory provisions in the service provider's jurisdiction would make it impossible for the outsourcing firm to comply with its own regulatory requirements – the TC believes that the outsourcing firm may not enter into that outsourcing arrangement. Moreover, firms should factor in the extra costs involved when making a decision as to whether or not to enter into an outsourcing arrangement.