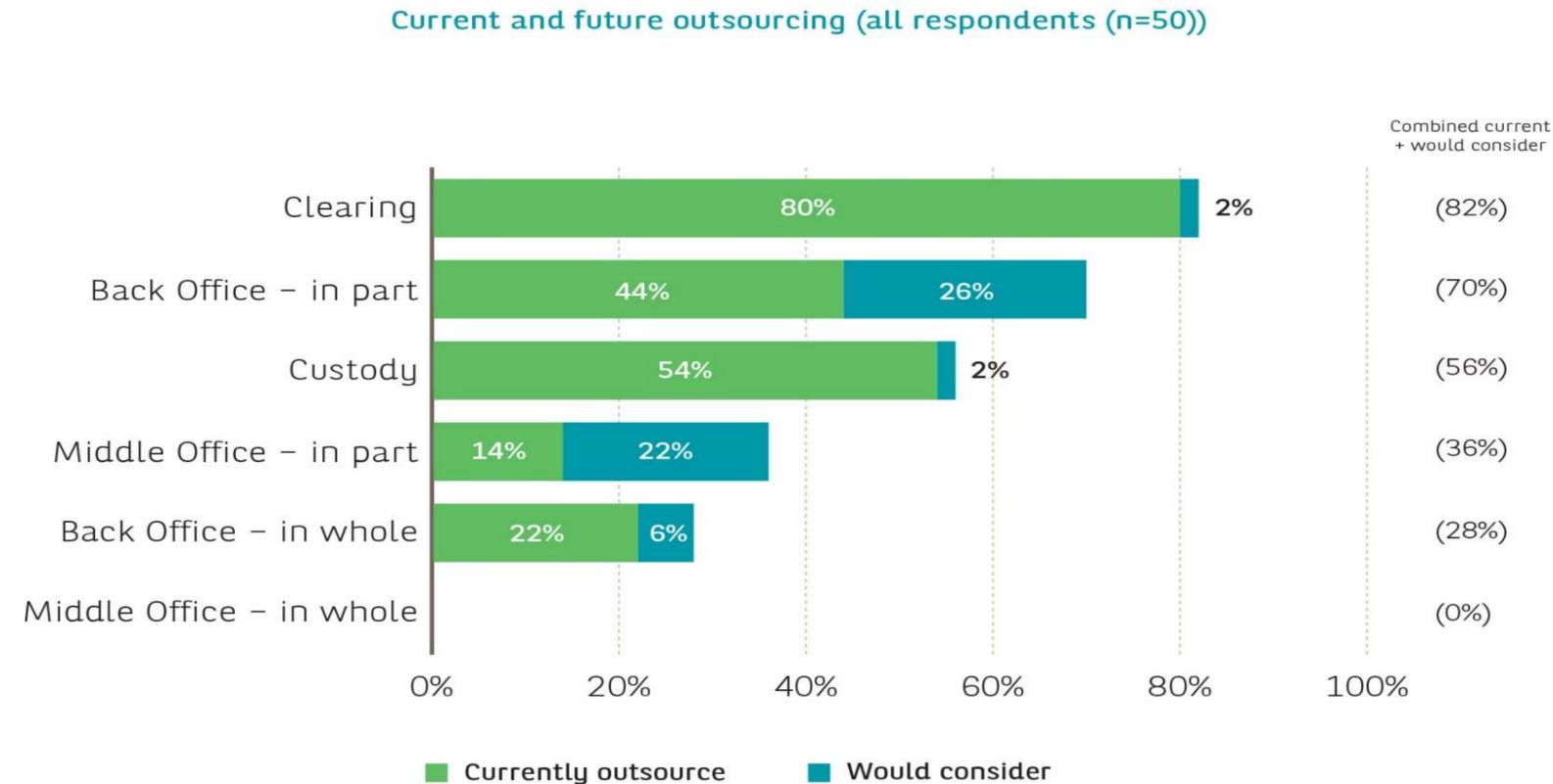


**If your business depends
on technology, you can
depend on us.**

Insights into
managing regulated
outsourcing in
financial services

09 / 06 / 2015

YouGov survey for BNP Paribas of 50 UK leading sell side firms



- 86% of respondents outsource to some degree
- 20% outsourcing their entire back office
- 78% outsource as a strategic, long term strategy to help focus on core activity, as opposed to only 4% focused on cost saving

IT Outsourcing

- 49% of banks plan to increase the use of IT outsourcing during 2015
- Only 9% of the banks said they will reduce IT outsourcing

research by Finextra

Banks

Last updated: August 28, 2014 6:15 pm

Deutsche Bank fined £4.7m by FCA over reporting blunders

By Daniel Schäfer in London

Share Author alerts Print Clip Comments



[Deutsche Bank](#) has been fined £4.7m in the UK for inaccurately reporting more than 29m transactions to the City regulator, exposing yet another setback to the lender's efforts to improve its reporting structures.

Germany's largest lender failed to report correctly all its transactions of a certain type of equity derivative in a six-year period between 2007 and 2013, the UK's [Financial Conduct Authority](#) said on Thursday.



The inaccuracies were down to a software coding error which prompted [Deutsche Bank](#) to misreport all of the bank's sales of these products as purchases and vice versa.

More

ON THIS TOPIC

[Deutsche Bank to create innovation hubs](#)

[Unravelling 'gap risk' at Deutsche Bank](#)

Transaction reporting has been a particular area of focus for regulators in the UK as well as the US, as they use the aggregated data to spot insider trading and market manipulation.



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FCA fines RBS, NatWest and Ulster Bank Ltd £42 million for IT failures



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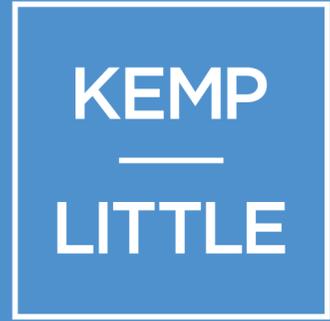


Agenda

- Introduction - Paul Hinton (paul.hinton@kemplittle.com)
- Regulatory Backdrop - Lucy Frew (lucy.frew@kemplittle.com)
- Practical Compliance and Contracting - Paul Hinton
- Contract Drafting Issues - Paul O'Hare (paul.ohare@kemplittle.com)

Also joining us for the panel discussion

- Josephine Harriman – Morgan Stanley
- Andy Nelson – Kemp Little Consulting



Let's start with a quick survey to gauge your thoughts on outsourcing.....

What has been the main driver leading to you considering outsourcing business functions?

1. to take advantage of better technology and services
2. reduce cost
3. to aggregate services and obtain centralised efficiency
4. reduce risk and error
5. other

What do you perceive to be your firm's biggest risks in relation to outsourcing?

1. service failure
2. data leak
3. exit
4. regulatory breach
5. other

What are your firms biggest challenges when dealing with outsourcing compliance?

1. scale – global issues and multiple internal inputs
2. risk assessment
3. additional cost in time and people
4. lack of strategic clarity
5. other

Have your firm's outsourcing arrangements been subject to increased focus and scrutiny by regulators in the last 2-3 years?

1. No - there has been a decrease
2. No - the same level
3. Yes - there has been a moderate increase
4. Yes - there has been significant increase
5. Don't know



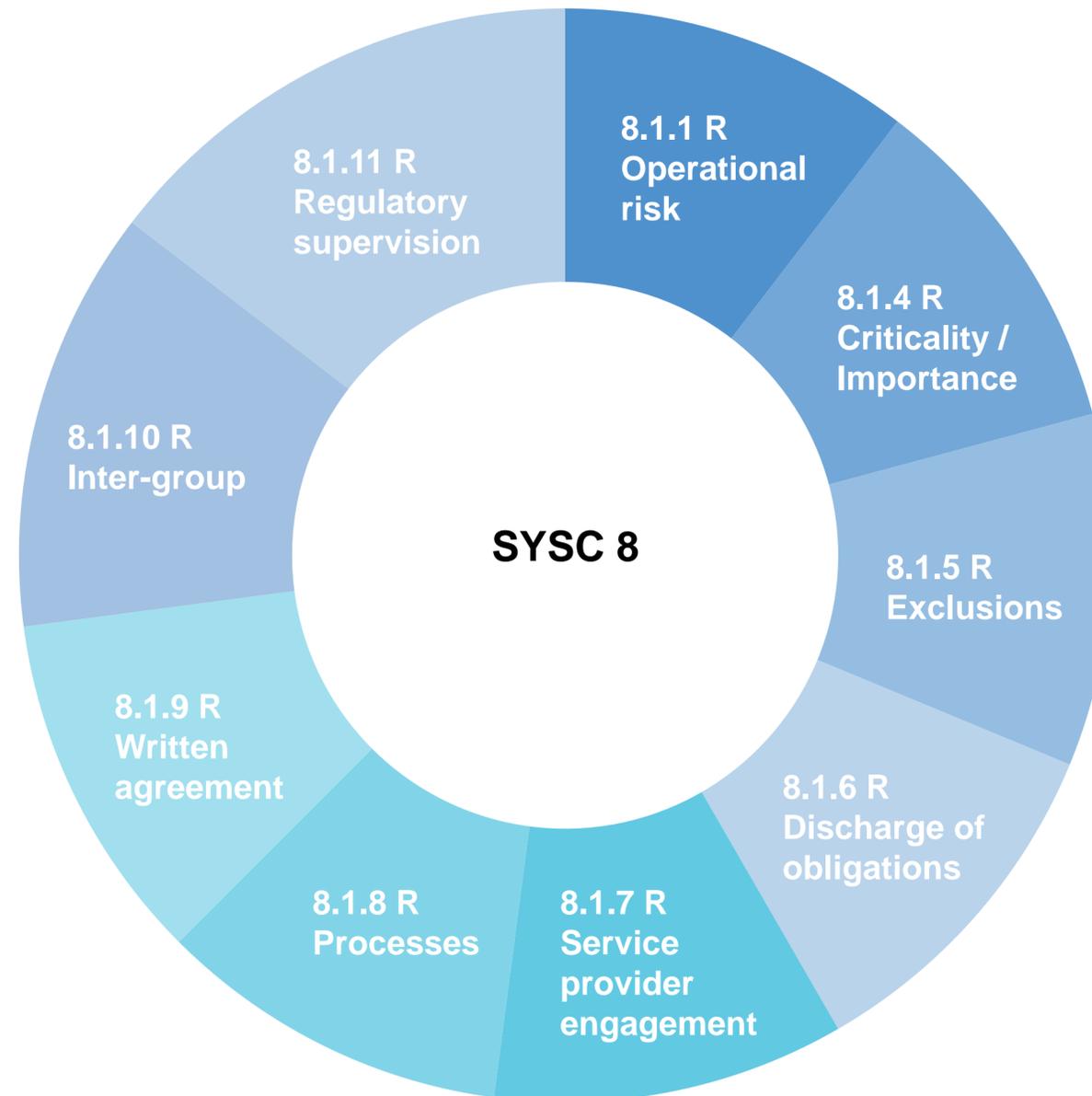
Regulatory backdrop

What Handbook sources do you need to be aware of?

The PRA and FCA Handbooks

- Principle 3, Threshold Condition 5
- Rules and guidance related to outsourcing by all authorised firms are scattered across the Regulators' Handbooks but in particular the Senior Management Arrangements, Systems and Controls ("SYSC") sourcebook.
- Additional requirements relate to:
 - banks, building societies and investment firms under SYSC 8
 - insurers under SYSC 13
 - outsourcing of home finance and insurance mediation activities to third party processors under MCOBS and ICOBS
 - recognised investment exchanges and auction platforms under REC 2.2
 - alternative investment fund managers under FUND 3.10
 - managers, directors and depositaries of UCITS under COLL 6.6

Key requirements of SYSC 8



Outsourcing operational functions

SYSC 8.1.1 R

A firm must:

- when relying on a third party for the performance of operational functions which are critical for the performance of regulated activities, activities listed in Annex 1 of the CRD (2013/36/EU) or ancillary services listed in Section B of Annex I to MiFID (in SYSC ‘relevant services and activities’) on a continuous and satisfactory basis, ensure that it takes reasonable steps to avoid undue additional operational risk
- not undertake the outsourcing of important operational functions in such a way as to impair materially:
 - the quality of its internal control; and
 - the ability of the appropriate regulator 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

What is “critical or important”? SYSC 8.1.4 R

An operational function is regarded as “critical or important” if a defect or failure in its performance would materially impair:

- the continuing compliance of the 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

What is not “critical or important”? SYSC 8.1.5 R

Without prejudice to the status of any other function, the following functions will not be considered as critical or important for the purposes of SYSC 8:

- 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
- the purchase of standardised services, including market information services and the provision of price feeds
- the recording and retention of relevant telephone conversations or electronic communications subject to COBS 11.8.4R

What other sources do you need to be aware of?

Regulatory investigations and enforcement action

For example:

- UNAT Direct Insurance Management Limited
- Zurich Insurance Plc
- Stonebridge International Insurance Limited
- Lloyd Pope and Peter Legerton, former directors of TailorMade Independent Ltd

EU legislation and regulation

For example

- AIFMD
- UCITS IV
- MiFID and incoming MiFID II/MiFIR

Thematic reviews and other sources

- FSA's 'Offshore Operations: Industry Feedback' report on offshore operations published by the FSA in April 2005
- FCA's Thematic Review TR13/8: The governance of unit-linked funds
- FCA's 'Dear CEO letter' of 11 December 2012 to the CEOs of Asset Managers
- FCA's Thematic Review TR13/10: Outsourcing in the asset management industry
- FCA's 'Considerations for firms thinking of using third-party technology (off-the-shelf) banking solutions'
- FCA's Risk Outlook 2014

MiFID II / MiFIR

Impact on outsourcing obligations

- SYSC 8 implements MiFID and the Level 2 MiFID Implementing Regulation.
- Member states must adopt and publish by 3 July 2016 the measures transposing the MiFID II Directive into national law, and must apply those provisions from 3 January 2017 – MiFIR will apply from the same date.
- MiFID II article 16(5) is identical to the current 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 II / MiFIR Level 2

- In its Consultation Paper on MiFID II/MiFIR dated May 2014, ESMA stated that:
“Considering that Article 16(2) of MiFID II consists of an identical recast of Article 13(2) of MiFID I, ESMA is of the view that the existing requirements set out in the MiFID Implementing Directive constitute a robust basis from which to build the provisions.”
- However, in December 2014, ESMA published final technical advice to the Commission and a consultation paper on MiFID II / MiFIR with draft regulatory technical standards and implementing technical standards at Annex B.
- Delay to finalisation and adoption by ESMA of the draft technical standards, delaying submission until September 2015 (instead of July 2015).

MiFID II Level 2

- ESMA's consultation proposes various outsourcing requirements for firms and market operators operating an MTF or OTF
- In ESMA's draft RTS there are additional outsourcing requirements applicable to:
 - outsourcing or procuring any software or hardware which is used in trading activities by investment firms engaged in algorithmic trading
 - regulated markets
 - multilateral trading facilities
 - organised trading facilities
 - data reporting services providers
- UK's proposed approach to the third-country regime for retail and elective professional clients under article 39 of MiFID II

The FCA's perimeter concerns

- Incoming regulatory trend – focus on the increasing interconnectedness of regulated and non-regulated activities.
- In the FCA's Risk Outlook 2014 it recognises that some financial sector businesses “*rely on technological systems of firms that are emerging outside the perimeter*”.
- It suggests that these unregulated entities can “*pose risks to market integrity and consumer protection through technological interfaces with regulated activities. These activities may have the potential to create systemic and financial crime risks that would be outside [the FCA's] perimeter*”.

Risks of outsourcing arrangements being perceived as not up to standard

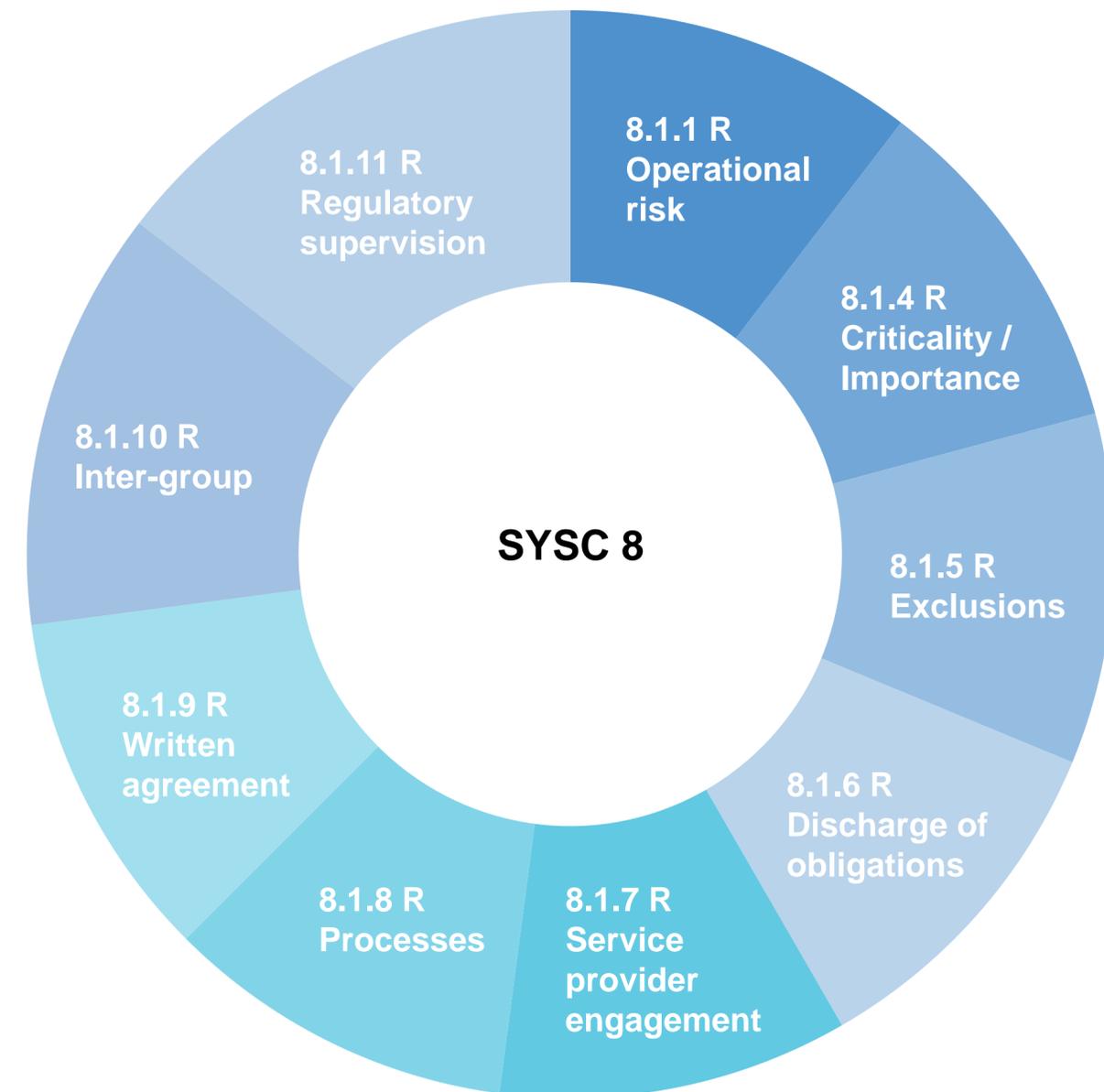
- Regulators may investigate themselves or use their powers to commission a report by independent external experts (“Skilled Persons” under section 166 of FSMA) – with costs borne by the firm
- Regulators also have an extensive range of disciplinary, criminal and civil powers to take action against regulated and non-regulated firms and individuals who are failing or have failed to meet the standards they require
- Regulators can take action even if there is no substantive damage
- The reputational risk arising from enforcement action and consequential business losses may be at least as damaging as the action itself
- Regulators are focussing on senior management responsibility – for outsourcing and generally. Regulators are requiring individuals to attest to the compliance of the a firm’s outsourcing arrangements



Practical compliance and
contracting

Key requirements of SYSC 8

5 practical points



1. Senior management focus SYSC requirements

“

A firm must ... must ensure that senior personnel and, where appropriate, the supervisory function are responsible for ensuring that the firm complies with its obligations under the regulatory system ... and must assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the regulatory system and take appropriate measures to address any deficiencies.

”

SYSC 4.3.1 R

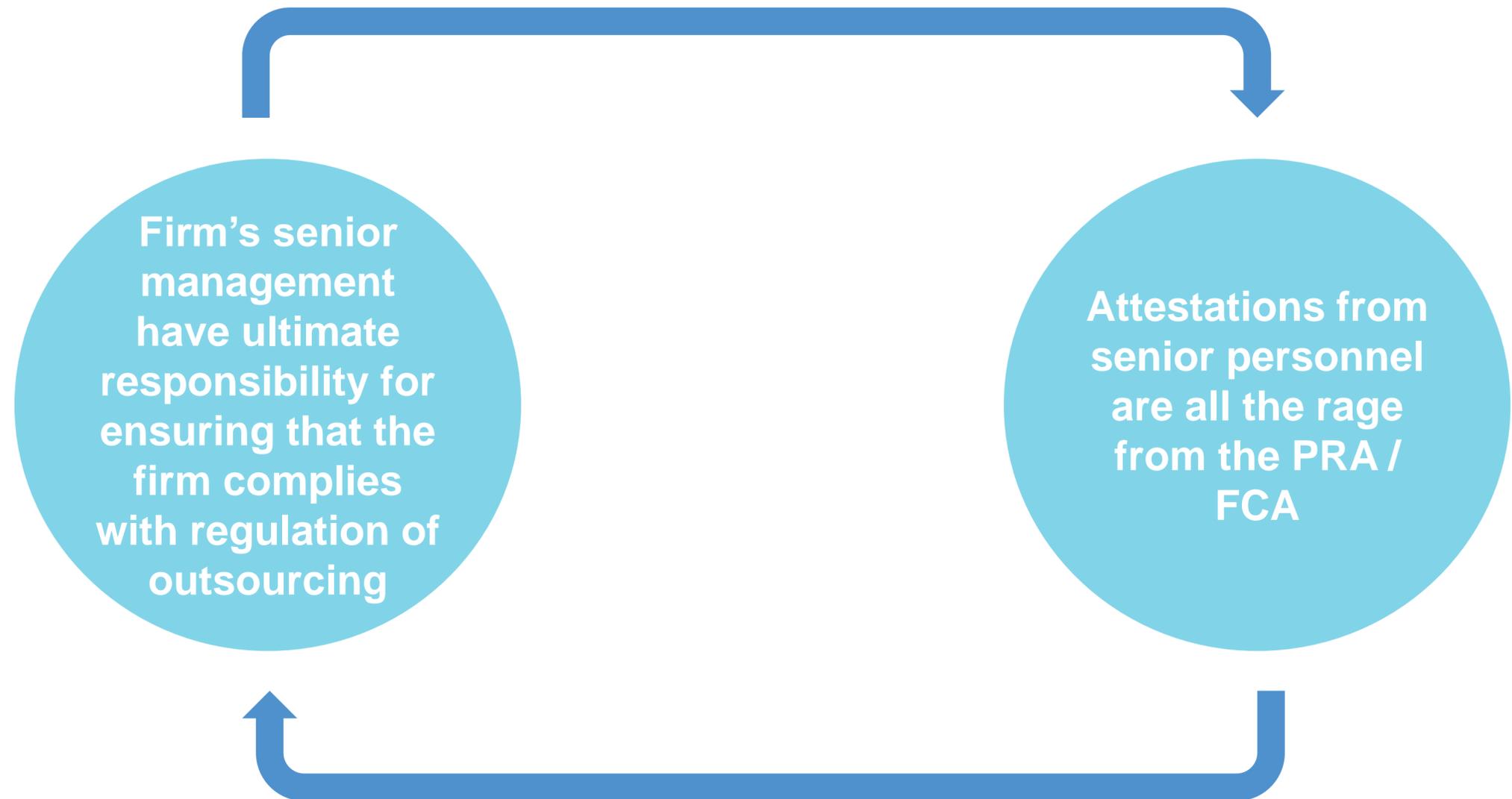
“

If a 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 condition[s] [that] the outsourcing must not result in the delegation by senior personnel of their responsibility ...

”

SYSC 8.1.6 R

1. Senior management focus



2. Strategic outsourcing policy SYSC requirements

“

The management body ... must approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the firm is or might be exposed to ...

”

SYSC 7.1.4 R

“

A firm must have ... effective processes to identify, manage, monitor and report the risks it is or might be exposed to[,] and internal control mechanisms...

”

SYSC 4.1.1 R

“

A firm must ... ensure that it takes reasonable steps to avoid undue additional operational risk...

”

SYSC 8.1.1 R

2. a) Senior strategic outsourcing policy

Expectation that senior management have given clear strategic direction in the form of a written policy which provides clear direction on:

- what can and can't be outsourced
- what is considered “critical or important”
 - SYSC 8.1.4 R
 - SYSC 8.1.5 R
- each firm to take its own view and there will be variations

Must ensure consistent interpretation and operation throughout the business

2 b) Implementation policy

Address governance and organisational roles and responsibilities in:

- the firm
- the business unit when outsourcing
- When managing outsourced relationships

Appropriate level of expertise must be retained to enable effective oversight of the outsourced services

The real challenge can be in co-ordinating teams / inputs and information on a global basis in a fast, efficient, consistent and compliant manner

International question – highest standard to apply?

2 b) Implementation Policy Contents

Process and standards for:

- risk assessment
- governance
- approvals process
- due diligence on suppliers
- contracts – minimum standards
- policies and standards for key issues e.g. BC/DR
- ongoing monitoring and oversight
- remediation
- reporting back up to board level and regulator
- change and updating the policy
- training in the policy / procedure
- testing of the policy
- critical outsourcing inventory kept

3. Risk assessment SYSC requirements

“

A firm must 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 internal control mechanisms

”

SYSC 4.1.1 R

“

A firm must establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment, which identify the risks relating to the firm's activities, processes and systems, and where appropriate, set the level of risk tolerated by the firm

”

SYSC 7.1.2 R

“

A firm must adopt effective arrangements, processes and mechanisms to manage the risk relating to the firm's activities, processes and systems, in light of that level of risk tolerance

”

SYSC 7.1.3 R

3. Risk assessment

- A documented outsourcing risk appetite assessment policy:
 - statements regarding the firm's outsourcing risk tolerance
 - alignment with firm's operational risk framework, e.g. Internal Capital Adequacy Assessment Process
- Criticality of each outsourced service consistently assessed based on the firm's definition and criteria
- Concentration and big picture group wide / supplier risks considered and identified
- Initial and periodic reassessments of individual and aggregated risks
- Appropriate mitigating actions to reduce residual risk to acceptable levels – formal risk acceptance where appropriate as part of the approval process
- Accountability for risk management must not be outsourced

4. Intra-group SYSC requirements

SYSC 8.1.10 ...the firm may take into account the extent to which it controls the service provider or has the ability to influence its actions.

Some firms have heavily relied on this and assumed intra-group outsourcing can be light touch from a risk perspective.

“

If a firm and the service provider are members of the same group, the firm may, for the purpose of complying with SYSC 8.1.7 R to SYSC 8.1.11 R 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.

”

SYSC 8.1.10 R

4. Intra-group FCA approach

FCA's Thematic Review TR13/8: unit-linked funds identified failings in the oversight of outsource service providers in approximately 50% of the sample:

- 2 of issues arose from intra-group arrangements
 - an ‘informal’ reliance on group control functions to provide assurance on the effectiveness of controls... This approach generally relied on personal relationships as opposed to specific, clear engagement ... a firm should not assume that because an outsource service provider is an intra-group entity an outsourcing arrangement with that provider will, in itself, necessarily imply a reduction in operational risk
 - deficiencies in circumstances where oversight was not direct – for example, where one outsource service provider was overseeing another. These ‘chains’ of outsource service providers led to gaps in accountability which posed risks to customers

4. Intra-group issues

- Has an objective assessment of the service been made or was it simply expedient?
- If outsourcing to a parent can the customer effectively dictate requirements to the parent?
- Lack of focus on the paperwork
- Intra-group outsourcing needs to be considered and documented with the same rigour as external outsourcing unless there are documented and clear rationales for not doing so

5. Procurement and contracting

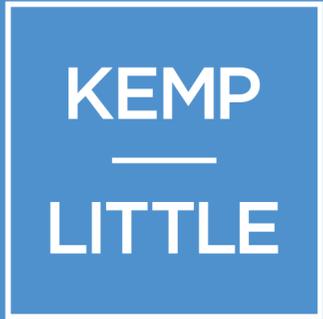
As early as possible and before RfP:

- Identify whether it is a critical outsource
- Complete risk assessments
- incorporate key points as requirements
- identify suggested mitigations or ask suppliers in RfP as to how they might offer fixes
- draft the contract in light of the above
- A failure to do this can undermine successful procurement and negotiation
- Document how each obligation risk /has been met

Procurement and contracting

Don't forget the commercial and business risks:

- Clear Strategy and Objectives
- Clear Scope and Business Requirements
- Understand the Market
- Effective Procurement Process
- Get the Pricing Right
- Incentivising service improvement and cost savings
- Commercial and Operational Skills are Key
- Never Forget the Humans
- Post Contract – the obligations are ongoing
 - Revisit the risks and mitigations
 - Change control



Contract issues: effective
exit planning

Exit planning – why does it matter?

Regulatory requirements/concerns

- SYSC 8.1.8(7): “*[firms] 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*”
- FCA ‘Dear CEO’ letter to asset management firms – concerns about the ‘considerable operational challenges inherent in a transfer’ to another outsource provider (Dec 2012)
- FCA thematic review – outsourcing in the asset management industry (Nov 2013)
 - IMA white paper response (May 2013)
 - Outsourcing Working Group (OWG) response (Dec 2013)

Exit planning – why does it matter?

Commercial drivers – cannot assume that supplier will co-operate on exit

- May provide leverage in any dispute
- Likely to involve co-operation with competitor
- Final opportunity to improve cash position
- Nothing to lose – if acrimonious exit

Vs

- Potential of future business
- Damage to reputation

Recent indications that suppliers may be less concerned about reputational damage

- H3G v Ericsson
- AstraZeneca v IBM

Exit planning: pre-contract considerations

- Cover supplier approach to exit in RFP
- Include supplier responses in contract
- Customer due diligence - exit references from former customers
- Consider (cold/warm) back-up/standby servicer arrangements (as per securitisation market)

Exit planning: transition

- Agreeing baseline exit plans:
 - If can't agree before contract signature (i) include exit principles in contract, and (ii) ensure exit plans are transition milestone deliverables
 - Separate plans for planned and emergency exits
 - Single and multiple customer exits

- Establishment of supplier user forum – to mitigate against risks of supplier financial distress scenarios

Exit planning: ongoing contract governance

- Regular testing and updating of exit plans – supplier and customer dependencies
- Up to date process manuals/databases (dealing with the ‘what, who and how’)
 - Monitoring and QA rights
 - Incentives to ensure testing, updating and reporting actually happen
- Regular supplier financial reporting and health checks
- Terms to minimise supplier/technology lock-in risk
 - Restrictions on introduction of supplier proprietary tools and processes

Exit phase

- Be realistic about exit timeframes (and likelihood of slippage)
 - Migration cannot start until replacement supplier has been appointed
- Include ability to extend exit period (with reasonable supplier protection)
 - Overall time limit
 - Notice period
 - Customer non-payment issues
- Be clear about what services can be extended (esp for data centre/cloud-based contracts)

Exit Schedule and Exit Plan

Capture exit principles/objectives in exit schedule

- Will help resolve ambiguities in contract/exit plan

Ensure phased/gradual migration is permitted

- By service component/instance (where applicable)

Beware false economy of 'free' exit assistance (even if for cause)

Agree baseline fixed price for exit assistance before contract signature

- Based on resourcing and timing assumptions
- Changes managed via change control
- Link payments to milestone achievement

Supplier personnel freezes

Exit Schedule/exit plan

Information and assistance to facilitate retendering

- Infrastructure and database space/sizing information
- Service delivery-related information – (e.g. resource-types and numbers)
- Ensure this can be obtained and disclosed before start of exit period

Information and assistance to assist migration

- Service/infrastructure set-up and configuration
- Access to process manuals/databases
- Copies of software images
- Asset/software distribution information
- Transfer of assets – hardware, software licences, personnel
- Knowledge transfer – training & assistance (pre- and post-transition)

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