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FSA Regulation on Outsourcing and Wider Policy Changes

by Tim Wright and Dominic Hodgkinson

The UK Financial Services Authority has announced that it will be incorporating industry recommendations in its regulation of outsourcing, reflecting a wider change of policy from the use of detailed rules to principles-based industry regulation. Tim Wright and Dominic Hodgkinson, of Pillsbury Winthrop Shaw Pittman LLP, examine the issues.

On 16 May 2007 the Financial Services Authority, the regulator for the United Kingdom financial services industry, confirmed that its supervision of outsourcing by regulated firms would take into account an industry guidance paper issued by MiFID Connect, the joint project set up by 11 financial services trade associations to support their members in implementing EU Directive 2004/39/EC on markets in financial instruments, also known as MiFID.

The confirmation marks the FSA's move away from detailed rules (such as are found in MiFID) and towards high-level principles-based regulation and should be welcomed by industry firms as healthy signs of a hands-off regulatory approach by the FSA, in particular the FSA's promise that firms who follow FSA-recognised industry guidance will not be held accountable for any breach of the rules.

MiFID

The Markets in Financial Instruments Directive is an EU law that seeks to harmonise throughout the Community the financial services sector. The Directive comes into force on 1 November 2007 and will have a major impact on current market and trading practice as well as upon the way in which the financial services sector is currently regulated.

Principles-based regulation

The FSA's confirmation should be seen as part of its current move away from detailed rules and towards principles-based regulation. In April 2007, the FSA released a round-up of their move in this respect entitled *Principles-based regulation - Focusing on the outcomes that matter*. The FSA commented that "there are constraints on how far and how fast we can move towards principles-based regulation, including...the current preference of the EU Commission to adopt specific rules and regulations. We will continue to work

actively with stakeholders...to make more principles-based regulation a reality.” MiFID is an EU law with specific rules and regulations. By adopting stakeholder guidance on MiFID, the FSA is putting its money where its mouth is.

Industry guidance

The FSA’s confirmation should also be seen in the context of the FSA’s paper DP 06/5 *FSA confirmation of Industry Guidance*, where the FSA set out its plans to encourage greater use of industry guidance as it moved towards a more principles-based approach to regulation. The FSA summed up the paper’s salient points as:

- recognising that industry guidance is not new, but already exists in different parts of the regulatory system;
- making clear that industry guidance will supplement rules, not replace them;
- setting out a standard process for the FSA to recognise industry guidance;
- making clear the standards that will be applied in recognising such guidance; and
- confirming that the FSA will not take action against a firm which has complied with recognised guidance covering the issue concerned.

The latter point is perhaps the most interesting to a regulated firm.

MiFID Connect’s outsourcing guideline

The guideline is divided into four sections. Section 1 comprises an introduction to outsourcing, including an overview of the new obligations relating to outsourcing. Section 2 comprises guidelines to help firms understand when the outsourcing obligation will apply to them. Section 3 comprises guidelines to help firms understand the nature of the outsourcing obligation and how this will vary depending on the type of arrangement. Section 4 comprises guidelines to help member firms understand the detailed requirements.

Section 1 : an introduction to outsourcing

Section 1 of the guideline provides a useful overview comparison of the current and new outsourcing regimes. The FSA’s new outsourcing regime does not significantly differ from its current regime, except insofar as it provides more detailed rules (which is anomalous given the FSA’s move towards principles-based regulation, but then MiFID is an EU law with specific rules and regulations). The current regime states that a regulated firm should take reasonable care to supervise the discharge of outsourcing functions, and particular care to manage material outsourcing arrangements. The MiFID regime applies to the outsourcing of critical or important operational functions and provides detailed rules that must be complied with in relation to such outsourcing. However, the FSA has gone further than MiFID and has also applied the MiFID regime as a guidance to be proportionately considered by regulated firms when outsourcing non-critical operational functions.

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The FSA has confirmed that it will not take action against a firm which has complied with FSA recognized guidance covering the issue concerned.

Section 2: definition of outsourcing

Section 2 takes the FSA Handbook Glossary definition of outsourcing (an arrangement of any form between a firm (as defined in the Glossary) 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) and provides some useful general principles as to when an action by a firm may or may not be caught by the FSA's definition of outsourcing.

Section 3: critical and important functions

Section 3 provides some practical examples of arrangements or activities **unlikely** to constitute outsourcing or to constitute outsourcing of critical/important functions, as follows:

- appointment of sub-custodians;
- participation in securities settlement systems and payment systems;
- provision of one-off, expert assistance with compliance, internal audit, accounting or risk management issues;
- provision of logistical support, for example cleaning, catering and procurement of basic services/products;
- provision of human resources support, for example sourcing of temporary employees and processing of payroll;
- buying standard software 'off-the-shelf' or engaging a software designer to develop bespoke software; and
- reliance on software providers for ad-hoc operational assistance in relation to off-the-shelf systems.

Section 3 also provides some practical examples of arrangements or activities **likely** to constitute outsourcing of critical/important functions:

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

Section 4: detailed implementing rules requirements

Section 8.1.8 of the FSA's new regime on outsourcing details the 11 MiFID Level 2 requirements that must be complied with when outsourcing and provides practical suggestions for ways in which firms can ensure they comply with these requirements. Section 4 also addresses:

- the requirement to outsource via a written agreement, ticking off various issues that should be addressed in such an agreement;
- intra-group outsourcing, commenting that such outsourcing is generally recognised as potentially posing a lower level of risk, in assessing whether such outsourcing is of a critical or important operational function;

- inability to contract out of responsibility, reminding firms that it is not possible to contract out of the obligation to comply with the outsourcing requirements;
- monitoring of relevant persons, pointing out that the FSA Handbook Glossary broad definition of relevant person means that those individuals directly involved in the provision of services to a firm under an applicable outsourcing arrangement are caught by a number of requirements under the new regime, and that firms will be required to monitor and impose controls over the behaviour of their service provider's employees more closely than under the current regime; and
- termination rights, advising that, because firms will be required to ensure that they have the ability to terminate the outsourcing arrangement without detriment to the continuity and quality of their service provision, they should ensure they 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.

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Conclusion

MiFID is the first review by the EU of the financial services market since 1993's Investment Services Directive. As such, it makes significant changes to the regulatory framework to reflect developments in financial services and markets since the ISD was implemented. It is therefore encouraging for UK regulated firms to find the FSA adopting industry guidance as part of its move towards principles-based regulation and stating that it will not take action against a firm which has complied with recognised guidance covering the issue concerned.