

**SURVEY RESULTS ON
OUTSOURCING OF FINANCIAL SERVICES**



OICV-IOSCO

**TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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I. Introduction

On August 2, 2004, the IOSCO Technical Committee's Standing Committee on the Regulation of Market Intermediaries (SC3) issued a Consultation Report on outsourcing for the securities industry, which presented a set of Outsourcing Principles designed to assist regulated entities in determining the steps they should take when considering outsourcing activities. The Principles are designed to assist securities regulators in addressing outsourcing in their regular risk reviews of firms. Following the August issuance of the Consultation Report setting forth the draft Outsourcing Principles, members of SC3 surveyed industry participants regarding their current outsourcing practices, and the survey was also posted on the IOSCO website. Survey reports were received from Australia, France, Germany, Hong Kong, Japan, Ontario, Singapore, the U.S. CFTC and the U.S. SEC, representing the three major regional areas (Europe, Asia and North America) where there are a substantial number of developed markets. The survey responses, as summarized in this Survey Report, were considered by SC3 in finalizing the Outsourcing Principles, which were approved by the IOSCO Technical Committee during its 31 January and 1 February 2005 meeting. The Technical Committee also approved on that occasion the public release of this Survey Report.

a. Overall Likelihood to Outsource

Overall, outsourcing is common in all reporting jurisdictions. A majority of respondent firms in each jurisdiction currently has in place some form of outsourcing arrangement. For example, 68% of respondent firms in Ontario (Canada) and 75% of respondent firms in Singapore employ some form of outsourcing. Similarly, a majority of firms in Hong Kong and the United States (under both the CFTC and SEC) and nearly all firms responding in Japan either currently outsource at least one function or plan to outsource some activity in the future. In general, the survey revealed no correlation between the size of a firm and the likelihood of the firm to engage in outsourcing.

A vast majority of respondent firms in all jurisdictions outsource less than 25% of their business.¹ For example, the U.S. CFTC reported no firms in which outsourcing services account for greater than 25% of their total expenses. Ontario, Singapore and Japan each reported a small percentage of respondent firms with outsourcing arrangements exceeding 25% of their total expenses². Whether or not a firm's size plays a role in outsourcing is unclear. Hong Kong reported that firms with fewer employees (between 1-10 employees) tended to outsource a greater percentage of their activities (11%-25% or greater). By contrast, Japan reported the opposite, with larger firms (more than 100 employees) tending to outsource at a higher ratio than smaller firms.³

¹ The total value of outsourcing services provided to a firm is calculated as a percentage of a firm's total expenses.

² Ontario reported one of the 17 respondent firms that outsource, Singapore reported one of the 12 respondent firms that outsource and Japan reported five of the 46 respondent firms that outsource, have arrangements exceeding 25% of their total expenses.

³ One key exception is in the case of foreign securities firms in Japan, in which the bigger firms tended to outsource at a lower ratio than small firms.

b. Functions Outsourced

A variety of functions are outsourced across a majority of jurisdictions, including human resource functions such as payroll, internal accounting, compliance supervision, securities research and information technology functions such as data backup and record retention and storage. In Germany, regulations prohibit the outsourcing of primary management functions, and all respondent firms in Germany reported keeping treasury activities in-house. Firms in Hong Kong reported a policy of not outsourcing core functions such as supervisory, monitoring, management and control functions, and any decisions regarding the commencement or discontinuation of business or business relationships.

In Singapore, most firms do not have written policies on those functions they would not outsource, but some firms stated they would not outsource core business functions or those that would generate value for their customers, such as personal client servicing, brokerage and dealing activities, and critical risk management. Similarly in Japan, many firms cited key functions such as business management and planning operations as well as compliance and risk management as functions that are never outsourced.

Firms that outsource cite various rationales, with cost savings being the most prevalent.⁴ Cost savings, however, are not the only factor. Firms also cite the ability to depend on the expertise of the service provider that the firm lacks in a particular function, allowing the firm to focus on their core functions, which in turn provides greater efficiency and enhanced service to their customers. Some firms in Singapore use service providers to gain access to foreign markets where the institution could otherwise not gain access. One firm in Hong Kong stated that it outsources as many functions as possible to avoid having a complete (front and back) office in each jurisdiction they operate in.

Outsourcing, however, can be a double-edged sword. One firm in Ontario stated that to maintain internal expertise across all functions, it does not engage in any outsourcing arrangement.

II. Selection of Service Provider

a. Due Diligence

Two jurisdictions reported regulations requiring due diligence in the selection of a service provider. For example, in Australia, ASIC expects registrants to have in place measures, processes, and procedures to ensure that due skill and care has been taken in choosing suitable providers of outsourced services. German law requires firms to use due care in choosing a service provider as well as instruct the provider concerning its duties and monitor the provider.

⁴ The U.S. SEC related that one firm had reported an estimated savings of \$83 million as a result of its outsourcing arrangements.

Respondent firms in other jurisdictions follow a variety of procedures during the selection of a service provider. For example, firms in Hong Kong consider the materiality of the function being outsourced, with service providers that perform core functions receiving more vigilant review. Respondents in Singapore perform on-site due diligence to assess potential service provider's capabilities. In addition, these firms conduct frequent ongoing due diligence exercises on the appointed service provider or conduct regular audits on the service provider's activities.

Due diligence procedures in the U.S. vary widely depending on several factors, including the materiality of the function being outsourced, the cost of outsourcing, and the location of the service provider. One respondent firm under the U.S. CFTC has specific written procedures including a review of the prospective service provider's history and financials. Another has a formal operational and credit review process applicable to every service provider, regardless of size or location. In Ontario, respondent firms typically consider the following factors when considering a service provider: pricing, services, accessibility (including flexibility in providing added services), compliance and operational and technological compatibility.

b. Selection of a Foreign Service Provider

In some jurisdictions, outsourcing to foreign service providers is less common, whereas this practice is more prevalent in other jurisdictions. Firms in Germany reported very limited arrangements with foreign service-providers. Similarly, less than 1% of Australian firms indicated that they have outsourced some part of their business to a foreign service-provider. In the U.S., over half of the CFTC-regulated firms responding to the survey report utilizing foreign service providers, while approximately 20% of the NASD and NYSE members surveyed outsource to foreign service-providers, some of which are affiliates. Functions generally outsourced in this manner include I/T support, human resources functions, accounting, research, and clearing services on foreign markets.

c. Risks in Outsourcing

i. Risks in Cross-Border Outsourcing

Risks involved in cross-border outsourcing have led to a mixture of procedures varying by jurisdiction and often by firm within a jurisdiction. For example, in Hong Kong, approaches to cross-border outsourcing were quite varied. Some respondent firms indicated no additional due diligence procedures when outsourcing to a cross-border service provider, whereas others require confidentiality clauses to be signed by the firm and service provider. Two respondent firms in Japan have additional procedures that set a duty on a service provider to deliver documents within a certain period or to facilitate on-site inspections. In Germany, the outsourcing institution is responsible for ensuring that the firm can exercise information rights, including the right to demand presentation of documents.

A few firms indicated that, due to the risks involved, they would not consider outsourcing of material functions on a cross-border basis. These firms were in three jurisdictions: Hong Kong, Japan, and the U.S. CFTC. A firm in Ontario reported that it would not outsource functions relating to the record- and bookkeeping function on a cross-border basis. One firm in Singapore specified a similar aversion to cross-border outsourcing if the function involves real-time operations.

ii. Concentration Risk

In general, firms across all jurisdictions take concentration risk into consideration when evaluating service providers. Even within the same jurisdiction, however, firms have divergent policies on outsourcing to a service provider that may perform the same task for other firms. To the extent concentration risk affects the decision to outsource, most firms view the concentration of a particular function with one service provider in a positive light. For example, in Ontario, 16 firms consider whether a service provider also provides services to multiple firms. Out of these firms, six noted this as an advantage, while three consider it as a disadvantage (the other Ontario firms did not comment). Firms in Hong Kong also had divergent views on the issue of concentration risk, with some believing that a firm with many industry clients indicates a proven track record while other firms saw heightened risks in such instances.

In Japan, a majority of firms stated that concentration risk has no effect on the selection of a service provider. Six firms, however, have policies against entering into contracts with service providers that provide similar services to other firms, and four firms out of these six firms do not worry about a concentration risk, but a leak of proprietary and customer related information where the outsourced service is IT related operation. By contrast, 27 firms view the provision of services to multiple firms as a positive. Similarly, respondents regulated by the U.S. CFTC generally see no negative risk factors in concentration risk.

Although the U.S. securities firms were not specifically asked whether they had concerns about concentration risk, their survey answers would indicate that this is not a major area of concern in light of the back-up systems in place at the outsourcing firm and/or the service provider. Regardless of whether firms see concentration positively or negatively, firms take steps to protect the assets of the firm and its customers and ensure that regulations are fulfilled. For example, most firms in Hong Kong complete an assessment of the service provider to ensure it maintains the capacity to fulfill the services required. Firms in the U.S. take appropriate steps to ensure that client confidentiality is not breached due to concentration risk.

d. Outsourcing to Affiliated Entities

i. Functions Outsourced to Affiliated Entities

Outsourcing to affiliated entities is common across all jurisdictions to varying degrees. For example, in Australia, 41% of firms outsource to affiliates, 8% exclusively.

Nearly half of Japanese firms outsource to affiliated entities, while most respondent firms in Hong Kong do so. Functions outsourced to affiliated entities include back office functions, information technology such as development and facilities management, and administrative functions, such as accounting, legal, and internal auditing. Firms in Hong Kong and Singapore also outsource some settlement functions to affiliated entities.

ii. Factors Leading to Outsourcing to Affiliated Entities

Common factors identified by firms that lead to outsourcing to affiliated entities include expertise, skill, and cost. Firms in the U.S. and Singapore also take into consideration the size and location of the affiliated group. There were firms in all jurisdictions reporting that they maintain the same due diligence procedures that are applied to non-affiliated service providers. Intra-group charges are also very common in these instances.

The survey results of NASD and NYSE members indicate that the decision whether to outsource to an affiliate (versus a non-affiliate) depends on the nature of the service required. For example, outsourced accounting and financial services are generally done only by affiliated entities. In contrast, more than 50% of outsourced IT operations are done through non-affiliates. Other outsourced operational services, including any outsourced Anti-Money Laundering (AML) functions, are overwhelmingly done through non-affiliates.

III. Relationship to Service Provider

a. Contractual Issues

i. Written Contracts⁵

Virtually all of the respondent firms of each country require a written contract for outsourcing arrangements with third party service providers. More variation exists with respect to outsourcing to an affiliate, however. For example, some respondent firms in Hong Kong indicated that they would not require contracts for outsourcing arrangements with affiliated entities. Firms in other countries however, such as Singapore, state that they would also require a written contract for outsourcing arrangements involving affiliates. Terms would include service level agreements and the rights and obligations of the parties.

ii. Topics Addressed

Taken together, the most common topic addressed in written outsourcing agreements of the respondent firms concerns the scope, description and definition of the services to be performed and the quality level of expected performance of those services.⁶ These provisions cover functions to be outsourced, scope of responsibilities, standards of care and

⁵ NYSE and NASD members were not surveyed concerning their written contracts. However, the SEC staff believes that the results below would generally be consistent with the practices of major U.S. broker-dealers.

⁶ Firms in the following jurisdictions reported including this topic in the written contract: Ontario, Germany, Hong Kong, Japan, Singapore and the U.S. CFTC.

duty, level of service performance measures, licenses, qualifications, roles and responsibilities, and response times. This topic was included by respondents on average five times as much as any other and was mentioned by respondents in all jurisdictions.

The next two most frequently mentioned topics by all jurisdictions' respondent firms concerned compliance, reporting, and regulatory requirements, and termination of the contract.⁷ The former provisions addressed such areas as how to comply with applicable laws and regulations and how and what to report to regulators as well as the outsourcing firms and those firms' rights of inspection. The termination clauses dealt with the built-in length of the agreement and the conditions under which either party had the right to terminate the contract and the procedure for doing so.

The next two most frequently included provisions in contracts appear to be terms relating to indemnification⁸ and ownership of intellectual property.⁹ The former provision addresses circumstances resulting in liability of one of the parties, usually the outsourced party, and who would be required to be indemnified under what circumstances and how. The latter provision relates to the ownership of codes, use of corporate brands, return of information, ownership of intellectual property rights and work product, and handling of trade secrets and software development.

Several other provisions were contained in many respondent firms' outsourcing agreements. This includes provisions regarding governing law and dispute resolution, the fees, costs and payment schedules for services rendered, confidentiality, access to information and records by the outsourcer, and the requirement to notify the outsourcer of problems and malfunctions.

Other provisions also contained in a good number of the jurisdictions' respondent firms' agreements include ones regarding the right to audit the service provider, disaster recovery and business continuity plans, penalties for losses, guarantees, outsourcing to subcontractors, and information technology security.

Respondents mentioned the following provisions only rarely: internal monitoring (Germany), and proof of adequate insurance coverage (Ontario).

iii. Service Performance/Monitoring

Standards for service levels are, as mentioned above, extremely likely to be in an outsourcing agreement. They can take various forms and contain various procedures and other terms that work in conjunction with the provision itself. Many are very specific while others are not. All firms from all jurisdictions that have service level agreements monitor

⁷ Firms in the following jurisdictions reported including these topics in the written contract: Ontario, Germany, Hong Kong, Japan, Singapore and the U.S. CFTC.

⁸ Firms in the following jurisdictions reported including indemnification in the written contract: Ontario, Hong Kong, Japan, Singapore and the U.S. CFTC.

⁹ Firms in the following jurisdictions reported including intellectual property ownership in the written contract: Hong Kong, Japan and the U.S. CFTC.

compliance with them. This is done by reviews, confirmations, or audits, either internal or external. Many firms have regular meetings with the service provider to assist in monitoring compliance. Germany reports that its regulated firms must instruct the service provider on how to meet service levels. Some outsourcing firms delegate employees to work at the service provider. Many firms' staff will discuss problems with service providers before contacting its management. For example, in Ontario, eight firms indicated that, in the event of a problem, they will discuss the problem with the service providers and will escalate them to senior management if there is not a satisfactory resolution.

Germany reports that all firms must conduct audits to make sure that the service provider is meeting regulatory requirements. In addition, subcontracting by service providers is permissible in some jurisdictions such as Germany, but the subcontracted firm may be bound by the agreement between the outsourcing firm and the subcontractor.

b. Contingency Planning and Data Protection

i. Protection of Proprietary/Customer Information

Most firms in the respondent jurisdictions have provisions in their contracts with their service providers that deal with confidentiality of proprietary and client information and set out the security standards that must be met when rendering information technology services. Some respondent firms have specific requirements in their contracts concerning regular back-up of data and internal control audits. In terms of monitoring the service providers' compliance with security standards, one firm in Ontario conducts what it refers to as a privacy assessment and an information security review.

Customer-related information is protected with various information technology measures and procedures agreed to in the outsourcing contract between the firm and service provider to protect customer information from unauthorized disclosure, whether intentional or not. These information security provisions include password requirements, functional access for each user, limiting access only to authorized personnel, separation of system development from operations, encoding data, and surrogate identifiers to protect client anonymity. Other measures include software via encryption and authentication protocols. One mid-size firm in the U.S. is in the process of developing an algorithm to mask client data. A number of firms reported that they have sufficient firewalls between their firms and the third party vendor to prevent unauthorized access or restrict access to information by the third party. Data security procedures may be audited by a firm or by a third party hired by a firm. If a procedure is violated, firms in some jurisdictions are able to obtain an injunction against the service provider.

Most firms indicated that they disclose to clients that they use external service providers, even if this disclosure is only on the firms' websites as opposed to being signed by the customer. Although many firms notify their customers that data may be transmitted to others, some respondent firms in several jurisdictions, including Japan, Hong Kong, the U.S. CFTC, and the U.S. SEC, do not inform their customers of outsourcing their data.

ii. Disaster Recovery

The vast majority of firms in the respondent jurisdictions have some type of business continuity plan to address potential failures by third party service provider. In Ontario, some outsourcing firms maintain an internal backup facility as part of their business continuity/disaster recovery programs. These facilities can take over the outsourced function if the service provider fails. In Hong Kong, most firms require, as part of the outsourcing agreement, that the service provider have a business continuity/disaster recover program comparable to the firm's minimum expectations. Some firms have in place both backup facilities and continuity plans in order to minimize disruptions. Some outsourcing firms require service providers to maintain duplicated IT systems. In some cases backup facilities at either the firm or the service provider could include manual procedures. In addition, some outsourcing companies print data on paper and keep them. There appears to be a positive correlation across all jurisdictions between the size of a firm and the quality of its backup arrangements. The larger the firm, the more likely it is to have robust measures for disaster recovery as part of a business continuity plan and backup facilities, require the service provider to have a disaster recovery program and backup facilities, or both. Where continuity plans exist, they are often required to be audited on a periodic basis whether at the firm or at the service provider.

c. Triggers for Remedial Action

Almost all the respondent firms have in their written outsourcing agreements certain conditions that trigger a right on the part of the firm to take remedial actions, including termination of a contract with a service provider. The most common of these types of provisions reported by all the jurisdictions include failure to meet minimum service levels, insolvency of the service provider, loss or limits on banking privileges, certain changes in control of the service provider, failure to maintain client confidentiality, and failure to meet regulatory requirements. The right to terminate usually has a minimum notice period. In addition to termination, some agreements provide for additional remedial actions such as monetary damages.

One firm in Japan responded that only one service provider is available for necessary services and a cancellation of a contract with that party would mean suspension of the business. Essentially, in this case, there is no specific action that could lead to a severance of the outsourcing arrangement.

d. Indemnification

The majority of firms have provisions in their outsourcing agreements with service providers that entitle the firms to indemnification under certain circumstances. These circumstances vary greatly with the particular contract and outsourced function involved. However, some common circumstances appear to include failure of the service provider to

meet minimum service levels, gross negligence, breach of representation or warranty, and breach of customer confidentiality. The circumstances must result in material loss to the firm or personal injury to an individual for the indemnification clause to apply.

A firm reporting to the U.S. CFTC noted that sometimes indemnification clauses are not included in an outsourcing agreement due to the unlimited liability it could bring to a service provider. In that case, the outsourcing firm will probably require the service provider to carry an insurance policy to cover certain kinds of events. Other jurisdictions indicated that their firms' indemnification provisions have limits on the maximum total amount that can be required to be indemnified.

e. Data/Resources to be returned

Most of the contracts from firms in all the respondent jurisdictions contain a provision in their outsourcing contracts that require the third party service provider to return certain information and other materials upon termination of the arrangement. The types of information that have been required to be returned in outsourcing contracts include customer information, confidential and personal data, financial data, proprietary data, transactions records, securities under custody, information of stock ownership, access logs, access to the source codes of software installed in a service provider, registered designs, licenses, software keys, written documentation and procedures for technology solutions, back-up facilities, and hardware.

Some firms in Japan and those regulated by the U.S. CFTC require the service provider to destroy data or materials instead of returning them. In this case, the firm may require a certificate of disposal or other type of proof of disposal or destruction. On the other hand, three firms in Ontario reported that they do not expect the return of any data from a third party service provider.

f. Accountability to Regulators

It is a fundamental precept of the draft IOSCO principles that the outsourcing of functions cannot be permitted to impair a regulatory authority's ability to monitor, regulate, and review the functions provided by the service provider to the same extent that they would do so if the functions were performed on an in-house basis by the outsourcing firm. It appears that this doctrine is already being fulfilled. Most of the respondent firms take affirmative steps to ensure that all regulatory obligations are met with respect to the services and activities undertaken by their service providers. Firms use a variety of specified internal and external monitoring controls to ensure regulatory obligations are being met. Some respondent firms regulated by the U.S. CFTC as well as firms in Ontario, Germany and Japan reported that they continue to monitor service providers after commencing an outsourcing arrangement to ensure sustained compliance with all appropriate regulations. Another internal control is the establishment of safeguards to prevent actions that run afoul of the law and regulatory requirements. This includes adequate security for important data or technological areas of functioning, and internal controls to prevent, for example, money laundering.

Some respondent firms in Japan reported that firms try to fulfill regulatory requirements by conducting a legal check prior to engagement of an outsourcing contract, which includes what they describe as prior corroboration of the business system of service providers, including examination of outsourcing contracts. Some outsourcing firms in Japan also conduct training for staff of service providers in meeting regulatory requirements applicable to the firm. Internal controls also include internal audits by personnel responsible for compliance.

External controls generally consist of outside audits to verify that pre-specified requirements are met. Audits range from daily to annual, depending upon the nature of the audited requirement. However, larger firms appear to rely more on internal compliance staff to conduct periodic reviews of service providers rather than outside auditors to ensure that regulatory compliance is met.

Finally, some firms in Ontario require any service provider to represent and warrant in the initial outsourcing contract between the parties that the service provider is capable of meeting all regulatory requirements.

i. Difficulties in Fulfilling Regulatory Requirements

Survey respondent jurisdictions generally have not reported any significant problems with complying with regulatory obligations in the outsourcing context. A number of firms from some jurisdictions indicated that they had never experienced any difficulty in fulfilling regulatory requirements with respect to an outsourced function. A firm in Ontario reported that there were situations where its service providers were not able to provide sufficient information or services necessary to allow them to comply with certain new regulatory requirements, while another indicated that it had some challenges in implementing a more user-friendly desktop interface to its back office to improve its ability to meet regulatory requirements.

Two outsourcing firms in Japan reported that they will discuss with their service providers any difficulties they may face in fulfilling regulatory requirements. Several expressed a high level of confidence that corrective and proactive controls would remedy any such situation.

ii. Books & Records

Service providers generally must maintain books and records relating to the service outsourced. However, many respondent jurisdictions' firms have no books or records required by their regulator to be maintained that are in the sole possession of a service provider or are not easily accessible by the firms. A large number of outsourcing firms maintain duplicate copies of all records on their premises. Some records are immediately accessible by computers in a network or through a private website. The rest have provisions in their outsourcing contracts mandating quick and reliable access to its books and records at the service provider by the outsourcing firms. This includes the ability of the service

provider to provide information electronically followed by a paper copy. Singapore reports that service providers must allow the firm, its management, internal/external auditors, and regulators or regulators' agents, the opportunity to inspect and audit the service providers' books and records. One firm whose books and records are kept only at and by the service provider only ensures that the service provider is able to retrieve records within a time frame that will allow the firm to satisfy any applicable regulations related to the production of required records. Some firms simply don't outsource the functions that involve the placement of books and records with a service provider.

IV. Conclusion

All jurisdictions stated that it is common for intermediaries to outsource certain functions. A majority of respondent firms currently outsource at least one function, or plan to outsource some activity in the future. Survey results revealed no clear correlation between the size of the firm and either the likelihood of the firm to engage in outsourcing or the extent of overall business they outsource to a service provider. Functions typically outsourced include human resource functions such as payroll, IT, internal accounting, compliance supervision and securities research. Cost savings was the most common reason cited by firms for engaging in outsourcing.

While only two jurisdictions (Australia and Germany) have regulations requiring due diligence in selecting a service provider, respondent firms across all jurisdictions review a variety of factors when considering a particular service provider, including the materiality of the function being outsourced, pricing, and operational and technological compatibility. It is interesting to note that, when evaluating concentration risk, a majority of respondent firms view the provision of services for multiple firms by one provider to be an advantage. These firms see this as a sign of the service provider's expertise and proven track record. Moreover, many firms, and/or their service providers, have sufficient back-up systems in place so that concentration risk is ameliorated.

Virtually all respondent firms employ a written contract to govern their relationship with a third party service provider. The most common topics addressed in these contracts include the scope, definition and description of the services provided, reporting and regulatory requirements, and termination of the contract. Most firms have at least general provisions in their contracts with service providers ensuring the confidentiality of proprietary and client information; most of these firms indicated that they disclose to clients that they use external service providers. A large majority of respondent firms include in their contracts with a service provider conditions that would trigger a right on the part of the firm to take remedial actions, including termination of the contract. Such triggers include failure to meet minimum service levels, insolvency of the service provider, and failure to meet regulatory requirements.

In addition, a majority of respondent firms include provisions in their contracts with service providers that entitle the firms to indemnification in certain circumstances, including gross negligence, breach of representation or warranty and breach of customer

confidentiality. In general, these circumstances must result in material loss to the firm for the indemnification clause to apply.

Ultimately, despite the variations in outsourcing practices amongst the various reporting jurisdictions and somewhat differing legal requirements, firms have not reported any significant problems with complying with regulatory obligations. While a few firms reported minor situations where service providers were not able to provide sufficient services to enable the firm to comply with new regulatory requirements, a number of firms indicated that they have never experienced any difficulty in fulfilling regulatory requirements with respect to an outsourced function.