



**Financial Services
Commission**

Financial Services Guidance Note

Outsourcing

Issued: April 2005

Revised: August 2007





Table of Contents

1. Introduction.....	3
1.1 Background.....	3
1.2 Definitions.....	3
2. Guiding Principles.....	5
3. Key Risks of Outsourcing	14

1. Introduction

1.1 Background

Outsourcing is increasingly being used as a business tool by firms conducting financial services. Firms may choose to outsource part of their business functions for various reasons. The most common of these is to achieve economies of scale, reduce costs or centralise activities. Areas in which firms have tended to outsource include information technology, back-office operations and accounting.

Outsourcing can raise issues related to risk transfer and management, and an increased reliance on outsourcing can have an impact on the ability of regulated firms to manage risks and monitor compliance with regulatory requirements. Regulated firms can mitigate these risks by taking a number of steps:

- Drawing up comprehensive and clear outsourcing policies;
- Establishing effective risk management programmes;
- Negotiating appropriate outsourcing contracts or agreements;
- Analysing the financial and infrastructural resources of the service provider;
- Requiring contingency planning.

The Joint Forum of the Basel Committee of Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) have developed a number of high-level principles that cover the responsibilities of regulated firms when they outsource their activities.

This Guidance Note applies to all firms regulated and authorised by the FSC. In addition, banking and investment firms to which the Markets in Financial Instruments Directive (MiFID) applies must also be aware of the detailed requirements applied by MiFID. These requirements set out the measures regulated firms must take to manage the risks associated with outsourcing material activities, and should also serve as a guide for the outsourcing of non-material activities. This is referred to as the “Outsourcing Obligation”, which is included in the guiding principles below, and applies to all new and existing outsourcing arrangements. The Outsourcing Obligation can be applied as appropriate and proportionate to the business when outsourcing non-material activities. In certain circumstances, the outsourcing of some functions will not immediately translate to higher risks for the regulated firm.

1.2 Definitions

For the purposes of these guidelines, the following is meant by:

- a. **outsourcing:** a regulated firm’s use of a third party (either an affiliated entity within the same group or an external entity) to perform activities on a continuing basis that would normally be undertaken by the regulated firm. Outsourcing is sometimes also referred to as “subcontracting”.

The definition of outsourcing is very broad and it is sometimes not possible to define a clear dividing line to determine whether an



arrangement falls within the definition of outsourcing or not. However, the following general rules should help firms determine whether arrangements can be regarded as outsourcing or not.

1. Where a firm provides investment services and certain elements of the delivery of those services are contracted to a third party:
 - where there is a direct contractual relationship 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.
2. Where a regulated firm arranges for the provision of a particular process, service or activity that it does not, or cannot, itself offer or provide (e.g. where the activity is not within the legal scope of the regulated firm), as opposed to simply delegating the provision of a process, service or activity to another entity because the regulated firm decides that it is more effective to delegate despite there being no legal or regulatory need to do so, this will not fall within the definition of outsourcing. 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 as 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 outsourcing;
 - If the regulated firm engages a third party to provide execution services for its clients, whether or not this constitutes outsourcing will depend on the nature of the services provided by the regulated firm. If the regulated firm does offer an execution service, delegating execution will be outsourcing. In comparison, if the relevant service offered by the regulated firm is simply the receipt and transmission of orders, transmitting orders for execution to a third party broker will not constitute outsourcing.
3. Where specialist providers (e.g. in the field of IT) are hired to import technical expertise on the operations managed by the firm, or to prepare and install a service, it will not fall under the definition of outsourcing. 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.

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.

- b. service provider: the supplier of goods, services or facilities, which may or may not be an authorised or regulated entity, and which may be an



- affiliated entity within a corporate group or an entity that is external to the group.
- c. regulated firm: the authorised entity which is the buyer of such goods, services or facilities.
 - d. material activities:
 - (i) activities of such importance that any weakness or failure in the provision of these activities could have a significant effect on the regulated firm's ability to meet its regulatory responsibilities and/or to continue in business;
 - (ii) key systems without which a regulated firm would be unable to deliver services to its clients, e.g. the sole means of providing a service;
 - (iii) any other activities requiring a licence or authorisation from the FSC;
 - (iv) any activity having a significant impact on a regulated firm's risk management; and
 - (v) the management of risks relating to these activities.

In any case, what is considered as a critical or important function varies according to the circumstances and nature of the regulated firm and the specific arrangements contemplated.
 - e. senior management: persons who effectively direct the business of the regulated firm.
 - f. "chain" outsourcing: outsourcing where the service provider subcontracts elements of the service to other providers.

2. Guiding Principles

- I. *A regulated firm seeking to outsource activities should have in place a comprehensive policy to guide the assessment of whether, and how, those activities can be appropriately outsourced. When drawing up the policy the regulated firm should recognise that no form of outsourcing is risk free. The board of directors or equivalent body should retain responsibility for the outsourcing policy and related overall responsibility for activities undertaken under that policy.*
 1. Prior to outsourcing, a regulated firm should establish specific criteria for making decisions about all areas of outsourcing. This should include an evaluation of the appropriateness of outsourcing activities and criteria for non-material and intra-group outsourcing.
 2. Limits on the overall level of outsourced activities and risks arising from outsourcing multiple activities to the same service provider should be considered.
 3. Management should also develop an understanding of the associated benefits and costs of outsourcing.
 4. The role of compliance, and internal audit where this exists, will be important in ensuring that activities undertaken by service providers adhere to the regulated firm's outsourcing policy. The

policy should also consider the potential effects of outsourcing on these functions (compliance and internal audit), when conducting the risk analysis prior to outsourcing.

5. The policy should consider the main phases that make up the life cycle of the regulated firm's outsourcing arrangements:
 - a. the decision to outsource or change an existing outsourcing arrangement;
 - b. due diligence checks on the outsourcing service provider;
 - c. drafting a written outsourcing contract and service level agreement;
 - d. contingency plans and exit strategies.
- II. *The ultimate responsibility for the management of the risks associated with outsourcing or the outsourced activities lies with the regulated firm's senior management.*
1. Regulated firms should have one or more persons with responsibility for supervising and monitoring the outsourced functions on an ongoing basis, and should retain adequate core competence at senior operational level 'in-house' to enable them to have the ability to resume direct control over an outsourced activity if necessary.
 2. The regulated firm must ensure the involvement of the right individuals at every stage of the outsourcing process so that the regulated firm can meet its requirement to exercise due skill, care and diligence.
 3. Outsourcing will not affect managers' full and unrestricted responsibilities under applicable legislation.
 4. Core management functions should not be outsourced. These include functions such as the setting of strategies and policies in respect of the regulated firm's risk profile and control, the oversight of the operation of the regulated firm's processes, and the final responsibility for customers.
- III. *The regulated firm should conduct appropriate due diligence in selecting third party providers to ensure they have the ability, capacity and authorisation required by law to perform the outsourced activities, reliably and professionally. The FSC reserves the right to examine such due diligence as part of the FSC's assessment of an outsourcing proposal.*

A regulated firm must develop criteria that enables it to assess a service provider's ability to perform the outsourced activities effectively and reliably. This should include:

- the regulated firm should require a written representation from the service provider regarding its ability, capacity and authority. This should include representations that it is qualified and appropriately resourced;
- the regulated firm should ensure that the service provider understands, and can meet, the objectives of the regulated firm;
- an assessment of the financial soundness of the service provider as well as the economic, legal or political conditions that might adversely impact

the service provider's ability to perform, especially if located in another jurisdiction;

- where appropriate to the nature of the outsourcing, the regulated firm can carry out additional due diligence. This may include obtaining publicly available information with details from online authorisation registers, carrying out site visits, obtaining and checking references and carrying out credit analysis.

In addition, the regulated firm should implement procedures in order to monitor relevant persons. For the purposes of this Guidance Note, a "Relevant Person" is a natural person who is directly involved in the provision of services to the regulated firm under an outsourcing arrangement for the purposes of the provision of regulated activities by that firm.

- Regulated firms are required to closely monitor and impose controls over the behaviour of its service provider's employees;
- It may be appropriate for a regulated firm to provide training to relevant persons in order to ensure that they are aware of any actions that may be restricted;
- Regulated firms should note that the interests of employees of service providers are relevant to the regulated firm's conflicts management obligations;
- In relation to personal account dealing, relevant persons must be made aware of the restrictions on personal transactions and of the measures established by the regulated firm in connection with personal transactions;
- Regulated firms should ensure that service providers maintain a record of personal transactions entered into by any relevant persons and provide that information to the regulated firm promptly on request.

IV. *The regulated firm should establish a comprehensive outsourcing risk management programme to address the outsourced activities and the relationship with the service provider. When outsourcing material activities the regulated firm must ensure it takes reasonable steps so as to not impair the quality of its internal control and the ability of the FSC to monitor the regulated firm's compliance with the regulatory obligations which apply to it.*

The assessment of outsourcing risk when establishing an outsourcing risk management programme will depend on several factors including:

- the scope and materiality of the outsourced activity;
- how the regulated firm manages, monitors and controls outsourcing risk;
- how the service provider manages and controls the potential risk of the operation;
- the financial, reputational and operational impact on the regulated firm of the failure of the service provider to adequately perform the activity;
- any potential losses to the regulated firm's customers in the event of a service provider failure;
- cost;
- the interrelationship of the outsourced activity with other activities within the regulated firm;



- the regulatory status of the service provider;
- the complexity of the outsourcing arrangement.

A comprehensive outsourcing risk management programme should provide for ongoing monitoring and controlling of all relevant aspects of the outsourcing arrangements and for procedures to be followed when certain events occur, e.g. when corrective action is required. The regulated firm should also inform the FSC of any material development.

V. *Outsourcing relationships should be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities and expectations of all parties.*

1. A written contract is an important management tool and appropriate contractual provisions can reduce the risk of disagreements regarding scope, nature and quality of service as well as reduce the risk of non-performance. Regulated firms should also consider adopting measures to ensure that such agreements remain up-to-date and accurate and reflect the arrangements that are actually in operation. The contents of the written agreement should be proportionate to the risks involved and the size and complexity of the outsourcing. A contract should as a minimum:
 - clearly define the activities to be outsourced and the responsibilities of the regulated firm and service provider;
 - specify precise quantitative and qualitative performance targets and how these will be monitored;
 - cover the ownership of intellectual property and the protection of confidential information;
 - not prevent or impede the regulated firm from meeting its regulatory obligations, nor the FSC from exercising its regulatory powers;
 - impose an obligation on the service provider to allow direct access to the FSC and the regulated firm's auditors to relevant data and its premises as required, and allow the regulated firm's external auditors full and unrestricted rights of inspection and auditing of that data;
 - provide for the continuous monitoring and assessment of the service provider;
 - include, where appropriate, conditions of subcontracting by the service provider to a third party for all or part of the outsourced activity, requiring approval from the regulated firm for the use of subcontractors, whilst allowing the regulated firm the ability to maintain control over the subcontracted activity;
 - impose an obligation on the service provider to immediately inform the regulated firm of any material changes in circumstances which could have a material impact on the continuing provision of services. This may require obtaining consents from affected parties.

- outline the agreed termination and exit management process.

In addition, the regulated firm should consider including other elements such as those which:

- confirm the choice of law, when 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 procedures to resolve disputes;
 - outline agreed business continuity measures to be taken by the service provider.
2. When drafting the contract, the regulated firm should bear in mind that the level of monitoring, assessment, inspection and auditing required by the contract should be proportionate to the risks involved and the size and complexity of the outsourced activity.

VI. *The regulated firm should ensure that outsourcing arrangements neither diminish its ability to fulfil its obligations to customers or to the FSC, nor impede effective supervision by the FSC.*

1. Outsourcing arrangements should not impair the FSC's ability to exercise its regulatory responsibilities nor impede proper supervision of the regulated firm. The regulated firm must ensure that its ability to comply with legal and regulatory requirements in both its home and host states is not impaired.
2. It is unlikely that approval for outsourcing arrangements will be granted if functions are to be outsourced to service providers or jurisdictions in which visits by local staff of the regulated firm, external auditors or the FSC would be either impractical or prohibited. Exceptions may be made where activities are outsourced to other group entities or where alternative arrangements can be made with the external auditors and/or the regulatory authority in the proposed jurisdiction.
3. Outsourcing of material activities to entities in other jurisdictions will only be granted if the regulation and supervision in the proposed jurisdiction is of an equivalent standard to that in Gibraltar.
4. Outsourcing arrangements should not affect the rights of a customer.
5. Responsibility for outsourced functions must always be retained by the regulated firm. The outsourcing of functions does not relieve a regulated firm of the regulatory responsibilities for its authorised activities or the function concerned.



6. The conditions with which the regulated firm must comply in order to be authorised, and to remain so, must not be undermined. In addition, none of the other conditions subject to which the regulated firm's authorisation was granted must be removed or modified.
- VII. *The regulated firm should take appropriate steps to require that service providers protect confidential information of both the regulated firm and its clients from intentional or inadvertent disclosure to unauthorised persons.*
1. The regulated firm must ensure that confidential customer information is protected and that this is not misused or misappropriated. This may entail the inclusion of provisions in the outsourcing contract prohibiting the service provider and its agents or employees from using or disclosing the regulated firm's proprietary information or that of its customers, except as required to meet regulatory and statutory provisions. Where applicable, the regulated firm should also consider whether it is appropriate to notify customers that customer data may be transmitted to a service provider.
 2. To ensure compliance with this obligation the regulated firm may document 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.
 3. The regulated firm can impose confidentiality requirements on the service provider, including requirements regarding the use of subcontractors.
 4. The regulated firm should also impose a requirement on the service provider to comply with all data protection rules and obligations.
- VIII. *The regulated firm must 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.*
1. The regulated firm should adopt measures to identify and report instances of unsatisfactory performance or non-compliance. Such measures include service delivery reports, self-certification or independent review by auditors.
 2. The regulated firm should request regular reporting from the service provider and should schedule meetings to monitor the service provider's compliance with obligations.
 3. The regulated firm can implement a service credit regime for non-compliance with performance targets, in order to address minor breaches.
 4. The regulated firm should warn the service provider, activate step-in rights or terminate the agreement where a significant or persistent breach is identified.



- IX. *The regulated firm and its service providers should establish and maintain contingency plans, including a plan for disaster recovery and periodic testing of back-up facilities.*
1. The regulated firm should assess and address the potential consequences of a business disruption or other problem at the service provider. The regulated firm should implement a contingency plan which addresses the possibility that one or more of the regulated firm's service providers fails to adequately perform their contractual obligations and should require that the service provider have a contingency plan which meets the standards required by the firm. Firms should take this into account in developing their business continuity arrangements.
 2. Essential changes in the service provider's organisation and ownership structure should be appropriately monitored and assessed by the regulated firm's management so that any necessary corrective measures can be taken immediately.
 3. The regulated firm should make arrangements for the swift transfer of the outsourced activities to another service provider or back to the regulated firm itself.
- X. *The regulated firm should take particular care when outsourcing material activities and should inform the FSC of this type of outsourcing.*
1. Decisions to outsource material functions should be approved at board level in the case of locally incorporated companies.
 2. Managers of the regulated firm should take suitable measures to ensure that the outsourced activities meet the performance and quality standards that would apply if their own institution were to perform the relevant activities in-house.
 3. The regulated firm should inform the FSC of any material activity to be outsourced in a timely manner in order to allow the FSC to evaluate the proposal and take appropriate action where necessary. The FSC may impose specific conditions when the outsourcing of material activities is proposed.
 4. The regulated firm should inform the FSC of any significant changes and developments affecting the service provider and its ability to meet its customer obligations.

Examples of activities which constitute material outsourcing include:

- the provision of compliance and MLRO functions. These activities may only be outsourced by small firms and require prior consent from the FSC;
- the provision of regular or constant internal audit, accounting or risk management support;
- provision of credit risk control and credit risk analysis;
- portfolio administration or portfolio management;
- provision of data storage (physical and electronic);
- provision of ongoing, day-to-day software/systems management (e.g. where a third party carries out day-to-day functionality and/or runs software or processes on its own systems).



The above is not an exhaustive list of examples. Other activities can also be considered material outsourcing.

- XI. *There are no restrictions on the outsourcing of non-material activities, and in such cases the regulated firm does not have to inform the FSC prior to entering into these arrangements.*
1. The regulated firm shall adequately manage the risks relating to such outsourcing arrangements.
 2. Areas regarded as non-material are those not falling within the definition of "material activities" and may include:
 - a. areas which do not potentially constitute relevant risks;
 - b. the provision to the regulated firm of advisory services, and other services which do not form part of the relevant services and activities of the regulated firm, including the provision of legal advice to the firm, the training of personnel of the firms, billing services and the security of the firm's premises and personnel;
 - c. the purchase of standardised services, including market information services and the provision of price feeds.
- XII. *The regulated firm should consider the risks associated with "chain" outsourcing and should inform the FSC of this type of outsourcing. The regulated firm should only agree to this if the subcontractor will fully comply with the existing obligations between the regulated firm and the service provider, including any regulatory obligations to the FSC.*
1. The regulated firm should address the risk of any weakness or failure in the provision of the subcontracted activities that can have a significant effect on the service provider's ability to meet its responsibilities.
 2. Sub-contractors should be treated by the regulated firm as a primary outsourcing measure. The contract should impose conditions and shall require prior consent of the regulated firm of the possibility and manner of subcontracting.
 3. The regulated firm should ensure that the service provider agrees that the contractual terms entered into with the subcontractor will always conform to the provisions of the agreement with the regulated firm.
- XIII. *Whilst intra-group outsourcing may be material outsourcing, it generally involves non-material activities which pose lower levels of risk and may therefore be subject to less onerous requirements.*
1. Where intra-group outsourcing takes the form of material activities, the FSC may take specific circumstances into account, when assessing the risks associated with intra-group outsourcing and the treatment to apply to such arrangements. This may include the extent to which the regulated firm controls the service provider or has the ability to influence its actions, and the extent to which the service provider is included in the consolidated supervision of the group;



2. In relation to intra-group outsourcing, the regulated firm has a certain amount of flexibility when determining whether a comprehensive written agreement is necessary or whether a less detailed written agreement is more appropriate. When arriving at such a decision, the regulated firm should take into account the ability of the firm to influence, and the level of control the regulated firm has over, the service provider.
- XIV. *Regulated firms should have an agreed termination and exit management process in place.*
1. Regulated firms should have agreed termination rights including minimum notice periods.
 2. Exit strategies should be in place to allow transfer of the service to another service provider or to the regulated firm itself to ensure continuity of the service and the return of customer data and any other resources.
 3. The termination agreement should include provisions to allow the regulated firm to cancel the contract by contractual notice of dismissal or extraordinary notice of cancellation if so required by the FSC.
 4. Regulated 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 adequate information and knowledge regarding the outsourced activities, to enable the regulated firm to either bring the function in-house or instruct an alternative service provider should the need arise.
- XV. *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 except where the client contracts separately with the other firm.*
1. Whilst the regulated firm remains responsible for ensuring that its regulatory obligations are met, it is not expected to be involved in the day-to-day management of the service provider.
 2. The requirements do not apply directly to service providers. However, the regulated firm must ensure that the service provider supplies the regulated firm with a service that allows it to comply with its obligations under the relevant legislation and requirements.

In relation to MiFID, regulated firms must ensure that arrangements entered into before 1 November 2007 adequately deal with the relevant risks of outsourcing. Whilst there is no specific requirement under the directive for regulated firms to formalise all existing arrangements following implementation of MiFID, regulated firms must ensure that their existing arrangements are compliant with the new requirements.

Where existing arrangements do not meet the new required standards, regulated firms may consider entering into a side letter arrangement which effectively amends their existing contractual agreements.

3. Key Risks of Outsourcing

Regulated firms need to ensure that any risks associated with the outsourcing of certain functions are managed effectively. Examples of key risks in outsourcing are set out below.

Risk	Major concerns
Strategic risk	<p>Failure to implement appropriate oversight of the service provider.</p> <p>Inadequate expertise to oversee the service provider.</p> <p>Conflicting goals of service provider and regulated firm.</p>
Reputational risk	<p>Poor service quality from the service provider.</p> <p>Fall in customer service standards.</p> <p>Practices of the service provider not in line with the stated practices of the regulated firm, e.g. on ethical issues.</p>
Compliance risk	<p>Financial services regulations and consumer legislation not adequately complied with.</p> <p>Service provider has inadequate compliance systems and controls.</p>
Operational risk	<p>Technology failure.</p> <p>Fraud or error.</p> <p>Inadequate financial capacity to fulfil obligations.</p>
Exit strategy risk	<p>Appropriate exit strategies not in place – this could arise from over-reliance on one firm, the loss of relevant skills and prohibitive costs associated with terminating relationship with service providers.</p> <p>Limited ability to reinstate functions due to loss of records, documents, etc.</p>
Counterparty risk	<p>Quality of service diminishes.</p>
Country risk	<p>Business continuity planning becomes more complex.</p> <p>Political, social and legal climate may create added risk.</p>
Contractual risk	<p>Ability to enforce contract.</p>
Access risk	<p>Outsourcing arrangements may hinder the ability of the regulated firm to provide timely information to the FSC.</p> <p>Additional layer of difficulty for the FSC in understanding the activities of the service provider.</p>
Concentration and systemic risk	<p>Lack of control of regulated firms over service provider.</p>