Outsourcing by UK-based Fund Managers: Identifying and Applying the Rules

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UK-based fund managers must comply with increasingly complex, and ever-changing regulation. The regulatory structure covers overarching principles of business and detailed regulation. Some requirements stem from European directives and regulations and others are home-grown. The exact extent of the applicable rules depends largely on the precise activities of the firm. Outsourcing receives specific regulatory attention.

In this article, we look at the regulatory structure that applies when fund managers look to outsource processes (such as investment operations, fund administration, transfer agency or corporate actions relating to instruments held). We consider the EU and UK legislative framework, look at recent developments, and offer outline guidance on how to negotiate outsourcing agreements.

This article does not cover the outsourcing of IT services or the use of IT solutions. But firms should note that, in another key development, not specifically aimed at the asset management industry, the Financial Conduct Authority (**FCA**) provided guidance to those using off-the-shelf technology. In its July 2014 paper, "Considerations for firms thinking of using third-party technology (off-the-shelf) banking solutions", the FCA provided a list of questions for a firm to consider as part of its preparations for the use, and the evaluation, of third parties in the delivery of technology services which are critical to the regulated firm's business operations. These questions are helpful in designing an IT strategy, especially given that functions that are considered "outsourced" depend heavily on technology that delivers processes and data timely and securely.

The Regulatory Framework

Fund managers in the UK are regulated by the FCA under the Financial Services and Markets Act 2000 (**FSMA**). FCA authorised firms must comply with high-level principles and detailed rules, designed to promote the integrity of the financial markets and to protect consumers.

Principles for Business

The 11 high level Principles for Business apply to every FCA-authorised firm. These are:

1. Integrity: A firm must conduct its business with integrity.
2. Skill, care and diligence: A firm must conduct its business with due skill, care and diligence.
3. Management and control: A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. Financial prudence: A firm must maintain adequate financial resources.
5. Market conduct: A firm must observe proper standards of market conduct.
6. Customers' interests: A firm must pay due regard to the interests of its customers and treat them fairly.

7. Communications with clients: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way that is clear, fair and not misleading.

8. Conflicts of interest: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

9. Customers: relationships of trust: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

10. Clients' assets: A firm must arrange adequate protection for clients' assets when it is responsible for them.

11. Relations with regulators: A firm must deal with its regulators in an open and cooperative way, and must disclose to the FCA appropriately anything relating to the firm of which the FCA would reasonably expect notice.

Many of these Principles are directly relevant to authorised firms such as fund managers seeking to outsource, but especially principles 2 and 3.

What rules apply to fund managers when they outsource?

This is no longer a simple question. Depending on the main nature of their business, fund managers will fall primarily under one of the Alternative Investment Fund Managers Directive (**AIFMD**), Undertakings for Collective Investment in Transferable Securities (**UCITS**) Directives or the Markets in Financial Instruments Directive (**MiFID**). Many fund managers provide "investment services" and must therefore comply with the MiFID-based rules in the FCA's rules that relate to these services even if they derive their main licence from, for example, the AIFMD. In any event, the MiFID-based rules are likely to apply as guidance. The complex analysis that firms must carry out even to decide which rules apply is exemplified by the High Level Standards module of the FCA's Handbook of Rules and Guidance.

Senior Management, Systems and Controls Rules

The FCA's Senior Management, Systems and Controls Rules (**SYSC**) contains a unified set of rules applying to "common platform firms" (i.e. firms that are subject to MiFID and/or either of the current or previous versions of the Capital Requirements Directive (**CRD**)) and certain other firms. The firm's business model will determine if the SYSC requirements apply as rules or guidance. So if the fund manager is:

- a **UCITS management company**, the requirements in SYSC 8 apply either as a rule (if the firm is a UCITS investment firm) or are not applicable or are otherwise guidance. (*See* SYSC 1 Annex 1 Part 3);
- a **full scope UK Alternative Investment Fund Manager (AIFM) of an authorised Alternative Investment Fund (AIF)**, the requirements in SYSC 8 do not apply;
- a **small authorised UK AIFM** or a **full scope UK AIFM of an unauthorised AIF**, the requirements in SYSC 8 apply as guidance. So the extent to which the firm must comply will depend on the nature, scale and complexity of the firm's business; or
- an **investment firm** that carries on some portfolio management activities and is a common platform firm, the requirements of SYSC 8 apply.

We explain the requirements of SYSC 8 later in this article.

How does FCA define outsourcing?

The FCA's definition of outsourcing depends on the business of the relevant firm. For SYSC 8, which applies to most regulated firms, the definition comes from MiFID and is:

> *"an arrangement of any form between a firm 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."*

For other purposes, the definition is…

> *"the use of a person to provide customised services to a firm other than: a) a member of the firm's governing body acting in his capacity as such; or (b) an individual employed by a firm under a contract of service."*

What are the MiFID requirements on outsourcing?

Article 13 of MiFID contains the high-level principles. Some apply generally, while others are specific to outsourcing. In summary:

- A firm must take reasonable steps to avoid undue added operational risk arising from the outsourcing of "*critical operational functions*" (Article 13(5)). "*Critical operational functions*" are those operational functions that are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis.
- A firm must ensure that it does not outsource "*important operational functions*" in a way that materially impairs the quality of its internal controls or the regulator's ability to monitor the firm's compliance with its obligations (Article 13(5)).
- A firm must put in place adequate policies and procedures to ensure it and its managers, employees and tied agents comply with MiFID, and also with rules governing personal transactions (Article 13(2)).
- A firm must take reasonable steps to ensure continuity and regularity in the performance of investment services and activities (Article 13(4)).
- A firm must have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment and effective control and safeguard arrangements for information processing systems (Article 13(5)).

The MiFID Level 2 Directive gives more detail:

- Investment firms may outsource activities if their outsourcing arrangements comply with certain conditions. However, if outsourcing critical or important operational functions or investment services or activities would lead to a delegation of functions to such an extent that the firm becomes a "letter-box entity", then this will be considered to undermine the firm's ability to meet the fundamental authorisation conditions.
- Notification of outsourcing. Outsourcing investment services or activities of critical and important functions may be a "material change" for the purposes of the firm continuing to meet the "threshold conditions" for authorisation. A firm should notify its regulator of any significant arrangements it makes after authorisation, under the Level 1 Directive.
- Risk management. Firms must set up, implement and maintain an adequate risk-management policy that covers risks associated with outsourcing critical or important functions or of investment services or activities. Relevant risks include those associated with the firm's relationship with the service provider and the potential risks of outsourced activities of multiple investment firms or other regulated entities being concentrated within a limited number of suppliers.

A new Directive known as MiFID 2 (with a supporting Regulation) will replace MiFID when it takes effect from 3 January 2017. The detail of its supporting legislation and guidance and the FCA's implementing rules will not be published for some time. However, there is unlikely to be any fundamental change to the rules on outsourcing.

What are the SYSC requirements on outsourcing?

The FCA's Rules in SYSC 8 implement the relevant provisions of MiFID and its Level 2 Directive (and, to a lesser extent, but so far as necessary, the UCITS Directive and its Level 2 Directive). They apply where a firm outsources a "critical or important operational function".

Whether a function is critical or important is for the firm to decide based on these criteria. However, SYSC 8.1.5R, following MiFID guidance, states the following functions are not critical or important for these purposes:

- the provision to the firm of advisory services, and other services which do not form part of the investment business of the firm, including legal advice for the firm, training, billing services and security;
- the purchase of standardised services, including market information services and price feeds; and
- the recording and retention of relevant telephone conversations or electronic communications under conduct of business requirements.

Where we say "firm", we mean, in relation to SYSC 8, an investment firm to which SYSC 8 applies.

Firm remains responsible

The regulated firm remains fully responsible for discharging all of its regulatory obligations and complying, in particular, with the following conditions:

- the outsourcing must not result in senior management delegating responsibility;
- the relationship and obligations of the firm towards its clients must remain unchanged;
- the ability of the firm to meet the basic authorisation conditions must not be undermined; and
- no other conditions subject to which the firm's authorisation was granted must be removed or modified. (SYSC 8.1.6R)

Firms must exercise due skill, care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any investment services or activities (SYSC 8.1.7). The firm must retain the necessary expertise to supervise the outsourced functions effectively and manage the risks associated with the outsourcing arrangement and must in fact supervise those functions and manage those risks.

Managing the outsourcing arrangement

SYSC 8 is prescriptive in its requirements on firms to carry out appropriate initial and on-going checks on service providers and build in sufficient safeguards into their contractual arrangements, to ensure the firm continues to meet its authorisation conditions.

Due diligence: The firm must ensure the service provider has the ability, capacity and any necessary licence to perform the outsourced functions, services or activities reliably and professionally. (Article 14.2(a), implemented in SYSC 8.1.8R(1))

Service management – standard of performance: The service provider must carry out the outsourced services effectively, so the firm must establish methods for assessing the provider's performance. (Article 14.2(b), implemented in SYSC 8.1.8R(2))

Service management – supervision: The firm must ensure the service provider properly supervises the carrying out of the outsourced functions, and adequately manages the risks associated with the outsourcing. The firm must keep the necessary expertise to supervise the outsourced functions effectively and to manage the risks associated with it. (Article 14.2(c) and (e), implemented in SYSC 8.1.8R(3) and (5))

Service management – appropriate action: In managing the outsourcing arrangement, the firm should take appropriate action if it appears the service provider may not be carrying out the functions effectively and compliantly. (Article 14.2(d), implemented in SYSC 8.1.8R(4))

Disclosure of material issues: The service provider must disclose to the investment firm any development that may have a material impact on its ability to carry out the outsourced functions effectively and compliantly. (Article 14.2(f), implemented in SYSC 8.1.8R(6))

Audit and access to data: The service provider must cooperate with the firm's regulators over the outsourced activities. (Article 14.2(h), implemented in SYSC 8.1.8R(8)). The firm, its auditors and the relevant authorities must have effective access to data about the outsourced activities, and to the business premises of the service provider, and the authorities must be able to exercise those rights of access. (Article 14.2(i), implemented in SYSC 8.1.8R(9)). The service provider must make available on request to the regulator all information necessary to allow the authority to assess whether the performance of the outsourced activities complies with the requirements of the MiFID Implementing Directive. (Article 14.5, implemented in SYSC 8.1.11R)

Maintenance of records of personal transactions: The firm must ensure the service provider keeps a record of personal transactions entered into by any relevant person and provides that information to the firm promptly on request. (Article 12 (2), implemented in COBS 11.7.4R(2)B)

Confidential information: The service provider must protect any confidential information relating to the firm and its clients. (Article 14.2(j), implemented in SYSC 8.1.8R(10))

Business continuity: Where appropriate, the investment firm and the service provider must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of back-up facilities. (Article 14.2(k), implemented in SYSC 8.1.8R(11))

Termination: The firm must be able to terminate the outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients. (Article 14.2(g), implemented in SYSC 8.1.8R(7))

Written agreement: The respective rights and obligations of the investment firms and of the service provider must be clearly allocated and set out in a written agreement. (Article 14.3, implemented in SYSC 8.1.9R)

Specific situations

UCITS management companies: A UCITS management company must keep the necessary resource and expertise to monitor the service providers' activities effectively, specifically with regard to risk management of those arrangements. (UCITS Directive Article 5(2), implemented in SYSC 8.1.13R)

Intra-group outsourcing: MiFID applies to intra-group outsourcing arrangements. However, if the firm and the service provider are members of the same group, the investment firm may take into account the extent to which the firm controls the service provider or can influence its actions when assessing its compliance needs. (Article 14.4, implemented in SYSC 8.1.10R)

Retail client portfolio management

MiFID sets significant conditions on direct or indirect outsourcings of retail client portfolio management. When a firm outsources the investment service of portfolio management provided to retail clients to a service provider located in a third country (that is, a country outside the European Economic Area), that firm must ensure that the following conditions are satisfied (SYSC 8.2.1R):

- the service provider must be authorised or registered in its home country to provide that service and must be subject to prudential supervision; and
- there must be an appropriate cooperation agreement between the competent authority of the investment firm and the supervisory authority of the service provider.

If these conditions are not satisfied, a firm must give prior notification to its regulator about the outsourcing arrangement. The notification must include:

- details about which of the conditions is not met;
- if applicable, details and evidence of the supplier's authorisation or regulation, including the regulator's contact details;
- the firm's proposals for meeting its obligations under SYSC on an on-going basis;
- why the firm wishes to outsource to the supplier;
- a draft of the outsourcing agreement between the supplier and the firm;
- the proposed start date of the outsourcing arrangement; and
- confirmation that the firm has had regard to the guidance discussed below or, if it has not, why not.

Subcontracting: If the outsourcing allows the supplier to subcontract any of the services to be provided under the outsourcing, any subcontracting shall not affect the supplier's responsibilities under the outsourcing agreement. (SYSC 8.3.4G)

Termination: The firm must be able to terminate the outsourcing if the supplier undergoes a change of control or becomes insolvent, goes into liquidation or receivership (or equivalent in its home state), or is in persistent material default under the agreement. (SYSC 8.3.5G)

Supplier is not authorised or registered in its home country and/or not subject to prudential supervision: Where this is the case:

- The firm should examine, and be able to show, to what extent the supplier may be subject to any form of voluntary regulation, including self-regulation in its home state. (SYSC 8.3.6G(1))
- The supplier must devote sufficient, competent resources to providing the service. (SYSC 8.3.6G(2))
- As well as the requirement to ensure that a supplier discloses any developments that may have a material impact on its ability to carry out the outsourcing (SYSC 8.1.8R(6)), where the conditions are not met, the developments to be disclosed should include (SYSC 8.3.6G(3)):
  - any adverse effect that any laws or regulations introduced in the supplier's home country may have on its carrying on the outsourced activity; and
  - any changes to its capital reserve levels or its prudential risks.
- The firm should satisfy itself that the supplier can meet its liabilities as they fall due and that it has positive net assets. (SYSC 8.3.6G(4))
- The firm should require that the supplier prepares annual reports and accounts which (SYSC 8.3.6G(5)):
  - are in accordance with the supplier's national law which, in all material respects, is the same as or equivalent to the international accounting standards; and
  - have been independently audited and reported on in accordance with the supplier's national law which is the same as or equivalent to international auditing standards.

- The firm should receive copies of each set of the audited annual report and accounts of the supplier. If the supplier expects or knows its auditor will qualify his report on the audited report and accounts, or add an explanatory paragraph, the supplier should tell the firm without delay. (SYSC 8.3.6G(6))
- The firm should satisfy itself, and be able to show, that it has in place suitable procedures to ensure that it is fully aware of the supplier's controls for protecting confidential information. (SYSC 8.3.6G(7))
- As well as the requirement at SYSC 8.1.8R(10) that the supplier must protect any confidential information relating to the firm or its clients, the outsourcing agreement should require the supplier to tell the firm immediately if there is a breach of confidentiality. (SYSC 8.3.6G(8))
- The outsourcing agreement should be governed by the law and subject to the jurisdiction of an EEA state. (SYSC 8.3.6G(9))

No cooperation agreement between the FCA and the supervisory authority of the supplier or there is no supervisory authority of the supplier. Where this is the case:

- The outsourcing agreement should ensure the firm can provide the FCA with any information relating to the outsourced activity that the FCA may require to carry out effective supervision. The firm should therefore assess the extent to which the supplier's regulator and/or local laws and regulations may restrict access to information about the outsourced activity. The notification to the FCA should include any relevant details. (SYSC 8.3.7G(1))
- The outsourcing agreement should require the supplier to provide the firm's offices in the UK with all requested information required to meet the firm's regulatory obligations. The FCA should have an enforceable right to get the information from the firm and to require the supplier to provide the information directly. (SYSC 8.3.7G(2))
- The guidance applies whether a firm outsources portfolio management directly or indirectly via a third party. The firm must notify the FCA of the arrangement only once it has carried out due diligence on the supplier and has considered the FCA guidance.
- If a firm can show it has taken the FCA's guidance into account and has satisfactorily concluded that it can continue to satisfy the outsourcing rules and provide adequate protection for consumers despite not satisfying the conditions, the FCA is unlikely to object to the outsourcing arrangement. (SYSC 8.3.3G)
- The regulator does not authorise or otherwise approve any arrangement or its terms. The purpose of the notification, rather, is to ensure the regulator has reasonable time to intervene in appropriate cases. It is the responsibility of the firm to negotiate the terms of any outsourcing arrangement and to ensure that those terms are consistent with its obligations, without any formal regulatory intervention.
- The firm's notice must include adequate details of the outsourcing arrangement. The FCA may seek further information about the outsourcing proposal.
- The firm may enter into the outsourcing arrangement if the FCA does not object or seek further information within one month. (SYSC 8.2.4G)
- Where the FCA has not objected to the outsourcing agreement, the firm should notify the FCA of any matters which could affect the firm's ability to provide adequate services to its customers or could result in serious detriment to its customers or where there has been material change in the information it has previously provided. (SYSC 8.2.9G)

Other relevant FCA rules

General organisational requirements: Considering the nature, scale and complexity of the business of the firm, and the nature and range of the investment services and activities undertaken in the course of that business, a firm must (Article 5(1) final paragraph, implemented in SYSC 4.1.4R):

- establish, implement and maintain decision-making procedures and an organisational structure which clearly and in a documented manner specifies reporting lines and allocates functions and responsibilities;
- establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the firm (Article 5(1)(c)); and
- establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the firm (Article 5(1)(e)).

Business continuity: A firm must establish, implement and maintain an adequate contingency and business continuity policy aimed at ensuring, in the case of an interruption to its systems and procedures, the preservation of its essential data and functions and the maintenance of investment services and activities, or, where that is not possible, the timely recovery of the data and functions and the timely resumption of its investment services and activities. (Article 5(3), implemented in SYSC 4.1.7R)

Regular monitoring: A firm must monitor and regularly evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements established and take appropriate measures to address any deficiencies. (Article 5(5), implemented in SYSC 4.1.10R)

General: The systems, internal control mechanisms and arrangements set up by a firm must consider the nature, scale and complexity of its business and the nature and range of investment services and activities undertaken in the course of that business. (Article 5(1) final paragraph), implemented in SYSC 5.1.13R)

A firm must monitor and, on a regular basis, evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements set up under this guide, and take appropriate measures to address any deficiencies. (Article 5(5), implemented in SYSC 5.1.14R))

Undertakings for the Collective Investment in Transferable Securities

What are the UCITS Directive requirements on outsourcing?

The key requirements of the UCITS Directive (which applies to UCITS managers) on outsourcing are in Article 13 of the Level 1 Directive and are as follows:

- A requirement to notify the regulator of any outsourcing arrangement.
- The arrangements must not prevent effective supervision of the management company, and, in particular, must not prevent the management company from acting, or the UCITS from being managed, in the best interests of its investors.
- If the outsourcing relates to investment management, the service provider must be authorised or registered for the purpose of asset management and subject to prudential supervision, and the delegation must be in accordance with the management company's investment-allocation criteria. If the service provider is outside the EEA, there must be cooperation between the supervisory authorities concerned.
- A management company must not give any mandate with regard to the core function of investment management to a depositary or to any other undertaking whose interests may conflict with those of the management company or the unit-holders.

- The management company must retain the ability to monitor effectively at any time the activity of its delegate.
- Nothing should prevent the persons who conduct the business of the management company from giving further instructions to the service provider or from withdrawing the mandate with immediate effect when this is in the interest of investors.
- The service provider must be qualified and capable of undertaking the functions in question.
- The UCITS' prospectuses must list the functions which the management company can delegate.
- The liability of the management company or the depositary must not be affected by any delegation. The management company must not delegate its functions to the extent that it becomes a letter-box entity.

The implementing (Level 2) Directive puts some flesh on this by specifically stating that management companies should be able to make arrangements for third parties to carry out some of their activities. It says that:

- The management company should perform due diligence to decide whether, having regard to the nature of the functions to be carried out by third parties, the undertaking performing those activities can be considered to be qualified and capable of undertaking the functions in question.
- The service provider should meet all the organisational and conflicts of interest requirements in relation to the activity to be carried out.
- The management company should check the third party has taken appropriate measures to comply with the relevant requirements and should monitor its compliance.
- Where the delegate is responsible for applying the rules governing the delegated activities, equivalent organisational and conflicts of interest requirements should apply to the activity of monitoring the delegated activities.
- If the delegate is itself subject to MiFID, the management company should be able to take this into account in the due diligence process.

The UCITS IV Directive has been amended by the UCITS V Directive 2014/91/EU. The UCITS V changes will take effect in March 2016. These will apply AIFMD-style rules on depositaries (see below) to UCITS managers. In summary, UCITS V upgrades the duties and liabilities of UCITS depositaries by clarifying the safeguarding, oversight and cash flow monitoring functions. As of the date of this article (1 October 2014), ESMA is consulting on technical measures to be made under UCITS V. ESMA's consultation on draft technical advice to the Commission addresses several issues and notably focuses on steps to be taken by a third party to whom safekeeping is delegated to ensure that the assets it holds are available for insolvency distribution in the event of its failure.

Alternative Investment Fund Managers Directive

What are the AIFMD requirements on outsourcing?

The AIFMD was adopted in July 2011 and was implemented in the EU in 2013. It was transposed in the UK by the Alternative Investment Fund Managers Regulations 2013 and the Investment Funds Sourcebook. AIFMD is supplemented by Level 2 Regulations (the **AIFM Regulations**).

The scope of the AIFMD is broad and, with a few exceptions, covers the management, administration and marketing of EU and non-EU AIFs by EU and non-EU AIFMs.

AIFMs will be subject to the delegation rules in Article 20 of AIFMD. In addition, the common platform requirements (including SYSC 8) continue to apply to an AIFM which is a full-scope UK AIFM of an unauthorised AIF and to the MiFID business of a UK AIFM. The delegation rules overlap with, and extend, the rules on outsourcing.

The provisions on delegation provide for the following:

- *Notification of delegation.* AIFMs which intend to delegate to third parties the task of carrying out functions on their behalf must notify the competent authorities in their home Member State before the delegation arrangements become effective.
- *Justification for delegation*. The AIFM must be able to justify its entire delegation structure on objective reasons. Article 76 of the AIFM Regulation sets out the criteria to consider – optimising of business functions and processes, cost saving, expertise of the delegate in administrations or in specific markets or investments and access of the delegate to global trading capabilities.
- *Resources of delegate.* The delegate must have sufficient resources to perform the relevant tasks and the people who effectively conduct the business of the delegate must be of sufficiently good repute and sufficiently experienced. Article 77 of the AIFM Regulation provides more details on how to satisfy this requirement, including the criteria for the delegate and its management to meet and giving guidance on what is considered to be sufficient "good repute".
- *Restrictions where portfolio or risk management are outsourced.* Where the delegation concerns portfolio management or risk management, an AIFM can appoint only authorised or registered asset managers who are subject to supervision or, where that condition cannot be met, only with the prior approval of the AIFM's regulator. Article 78 of the AIFM Regulation sets out which undertakings are authorised (essentially UCITS managers or external AIFMs, MiFID investment firms, credit institutions authorised to perform MiFID portfolio management services and appropriate authorised third country entities).
- *Cross-border delegation of portfolio or risk management.* Where the delegation concerns portfolio management or risk management and the delegate is a third-country undertaking, as well as the requirements above, there must be cooperation between the competent authorities of the home Member State of the AIFM and the supervisory authority of the undertaking. Article 78 of the AIFM Regulation goes on to list the conditions the cooperation agreement must meet.
- *Continuing effective supervision of AIFM.* The delegation must not prevent effective supervision of the AIFM, and, in particular, must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors. This is fleshed out by Article 79 of the AIFM Regulation which includes the requirement for access to information and business premises as well as the delegate's cooperation with the AIFM's regulators.
- *Qualifications of delegate.* The AIFM must be able to show that the delegate is qualified and capable of undertaking the functions in question, that it was selected with all due care and that the AIFM can monitor effectively at any time the delegated activity, give at any time further instructions to the delegate and withdraw the delegation with immediate effect when this is in the interest of investors. Several Articles in the AIFM Regulation supplement this condition including Article 75(h) and Article 77.
- *Review of services*. The AIFM must review the services provided by each delegate on an ongoing basis. Article 75(e) of the AIFM Regulation adds that the AIFM must take appropriate action if it appears the delegate cannot carry out the functions effectively or in compliance with applicable laws and regulatory requirements.
- *Restrictions on delegation of portfolio or risk management.* AIFMS must not delegate portfolio management or risk management to a depositary (or a delegate of the depositary) or any other entity whose interests may conflict with those of the AIFM or the investors of the AIF, unless the delegate has functionally and hierarchically separated the performance of its portfolio management

or risk management tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF. Article 80 of the AIFM Regulation expands on this point and includes "controlling" and "operating" as conflicting tasks. It also requires that the individuals engaged in risk management are not supervised by those responsible for the performance of operating tasks to ensure separation of functions.

- *Liability of AIFM.* The AIFM's liability towards the AIF and its investors must not be affected by the fact the AIFM has delegated functions to a third party, or by any further sub-delegation, nor must the AIFM delegate its functions to the extent that, in essence, it becomes a letter-box entity rather than the manager of the AIF. Article 82 of the AIFM Regulation sets out the criteria under which an entity will be considered a letter-box entity. These include loss of powers and contractual rights but it does not impose a blanket ban on delegation on a proportion of the investment management function.
- *Sub-delegation*. The third party may sub-delegate any of the functions delegated to it on the following conditions:
  - the AIFM consented before the sub-delegation. Article 81(1) of the AIFM Regulation states the consent must be in writing and a general consent in advance will not be deemed consent;
  - the AIFM notified the competent authorities of its home Member State before the sub-delegation arrangements become effective. Article 81(2) of the AIFM Regulation sets out what details the notification should include; and
  - the conditions set out in paragraph 1, on the understanding that all references to the "delegate" are read as references to the "sub-delegate."
- *Restrictions on sub-delegation*. There can be no sub-delegation of portfolio management or risk management to a depositary (or a delegate of the depositary) or any other entity whose interests may conflict with those of the AIFM or the investors of the AIF, unless that entity has functionally and hierarchically separated the performance of its portfolio management or risk management tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF. The relevant delegate must review the services provided by each sub-delegate on an on-going basis.
- *Conditions for further sub-delegation.* Where the sub-delegate further delegates any of the functions delegated to it, the conditions set out in the paragraph above will apply to that sub-delegation.
- *General principles*. Article 75 of the AIFM Regulation summarises the principles with which the AIFM must comply when delegating the task of carrying out one or more functions on its behalf:
  - the delegation structure does not allow the AIFM to delegate its responsibilities or liability;
  - the obligations of the AIFM towards the AIF and its investors are not altered as a result of the delegation;
  - the conditions with which the AIFM must comply in order to be authorised and carry out activities in accordance with Directive 2011/61/EU are not undermined;
  - the delegation arrangement takes the form of a written agreement between the AIFM and the delegate;
  - the AIFM ensures the delegate carries out the delegated functions effectively and in compliance with applicable law and regulatory requirements and must establish methods and procedures for reviewing on an on-going basis the services provided by the delegate. The

AIFM must take appropriate action if it appears the delegate cannot carry out the functions effectively or in compliance with applicable laws and regulatory requirements;

- the AIFM effectively supervises the delegated functions and manages the risks associated with the delegation. The AIFM must have the necessary expertise and resources to supervise the delegated functions. The agreement should contain the AIFM's right of information, inspection, admittance and access, and its instruction and monitoring rights against the delegate. The AIFM must also ensure the delegate properly supervises the performance of the delegated functions, and adequately manages the risks associated with the delegation;
- the AIFM ensures the continuity and quality of the delegated functions, or of the delegated task of carrying out functions, even if the delegation terminates, either by transferring the delegated functions or the delegated task of carrying out functions to another third party or by performing them itself;
- the respective rights and obligations of the AIFM and the delegate are clearly allocated and set out in the agreement. In particular, the AIFM must contractually ensure its instruction and termination rights, its rights of information, and its right to inspections and access to books and premises. The agreement must make sure that sub-delegation can take place only with the consent of the AIFM;
- where it concerns portfolio management, the delegation is in accordance with the investment policy of the AIF. The AIFM must tell the delegate how to implement the investment policy and the AIFM must continually monitor compliance;
- the AIFM ensures the delegate discloses to the AIFM any development that may have a material impact on the delegate's ability to carry out the delegated functions effectively and in compliance with applicable laws and regulatory requirements;
- the AIFM ensures the delegate protects any confidential information relating to the AIFM, the AIF affected by the delegation and the investors in that AIF; and
- the AIFM ensures the delegate establishes, implements and maintains a contingency plan for disaster recovery and periodic testing of backup facilities while taking into account the types of delegated functions.

The Letter-Box Debate

The issue of delegation of investment management under AIFMD has proven to be highly controversial. It was one of the main reasons for the delay in agreeing the AIFM Regulation. Draft regulation prepared by the European Commission ignored advice received from the European Securities and Markets Authority (**ESMA**) in 2011 to the effect that the regulation would prevent future delegation of fund management.

However, the final versions of the Level 1 Directive and the AIFM Regulations are not as restrictive as the proposed text in the earlier drafts. Subject to certain conditions (detailed above), the AIFM may delegate (and sub-delegate) risk or portfolio management to other service providers, if the home regulator has prior notice.

AIFMs must not delegate their functions to the extent that they would cease to be the manager of the AIF and become a letter-box entity. This means the delegation arrangements must not allow for the circumvention of the AIFM’s responsibilities, obligations or liability.

To avoid the risk of being categorised as a letter-box entity, an AIFM must perform a significant degree of day-to-day investment management itself. Proportionally, this should not be significantly outweighed by the amount of day-to-day investment management it has delegated.

Article 82 of the AIFM Regulations contains detailed rules on where an AIFM will be deemed to be a "letter-box entity" and therefore no longer considered to be the manager of the AIF as a result of delegation. This will occur if:

- the AIFM no longer has the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;
- the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to the implementation of the general investment policy and investment strategies;
- the AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of these rights becomes impossible in practice;
- the AIFM delegates performing investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself. When assessing the extent of delegation, authorities must assess the entire delegation structure considering not only the assets managed under delegation but also the following qualitative criteria:
  - the types of assets the AIF or the AIFM acting on behalf of the AIF is invested in, and the importance of the assets managed under delegation for the risk and return profile of the AIF;
  - the importance of the assets under delegation for achieving the investment goals of the AIF;
  - the geographical and sectoral spread of the AIF's investments;
  - the risk profile of the AIF;
  - the investment strategies followed by the AIF or the AIFM acting on behalf of the AIF;
  - the types of tasks delegated in relation to those retained; and
  - the configuration of delegates and their sub-delegates, their geographical sphere of operation and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM.

The European Commission intends to review the application of these provisions after two years (i.e. 2015) in light of market developments and may specify further conditions under which an AIFM will be deemed to be a letter-box entity. ESMA can also issue guidelines on delegate arrangements. This means firms may need to revisit their analysis of whether their manager is a letter-box entity.

Remuneration Code

Full scope UK AIFMs (i.e. those with assets under management of at least €100m or €500m (if the funds managed are unleveraged and do not grant investors redemption rights for at least 5 years)) must comply with:

- the AIFM Remuneration Code (which is set out in chapter 19B of SYSC);
- the Guidelines on Sound Remuneration Policies under the AIFMD issued by ESMA on 3 July 2013; and
- the additional guidance issued by the FCA on the application of principles of proportionality to remuneration policies of AIFMs.

This means the AIFMs must establish, implement and maintain remuneration policies and practices that promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles of the AIFs they manage.

The remuneration requirements apply to staff whose activities have a material impact on the risk profiles of the AIFM and/or the AIFs it manages. This includes those working for firms to which the AIFM delegates portfolio or risk management.

The ESMA Guidelines say delegates must be subject to requirements on remuneration which are "equally as effective". Alternatively the delegate and the AIFM must put in place contractual arrangements to ensure that the remuneration requirements are not circumvented. The FCA has clarified that "equally as effective" does not require compliance with the same rules. Compliance with the rules and requirements in MiFID and CRD IV (even if a national regulator has dis-applied some CRD requirements for certain categories of investment firms, as the FCA has done) will be good enough.

Where contractual arrangements must be put in place, both ESMA and the FCA have confirmed that those arrangements should only apply to those staff who have a *material impact* on the risk profile of the relevant AIFs and in respect of remuneration which is connected with the delegated activities.

When assessing the materiality of influence on an AIFM's risk profile or an AIF it manages, AIFMs should define what is materiality within the context of their AIFMs and the AIFs they manage.

Depositary Liability

Another contentious part of the AIFMD has been its rules on depositary liability. The AIFM Regulation imposes near strict liability on the depositary for "losing" assets held in custody. Article 83 of the AIFM Regulation sets out the contractual particulars for the agreement between the depositary and AIFM or AIF. The contract must include significant details on the services to be provided and the way in which the safe-keeping and oversight function should be performed. The contract must also cover issues such as liability, transmission of information, re-use of assets, exchange of information, use of third parties, responsibility for compliance with anti-money laundering legislation, segregation of assets and complaints handling.

A financial instrument held in custody by the depositary is deemed to have been lost when:

- a right of ownership is invalid because it either ceased to exist or never existed;
- the fund has been definitively deprived of its right of ownership; or
- the AIF is definitively unable to directly or indirectly dispose of the instrument.

However, the depositary will not incur liability if the event which led to the loss:

- is not the result of any act or omission of the depositary or a third party which it has delegated to; or
- the depositary could not have reasonably been prevented despite adopting all precautions incumbent on a diligent depositary as reflected in common industry practice.

Depositaries will also avoid liability if they could not have prevented the loss, and they have established, implemented and they apply, on an on-going basis, certain structures and procedures as set out in Article 101(c)(i) to (iii) of the AIFM Regulation.

The AIFM Regulation also addresses the criteria for assessing the prudential regulation applicable to depositaries in third countries (Article 84) and a long list of duties on both the depositary and the fund around its functions, due diligence obligations and segregation requirements (Articles 85 to 99).

UK Regulatory Developments

The “Dear CEO” Letter (December 2012)

The then FSA wrote an open letter to the CEOs of asset managers in 2012, highlighting its concerns on the risks associated with outsourcing by asset managers. It queried the solidity of recovery plans.

It concluded that "*if an outsource provider were to face financial distress or severe operational disruption, UK asset managers would not be able to perform critical or important regulated activities, thereby causing detriment to customers*". Two areas of particular concern were:

- **Resilience**. Firms should have adequate resilience plans in place to enable them to carry out regulated activities if a service provider were to fail.
- **Oversight**. Firms should exercise due skill, care and diligence when entering into, managing or terminating an outsource arrangement.

The FCA asked asset managers to review their contingency plans to ensure compliance with regulated obligations.

FCA Thematic Review of Outsourcing in the Asset Management Industry (November 2013)

The FCA conducted a thematic review of outsourcing in the asset management industry and published its report in 2013. It examined the outsourcing arrangements of 17 asset managers and concluded many were not compliant with existing regulations governing outsourcing. The FCA's thematic review focused on two risks where outsourcing could have an adverse effect on customers: resilience risk and oversight risk.

Resilience Risk. It found asset managers were not adequately prepared for the failure of a service provider. Examples of underdeveloped contingency plans include:

- moving from the failed incumbent to another service provider. It said this was likely to take too long and may be unrealistic due to the lack of competitive alternate service providers;
- exercising individual step-in rights and taking over the outsourced activity. It said firms were failing to show how they would overcome the operational difficulties of stepping in to the service provider, with delays, detrimental client service and data privacy issues likely;
- taking the activities in-house. It said firms were failing to prove they have timely access to the required expertise, technology and data to enable them to insource at short notice; and
- too big to fail. The service providers are part of systemically important banking groups that are too big to fail and their governments would bail them out. FCA said that no service provider is too big to fail but found that service providers were failing to put in place effective recovery and resolution plans.

The FCA expects asset managers to consider how contingency plans would work under stressed market conditions. Although a well prepared contingency plan for the failure of a service provider is important, business failure is a comparatively rare situation. In addition, major disaster incidents can affect any business, and there are some situations in which even a best practice and comprehensive contingency plan will not prevent the resultant interruption.

FCA accepted there is no one size fits all solution or "silver bullet" that will mitigate the resilience risk. However, measures an asset manager could take include:

- considering how to continue to service customers during a transfer period to a new service provider;
- forming a relationship with a "stand-by" provider that could step in if the primary service provider fails;
- keeping a detailed understanding of its operational exposure to the service provider;

- identifying the outsourced activities that are essential to ensure a basic level of service to customers;
- improving surveillance of a service provider's financial position to anticipate any potential failure; and
- knowledge of how, where and how often essential activities are performed.

Contingency plans should be "viable, robust and realistic".

Oversight Risk. The FCA found asset managers were not maintaining adequate in-house expertise to supervise the outsourced activities effectively. It said this was either through a shortage of staff overseeing the service provider or because the staff do not have the relevant and necessary depth of expertise. This results in the asset manager placing undue reliance on the service provider's own expertise and controls. The FCA identified several asset managers who accepted management information provided by the service provider without any independent verification.

Asset managers varied considerably in their monitoring of service levels, management information, compliance, pricing valuations, trade processing and corporate actions and displayed varying degrees of rigour. While one asset manager carried out extensive on-site visits at the service provider and produced six-monthly reports, another simply checked that its service provider was following control processes without verifying the accuracy. Asset managers were too reliant on information provided by their service providers and were not checking for errors themselves. Occasionally firms did not have staff with relevant expertise to supervise outsourced activities, placing strain on the service provider.

The FCA said it wanted asset managers to develop solutions to address its concerns.

An Industry Response to the Dear CEO Letter (December 2013)

In December 2013, the Investment Management Association (**IMA**) published an industry response prepared by the Outsourcing Working Group (**OWG**) to address regulatory concerns about outsourcing in the asset management sector.

The OWG formed in July 2013 to consider the issues raised by the regulator. The OWG comprises over 30 individuals from 24 organisations including the IMA, asset managers, outsourcing service providers and support from accountancy firms.

The OWG issued Guiding Principles and Considerations for asset managers. The principles cover oversight, exit planning and standardisation and focus on the outsourcing of fund accounting, transfer agency and investment operations. The OWG expects firms to apply the Guiding Principles and Considerations in a way that is proportionate and most appropriate for their business. This will also depend on the nature, size and source of the outsourced arrangements.

Asset managers should document and review their assessment of each of the Guiding Principles and Considerations on a periodic basis and in response to significant events.

OWG Key Principles of an Oversight Model

Principle 1: Know Your Outsourcing or "KYO"
Firms should have a full understanding of the scope, nature, locations and contractual terms of their outsourcing arrangements to enable them to manage and oversee the relationship with service providers.

Principle 2: Risk-Based Assessment
Firms should conduct a risk-based assessment of outsourcing arrangements to understand the impact of those outsourced activities on the asset manager and the end client. Considerations should include: • service and company characteristics: assessment of service criticality, complexity and risk appetite; • service provider characteristics: assessment of the provider itself, including capabilities, control framework, maturity of service provision, financial position, industry credentials and reputation; • impact on the end client: consideration of the potential consequences of service failure or disruption on the end client and the mitigants and controls that are in place; and • contractual characteristics: assessment of relevant contractual provisions, including commercial terms, service, governance, termination provisions, notice periods, exit planning, business continuity, risk and control transparency.
Principle 3: Ownership
Firms should establish an appropriate level of ownership at a senior level for outsourced activities. Considerations should include: • clear ownership of the outsourcing relationship at both a commercial and operational level; • retaining accountability for mitigating operational risks; • retaining appropriate in-house knowledge and expertise of outsourced functions; and • understanding relevant regulatory requirements.
Principle 4: Governance Framework
Firms should set up an appropriate framework for oversight. Considerations should include: **Governance, both internal and external:** • carrying out due diligence on financial strength, service provider control reports, site visits, internal audit, risk, compliance, security programmes and business continuity planning/ disaster recovery; • performing formal periodic reviews of extent of arrangements, risk assessment, ownership and documentation governing the service provider relationship and contractual arrangements to ensure they remain appropriate to nature, scale and complexity; • ensuring appropriate engagement of and reporting to senior management; • reviewing and addressing key changes in the end-to-end operating model including people, processes, locations and systems; and • performing internal assessment of compliance with regulatory requirements; **People and organisation:** • establishing and maintaining clearly defined internal roles, responsibilities and reporting lines; and • providing training to the oversight team and ensuring teams continue to have appropriate skills, industry awareness, capacity and expertise to manage and oversee the outsourced activities. **Operational oversight:** • ensuring engagement and ownership from operations and control functions (audit, risk and compliance);

- performing on-going monitoring at appropriate frequencies, including risk and issues logs, scope changes, key milestones reporting, key decision points, escalation process and key dependencies; and
- convening joint steering committee, internal steering committee and project team meetings as appropriate. Setting up regular contact to resolve issues and maintaining a strong business-as-usual relationship. Assessing appropriateness of the service provider’s resourcing model.

Change management:

- setting up processes to manage regulatory change, business change and scope change for the life of the transition; and
- operating and monitoring a change management process and jointly agreeing on changes.

There is no prescriptive approach to oversight. Oversight principles change during the lifecycle of the outsourced relationship. During the appointment and transition process, the focus is on setting up the oversight model and setting up good working relationships and practices across the firm and service provider. Then the focus will be on ensuring services are provided to the expected standard and keep pace with industry and business changes. During the exit phase, the focus will be on incremental oversight and ensuring continued quality of service while the relationship is in transition. The OWG has produced user-friendly guidance on the key principles and lifecycle.

Key Principles of Exit Planning

The exit plan describes the process from transitioning business from one service provider to another. The overriding priority for all parties involved in executing a transition is to ensure continuity of service and no impact to end investors. Asset managers should be realistic on how long it will take to find and appoint a replacement supplier.

There are seven guiding principles for exit planning.

OWG Guiding Principles for Exit Planning

Principle 1: Comprehensive Exit Plan
Firms should have a comprehensive exit plan to be able to transition from one outsourcing service provider to another. Exit plans for each outsourced function should form part of a firm's resilience arrangements. Firms should develop and maintain exit plans in consultation with the service providers.
Principle 2: Governance Framework
The existence and contents of the exit plan should be overseen by the firm’s wider governance framework.
Principle 3: Periodic Review
Asset managers and service providers should review the exit plan at least annually and when there have been any material changes to the outsourcing profile of the firm.
Principle 4: Single Approach
The exit plan should include the arrangements in place for a controlled business-as-usual exit from an outsource relationship. The exit plan should also include considerations associated with exit in the

event of a provider's severe operational distress (including insolvency), especially any potential impact to the end investor.
Principle 5: Key Documentation
The exit plan should detail the relevant outsourcing arrangements or refer to other documents that do (e.g. service level agreements). Details should include the outsourced functions, the contractual entity and where the work is performed.
Principle 6: End-to-End Transition
The exit plan should consider end to end transition from old to new provider.
Principle 7: Transition Governance
The exit plan should identify a governance framework to oversee a transition and a migration plan by which a transition would be effected.

Key Considerations for Effective Exit Planning

Detailed awareness of what is outsourced and to whom - key areas to consider:

- maintaining a detailed record of relevant outsourcing arrangements;
- signposting key documents including service level agreements and identifying any relevant triggers in place to instigate the possible termination of the outsourced service;
- understanding how the contract would operate in the event of termination; and
- having awareness of other service providers' capability to provide the service.

Transition arrangements- key areas to consider:

- maintaining a transition project plan;
- accountability for effecting the transition;
- high level options and associated risks;
- resource requirements within the relevant parties;
- consideration of continuity of business and regulatory requirements through a transition (e.g. new products, fund launches, legacy business and M&A); and
- timeline setting out how the firm will undertake key activities, including analysis and articulation of the service requirements, RFP and due diligence, IT and data analysis/ transition. Management of key resourcing issues including staff transfer and future training requirements and management of the pre go-live phase including testing and rehearsal regime.

Governance and maintenance of the exit plan - key areas to consider:

- clarity of ownership and accountability for exit plans – likely to rest with senior management of the asset manager;
- review, challenge and approval of exit plans by senior management – including at least an annual review and additionally at the point of any material changes to outsourcing arrangements;
- periodic walk through of off-boarding arrangements with relevant providers;
- consideration of quantity and expertise of available resources associated with possible future transitions; and

- review of exit plans by assurance functions – internal audit, compliance and operational risk.

Key Principles of Standardisation

The OWG recognises the transition process for outsourcing arrangements is time-consuming and complex. This is partly due to the degree of customisation which varies from one asset manager to another.

The Guiding Principles and Considerations focus on adopting standard terminology and documents, data interfaces and testing processes. This will help asset managers and service providers to manage more effectively the transition of outsourced services and reduce the time taken when transitioning to a new service provider.

The Guiding Principles and Considerations suggest key areas to consider for governance and maintenance of the exit plan are as follows:

- identifying the areas which have the most impact on transition timescales;
- discussing the steps required to increase standardisation in these areas;
- looking into how standardisation would benefit the customer;
- agreeing a shortlist of focus areas where the work stream can realistically deliver value in the available timeframes; and
- starting to draft and refine these deliverables.

The OWG felt that a standard suite of documents could help asset managers ensure effective management over outsourced services. For example, a standard exit plan could cover key areas regarding governance and maintenance of the exit plan such as the following:

- **operating model**: setting out processes, services and inter-dependencies for the relationship;
- **location model**: where services are multi-jurisdictional. This helps ensure the asset manager is clear on what services are undertaken and the governance model in operation within the service provider across these locations;
- **functional breakdown document**: detailing the sub-functions;
- **service definitions**: list all services delivered within the relationship in an agreed format, so the asset managers' business, technology, operations and control functions have a common understanding of the service components**;**
- **service level agreement (SLA) for each outsourced activity**: this should contain details of the agreed service levels, key performance indicators, dependencies and related processes for both parties (the asset manager and the service provider);
- **SLA appendices**: this should list core service details – i.e. lists of funds, clients, reports, data delivery files, specific processes and accounting rules, derivative pricing policies, data definitions and where data is stored;
- **critical data and functions required for transition to another service provider**: define these and include data elements, definitions, delivery timings, delivery mechanism, contingency method and related impact on third parties or customers of non-delivery;
- **mapping services**: consider how critical and non-critical functions map to the service providers' standard and bespoke services. Agree on how they impact on any transition plan;

- **data:** set out how the existing service provider will provide static data, account profiles and portfolio data. Develop and maintain testing criteria and approach as part of transition process planning; and
- **standardise testing methodology**: to expedite a transition so all parties understand what is expected. Each asset manager will have its own testing protocols and timeframes.

Next Steps for Asset Managers

The FCA, in its 2013 Thematic Review of Outsourcing in the Asset Management Industry, recommends that asset managers review their outsourcing arrangements, and, if necessary:

- enhance their contingency plans to deal with the failure of a service provider providing critical activities; and
- assess the effectiveness of their oversight arrangements to oversee critical activities outsourced to a service provider, making sure the required expertise is in place.

Firms should also review their outsourced arrangements in light of the Guiding Principles and Considerations and consider what is appropriate for their business model. To evidence compliance with applicable rules, firms should document their rationale and the procedures they adopt, for example, in an outsourcing manual and checklist.

The FCA has signalled that it may conduct follow-up work on the issues raised in its report and see if asset managers have started to implement its recommendations. If it considers there has not been enough progress, it will then consider further policy action.

It is therefore more important than ever that asset managers plan effectively and spend enough time and resources on managing their outsourcing agreements.

Hints and tips

With so much prescriptive guidance on outsourcing, fund managers may think that so long as they can tick compliance with each rule off their list, their outsourcing arrangements will entail little commercial risk. However, any firm considering an outsourcing should put in place systems and controls that ensure it considers all appropriate issues and risks necessary to ensure that the outsourcing arrangement is successful. This may include some of the following key issues:

- *Good for the business:* Firms must consider whether outsourcing of a particular function makes good business sense. Many fund managers outsource to help convert their fixed cost base into a flexible cost base, or simply to cut costs. But firms must weight up the benefit of keeping the functions in-house against the cost savings or other benefits of outsourcing them. Knowing why the outsourcing makes business sense will be critical in achieving a well-negotiated agreement.
- *Due diligence:* Before a firm starts an outsourcing project it should carry out enough due diligence to make sure that outsourcing is the best way to achieve its desired business outcome. Common problems arise in the fund management sector when:
    - the fund manager fails to identify its objectives clearly;
    - the fund manager fails to understand its specific service needs;
    - the parties underestimate the extent to which the supplier's standard operating model will satisfy the customer's specific service needs;

  - the customer fails to assess the supplier's proposed charging level and method adequately (especially if cost cutting is a primary driver); or
  - the parties fail to consider the implications of TUPE.
- *Proper preparation and procurement:* An effective procurement procedure is critical. As with most commercial projects, the most successful outsourcing arrangements have a good project plan with budgets agreed at the start, with an appropriate project team and strong manager. The better thought out the arrangements before the agreement is signed, the more likely it is that the arrangements will be fit for purpose and will succeed. It is important to document all decisions.
- *Agreeing liability under the arrangements:* One of the most difficult areas to deal with in business process outsourcing agreements in the fund management market is liability. Market practices have arisen in several areas that managers often outsource:
  - *Custody suppliers*: Custody suppliers traditionally limited their liability to negligence, and often wish to limit the liability to an amount of 12 to 18 months' fees. AIFMD has changed this standard of liability completely. So will UCITS V. Under AIFMD, each AIFM caught by the AIFMD must enter into a written contract with a depositary or custodian for each fund it manages. The depositary will be liable *to the relevant fund or its investors* for losses of financial instruments held in custody (whether it is responsible for the loss or not) except if the loss has arisen as a result of an external event beyond its reasonable control, *as well as* for losses as a result of negligently or intentionally failing to perform its duties in the AIFMD. Further, the custodian will be liable for any act of sub-custodians.
  - *Fund administration/investment operations*: Limiting liability to negligence, as some service providers try to do, is contentious for business process outsourcing. The nature of the contractual relationship is often different to a custody relationship (as conceived of outside the depositary regime in AIFMD). Also, unlike custody outsourcing arrangements, business process outsourcing agreements are usually not commodity agreements and the firm may feel that ending the agreement and moving to an alternative supplier is not an acceptable remedy.
- *Service providers*: Firms must ensure that they understand the liability that the competing suppliers are willing to accept before down-selecting a preferred supplier. Once a firm has selected its preferred supplier, it loses bargaining power and is likely to end up with a less than satisfactory allocation. Agreement at the selection stage should cover the general principles on which liability will be based (e.g. negligence vs. breach of contract), the limit of liability (if relevant), the extent of liability for events outside a party's control (so-called force majeure events), the extent of liability for third parties (such as members of the supplier's group and sub-contractors) and the extent of the supplier's liability to the firm's underlying customers. It may be helpful to document who will be responsible for specific losses (such as regulatory fines or posting collateral with an insolvent counterparty which can then not be recovered). The parties should also agree the terms of any indemnity the supplier will need the firm to give to protect it against claims by the firm's underlying customers in circumstances where the supplier is acting in accordance with the outsourcing agreement or on the firm's direct instructions.
- *Services:* The service description must be prepared in a logical manner, be sufficiently detailed to include the firm's requirements (including, for example, service hours), describe the scope of the services and define all relevant definitions to ensure a mutual understanding of these. It should also cover issues such as the authentication procedure, authorised signatories, definition of proper instructions, security requirements and business continuity requirements. It is good practice for the parties to agree a detailed service description containing all information necessary for the supplier to provide the customer with firm prices or rates for the services before signature of the

agreement. The parties must also agree in what circumstances extra charges will be payable and on what basis these will be calculated.

- *Charging:* It is essential the services to be provided under the agreement and the charges to be paid for these services are described clearly and comprehensively.
- *Appropriate incentives*. Firms often have strong views on whether it is appropriate to include service credits (payable by the supplier for poor performance). It is critical for firms to understand the merits of service credits during negotiations and build them in appropriately.
- *Adequate controls over how the services are provided:* Although outsourcing suppliers often think their client firm should merely be interested in the services that are provided to it, not how they are provided, fund managers will need to look into the "black box" not least to ensure they meet the SYSC requirements and FCA's expectations.
- *Proper remedies:* Firms sometimes underestimate the amount of effort required to manage continuing outsourcing arrangements. Firms will need to set up appropriate governance arrangements to get the information and reports they need to monitor supplier performance. The outsourcing agreement must incorporate appropriate notification requirements, and allow the fund manager access to all necessary documents and records, to ensure it meets its FCA requirements. The agreement should, however, also include satisfactory remedies for failure in their outsourcing agreements, such as preparing a correction plan.
- *Managing change:* The outsourcing agreement should clarify which party will bear which costs of changes in legislation. Fund managers will need to ensure their agreements are flexible enough to allow change, but that costs of change are proportionate. They will also want to ensure that changes are implemented swiftly. This can be important where the sale of a new product is dependent on the supplier completing any changes to the services necessary to support the new product. Incentives including service credits and service bonuses may be helpful in specific cases.
- *Smooth termination arrangements:* It is essential that firms consider how to ensure business continuity under the outsourcing arrangements, particularly on termination. The arrangements should include discussion of not only financial and operational assistance but must also deal with employment and intellectual property issues that may arise.

For a detailed description of all of the above issues and other relevant issues, please see Amanda Lewis's book **Business Services, Partnering and Outsourcing: A Practical Guid**e published by Thomson Reuters.

Conclusion

With so much prescriptive law governing outsourcings of critical functions by fund managers, one might think there is little scope for error. But a successful outsourcing is about ensuring the requirements of FCA rules are met, while protecting the commercial and business interests of the parties. No fund manager should assume that ticking all the FCA boxes will mean they have good outsourcing arrangements. We would recommend that, if firms are reviewing their outsourcing arrangements to ensure that they comply with applicable rules, they should also review them against other key requirements for successful outsourcing arrangements, such as those described above and in Amanda's book. The devil is in the detail.

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