

# Insight

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## MiFID and outsourcing

The Markets in Financial Instruments Directive (Directive 2004/39 EC) ("MiFID") came into force on 1 November 2007. Its essential aim is to liberalise the European market for certain investment services.

MiFID seeks to do this by: (i) establishing a common regulatory framework for the execution of transactions in financial instruments, with the emphasis being on high quality execution for customer transactions; and (ii) facilitating the carrying out of investment transactions by investment firms on financial markets across Europe. MiFID does not apply to a number of bodies including, notably, insurance undertakings, credit institutions and investment funds.

MiFID expressly addresses outsourcing in Article 13(5), which sets forth the outsourcing obligation with which investment firms must comply. Article 13(5) distinguishes between:

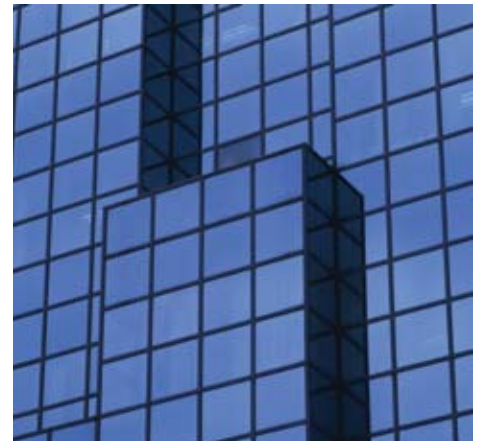
- Outsourcing of operational functions which are **critical** for the provision of continuous and satisfactory services to clients and the performance of investment activities on a continuous and satisfactory basis. In those circumstances, the investment firm must take reasonable steps to avoid undue additional operational risk; and
- Outsourcing of **important** operational functions, which may not be undertaken in such a way as to impair materially the

quality of the investment firm's internal controls of the ability of the applicable regulatory authority to supervise the firm's compliance with its obligations.

In the UK, changes have been made to the FSA Handbook to reflect the additional requirements of MiFID. Those changes have been in effect since 1 November 2007 and apply to outsourcing arrangements entered into after that date as well as arrangements already in place at that date. In particular, modifications were made to the SYSC Module of the FSA Handbook and the MiFID requirements are also reflected in the MiFID Connect Outsourcing Guideline, which is FSA-approved industry guidance on the application of MiFID to outsourcing arrangements. It is important to note that, unlike the MiFID Connect Guidelines, the rules set forth in the FSA Handbook are legally binding obligations with which investment firms are required to comply.

### Outsourcing of "critical or important" functions

The MiFID requirement in Article 13(5) maps to Rules SYSC 8.1.1R, 8.1.3R and 8.1.4R of the FSA Handbook. SYSC 8.1.4R provides that a function is critical or important if a defect or failure in its



### Outsourcing Practice

White & Case has served as outsourcing counsel to some of the most prominent companies in the world, including financial services leaders, international food giants, multinational telecommunications companies and media and technology leaders. We have the capability to advise on the legal issues that arise in even the most complex outsourcing transactions, including confidentiality and privacy, technology transfers, intellectual property, employment law, tax, real estate, dispute resolution, regulatory clearances, equity and debt financing and related governance issues, as well as contract and regulatory compliance.

### Financial Services Regulatory Practice

Effective management of regulatory risk is vital. White & Case has a comprehensive practice dealing with financial services regulation. We advise financial institutions, corporate clients and individuals on all aspects of regulatory compliance and in relation to contentious regulatory matters.

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The MiFID Connect Outsourcing Guidelines suggest that “critical or important” is a single concept, such that something which is identified as “critical” will also tend to be considered as “important”.

performance would materially impair the continuing compliance of an investment firm with the conditions and obligations of its authorisation or its other obligations under the regulatory system, or its financial performance, or the soundness or the continuity of its relevant services and activities. The focus is therefore upon whether the performance of the function in question is likely to have an impact on the operational risk of the investment firm.

The MiFID Connect Outsourcing Guidelines suggest that “critical or important” is a single concept, such that something which is identified as “critical” will also tend to be considered as “important”. The Guidelines state that what is “critical or important” may well depend upon the circumstances of a particular firm. Nevertheless, the following fairly common operations are given as examples of what might be potentially critical or important functions:

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

By contrast, legal advice, billing services, training and security are not, according to Rule SYSC 8.1R, considered to be “critical or important” as they do not form part of the services for which an investment firm requires regulatory approval. MiFID Connect supplements this list of non-critical or important functions by including

such matters as the appointment of sub-custodians, the development of bespoke software, the purchase of “off-the-shelf” software products and assistance in relation to “off-the-shelf” systems.

#### **Scope of the outsourcing obligation**

SYSC 8.1 provides a body of rules and guidance which will apply to outsourcings of both “critical/important” and to non-critical/important functions. In short, where the outsourcing relates to a “critical/important” function, SYSC 8.1.1R reiterates the provisions of Article 13(5) of MiFID, i.e., taking reasonable steps to avoid undue additional operational risk, preservation of the investment firm’s internal controls and the ability of the FSA to monitor the firm’s compliance with its regulatory obligations. SYSC 8.1.6R expands upon this by adding the following conditions with which an investment firm outsourcing a “critical or important” function must comply:

- the outsourcing must not result in the delegation by senior personnel of their responsibility;
- the relationship and obligations of the firm towards its clients under the regulatory system must not be altered;
- the conditions with which the firm must comply in order to be authorised, and to remain so, must not be undermined; and
- none of the other conditions subject to which the firm’s authorisation was granted must be removed or modified.

Arguably, the matters set out above in relation to “critical/important” functions should also be taken into account in respect of non-critical outsourcings in light of the investment firm’s overarching obligation pursuant to SYSC 4.1.1R to have in place robust governance arrangements.

Rules common to both outsourcings of "critical/important" functions and non-critical functions include:

- exercising due skill and care and diligence when entering into, managing or terminating any outsourcing arrangement. This would include having in place a written agreement with the relevant service provider, which includes appropriate change control provisions to ensure that no changes are agreed during the life of the outsourcing agreement which would contravene the provisions of MiFID or the FSA Handbook;
- ensuring the service provider has the ability, capacity and right to perform the services reliably, effectively and professionally;
- having in place supplier performance measurement and supervision processes (and ensuring adequate resources to undertake these activities are retained by the investment firm);
- taking appropriate action if it appears supplier performance is not effective or legally compliant;
- the ability to terminate the outsourcing agreement where necessary without detriment to the continuity and quality of service provided to clients;
- ensuring the supplier co-operates to ensure that the performance of the outsourced functions remains in compliance with the firm's regulatory obligations. This includes appropriate audit procedures (both by the firm and its regulator) but also ensuring supplier processes and technology do not place the firm in breach of its regulatory obligations;

- appropriate protection of the firm's and its clients' confidential information; and
- establishing, implementing and maintaining a contingency plan for disaster recovery and periodic testing of backup facilities where that is necessary having regard to the function, service or activity that has been *outsourced*.

Although outsourcing guidance is not something which the FSA discovered with the advent of MiFID, the impact of MiFID has been to bring into sharper relief the fact that operational risk needs to be considered carefully in undertaking, negotiating and managing an outsourcing arrangement, particularly if, as expected, the regulatory environment in which investment firms operate continues to tighten.

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For more information about this subject, please contact:

##### Ashley Winton

Partner, London

Tel: +44 20 7532 2514

Email: [awinton@whitecase.com](mailto:awinton@whitecase.com)

##### Anthony Sourgnès

Associate, London

Tel: +44 20 7532 2506

Email: [asourgnès@whitecase.com](mailto:asourgnès@whitecase.com)

[www.whitecase.com](http://www.whitecase.com)

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