

**Outsourcing in the Securities Industry:
The Legal and Regulatory Landscape**

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I. Traditionally Recognized Outsourcing Arrangements

A. Clearing Arrangements

1. For many years, broker-dealers have used clearing arrangements to assist in the processing of securities transactions. Clearing arrangements generally allow introducing brokers to operate a securities business without having to invest in all of the infrastructure necessary to process, clear, and settle their customers' transactions. Instead, the introducing brokers outsource "back office" functions to clearing brokers that have the necessary infrastructure and technology, and, in turn, provide clearing services to a number of different introducing brokers.

2. In a typical clearing arrangement, the introducing broker agrees to retain responsibility for the opening, approving, and monitoring of accounts. The clearing broker handles certain "back office" functions for the introducing broker, such as order execution and clearance and settlement of transactions. However, the nature of clearing arrangements varies widely, and can include the outsourcing of such required functions as delivery of trade confirmations and account statements, custody of customer funds and securities, and provision of margin financing.

3. NYSE Rule 382 and NASD Rule 2320 expressly permit broker-dealers to enter into clearing arrangements. Under those rules, the clearing agreement between the introducing broker and the clearing broker must specify the respective functions and responsibilities of each party to the agreement, the allocation of which must be disclosed to customers. In addition, NYSE Rule 382 requires NYSE member firms to submit clearing agreements for approval by NYSE.

B. Recordkeeping

1. Broker-dealers, investment companies, and transfer agents are expressly permitted under SEC Rules to use third parties to maintain and preserve required records. Rule 17a-4(i) under the Securities Exchange Act of 1934 ("Exchange Act") (relating to broker-dealers), Rule 17Ad-7(f)(6) under the Exchange Act (relating to transfer agents), and Rule 31a-3 under the Investment Company Act of 1940 ("Investment Company Act") (relating to investment companies) all permit the use of third party service providers to maintain required records. Under all of those rules, the regulated entity must obtain a written undertaking from the service provider to the effect that the records will be made available for examination promptly on request. Broker-dealers and transfer agents must file any such undertakings with the SEC.

2. The SEC has not provided the same latitude to investment advisers. Rule 204-2(e)(1) under the Investment Advisers Act of 1940 ("Advisers Act") requires investment advisers to keep most of their books and records "in an appropriate office of the investment adviser." In 2005, the SEC staff granted limited no-action relief in this area, stating that it would not recommend enforcement action against an investment adviser to hedge funds for using a

third-party administrator to maintain and preserve the adviser's required books and records, provided that: (a) the administrator acts as a service provider to the adviser in maintaining, preparing, organizing or updating the adviser's records for the adviser's ongoing use in its business, and does not merely provide long-term storage of the records; and (b) on request of the SEC staff, the records are produced promptly for the staff at the appropriate office of the adviser or an office of the administrator.¹

C. Mutual Fund Transfer Agents

1. Although not expressly contemplated under securities regulations, many mutual funds outsource certain regulatory functions to their transfer agents. Transfer agents are often the most logical parties to carry out these functions because they have primary responsibility for, and direct access to, daily fund activity.

2. While practices vary, many mutual fund transfer agents are responsible for performing anti-money laundering compliance with respect to the fund's investors and for enforcing the fund's policies on market timing and late trading. The SEC recognized the role that transfer agents play in mutual fund compliance by including them as required service providers in Rule 38a-1 under the Investment Company Act, which requires mutual funds to establish and implement written policies and procedures for compliance with the federal securities laws by the funds and their service providers.²

3. Additionally, mutual funds often staff call centers with transfer agent personnel. Securities regulators have not given clear guidance in this area, but mutual funds may require call center personnel also to be registered representatives of a broker-dealer depending on the nature of interaction with existing and potential investors.

II. Regulatory Guidance Regarding Outsourcing in the Securities Industry

A. Self-Regulatory Organization Guidance on Outsourcing

1. NASD/NYSE Joint Survey of Broker-Dealer Outsourcing Practices

a. In October 2004, NASD and NYSE, which have since been consolidated into the Financial Industry Regulatory Authority ("FINRA"),³ conducted a joint survey of member firms' outsourcing practices. The survey requested information about the types of activities being outsourced and the nature of the third-party service providers being used. To that end, the survey covered both general and specific areas, including whether

¹ Letter to ABA Subcommittee on Private Investment Entities (December 8, 2005).

² See Investment Company Act Release No. 26299 (December 17, 2003), 68 FR 74714; see also Investment Company Act Release No. 26782 (March 11, 2005), 70 FR 13328, 13332 (n. 46) (providing that the SEC expects mutual funds and their transfer agents to use their best efforts in connection with assessing redemption fees), Investment Company Act Release No. 26288 (December 11, 2003), 68 FR 70388 (including mutual fund transfer agents in proposed rules regarding pricing of fund shares).

³ On July 30, 2007, the member regulation functions of NYSE were consolidated with NASD into a single self-regulatory organization, namely FINRA.

functions are outsourced to foreign locations, whether service providers are affiliated entities, the regulatory status of the service providers, and the economics of the outsourcing arrangement.

b. According to NASD and NYSE, the results of the survey indicated that broker-dealers frequently outsourced functions associated with accounting and finance (payroll, expense account reporting, etc.), legal and compliance, information technology (IT), operations functions (e.g., statement production, disaster recovery services, etc.), and administration functions (e.g., human resources, internal audits, etc.). In addition, the survey indicated that approximately two-thirds of the third-party vendors used by survey participants were regulated entities, subject to the jurisdiction of the SEC, NASD, NYSE, the Board of Governors of the Federal Reserve System, or the Office of the Comptroller of the Currency. The remaining third-party vendors were unregulated entities located both inside and outside the United States. According to NYSE, survey participants indicated that they used non-U.S. third-party vendors most often when outsourcing IT and communications activities.

c. Both NASD and NYSE stated that, in many instances, broker-dealers had not implemented written procedures to monitor the outsourcing of services or formalized a due diligence process to screen service providers for proficiency. In addition, NASD and NYSE stated that many service providers used in broker-dealer outsourcing arrangements lacked business continuity plans.

2. *Regulatory Initiatives by FINRA and NYSE*

During 2005, FINRA and NYSE separately announced the results of their surveys and their next steps regarding member firms' outsourcing practices. In July 2005, FINRA issued a Notice to Members to "remind" FINRA member firms of their responsibilities when outsourcing activities to third-party service providers.⁴ On March 16, 2005, NYSE filed a proposed rule change with the SEC to implement specific conditions to be satisfied by NYSE member firms in connection with outsourcing arrangements with service providers;⁵ NYSE has since filed two amendments to its proposal.⁶

a. ***FINRA Notice to Members 05-48***: FINRA issued its guidance on outsourcing in the context of broker-dealers' existing supervisory obligations under NASD Rule 3010.⁷ NtM 05-48 addresses two general areas with respect to outsourcing arrangements: supervisory responsibility for outsourced functions and activities and functions that are prohibited from being outsourced.

⁴ NASD Notice to Members 05-48 (July 2005) ("NtM 05-48").

⁵ File No. SR-NYSE-05-22.

⁶ On February 16, 2007, NYSE filed Amendment No. 1 to its proposal. On April 12, 2007, NYSE filed Amendment No. 2 to its proposal.

⁷ NASD Rule 3010 provides generally that each member firm must establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.

(i) Supervisory Responsibility for Outsourced Functions

(a) In NtM 05-48, FINRA stated that, if a member firm outsources “covered activities,”⁸ the member’s supervisory system and written supervisory procedures must include procedures regarding its outsourcing practices to ensure compliance with applicable securities laws and regulations and NASD rules. FINRA stated that the required procedures should include, without limitation, a due diligence analysis of all of its current or prospective third-party service providers to determine whether they are capable of performing the outsourced activities.

(b) NtM 05-48 provides further that FINRA member firms have a continuing responsibility to oversee, supervise, and monitor the service provider’s performance of covered activities. In particular, member firms must have in place specific policies and procedures that will monitor the service providers’ compliance with the terms of any agreements and assess the service provider’s continued fitness and ability to perform the covered activities being outsourced. In addition, NtM 05-48 provides that FINRA member firms should ensure that FINRA and all other applicable regulators have the same complete access to the service provider’s work product for the member as if the covered activities had been performed directly by the member firm.

(c) FINRA also stated in NtM 05-48 that member firms should establish specific policies and procedures to determine whether any covered activities that the member is contemplating outsourcing are appropriate for outsourcing. To that end, FINRA suggested that, to determine the appropriateness of outsourcing a particular activity, member firms may want to consider certain factors, such as the financial, reputational, and operational impact on the member firm if the third-party service provider fails to perform; the potential impact of outsourcing on the member firm’s provision of adequate services to its customers; and the impact of outsourcing the activity on the ability and capacity of the member firm to conform with regulatory requirements and changes in requirements.

(d) FINRA also reminded member firms of its view that outsourcing covered activities in no way diminishes a member’s responsibility for either its performance or its full compliance with all applicable federal securities laws and regulations, and FINRA and MSRB rules.

(ii) Functions and Activities Prohibited from being Outsourced

(a) In NtM 05-48, FINRA expressed the view that the performance of covered activities requiring qualification and registration cannot be deemed to have been outsourced because the person performing the activity is an associated person of the member firm irrespective of whether such person is registered with the member. However, FINRA recognized an exception from this requirement where a third-party service provider is separately registered as a broker-dealer and the contracted arrangement between the member

⁸ The term “covered activities” is defined to include order taking, handling of customer funds and securities, and supervisory responsibilities under NASD Rules 3010 and 3012, and any other activities that, if performed by the member itself, would be subject to the supervisory procedures requirements of Rule 3010.

firm and the service provider is contemplated by FINRA rules, MSRB rules, or applicable federal securities laws or regulations (e.g., a clearing arrangement executed pursuant to NASD Rule 3230 between a member firm and a clearing broker).

(b) FINRA also stated that a member firm may never contract its supervisory and compliance activities away from its direct control. However, FINRA also stated that this general prohibition does not preclude a member firm from using a supervisory system designed by another party (e.g., a computer software program that detects excessive trading in customer accounts). In those cases, the member firm must make its own determination that the system implemented is current and reasonably designed to achieve compliance as required under Rule 3010.

b. **NYSE Proposed Rule Change 05-22**

(i) **Initial Filing with SEC**

(a) As initially filed with the SEC, NYSE's proposal to adopt a new Rule 340 regarding outsourcing incorporated the same general themes as NtM 05-48 regarding functions and oversight. For example, the initial proposal provides that NYSE member firms would be prohibited from delegating, contracting, or outsourcing to any service provider supervisory or compliance responsibilities under NYSE Rule 342 ("Offices - Approval, Supervision and Control"), as well as activities that require registration and qualification under NYSE Rules. In addition, the proposed rule change emphasized member firms' responsibilities in connection with "core activities" (i.e., functions and activities that are considered material to a member firm's functioning as a broker-dealer).⁹

(b) In addition to the concepts noted by FINRA, however, NYSE's initial proposal included specific requirements on NYSE member firms' with respect to their ability to enter into outsourcing arrangements. In particular, the proposed rule change provides for prior written notification to NYSE and for specific due diligence requirements.

(ii) **Amended Filing with SEC**

(a) NYSE's second amendment to its proposed rule change replaced the initial filing and first amendment in their entirety. The amended proposal followed discussions between NYSE and the SEC regarding the content of the filing. In addition, the NYSE staff circulated a number of versions of the rule text of the proposal for informal industry comment.

(b) Under the amended proposal, the prior written notice and due diligence requirements are substantially similar to the requirements in the initial

⁹ Under the initial proposal, core activities were defined to include: the solicitation and handling of customer orders and accounts; order taking, entry and execution; the comparison, allocation, clearance, and settlement of securities transactions; the opening, approving, monitoring and maintenance of customer accounts; the delivery, handling and safeguarding of funds and securities; the creation of original books and records (including, but not limited to, confirmations and statements); and the extension of credit.

proposal. However, the amended proposal differs substantially from the initial proposal in that it includes a number of specific prohibitions on a member firm's ability to outsource particular functions, as well as specific requirements for member firms' oversight of their outsourcing arrangements.

(c) Functions and Activities Prohibited from being Outsourced. Under NYSE's amended outsourcing proposal, member firms would be prohibited from outsourcing the following functions and activities:

- Establishing supervisory principles or exercising supervisory or compliance responsibilities (including those arising under NYSE Rule 342);
- Activities that require registration with, or qualification by, NYSE, including the performance of functions customarily performed by principal executives including, without limitation, chief executive officer, chief financial officer, chief operations officer, and chief compliance officer;
- Control over cash or securities of the member firm or its customers;
- Control over the accuracy and integrity of the books and records of the member firm;
- Control over compliance with Exchange Act Rule 15c3-1 or 15c3-3;
- Non-ministerial clearing and custodial services other than: (i) those performed pursuant to a clearing agreement approved under NYSE Rule 382; or (ii) those performed by a bank in regard to U.S. Government and/or U.S. Government Agency Obligations enumerated in Section 3(a)(2) of the Securities Act of 1933; and
- Establishment of and control over the maintenance and implementation of risk management control systems required under Exchange Act Rule 15c3-4, except where required to be effectuated on an affiliate group-wide basis (such as in the case of consolidated regulatory supervision of an enterprise by the SEC).

(d) Prior Written Notification

(1) Under the amended proposal, an NYSE member firm generally would be required to provide prior written notification to NYSE when outsourcing "regulated functions and activities," which are defined as "functions or activities essential to its functioning as a broker-dealer." The notification would have to include the identity and location of the service provider; the service provider's regulator, if any; the nature of the service to be provided; any affiliation with the service provider; and a brief or summary description of the relevant controls maintained by the service provider related to the specific services proposed to be provided.

(2) The prior written notification requirement would not apply where regulated functions and activities are outsourced to any registered or regulated foreign or domestic entity, and where the outsourcing arrangement involves the regulated services or expertise that are the specific subject of such registration or regulation. In addition, the prior written notification requirement would not apply to clearing agreements subject to NYSE Rule 382.

(e) Due Diligence Requirements

(1) *U.S. Service Providers.* When outsourcing regulated functions and activities, NYSE member firms would be subject to a prescribed due diligence standard made up of mandatory elements that member firms would have to consider in making those arrangements. Under the proposed rule change, NYSE member firms' due diligence would have to include the following considerations (if any of these factors were not applicable, the member firm would be required to specify each such factor and state the reason for its exclusion):

- The experience and ability of the service provider to perform the services being provided;
- The adequacy of the written agreement governing the terms of the outsourcing arrangement, which must clearly define material terms and detail corrective and exit strategy or transition provisions;
- If the service provider is a regulated entity, its reasonably available record of regulatory compliance;
- If the service provider sub-contracts services material to the performance of the outsourced services to sub-vendors, the ability of such sub-vendors to perform the services in a manner consistent with the provisions of NYSE Rule 340;
- The service provider's reputation and financial status;
- That appropriate internal controls related to the specific services provided are maintained by the service provider;
- Whether the service provider's business continuity plan affects the ability of the member firm to comply with NYSE Rule 446;
- The extent of insurance coverage maintained by the service provider with respect to losses arising from the service provider's performance of the services provided;
- The effectiveness of the service provider's privacy and confidentiality controls in regard to the information provided to it by the member firm or that it generates in the performance of its arrangement, and assurance that such controls will not adversely affect the ability of the member firm to remain in full compliance with SEC Regulation S-P;
- Effective access by NYSE (and other applicable regulators, such as FINRA and the SEC) to the information, policies and records produced pursuant to the arrangement and on behalf of the member firm, which are deemed, for all regulatory purposes, to be the property of the member firm, and when such regulators shall deem necessary, to the pertinent facilities and operations of the service provider in regard to the services performed on behalf of a member firm;
- Monitoring of the level of service over time; and
- The risk of concentration of functions by a member firm in any single service provider.

(2) *Non-U.S. Service Providers.* In addition to the due diligence factors applicable to U.S. service providers, if the service provider is located or is performing contemplated services outside of the United States, the member firm's organization's due diligence must include (and record) an assessment of:

- The impact of the laws and business practice of the jurisdiction to which the service provider is subject; and

- The political and legal factors that may bear on the service provider’s ability to perform the contracted services.

(3) *Affiliated Service Providers.* NYSE’s amended proposal provides that, in determining the level of due diligence appropriate for the selection of a service provider that controls, is controlled by, or is under common control with the member firm, the member firm must use its reasonable discretion in the effectuation of its review processes, guided by the specified due diligence standards.

(f) Oversight Responsibilities. NYSE’s amended proposal also includes a number of specific requirements regarding the member firm’s oversight of outsourced functions and activities. Specifically, member firms would be subject to the following requirements and prohibitions:

(1) Member firms would be required to appropriately oversee and monitor the service provider’s performance of functions outsourced pursuant to NYSE Rule 340, its compliance with the terms of the contract, and its continued fitness and ability to provide the services being contracted.

(2) Member firms would be prohibited from seeking or purporting to disclaim responsibility for any regulated functions or activities outsourced by it to any service provider.

(3) No outsourcing agreement could compromise the ability of a member firm to discharge its obligations under NYSE Rules or under any other securities or financial regulatory authority to which the member firm is subject and no outsourcing agreement could seek or purport to obviate the duties of the member firm thereunder.

(4) A member firm would be required to promptly consult with NYSE if it becomes aware of any impending or reasonably foreseeable disruption or failure in the provision of a regulated function or activity that has been outsourced and that may give rise to a violation of SEC or NYSE Rules.

(5) Where necessary to comply with NYSE Rules and federal securities regulations or otherwise protect the public interest, NYSE would be able to require a member firm to take prompt corrective measures regarding an arrangement for the outsourcing of regulated functions and activities. Among generally appropriate measures would be: (a) exercising heightened oversight and monitoring of the service provider with regard to such outsourced functions and activities; (2) transferring such outsourced functions or activities to another service provider; or (3) performing itself the outsourced functions and activities.

(6) All agreements for the outsourcing of regulated functions and activities that are executed, renewed, amended or assigned after the approval date of NYSE Rule 340 would be required to contain provisions for the immediate and effective corrective action specified in NYSE Rule 340, and otherwise conform to the requirements of the Rule.

(7) Within six months of the effectiveness of NYSE Rule 340, member firms would be required to notify NYSE of all outsourcing agreements covered under the rule in effect at that time.

B. SEC Order Exempting CIBC Mellon Trust Company From Broker-Dealer Registration

1. On February 25, 2005, the SEC issued an order conditionally exempting CIBC Mellon Trust Company (“CIBC Mellon”) from broker-dealer registration in connection with CIBC Mellon’s administration of dividend reinvestment and stock purchase plans, employee stock purchase plans, employee stock option plans, and odd-lot programs (“Stock Plans”) with U.S. resident investors.¹⁰ The SEC issued the order as part of the settlement of an enforcement action with CIBC Mellon, in which the SEC had charged that CIBC Mellon had acted as an unregistered broker-dealer and transfer agent in connection with its administration of Stock Plans.

2. The order itself applies only to CIBC Mellon, but it has been viewed by some commentators as an indication on the SEC’s thinking on the types of functions that can be outsourced by a broker-dealer to a transfer agent without subjecting the transfer agent to broker-dealer registration.¹¹ Among other things, the conditions of the exemption provide that CIBC Mellon:

a. May not solicit transactions or provide investment advice to U.S. resident investors with respect to the purchase or sale of securities;

b. May not net customers’ buy and sell orders.

c. In connection with administering Stock Plans through a call center, may respond to inquiries received about a Stock Plan, but may not: (1) identify a particular security except as requested by the investor and then only as necessary to be responsive to the specific inquiry; (ii) respond to inquiries concerning the advisability of investing in the particular security or participating in the Stock Plan rather than using the services of a registered broker-dealer; or (iii) take verbal orders to buy or sell securities for U.S. resident investors.

3. SEC staff members have indicated publicly that the SEC plans to issue a rulemaking proposal in this area, but have not indicated specifically when the proposal will be issued.

¹⁰ Securities Exchange Act Release No. 51253 (February 25, 2005).

¹¹ On April 18, 2006, the SEC issued a largely similar order to Computershare Trust Company of Canada and Computershare Investor Services Inc. Securities Exchange Act Release No. 53667 (April 18, 2006).

III. Practical Questions to Consider in Securities Industry Outsourcing Arrangements

A. Who Are the Parties to the Outsourcing Arrangement?

1. The outsourcing entity should consider the types of regulated entities involved in the arrangement (*e.g.* broker-dealers, investment advisers, transfer agents), and whether the service provider is a regulated entity).

2. Depending on the functions to be outsourced, the outsourcing entity may or may not be required to use a regulated entity as the service provider.

B. What Are the Functions and Activities To Be Outsourced?

1. The parties should create an inventory of the specific functions and activities to be outsourced and should analyze the regulatory impact of types of specific types of functional arrangements.

2. Certain functions and activities will always raise status issues in outsourcing arrangements, for example:

a. **Broker-Dealer Registration**: Arrangements that involve the service provider having direct contact with customers and investors (*e.g.*, call centers).

b. **Transfer Agent Registration**: Arrangements that involve the service provider in transferring ownership of shares.

C. Does the Arrangement Include Appropriate Oversight Controls?

1. ***Maintenance of Responsibility***: While securities regulators may expressly permit outsourcing arrangements in certain cases, they have been clear in their guidance that even when functional responsibility may be outsourced to a service provider, legal responsibility may not be outsourced. For example, a broker-dealer can outsource its functional responsibility to deliver trade confirmations and customer account statements, but the broker-dealer remains responsible for compliance under the applicable regulatory requirements if the service provider does not fulfill that functional responsibility.

2. ***Establishment of Controls***: Outsourcing arrangements should include specific controls for oversight, supervision, and monitoring of the service provider's activities. In particular, securities regulators will expect the same access to records produced by the service provider that they would have if the records were produced by the regulated entity.