

outsourcing
in the financial services:
essential business, legal and
regulatory considerations

March 8, 2006

ACC AMERICA
Association of Corporate Counsel
Greater New York Chapter

Morgan Lewis
C O U N S E L O R S A T L A W



**The
Regulatory
Landscape**

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The Regulatory Landscape

- Bank Regulatory Guidance
- Securities Regulatory Guidance
- Common Themes and Approaches

Bank Regulatory Guidance

- Guidance from bank agencies
 - For Federal Reserve member banks and BHCs:
 - FRB SR Letter 00-04
 - For national banks:
 - OCC Bulletin 2001-47
 - OCC Bulletin 2002-16 (Foreign-Based)
 - For Thrifts and Thrift Holding Companies:
 - OTS TB 82a
 - Interagency information security guidelines implementing Section 501(b) of GLBA
- Basel Committee on Banking Supervision (Joint Forum – Outsourcing in Financial Services, February 2005)
- FFIEC IT Examination Handbook: Outsourcing Technology Services (June 2004)

Bank Regulatory Guidance

- Basic Principles:
 - Address outsourcing as part of overall risk management plan
 - Don't make a mistake
 - Involve board of directors and senior management
 - Manage outsourced process as an extension of bank
 - Maintain a flexible, risk-based approach (large complex deals involving core functions vs. routine, smaller deals)

Securities Regulatory Guidance

- Past regulatory guidance touched on issue
 - Framework for clearing arrangements represents most comprehensive guidance to date
- Joint SRO Survey in 2004
- NASD Notice to Members 05-48
 - Accountability & responsibility
 - Functions that may not be outsourced
- NYSE Rule Filing 2005-22
 - Prior notice
 - Due diligence

Securities Regulatory Guidance

- Limits of what can be outsourced
 - Status issues
 - Core vs. Non-Core Functions
- Supervision & accountability
- Records
- Privacy and data breaches
- Offshore issues

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Securities Regulatory Guidance

- Core Functions
 - Order acceptance
 - Solicitation of accounts or transactions
 - Supervising representatives
 - Final approval of financial reports
 - Responsibility for general ledger – NYSE Rule 440.20

Securities Regulatory Guidance

- Non-Core Functions
 - Reporting functions
 - Trade data reporting by clearing firms – NASD Rule 3150
 - Reporting of order routing and execution – SEC Staff Legal Bulletin No. 13A (2001)
 - Communications to beneficial owners – Rule 14b-1, NYSE Rule 452 & NYSE IM 04-58 (2004)
 - Customer account statements – NYSE Rule 409 & IM 97-56
 - HR functions, including payroll, health benefits & employee leasing – Headway Corporate (2002) & Investacorp (2003)
 - Customer support functions
 - Third Party Administrator services – UPI (SEC staff 1998)
 - Telemarketers, Brokerage Administrators Corp. (NASD staff 1999)
 - Stock plan services – CIBC Mellon exemption (SEC staff 2005)

Securities Regulatory Guidance

- Records
 - Rule 17a-4 undertaking
 - Form BD & ADV identification
 - Regulator access
 - “Where and how” requirements
 - Advisers Act – Applicable Office requirement
 - Exchange Act – WORM requirements

Common Themes and Approaches

1. Identify functions to be outsourced
2. Conduct risk assessment
3. Conduct due diligence on vendor
4. Develop contract to govern arrangements
5. Develop procedures to supervise, monitor and oversee vendor
6. Consider regulatory notice or approval requirements

Risk Assessment

- Strategic (system or goal incompatibility, failure in due diligence, inadequate expertise to monitor)
- Reputation (poor service, disruptions, litigation)
- Compliance (supplier violates laws, ethical standards and policies or procedures of FI)
- Transaction/Operational (fraud, error, tech failure, lack of business continuity planning)
- Credit risk (financial strength, outsourced lending)
- If foreign provider, foreign currency risk, country risk
- Economic, social and political risks
- Over-concentration of functions with one provider

Due Diligence

- Experience
- Financial condition
- Business reputation, complaints and litigation
- Internal controls environment
- Adequacy of management information systems
- Business continuity plans
- Cost, including support function
- Use of subcontractors and their capabilities
- Insurance coverage
- Privacy and confidentiality controls
- Access to regulators
- Service levels

Contract Issues

- Scope of arrangement
- Security and confidentiality of information (both FI's and customers' information)
- Compliance with regulatory requirements
- Examination authority of regulators
- Maintenance of records (including access, means of retention & disposition on termination)

Contract Issues

- Frequency and types of reports
- Business continuity plans
- Sub-contracting and multiple service provider relationships
- Cost, indemnification, termination and assignability
- Dispute resolution
- Limitation on Liability
- Foreign providers
 - Choice-of-law
 - Jurisdiction

outsourcing

Supervision, Monitoring & Oversight

- Develop specific written procedures to govern supervision of provider
- Supervise conduct of “core” activities (and ensure inappropriate activities are not being performed)
- Monitor compliance with agreement
- Monitor fitness and ability to perform covered services
- Monitor controls by reviewing
 - Audit & exam reports
 - Provider’s policies
 - Business continuity planning and testing
 - Compliance with applicable law
- Assess quality of service and support

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Regulatory Notice or Approval

- Records notice (Rule 17a-4 and Form BD/ADV)
- SRO notice or approvals
- Bank agencies

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