
Legal a la Carte

outsourcing and financial
services: regulatory and
commercial considerations

July 19, 2006

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



What We Hope to Accomplish Today

- Help you understand how a financial services institution can use an effective outsourcing process to reduce risk
 - Define the outsourcing model
 - Identify outsourcing risks
 - Demonstrate how risks can be mitigated by using the appropriate process
- Help you understand how a financial services institution can use an effective outsourcing process to commercial advantage

What We Hope to Accomplish Today

- Focus on concluding a successful outsourcing
 - Identify the key issues unique to outsourcing transactions
 - Describe the process for identifying and reaching consensus on those issues
 - Explore how the negotiation environment can impact your ability to accomplish your goals
 - Provide tactical means to realize your strategy
- How to visualize an outsourcing agreement and how to get there
 - Team building
 - Techniques
 - Common mistakes

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, FRB SR Letter 03-5 (Internal Audit Function)
 - New York Fed – “Outsourcing IT and Business Processes: A Supervisory Primer”
 - For Non-Fed member, state-chartered banks:
 - Financial Institution Letter 52-2006, Financial Institution Letter 49.99
 - For national banks:
 - OCC Bulletin 2001-47, OCC Bulletin 2002-16 (Foreign-Based)

Bank Regulatory Guidance

- OCC White Paper – “Cross-border outsourcing and risk management for banks” (August 2003)
- For Thrifts and Thrift Holding Companies:
 - OTS TB 82a
- Interagency information security guidelines implementing Section 501(b) of GLBA

Bank Regulatory Guidance

- Basel Committee on Banking Supervision (Joint Forum –Outsourcing in Financial Services, February 2005)
- FFIEC IT Examination Handbook: Outsourcing Technology Services (June 2004)
- Future Guidance – The Federal Reserve’s Risk Management Initiative

Bank Regulatory Guidance

- Basic Principles:
 - Address outsourcing as part of overall risk management plan
 - 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)
 - Don't make a mistake

Securities Regulatory Guidance

- Common Regulatory Themes
 - Functional Limitations
 - Supervision & Accountability
 - Records
 - Privacy and Data Breaches
 - Offshore Issues

Securities Regulatory Guidance

- Core Functions
 - 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
- Recordkeeping
 - Exchange Act Rule 17a-4 undertaking
 - Form BD & ADV identification
 - Regulator access
- 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

Securities Regulatory Guidance

- Non-Core Functions
- HR functions (payroll, health benefits & employee leasing)
 - Headway Corporate (SEC Staff 2002)
 - Investacorp (SEC Staff 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 2005)

Securities Regulatory Guidance

- Clearing Arrangements – NYSE Rule 382 & NASD Rule 3230
- Joint SRO Survey in 2004
- NASD Notice to Members 05-48
- NYSE Draft Proposed Rule 340
- International Perspectives
 - Basel Committee on Banking Supervision, “Outsourcing in Financial Services” (Joint Forum, February 2005)
 - IOSCO, “Principles on Outsourcing of Financial Services for Market Intermediaries” (August 2004)

Securities Regulatory Guidance

- NASD – “guiding principles” approach
 - Primary focus is on supervision and oversight
 - Principles-based approach to due diligence
 - Prohibitions on outsourcing certain “covered activities” (e.g., order taking, handling of customer funds and securities, and supervisory responsibilities)

Securities Regulatory Guidance

- NYSE – a more prescriptive approach
 - Prior written notice to NYSE required to outsource “regulated functions and activities”
 - Laundry list of prohibitions on outsourcing specific categories of functions, including:
 - Supervisory or compliance programs (including those arising under NYSE Rule 342)
 - Control or disposition of cash or securities of the NYSE member firm or its customers
 - Responsibility for Exchange Act Rule 15c3-1 or 15c3-3

Securities Regulatory Guidance

- NYSE Approach (cont'd)
 - Specific due diligence requirements, including:
 - Experience and ability of service provider
 - Service provider's reputation and financial status
 - Extent of service provider's insurance coverage
 - Arrangements with non-U.S. service providers trigger even more requirements:
 - Impact of the laws and business practices of service provider's home jurisdiction
 - Applicable political and legal factors
 - All required due diligence factors must be considered and documented, even if inapplicable

Appendix



Why Customers Outsource

- Financial Objectives:
 - To achieve of significant cost savings in the prices customer pays for the provision of the services
 - To have transparency into Supplier's pricing and cost structures so that customer may better control customer's total cost of ownership for the IT or business process functions and related systems and platforms
 - To have market competitive pricing throughout the term

Why Customers Outsource (con't)

- Business Objectives:
 - To leverage the supplier's capability to deliver world class services based on industry best practices and standards; improving quality, productivity and reliability, and speed to market of new customer products
 - To achieve customer's short and long term transformation objectives aimed at implementing innovations that will enhance current functionality and efficiency

Why Customers Outsource (con't)

- To better align and energize relations between IT, business processes and customer's business
- To gain access to the supplier's high caliber, knowledgeable, experienced and skilled pool of resources that will provide customer value-added strategic thought, vision and leadership
- To shift performance/delivery, regulatory and pricing risks from the customer to the supplier

Why Customers Outsource (con't)

- Operational Objectives:
 - to use technologically current tools, equipment and software in performing the services
 - to establish a global relationship and contract governance structure combined with a single, integrated service delivery model to facilitate the use of consistent, integrated approaches and processes across geographies
 - to increase customer's flexibility and capacity and to continuously improve and evolve the services to meet the dynamic requirements of customer's business

Key Contract Terms



Scope of Services

- Describe “Services” in broad terms
- Services “evolve”
- Scope ties to pricing
- “Projects” v. “New Services”
- Change control

Performance Standards

- General performance measures
- Service Levels
 - Documented vs. actual service levels
 - Measurable and achievable
 - Flexibility and weighting
 - Continuous improvement
- Service level credits and priorities
 - Allow for periodic evaluation and adjustment

Performance Standards (con't)

- Reporting
- Root cause analysis
- Correction
- Gain-sharing
- Service Level credits
 - Clearly understandable calculation formula
 - Based on priorities
 - Not designed to punish; it is an incentive for better performance
 - Taking credits

Price and Payment – Transfer of Costs

- At its core, an outsourcing is the transfer of customer's costs and all of its associated activities and resources to supplier
- The transferred costs will be among the factors utilized by supplier in setting a price such that the customer's anticipated level of spend will remain the same, less those savings offered by supplier
- Supplier will achieve savings by leveraging its economies of scale and increasing operational efficiency

Price and Payment – Price

- To capture in writing a charging mechanism that:
 - Allows customer to meet its financial objectives for the outsourcing over a multi-year term
 - Allows supplier an opportunity to realize a reasonable return
 - Aligns risk and responsibility between supplier and customer
 - Allows customer to retain leverage during the term
 - Establishes flexibility to deal with changing business climate

Price and Payment – Price (con't)

- Pricing models
 - Resource based (the most typical model)
 - Price times quantity ($P \times Q$)
 - Utility pricing
 - AD&M
 - BPO
- Extraordinary events
- Non-exclusivity
- Most favored customer
- Right to withhold disputed amounts

Price and Payment – Benchmarking

- Customer wants:
 - Assurance that Supplier's prices will be market-competitive throughout the term
 - Automatic adjustment of prices
- Benchmarking makes for effective contractual leverage
 - The benchmarking process can jump start price or service level renegotiations
- Price benchmarking should NOT substitute for well-defined pricing algorithms

Term

- Range from 3 to 7 years and sometimes 10 years
 - Customer must have right to terminate for convenience
- The Supplier's justification for a long term:
 - Large, up-front costs to market and establish relationship
 - Time needed to accomplish necessary changes to:
 - Make significant investments in “new” technology
 - Implement productivity improvements
 - Achieve “cultural” change or other transformation

Exit Strategy

- Protecting the business upon any cessation of service or any termination or expiration of the Agreement
 - Disengagement assistance – orderly migration of services
 - Transfer of resources back to customer or customer's designees:
 - Supplier personnel (employees and contractors)
 - Equipment owned or leased
 - Software owned or licensed
 - Third party agreements
 - Intellectual property rights

Other Legal Issues - Liability

- General Intent:
 - A party is liable to other for any actual damages suffered or incurred by the other party's failure to perform its obligations in the manner required by the Agreement
 - Each party shall have a duty to mitigate damages for which the other party is responsible

Other Legal Issues - Liability

- Common Supplier-requested Limits on Liabilities:
 - Limits on Liability Type: Not liable for consequential damages
 - Limits on Liability Amount: Not to exceed 12 month's worth of charges

Other Legal Issues - Liability (con't)

- The limits on liabilities do not apply to damages attributable to or occasioned by:
 - A party's willful misconduct or gross negligence
 - A party's breach of its confidentiality obligations
 - A party's infringement or misappropriation of the other's IP rights
 - A party's violation of law or Customer's regulations
 - A party's improper or wrongful termination of the Agreement

Other Legal Issues - Liability (con't)

- Supplier's breach of its obligations with respect to Customer Data
- Supplier's abandonment of the provision of Services or refusal to provide Disengagement Assistance; nor to
- Losses that are the subject of indemnification

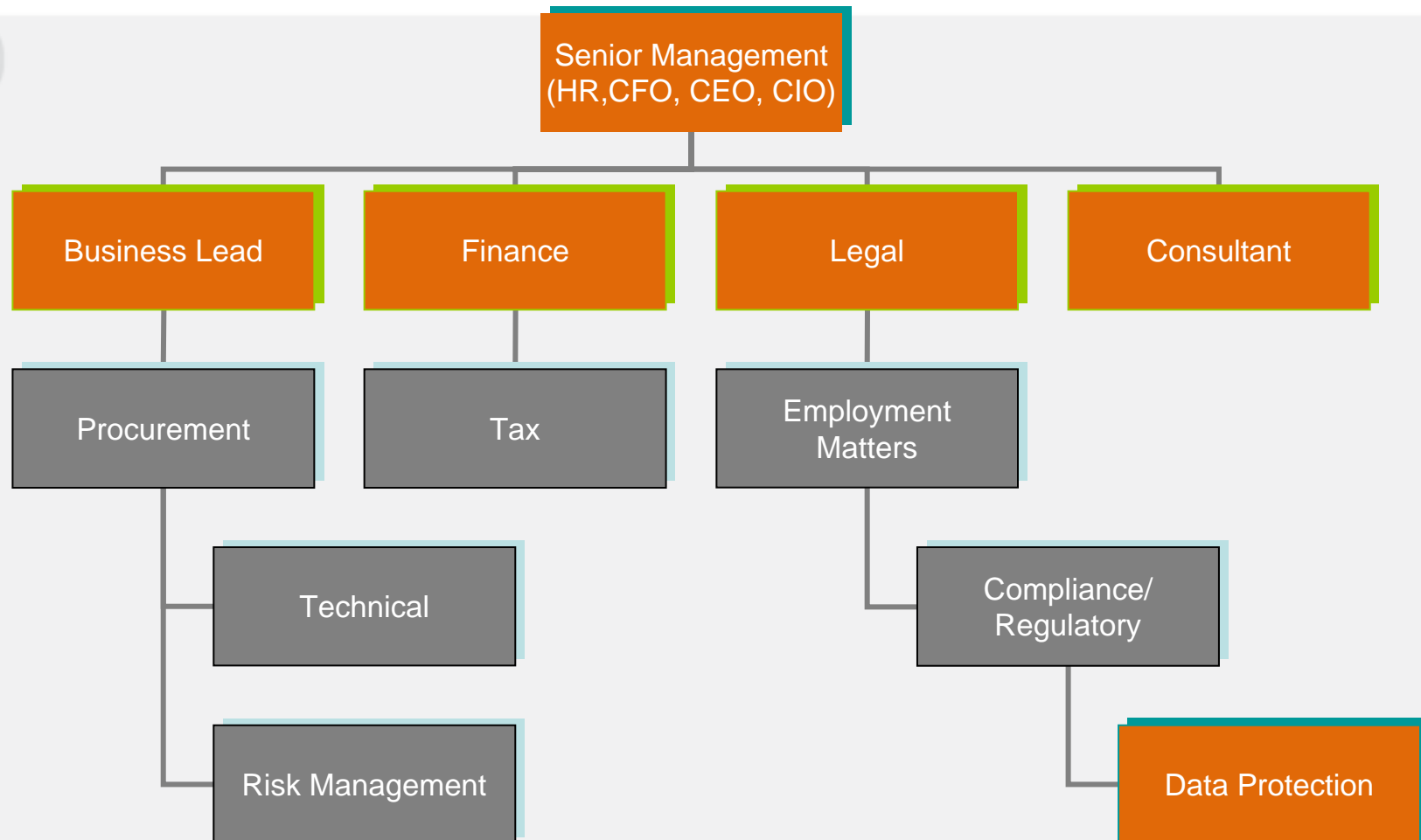
European Specific Key Issues

- It is **EXTREMELY** important that TUPE/Acquired Rights Directive issues are dealt with, both on the way in and on the way out-new legislation (TUPE 2-Revenge of the Regulator) coming in October in the UK. In France Article L122/12 will apply
- Understand the tax position from the outset. VAT and transfer pricing issues can affect both the structure and the viability of the deal particularly in the financial services sector

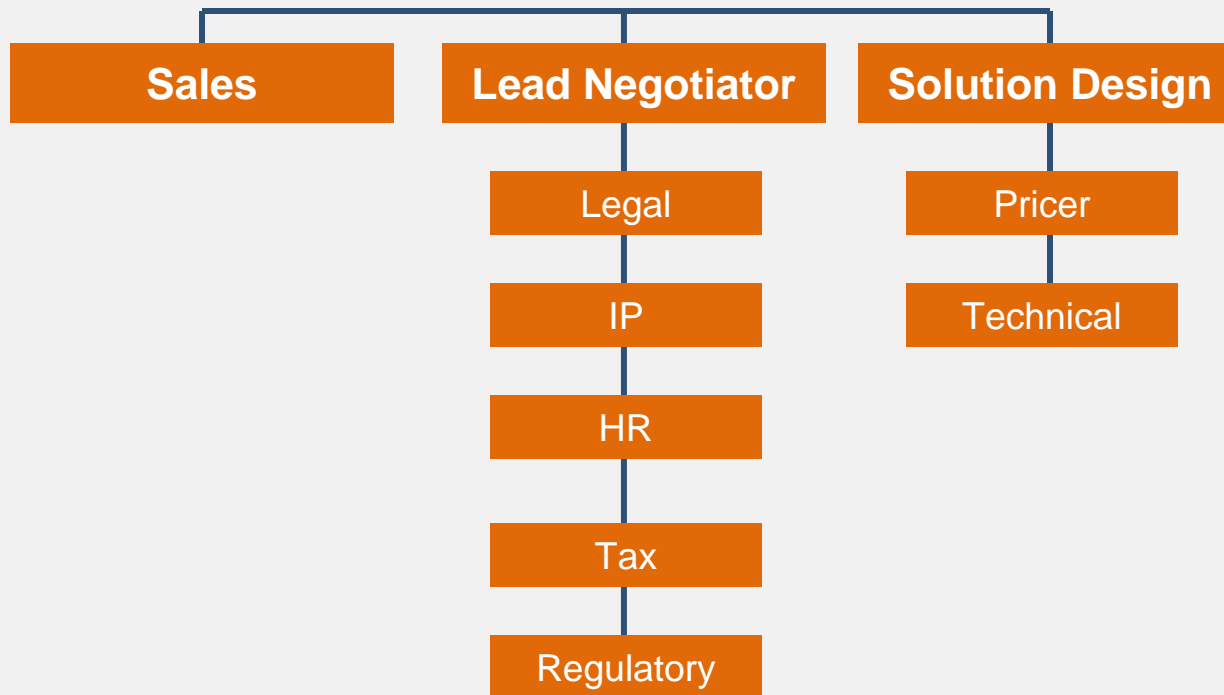
European Specific Key Issues

- A different approach to limitations of liability
- Third party rights e.g. impact of Contracts (Rights of Third Parties) Act
- Does the supplier have adequate controls and processes to protect personal data-will data travel outside Europe? Privacy issues?

Customer Team



Supplier Team



Why Morgan Lewis for Outsourcing

- A truly global outsourcing practice.
- Substantial experience in complex outsourcing transactions with a broad range of business, technical and legal skills.
- One of the world's largest, best-known, and highly regarded labor and employment and employee benefits practices.
- Significant depth and breadth in financial services, energy and life sciences.

Why Morgan Lewis for Outsourcing

- Well-defined outsourcing methodology and approach that are structured yet flexible.
- Rich knowledge management capabilities accessible through the firm and by our clients.
- We know and have worked with almost all of the major outsourcing service providers and consultants and our approach and lawyers are well known to them.

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