MiFID - and its effect upon outsourcing

MiFID - or markets in financial instruments directive - is a European Union (EU) directive coming into effect across the EU by November 2007.

This directive will affect profoundly the conduct of business and approach to operational risk of investment firms, including banks, insurance and pension providers, and other financial services institutions that operate within the EU. MiFID is explicit in addressing and will directly impact upon the provision of outsourced services to such investment firms, whether those services are provided from within or outside of the EU.

The Legislative Background

MiFID is one of the pillars of the European Union's Financial Services Action Plan, which is designed to create a single European market for financial services. Other key directives in this plan include the Market Abuse Directive, Prospectus Directive and the Capital Adequacy Directive, which will address Basel II. Originally focused upon the regulation of securities, the Plan's scope now encompasses legislation for the banking, insurance and pensions businesses.

MiFID is intended to replace the current Investment Service Directive. Unlike that directive, MiFID is explicit in addressing the role and management of outsourcing within the financial services sector.

MiFID follows the Lamfalussy legislative process: Level 1, which provides the overall framework of the directive, was first published in 2004, and in February of this year the Commission published its draft Level 2 measures for MiFID. Both levels were finalised in June 2006.

These measures put substantial technical and operational detail around the original framework text. Within the next few months, the Commission will publish a cost benefit analysis of MiFID and this will further shape the legislation. The EU member states have until January 2007 to produce domestic legislation (Level 3) to implement MiFID within their own jurisdictions Such legislation must come in to effect by November 2007

Key Provisions Affecting Outsourcing Relationships

The key provision of MiFID for the outsourcing world is Article 13(5) of Level 1:

“An investment firm shall ensure, when relying on a third party for the performance of operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous basis, that it takes reasonable steps to avoid undue additional operational risks. Outsourcing of operational functions may not be undertaken in such a way as to impair materially the quality of its internal control and the ability of the supervisor to monitor the firm's compliance with all obligations."

The Level 2 measures provide more detailed and practical guidance on how they envisage Article 13(5) should be implemented, including:

No delegation of compliance: Where an investment firm delegates a function to a service provider, the responsibility for performance of such function remains with the management of the investment firm.

Service Agreements: There must be a written agreement between the investment firm and the service provider, which provides for:

- Delineation of the functions of the parties;
- Continuous monitoring (of, in particular, quality);
- Mechanisms to manage and adjust services;
- Adequate termination of rights and remedies; • Protection of client information;
- Appropriate business continuity and disaster recovery functions and
- Audit rights of the competent authority to audit service providers.

There are specific general requirements of the investment firms to supervise services and risk management; monitor quality; have the expertise internally to supervise; and have the appropriate rights of termination.

There is an additional requirement if an institution outsources any aspect of its asset management function for retail customers to a service provider in a country outside the European Economic Area. The investment firm must ensure that:

- The service provider is subject to prudential regulation; and
- There is a mechanism for formal cooperation between the institution's regulator(s) and the regulator of the service provider.

For example, if a service provider in India provides back-office functions for the asset management part of a retail bank in London that is regulated by the FSA, then the service provider will need to enter into an agreement with the Reserve Bank of India to provide a mechanism for supervision.

The practical effect of such a requirement is far from clear, and it appears to be a rather passive form of regulation. However, if the service provider does not subject itself to prudential regulation, then, on the basis of the current draft of MiFID, the regulator of the bank could refuse to permit the outsourcing.

The effects of MiFID

Many commentators believe that MiFID will lead to consolidation amongst small or medium size financial institutions in order to reduce and share additional regulatory costs. Estimates of the initial cost of compliance for financial institutions across the EEA are expected to be around one billion euros.

As part of their overall risk management strategy, financial institutions will need to develop specific risk management plans in relation to their outsourced functions. Such plans should be dynamic and not only assess risk on execution of an outsourcing deal but also create a framework for the continuous monitoring, assessment and management of risk arising from all outsourcing relationships.

In addition, financial institutions must carry out a critical review of their pre-existing outsourcing agreements, performing appropriate gap analysis between the pre-existing arrangements and the requirements of MiFID. All risks identified from such analysis will need to be considered with the overall risk management plan.

MiFID substantially empowers EU regulators of financial service institutions through their ability to influence intended outsourcing relationships before they are agreed between the parties. In the UK, MiFID can be seen as an extension of the FSA's existing rules on outsourcing. The key difference is that the Level 2 measures of MiFID address not only the outsourcing "critical" or "important" operational function but also the outsourcing of any function of a regulated financial institution.

For those intending to enter into an outsourcing relationship in the financial services sector, there will be a renewed focus upon service levels and, more generally, upon reporting and audit requirements. For those currently in outsourcing relationships, the parties will need to focus on addressing the concerns of MiFID, whether that be through renewal, renegotiation or contract change.

It is crucial for service providers to consider and prepare for the impact of this directive on existing and intended outsourcing relationships with EU financial institutions. It is also important that these providers examine related structural and operational changes that will be needed within their own organisations.
This directive will provide a new regulatory challenge for service providers and financial institutions alike. At the same time, the directive also opens new opportunities for the provision of services to specifically prepare for and address MiFID.

For more information, please contact:

Simon White
Associate

Morgan Lewis
Condor House
5-10 St Paul's Churchyard
London
EC4M 8AL

Phone: +44 (0)20 3201 5598
Fax: +44 (0)20 3201 5001
Email: simon.white@morganlewis.com