

# **Principles on Outsourcing by Markets**

## **Consultation Report**



**OICU-IOSCO**

**TECHNICAL COMMITTEE  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

**FEBRUARY 2009**

**This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.**

## Foreword

The International Organization of Securities Commissions (IOSCO) Technical Committee (TC) has published for public comment this consultation report on *Principles on Outsourcing by Markets* (Report). The Report sets out a set of principles that are designed to assist markets and market authorities when considering outsourcing arrangements. The Report will be finalised after consideration of comments received from the public.

## How to Submit Comments

Comments may be submitted by one of the three following methods **on or before 20 May 2009**. To help us process and review your comments more efficiently, please use only one method.

### 1. E-mail

- Send comments to Greg Tanzer at OutsourcingReport@iosco.org.
- **The subject line of your message should indicate “Principles on Outsourcing by Markets.”**
- Please do not submit any attachments as HTML, GIF, TIFF, PIF or EXE files.

**OR**

### 2. Facsimile Transmission

Send a fax for the attention of Mr. Greg Tanzer, using the following fax number:  
+ 34 (91) 555 93 68.

**OR**

### 3. Post

Send your comment letter to:

Mr. Greg Tanzer  
IOSCO General Secretariat  
C / Oquendo 12  
28006 Madrid  
Spain

**Your comment letter should indicate prominently that it is a “Public Comment on Principles on Outsourcing by Markets.”**

**Important:** All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

## Principles on Outsourcing by Markets

### I. Introduction

Many markets<sup>1</sup> and their market operators use third party service providers to perform processes, services or activities (regulated or not) that would otherwise be undertaken by the markets or market operators themselves. Such arrangements are referred to as outsourcing.

Outsourcing may bring substantial benefits for markets. For example, outsourcing may lower the costs of performing a particular function while giving markets access to a high level of expertise and the latest technology. On the other hand, outsourcing may raise a number of issues. For example, in certain jurisdictions, risk management and compliance functions may be transferred to third parties who may not be regulated or may operate in a different jurisdiction. Increased reliance on outsourcing of activities may impact on the ability of markets to manage risks and monitor compliance with regulatory requirements. Outsourcing could also impede the ability of markets to demonstrate to market authorities<sup>2</sup> that they are taking appropriate steps to manage their risks and comply with applicable regulations. Outsourcing thus poses a number of important challenges to both markets and market authorities and may have an impact on the effectiveness and integrity of markets.

This Report complements existing International Organization of Securities Commissions (IOSCO) report entitled *Principles on Outsourcing of Financial Services for Market Intermediaries*,<sup>3</sup> which establishes a set of principles that are designed to assist regulated market intermediaries in determining the steps they should take when considering outsourcing activities. That report also contains some broad principles to assist securities regulators in addressing outsourcing in their regular risk reviews of firms.<sup>4</sup>

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<sup>1</sup> For the purpose of this Report, the term “market” refers to exchanges only and does not include Alternative Trading Systems (ATS) or Multilateral Trading Facilities (MTFs).

<sup>2</sup> The term “market authority” is used to refer to the authority in a jurisdiction that has statutory or regulatory powers with respect to the exercise of certain regulatory functions over a market. The relevant market authority may be a regulatory body, a self-regulatory organization and/or the market itself.

<sup>3</sup> *Principles on Outsourcing of Financial Services for Market Intermediaries* — Final Report, Report of the Technical Committee of IOSCO, February 2005, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD187.pdf>.

<sup>4</sup> In February 2005, the Joint Forum, consisting of the Basel Committee on Banking Supervision, IOSCO, and International Association of Insurance Supervisors also released a report, *Outsourcing in Financial Services*, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD184.pdf>. The IOSCO and the Joint Forum worked closely to ensure that their sets of principles are complementary and consistent with each other. The IOSCO principles on outsourcing of financial services are designed specifically for intermediaries in the securities sector, whereas the Joint Forum principles are high level and aimed collectively at the banking, insurance and securities sectors. They are designed to provide a benchmark against which all financial institutions can gauge their approach to outsourcing.

The IOSCO report entitled *Regulatory Issues Arising from Exchange Evolution*,<sup>5</sup> identified outsourcing among the broad regulatory issues arising from the new business model of exchanges. That report noted that “*more complex issues may arise in this context [outsourcing] when exchanges propose to outsource activities relating to regulatory functions*”. That report also stated that “*an emerging issue is the degree to which an exchange should outsource its key operational functions.*”

Given the role played by markets as trading venues and, in some cases, the regulatory functions they perform, outsourcing by markets may pose risks which differ from those arising from outsourcing by market intermediaries, both in terms of their nature and their magnitude. This is because, in general, markets have the following characteristics:

- Markets provide trading infrastructure, have a public interest mandate and must maintain fair and orderly markets in order to ensure market integrity.
- In many cases, there are few substitutes to the services provided by markets in each jurisdiction.
- Markets often perform regulatory functions (for example, market surveillance and supervision).
- Markets generally deal with market sensitive information and are responsible for keeping that information confidential.

However, outsourcing poses important challenges to the integrity and effectiveness of the financial and capital markets and for the market authorities that are similar to the ones identified for the financial market intermediaries. Hence, with respect to markets, hiring a third party to perform a function may have a detrimental impact on its understanding of how the function is performed and the related processes, with a consequent loss of control. In most TC Standing Committee on Regulation of Secondary Markets (TCSC2) jurisdictions, the outsourcing market, including its board of directors and senior management, remain fully responsible (toward members and regulatory authorities) for the outsourced function, as if the service was being performed in-house. In some jurisdictions, as discussed below, market authorities impose restrictions on the outsourcing of certain functions where they believe the outsourcing arrangement introduces an unacceptable risk or is critical to the function of a market. There is the potential that the inappropriate selection of a service provider may lead to a business disruption or non-compliance with relevant laws, with negative consequences for the outsourcing market’s members and their clients. In certain instances, the potential for systemic risk to the market as a whole, which may be exacerbated in the event that multiple markets use a common service provider, also should be considered. In addition, market authorities expect, and in some jurisdictions require, that they will have complete and ready access to books and records concerning an outsourcing market’s activities, even if such documents are in the custody of the market’s service provider.

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<sup>5</sup> *Regulatory Issues Arising From Exchange Evolution* — Final Report, Report of the Technical Committee of IOSCO, November 2006, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD225.pdf>.

## **II. Survey Results**

This Report has been prepared with the assistance of research by TCSC2 members in their jurisdictions.<sup>6</sup> A detailed questionnaire was completed identifying the regulatory approaches to outsourcing by markets and describing the nature and extent of outsourcing by markets in each jurisdiction.

All TCSC2 jurisdictions allow their markets to enter into outsourcing arrangements. Some TCSC2 jurisdictions have rules that allow markets to enter into outsourcing arrangements subject to certain conditions (for example, an outsourced service provider must be fit and proper, and willing and able to perform the outsourced functions). Other TCSC2 jurisdictions may permit outsourcing arrangements under their general rules that govern the initial authorisation of the market (for example, when considering whether there is a fair and orderly market). In this respect, some TCSC2 jurisdictions require the market to seek specific regulatory approval before outsourcing arrangements can be put in place (particularly in relation to regulatory functions). However, in the majority of TCSC2 jurisdictions, no specific regulatory approval is necessary for markets to outsource their functions.

On an ongoing basis, most TCSC2 jurisdictions consider outsourcing arrangements as part of their continuing oversight of the market's compliance with its obligations. The level of oversight by TCSC2 jurisdictions of markets with outsourcing arrangements depends on how those arrangements affect the market's ability to comply with its regulatory obligations. In most instances, this includes a requirement that a market provides notice to the relevant market authority of the market's intent to outsource certain (material) functions or to modify an existing outsourcing arrangement.

The survey covered four key areas: outsourced activities; outsourcing arrangements; selection of service providers; and legal accountability.

### **A. Outsourced activities**

In the majority of TCSC2 jurisdictions, the outsourcing of every activity is possible. However, a number of TCSC2 jurisdictions restrict what activities can be outsourced, e.g., some of them do not allow the outsourcing of key tasks associated with running/managing the market. Other markets do not allow the outsourcing of functions regarding the admission of members or the admission to trading on that market of financial instruments to be outsourced. Some markets are required to obtain the prior consent of the market authority before the decision to outsource is taken by the market (as in the case of the organisation of trading, the recording and publication of trades, the suspension of trading or the compliance functions).

The survey conducted among markets reveals that in fact the vast majority of them undertake outsourcing to some degree, although the extent and nature of outsourced functions varies considerably. Most commonly, markets outsource information technology (IT) services and operation and/or support of exchange trading platforms, as well as supervisory and regulatory functions such as real-time monitoring of trading, post-trade surveillance, member audits and

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<sup>6</sup> The jurisdictions of TCSC2 members are: Australia, Brazil, France, Germany, Hong Kong, India, Italy, Japan, Malaysia, Mexico, Netherlands, Ontario, Quebec, Singapore, Spain, Switzerland, United Kingdom, United States (Commodities Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC)).

investigations. Other outsourced activities include printing and mailing statement of accounts/notices to account holders, recruitment, advertising strategy and production and index design/calculation/promotion.

## **B. Outsourcing arrangements**

Market authorities in most TCSC2 jurisdictions limit their assessment of outsourcing arrangements to activities that they consider “material” or “core” to the business of the market.<sup>7</sup> Nonetheless, a variety of factors are considered in the assessment of outsourcing arrangements. Typically, the main concern of market authorities is whether markets can continue to meet their obligations if an activity is outsourced and whether the selection process for the service provider is sufficiently rigorous. In addition to considering the materiality of the outsourcing arrangement to the market's core business, TCSC2 jurisdictions identified, among others, the following factors they would consider when assessing outsourcing arrangements:

- The potential risks to the regulatory objectives of maintaining fair, orderly and transparent markets;
- Potential impact on price formation;
- Potential negative impacts on investor protection;
- Potential threats to the jurisdiction's clearance and settlement system.

Regulatory requirements may vary according to the outsourced function, the service provider and their location. TCSC2 jurisdictions would normally consider the arrangements between the market and service provider, such as the ability of the market to monitor and exercise control over the performance of the outsourced activities, the framework/process for managing potential conflicts of interest between the market and the service provider, the protection of confidential regulatory information, the risk management processes and safeguards, including the role of internal and external audit and disaster recovery and business continuity plans and the contracts between the market and service provider. TCSC2 jurisdictions also consider the effect of the outsourcing arrangements on their ability to supervise the market, including the ability of a TCSC2 member jurisdiction to exercise its supervisory powers to access information or inspect offices of the service provider.

The survey conducted among markets reveals that some markets perform due diligence assessments of outsourcing proposals in accordance with internal rules and formal written procedures. However, most markets carry out due diligence on a case-by-case basis depending on the materiality of the outsourcing, taking into account a variety of factors (such

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<sup>7</sup> Various TCSC2 jurisdictions have identified activities that they would consider to be core activities, among others, the following:

- Provision and daily operation of trading facilities;
- Management of the market functioning, including market surveillance and monitoring;
- Enforcement of exchange rules/self-regulation;
- Post-trade services, such as clearing and settlement;
- Trading information disclosure;
- Product development;
- IT operation;
- Admission of members authorizing them to trade directly on the market;
- Authorizing the trading of specific securities on the market;
- Functions of a board that has management responsibilities.

as commercial considerations (including competitive pressures), applicable regulatory and other legal factors, and the characteristics and qualifications of the proposed service firm (e.g., the company's experience, capabilities (including infrastructure), financial standing and past performance)). The market will also consider its ability to supervise adequately the services performed by the service provider.

The majority of TCSC2 jurisdictions require markets to enter into a written<sup>8</sup> outsourcing agreement/contract with the service provider. Markets will generally require service contracts to provide for internal audits, monitoring of service providers and/or the inclusion of audit rights. Some responses noted that the policies and procedures are governed through the use of service level agreements (SLAs) or contracts.

### **C. Selection of Service Providers**

In many jurisdictions, there are no restrictions on the parties to whom services are outsourced as long as the market continues to comply with its legal obligations. TCSC2 jurisdictions seek to ensure that markets will continue to comply with their legal obligations by considering how a market selects the service provider and by evaluating how the market can maintain control over the service performed by the service provider. For example, TCSC2 jurisdictions will consider the service provider's suitability, reputation and track record. They will also consider both the location of the service provider and where outsourced services will be performed. If a service provider is located abroad or services are performed in a different jurisdiction, TCSC2 jurisdictions may have additional concerns in respect of effective supervision, reliability of the service provider and their ability to access information or inspect offices. Accordingly, some TCSC2 jurisdictions impose additional requirements on the service provider and/or market with respect to activities that are performed in a different jurisdiction or when a provider is located outside their jurisdiction.

In some jurisdictions, functions can only be outsourced to self-regulatory organizations (SROs) or regulated entities.

### **D. Legal accountability**

In most TCSC2 jurisdictions, the outsourcing market remains legally accountable for all outsourced functions at all times, regardless of whether the service provider was primarily responsible for the failure to meet regulatory requirements. One important limited exception is in the US securities sector. In the United States, all registered markets are themselves SROs. Moreover, they often will have "common members", meaning that an intermediary will be a member of more than one market. Normally, each such SRO or market would be responsible for examining the same member. Under a special rule,<sup>9</sup> a single SRO (known as the designated examination authority or DEA) is named to examine common members, specifically, for compliance with the financial responsibility requirements.<sup>10</sup> In other words, this compliance function is outsourced to the DEA. When an SRO has been named as a

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<sup>8</sup> The following jurisdictions require that the contract be in writing: Germany, Italy, Japan, Malaysia, Netherlands, Ontario, Quebec, Singapore, Switzerland, United States (CFTC).

<sup>9</sup> Rule 17d-1 under the Exchange Act authorizes the SEC to name a single SRO as the designated examining authority (DEA).

<sup>10</sup> As imposed by the Exchange Act, or by SEC or SRO rules. *See* Securities Exchange Act Release No. 12352 (20 April 1976), 41 FR 18808 (7 May 1976).

common member's DEA, all other SROs to which the common member belongs are relieved of the responsibility solely to examine the firm for compliance with the applicable financial responsibility rules. However, the rule does not relieve an SRO from its obligation to examine a common member for compliance with its own rules and provisions of the federal securities laws governing matters other than financial responsibility. To address regulatory duplication in sales practices and trading activities (and practices in other areas), the SEC adopted another targeted rule<sup>11</sup> that permits SROs to propose joint plans for the allocation of regulatory responsibilities with respect to their common members.<sup>12</sup> SEC approval of a plan filed pursuant to this rule relieves an SRO of those regulatory responsibilities allocated (*i.e.*, outsourced) by the plan to another SRO.

Answers by markets to the TCSC2 survey indicate that service agreements with arms-length service providers often contain provisions that identify specific events that will automatically trigger the termination of the service contract. The most common such event would be a "material" breach of any obligation under the agreement or if the service provider becomes insolvent. Additional events that could trigger the termination of a service agreement include breach of confidentiality and/or security obligations, change of control, failure to comply with applicable laws, as well as withdrawal of any authorization or license necessary to conduct the business of the service provider.

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<sup>11</sup> Rule 17d-2 under the Exchange Act. *See* Securities Exchange Act Release No. 12935 (28 October 1976), 41 FR 49091 (8 November 1976).

<sup>12</sup> The SEC may declare such a plan effective if it determines that the plan is necessary or appropriate in the public interest and for the protection of investors; to foster cooperation and coordination among the SROs; to remove impediments to, and foster the development of, a national market system and a national clearance and settlement system; and is in conformity with the factors set forth in Section 17(d) of the Exchange Act.



### III. Preface to Proposed Outsourcing Principles

#### A. Materiality and nature of outsourcing

The principles set forth in section IV below (Outsourcing Principles), reflect TCSC2 market authorities' expectations for outsourcing markets. These Outsourcing Principles should be applied according to the degree of materiality and the nature of the outsourced activity. This is particularly important in instances where the market proposes to outsource activities relating to regulatory functions or another core function, assuming that this is permitted in the market's jurisdiction. Core functions identified in some jurisdictions generally include, but are not limited to:

- Provision and daily operation of trading facilities;
- Management of the market functioning, including market surveillance and monitoring;
- Enforcement of exchange rules/self-regulation;
- Post-trade services, such as clearing and settlement;
- Trading information disclosure;
- Product development;
- IT operation;
- Admission of trading participants to exchange trading;
- Admission of securities to trading on the exchange;
- Functions of a board that has management responsibilities.

The outsourcing market should develop a process for determining the materiality of outsourcing arrangements to the business of the market with particular emphasis on the potential impact on the market if a service provider fails to perform. The assessment of what is material is often a subjective one and depends on the circumstances of the particular outsourcing market. Factors to be considered by the outsourcing market include, but are not limited to:

- In the event of a failure of a service provider to perform:
  - Potential market integrity impact;
  - Potential financial impact;
  - Potential reputation impact;
  - Potential operational impact;
  - Potential impact on the provision of adequate services to its members;
  - Potential losses for its members;
  - Potential impact on its ability and capacity to conform with regulatory requirements and changes in requirements.
- The cost of outsourcing;
- Affiliation or other relationship between the outsourcing market and the service provider;
- Whether the activity being performed is a regulatory function (*e.g.*, market surveillance or supervision);
- Regulatory status of the service provider;
- Territory of location of the service provider;

- Degree of difficulty and time required to select an alternative service provider and have in place an effective agreement with another service provider or to bring the business activity in-house, if necessary; and
- The need for regulatory approval of the outsourcing arrangements.

## **B. Accountability and scope of outsourcing**

The outsourcing market, its management and its governing body generally retain full legal liability and accountability to the market authority for any and all functions that the market may outsource to a service provider to the same extent as if the service were provided in-house (with limited exceptions noted earlier in this report with respect to the US securities sector). In this regard, the relevant market authority may impose sanctions and penalties on regulated markets in its jurisdiction for violations of statutory and regulatory requirements that resulted in whole or in part from the failure of a service provider (whether regulated or unregulated) to perform its contractual obligations for the outsourcing market.

Accordingly, management and the governing body of the outsourcing market should develop and implement appropriate policies and procedures designed to ensure compliance with these Outsourcing Principles, periodically review the effectiveness of those policies and procedures, and address outsourcing risks in an effective and timely manner. Outsourcing markets should also be aware of and comply with local measures that may have been put in place to implement these Outsourcing Principles. Such measures may take the form of government regulation, regulations imposed by non-government statutory regulators, industry codes or practices, or some combination of these items. Whatever level of outsourcing is utilized, outsourcing markets remain responsible for conducting due diligence.

Under the laws of most TCSC2 members' jurisdictions, the outsourcing market must retain the competence and ability to be able to ensure that it complies with all regulatory requirements. Accordingly, with respect to the outsourcing of key regulatory functions, such as market surveillance, markets should consider how and whether such functions may be outsourced. Moreover, outsourcing should not be permitted if it impairs the market authority's ability to exercise its statutory responsibilities, such as the proper supervision and audit of the market.

Market authorities should also consider whether using unregulated service providers may impact the market authority's ability to supervise market activities in their jurisdiction. Such concerns may be heightened where the outsourcing market delegates to the service provider the authority to act in the name of the outsourcing market or where the service provider is located in a foreign jurisdiction.

## **C. Outsourcing to affiliates**

While the Outsourcing Principles apply regardless of whether outsourcing is performed by an affiliated entity of a corporate group or by an entity that is external to the corporate group, the risks associated with outsourcing activities to an affiliated entity within a corporate group may be different than those encountered in outsourcing to an unaffiliated entity. In certain cases, risks may not be as pronounced within an affiliated group. For example, there may be an ability by the outsourcing market to control the actions of the service provider, and the outsourcing market may have a high familiarity with the service provider's business attributes. Such factors might reduce the risks involved in outsourcing. Intra-group

outsourcing is usually not undertaken on an arm's-length basis and the interests of an outsourcing market (and its members) and its affiliated service-provider may not be fully aligned. Moreover, in some cases, the intra-group relationship may as a practical matter restrict the outsourcing market's ability to control the service provider. These factors may increase the potential risk in certain instances. Accordingly, while it is necessary to apply the Outsourcing Principles to affiliated entities, it may be appropriate to adopt them with some modifications.

#### **D. Sub-contracting of outsourced functions**

Where the service provider proposes to use the services of a sub-contractor to perform the activities, the outsourcing market should take particular care to ensure that sub-contracting would not be possible without its approval and that it would consider the ability of the sub-contractor to perform the services as part of its due diligence process (see Topic 1). In addition, the outsourcing market should ensure that it keeps its ability to access books and records maintained by the sub-contractor (see Topic 6).

#### **E. Outsourcing on a cross-border basis**

The Outsourcing Principles apply to functions that are outsourced either on a cross-border basis or within a foreign jurisdiction where the outsourcing market maintains a presence or carry on activities. With respect to outsourcing on a cross-border basis, there may be additional issues that arise which may not necessarily be present in circumstances where the service provider is located in the same jurisdiction as the outsourcing market. For example, in the event of an emergency, it may be more difficult to monitor and control the function that was outsourced to a foreign service provider, or to implement appropriate responses in a timely fashion, as opposed to a service provider located in the same jurisdiction. It may also be necessary to consider whether there are any economic, social, legal or political conditions that might adversely impact the foreign service provider's ability to perform effectively for the outsourcing market, the ability of the outsourcing market to efficiently manage its arrangement with the service provider and the ability of the market authority to legally inspect or obtain records in the possession of the service provider.

In light of these concerns, outsourcing on a cross-border basis may raise additional issues that should be addressed during the due diligence process (see Topic 1), as well as during the implementation of a contract with a foreign service provider (see Topic 2). Special consideration and procedures may be necessary with respect to other issues relating to the use of a foreign service provider – for example, as discussed in Topic 6, there may be particular concerns with the provision of books and records maintained in a foreign jurisdiction, as well as issues relating to the translation of such books and records.

#### **F. Concentration of outsourcing function**

Where multiple outsourcing markets use a common service provider, operational risks are correspondingly concentrated, and may present a systemic risk.

For example, if the service provider suddenly and unexpectedly becomes unable to perform services that are critical to the business of a significant number of outsourcing markets, each of the markets will be similarly disabled. For example, a latent flaw in the design of a product or service that multiple outsourcing markets rely upon may affect all of those markets. A

vulnerability in application software relied upon by multiple outsourcing markets may permit an intruder to disable or contaminate the systems or data of some or all of those markets. If multiple outsourcing markets depend upon the same provider of business continuity services (*e.g.*, a common disaster recovery site), a disruption that affects a large number of those markets may result in lack of capacity for the business continuity service. Each of these scenarios may result in follow-on effects to other sectors or on public confidence.

Outsourcing markets should take steps to ensure, to the degree practicable, that the service provider has adequate capacity to meet the needs of all outsourcing markets, both during normal operations as well as unusual circumstances (*e.g.*, unusual market activity, physical disaster, etc.). In particular, outsourcing markets should consider concentration issues in the assessment of business continuity and disaster recovery arrangements (*see* Outsourcing Principles Topic 3) and with respect to ensuring the security and confidentiality of information (*see* Outsourcing Principles Topic 4).

## IV. Outsourcing Principles

### Topic 1: Due diligence in selecting the service provider and in monitoring the service provider's performance

*Principle: An outsourcing market should conduct suitable due diligence processes in selecting an appropriate third party service provider and in monitoring its ongoing performance.*

*The outsourcing market should also take appropriate steps to identify any conflicts of interest between the outsourcing market and the service provider (including affiliated entities and sub-contractors) and ensure that policies and procedures are in place to mitigate and manage any potential conflicts of interest which have been identified or could arise.*

It is important that outsourcing markets exercise due care, skill and diligence in the selection of third party service providers, so that they can be satisfied that the third party service provider has the ability and capacity to undertake the provision of the service effectively. The outsourcing market should consider whether the service provider should be regulated to conduct the service.

Potential conflicts of interest may arise for an outsourcing market as a result of its connection with the service provider and/or subcontracting provider. A conflict of interest can create an appearance of impropriety that can undermine confidence in the market. It is important that outsourcing markets take steps to identify potential conflicts of interest and devise procedures to mitigate and manage such conflicts. The nature and type of the outsourced activity, whether it is a core function or related to a regulatory function, should also be considered in the assessment of the impact of any potential conflicts of interest.

The outsourcing market should also establish appropriate processes and procedures for monitoring the performance of the third party service provider. In determining the appropriate level of monitoring processes and procedures, the outsourcing market should consider the materiality as well as the nature and type of the outsourced activity to the ongoing business of the outsourcing market and its regulatory obligations, as discussed in the introduction to these Outsourcing Principles. Furthermore, the outsourcing market should consider whether the service provider is regulated.

#### *Means for Implementation:*

It is expected that outsourcing markets will implement appropriate means, such as the following, for ensuring that they select suitable service providers and that service providers are appropriately monitored, having regard to the services they provide:

- Documenting processes and procedures that enable the outsourcing market to assess, prior to selection, the third party service provider's ability and capacity to perform the outsourced activities effectively, reliably, and to a high standard. This will include a consideration of the service provider's technical and human resources capabilities, along with its financial strength.

- Documenting processes and procedures that enable the outsourcing market to monitor the third party service provider's performance and compliance with its contractual obligations, including processes and procedures that:
  - Clearly define metrics that will measure the service level, and specify what service levels are required; and
  - Establish measures to identify and report instances of non-compliance or unsatisfactory performance to the outsourcing market as well as the ability to assess the quality of services performed by the service provider on a regular basis (see also Topic 2 – the contract with the service provider).
  
- Documenting a clear framework for managing potential conflicts of interest between the outsourcing market and the service provider that:
  - Ensures that the outsourcing market's governance structure is appropriate and allocates responsibility for decisions so that it can continue to take proper decisions taking into account the potential conflicts of interest with service providers, their affiliates and sub-contractors;
  - Puts in place appropriate systems and controls to ensure that conflicts of interest are identified and managed; and
  - Establishes procedures for identifying and handling conflicts of interest, including appropriate and timely disclosure and recording of conflicts of interest.
  
- Implementing processes and procedures designed to help ensure that the service provider is in compliance with applicable laws and regulatory requirements in its jurisdiction, and that where there is a failure to perform duties required by statute or regulations, the outsourcing market, to the extent required by law or regulation, report the failure to its market authority and takes corrective actions. For example, procedures may include:
  - The use of service delivery reports and the use of internal and external auditors to monitor, assess and report to the outsourcing market on performance;
  - The use of written service level agreements or the inclusion of specific service level provisions in contracts for service to achieve clarify of performance targets and measurements for third party service providers.
  
- Where the service provider proposes to use the services of a sub-contractor to perform the activities, the outsourcing market should also conduct suitable due diligence processes on that sub-contractor and ensure that it has similar rights to intervene if needed.

## **Topic 2: The contract with a service provider**

*Principle: There should be a legally binding written contract between the outsourcing market and each third party service provider, the nature and detail of which should be appropriate to the materiality and nature of the outsourced activity to the ongoing business of the outsourcing market.*

A legally binding written contract between the outsourcing market and a service provider, including appropriate contractual provisions, is a crucial management tool since it can significantly reduce the risks of disagreements regarding the scope, nature and quality of the service to be provided and provides a legal framework to deal with non-performance. A written contract will help facilitate the monitoring of the outsourced activities by the outsourcing market and/or by its market authority.

### *Means for Implementation*

Outsourcing markets are expected to have a written, legally binding contract, appropriate to the materiality and nature of the outsourced activity to the ongoing business of the market, between the outsourcing market and the third party service provider. Where applicable, the written contract may require the service provider to obtain appropriate regulatory approval. The contract may include, as applicable, provisions dealing with:

- Defining the responsibilities of the outsourcing market and the responsibilities of the service provider and how such responsibilities will be monitored;
- Service standard levels, process for monitoring performance against these levels and related penalties;
- Confidentiality of information (*see* Outsourcing Principles Topic 4);
- Limitations, or conditions, if any, on the service provider's ability to sub-contract, and, to the extent subcontracting is permitted, obligations, if any, in connection therewith;
- Responsibilities relating to IT security (*see* Outsourcing Principles Topic 4);
- Payment arrangements;
- Liability of the service provider to the outsourcing market for unsatisfactory performance or other breach of the agreement;
- Guarantees and indemnities;
- Obligations of the service provider to provide, upon request, records, information and/or assistance concerning outsourced activities to the outsourcing market, its auditors and/or its market authorities (*see* Outsourcing Principles Topic 6);
- Mechanisms to resolve disputes that might arise under the outsourcing arrangement;
- Business continuity provisions (*see* Outsourcing Principles Topic 3);
- With respect to outsourcing on a cross-border basis, choice of law provisions;
- Termination of the contract, transfer of information and exit strategies (*see* Outsourcing Principles Topic 5).

### **Topic 3: Business Continuity at the Outsourcing Provider**

*Principle: The outsourcing market should take appropriate measures to determine that its service providers establish and maintain emergency procedures and a plan for disaster recovery, with periodic testing of backup facilities.*

This Outsourcing Principle is particularly important to markets because they are infrastructure providers and in many cases there are no alternative providers. Issues affecting the functioning of a market can have effects beyond its own operations and may have market-wide implications and ramifications for the financial system as a whole. It is important that markets ensure resilience of their operations, including those operated by service providers or affected (either directly or indirectly) by outsourcing arrangements.

An outsourcing market should also take into account whether additional issues are raised when the outsourcing is performed on a cross-border basis or in circumstances where a service provider is providing a service for more than one outsourcing market.

#### *Means for implementing*

Outsourcing markets are expected to take appropriate steps to require that service providers have in place a comprehensive business continuity program. These steps may include:

- Provisions that address the service provider's emergency procedures and disaster recovery and contingency plans as well as any particular issues that may need to be addressed where the outsourcing market is utilizing a foreign service provider or where concentration issues are identified. Where relevant, this may include the service provider's responsibility for backing up and otherwise protecting program and data files, as well as regulatory reporting. It may also include a requirement in order to oblige the service provider to inform the outsourcing market in the event of significant operational failures regarding the services provided to this market as well as to other markets for which the service provider is offering similar services.
- Where appropriate, requirement of testing by the service provider of critical systems and back-up facilities on a periodic basis in order to review the ability of the service providers to perform adequately even under unusual physical and/or market conditions at the outsourcing market, the service provider, or both, and to determine whether sufficient capacity exists under all relevant conditions.
- Provisions in the outsourcing market's own contingency plans that address circumstances in which one or more of its service providers fail to adequately perform their contractual obligations. Where relevant, this may include regulatory reporting.



#### **Topic 4: Security and Confidentiality of Information**

*Principle: The outsourcing market should take appropriate measures to determine that procedures are in place to protect the outsourcing market's proprietary, member-related and potentially market sensitive information and software.*

*The outsourcing market should take appropriate steps to require that service providers protect confidential information regarding the outsourcing market's members from intentional or inadvertent disclosure to unauthorised individuals.*

Security breaches (*e.g.* unauthorised disclosure of confidential information or potentially market sensitive information) can undermine market members' privacy interests, and have a damaging effect on an outsourcing market's reputation, which may ultimately affect market confidence. It is therefore critical that any information technology system operated by a service provider for an outsourcing market is able to ensure the security and confidentiality of information.

Unauthorised disclosure of confidential information or potentially market sensitive information could have a number of serious negative consequences. Such unauthorised disclosure could result in the disclosure of private and sensitive information about the market, its members and their transactions, and might also result in a material financial loss to a market's members or a distortion of the market.

Outsourcing markets and market authorities should be particularly mindful of data confidentiality issues in circumstances where a service provider is providing a service for more than one outsourcing market or when the outsourced activity is or is related to a regulatory function.

##### *Means for implementation*

Markets that engage in outsourcing are expected to take appropriate steps to confirm that confidential member information and market sensitive information is not misused or misappropriated. Such steps may include provisions in the contract with the service provider:

- Prohibiting the service provider and its agents from using or disclosing the outsourcing market's proprietary information or that of the market's members, except as necessary to perform the contracted services.
- Where appropriate, including terms and conditions relevant to the use of subcontracts with respect to confidentiality of member information and market sensitive information.

Outsourcing markets should consider whether it is appropriate to notify members that member data may be transmitted to a service provider, taking into account any regulatory or statutory provisions that may be applicable.

Outsourcing markets are further expected to take appropriate steps to require, in appropriate cases based on the materiality of the function that is being outsourced, that service providers have in place a comprehensive IT security program. These steps may include:

- Specification of the security requirements of automated systems used by the service provider, including the technical and organisational measures that will be taken to protect market sensitive and members-related data. This may be particularly important if concentration issues are identified. Appropriate care should be exercised to ensure that IT security protects the privacy of the outsourcing market's members as mandated by law.
- Requirements that the service provider maintain appropriate measures to ensure security of both the outsourcing market's software as well as any software developed by the service provider for use of the outsourcing market.
- Specification of the rights of each party to change or require changes to security procedures and requirements and of the circumstances under which such changes might occur.
- Where appropriate, terms and conditions relevant to the use of subcontractors with respect to IT security, and appropriate steps to minimize the risks arising out of each subcontracting.
- Requirement of disclosure by the service provider of breaches in security resulting in unauthorised intrusions (whether deliberate or accidental, and whether confirmed or not) that may affect the outsourcing market or its customers, including a report of corrective action taken.

Market authorities should seek to become aware of whether outsourcing markets within their jurisdiction are taking appropriate steps to monitor their relationships with service providers with respect to the protection of confidential member information or market sensitive information.

## **Topic 5: Termination Procedures**

*Principle: Outsourcing with third party service providers should include contractual provisions relating to the termination of the contract and appropriate exit strategies.*

Where an activity is outsourced, there is an increased risk that the continuity of the particular activity in terms of daily management and control of that activity, information and data, staff training, and knowledge management, is dependent on the service provider continuing in that role and performing that function. This risk should be managed by an agreement between the market and the service provider taking into account factors such as when an arrangement can be terminated, what will occur on termination and strategies for managing the transfer of the activity back to the market or to another party.

### *Means for Implementation*

Outsourcing markets are expected to take appropriate steps to manage termination of outsourcing arrangements. These steps may include provisions in accordance with service providers such as the following:

- Termination rights, *e.g.*, in case of insolvency, liquidation and receivership, change in ownership, failure to comply with regulatory requirements, or poor performance;
- Minimum periods before an announced termination can take effect to allow an orderly transition to another provider or to the market itself, and to provide for the return of the third party's data, and any other resources;
- The clear delineation of ownership of intellectual property following the contract's termination, and specifications relating to the transfer of information back to the outsourcing market.

## **Topic 6: Regulator's and Market's Access to Books and Records, including rights of inspection**

*Principle: The market authority, the outsourcing market, and its auditors, should have access to the books and records of service providers relating to the outsourced activities and the market authority should be able to obtain promptly, upon request, other information concerning activities that are relevant to regulatory oversight.*

The outsourcing market should always maintain direct access to such books and records.

Market authorities should be able, upon request, to obtain promptly any books and records pertaining to the regulated activity, irrespective of whether they are in the possession of the outsourcing market or the third party service provider, and to obtain additional information concerning regulated activities performed by the service provider. A market authority's access to such books and records may be direct or indirect. This may include a requirement that the books and records be maintained in the regulator's jurisdiction, or that the service provider agrees to send originals or copies of the books and records to the market authority's jurisdiction upon request.

In order to facilitate the market authority's access to books and records as well as to maintain orderly business operations of the outsourcing markets, arrangements between outsourcing markets and service providers should seek to ensure that the outsourcing markets have appropriate access to books and records and other information where it is in the custody of a third party.

### *Means for implementation*

Outsourcing markets are expected to take steps to ensure that they and their market authorities have access to books and records of service providers concerning outsourced activities, and that their market authorities have the right to obtain, upon request, other information concerning the outsourced activities. These steps may include the following:

- Contractual provisions by which the outsourcing market (including its auditor) has access to, and a right of inspection of, the service provider's books and records dealing with outsourced activities, and similar access to the books and records of any subcontractor. Where appropriate, these may include physical inspections at the premises of the service provider, delivery of books and records or copies of books and records to the outsourcing firm or its auditor, or inspections that utilize electronic technology (i.e. virtual inspections).
- Contractual provisions by which the service provider is required to make books, records and other information about regulated activities by the service provider available to the regulator upon request and, in addition, to comply with any requirements in the outsourcing market's jurisdiction to provide periodic reports to the market authority.

Market authorities should consider implementation of appropriate measures designed to support access to books, records and information of the service provider about the performance of regulated activities. These measures may include:

- Where appropriate, taking action against outsourcing markets for the failure to provide books and records required in that jurisdiction, without regard to whether the regulated entity has transferred possession of required books and records to one of more of its service providers.
- Imposing specific requirements concerning access to books and records that are held by a service provider and which are necessary for the market authority to perform its oversight and supervisory functions. These may possibly include requiring that records be maintained in the regulator's jurisdiction, in a specific language, allowing for a right of inspection of the books and records, or requiring that the service provider agree to send originals or copies of the books and records to the market authority's jurisdiction upon request.
- In the case of the outsourcing of a regulated function, establishing a co-operation and information sharing agreement with the regulator of a regulated service provider.

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