

Guidance Note on Outsourcing/Delegation of Functions

Supervision Division

Financial Supervision Commission

7 May 2002

Updated 1 August 2008 and Appendix 2 added March 2010

Guidance Note on Outsourcing/Delegation of Functions

Introduction

This guidance applies to all licenceholders that are licensed by the Financial Supervision Commission ('Commission') the Financial Services Act 2008 to conduct regulated activities within Class 1, 2, 3, 4 or 5 (as defined in the Regulated Activities Order 2008).

Rule 8.13 requires licenceholders to obtain the prior consent of the Commission before delegating any material management or business functions. This guidance outlines the Commission's policy and requirements in relation to outsourcing/delegation of functions, which applies to activities regulated by the Commission.

Other Relevant Policy Statement

Licenceholders should consider the following policy issued by the Commission in conjunction with this guidance:

- ◆ General Licensing Policy

Material Functions

The use of the term 'material functions' throughout this guidance refers to functions that are part of, or are fundamental to *the management of the licenceholder*, the conduct of the licenceholder's business, for which the licence or authorisation is required, *or the licenceholder's ability to comply with the regulatory requirements as defined in Rule 8.2*. Therefore, a function will be likely to be material where a weakness in, or a failure of, the delegatee's ability to perform the function would have a significant impact on the licenceholder's reputation or its ability to continue to conduct its operations in a proper manner. 'Non-material' functions will generally be services that can be provided by unregulated businesses, e.g. IT functions, payroll services.

Rationale for Delegating Functions

The Commission recognises that a licenceholder's decision to outsource functions may be based on a number of factors, such as to achieve economies of scale or to improve the quality of service to clients. It is accepted that many financial services groups have, or are establishing, 'centres of excellence' in suitable jurisdictions in order to centralise certain activities or functions. The Commission recognises that such centralisation may lead to cost savings for clients (as well as for the firms themselves) and may contribute more specialized 'know-how' that a stand-alone operation may lack.

Some material services that are provided by regulated entities are commonly or necessarily outsourced or segregated for prudential reasons e.g. custody arrangements, clearing facilities or disaster recovery arrangements. In such cases there would be a presumption in favour of properly structured outsourcing to a suitable delegatee.

On the other hand, the Commission would be concerned if the delegation of functions was likely to reduce the protection available to depositors, investors or other clients or was used as a way of avoiding complying with the standards of conduct imposed by the Isle of Man regulatory framework. A primary concern for the Commission would be that the delegation does not defeat the purpose of its regulatory requirements. For example, if a complete and systematic delegation of functions leads to the licenceholder divesting itself of any role in the conduct of the functions so that it became nothing more than a 'brass plate' or 'empty box'.

Commission's General Approach

From the Commission's prudential supervisory viewpoint, it will consider all proposals to outsource services or functions from the point of view of the continuance of adequate management control over the functions and the ability of internal compliance and internal audit functions, as well as external audit (and, where applicable, a trustee), to monitor and perform the necessary checks on the outsourced functions.

In assessing proposals, the Commission will take into account the possibility that certain of its concerns may not apply, or be more easily addressed, in cases of outsourcing to other entities within the same economic group.

This guidance deals only with the prudential issues related to outsourcing and does not deal with the legal or other issues which may be relevant, such as, for example, data protection or confidentiality of customer information. These are issues that should be considered by the licenceholder's own management in arriving at a decision to outsource functions.

While recognizing that there are circumstances, some of which have been outlined above, where outsourcing is desirable or attractive from a licenceholder's point of view, the Commission's overriding consideration will be whether the delegation is against the interests of depositors, investors or other clients. Neither is the issuing of this guidance intended to encourage outsourcing, rather the Commission, for prudential reasons, will continue to prefer licenceholders conducting all functions inhouse, insofar as this is practicable.

Submissions to Commission

Proposals to outsource material functions should be submitted to the Commission in writing well in advance of the date on which it is intended that the outsourcing will commence.

Before submitting proposals to the Commission, decisions to outsource material functions should be approved at Board level in the case of locally incorporated licenceholders. For licensees that are branches of non-Isle of Man institutions, the approval should be by the Local Supervisory Board or Head Office Director or Senior Executive with responsibility for the branch's operations, as appropriate. In considering the proposal(s) the Commission expects the Board to consider the risks of the

outsourcing and any mitigating factors. Pre-notification to the Commission of proposals to outsource nonmaterial functions is not required. However, licenceholders should seek clarification from the Commission if they are in any doubt whether an activity should be considered 'material' or not.

The degree of detail that the Commission will require will depend on the functions that the licenceholder proposes to outsource and the delegatee (service provider) to be used. In general, proposals should include details of the functions to be outsourced as well as the rationale for the outsourcing; details relating to the proposed delegatee; and a description of the methods that the licenceholder will employ to ensure that it retains its ability to control and monitor the outsourced functions.

Before selecting a delegatee, the Commission expects the licenceholder to conduct detailed due diligence on the delegatee and it reserves the right to examine that due diligence as part of its assessment of an outsourcing proposal. The Commission will also require sight of a draft outsourcing agreement between the parties involved.

Such agreements must ensure that the licenceholder can provide to the Commission any information relating to the outsourced activity that it requires in order for the Commission to carry out its supervisory functions. The agreements must not contain any provisions which are contrary to the principles contained in this guidance.

Assessment of Proposals

The general principles that will guide the Commission in assessing applications from licenceholders to outsource functions follow. However, proposals will be considered on a case by case basis and the Commission reserves the right not to approve proposals although they may appear to comply with these general principles.

Conversely, the Commission may grant approval for proposals which do not strictly meet the criteria, if the merits of the specific case justify such a decision. In assessing a proposal from a licenceholder to outsource functions, the Commission will at first consider whether any of the fundamental or statutory criteria which must be complied with before a licence is granted, and which have to be adhered to on an ongoing basis, will be adversely affected. In particular, the Commission will consider if, after the outsourcing, the "mind and management" of the licenceholder and control of its operations will remain in the Isle of Man - this automatically imposes limits on the extent to which functions can be outsourced. In making this judgement, the Commission will distinguish between functions that it considers to be material in the context of the licenceholder's overall operations. The Commission's policy in granting consent for the outsourcing of any of the functions for which the specific licence or authorisation was required will be restrictive. The general principles to be applied by the Commission are based primarily on four main considerations;

- Is the delegation appropriate/not against the depositors' or investors' or other clients' interests?

- Will the licenceholder continue to be in a position to monitor the outsourced functions following the outsourcing?
- Will the Commission continue to be in a position to regulate adequately the activities of the licenceholder following the outsourcing? and
- Is there potential reputational risk for the licenceholder or the Isle of Man in permitting the outsourcing?

General Principles

In general, proposals to outsource material functions will only be permitted where the outsourcing is to other group entities. Where the proposal is to outsource to a third party delegatee, the third party must be a regulated entity in a jurisdiction acceptable to the Commission. In such cases, the Commission will expect the licenceholder to conduct detailed due diligence on the proposed delegatee to ensure that it meets the 'fit and proper' criteria that are applied by the Commission to the licenceholder itself.

The Commission must be in a position to be able to continue to supervise the outsourced functions, including having access to documentation and accounting records in relation to the outsourced activities. This implies that approval will be unlikely to be granted for functions to be transferred to entities or jurisdictions where visits by the licenceholder's staff, external auditors or Commission staff would be impractical or would be prohibited. Exceptions may be made where, for example,

- the outsourcing is to other group entities; or
- where alternative arrangements can be made with external auditors or with financial regulators in these other jurisdictions; or
- where the licenceholder has full electronic access to the records held by the delegatee and such access is available at all times without recourse to third parties.

In general, approval for functions to be outsourced to entities outside of the Isle of Man will only be granted where the outsourcing is to a regulated entity in a jurisdiction with an equivalent standard of regulation or supervision as pertains in the Isle of Man. If the Commission so requires, the delegate must give its consent to its home regulator releasing any relevant information in relation to its operations that the Commission would wish to receive and in no case should it be prohibited, implicitly or explicitly, from doing so.

The licenceholder's management must satisfy the Commission that adequate procedures are in place and that it has the ability to monitor and control the outsourced functions on an ongoing basis. The Commission will hold the licenceholder's management responsible for ensuring that the outsourced functions are carried out to an appropriate standard and that the integrity of the licenceholder's systems and controls is maintained.

In particular, the Commission will need to be satisfied that any anti-money laundering requirements can continue to be met. If original evidence of client identity is being held off-Island, the Commission would expect copies to be readily available to staff conducting regulated functions and to the Commission's officers during a visit. The licenceholder must also be in a position to satisfy all the reporting requirements of the Commission in relation to these activities. The licenceholder's management will be responsible to the Commission for the outsourced functions as if no outsourcing had taken place.

On-site visits to the licenceholder may include coverage of outsourced functions, where appropriate. In the event that the Commission's Officers would, for whatever reason, not be in a position to carry out this task, outsourcing may not be permitted or approval may be withdrawn, as the case may be.

The Commission will reserve its right in all cases where approval to outsource functions is granted to review this consent should any of the circumstances under which the approval was granted change.

Particular Issues

Although the principles contained in this guidance apply to all licenceholders in Classes 1 to 5, additional issues will need to be considered in certain circumstances in certain sectors, e.g. the ability of the trustee of a collective investment scheme authorized in the Isle of Man to perform its functions where, for example, fund administration functions have been, or are proposed to be, delegated to a delegatee outside the jurisdiction.

Licenceholders which are permitted under Class 7 to manage another licenceholder must also be in a position to satisfy the Commission that any proposals for outsourcing are consistent with the maintenance of a real presence by the managed entity.

Other Issues

(a) Contingency Planning

Licenceholders which propose to outsource functions must have contingency plans in place in the event of an outsourcing agreement being suddenly terminated or failure of the delegatee to perform.

(b) Sub-contracting

The Commission must be made aware if a delegatee, to which a licenceholder proposes to outsource (or has outsourced) functions, has plans to further outsource (sub-contract) any of the functions to another delegatee. The Commission recognizes that in certain situations pre-notification may not always be appropriate and, therefore, some arrangements should be exempt from this requirement, e.g. global custody arrangements.

Date of application of this Guidance

The criteria and policies set out above apply to all outsourcing arrangements entered into by banking and investment business licenceholders after 7 May 2002. The policy was updated on 19 January 2007 to refer to fiduciary licenceholders also. In relation to outsourcing arrangements entered into before those dates, the Commission would wish to be advised of any material outsourcing arrangements in place. As such arrangements become due for renewal they should be discussed with the Commission before being renewed.

A further update was issued effective from 1 August 2008 to reflect the introduction of the Financial Services Act Rule Book. It applies to licenceholders from the date of the application of Rule 8.13 to their business.

APPENDIX I

Typical conditions that the Financial Supervision Commission would impose on licenceholders outsourcing material functions. This list is not intended to be exhaustive and not all of these conditions would necessarily be applied in every case.

- Delegations must be covered by mandates or agreements.
- Mandates must be capable of being amended or withdrawn.
- The Commission must be notified in advance of significant changes to mandates.
- Delegations must be only to group entities or regulated entities in jurisdictions acceptable to the Commission.
- Delegates must be sufficiently qualified and capable of undertaking delegated functions.
- Delegations to certain types of delegates may be prohibited, e.g. delegation of investment management by a fund manager to a trustee would not be permitted.
- The Licenceholder must retain ultimate administrative responsibility for, and be capable of monitoring, the delegated functions.
- The Licenceholder must retain legal responsibility/liability for the outsourced functions.
- The Commission must be able to continue to exercise supervision over outsourced functions, e.g. visits to delegatee or its jurisdiction should not be prohibited.
- The jurisdiction in which the delegatee is located must be recognised by the Commission as having equivalent standards of regulation or supervision and the regulator must be willing to cooperate with the Commission.

Use of overseas company formation agents by Class 4 licenceholders

This appendix to the Guidance Note provides additional information to Class 4 licenceholders (“CSPs”) on the application of the Guidance Note in circumstances where a CSP uses an overseas company formation agent to supply a company from that jurisdiction.

It is a common practice amongst CSPs to administer companies which are incorporated in various jurisdictions. About half of the companies managed or administered by CSPs are incorporated outside the Isle of Man.

This schedule is to help CSPs assess whether such arrangements are material outsourcing for the purposes of the Guidance Note.

In most of these cases the overseas company formation agent has a limited role in carrying out local statutory compliance and the bulk of the administration of the company is carried out by the Isle of Man CSP. Examples of the activities that might typically be carried out by an overseas company formation agent include:

- Formation and supply of the company;
- Provision of registered office;
- Maintaining registers at the registered office;
- Filing returns at the local companies registry;
- Paying filing fees;
- Acting as registered agent or a company officer, where this is required by the local law;
- Registering business names.

The arrangement with the overseas company formation agent would not be regarded as material outsourcing if it was restricted to the activities listed above. The Commission would expect that the vast majority of arrangements with overseas company formation agents do not represent material outsourcing.

However, the Commission is likely to view an arrangement as material outsourcing if it includes:

- Supplying officers (other than to a minimum level required by local statute)
- Operating bank accounts or brokerage accounts;
- Otherwise controlling the company’s assets;
- Administration of the company’s affairs;
- Ongoing contact with the client or beneficial owner.

March 2010