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GUIDANCE NOTE

**OUTSOURCING OF FUNCTIONS BY
ENTITIES LICENSED UNDER THE
PROTECTION OF INVESTORS
(BAILIWICK OF GUERNSEY) LAW, 1987**

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1. Introduction

This guidance note applies regardless of whether such outsourcing is performed by an affiliated entity within the same group or by an entity that is external to the group. The risks associated with outsourcing activities to an affiliated entity within a group may be different from those encountered in outsourcing to an unaffiliated external service provider. In certain cases, risks may not be as pronounced within an affiliated group. For example, the outsourcing Guernsey Licensee may be able to control the actions of the service provider, and the outsourcing Guernsey Licensee may have a high familiarity with the service provider's business attributes. Such factors might reduce the risks involved in outsourcing. However, intra-group outsourcing may be less than an arm's length relationship, and the outsourcing Guernsey Licensee (and its investors) may have different interests from the affiliated service provider. Moreover, in some cases, the intra-group relationship may as a practical matter restrict the outsourcing Guernsey Licensee's ability to control the service provider. These factors may therefore increase the potential risk in certain instances. Accordingly, while it is necessary to apply this guidance note to affiliated entities; it may be appropriate to adopt them with some modification.

The volume and types of activities that Guernsey Licensees outsource to third party service providers continues to increase. The Commission has considered proposals to outsource various functions from all sectors of the Investment Business industry including, Designated Managers, Closed-Ended Fund Administrators, Investment Managers and Asset Managers. The purpose of this guidance note is to set out the Commission's policy relating to such outsourcing, and to give practical guidance to Guernsey Licensees who may be considering outsourcing. This guidance note has been conformed to IOSCO's "Principles on Outsourcing of Financial Services for Market Intermediaries" and aims to provide a flexible and practical approach that Guernsey Licensees can use to guide their outsourcing practices in order to promote effective controls, business continuity, investor protection and regulatory access to books and records. Consequently, it is the Commission's intention to be non-prescriptive. For the avoidance of doubt, and as set out below in this introduction, whilst it is expected that licensees communicate with the Commission in respect of any proposals to outsource functions, or any changes to existing arrangements, it is not necessary to seek the Commission's formal approval, or confirmation that it has no objection, to the proposals. The Commission will not approve or confirm that it has no objection to such arrangements.

For the sake of clarity, it is the Commission's expectation that the following guidance applies to any entity licensed under the Protection of Investors (Bailiwick of Guernsey) Law, 1987, as amended, ("the Law") where functions are outsourced to either entities within the same group or third parties, both within the Bailiwick and outside the Bailiwick.

Outsourcing for the purposes of this guidance note occurs when a Licensee decides to transfer the performance of some part of its business to another party. Note that the

purchase of a standard service from, for example, an information screen provider such as Bloomberg or Reuters falls outside the scope of this guidance note. The service provider may itself be regulated, either by the Commission or by some other financial services regulator, or may be an unregulated entity.

All Guernsey Licensees should examine existing outsourcing arrangements to satisfy themselves they meet the requirements of this guidance note. Where the current arrangements do not meet the requirements, the Commission expects that the appropriate action will be taken to meet the requirements of this guidance note.

Whilst it is primarily a business issue for the Guernsey Licensee whether to enter into an outsourcing arrangement, the Commission has a legitimate regulatory concern under the Law, in respect of the conduct of a Licensee's controlled investment business. In addition, Principle 10 of The Licensees (Financial Resources, Notification, Conduct of Business and Compliance) Rules 1998 requires that "A licensee should deal with the Commission in an open and co-operative manner and keep the regulator promptly informed of anything concerning the firm which might reasonably be expected to be disclosed to it". Consequently, the Commission would expect to be advised at an early stage of any proposals to outsource. For the avoidance of doubt, whilst it is expected that licensees communicate with the Commission in respect of any proposals to outsource functions, or any changes to existing arrangements, it is not necessary to seek the Commission's formal approval, or confirmation that it has no objection, to such proposals. The Commission will not approve, or confirm that it has no objection to, such arrangements.

The Commission considers outsourcing arrangements on the basis that responsibility cannot be outsourced and that the Licensee at all times remains responsible and accountable to the Commission, as its regulator, for compliance with the Law and the rules and regulations made thereunder. The outsourcing arrangement must not impair the Commission's ability to exercise its statutory responsibilities.

2. The Commission's Policy

2.1 The Commission's policy is based on the following premises:-

- (a) the ultimate responsibility and accountability for the outsourced function(s) remains with the Guernsey Licensee, including its Board of Directors and Senior Management. The Guernsey Licensee cannot discharge itself of its obligations in this respect. Consequently, the Board of Directors and Senior Management of the Licensee should keep the arrangements under regular review;
- (b) the Guernsey Licensee should satisfy itself at the outset, and on a continuing basis thereafter, that the delegate is fit and proper, and be able to evidence that it is doing so if required by the Commission;
- (c) the Guernsey Licensee cannot outsource any function where the Guernsey Licensee does not retain the expertise (skills and knowledge) to oversee the function. The Guernsey Licensee must retain the competence and ability to be able to ensure that the delegate complies with the relevant regulatory requirements, and any changes in the requirements.

2.2 The Commission needs to ensure that where functions are outsourced that the mind and management of the operation rests within the Bailiwick.

Outsourcing arrangements may be considered as part of the licence application process.

2.3 As always, the Commission is prepared to meet with the Guernsey Licensee and other parties to discuss proposals to outsource functions and would encourage such discussion at an early stage of any proposal.

2.4 As stated in the introduction to this guidance note whilst it is expected that licensees communicate with the Commission in respect of any proposals to outsource functions, or any changes to existing arrangements, it is not necessary to seek the Commission's formal approval, or confirmation that it has no objection, to such proposals. Nor will the Commission approve or confirm that it has no objection to such arrangements. The Commission will consider, in detail, the provisions of any outsourcing arrangements utilised by licensees as part of its ongoing monitoring of licensees, predominantly but not solely restricted to its on-site compliance visits to licensees undertaken on a regular basis. Licensee's compliance with this guidance note will form part of that consideration.

2.5 In the case of investment funds, whether open-ended collective investment schemes or closed-ended investment funds, the Commission would not expect them to bear the costs of the implementation and continuation of any outsourcing arrangements or any errors or problems arising therefrom.

3. Outsourcing Principles

3.1 **Principle 1 - A licensee should conduct suitable due diligence processes in selecting an appropriate third party service provider and in monitoring its ongoing performance**

It is important that licensees 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 licensee should also establish appropriate documented processes and procedures for monitoring the performance of the third party service provider. In determining the appropriate level of documented monitoring processes and procedures, the licensee should consider the materiality of the outsourced activity to its ongoing business and its regulatory obligations.

It is expected that licensees will implement appropriate means for ensuring that they select suitable service providers and that service providers are appropriately monitored, having regard to the service that they provide. Appropriate means may include:

- documenting processes and procedures that enable the licensee 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, including the service provider's technical, financial and human resources capacity, together with any potential risk factors associated with using a particular service provider.
- documenting processes and procedures that enable the licensee to monitor the third party service provider's performance and compliance with its contractual obligations, including processes and procedures that:
 - > specify on a regular basis what service levels are required, and measure the service level delivered; and
 - > establish measures to identify and report instances of non-compliance or unsatisfactory performance to the licensee (see also Principle 2).
- 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 licensee, to the extent required by law or regulation, reports the failure to the Commission and takes corrective action. Procedures may include:
 - > the use of service delivery reports and the use of internal and external auditors to monitor, assess and report to the licensee on performance;

- > the use of written service level agreements or the inclusion of specific service level provisions in contracts for service to achieve clarity of performance target and measurements for third party service providers.
- with respect to outsourcing to service providers outside the Bailiwick of Guernsey, in determining whether the use of a foreign service provider is appropriate, the licensee may, with respect to a function that is material to the licensee, need to conduct enhanced due diligence that focuses on special compliance risks, including the ability to effectively monitor the foreign service provider, the ability to maintain the confidentiality of firm and client information; and the ability to execute contingency plans and exit strategies where the service is being performed outside the Bailiwick of Guernsey.

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3.2 Principle 2 – There should be a legally binding written contract between the licensee and each third party service provider, the nature and detail of which should be appropriate to the materiality of the outsourced activity to the ongoing business of the licensee.

A legally binding written contract between the licensee and a service provider is an important management tool. Appropriate contractual provisions can reduce the risks of non-performance or disagreements regarding the scope, nature and quality of the service to be provided. A written contract will help facilitate the monitoring of the outsourced activities by the licensee or by the Commission.

The level of detail of the contents of the written contract should reflect the level of monitoring, assessment, inspection and auditing required, as well as the risks, size and complexity of the outsourced services provided.

A licensee is expected to have a written, legally binding contract between itself and the third party service provider, appropriate to the materiality of the outsourced activity to the ongoing business of the licensee. The contract may include, as applicable, provisions dealing with:

- 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;
- firm and client confidentiality (see also Principle 4);
- the defined responsibilities of the licensee and of the service provider and any subcontractors, if any, and how such responsibilities will be monitored;
- responsibilities relating to IT security (see also Principle 3);
- payment arrangements;
- liability of the service provider to the licensee for unsatisfactory performance or other breach of the agreement;
- guarantees and indemnities;
- the service provider's obligations to provide, upon request, records, information and/or assistance concerning outsourced activities to the licensee, its auditors and the Commission (see Principle 6);
- mechanisms to resolve disputes that might arise under the outsourcing arrangements.
- business continuity provisions (see Principle 3);

- with respect to outsourcing outside the Bailiwick of Guernsey, choice of law provisions;
- termination of the contract, transfer of information and exit strategies (see also Principle 5).

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- 3.3 Principle 3 – The licensee should take appropriate measures to determine that:**
- (a) Procedures are in place to protect the licensee’s proprietary and client related information and software; and**
 - (b) Its service providers establish and maintain emergency procedures and a plan for disaster recovery, with periodic testing of backup facilities.**

Effective and reliable information technology systems are fundamental to the ongoing business of investment firms. Security breaches can undermine investors’ and clients’ privacy interests and have a damaging impact on an outsourcing licensee’s reputation, which may ultimately cause a lack of confidence and impact on the overall operational risk profile of the licensee. Moreover, robust IT security is particularly important where details of client assets or the assets themselves might be vulnerable to unauthorised access. Accordingly, licensees should seek to ensure that service providers maintain appropriate IT security and, when appropriate, disaster recovery capabilities.

Licensees are 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 programme. These steps may include:

- specification of the security requirements of automated systems to be used by the service provider, including the technical and organisational measures that will be taken to protect licensee and client-related data. Appropriate care should be exercised to ensure that IT security protects the privacy of the licensee’s clients as required by law;
- requirements that the service provider maintain appropriate measures to ensure security of both the licensee’s software as well as any software developed by the service provider for the use of the licensee;
- 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;
- 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 licensee is utilising a foreign service provider. Where relevant, this may include the service provider’s responsibility for backing up and otherwise protecting programme and data files, as well as regulatory reporting;
- where appropriate, terms and conditions relevant to the use of subcontractors with respect to IT security, and appropriate steps to minimise the risks arising from such subcontracting;
- where appropriate, the service provider’s duty to test critical systems and back-up facilities on a periodic basis in order to review the ability of the service provider to perform adequately even under unusual physical and/or market

conditions at the licensee, the service provider, or both, and to determine whether sufficient capacity exists under all relevant conditions;

- the service provider's duty to report breaches in security resulting in unauthorised intrusions (whether deliberate or accidental and whether confirmed or not) that may affect the licensee or its clients, including a report of any corrective action taken; and
- provision in the licensee's own contingency plans in cases where one or more of its service providers fails to perform their contractual obligations adequately. Where relevant, this may include reporting by the licensee to the Commission.

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3.4 Principle 4 - The licensee should take appropriate steps to require that service providers protect confidential information regarding the licensee's proprietary and other information, as well as the licensee's clients or investors from intentional or inadvertent disclosure to unauthorised individuals.

Unauthorised disclosure of confidential firm and client or investor information could have a number of negative consequences. Such unauthorised disclosure could result in damage to the licensee's reputation, financial losses and the loss of or risk to proprietary information. In addition, unauthorised disclosure could result in the disclosure of private and sensitive information about individuals who have a reasonable expectation of privacy, and might also result in a material financial loss to a licensee's clients or investors. In addition to the potential harm to a licensee's clients, an unauthorised disclosure could result in the licensee having financial liability to its clients and other parties, possibly affecting the firm's solvency.

Licensees that engage in outsourcing are expected to take appropriate steps to confirm that confidential firm and client or investor information is not misused or misappropriated. Such steps may include insertion of provisions in the contract with the service provider prohibiting the service provider and its agents from using or disclosing the licensee's proprietary information or that of the licensee's clients or investors, except as necessary to provide the contracted services.

Licensees should also consider whether it is appropriate to notify clients or investors that client and/or investor data may be transmitted to a service provider, taking into account any relevant regulatory or statutory provisions including the Data Protection (Bailiwick of Guernsey) Law, 2001.

3.5 Principle 5 – Outsourcing to third party service providers should include contractual provisions relating to 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 needs to be managed by an agreement between the licensee 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 activity back to the licensee or to another service provider.

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

- termination rights, for example, in case of insolvency, liquidation or receivership, change of 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 service provider or to the licensee itself, and to provide for the return of client-related 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 licensee.

3.6 Principle 6 – The Commission, the licensee and its auditors should have access to the books and records or service providers relating to the outsourced activities and the Commission should be able to obtain promptly, upon request, information concerning activities that are relevant to its regulatory oversight.

Licensees are expected to take steps to ensure that they and the Commission have access to books and records or service providers concerning outsourced activities, and that the Commission has the right to obtain, upon request, information concerning the outsourced activities. These steps may include the following:

Contractual provisions by which the licensee has real time links to the service provider's systems, with at least "read-only" access to information held by the service provider in electronic form.

Contractual provisions by which the licensee, and 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 to the licensee or its auditor, or inspections that utilise electronic technology.

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 Commission upon request and, in addition, to comply with any requirements in the Bailiwick of Guernsey to provide periodic reports to the Commission.

3.7 Principle 7 – Licensees should be aware of the risks posed where one service provider provides outsourcing services to multiple licensees.

Where multiple licensees use a common service provider, operational risks are correspondingly concentrated, and may pose a threat of 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 licensees, each of the licensees will be similarly disabled. Alternatively, if multiple licensees depend upon the same provider of business continuity services (for example, a common disaster recovery site), a disruption that affects a large number of those entities may result in a lack of capacity for the business continuity services.

Where a licensee has identified a possible concentration risk issue, it should consider taking steps to ensure, to the degree practicable, that the service provider has adequate capacity to meet all the needs of the licensee, both during normal operations as well as unusual circumstances (for example, unusual market activity or physical disaster).

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4. **Liaison with Designated Trustees/Custodians in connection with Open-ended Collective Investment Schemes**

The Commission would expect the Designated Manager of an authorised scheme to keep the Designated Trustee/Custodian advised of any proposals to outsource any functions and for the latter to be content with the proposed arrangements. There are also implications under the Commission's "Incorrect Pricing of Authorised Collective Investment Schemes - Guidance Note on Correction and Compensation" (for example, 2.1, 2.2, 2.3 and 3.2 of the Guidance Note) that will need to be considered.

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