Discussion Paper on Outsourcing of Activities Related to Intermediation Services

Securities and Exchange Board of India ("SEBI") has prepared a Discussion Paper on Outsourcing of Activities Related to the Intermediation Service ("Discussion Paper") since outsourcing by intermediaries is an area which is not very broadly covered by various SEBI Regulations made for intermediaries.

Outsourcing of activities is done by intermediaries in order to perform activities associated with intermediary services. The third party may be used to perform all the activities associated with intermediation services which would involve legal and regulatory compliances as well as risk management. In the present context, outsourcing has become increasingly complex. In many jurisdictions, the security market intermediaries are practicing outsourcing to reduce costs and for strategic reasons. However since the third party may not be subject to regular scrutiny, outsourcing raises variety of concerns for the regulator as well as the intermediary.

SEBI in this discussion paper has identified various risks associated with outsourcing categorizing them into three broad categories. These categories are operational, reputational and legal. The operational risks arise due to the lack of control over activities, procedures and processes by the intermediary. Failure to comply with regulations and contractual obligations may invite reputational and legal risks. Country risk may also arise if outsourcing has been made to a third party who is regulated only by the laws of its country and not in any manner by the Indian market regulator. The intermediary on having the required infrastructure may register with the regulator. However the third party to whom the activity is outsourced by the intermediary may not have the infrastructure or may not be a fit and proper person. A situation may arise whereby the market may be loaded with third parties to provide intermediation services while the registered intermediaries may confine themselves to collecting rents leading to market risks.

Therefore in order to overcome such risks SEBI has proposed certain principles on which the outsourcing activities should be based. These principles are in consonance with the International Organizations of Securities Commission (IOSCO) Princples on outsourcing of financial services for intermediaries. The Principles prescribed by SEBI in summary are as follows:

1. An intermediary seeking to outsource should have in place a comprehensive policy for guiding the activities which have to be outsourced. The policy should cover all the activities, the nature of activities, the authorizer and the type of third party to whom it can be outsourced.
2. Risk management programme should be established by the intermediary to manage, monitor and control outsourcing risk. Programme should also control the potential risks involved with respect to the third party. Systems should be in place to have an arm's length distance between the intermediary and the third party to avoid potential conflict of interest. The risk management programme should be similar with respect to third party as well as an unrelated party.
3. The intermediary should ensure that the outsourcing arrangement should not affect the rights of a customer against the intermediary, nor should it impair the regulators ability to exercise its regulatory responsibilities such as supervision of the intermediary.
4. The intermediary should conduct appropriate due diligence in selecting the third party and monitoring its performance.
5. The relation between the intermediary and the third party should be governed by a written contract which describes all material aspects of the outsourcing arrangement and provisions to reduce the risk of non-performance or disagreements with respect to the quality of the service provided.
6. Contingency plans should be maintained to include a plan for disaster recovery and testing of backup facilities. The plans should include a shift of activities to an alternative third party on account of unsatisfactory responsiveness from the third party.

7. The intermediary should take appropriate steps to ensure the confidentiality of the intermediary and the customers from intentional or inadvertent disclosure to unauthorized persons.
8. Regulators should assure themselves by appropriate means that any outsourcing arrangements do not hamper the ability of the intermediary to meet its regulatory requirements.
9. Regulators have to keep a check on the potential risks which could arise as a result of multiple intermediaries and a limited number of third parties.

Further, SEBI has also prescribed a list of activities which can and cannot be outsourced with respect to each intermediary. The Discussion Paper states that the key activities which are crucial to the intermediation service may be delivered by the intermediary itself. Further, it is also indicated that the compliance with securities laws, investor grievance redressal and Know Your Customer norms should not be outsourced. For eg. In relation to portfolio managers it is stated that they cannot outsource the activity of “Fund Management” or “Portfolio Management”, however they can outsource certain activities like client services, fund accounting, custodian services, research activity, financial accounting, account opening, data entry and operational activity. Therefore, the aim of prescribing such principles is that the key activities in the intermediary services should not be carried out by the unregistered entities.