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ACC AMERICA
Association of Corporate Counsel
Greater New York Chapter

the second annual
Outsourcing in the Financial Services
seminar

Essential Business, Legal, and
Regulatory Considerations

May 6, 2009

The Regulatory Landscape

- Common Regulatory Themes
- Regulatory Guidance
- Practical and Compliance Implications
 - Risk Assessment
 - Due Diligence
 - Supervision, Monitoring and Oversight
- Common Themes and Approaches

Common Regulatory Themes

- Functional Limitations
- Supervision & Accountability
- Records
- Privacy and Data Breaches
- Offshore Issues

Securities Regulatory Guidance

- SRO Rules on Clearing Arrangements:
NYSE Rule 382 & NASD Rule 3230
- FINRA (f/k/a NASD) Notice to Members 05-48
- Legacy NYSE -- Proposed Rule 340
- International Perspectives
 - Basel Committee on Banking Supervision, “Outsourcing in Financial Services” (Joint Forum, February 2005)
 - IOSCO, “Principles on Outsourcing of Financial Services for Market Intermediaries” (August 2004)

Bank Regulatory Guidance

- Guidance from bank agencies
 - For Federal Reserve member banks and Bank Holding Companies:
 - *FRB SR Letter 00-04, FRB SR Letter 03-5 (Internal Audit Function)*
 - *New York Fed – “Outsourcing IT and Business Processes: A Supervisory Primer”*
 - For non-Fed member, state-chartered banks:
 - *FDIC Financial Institution Letter 44-2008, Financial Institution Letter 52-2006, Financial Institution Letter 49-99*
 - *FDIC Study on Offshore Outsourcing of Data Services- June 2004.*
 - For national banks:
 - *OCC Bulletin 2001-47, OCC Bulletin 2002-16 (Foreign-Based)*
 - *OCC White Paper – “Cross-border outsourcing and risk management for banks” (August 2003)*
 - For thrifts and thrift holding companies:
 - *OTS TB 82a*
 - Interagency information security guidelines implementing Section 501(b) of GLBA
- Basel Committee on Banking Supervision (Joint Forum –Outsourcing in Financial Services, February 2005)
- FFIEC IT Examination Handbook: Outsourcing Technology Services (June 2004)

SRO Outsourcing Guidance

- FINRA – “guiding principles” approach
 - Primary focus is on supervision and oversight
 - Principles-based approach to due diligence
 - Prohibitions on outsourcing certain “covered activities” (e.g., order taking, handling of customer funds and securities, and supervisory responsibilities)

SRO Outsourcing Guidance

- Legacy NYSE Proposal – a more prescriptive approach
 - Prohibitions on outsourcing specific categories of functions
 - Prior written notice to NYSE required to outsource “regulated functions and activities”
 - Specific due diligence requirements that must be considered and documented, even if inapplicable
 - Additional requirements for arrangements with non-U.S. service providers

Risk Assessment

- Strategic (system or goal incompatibility, failure in due diligence, inadequate expertise to monitor)
- Reputation (poor service, disruptions, litigation)
- Compliance (supplier violates laws, ethical standards, or policies or procedures of financial institution)
- Transaction/Operational (fraud, error, tech failure, lack of business continuity planning)
- Credit risk (financial strength, outsourced lending)
- For non-U.S. providers: currency risk, country risk
- Economic, social and political risks
- Over-concentration of functions with one provider

Due Diligence

- Experience
- Financial condition
- Business reputation, complaints and litigation
- Internal controls environment
- Adequacy of management information systems
- Business continuity plans
- Cost, including support function
- Use of subcontractors and their capabilities
- Insurance coverage
- Privacy and confidentiality controls
- Access to regulators
- Service levels

Supervision, Monitoring and Oversight

- Develop specific written procedures to govern supervision of provider
- Supervise conduct of outsourced activities (and ensure inappropriate activities are not being performed)
- Monitor compliance with agreement
- Monitor fitness and ability to perform covered services
- Monitor controls by reviewing
 - Audit & exam reports
 - Provider's policies
 - Business continuity planning and testing
 - Compliance with applicable law
- Assess quality of service and support

Common Themes and Approaches

1. Identify functions to be outsourced
2. Conduct risk assessment
3. Conduct due diligence on vendor
4. Develop contract to govern arrangements
5. Develop procedures to supervise, monitor and oversee vendor
6. Consider regulatory notice or approval requirements

“At Risk” Service Providers

- Banks, Thrifts in Conservatorship or Receivership
 - Conservatorships/Receiverships different from bankruptcy procedure
 - FDIC as conservator/receiver — many powers that affect rights of creditors, parties who have contracted with a failed bank or thrift
 - *Claims process-administrative procedure, strict bar dates, deposit preference*
 - *Executory contracts — power to repudiate “burdensome” contracts within a “reasonable” time*
 - Damages limited to direct, compensatory
 - No lost profits
 - 180 days for FDIC to decide claims, if disappointed must litigate in U.S. District Court for District of Columbia or District Court where bank/thrift was located
 - Cannot use appointment of FDIC as conservator or receiver as an event of default under any agreement with bank/thrift

"Retained Entities" Conflict of Interest Rules under the Troubled Asset Relief Program

- "Retained entity" is an individual or entity seeking an arrangement with the Treasury or having an arrangement with the Treasury, and includes any subcontractors and consultants it hires to perform services under the arrangement. 31 CFR 31.201
- "Arrangement" is a contract or financial agency agreement between a private sector entity and the Treasury for services under TARP
- "Administrative services" exception for some services
- Retained entities are precluded from permitting an organizational conflict of interest unless it discloses and mitigates the conflict under a treasury-approved plan, or unless it receives a waiver
- Retained entities must maintain a compliance program designed to detect and prevent violations of federal securities laws and organizational conflicts of interest

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