

# Client Alert

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## Technology Outsourcing and UK Financial Services Regulation

By Alistair Maughan

The UK financial services regulator, the Financial Conduct Authority, has published a new list of considerations for regulated financial services firms planning to use third-party technology to support their operations. The list will need to be taken into account by any regulated financial services entity that falls under the auspices of the FCA.

Since FCA pronouncements on regulated firms' use of technology and outsourcing are rare, the new list will be studied closely. However, anyone expecting to find new insights into the FCA's approach to regulation of technology and outsourcing operations is likely to be disappointed – and the list is possibly more notable for what it doesn't cover (e.g., cloud and as-a-service solutions) as for what it does.

Technology platforms and outsourcing solutions are, of course, fundamental to the operations of all financial institutions. The entire financial services sector has been an enthusiastic (and, often, trail-blazing) adopter of successive waves of technology, both through in-house implementation and through outsourced service provision arrangements.

But just as the law itself, regardless of jurisdiction, has struggled to keep up with the speed at which the technology industry has evolved, so the financial services regulators have lagged far behind in the wake of the technology adoption by the entities which they regulate.

The FCA rules on outsourcing are both risk-based and principle-based – see separate Box. Much is left to regulated firms to interpret the rules and the way they apply to individual operational functions, technology platforms and specific contracts with technology providers. Risk and Compliance functions in banks and financial institutions are expected to bridge the gap between the published rules and what their technology and operational counterparts are implementing. That task can be complex when technology is stable, but even more challenging when technology rapidly evolves.

The new guidance reiterates that a regulated firm must retain full accountability for discharging all of its regulatory responsibilities and cannot delegate any part of that responsibility to a third party. However, that does not restrict the use of outsourcing or third-party off-the-shelf technology products as long as that use is appropriately managed.

In setting out its suggested approach, the FCA is looking to ensure that the activities of regulated financial services entities are supported by technology services that are effective, resilient, and that secure and have been appropriately designed to meet known and expected future business needs and to avoid risks. Additionally, the FCA wants firms to undertake sufficient due diligence and preparatory work to provide reasonable assurance that

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any third-party service provider will deliver its services effectively, resiliently and securely. Firms should also put in place appropriate arrangements for the ongoing oversight of their external service providers and the management of associated risks.

In practical terms, the checklist includes suggested considerations under the following headings:

- **Decision to Outsource Critical Technology Services:** assess the rationale for using third-party technology and the associated risks.
- **Selection of Outsource Service Provider:** consider key technical and commercial issues such as the relevant pricing model, suitability of the technical solution, and the eventual exit plan.
- **Oversight and Governance:** review the procedures for ensuring accountability for all of its activities and ensuring oversight of the provider, including specific service issues (via service levels, for example) and general risk management principles.
- **Operational:** assess the approach to ensuring future support and maintenance, scalability of solution, incident management, and quality of service.
- **Service Protection:** specify the procedures for security, incident and disaster management, and risk mitigation.
- **Data:** ensure that data privacy rules will be complied with.

## ANALYSIS

There is no real indication as to how the questions relate to the overall regulatory obligations in SYSC on critical outsourcing projects. It is also somewhat puzzling what the FCA believes that it's adding to the risk management armoury of regulated firms and what the real target of the guidance is.

Firstly, the FCA's new set of considerations is pretty short: four pages of suggested questions. While brevity may be commendable in many cases, most financial institutions will already have procurement checklists that run to considerably greater lengths and go into specific detail on many individual aspects or differentiated technology delivery channels.

In best-practice terms, of course, it would also normally be preferable to be more nuanced about the type of technology or outsourced arrangement being addressed. One immediately noticeable aspect of the guidance questions is that they are specifically targeted at the use of third-party technology (off-the-shelf) banking solutions. So, for example, suggested questions relate to the inclusion and pricing of software upgrades – which is not typically a core outsourcing or as-a-service platform issue. But other parts seem to be loosely targeted at critical outsourcing projects and address service issues not typically found in relation to commercial off-the-shelf packages. So what's the real target?

Further, without specifically mentioning the words "cloud computing" anywhere in the checklist, it seems that the FCA could be trying at least to provide some guidance to regulated firms as to how cloud computing or other as-a-service technology solutions should be assessed. Cloud solutions are squarely within the FCA's purview; for

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example, the FCA's application form for authorisation specifically states that, as part of the description of outsourced relationships, entities must include the use of third-party data centres and cloud service solutions. But regulated firms have been provided with no guidance as to what uses of cloud solutions may or may not be considered acceptable from a regulatory perspective.

Contrast this with the United States where, in July 2012, the federal financial regulatory agencies issued a [joint interagency statement](#) on the use by financial institutions of outsourced cloud computing services and the key risks associated with such services.

The hope may have been that the UK regulator would follow the lead, but the FCA has not taken that opportunity to clarify its approach to key technological developments such as the significant growth in cloud computing and the evolving internet trends. As such, this may be regarded either as a useful (if small) step forward – or a missed opportunity.

Finally, the guidance only goes far enough to raise a list of questions – and very basic questions at that – that may help to assess the overall risk. It gives no helpful guidance as to the threshold levels at which, for example, regulated firms should steer away from technology platforms such as cloud computing. We recently reported that a [European Commission sponsored initiative](#) had produced suggestions on what service parameters might be relevant to organizations seeking to adopt cloud services. There is no similar indication in this FCA guidance as to what technical service parameters might be considered appropriate or not when adopting off-the-shelf outsource technology solutions.

So the FCA guidance is something of a mixed bag – helpful in the sense that it goes beyond the SYSC 8.1 general outsourcing requirements, but curiously old-fashioned in that it provides relatively little new guidance beyond that which a well-advised firm would have had in place anyway, and no insight into the approaches that regulated firms should take to newer forms of as-a-service technology delivery.

Previously, the FCA has not tended to go beyond its core set of rules around sourcing. At least the new guidelines show an inclination from the FCA to take a broader view of the relevant issues and to provide some guidance as to how those issues should be addressed, not just from a regulatory perspective but also from a best practice procurement perspective.

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## THE FCA AND OUTSOURCING

On 1 April 2013, the functions of the UK's former financial services regulator, the Financial Services Authority, were transferred to the FCA and the Prudential Regulatory Authority. The rules and guidance on outsourcing form part of both the FCA and PRA Handbooks.

A regulated entity must take reasonable care to organise and control its affairs responsibly and effectively, which includes having adequate systems and controls, and ensuring that it conducts its affairs soundly and prudently. A firm's outsourcing arrangements must meet these requirements.

The longstanding approach of the FCA (and its predecessor, the FSA) has been to focus on a core set of rules relating to outsourcing. The central requirement has been that a regulated firm must demonstrate that it meets the FCA's threshold conditions on appropriate resources and suitability. When a firm uses a third party for the delivery of services critical to its operations, then it must also comply with the general outsourcing requirements in a section of the FCA Handbook known as SYSC 8.

The overall aim of these regulatory obligations is to ensure that each regulated firm remains appropriately managed, especially in terms of the operational risk that derives from the use of third-party technology solutions and services. It must ensure that its arrangements with third-party outsourced service providers and reliance on technology platforms, (i) do not create undue risk for the financial institution or its customers and, (ii) do not impair the regulator's ability to regulate the firm.

When the EU's Markets in Financial Instruments Directive (MiFID) came into force in the UK in 2007, the FCA's predecessor (the FSA) made various changes to the rules and guidance in its Handbook to incorporate MiFID's requirements.

MiFID set out a broad description of what it meant by outsourcing: "an arrangement of any form between a firm and a service provider by which the service provider performs a process, a service or an activity which would otherwise be undertaken by the firm itself." Regulated firms need to bear this in mind when reviewing third-party supply contracts which, in the past, they may not have traditionally viewed as outsourcing contracts.

Many of the rules and guidance under MiFID apply only when critical or important functions are outsourced by the regulated firm. An operational function is regarded as critical or important if a defect or failure in its performance would materially impair a firm's compliance obligations, its financial performance, or the soundness or continuity of its relevant services and activities. However, there are express exceptions to this rule, such as outsourcing advisory services, training for the firm's personnel, billing services, and security of the firm's premises and personnel. That said, SYSC 8.1.3 of the FCA Handbook states that even if non-critical or important functions are outsourced, firms must take account of the rules in a manner that's proportionate given the scale and complexity of the outsourcing. Therefore, a best-practice approach would be to treat all outsourcing activities in the same way from an operational perspective.

SYSC 8.1 goes on to provide a series of rules and principles to be applied in relation to outsourcing by regulated financial services entities. For further details, please see our previous [Alert](#).

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