

# IIROC NOTICE

## **Rules Notice Request for Comments**

Dealer Member Rules

*Please distribute internally to:*

Internal Audit  
Legal and Compliance  
Operations  
Regulatory Accounting  
Senior Management

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**12-0311**  
**October 22, 2012**

## **Request for comments on draft guidance regarding outsourcing arrangements**

This Notice requests comments on draft guidance with respect to outsourcing arrangements.

The attached draft guidance:

- summarizes the existing requirements and guidance relating to entering into and maintaining outsourcing arrangements,
- identifies the Dealer Member business activities that may not be outsourced and those that may be outsourced,
- sets out IIROC's expectations as to the appropriate due diligence procedures that must be undertaken by IIROC Dealer Members before outsourcing any business activity, and
- sets out IIROC's plans to propose rules relating to outsourcing.

Dealer Members and other interested parties are requested to provide comments on the attached draft Guidance Note. Comments should be made in writing and delivered by January 20, 2013 (90 days from the publication date of this Notice).

# IIROC NOTICE

## **Rules Notice Guidance Note**

Dealer Member Rules

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**12-XXXX  
October XX 2012**

## **Outsourcing arrangements**

### **Guidance Note objectives**

The objectives of this Guidance Note are to:

- summarize the existing requirements and guidance relating to entering into and maintaining outsourcing arrangements,
- identify the Dealer Member business activities that may not be outsourced and those that may be outsourced,
- set out IIROC's expectations as to the appropriate due diligence procedures that must be undertaken by IIROC Dealer Members before outsourcing any business activity, and
- set out IIROC's plans to propose rules relating to outsourcing.

Background information and context are also provided on the development of regulatory principles governing outsourcing arrangements by regulated entities and relevant financial sector guidance published on this subject matter.

The concept of outsourcing is not new in the securities industry. The IIROC Dealer Member Rules set out the requirements for many of the common outsourcing arrangements that are entered into by Dealer Members, including:

- Back office sharing arrangements with an affiliated Canadian financial institution,
- Introducing broker/carrying broker arrangements,



- Security custody arrangements, and
- External portfolio management arrangements.

However, as firms face increasing competitive pressures to contain and reduce costs, there is a corresponding trend to outsource more business functions, activities and processes to third-party service providers through arrangements that IIROC Dealer Member Rules do not adequately address.

In recent years, there has been an evolution of outsourcing arrangements put in place between Dealer Members and regulated/unregulated entities that may or not be affiliated, and that may be foreign or domestic. For example, Canadian bank parent employees of Dealer Members conduct certain back-office operational functions on behalf of the Dealer Member and the bank parent charges for those costs pursuant to a service agreement. Similar arrangements exist for US FINRA registered parent companies of Dealer Member subsidiaries. These functions include accounting and back-office support that are outside the scope of Rule 35 – *Introducing broker/carrying broker arrangements*.

There is a growing interest by self-clearing Dealer Members to outsource the daily management of books and records, including the reconciliation of bank account balances, positions held in custody, dividend/interest income received, and stock reorganizations, to both domestic and foreign unregulated, third-party service providers. Without adequate safeguards, this industry trend may give rise to incremental investor protection, market reputation, credit and systemic risks.

Dealer Members are reminded of their obligation to provide IIROC with advance notification of material changes in their business model, including operations pursuant to IIROC Rules Notice 10-0060 – *Reporting of changes to business models* dated March 2010.

## **1. What is outsourcing?**

A report prepared in 2005 by the International Organization of Securities Commissions (IOSCO) sets out the following definition for outsourcing:

*“...outsourcing is defined as an event in which a regulated outsourcing firm contracts with a service provider for the performance of any aspect of the outsourcing firm’s regulated or unregulated functions that could otherwise be undertaken by the firm itself. It is intended to include only those services that were or can be delivered by internal staff and management... the service provider may be a related party within a corporate group, or an unrelated outside entity. The service provider may itself be either regulated (whether or not by the same regulator with authority over the outsourcing firm), or may be an unregulated entity .... outsourcing would not cover purchasing contracts, although as with outsourcing, firms should ensure that what they are buying is appropriate for the intended purpose. Purchasing is defined as the*



*acquisition from a vendor of services, goods or facilities without the transfer of the purchasing firm's non-public proprietary or customer information"*<sup>1</sup>.

The IOSCO report makes an important distinction between material “core” and “non-core” outsourcing functions of a firm. It describes a core function as one that is “critical to the ongoing viability of an entity as well as meeting its regulatory obligations to customers”. Core functions include recommending, entering into and clearing and settling investment product transactions with clients, holding client investment product positions in custody, reporting to clients on the account positions and cash balances held (and the value of those positions and balances) and responding to client complaints. Non-core activities would include office service management activities; consultant advisory services; and human resources activities. The distinction of core versus non-core functions should be considered by Dealer Members seeking to demonstrate that they are discharging their regulatory obligations in the context of outsourcing core functions.

The IOSCO study provided nine guiding principles in regards to outsourcing by financial intermediaries – as listed below:

1. Corporate governance - A regulated entity seeking to outsource activities should have in place a comprehensive policy to guide the assessment of whether and how those activities can be appropriately outsourced. The board of directors or equivalent body retains responsibility for the outsourcing policy and related overall responsibility for activities undertaken under that policy.
2. Risk management – A regulated entity should establish a comprehensive outsourcing risk management program to address the outsourced activities and the relationship with the service provider.
3. No subrogation of regulatory responsibility – A regulated entity should ensure that outsourcing arrangements neither diminish its ability to fulfill its obligations to customers and regulators, nor impede effective supervision by regulators.
4. Due diligence – A regulated entity should conduct appropriate due diligence in selecting third-party service providers.
5. Contract - Outsourcing relationships should be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities and expectations of all parties.
  - The contract should neither prevent nor impede the regulated entity from meeting its respective regulatory obligations, nor the regulator from exercising its regulatory powers.

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<sup>1</sup> Source: Principles on Outsourcing of Financial Services for Market Intermediaries, Chapter 1 – Technical Committee of the International Organizations of Securities Commission (IOSCO), February 2005.



- The regulated entity must ensure it has the ability to access all books, records and information relevant to the outsourced activity being performed at the service provider.
  - The contract should provide for the continuous monitoring and assessment by the regulated entity of the service provider so that any necessary corrective measures can be taken immediately.
  - A termination clause and minimum periods to execute a termination provision, if deemed necessary, should be included. The latter would allow the outsourced services to be transferred to another third-party service provider or to be incorporated into the regulated entity. Such a clause should include provisions relating to insolvency or other material changes in the corporate form, and clear delineation of ownership of intellectual property following termination, including transfers of information back to the regulated entity and other duties that continue to have an effect after the termination of the contract.
  - The contract should include, where appropriate, conditions of subcontracting by the third-party service provider for all or part of an outsourced activity. It should require approval by the regulated entity of the use of subcontractors by the third-party service provider for all or part of a serviced activity or activity being delivered. More generally, the contract should provide the regulated entity with the ability to maintain similar control over the risks that may arise when a service provider outsources to other third parties as might arise under the original direct outsourcing arrangement.
6. Business Continuity – A regulated entity and its service providers should establish and maintain contingency plans, including a plan for business disruption recovery and periodic testing of backup facilities.
7. Confidential Information – A regulated entity should take appropriate steps to require that service providers protect confidential information of both the regulated entity and its clients from intentional or inadvertent disclosure to unauthorized persons.
8. Regulatory Assessment - Regulators should take into account outsourcing activities as an integral part of their ongoing assessment of the regulated entity.
- Regulators should assure themselves by appropriate means that any outsourcing arrangements do not hamper the ability of the regulated entity to meet its regulatory requirements.
  - Regulators should consider outsourcing activities as part of their overall risk assessment of a regulated entity.
  - In order to be able to assess and monitor the outsourcing policy and outsourcing risk management program of a regulated entity, regulators should be able, upon request, to obtain promptly any relevant books and records pertaining to the outsourced activity, irrespective of whether they are in the possession of the



outsourcing firm or the third-party service provider, and to obtain additional information concerning outsourced activities.

- A regulator’s access to such books and records may be direct or indirect, though the regulated entity should always maintain direct access to such books and records. This may include a requirement that the books and records be maintained in the regulator’s jurisdiction, or that the service provider agrees to send originals or copies of the books and records to the regulator’s jurisdiction upon request.
  - Regulators should consider implementation of appropriate regulations and measures designed to support access to books, records and information of the service provider about the performance of outsourced activities. This may include the requirement that regulated entities incorporate in outsourcing arrangements contractual provisions that provide the regulated entity with 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, as well as contractual provisions by which the service provider is required to make books, records and other information about outsourced activities by the service provider available to the regulator upon request.
9. Concentration - Regulators should be aware of the potential risks posed where the outsourced activities of multiple regulated entities are concentrated within a limited number of service providers.

These guiding principles have been adopted internationally by securities commissions, including the CSA jurisdictions. In addition, the Office of the Superintendent of Financial Institutions (OSFI)<sup>2</sup> has issued similar guidelines.

## **2. What are the CSA requirements for outsourcing?**

When National Instrument 31-103 was implemented in September 2009, its Companion Policy introduced general principles for the establishment and maintenance of internal control systems at registrants with specific reference to the need to follow prudent business practices and to conduct a due diligence analysis when considering whether or not to outsource.

Part 11 of the Companion Policy states that registered firms are responsible and accountable for all functions that they outsource to a service provider. The functions outsourced should be set out in a written, legally binding contract that includes the expectations of the parties to the outsourcing arrangement. It requires that registered firms conduct a due diligence analysis of prospective third-party service providers, including affiliates of the firm. Due

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<sup>2</sup> Dealer Members that are affiliated with a Canadian federally regulated financial entity (FRFE) should also be cognizant of the Office of the Superintendent of Financial Institutions (OSFI) revised Guideline B-10 on “Outsourcing of Business Activities, Functions and Processes” dated March 2009.



diligence should include an assessment of the service provider's reputation, financial stability, relevant internal controls and ability to deliver the services.

The registrant firm should:

- ensure that third-party service providers have adequate safeguards for keeping information confidential and, where appropriate, for recovering from a business disruption;
- conduct ongoing reviews of the quality of outsourced services;
- develop and test a business continuity plan to minimize disruption to the firm's business and its clients if the third-party service provider does not deliver its services satisfactorily; and,
- consider other legal requirements, such as privacy laws, that may apply when entering into outsourcing arrangements.

The registrant firm, its regulator and auditors should have the same access to the work product of a third-party service provider as they would if the firm itself performed the activities. Firms should ensure this access is provided and should include a provision requiring it in any contract entered into with a service provider.

A control list of all outsourcing arrangements and effective dates of agreements executed must be maintained by Dealer Members. These arrangements which form a critical element of a Dealer Member's operations are subject to IIROC examination and must be available upon request. This may include inspection of any records maintained by the service provider and its operations.

### **3. Other industry guidance on outsourcing**

Relevant industry guidance on outsourcing was developed by the Markets in Financial Instruments Directive (MiFID) Connect - a joint project set up by 11 trade associations in the European Union (EU) to support their members in implementing EU legislation on outsourcing<sup>3</sup>, including the Financial Securities Authority (FSA)<sup>4</sup>. The guidance provides Dealer Members with a useful checklist in developing its own written policies and procedures in respect to outsourcing and meeting the requirements set out in the Companion Policy to National Instrument 31-103. A summary of the guidance is set out in Appendix A.

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<sup>3</sup> The 11 members of MiFID Connect are The Association of British Insurers (ABI), The Association of Private Client Investment Managers and Stockbrokers (APCIMS), Association of Foreign Banks (AFB), The Bond Market Association, the British Bankers' Association (BBA), Building Societies Association (BSA), the Futures and Options Association (FOA), The International Capital Market Association (ICMA), Investment Management Association (IMA), The International Swaps and Derivatives Association (ISDA) and the London Investment Banking Association (LIBA).

<sup>4</sup> FSA adopted MiFID Connect industry guidance into their Handbook (Chapter 8 - Senior Management Arrangements, Systems and Controls (SYSC) sourcebook) in May 2010.



#### 4. Which investment dealer activities may be outsourced?

IIROC supports the approach taken in the IOSCO study of distinguishing between core and non-core activities. As part of its analysis of Dealer Member activities, IIROC has made use of these same distinctions. In performing its analysis, and in establishing IIROC expectations, IIROC has applied an approach that is consistent with the principles set out in the IOSCO study and with the guidance set out in the Companion Policy to National Instrument 31-103.

In order to identify which investment dealer activities may be outsourced, the major activities that are performed at a Dealer Member have been analyzed and categorized as either:

- “core” activities which *may not* be outsourced;
- “core” activities which *may* be outsourced; or
- “non-core” activities which *may* be outsourced.

For further details of the activities analyzed and their eligibility for outsourcing, please refer to Appendix B.

##### ***Core activities which may not be outsourced***

IIROC Dealer Member Rules prohibit certain core activities of the Dealer Member from being outsourced. For the most part, these prohibitions stem from the requirement set out in IIROC Dealer Member Rule 39.3, which limits individuals conducting securities related business on behalf of a Dealer Member to either employees or agents of a Dealer Member. This requirement effectively prohibits the outsourcing of most core, client-facing, activities of the Dealer Member including:

- the account opening process (including collection of know your client information and provision of relationship disclosure information);
- the performance of suitability assessments (trade, order, trade type, trade strategy, method of financing, account type, etc.); and
- the handling of client complaints.

An exception to the prohibition of the outsourcing of core client-facing activities is the outsourcing of the performance of investment decision making in managed accounts. IIROC Dealer Member Rules specifically allow for the outsourcing of managed account investment decision making to an external portfolio manager hired by the Dealer Member, as per the definition of “managed account” set out in Dealer Member Rule 1300.3.

##### ***Core activities which may be outsourced***

Other core activities of a Dealer Member that are *not* prohibited from being outsourced are as follows:

- the performance of investment decisions in managed accounts (as previously mentioned);
- the performance of certain client account-related operations activities, such as the clearing and settlement of client trades
- the administration of margin loans and other client account loans





- the preparation of client account statements
- the preparation of regulatory financial reports
- the preparation of non-financial regulatory reports
- the performance of registration-related filing and database maintenance activities
- the performance of treasury activities
- the performance of corporate finance activities
- the preparation of research reports and marketing newsletters
- the performance of marketing activities
- the use of outside professional services relating to the business activities of the Dealer Member, such as accounting and internal audit services
- the management and maintenance of Dealer Member information systems

Where any of these activities are to be outsourced, including where activities are outsourced to another Dealer Member:

- IROC expects the Dealer Member to formally assess the initial and ongoing appropriateness of the outsource service provider (see section 5 of this notice for further details); and
- the Dealer Member that has outsourced specific activities retains responsibility for ensuring that the activities are performed properly and in compliance with relevant IROC requirements.

#### ***Non-core activities which may be outsourced***

There are non-core activities of the Dealer Member that are not prohibited from being outsourced under the applicable IROC Dealer Member Rules and that would not give rise to regulatory concern if they were outsourced. These activities include:

- office service management activities;
- the procurement of external consultant services; and
- human resources management activities.

Similar to the outsourcing of core activities, where any of these activities are to be outsourced IROC expects the Dealer Member to formally assess the initial and ongoing appropriateness of the outsource service provider (see section 5 of this notice for further details).

### **5. What should be assessed when determining whether or not to outsource a particular activity?**

As previously stated, IROC Dealer Member Rules set out detailed requirements for specific outsourcing arrangements (such as introducing broker/carrying broker arrangements, security custody arrangements and external portfolio management arrangements) but the Rules do not set out general requirements to be met when considering whether or not to enter into an outsourcing arrangement. The following principles establish IROC's expectations of Dealer Members' due diligence regarding outsourcing:



- A Dealer Member should have a comprehensive outsourcing policy that guides the performance of due diligence assessment(s) that will underlie decisions regarding whether, and how, certain activities can be appropriately outsourced
- A Dealer Member should never enter into an outsourcing arrangement that:
  - diminishes its ability to fulfill its obligations to clients and regulators,
  - impedes effective supervision by regulators, or
  - unduly concentrates its outsourced activities in one or a few outsource service providers.
- A Dealer Member should inform IIROC of any new outsourcing arrangements involving core Dealer Member activities that are being entered into by a Dealer Member, in accordance with IIROC Rules Notice 10-0060, *Reporting of Changes to Business Models*.
- A Dealer Member that has outsourced certain activities should:
  - enter into written outsourcing contracts that clearly describe all material aspects of the outsourcing arrangements, including the rights, responsibilities and expectations of all parties
  - maintain a centralized list, along with copies of related agreements, of the outsource service providers to which core Dealer Member activities have been outsourced
  - establish and carry-out a comprehensive outsourcing risk management program that monitors the risks associated with:
    - the outsourced activities; and
    - the outsourcing relationship entered into with the service provider.The risks associated with the outsourcing relationship that need to be managed include:
    - *reputation risk*, the risk that poor service by the outsource provider will affect the reputation of the Dealer Member;
    - *compliance risk*, the risk that the outsource provider will not comply with regulatory or other requirements that apply to the Dealer Member;
    - *exit strategy risk*, the risk that due to over-reliance on the outsource provider and a lack of relevant skills within the Dealer Member, the Dealer Member won't be able to re-assume performance of the outsourced activities or contract with another outsource provider on a timely basis;
    - *access risk*, the risk that the Dealer Member won't have timely access to data, records or assets; and
    - *concentration risk*, the risk that the industry as a whole, or a material portion thereof, has significant exposure to the outsource providerSee Appendix C for a more complete list of the key risks associated with outsourcing and the major concerns associated with these risks.
  - where applicable, obtain and provide to IIROC an audit report, such as the CICA 5970 (now changed to CSAE 3416) report or the SAS 70 (now changed to SSAE 16) report, for each outsource arrangement relating to a core Dealer Member activity; and



- include as part of its business continuity planning, plans that address the scenario where one or more major outsource service providers undergo a business disruption.

## **6. Are outsourcing arrangements involving affiliates subject to this guidance?**

The guidance set out in this notice covers both arm's length and non-arm's length outsourcing arrangements. In the case of non-arm's length outsourcing arrangements, such as arrangements involving affiliates, the following additional *access risk* consideration applies:

- the arrangement should include procedures designed to limit affiliate employee and dual affiliate employee / Dealer Member employee access to and control over Dealer Member data, records and assets

Without such procedures in place, employees acting in the best interests of their affiliate employer may be able to make material changes to Dealer Member data and records or move Dealer Member and Dealer Member client assets without considering or acting in the best interests of the Dealer Member.

## **7. Will IIROC be introducing outsourcing rules?**

In addition to the guidance set out in this notice, IIROC is currently working on proposed rules relating to outsourcing that will codify:

- the general due diligence obligations of Dealer Members that must be met when:
  - the outsourcing of particular activities is being considered and
  - an outsourcing arrangement has been entered into.

It is intended that the obligations set out in this proposed rule will be principle-based and similar in nature to those set out in section 5 of this notice.

- the specific obligations of Dealer Members to ensure ongoing access to and control over:
  - its books and records, including client account records; and
  - Dealer Member and Dealer Member client account assets held by or under the control of the Dealer Member.

### *Books and Records*

In order for a Dealer Member to meet its obligations concerning the maintenance of books and records, the rule proposals will require that:

- the Dealer Member maintain its books and records at a central office location; and
- access to books and records be limited to:
  - employees and agents of the Dealer Member, and
  - employees and agents of an outsourcing service provider, with which the Dealer Member has entered into an outsourcing arrangement.

In the case of an employee or agent of the Dealer Member, if the individual is also an employee or agent of an affiliated organization, the rule proposals will specify that books



and records access should only be granted where it is necessary for the individual to carry out their responsibilities as an employee or agent of the Dealer Member.

*Dealer Member and Dealer Member client account*

In order to meet its asset safeguarding obligations, the rule proposals will similarly require that the Dealer Member restrict access to Dealer Member and client assets to:

- employees and agents of the Dealer Member, and
- employees and agents of an outsourcing service provider with which the Dealer Member has entered into an outsourcing arrangement.

Further, in the case of an employee or agent of the Dealer Member, if the individual is also an employee or agent of an affiliated organization, the rule proposals will specify that access to Dealer Member and Dealer Member client account assets should only occur where it is necessary for the individual to carry out their responsibilities as an employee or agent of the Dealer Member.

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### Other industry guidance on outsourcing - MiFID

The MiFID guidance encourages firms to take reasonable steps to avoid undue additional operational risk, such as the outsourcing of important operational functions in such a way as to impair materially the quality of its internal control and the ability of the firm to monitor compliance with all obligations under its regulatory system.

Specifically, the MiFID guidance categorizes activities based on the likelihood as to whether they constitute outsourcing of potentially critical and important functions. Examples of such functions include:

- (a) Compliance, internal audit, accounting or risk management support;
- (b) Credit risk control;
- (c) Portfolio administration or portfolio management by a third-party;
- (d) Data storage (physical and electronic);
- (e) Ongoing, day-to-day systems maintenance/support; and,
- (f) Ongoing, day-to-day software/systems management (such as, where third-party carries out day-to-day functionality and/or runs software or processes on its own systems).

For activities that are highly likely to be critical to the firm, the MiFID guidance sets out the following conditions to be satisfied:

- (i) the service provider must have the ability, capacity, and any *authorisation* required by law to perform the *outsourced* functions, services or activities reliably and professionally;
- (ii) the service provider must carry out the *outsourced* services effectively, and to this end the *firm* must establish methods for assessing the standard of performance of the service provider;
- (iii) the service provider must properly supervise the carrying out of the *outsourced* functions, and adequately manage the risks associated with the outsourcing;
- (iv) appropriate action must be taken if it appears that the service provider may not be carrying out the functions effectively and in compliance with applicable laws and regulatory requirements;
- (v) the *firm* must retain the necessary expertise to supervise the *outsourced* functions effectively and manage the risks associated with the *outsourcing* and must manage those risks and must supervise those functions and manage those risks;
- (vi) the service provider must disclose to the *firm* any development that may have a material impact on its ability to carry out the *outsourced* functions effectively and in compliance with applicable laws and regulatory requirements;
- (vii) the *firm* must be able to terminate the arrangement for the *outsourcing* where necessary without detriment to the continuity and quality of its provision of services to *clients*;
- (viii) the service provider must co-operate with the relevant regulatory authorities in connection with the *outsourced* activities;
- (ix) the *firm*, its auditors, and relevant regulatory authorities must have effective access to data related to the *outsourced* activities, as well as to the business premises of the service provider; and the regulatory authorities must be able to exercise those rights of access;

## Appendix A

- (x) the service provider must protect any confidential information relating to the *firm* and its *clients*; and,
- (xi) the *firm* and the service provider must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities, where necessary, having regard to the function, service or activity that has been *outsourced*.

In addition, the FSA has issued guidance that specifies that the following critical issues should be addressed in any outsource agreement:

- *Specific functions to be outsourced* - outline and clearly define the functions to be outsourced, the responsibilities of the firm and the service provider;
- *Service and performance level standards* - specify the precise service and performance levels in both quantitative and qualitative terms and how these will be monitored;
- *Regulator/auditor access to information* - impose an obligation on the service provider to provide to the firm, its auditors and/or its regulators with rights of inspection and access to books, records and information relevant to the outsourced activity (and books, records and information of sub-contractors where relevant) where required;
- *Termination process* - outline the agreed termination and exit management process, including exit strategies to allow for transfer of the service to another service provider or to the firm itself;
- *Property ownership and confidentiality* - the ownership of intellectual property and the protection of confidential information;
- *Prior consent before sub-contracting* - require prior consent of the firm to the possibility and circumstances of any sub-outsourcing (that is, where a service provider subcontracts elements of the service to other third-party providers) and ensure that any terms agreed between the service provider and any third-party do not contradict the terms of the agreement between the firm and the service provider; and,
- *Material change notification requirement* - require the service provider to immediately inform the firm of any material change in circumstances which could have a material impact on the provision of services by the service provider.
- *Other* - In addition, consideration should be given to including other elements such as those which:
  - confirm the choice of law where the service provider is located abroad;
  - outline the responsibilities of the service provider with regard to IT security;
  - require acceptance of liability by the service provider for unsatisfactory performance or other breach of the agreement;
  - outline payment processes;
  - require guarantees and indemnities from the service provider;
  - outline agreed mechanisms to resolve disputes; and,
  - outline agreed business continuity measures to be taken by the service provider.

**List of Outsourcing Functions**

**CORE**

The following are examples of outsourcing activities/functions that are core and likely critical to the reputation and ongoing viability of a securities firm:

| <b>Activity</b>  | <b>Activity outsourcing eligibility<sup>5</sup></b>   |
|--|---|
| <ul style="list-style-type: none"> <li>▪ Client facing-related activities such as:               <ul style="list-style-type: none"> <li>○ Account opening process (including collection of know your client information and provision of relationship disclosure information);</li> <li>○ Investment decisions in managed accounts</li> <li>○ Suitability assessments in advisory accounts (trade, order, trade type, trade strategy, method of financing, account type, etc.); and</li> <li>○ Client complaint handling.</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>○ <b>Outsourcing of account opening process is prohibited</b> - because the activity must be performed and supervised by Approved Persons who must be employees or agents of the Dealer Member, it cannot be outsourced</li> <li>○ <b>Outsourcing of investment decisions in managed accounts is permitted</b> - Dealer Member Rules specifically allow for the outsourcing of managed account investment decisions to an external portfolio manager hired by the Dealer Member, as per the definition of “managed account” set out in Dealer Member Rule 1300.3</li> <li>○ <b>Outsourcing of suitability assessments in advisory accounts is prohibited</b> - because the activity must be performed and supervised by registered individuals who must be employees or agents of the Dealer Member, it cannot be outsourced</li> <li>○ <b>Outsourcing of client complaint handling is prohibited</b></li> </ul> |

<sup>5</sup> **Please note:** Not all IIROC Dealer Member Rules applicable to a specific activity have been cited in this column. Rather, only those rules believed to be most relevant to the issue of outsourcing have been cited.

| Activity  | Activity outsourcing eligibility <sup>5</sup>   |
|---|---|
| <ul style="list-style-type: none"> <li>▪ Client account-related operations activities, including:               <ul style="list-style-type: none"> <li>○ Operations activities such as cash deposits/disbursements, security receipts and deliveries, security transfers, trade execution processing, clearing, settlement, security reorganizations, dividends and interest, shareholder proxies and solicitations;</li> <li>○ Activities relating to the safeguarding of client account positions;</li> </ul> </li> </ul> | <p><b><i>Outsourcing of the performance of operations activities relating to security transaction, transfer, reorganization and entitlement events is permitted</i></b></p> <p><b><i>Outsourcing of client account asset custody is permitted, subject to complying with the following requirements:</i></b></p> <ul style="list-style-type: none"> <li>○ Client positions held outside of a Dealer Member must comply with the requirements set out in IIROC Dealer Member Rules 17.3 through 17.3B, 2000 and 2600, Statements 4 through 6 and Form 1</li> <li>○ In addition, there are also IIROC Dealer Member Rules that are specific to outsourcing arrangements involving the external custody of client account positions as follows:               <ul style="list-style-type: none"> <li>• security custody, provided securities are held in an “acceptable securities location” as defined in Form 1</li> <li>• back office sharing arrangements, provided the arrangements comply with the requirements set out in IIROC Dealer Member Rule 35.1(d)</li> <li>• introducing/carrying broker arrangements, provided the arrangements comply with the requirements set out in IIROC Dealer Member Rule 35</li> </ul> </li> <li>○ On a related matter, IIROC has recently issued draft guidance on clearing arrangements, another back office outsourcing arrangement. The draft guidance set out in IIROC Rules Notice 12-0312 indicates that while there are no IIROC rules specific to</li> </ul> |



| Activity   | Activity outsourcing eligibility <sup>5</sup>   |
|--|---|
| <ul style="list-style-type: none"> <li>○ Activities relating to the valuation of client account positions;</li> <li>○ Activities relating to the maintenance of client account records and reporting to clients on the account positions and cash balances held; and</li> <li>○ Margin and overdue cash account administration such as, credit limits, margin calls, collection of bad loans.</li> </ul> | <p>clearing arrangements, there are practical issues and general outsourcing due diligence issues that must be assessed in order to determine the appropriateness of entering into a particular clearing arrangement</p> <p><b>Outsourcing of client account asset valuation is permitted</b>, subject to complying with the following requirements:</p> <ul style="list-style-type: none"> <li>○ Valuation must be done in accordance with the requirements set out in IIROC Dealer Member Rule 2600, Statements 7 and Form 1</li> </ul> <p><b>Outsourcing of client account record maintenance and account statement preparation is permitted</b>, subject to complying with the following requirements:</p> <ul style="list-style-type: none"> <li>○ Client account records must be maintained and account statements must be provided to clients in accordance with the requirements set out in IIROC Dealer Member Rule 200</li> </ul> <p><b>Outsourcing of account loan administration is permitted</b></p> |
| <ul style="list-style-type: none"> <li>▪ Financial regulatory reporting (financial filings, etc.)</li> </ul>   | <p><b>Outsourcing of financial report preparation is prohibited</b> - under:</p> <ul style="list-style-type: none"> <li>○ Dealer Member Rule 17.1, the Dealer Member must maintain risk adjusted capital greater than zero at all times; and</li> <li>○ Dealer Member Rule 2600, Statement 2, the Dealer Member must have in place internal policies and procedures designed to ensure its capital adequacy obligation is being met at all times</li> </ul> <p>These obligations could not be met if the preparation of regulatory financial reports was outsourced.</p>  |

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| <b>Activity</b>  | <b>Activity outsourcing eligibility<sup>5</sup></b>   |
|--|---|
| <ul style="list-style-type: none"> <li>▪ Non-financial regulatory reporting (non-financial filings, gatekeeper filings, etc.)</li> </ul>   | <p><b><i>Outsourcing of non-financial report preparation is prohibited</i></b></p>  |
| <ul style="list-style-type: none"> <li>▪ Registration-related activities such as:               <ul style="list-style-type: none"> <li>○ Filing of firm and individual registration applications;</li> <li>○ Filing of annual and ongoing information updates (outside business activities, claims filed, office location);</li> <li>○ Filing of individual termination notices; and</li> <li>○ Maintenance of central database tracking individual registrations and related proficiency requirements.</li> </ul> </li> </ul> | <p><b><i>Outsourcing of registration-related activities is permitted</i></b></p>  |
| <ul style="list-style-type: none"> <li>▪ Treasury activities (such as security borrowing and lending, cash management)</li> </ul>  | <p><b><i>Outsourcing of treasury activities is permitted</i></b></p>  |
| <ul style="list-style-type: none"> <li>▪ Corporate finance activities</li> </ul>   | <p><b><i>Outsourcing of corporate finance activities is permitted</i></b></p>   |
| <ul style="list-style-type: none"> <li>▪ Research reports and market newsletters</li> </ul>  | <p><b><i>Outsourcing of the preparation of research reports and market newsletters is permitted, subject to complying with the following requirements:</i></b></p> <ul style="list-style-type: none"> <li>○ <b><i>Preparation of research reports</i></b> - Requirement #4 and Guideline #2 of Rule 3400 specifically refer to and permit the distribution of third-party produced research reports subject to certain conditions being met.</li> <li>○ <b><i>Approval of research reports and market newsletters for distribution</i></b> - Rule 29.7(3) requires that research reports and market newsletters be approved by a Supervisor prior to publication</li> </ul> |

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| <b>Activity</b>   | <b>Activity outsourcing eligibility<sup>5</sup></b>   |
|---|---|
| <ul style="list-style-type: none"> <li>▪ Marketing (advertising, call centres)</li> </ul>   | <p><b><i>Outsourcing of the preparation of marketing materials is permitted</i></b>, subject to complying with the following requirement:</p> <ul style="list-style-type: none"> <li>○ <b><i>Approval of marketing materials and advertising</i></b> - Rule 29.7(3) requires that telemarketing scripts, promotional seminar texts, original advertisements and any other materials used to solicit clients that contains performance reports or summaries be approved by a Supervisor prior to publication or use</li> </ul> |
| <ul style="list-style-type: none"> <li>▪ Professional services related to the business activities of the securities dealer (such as, accounting, internal audit)</li> </ul>   | <p><b><i>Outsourcing the contracting of external professional services is permitted</i></b>, subject to complying with the following requirement:</p> <ul style="list-style-type: none"> <li>○ <b><i>Hiring of external auditors</i></b> - Rule 16.1 requires each Dealer Member to select its external auditor for the purposes of the annual audit of IIROC Dealer Member Form 1 from a list of auditors approved by the applicable IIROC District Council.</li> </ul>  |
| <ul style="list-style-type: none"> <li>▪ Information system management and maintenance (such as, data entry and processing, data centers, server facilities management, end-user support, local area networks, help desks)</li> </ul> | <p><b><i>Outsourcing of information system management and maintenance is permitted</i></b></p>  |

### NON-CORE

The following would not be considered outsourcing activities/functions that are critical to the ongoing viability of the firm:

- Office service management activities such as:
  - Market information services (e.g. Bloomberg, Moody's);
  - Purchase of goods, wares, commercially available software and other commodities;
  - Repair and maintenance of fixed assets; and
  - Courier services, regular mail, utilities, telephone.

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- Consultant services such as:
  - Independent audit reviews;
  - Credit bureau checks;
  - Discrete advisory services (e.g. legal and tax opinions); and
  - Independent consulting;
  
- Human resource management activities such as:
  - Staff recruitment assistance;
  - Procurement of specialized training or continuing education; and
  - Payroll processing and benefits administration.

**Key Risks of Outsourcing**

While the outsourcing of certain activities can be beneficial to a financial services organization, outsourcing can give rise to risks which need to be managed effectively.

| <b>Risk</b>                     | <b>Major Concerns</b>   |
|---------------------------------|---|
| Strategic risk                  | <ul style="list-style-type: none"> <li>▪ The third-party outsource service provider may conduct activities on its own behalf which are inconsistent with the overall strategic goals of the regulated entity.</li> <li>▪ Failure to implement appropriate oversight of the outsource service provider.</li> <li>▪ Failure to maintain adequate in-house expertise to oversee the outsource service provider.</li> </ul>                                       |
| Reputation risk                 | <ul style="list-style-type: none"> <li>▪ Poor service from third-party outsource service provider.</li> <li>▪ Customer interaction is not consistent with overall standards of the regulated entity.</li> <li>▪ Third-party outsource service provider practices are not in line with stated practices (ethical or otherwise) of regulated entity.</li> </ul>   |
| Compliance risk                 | <ul style="list-style-type: none"> <li>▪ Privacy laws are not complied with.</li> <li>▪ Consumer and prudential laws not adequately complied with.</li> <li>▪ Outsource service provider has inadequate compliance systems and controls.</li> </ul>   |
| Operational risk                | <ul style="list-style-type: none"> <li>▪ Technology failure.</li> <li>▪ Inadequate financial capacity to fulfill obligations and/or provide remedies.</li> <li>▪ Inadequate internal controls leading to undetected errors or fraud.</li> <li>▪ Difficult/costly for firm to undertake inspections of the outsource service provider's operations.</li> </ul>   |
| Exit strategy risk              | <ul style="list-style-type: none"> <li>▪ The risk that appropriate exit strategies are not in place. This could arise from over-reliance on one firm, the loss of relevant skills in the institution itself preventing it from bringing the activity back in-house, and contracts which make a timely exit prohibitively expensive.</li> <li>▪ Limited ability to return services to firm due to lack of staff or loss of institutional knowledge.</li> </ul> |
| Counterparty risk               | <ul style="list-style-type: none"> <li>▪ Inappropriate underwriting or credit assessments.</li> <li>▪ Quality of receivables may diminish.</li> </ul>   |
| Country risk                    | <ul style="list-style-type: none"> <li>▪ Political, social and legal climate may create added risk.</li> <li>▪ Business continuity planning is more complex.</li> </ul>   |
| Contractual risk                | <ul style="list-style-type: none"> <li>▪ Ability to enforce contract.</li> <li>▪ For off shore outsourcing arrangements, choice of law is important.</li> </ul>   |
| Access risk                     | <ul style="list-style-type: none"> <li>▪ Outsourcing arrangement hinders ability of regulated entity to provide timely data and other information to regulators.</li> <li>▪ Additional layer of difficulty in regulator understanding activities of the outsource provider.</li> </ul>  |
| Concentration and systemic risk | <ul style="list-style-type: none"> <li>▪ The industry, as a whole, has significant exposure to the outsource provider. This concentration risk has a number of facets, including:                             <ul style="list-style-type: none"> <li>○ Lack of control, by individual firms, over provider; and</li> <li>○ Systemic risk to industry as a whole.</li> </ul> </li> </ul>   |