

# IIROC NOTICE

## **Rules Notice Request for Comments**

Dealer Member Rules

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**14-0011**  
**January 13, 2014**

## **Outsourcing arrangements**

### **Notice of issuance of final guidance note and summary response to comments received**

#### **Final guidance note issued**

On October 22, 2012, the Investment Industry Regulatory Organization of Canada (“IIROC”) issued a draft Guidance Note for public comment<sup>1</sup> setting out guidance regarding outsourcing arrangements.

[Guidance Note 14-0012](#) has been amended to address public comments received and is being issued in final form today.

The next section of this notice sets out IIROC’s summary response to public comments received on this draft Guidance Note.

#### **Summary response to comments received**

This summary responds to the seven comment letters received on the draft outsourcing arrangements guidance note that was published for comment on October 22, 2012. We have considered the comments received and we thank all the commenters for their submissions. The comments specific to the draft guidance note have been summarized and categorized by major

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<sup>1</sup> Rules Notice 12-0311, “*Request for comments on draft guidance regarding outsourcing arrangements*”



comment themes. Our response to each comment is set out at the end of each section of categorized comments.

### **Reason for guidance**

- It would be helpful to understand the specific problem or issue that resulted in the issuance of the draft guidance

#### **IIROC Response**

The primary reasons for issuing this guidance note are to remind Dealer Members of the requirement under Part 11 to the Companion Policy to National Instrument 31-103 to follow prudent business practices, as well as the requirement to perform a due diligence analysis when considering whether or not to outsource. We believe it is important to remind Dealer Member of these requirements as recent IIROC field examinations have identified a wide range of Dealer Member outsourcing due diligence policies and procedures and inconsistencies in the outsourcing agreements that are being executed with outsource service providers (e.g. a wide variation in the agreement standard clauses relating to issues such as minimum service levels, information and asset safeguarding and business continuity). To assist Dealer Members in meeting their outsourcing due diligence obligations, the proposed guidance was drafted to:

- specify the existing functions that may not be outsourced under the current IIROC Dealer Member Rules;
- identify the core functions which, if outsourced, would be of greatest regulatory interest to IIROC; and
- list the policies/procedures a Dealer Member should consider employing when performing any due diligence analysis of a proposed outsourcing arrangement.

Finally, the proposed guidance makes it clear that “outsourcing” arrangements between affiliates are subject to the guidance, as there are unique risks associated with affiliate outsourcing arrangements.

### **Approach taken in guidance**

- We support the principles outlined in the guidance and most particularly that a Dealer Member’s regulatory responsibility may not be subrogated to a service provider
- Support for a principles-based approach, as supplemented by interpretive guidance, to outsourcing
- Because of the risks associated with outsourcing, IIROC needs to expand its oversight over such arrangements
- There are a number of specific challenges with outsourcing that should be listed in the guidance note
- The determination of which activities may not be outsourced should be done using a principles-based approach



- We agree with the IIROC approach of specifically identifying activities which may not be outsourced
- The existing OSFI guidance that applies to bank-owned Dealer Members is adequate and IIROC should either exempt bank-owned Dealer Members from the guidance or align the IIROC guidance with the OSFI guidance
- In addition, there is guidance set out in Part 11 of the Companion Policy to NI 31-103 that sets out the CSA's expectations with respect to outsourcing; because of the existence of both OSFI and CSA guidance in this area we are concerned that the proposed IIROC guidance is duplicative

### **IIROC Response**

The proposed guidance was drafted to provide Dealer Members with a summary of the current rule requirements that relate to outsourcing and to assist Dealer Members in meeting their outsourcing due diligence obligations. In developing this guidance we have made every effort to consider and, where appropriate, be consistent with the guidance previously issued by:

- the Office of the Superintendent of Financial Institutions of Canada (OSFI) in 2003 and updated in 2009;
- the International Organization of Securities Commissions (IOSCO) in 2005; and
- the Canadian Securities Administrators (CSA) in 2009.

all of which use a principles-based rule approach, supplemented by interpretive guidance.

The commenter's suggestion that IIROC needs to expand its oversight over outsourcing arrangements will be considered as part of a separate project IIROC will be undertaking. This project, will involve the development of a principles-based rule that will codify the Dealer Member's outsourcing due diligence obligations and establish specific requirements to be met when the proposed outsourcing arrangement involves either books and records, or assets of the Dealer Member and/or its clients.

The specific challenges associated with outsourcing are numerous and vary from one outsourcing arrangement to the next. Rather than adopting the commenter's suggestion (i.e. that each specific challenge should be identified) the proposed guidance, consistent with the intended principles-based approach tries to focus the reader on the importance of identifying and assessing the important risks associated with a proposed outsourcing arrangement and how the outsource services provider and the Dealer Member intend to mitigate those risks through proper controls and procedures.

Commenters have differing views as to whether IIROC should prescribe the list of functions/activities that may not be outsourced or, alternatively, use a principles-based approach to determine the list of functions/activities that may not be outsourced. In the revised guidance note, the only functions/activities that we have identified as being prohibited are those functions/activities that our rules effectively prohibit from being outsourced. To further clarify that the functions/activities that cannot be outsourced are limited to those functions/activities prohibited from being outsourced under IIROC rules, we have amended the guidance note



language to more precisely describe activities/functions that our rules effectively prohibit from being outsourced and to include a reference to the applicable IIROC Dealer Member Rule.

A number of commenters recommended either that bank-owned Dealer Members be exempted from the IIROC guidance, as they are already subject to the OSFI guidance, or that the IIROC guidance be rewritten to align with the OSFI guidance. We believe both of these recommendations to be impractical as:

- it would be unfair to apply one standard to bank-owned Dealer Members and another standard to all other Dealer Members; and
- the OSFI guidance allows that a streamlined due diligence analysis be performed when the proposed outsource service provider is:
  - another member of the financial institution group (all of whom report to OSFI as part of the consolidated reports that OSFI receives); or
  - another financial institution regulated by OSFI.

Regarding the streamlined due diligence analysis that OSFI allows for in certain arrangements, use of this approach would not be workable for IIROC as most of the domestic institutions referred to in the OSFI guidelines are outside the regulatory oversight of IIROC and would therefore pose equivalent challenges to those that arise when IIROC Dealer Members enter into arrangements involving foreign affiliates.

Finally, a number of commenters suggested that there was no need for IIROC to issue guidance on outsourcing as there is adequate guidance set out in Part 11 of the Companion Policy to NI 31-103 (CSA guidance). As we have drafted the guidance note to be consistent with the CSA guidance, we acknowledge that some elements of the IIROC guidance may be duplicative. However, the IIROC guidance as a whole is not duplicative of the CSA guidance as it:

- lists the functions and activities that are prohibited by the IIROC rules from being outsourced; and
- provides a detailed list of considerations relevant to the performance of an outsourcing arrangement due diligence analysis

### **Specific concerns with guidance**

Scope of activities considered to be outsourcing

- There needs to be more clarity as to the scope of arrangements covered by the guidance
- The use of third-party service providers to assist the Dealer Members in one of its functions “should not be considered as outsourcing, for as long as key staff of Dealer Members remain accountable for the overall function”
- It is not clear whether the guidance applies to introducing broker / carrying broker arrangements
- Are clearing and/or settlement services within the scope of the guidance?



### **IIROC Response**

The scope of the proposed guidance has been clarified in the revised guidance note by adopting the definition of “outsourcing” set out in the report entitled “Principles on Outsourcing of Financial Services for Market Intermediaries” issued by the IOSCO Technical Committee Standing Committee on the Regulation of Market Intermediaries (SC3) in February 2005.

The guidance makes it clear that a Dealer Member that outsources certain activities or functions is still responsible for ensuring that those activities/functions are performed properly and in compliance with relevant IIROC requirements. We therefore see no reason to exempt the use of third-party service providers from the list of arrangements considered to be outsourcing on the basis that “...key staff of Dealer Members remain accountable for the overall function” - as IIROC has the same expectation for outsourcing arrangements.

We have clarified in section 2 of the revised notice that the guidance applies to introducing broker / carrying broker arrangements, along with a number of other arrangements for which IIROC has specific rule requirements.

Clearing and settlement services provided by recognized clearing corporations, which include Canadian Derivatives Clearing Corporation (CDCC), CDS Clearing and Depository Services Inc. (CDS), FundSERV Inc. (FundSERV) and ICE Clear Canada Inc. (ICE)<sup>2</sup>, would not be considered to be “outsourcing” for the purposes of the guidance note as they are not “...functions that could otherwise be undertaken by the firm.” Other clearing and settlement related services, such as those provided by CANNEX Financial Exchanges Limited, would be considered to be “outsourcing” as their use by a Dealer Member is voluntary.

### **Precision of description of prohibited activities**

- General support for the prohibition on outsourcing of certain client facing and decision making activities but guidance should clearly articulate that prohibition should be limited to the client facing and decision making components of such activities
- Concern about precision of description of activities for which outsourcing is prohibited (i.e. the account opening process, the performance of suitability assessments, the handling of client complaints)
- Specific suggestion that guidance needs to be amended to make it clear that not all tasks associated with the account opening process are prohibited from being outsourced
- We would also like to clarify that situations where a portfolio management firm is using a Dealer Member as a custodian to custody client assets would not be considered outsourcing of the account opening process

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<sup>2</sup> CDCC, CDS, FundSERV and ICE are clearing and settlement services that are used for the vast majority of trades in Canadian investment products. These services are generally used, unless both trade counterparties opt out, and as such the services provided by these clearing corporations are not considered to be “...functions that could be otherwise undertaken by the firm” and not considered to be outsourcing.



- The proposed guidance would make suitability the responsibility of Dealer Members when a portfolio management firm uses a Dealer Member as an outsource services provider - this is not an appropriate result when it is the portfolio manager that has the responsibility to “know their clients” and make suitability assessments
- Complaint handling is currently being done at the financial institution group level - the guidance seems to prohibit this along with the use of a mediator, an external lawyer and /or the OBSI to resolve a complaint
- IIROC needs to clarify whether the use of third party technology systems or platforms are acceptable for opening client accounts or for performing suitability assessments
- The guidance does not specifically address which “non-core” activities cannot be outsourced

### **IIROC Response**

To address concerns regarding the precision of the description of activities that are prohibited from being outsourced, IIROC has revised the guidance note to more clearly and specifically describe each prohibited activity and to include the reference for the rule that sets out each prohibition.

With respect to the request for clarification as to whether arrangements, in which a portfolio management firm uses a Dealer Member as a custodian of their clients’ assets, would be considered to be a prohibited outsourcing of the account opening process, there are a number of different arrangements that exist today to consider. Specifically there are arrangements:

- where the originating and primary client relationship is with the portfolio management firm and the Dealer Member only provides custodial services
- where the originating and primary client relationship is with the portfolio management firm but the Dealer Member not only provides custodial services but also provides margin lending services to the client
- where originating and primary client relationship is with the Dealer Member and the Dealer Member outsources the provision of portfolio management services to an external portfolio management firm

In the second and third instances, where the Dealer Member and the portfolio manager both assume responsibility for the assessment of “know your client information”, the Dealer Member Rules effectively state that the Dealer Member responsibility for this assessment may not be delegated / outsourced to the portfolio manager.

Also, the proposed guidance would not shift the responsibility for assessing suitability to the Dealer Member when a portfolio management firm uses a Dealer Member as an outsource services provider, unless the Dealer Member is providing client services that extend beyond custody and custody-related reporting services. Suitability assessment remains the sole responsibility of the portfolio management firm, provided the Dealer Member:

- is not the primary point of contact for the client,
- is not collecting, maintaining and assessing “know your client” information for each client,



and

- does not provide additional services to the client beyond custodial services (i.e. does not provide margin loan services directly to the client or open a separate account directly with the client).

With regard to complaint handling, the proposed guidance has been revised to refer to the specific IIROC rule requirement that stipulates that the handling of Dealer Member complaints must be overseen by a Designated Complaints Officer of the Dealer Member. The revised guidance makes it clear that the use of a mediator, an external lawyer and /or the OBSI to resolve a complaint is permitted within the Dealer Member Rules, provided that the complaint handling process is overseen by an officer of the Dealer Member.

Regarding the request for clarification as to whether or not the use of third party technology systems or platforms is acceptable for opening client accounts or for performing suitability assessments, the revised guidance note clarifies that the Dealer Member Rules require that the Registered Representative be primarily responsible for ensuring for each of their clients that the “know your client” information maintained on file is current, complete and accurate and for ensuring that account portfolios are suitable. While the use of technology (both third party and internal) is acceptable in assisting the Registered Representative in meeting their “know your client” and suitability assessment obligations, the use of technology alone would not enable the Registered Representative to meet these obligations.

To address the request for further clarity about which non-core activities are prohibited from being outsourced, the revised listed of activities that are prohibited from being outsourced includes only core activities, as there are no non-core activities that are prohibited within the IIROC rules from being outsourced.

### **Impact on current outsource arrangements**

- The proposed guidance provides no direction regarding its applicability to current outsourcing arrangements - we recommend that current outsourcing arrangements be grandfathered until the firm has its opportunity to update or revise the agreement



### **IIROC Response**

We agree that firms should be given adequate time to update their due diligence policies and procedures and to update or revise existing agreements, in order to adopt the recommendations and/or to address the due diligence considerations set out in the guidance note. However, as none of these guidance note recommendations or considerations represent new requirements, we see no need to formally grandfather current outsourcing agreements for a certain period of time. Rather, to address this concern, the effective date of the guidance will be set at 90 days after its date of issuance.

### **Requirement to inform IIROC when entering into an outsourcing arrangement**

- The proposed guidance requires firms to inform IIROC when entering into a new outsourcing arrangement - is IIROC intending to require approval of outsourcing arrangements?

### **IIROC Response**

No, consistent with the IOSCO Principles, IIROC is not intending to require Dealer Members to obtain IIROC approval of outsourcing arrangements

### **Risks associated with outsourcing**

- The statement “Dealer Members should *never* enter into an outsourcing arrangement that unduly concentrates its outsourced activities in one or a few outsource service providers” needs to be explained. Does the concern relate to a firm outsourcing too many activities to one outsource service provider or does the concern relate too many firms outsourcing to the same service provider? Does this apply to affiliate outsource arrangements? “Client harm” risk should be added to the list of risks associated with outsourcing

### **IIROC Response**

Regarding the statement in the draft guidance note relating to concentration risk, the statement is specific to an individual Dealer Member outsourcing too many of its activities to one outsource service provider. We have reviewed the language used in the guidance note and believe that it is clear, as currently worded and would apply to affiliate outsourcing arrangements. To further clarify this concept of “individual firm concentration risk”, we have specifically discussed this risk in section 5 of the guidance note and defined this risk in Appendix B to the guidance note.

While many of the aspects of “client harm” risk are referred to indirectly in the other types of risk listed in the appendix entitled “Key Risks of Outsourcing”, we agree with the commenter that it is very important to consider the risk of client harm and have added this risk to the list of key risks to consider.

### **Guidance inconsistencies**

- There is an inconsistency between the guidance note and Appendix B relating to the preparation of financial reports - IIROC needs to clarify whether or not this activity may be outsourced



**IIROC Response**

We thank the commenters for pointing out this inconsistency. We have revised the guidance note to clarify that these activities are eligible to be outsourced, as there is no IIROC rule that prohibits the outsourcing of such activities.