

16 September 2009

To the Senior Executive Officers
of DFSA Authorised Firms

Dear SEO,

Outcome of Theme Review – Outsourcing of functions

We have completed a theme review in relation to the outsourcing of functions.

This review had a particular focus on the outsourcing of a Firm's Compliance function. A representative cross-section of fifteen Firms was reviewed. Three of these Firms acted as a "control group" and had not outsourced their Compliance function. We also reviewed information received from a questionnaire sent to all existing service providers acting on behalf of Firms.

The DFSA is grateful for the assistance provided by all persons in undertaking this theme review.

Executive Summary

Generally, the review disclosed that Firms need to improve their compliance with DFSA's requirements relating to outsourcing (see Appendix 1). In particular, the areas requiring attention include:

1. The initial and ongoing due diligence conducted in relation to a service provider. There should be proper documentation evidencing the due diligence;
2. Firms need to ensure they provide appropriate and effective oversight and supervision of their service provider; and
3. The quality of agreements between a Firm and their service providers.

The outsourcing of functions does not absolve managerial or board responsibility and accountability for ensuring proper administration and execution of these functions.

Background to the Theme Review

In the past two years, the DFSA has seen an increased number of Firms choosing to outsource their Compliance and anti money laundering reporting functions. This has arisen due to a number of factors. These factors include access to a level of compliance expertise when the firm has relatively limited number of employees, low volume of business and limited transactions.

The theme review involved a fact finding exercise to confirm:

1. The number and types of Firms which have elected to outsource their Compliance function. Further, the number and types of service providers of Compliance functions (including Compliance Officers and supporting staff);
2. The level of due diligence undertaken by a Firm in the selection of a service provider;
3. How effectively the Firm supervises the outsourced Compliance function;
4. The adequacy of terms contained within an outsourcing agreement; and
5. Whether a Compliance Officer from a service provider can provide adequate Compliance services when acting for more than one Firm.

The theme review was also aimed at identifying good and best practices involving outsourcing.

General Findings

1. Undertaking due diligence

Firms conducted varying levels of due diligence in relation to the selection of their service provider. This selection was based on prior relationships, dealings with other group entities or by viewing their competitors' arrangements. Other means included reviewing those service providers listed on DIFC's website¹ and from recommendations given by law Firms or other consultancy services etc. Cost was specified as one of the most important considerations in a Firm's selection of a service provider.

Overall, we consider Firms can improve their initial and any ongoing due diligence conducted with a service provider. Factors for consideration in this due diligence includes but not limited to: experience and qualifications of the Compliance Officer proposed; number of other firms to which the Compliance Officer is appointed and conflicts arising; alternative arrangements should the Compliance Officer become unavailable; and the level of professional indemnity insurance. Such due diligence should be supported by appropriate documentary evidence.

2. Supervision of the service provider

Firms can improve how effectively they supervise their service providers. We consider effective supervision should at least include consideration of the following:

- a. ensure regular meetings between the Firm (in particular the SEO) and the Compliance Officer. We consider the Compliance Officer should aim to spend a sufficient level of their nominated time at the Firms premises;
- b. the Compliance Officer and service provider should disclose any developments that may have a material impact on their ability to carry out the outsourced function effectively and in compliance with applicable DFSA laws and rules. For

¹ http://www.difc.ae/service_providers/

example, this should include disclosure of the service providers' commitments to other Firms;

- c. the Firm should ensure the service provider addresses any relevant potential conflicts of interest and include a provision for a written notification in the event a conflict arises; and
- d. ensure the Compliance Officer has direct access to the SEO and Governing Body of the Firm.

We note the role of a Compliance Officer (even where such person is from a service provider) is a Licensed Function of the Firm under AUT Rule 10.2.2(e) and such a person is an employee of the Firm.

3. Outsourcing agreements/Engagement letters

In addition to the requirements specified in SUP Rule 2.4.1, we believe that outsourcing agreements should consider best practice as outlined in relevant international standards. Such standards include the guiding principles for outsourcing in financial services issued by the Joint Forum² (Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors). Please see Appendix 2.

4. Compliance Officers acting for more than one Firm

We consider that Compliance Officers from service providers and the Firms they service, need to be mindful of the number of Firms the Compliance Officer manages. This number may vary depending on factors such as the prudential category of the Firm, the type of activities being undertaken by the Firm and the level of business being conducted.

Conclusion

The outsourcing of the Compliance function poses important challenges to Authorised Firms, service providers, Compliance Officers and to the DFSA. Ultimately, the Compliance function must be adequately monitored and controlled by the Firm's Governing Body and Senior Management. The adequacy of a Firm's Compliance function continues to be accorded an important priority by the DFSA and consequently will continue to be closely monitored by the DFSA.

Finally, we also consider that a Firm should be adopting similar practices as outlined in this letter when outsourcing other material arrangements.

Yours faithfully,



Michael J. Zamorski
Managing Director – Supervision

cc. Compliance Officer of Authorised Firms

² <http://www.bis.org/publ/joint12.htm>

Appendix 1: DFSA's Outsourcing Requirements

As part of this theme review, the DFSA tested compliance with its outsourcing requirements in GEN Rules 5.3.21 and 5.3.22 and SUP Rule 2.4.1 of the DFSA Rulebook.

GEN Rule 5.3.21(3) sets out the procedures that a Firm must follow when outsourcing. These are:

1. undertaking due diligence in choosing a third party provider;
2. effectively supervising outsourced functions or activities; and
3. dealing effectively with any actions or omissions of third party providers, which lead or may lead to breaches of legislation applicable in the DIFC by the third party provider.

The SUP Module, in particular SUP Rule 2.4.1, also requires that any material outsourcing arrangements entered into by a Firm contains particular terms such as allowing the DFSA access to their premises to view information on a Firm and dealing in an open and co-operative way with the DFSA.

We note that an Operator of a Collective Investment Fund or Trustee of a Domestic Fund, must comply with the delegation and outsourcing requirements in Chapter 7 of the CIR Module of the DFSA Rulebook.

Appendix 2: Guiding Principles for outsourcing in financial services issued by the Joint Forum

Principle 1 - 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.

Principle 2 - The regulated entity should establish a comprehensive outsourcing risk management programme to address the outsourced activities and the relationship with the service provider.

Principle 3 - The 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.

Principle 4 - The regulated entity should conduct appropriate due diligence in selecting third-party service providers.

Principle 5 - 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.

Principle 6 - The regulated entity and its service providers should establish and maintain contingency plans, including a plan for disaster recovery and periodic testing of backup facilities.

Principle 7 - The 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.

Principle 8 - 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 a regulated entity to meet its regulatory requirements.

Principle 9 - 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.