



## Securities Industry Association

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December 1, 2005

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William Jannace  
Director of Rule and Interpretive Standards  
Member Firm Regulation  
New York Stock Exchange  
20 Broad Street, 23<sup>rd</sup> Floor  
New York, NY 10005

**Re: Proposed New York Stock Exchange Rule 340 (“Outsourcing: Due Diligence and Conditions Required in the Use of Service Providers”) and proposed amendment to Rule 342.30(c) (“Annual Report and Certification”)**

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Dear Messrs. Van Weezel and Jannace:

The Outsourcing Subcommittee of the Technology & Regulation Committee of the Securities Industry Association (“SIA”)<sup>1</sup> submits these general comments on proposed Rule 340 on outsourcing and the proposed amendment to Rule 342.30(c) (collectively, the “Proposed Rules”). SIA acknowledges the value of regulatory guidance in the outsourcing area. Although we commend the New York Stock Exchange (the “Exchange”) for addressing this important subject, we cannot support the current proposed rule, as it is inconsistent with other regulatory approaches and does not provide sufficient flexibility. We offer below the SIA’s view on the appropriate regulatory approach to outsourcing. We would appreciate an opportunity for some of our members

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<sup>1</sup> The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated \$227.5 billion in domestic revenue and \$305 billion in global revenues. (More information about SIA is available at: [www.sia.com](http://www.sia.com).)

to meet with you to discuss these topics, and will contact you soon to arrange such a meeting.<sup>2</sup>

## **Introduction**

As the Staff recognizes, outsourcing in the securities industry is nothing new. For decades, financial services firms have retained service providers to lower costs and improve service. Outsourcing has yielded enormous benefits to member firms and their public customers. To ensure that such benefits continue and are not impaired by unnecessarily restrictive rulemaking, SIA urges the Exchange to proceed cautiously and embrace an approach to the regulation of outsourcing that promotes customer protection consistent with the need for flexibility. As discussed more fully below, the Exchange's regulatory initiatives in this area should take into account the following:

- Outsourcing is a cross-border phenomenon. It is important that the Proposed Rules be consistent with and not unnecessarily duplicative of other U.S. and non-U.S. regulations.
- Outsourcing arrangements vary in terms of function, purpose and scope. In order to preserve the economic efficiencies driving the proliferation of outsourcing, such arrangements should not be governed by fixed or inflexible standards.
- The Proposed Rules should be clarified to exclude longstanding activities not commonly viewed as outsourcing and which are not in need of additional regulation (such as, for example, independent contractor arrangements, common utility and shared services providers, and professional services firms).
- The Proposed Rules should not prescribe specific contract provisions, which could have unintended negative consequences.

SIA respectfully requests that the Exchange reconsider the prescriptive approach it has taken in the Proposed Rules. Given the need for flexibility, we believe that prescriptive rules with detailed requirements are not an effective method of regulating outsourcing. By its very nature, outsourcing is fluid and innovative. Its purpose is to find better and more efficient ways to deliver products and services. Hard-and-fast rules do not fit each outsourcing arrangement. An inflexible 60-day period for "corrective action," for example, may be sufficient in the context of the outsourcing of a single, clearly-defined support function, but is unrealistic in the context of a large, multi-function outsourcing arrangement. (See Proposed Rule 340B(5)). Similarly, a prescribed six-

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<sup>2</sup> This comment letter contains general comments on the Proposed Rules. SIA intends to provide line-item comments on the Proposed Rules at a later stage of the rulemaking process. If the Staff would like line-item comments before such time, please let us know and we will be happy to provide them.

month review period for existing outsourcing arrangements may be sufficient for a small-scale outsourcing, but not a large-scale outsourcing arrangement involving several functional areas. (See Proposed Rule 340C(5)).

Recognizing the need for flexibility, the NASD has taken a principle-based approach in Notice to Members 05-48 (“NTM 05-48”). Without prescribing particular factors, NTM 05-48 makes clear that NASD members outsourcing covered activities should conduct “a due diligence analysis” of their third-party service providers to determine “whether they are capable of performing the outsourced activities.” Similarly, NTM 05-48 makes clear that NASD members have a “continuing responsibility to oversee, supervise, and monitor the service provider’s performance of covered activities,” without prescribing precisely how the supervision should be crafted. NTM 05-48 recognizes that such supervision must be “appropriately tailored to each member’s business structure.” SIA believes that the NASD has taken the right approach.

The primary regulatory objective with respect to outsourcing core or securities-related activities should be to assure that the outsourcing process, from initiation, through performance, to termination, is subject to proper oversight by member firms. The principles guiding outsourcing of regulated activities should be essentially the same as those guiding a member firm’s responsibility to supervise those activities generally — namely, to assure that: (1) there are qualified principals with responsibility and authority for the supervision and control of the outsourced activities; and (2) member firms adopt, implement and enforce appropriate written procedures to supervise those activities. This principle-based approach to supervision recognizes that member firms differ in size, organization, resources and methods of doing business. Likewise, it allows for flexibility without diminishing the responsibility of each member firm to develop a system of supervision and control tailored to its business activities. (See, e.g., Notice to Members 99-45 (acknowledging the benefits of NASD Rule 3010, which requires individual firms in performing covered activities to “design a supervisory system that is currently and appropriately tailored to its specific attributes and structure”)). A prescriptive approach, in contrast, presumes that “one size fits all” and sacrifices the significant benefits of a flexible approach to regulation.<sup>3</sup> The wisdom of a principle-based approach to the regulation of outsourcing has been widely accepted by regulators and industry groups alike.<sup>4</sup>

## **I. Avoidance of Duplicative Rulemaking**

To avoid potentially duplicative and contradictory rulemaking, SIA requests that the Exchange coordinate with other U.S. regulatory bodies to adopt rules and/or provide

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<sup>3</sup> Generally, prescriptive rules are used to regulate specific conduct that is considered improper, regardless of the context in which it is engaged. (See, e.g., NYSE Rule 97 (imposing prescriptive limits on member’s trading because of “block positioning”); and NYSE Rule 92 (imposing prescriptive standards on member’s trading because of “customer orders”)).

<sup>4</sup> See The Joint Forum Report entitled “Outsourcing in Financial Services,” dated February 2005 and the IOSCO Report entitled “Principles on Outsourcing of Financial Services for Market Intermediaries,” dated February 2005; Notice to Members 05-48.

regulatory guidance that is consistent with existing U.S. and non-U.S. regulatory guidance on outsourcing.

**A. Consistency with Other U.S. Securities Regulators**

SIA requests that before the Exchange promulgates any rule on outsourcing, the Exchange coordinates its efforts with other U.S. securities regulators.<sup>5</sup> This will help to avoid a potentially burdensome duplication of effort by member firms and minimize confusion due to differing regulatory approaches, particularly in view of NTM 05-48 as described above. SIA is especially concerned about such duplication of effort and confusion in the context of requirements to amend contracts, such as under Proposed Rule 340B(5), or to implement a specific due diligence program, such as in Proposed Rule 340C.

**B. Consistency with International Regulation Under Basel**

The Proposed Rules should not apply to global securities firms that already are subject in the United States and abroad to the SEC's consolidated global supervision under Basel II. Basel II is designed to produce uniformity in the way financial services firms and regulators approach risk management across national borders, including with respect to operational risks in outsourcing arrangements. Where the SEC supervises member firms in implementing global risk management frameworks, which include outsourcing arrangements, the Proposed Rules would present unnecessary, confusing and potentially contradictory regulatory burdens on a member firm's U.S. operations. SIA appreciates that the Exchange has reduced the regulatory requirements of the Proposed Rules in certain respects with respect to entities subject to the SEC's consolidated supervision, but respectfully submits that the Proposed Rules do not go far enough by exempting such member entities from their application.

**C. Consistency with International Regulation That is in the Nature of Guidance**

The Proposed Rules should be consistent with existing guidance promulgated by international organizations such as the Basel Committee on Banking Supervision and the International Organization of Securities Commissioners. These organizations, both individually and through The Joint Forum, have conducted extensive reviews of outsourcing in the financial services and securities industries. After careful consideration, they have published Reports containing guidance to regulators and financial services organizations.<sup>6</sup> The primary difference between the Proposed Rules

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<sup>5</sup> In many instances, securities regulators have successfully coordinated their regulatory efforts. Recent examples include, among others, the Exchange and NASD rules governing research analysts' conflicts of interest (see Information Memo 02-26; Notice to Members 02-39), and the Exchange and NASD rules governing supervisory controls and CEO certifications (see Information Memo 05-07; Notice to Members 05-08).

<sup>6</sup> See The Joint Forum Report entitled "Outsourcing in Financial Services," dated February 2005, and the IOSCO Report entitled "Principles on Outsourcing of Financial Services for Market Intermediaries," dated February 2005.

and these Reports is in overall approach. The Proposed Rules consist of detailed, mandatory requirements to be followed in all specified instances. The Reports present guidance and principles for mitigating outsourcing-related risks to be implemented by firms in policies tailored to a firm and its particular circumstances.

SIA believes that the approach taken in the Reports is preferable. Rather than adopting a “one size fits all” approach, member firms should be free to achieve the objectives of the Proposed Rules through means that are most suitable to their circumstances. As the Exchange observed in its submission of the Proposed Rules, “[d]ifferent outsourcing configurations have given rise to different types of regulatory concerns.”<sup>7</sup> (Proposed Rule Change, p.4). As a result, different solutions may be needed to address the concerns raised by a particular outsourcing arrangement.

Proposed Rule 340B(5) is a case in point. As described in greater detail below, Proposed Rule 340B(5) would require member firms to include in outsourcing agreements involving “core activities” a provision allowing the Exchange to terminate or suspend the arrangement on short notice. SIA believes that this mandatory termination provision in Proposed Rule 340B(5) would be much less effective than the relevant guidelines in the Reports. The Reports provide guidance as to several types of contractual provisions to mitigate risk, *e.g.*, provisions clearly defining the functions to be outsourced with associated service levels, exit clauses including transition assistance, business continuity plans, dispute resolution mechanisms, and many others.<sup>8</sup> These provisions can trigger a contractual right of termination in the event of a material breach or service failure by the service provider.

In another example, Proposed Rule 340C mandates specific due diligence when outsourcing a “core function.” The Reports, in contrast, require member firms to develop suitable due diligence processes and criteria designed to validate the service provider’s ability to provide the service.<sup>9</sup> In view of the wide variety in the size and characteristics of member firms, as well as the outsourcing arrangements themselves, the Reports’ approach to outsourcing agreements and due diligence better accommodates the need for flexibility.

## **II. The Objective of Proposed Rule 340B(5) (the “Termination Provision”) Can Be More Effectively Addressed Through the Approach in the Basel and IOSCO Reports**

Proposed Rule 340B(5) is an extraordinary provision. It would require member firms to amend their existing outsourcing agreements involving “core activities” to

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<sup>7</sup> Further, because of the interdependencies of global enterprises, the need to adopt the Proposed Rules in the U.S. may effectively require member firms to adopt the regulatory guidance of the Reports abroad as well. This would defeat the flexible approach of the Reports and disadvantage U.S. firms from competing internationally against foreign competitors not subject to the Proposed Rules.

<sup>8</sup> Joint Forum Report at 16-17, IOSCO Report at 7-8.

<sup>9</sup> Joint Forum Report at 15-16, IOSCO Report at 5-6.

expressly permit the Exchange to cause a termination or suspension of the agreement. Proposed Rule 340B(5) would grant the Exchange unnecessarily drastic powers, particularly in view of the readily-available alternatives described in the Reports.

Pursuant to Proposed Rule 340B(5), the Exchange would have the power to terminate or suspend an outsourcing arrangement involving “core activities” whenever “necessary to comply with the Proposed Rules of the Exchange and federal securities regulation or otherwise to protect the public interest.” This assumption of power would be both extreme and unwarranted. We are not aware of a parallel in any other area of securities regulation where the Exchange can compel a member firm to terminate a relationship. The powers granted to the Exchange in Proposed Rule 340B(5) are exceptional when compared with the other regulatory guidance addressing outsourcing in the securities industry. Further, Proposed Rule 340B(5) is ill-conceived in that:

- The “deficiency” that is the basis for the termination need not be “material,” or, for that matter, the cause of a violation of any regulatory requirement.
- There is no differentiation between isolated incidents and patterns of failures.
- The Exchange would be restricting itself from granting more than sixty days to allow a firm to resolve a deficiency with “corrective action.”
- The Exchange is not empowered to grant an extension of the initial period beyond sixty days under any circumstances.

If adopted, Proposed Rule 340B(5) could have significant adverse consequences. In response to the increased risk of early termination of an outsourcing arrangement by the Exchange, service providers to member firms are likely to seek a sharp increase in fees. Alternatively, because of the substantial start-up costs involved in complex outsourcing relationships, service providers may impose a penalty on member firms when the Exchange invokes its rights under this provision.

SIA respectfully urges that consideration be given to more flexible approaches, such as those reflected in the Basel and IOSCO Reports. The process described in the Reports requires termination and risk-related provisions to be thoughtfully considered and negotiated according to the particular circumstances of each major outsourcing engagement. As an alternative, SIA suggests that the Exchange require a provision in outsourcing agreements involving “core functions” granting the Exchange the right, under defined circumstances, to review the relevant records. If the Exchange were to find a material deficiency, the member firm would have the responsibility to correct it by working with the service provider, or by terminating the outsourcing agreement in accordance with its negotiated terms. Further, as in the case of other member firm deficiencies, the Exchange may use its existing authority to bring an action against the member firm where an outsourcing deficiency results in a violation by the member firm.

### **III. Focus on Outsourcing of Core Functions as Opposed to Activities**

To focus the Proposed Rules on outsourcing-specific risks associated with core functions, Proposed Rule 340B(1) should clarify that certain business activities, systems, and support functions are not included within the definition of “core.” In particular:

- The Proposed Rules should be clarified to exclude arrangements where a member firm simply uses supplemental resources, or where contract consultants act as additional resources on teams managed by the firm. This occurs, for example, when a member firm engages information technology (“IT”) consultants in a supplemental capacity to assist its information technology IT department. Such arrangements do not require additional regulation as “outsourcing” under the Proposed Rules. If a member firm performs functions with the assistance and support of independent contractors, the risks to the firm do not change materially, regardless of whether the particular resources are individual employees or contractors.
- The Proposed Rules should be clarified not to layer additional regulatory requirements beyond those which may already exist concerning the use of systems and activities in support of core functions. This would include systems such as order management and related software. These types of ancillary systems and activities pose little increased operational risk. Security concerns presented by these types of systems and activities are already addressed under existing regulations, including Regulation S-P.
- The Proposed Rules should be clarified to exclude common utilities and shared services providers that perform services that the member firm cannot, as a practical matter, perform itself, or which historically have been performed by such utilities. These include, for example, depositories, custodians, and trading utilities. Such arrangements have been operating successfully for decades and do not require additional regulation as outsourcing under the Proposed Rules. Although some of these are excluded from the notification requirement in Proposed Rule 340B(1), the Proposed Rules should exempt these common utilities and shared services providers. Similarly, the Proposed Rules should exempt the practice of engaging registered contractors to perform regulated functions as associated persons of a member firm (in which case the activities already will be regulated in connection with the member firm so no further regulation is needed).
- The Proposed Rules should be clarified to exclude longstanding business advisory services that long predate recent trends in outsourcing and pose no new risks that require special outsourcing regulation. These include, for example, advisory functions such as legal, accounting, and management consulting. Their purpose is to advise management in their decision-making, or to supply standardized

products that do not involve inputs from the financial institution, such as market data services.

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Given the rapidly growing use of outsourcing arrangements by member firms, SIA acknowledges the value of regulatory guidance from the Exchange in this area. To be effective, the Exchange's regulatory approach must take into account the growing, varied use and evolving nature of outsourcing. As described above, member firms outsource in order to increase efficiencies and improve customer service. The wrong approach to regulation can easily impair these objectives.

SIA would appreciate an opportunity for some of our members to meet with you to discuss our comments and we will contact you shortly. In the interim, if you have any questions or comments, please call Sylvia Khatcherian, Co-Chair of the Outsourcing Subcommittee of the SIA Technology & Regulation Committee, at (212) 537-3380 or Andrew Cadel at (212) 622-5139, also Co-Chair, or me at (202) 216-2034.

Very truly yours,

Melissa MacGregor

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