



**ISLE OF MAN
FINANCIAL SERVICES AUTHORITY**

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Financial Services Act 2008

Guidance on Rule 8.16

Outsourcing and Delegation of Functions

For licenceholders excluding Class 8(1), 8(2)(b) or 8(3) and Professional Officers

STATUS OF GUIDANCE

The Isle of Man Financial Services Authority (“the Authority”) issues guidance for various purposes including to illustrate best practice, to assist licenceholders to comply with legislation and to provide examples or illustrations. Guidance is, by its nature, not law, however it is persuasive. Where a person follows guidance this would tend to indicate compliance with the legislative provisions, and vice versa.

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Relevant policies and rules

Licenceholders should consider the following policy and rules issued by the Authority, in conjunction with this guidance:

- Licensing Policy under the Financial Services Act 2008; and
- Financial Services Rule Book Part 8 – Risk Management and Internal Control

Introduction

Rule 8.16 of the Financial Services Rule Book requires licenceholders to obtain the prior consent of the Authority before delegating any material management or business functions. This guidance outlines the Authority's policy and requirements in relation to outsourcing/delegation of functions.

Outsourcing is a widespread business practice. Its potential advantages include:

- Access to specialist services, skills and knowledge, which the licenceholder could not otherwise provide to its clients;
- Improved service to clients;
- Access to intellectual property such as proprietary software;
- Freeing management to concentrate on developing the core business and areas in which it has a competitive advantage;
- Possible cost-savings;
- Centralisation of core functions within groups, to reduce or eliminate duplication.

However, outsourcing brings a number of risks, which the business must manage. These include:

- Reliance on the provider, including loss of in-house capability and the need to have a recovery plan in the event of a breakdown of the outsourcing relationship;
- Loss of control of data;
- Risks to data security;
- Remoteness of the outsourced function from decision making; and
- Potential difficulties in monitoring and intervening in standards of service.

The Authority expects all proposals to outsource services or functions to include the maintenance of adequate management control over the functions. Scrutiny by compliance, internal audit, external audit, regulators and (where applicable) a scheme trustee or fiduciary custodian should also be maintained.

In assessing proposals, the Authority will take into account the possibility that certain risks may not apply, or may be more easily addressed, in cases of outsourcing to other entities within the same economic group.

This guidance deals primarily with regulatory issues related to outsourcing. Legal or other issues may also be relevant and should be considered by the licenceholder's management.

While recognising the potential benefits of outsourcing for the licenceholder, the Authority's principal

consideration will be the interests of depositors, investors or other customers. This guidance is not intended to encourage outsourcing; the Authority generally prefers licenceholders to conduct functions in-house, in so far as this is practicable.

What constitutes a Material Function?

A function is “material” if a weakness in, or a failure of, the delegate’s ability to perform the function would have a significant impact upon the licenceholder’s ability to conduct its operations in a proper manner. This includes, for example, functions that are part of, or are essential to:

- the management of the licenceholder;
- effective delivery of the licenceholder’s services to its clients – for example, outsourced IT functions for a licenceholder whose business model is highly IT dependent, such as an online bank or payment service provider;
- the conduct by the licenceholder of regulated activities; and
- the licenceholder's ability to comply with the regulatory requirements as defined in rule 8.2.

Licenceholders may seek clarification from the Authority if they are in doubt as to whether an activity should be considered material. Irrespective of whether outsourcing is material, rule 8.16(4) requires the arrangement to be evidenced in writing.

Prudential and policy issues

Some material services that are provided by licenceholders are commonly or necessarily segregated. These include custody arrangements, clearing facilities and disaster recovery. In such cases there is a presumption in favour of properly structured outsourcing to a suitable delegate.

The Authority would not consent to any proposal for a delegation of functions which was so extensive as to leave the licenceholder in breach of the real presence requirement of the Licensing Policy, or which would deprive depositors, investors or other customers of the protection of the Isle of Man regulatory framework.

Submitting a proposal

Before submitting proposals to the Authority, decisions to outsource material functions should be considered by the “responsible officers” (the Board of locally incorporated licenceholders or the local senior management of licenceholders that are not locally incorporated). The responsible officers should consider and document the risks of the outsourcing and any mitigating factors.

Proposals to outsource material functions should be submitted to the Authority in writing well in advance of the proposed commencement date. The degree of detail that the Authority will require will depend on the functions that the licenceholder proposes to outsource and the service provider to be used.

Typical questions that the Authority may ask are at Appendix 1.

The licenceholder should conduct appropriate due diligence as part of the process of selecting a provider of outsourced services.

The Authority will require sight of the draft outsourcing agreement (or other legal agreement) between the licenceholder and other parties involved and followed up by a copy of any final agreement, once it has been signed.

Outsourcing must not restrict the Authority's access to information. Agreements must ensure that the licenceholder can provide to the Authority any information relating to the outsourced activity that it requires in order for the Authority to carry out its visits, supervision and other functions.

Assessment of proposals

Proposals will be considered on a case by case basis. The Authority reserves the right to refuse consent although the proposal may appear to comply with these general principles. Conversely, the Authority may grant consent for proposals which do not strictly meet the criteria, if the merits of the specific case justify such a decision.

In assessing a proposal from a licenceholder to outsource functions, the Authority will consider the proposal against criteria in the Licensing Policy. In particular, the Authority will consider whether the real presence test will continue to be met and the "mind and management" of the licenceholder and control of its operations will remain in the Isle of Man. The Authority's approach will be restrictive in respect of outsourcing the regulated activities for which the licence is required. The Authority will primarily take account of five main considerations;

- Is the delegation appropriate and not against customers' interests?
- Will the licenceholder continue to be in a position to monitor the outsourced functions following the outsourcing?
- If the delegation were to break-down would the licenceholder be able to carry out or resume control of the delegated function?
- Will the Authority continue to be in a position to supervise adequately the activities of the licenceholder following the outsourcing? and
- Is there potential reputational risk for the licenceholder or the Isle of Man in permitting the outsourcing?

The following principles are also relevant:

1. Consent to outsource is based on the facts at the time

The Authority reserves the right to review its consent to outsource functions, and if necessary to withdraw that consent, if there is a change to any of the circumstances under which the consent was granted.

2. Supervision must not be compromised

The Authority must be able to continue to supervise the outsourced functions. The licenceholder should remain in a position to satisfy the Authority's reporting requirements. The licenceholder should be able to provide access to documents and accounting records in relation to the outsourced activities during the visit process. Consent is unlikely to be granted for functions to be transferred to entities or jurisdictions where visits by the licenceholder's staff, external auditors or Authority staff would be impractical or would be prohibited.

The decision will take into account whether the licenceholder has full electronic access to the records held by the delegate at all times without recourse to third parties. In some circumstances it may be possible to make suitable alternative arrangements with external auditors or with financial regulators.

3. Compliance with the Financial Services Act 2008 must be maintained

Licenceholders should ensure that any proposed outsourcing of a regulated activity does not breach the general prohibition in section 4 of the Act. Some exemptions from licensing are available only to employees or subsidiaries of a licenceholder.

4. Outsourced regulated activities should be conducted by regulated entities

In general, consent for functions to be outsourced outside the Isle of Man will only be granted where the outsourcing is to a regulated entity in a jurisdiction with a standard of regulation or supervision equivalent to the Isle of Man. The Authority will exchange information with the home regulator. The delegate must give consent to its home regulator releasing relevant information to the Authority, where such consent is necessary under local laws.

5. Compliance with AML/CFT requirements must be maintained

If original evidence of client identity is being held off-Island, the Authority would expect copies to be readily available to staff conducting regulated functions and to the Authority's officers during a visit.

6. Compliance with Data Protection requirements must be maintained

If outsourcing would result in client data being held off Island licenceholders should; address their obligations under data protection and other legislation to protect clients' personal data; and, make clients aware of this fact and of the location where their data will be held.

7. Effective monitoring and control should be in place

The licenceholder's management must satisfy itself and the Authority that adequate procedures are in place to monitor and control the outsourced functions on an ongoing basis.

The licenceholder's management remains responsible for outsourced functions as if no outsourcing had taken place (see for example rule 8.16(2) and rule 8.2). The Authority will hold the licenceholder's management responsible for ensuring that the outsourced functions are carried out to an appropriate standard and that the integrity of the licenceholder's systems and controls is maintained.

Depending on the nature of the outsourced function, arrangements for Board oversight may include appointing a suitable individual to monitor the performance of the outsourced function and report to the Board.

In order to demonstrate compliance with rule 8.16(3)(b), the Authority expects licenceholders to maintain a schedule of all delegations and outsourcing arrangements made under rule 8.16. For each function, the Authority would expect the schedule to contain information such as:

- name and location of the service provider;
- description of the outsourced/delegated activity;
- consideration of materiality;
- date of Authority consent (if applicable);
- implementation date;
- details of any sub-contractor (where applicable);
- reference to the legal document detailing the outsourcing arrangement between the parties;
- information as to any clients affected;
- date of last review undertaken to monitor performance;
- name of the individual appointed to monitor the performance of the outsourced function and report to the Board;
- when the insurer was advised;
- date of termination of the arrangement.

The schedule should be maintained by compliance or risk, and it can be used to consider independent monitoring work (as part of compliance or internal audit plans).

8. Outsourcing to group entities is preferred

The Authority is more likely to consent to outsourcing to other group entities. This reflects the degree of common systems, control and responsibility between the licenceholder and the service provider.

Where the Isle of Man licence is granted to a branch which is reliant upon centralised functions (as is common in the case of deposit takers), the nature of the branch/parent relationship will be taken into account. The real presence test of the Licensing Policy will however continue to apply.

9. Contingency planning

Licenceholders which propose to outsource functions should have contingency plans in place in the event of an outsourcing agreement being suddenly terminated, failure of the delegate to perform, or the insolvency of the delegate.

10. Sub-contracting

If a delegate plans to further outsource or sub-contract any of the functions, this is viewed as an event needing consent under rule 8.16, because it is a material change to the basis on which consent was given to the delegation. Some arrangements may be exempt from this requirement, e.g. global custody arrangements.

FAQs: Matters that can arise in specific types of outsourcing

1. Outsourcing, of IT support, including cloud computing

Businesses are increasingly IT-reliant. Many licenceholders now rely on specialist providers of IT services rather than running their IT in-house.

The Authority's approach is principles-based and takes into account the stance of other regulators.¹ The Authority does not assess the technical merits of particular proposals; instead it focusses on what steps the management of the business has taken.

Some licenceholders make use of cloud computing. Cloud computing may give rise to issues in respect of data protection. Licenceholders should give particularly careful consideration to data security and data protection issues before using cloud computing for personal data or other business-critical data. The Authority would strongly recommend prior consultation with the Isle of Man Information Commissioner before considering such a move for personal data, in relation to the eighth data protection principle:

"Personal data shall not be transferred to a country or territory outside the Island unless it provides an adequate level of protection for the rights and freedoms of data subjects in relation to the processing of personal data."

2. Maintenance of security, including cyber security

Licenceholders should consider whether the proposed outsourcing may have other security implications, including for the physical security of the licenceholder's premises and for cyber security.

Depending upon the nature of the services obtained, this could involve checking the service provider's hiring and staff screening procedures and might include reviewing and taking technical advice where necessary, on the standards of the service provider's [Cyber Security](#) and any risks to the licenceholder's own systems that might arise.

Licenceholders should consider whether to make data security standards contractually binding and subject to inspection under the outsourcing agreement.

3. Licenceholders seeking compliance support

The Authority would only expect to see outsourcing of compliance services by a larger licenceholder in response to a specific short-term need i.e. to cover a temporary vacancy or support in-house compliance for a particular project.

In smaller licenceholders the use of external compliance support can bring in specialist expertise and can improve segregation from the day-to-day operations of the licenceholder. Where outsourced compliance services are used, a licenceholder must address the need to build and maintain a

¹ In July 2016 the UK FCA published a document FG 16/5 - Guidance for firms outsourcing to the "cloud". The FCA's framework includes tables of matters to consider (pages 6 to 11) which may be useful to licenceholders.

compliance culture within the organisation and to build in-house capability. In addition to the obligation upon the Board as a whole, it may be appropriate for a director of the licenceholder to be appointed as the Head of Compliance under rule 8.21 and be responsible for the managerial oversight of the compliance services and bringing compliance issues before the Board.

Provision of services between licenceholders

The principles contained in this guidance apply to all licenceholders. Additional issues will need to be considered in certain circumstances, e.g. the ability of an Isle of Man-based trustee or fiduciary custodian of a collective investment scheme to perform its functions where fund administration functions are outsourced to a delegate outside the jurisdiction.

Agreements between licenceholders under Class 3(9) or Class 7 must be documented. Licenceholders which are permitted to manage another licenceholder must also be in a position to satisfy the Authority that any proposals for outsourcing are consistent with the maintenance of a real presence by the managed entity.

Provision of services on an outsourced basis by the licenceholder

Any licenceholder which provides services on an outsourced basis to other parties, whether or not themselves licenceholders, is obliged to apply the requirements of the Rule Book to that activity in full.

Acceptance of insourcing may require:

- An application for an extension of a licence, if it involves the conduct of new regulated activities; and/or
- A revision to the licenceholder's business plan under rule 8.11, which may require the provision of an updated plan to the Authority.

APPENDIX 1

Typical questions in relation to proposed outsourcing

Details of the proposed outsourcing

- I. A copy of the draft outsourcing agreement and service level agreement if separate. The agreement should provide for access to information by the Authority. (Subsequently, a copy of the outsourcing agreement once it has been signed).
- II. The proposed implementation date
- III. The rationale for the outsourcing
- IV. Due diligence being undertaken by the licenceholder
- V. Contingency plan if the outsourcing is unsuccessful
- VI. Is sub-delegation permitted – and if so how is it monitored and controlled?
- VII. List of clients if applicable.
- VIII. Notification to clients, if any is planned
- IX. Any changes to level of protection of clients' assets or data?
- X. Details of any overseas regulator. The Authority may contact the regulator.

Organisation, Corporate governance and compliance

- I. A management and staff plan reflecting any proposed changes to the structure
- II. Fitness and propriety assessment forms, as applicable
- III. Proposals for oversight and management controls, including any changes to procedures
- IV. Identified risks and proposals for risk management
- V. Any PII implications and arrangements for the extension of PII cover
- VI. Compliance arrangements
- VII. Any changes to the business resumption plans

Business planning

- I. Any changes to the corporate strategy of the licenceholder
- II. Updated business plan, if applicable

AML-CFT

- I. Proposals for AML/CFT compliance
- II. AML/CFT risk assessment of any new technological developments
- III. Proposals for the achievement of equivalent AML-CFT standards if the outsourced services are being provided from off-Island

APPENDIX 2

Typical conditions that the Authority may impose on licenceholders outsourcing material functions

This list is not intended to be exhaustive and not all of these conditions would necessarily be applied in every case.

- Delegations must be covered by mandates or agreements.
- Mandates must be capable of being amended or withdrawn.
- The Authority must be notified in advance of significant changes to mandates.
- Delegations must be only to group entities or to regulated entities in jurisdictions acceptable to the Authority.
- Delegates must be sufficiently qualified and capable of undertaking delegated functions.
- Sub-delegation is not permitted without the consent of the Authority.
- Delegations to certain types of delegates may be prohibited, e.g. delegation of investment management by a fund manager to a trustee would not be permitted.
- The licenceholder must retain ultimate responsibility for, and be capable of monitoring, the delegated functions.
- The licenceholder must retain legal responsibility/liability for the outsourced functions.
- The Authority must be able to continue to exercise supervision over outsourced functions, e.g. visits to delegate or its jurisdiction should not be prohibited.
- The jurisdiction in which the delegate is located must be recognised by the Authority as having equivalent standards of regulation or supervision and the regulator must be willing to cooperate with the Authority.
- The Licenceholder should confirm that the PII Insurance Company has been advised and the Authority notified if it impacts on the current PII policy.
- The Licenceholder has considered the risks and updated its policies and procedures accordingly.

APPENDIX 3

Use of overseas company formation agents by Class 4 licenceholders

This appendix to the guidance note provides additional information to Class 4 licenceholders (“CSPs”) on the application of the guidance note in circumstances where a CSP uses an overseas company formation agent to supply a company from that jurisdiction.

About half of the companies managed or administered by CSPs are incorporated outside the Isle of Man.

This appendix is to help CSPs assess whether such arrangements are material outsourcing for the purposes of the guidance note.

In most of these cases the overseas company formation agent has a limited role in carrying out local statutory compliance and the bulk of the administration of the company is carried out by the Isle of Man CSP. Examples of the activities that might typically be carried out by an overseas company formation agent include:

- Formation and supply of the company;
- Provision of registered office;
- Maintaining registers at the registered office;
- Filing returns at the local companies registry;
- Paying filing fees;
- Acting as registered agent or a company officer, where this is required by the local law;
- Registering business names.

The arrangement with the overseas company formation agent would not be regarded as material outsourcing if it was restricted to the activities listed above.

However, the Authority is likely to view an arrangement as material outsourcing if it includes:

- Supplying officers (other than to a minimum level required by local statute)
- Operating bank accounts or brokerage accounts;
- Otherwise controlling the company’s assets;
- Administration of the company’s affairs;
- Ongoing contact with the client or beneficial owner.