

Guide to Sound Practices for Outsourcing by Investment Managers



Executive Summary

Outsourcing arises where a regulated entity enters into an arrangement with another party (including a related company) to have that party provide a service or perform a regulated business activity that currently is, or could be, undertaken by the regulated entity itself.

Investment managers often use outsourcing for one or more of the following reasons:

- reducing and controlling operating costs;
- improving the investment manager's corporate focus;
- gaining access to expert capabilities not available in-house;
- freeing up internal resources for other purposes;
- streamlining or increasing efficiency for time-consuming and/or repetitive functions; and/or
- maximising the use of external resources.

An investment manager should not take the decision to outsource lightly. It should consider the reasons to outsource listed above and create a checklist of its own reasons for each decision to outsource. In some jurisdictions, the regulator requires the investment manager to be able to justify objectively decisions to delegate or outsource functions and remain liable for the acts and omissions of its delegates. Even where this is not the case, the investment manager's internal governance process may benefit from the preparation of such a checklist and help the investment manager be prepared to address questions from regulators or investors.

While each outsourcing arrangement differs, some types of risks arise in relation to all types of outsourcing arrangements. If the outsource service provider ('OSP') fails to deliver, the investment manager will face one or more of the following risks:

- the risk that the investment manager will be unable to provide services to its clients as contracted or to the required standard;
- the risk to the investment manager's reputation with clients, prospective clients and the relevant regulator(s) if it is unable to provide services to one or more of clients as contracted or to the required standard;
- the risk that the investment manager will be unable to comply with its legal and/or regulatory obligations;
- the risk that the arrangement conflicts with its obligation to act in the best interests of its clients;
- the risk that the investment manager will suffer an operational failure causing loss to the investment manager and/or its clients; and
- the risk that the investment manager may be held liable for the acts and omissions of the outsource service provider.

These risks can be magnified or intensified, depending on the circumstances, where:

- the OSP operates in a country other than the one where the investment manager is located;
- more than one service, activity or function is outsourced by the investment manager to the same OSP; and
- the OSP is the dominant or sole provider of the outsourced service, activity or function and is relied on by many other entities, especially where the failure of one of those relying entities could lead to a failure of the OSP.

With respect to each existing and prospective outsourcing arrangement, the investment manager should seek to identify whether any of these risks, or other more specific risks, are presented as a result of the arrangement and then seek to mitigate, manage and monitor any risks that cannot be avoided.

When outsourcing, an investment manager should follow certain general principles of risk management as a matter of sound practice, although in some jurisdictions certain aspects of these will be mandatory.

In this regard, regulatory risk management obligations that generally apply to all outsourcing arrangements may be summarised as follows and are discussed in greater detail in the Guide:

- an investment manager should seek to ensure that each outsourcing arrangement is not in conflict with its obligation to act in the best interests of its clients;
- outsourcing should not limit the ability of an investment manager's regulator to supervise the performance of the services or activities (see **Section 2.6** of the Guide);
- an investment manager and its senior management continue to be responsible/accountable for the outsourced services and activities. This responsibility/accountability is not capable of delegation (see **Section 3** of the Guide);
- where the outsourced activities are regulated, an investment manager's written procedures and monitoring must ensure compliance with applicable laws and regulations (see **Section 3.1** of the Guide);
- an investment manager must retain the knowledge and expertise to monitor the performance (and associated risks) of the outsourced services and activities (see **Section 3.2** of the Guide);
- an investment manager should carry out due diligence before entering into any outsourcing arrangements, and thereafter, monitor performance and action any concerns (see **Section 4** of the Guide);

- an investment manager should ensure that the protection of client confidentiality and data protection are maintained regardless of the outsourcing, and comply with the data protection and privacy requirements set by applicable regulators for the investment manager and its clients (see **Section 4.5** of the Guide);
- the outsourcing arrangement should be memorialised in a legally binding written document (see **Section 6** of the Guide);
- an investment manager should ensure it gets rights of access to the premises of the OSP and the right to audit the OSP's books and records, and is able to perform the necessary supervision in due time and depth (see **Section 6** of the Guide); and
- an investment manager should make provisions for termination and continuity of services, as well as disaster recovery and periodic testing of backup facilities of the investment manager and the OSP (see **Section 9** of the Guide).

An investment manager should only enter into an outsourcing arrangement where the benefits to be achieved from the outsourcing outweigh the costs and additional risks associated with outsourcing, which the investment manager would not otherwise face but for the outsourcing arrangement.

The key to achieving the appropriate risk/reward balance in connections with outsourcings:

- maintaining oversight by the investment manager's governing body and senior management (see **Section 3** if the Guide), as well as good governance generally;
- exercising sound risk management (see **Section 7** of the Guide); and
- developing and implementing sound internal controls (see **Section 8** of the Guide).

While regulators globally have published principles and best practices governing outsourcing arrangements which are of general application, these differ between jurisdictions and types of asset management activities. Typically - though to varying degrees - these are prescriptive as to the requirements to be fulfilled before outsourcing may be permitted. Although the Guide does identify examples where specific regulators have prescribed requirements, this should not be regarded as exhaustive and investment managers should apply with the requirements specifically applicable to their businesses in all events. Where the Guide identifies practices that are not specifically required by their particular regulators, investment managers should consider these as a matter of sound practice to the extent they do not conflict with the requirements applicable to them.

Table of Contents

1. What is "outsourcing" and why do investment managers do it?

- 1.1 Reasons to outsource
- 1.2 Risks and risk management associated with outsourcing
- 1.3 Cost benefit analysis

2. Regulation of outsourcing

- 2.1 Specific obligations in relation to "material" outsourcing arrangements
- 2.2 Right of access
- 2.3 Right of inspection
- 2.4 Legal and regulatory responsibilities unaffected by outsourcing

3. Governance and oversight of outsourcing arrangements

- 3.1 Establishing a governance and control framework
- 3.2 Oversight, supervision and control

4. Selecting an OSP

- 4.1 Quotes and tenders
- 4.2 Frequently identified risks in OSPs
- 4.3 Impact on strategy and operations
- 4.4 Cross-border outsourcing
- 4.5 Intra-group outsourcing
- 4.6 Due diligence checks and site visits
- 4.7 Information technology security and business continuity at the OSP
- 4.8 Information/data security implications

5. Approving an OSP arrangement

6. Outsourcing contracts

- 6.1 Common terms
- 6.2 Agreements relating to cloud computing

7. Service levels

- 7.1 Service level agreements (SLAs)
- 7.2 Standard operating procedures (SOPs)
- 7.3 Key performance indicators (KPIs)

8. Implementation, management and monitoring

- 8.1 Implementation
- 8.2 Management
- 8.3 Monitoring
- 8.4 Periodic review of written agreement, SLAs and SOPs

9. Contingency and exit planning

10. Recordkeeping

11. Other considerations

- 11.1 Client notifications and consents
- 11.2 Other contractual obligations

Appendix A: AIMA Working Group Members

Appendix B: About AIMA

Due Diligence Questionnaires:

- Alternative Data Vendors
- Clearing Members
- Fund Administrators
- Fund Directors
- Investment Managers
- Liquid Alternative Funds
- Outsourcing Service Providers
- Prime Brokers
- Vendor Technology and Cyber Security

Guides and Guidance Notes:

- Expense Allocation
- Fund Directors' Guide
- Guide to Liquid Alternative Funds
- Guide to Managed Accounts
- Implementing MiFID II
- Side Letter Guidance

Guides to Sound Practice:

- Business Continuity Management
- Cyber Security
- Fund Administration
- Investor Relations
- Media Relations
- Operational Risk Management
- OTC Derivatives Clearing
- Outsourcing by Investment Managers
- Paying for Research[^]
- Platforms^{*}
- Private Credit^{*}
- Selecting a Prime Broker
- Valuation of Investments

* Forthcoming ^ Update in progress

Electronic copies of the full *Guide to Sound Practices for Outsourcing by Investment Managers* is available to AIMA member contacts via the AIMA website. The electronic copies are subject to a limited licence and are reserved for the use of AIMA members only.

For further details on AIMA membership, please contact Fiona Treble (ftreble@aima.org), who will be able to assist you.

About AIMA

AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA has an active influence in policy development and provides leadership in industry initiatives such as educational programmes and areas of sound practices. AIMA has developed long-term relationships with regulators worldwide and has built a close collaboration with many investors in alternative funds.

AIMA provides a global network for its members. Its primary membership is drawn from the alternative funds industry whose managers pursue a wide range of modern asset management strategies. AIMA's manager members collectively manage more than \$2 trillion in assets.

AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists.

For further information, please visit AIMA's website, www.aima.org.



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