

# K&LNGAlert

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## Investment Management

### NASD Notice to Members 05-48: Member's Responsibilities When Outsourcing Activities to Third-Party Service Providers

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The National Association of Securities Dealers ("NASD") recently issued a Notice to Members 05-48 (the "Notice") providing guidance to govern members in relation to outsourcing arrangements with third-party service providers. As outsourcing arrangements have gone beyond the mere use of clearing agreements and members regularly enter into arrangements with entities other than registered member broker-dealers, the Notice establishes NASD policy that outsourcing arrangements do not relieve members of the ultimate responsibility for compliance with federal securities laws, NASD rules and Municipal Securities Rulemaking board ("MSRB") rules, regarding outsourced activity function. The Notice establishes that even outsourced activities, performed by a third party are required to be subject to a supervisory system and written supervisory procedures pursuant to NASD Rule 3010, as if they were performed by the member itself.

#### BACKGROUND

NASD and the New York Stock Exchange ("NYSE") conducted a joint survey of member broker-dealers throughout October 2004 (the "Survey") to ascertain the dynamics of members' outsourcing activities. The Survey indicated that, in general, there is: (i) a lack of written procedures to monitor outsourcing; (ii) a lack of business continuity plans on the part of service providers; and (iii) a lack of formalized due diligence processes to screen service providers for proficiency.

The Survey illustrated that while most respondents utilized some method to ensure compliance with federal securities laws and NASD/MSRB rules, most did not possess written procedures to ensure compliance and satisfactory performance from third-party service providers. The Notice suggests that members that do not reach a minimum level of Rule 3010 oversight should adjust their supervisory structure to ensure that outsourced arrangements: (i) are selected through a considered due diligence process, (ii) are appropriately monitored, (iii) and are not activities prohibited from being outsourced.

#### SUPERVISORY RESPONSIBILITY FOR OUTSOURCING

NASD Rule 3010 requires members to design a supervisory system and create corresponding written supervisory procedures that are appropriately tailored to each member's business structure. For members that outsource parts of their business, Rule 3010 supervisory procedures must also include procedures regarding outsourcing practices to ensure compliance with applicable securities laws and NASD rules. The Notice suggests that appropriate supervisory procedures should include the following:

- a due diligence analysis of current and prospective third-party service providers to determine whether the third-party service providers are capable of performing the anticipated outsourced activities;

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- a plan for overseeing, supervising and monitoring the third-party service providers' performance of the outsourced activities through specific policies and procedures geared to monitor the third-party service providers' compliance with the terms of outsourcing agreements;
- a plan to ascertain the continued fitness of the third-party service providers to perform the outsourced activities; and
- a plan to ensure that NASD has complete access to the third-party service providers' work product, in the same way that the NASD would have access to work product if it had been performed directly by the member.

When implementing a supervisory system overseeing outsourcing activities, the member must make its own determination that the system implemented is current and reasonably designed to achieve compliance as required under Rule 3010.

#### **DETERMINING APPROPRIATENESS OF ACTIVITIES FOR OUTSOURCING**

Supervisory policies and procedures, relating to third-party service providers, must also include a mechanism to determine whether the activities contemplated for outsourcing are appropriate for outsourcing. Although not an exhaustive list, the NASD proposes considering the following factors when determining if something is appropriate for outsourcing:

- the financial reputational and operational impact on the member firm in the event of a failure to perform;
- the potential impact of outsourcing on the member's provision of adequate services to its customers; and

- the impact of outsourcing the activity on the ability and capacity of the member to conform to regulatory requirements and changes in those requirements.

#### **ACTIVITIES PROHIBITED FROM BEING OUTSOURCED**

The Notice also establishes certain activities that would not be acceptable for member firms to outsource. For example, the performance of covered activities, requiring qualification and registration, cannot be outsourced because the person performing the activity has to be an associated person of the member, regardless of whether the person is registered with the member. In addition, as supervisory responsibility ultimately falls with the member, a member may not contract its supervisory or compliance activities out of its direct control. The NASD specifically carved out an exception, however, and indicating that members may outsource certain activities that *support* the performance of its supervisory and compliance responsibilities, such as implementing a supervisory system designed by another party (*i.e.*, a software program that detects excessive trading in customer accounts).

For additional information on NASD Notice to Members 05-48, please contact your K&LNG attorney.

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