

Overwhelmed? Consider Outsourcing — Carefully!

Law360, New York (January 25, 2012, 1:51 PM ET) -- In these days of ever-expanding responsibilities and shrinking budgets, compliance departments are pushed to do more with less. One way that firms and/or compliance departments are looking to address the disparity between too much to do and not enough human capital is to outsource some of their responsibilities.

This move comes with its own risks. Regulators expect firms to supervise the outsourcing of duties and have recently put firms on notice of their intent to focus on this issue. To demonstrate their commitment to this area, regulators have proposed new rules, and even before these rules could take effect, have brought actions for failure to properly oversee outsourced duties based on previous guidance.

The Financial Industry Regulatory Authority outlined its position on outsourcing in its Notice to Members 05-48 and in its recent rule proposal detailed in Regulatory Notice 11-14. In July 2005, the National Association Of Securities Dealers provided guidance on the accountability and supervisory responsibility for outsourced functions and the prohibition of outsourcing certain functions.[1] The notice to members stated that a firm's supervisory system and written supervisory procedures must include procedures related to its outsourcing functions, which should include a due diligence analysis of its third-party providers.[2]

The NASD further declared that firms have an initial obligation to determine whether certain activities are appropriate for outsourcing and a continuing obligation to oversee, supervise and monitor any activities that are outsourced. Finally, firms were advised not to outsource activities that require registration or to delegate their responsibilities for, or control over, any functions or activities performed by a third-party service provider.[3]

In March 2011, FINRA released Regulatory Notice 11-14, "Third Party Service Providers," requesting comments on a proposed rule "to clarify a member firm's obligations and supervisory responsibilities regarding outsourcing arrangements." The fact that FINRA is treating the 2005 notice to members as an obligation (i.e., rule) instead of best-practice guidance raises concern that all such guidance is actually a true obligation, not merely a best practice.

Under the rule proposal, the use of a third-party service provider would not relieve the firm of its obligation to comply with applicable securities laws. In addition, the proposed rule would not permit any person to engage in activities that require registration without being properly registered, and would require each firm to establish and maintain supervisory systems and procedures for any functions and activities performed by a third-party service provider.

Specifically, under the proposal, a firm would also have to perform a due diligence analysis to determine whether the third-party service provider is capable of performing the activities and whether the firm can achieve compliance with applicable securities laws.

The proposed rule also introduces new heightened requirements for clearing/carrying firms considering outsourcing arrangements. Generally, the additional restrictions require clearing/carrying firms to “vest an associated person of the firm with the authority and responsibility for the following activities”:

- the movement of customer or proprietary cash or securities;
- the preparation of net capital or reserve formula computations; and
- the adoption or execution of compliance or risk management systems.

In those instances where clearing/carrying firms enter into outsourcing arrangements under the proposed rule, firms would have to limit certain enumerated activities to persons directly subject to the control and supervision of the member, have additional supervisory procedures to oversee third-party service providers and notify FINRA of its outsourcing arrangements. The proposed rule provides exceptions for ministerial activities performed on behalf of a firm.

FINRA has also expressed its intent to focus on outsourcing through the distribution of its 2008 and 2010 examination priority letters.[4] Those letters emphasize that FINRA will focus on how firms are supervising their outsourced activities.

Even prior to the rule proposal being published, FINRA began bringing enforcement actions for firms’ failures to properly oversee their outsourced activities. Over the past several years, FINRA has brought multiple actions with the vast majority of them citing a firm’s failure to implement an audit system regarding the maintenance and preservation of its electronic records/communications by a third-party vendor.[5]

There are a few other cases worth noting. Specifically, in one case, a firm agreed to a fine of \$175,000 as part of a FINRA letter of acceptance waiver and consent in which it neither admitted nor denied that after learning, among other things, that its third-party vendor failed to properly verify new customers’ identities for anti-money laundering purposes, it failed to go back and retroactively verify the customer information not previously subjected to the verification process.[6]

Another firm was fined \$20,000 as the result of a vendor’s software programming error failing to take certain B share transactions into consideration when determining breakpoints.[7] Yet another firm was fined \$7.5 million for, among other things, failing to ensure that corrections were made to its website when the firm learned that its vendor was underreporting certain information using erroneous data.[8] The firm identified the issue and gave the third-party vendor the corrected data, but the firm failed to ensure that the vendor posted the corrected information which resulted in the firm continuing to post inaccurate information for its customers on its website.

Another firm was cited for what regulators deemed to be an improper outsourcing activity, simply for having a proprietary investment account where transactions are effected on a discretionary basis. The regulators claimed that the mere maintenance of its own discretionary account was in violation because the firm gave up control of the trading in the account.[9]

Failure to deliver prospectuses or failure to deliver them in a timely manner has also resulted in numerous FINRA outsourcing-related actions. Specifically, FINRA cited a firm with a failure, among other things, to deliver prospectuses to customers and failing to monitor and/or supervise the activities of its outside vendor contracted to deliver the prospectuses, fining the firm \$1.4 million.[10]

Another firm was fined \$1 million for failing to deliver prospectuses in a timely manner despite reports from its service provider that it was unable to procure sufficient paper copies of prospectuses from certain fund families. FINRA contended the firm failed to take sufficient steps to remedy the deficiency such as providing electronic copies of the prospectuses available to it by its third-party provider.[11]

Most recently, a firm was fined \$100,000 when it also failed to deliver customer prospectuses in a timely manner. Like the previous matter, the third-party service provider was unable to obtain an adequate supply of paper copies of fund prospectuses from the fund company. The third-party service provider met with the firm and provided exception reports showing that 4 percent to 5 percent of its customers were not receiving their prospectuses in a timely manner. According to FINRA, the firm failed to take alternative steps to remedy the problem, such as using the prospectus print-on-demand service offered by the third-party provider.[12]

So what should firms consider to minimize the risks when using a third-party service provider? The first consideration may be establishing a due diligence system in which the firm analyzes whether the activities are appropriate for outsourcing and whether the particular third-party service provider is capable of handling the activities for the firm.

Depending on the outsourced activity, the due diligence system could be anything from reviewing contracts and talking with the vendor to actually conducting an on-site visit with the firm to see its operations and to determine whether it has sufficient controls in place.

Another best practice is to have a detailed agreement which establishes the requirements and expectations of both the vendor and the member firm stating, among other things, the firm's expectation of the third-party service provider to comply with FINRA rules, U.S. Securities and Exchange Commission Regulation S-P, etc. Written agreements should also be considered when affiliates are performing the outsourced functions. Finally, firms should ensure that the third-party provider has sufficient privacy policies and practices in place to protect its customers' information.

Based on the proposed rule, once a firm determines it will outsource certain activities, written supervisory procedures and systems to monitor the performance of the third-party service provider should be established. In addition, as seen from some of the cases noted above, it is often not enough to simply identify a vendor's deficiencies as part of a firm's supervisory process. The cases demonstrate that regulators expect firms to not only correct the deficiencies going forward, but where applicable to fix any possible deficiencies retroactively.

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[1] See NASD Notice to Members 05-48 – “Outsourcing”
<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014735.pdf>

[2] Id.

[3] Id.

[4] FINRA 2008 Improving Examination Results Letter:
<http://www.finra.org/Industry/Regulation/Guidance/ImprovingExaminationResults/p038526>. FINRA 2010 Examination Priorities Letter:
<http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121004.pdf>

[5] US Financial Investments Inc., FINRA AWC No. 2009016309701 (Nov. 22, 2010), available at:
<http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=11765>; Activa Capital Markets Inc., FINRA AWC No. 2009015972001, (Oct. 18, 2010) available at:
<http://disciplinaryactions.finra.org/viewDocument.aspx?DocNb=1199> ; Coady Diemar Partners LLC, FINRA AWC No. 2008011683801, (Jul. 19, 2010) available at:
<http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=13445>; First London Securities Corporation, FINRA AWC No. 2008011589801, available at:
<http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=16467>; Dome Securities Corp., FINRA AWC No. 2009016131601, (Dec. 10, 2009), available at:
<http://disciplinaryactions.finra.org/viewDocument.aspx?DocNb=15101>

[6] Janney Montgomery Scott LLC, FINRA AWC No. 2007009458001 (Nov. 03, 2010) , available at:
<http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=13339>

[7] PlanMember Securities Corporation, FINRA AWC No. 2009016589701 (Apr. 16, 2010) , available at:
<http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=16630>

[8] Deutsche Bank Securities Inc., FINRA AWC No. 2008012808701 (Jul. 21, 2010) , available at:
<http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=16374>

[9] The discretionary account was solely for transactions; the adviser was unable to access the firm’s funds or securities.

[10] Wachovia Securities LLC, FINRA AWC No. 2007010181101 (May 01, 2009) , available at:
<http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=16685>

[11] Wells Fargo Advisors LLC, FINRA AWC No. 2010022921801 (May 04, 2011) , available at:
<http://disciplinaryactions.finra.org/viewDocument.aspx?DocNb=11155>

[12] TD Ameritrade Inc., FINRA AWC No. 2010022922701 (Aug. 11, 2011) , available at:
<http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=20469>

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