Republic of the Philippines
Department of Finance
Securities and Exchange Commission
SEC Building, EDSA, Greenhills, Mandaluyong City

SEC MEMORANDUM CIRCULAR NO. 5
SERIES OF 2014

TO	:	**ALL CONCERNED CORPORATIONS**
SUBECT	:	**GUIDELINES ON THE OUTSOURCING OF FUNCTIONS OF BROKER DEALERS**
DATE	:	**5 FEBRUARY 2014**

GUIDELINES ON THE OUTSOURCING OF FUNCTIONS BY BROKER DEALERS

WHEREAS, Section 2 of the Securities Regulation Code ("SRC") declares that it is the policy of State to, among others, establish a socially conscious, free market that regulates itself, and to promote the development of the Philippine securities market;

WHEREAS, Section 28.1 of the SRC provides that no person shall engage in the business of buying or selling of securities in the Philippines as a broker or dealer, or act as a salesman, or an associated person of any broker or dealer unless registered as such with the Commission;

WHEREAS, the Commission recognizes that as the Philippine capital market develops and expands, the volume of activities undertaken by brokers and dealers increases, and it becomes more cost effective for brokers and dealers to outsource certain activities to third party service providers ("service providers");

WHEREAS, the Commission understands that breaches by service providers in their outsourcing arrangements with brokers and dealers may lead to disruptions in the Philippine securities market, with negative consequences to the public;

WHEREAS, the SRC authorizes the Commission to formulate policies and recommendations on issues concerning the securities market, and to prepare and approve rules, regulations and orders to make effective the provisions of the SRC;

NOW, THEREFORE, pursuant to the foregoing provisions of the SRC, the Commission hereby adopts and issues the following guidelines on the outsourcing of functions by broker dealers:

Section 1. Coverage – These Guidelines shall prescribe the principles and standards which shall be observed by broker dealers in its outsourcing arrangements with service providers.

Section 2. Definitions – The following terms shall have the meaning indicated, unless the context provides otherwise:

a. **Back office functions** refer to administrative or operational functions other than material activities, such as but not limited to clearing and settlement functions, information technology ("IT"), finance and accounting, marketing and legal services.

b. **Commission** refers to the Securities and Exchange Commission of the Republic of the Philippines.

c. **Exit strategies** refer to the procedures that shall be undertaken upon the termination of the outsourcing arrangement for the orderly transfer of the outsourced documents, materials, and activities back to the broker dealer or to another service provider. In case of the latter, the transfer of the outsourced documents, materials and activities to another service provider shall be subject to and in accordance with the provisions of these Guidelines.

d. **Foreign service provider** refers to a service provider who is not licensed to do business in the Philippines and who performs the outsourced services outside the Philippine jurisdiction.

e. **Material activities** refers to activities requiring a license from the Commission, such as the buying and selling of securities in the Philippines as a broker or dealer, or acting as a salesman or associated person of a broker or dealer, and other activities of such importance that any weakness or failure in the conduct thereof shall have a significant effect on the entity's ability to comply with its statutory obligations. Factors to be considered shall include, but are not limited to, the following: financial, reputational and operational impact on the broker dealer of the failure of the service provider to perform the outsourced functions; potential impact of outsourcing on the provision of adequate services to the broker dealer's customers; potential losses to the broker dealer's customers in case of the service provider's breach; and the impact of outsourcing the activity on the ability and capacity of the broker dealer to conform with regulatory requirements and changes in requirements.

f. **Outsourcing** refers to the broker dealer's use of a service provider to perform activities that would normally be undertaken by the broker dealer itself. The term shall exclude purchasing contracts, or the acquisition by the broker dealer of services, goods or facilities without the transfer of non-public proprietary or customer information from the broker dealer.

g. **Service provider** refers to the entity which supplies goods, services or facilities to the broker dealer, which may or may not be an entity licensed by the Commission to engage in the buying or selling of securities, and which may or may not be an entity which is affiliated or otherwise connected with the broker dealer.

h. **Sub-contracting** refers to the further transfer by a service provider of the outsourced functions to another service provider.

i. **Sub-contractor** refers to the third party service provider contracted by the service provider to perform the outsourced functions in a sub-contracting arrangement.

Section 3. Scope of Outsourcing – Subject to the outsourcing principles and standards set out below, and without prejudice to pertinent rules and regulations regarding the outsourcing by banks and investment houses with quasi-banking authority, a broker dealer can only outsource its back office functions; *Provided,* further, that broker dealers must not outsource (i) material activities and (ii) any activity which involves any interaction or direct contact with the clients of the broker dealer for the purpose of buying and/or selling securities or the solicitation of investments in securities, except in cases permitted under the Securities Regulation Code, the Anti-Money Laundering Act, as amended, or other law, rule or regulation; *Provided, finally,* that clearing and settlement activities may only be outsourced to service providers who are authorized by the Commission to conduct such activities.

Outsourced activities may further be sub-contracted by the service provider; *Provided*, that the principles and standards set forth below shall be likewise applicable to the sub-contractor; *Provided, further*, that the foregoing is without prejudice to the right of the broker dealer to prohibit any further sub-contracting by the service provider; *Provided, finally,* that any further sub-contracting shall not be implemented without prior notice to the Commission as provided in Section 10 hereof.

Section 4. Service Provider

a. In the engagement of a service provider, broker dealers must conduct suitable due diligence processes to ensure that the appropriate service provider is selected, such as, but not limited to, (i) the prior assessment of the service provider's ability and capacity to perform the outsourced activities effectively, reliably and in accordance with the broker dealer's standards; (ii) the service provider's financial condition; and (iii) risk management practices.

b. In case of a foreign service provider, broker dealers must assess whether the engagement of such foreign service provider is appropriate. Further, broker dealers must conduct an enhanced due diligence, with focus on (i) the ability to effectively monitor the performance of the foreign service provider, (ii) the foreign service provider's ability to maintain the confidentiality of customer and other proprietary information, (iii) the foreign service provider's ability to execute contingency plans and exit strategies, and (iv) an analysis of the economic, social or political conditions that might adversely affect the foreign service provider's ability to perform the outsourced functions.

c. Broker dealers must monitor the performance by the service provider of the outsourced functions. In particular, broker dealers must establish standards which must be met by the service providers, and measures that will identify non-compliance or unsatisfactory performance by the service providers such as, but not limited to, the annual review of the service provider's processes, performance and compliance with the terms of the outsourcing contract.

d. Broker dealers must ensure compliance by the service providers with applicable Philippine securities laws and regulations. It shall be the duty of the broker dealer (i) to terminate the outsourcing contract in case of any failure, on the part of the service provider, to comply with Philippine laws and regulations, and (ii) to report such failure and the measures undertaken by the broker dealer to remedy the same to the Commission.

Section 5. Accountability of the Broker Dealer – The outsourcing broker dealer, its management and officers retain full legal liability and accountability to the Commission and the relevant self-regulatory organization for any and all functions that it may outsource to a service provider, to the same extent as if the outsourced activity was performed by the broker dealer itself. The broker dealer shall be responsible for ensuring that the service provider complies with the pertinent laws and regulations, and that the outsourcing arrangement does not impair or hinder the exercise by the Commission of its regulatory and supervisory powers.

Section 6. Outsourcing Contract – The broker dealer and the service provider shall execute a legally binding written contract which shall contain, among others, provisions on the following:

a. Limitations or conditions, if any, on the service provider's right to sub-contract the outsourced functions;
b. Firm and client confidentiality, such as but not limited to restrictions on disclosures to agents and employees of the service provider;
c. Responsibilities and warranties of the broker, service provider, and sub-contractor, if any;

d. Responsibilities relating to IT security and data protection, such as the service provider's duty to report any breaches in security or other similar events to the broker dealer;
e. A clear delineation of ownership of intellectual property rights in the books, records, hardware, software, and other material involved in the outsourcing arrangement;
f. Liability of the service provider to the broker dealer for breaches of the outsourcing arrangement;
g. Obligation of the service provider to provide, upon request, records, information and/or assistance concerning the outsourced activities to the broker dealer, its auditors, and/or the Commission;
h. Dispute resolution mechanisms and choice of law provisions, if applicable;
i. Business continuity provisions; and
j. Contract termination provisions and exit strategies, including the following:
    1. Events that may cause the pre-termination of the contract;
    2. Termination rights in case of insolvency, liquidation, receivership, changes in ownership, non-compliance with regulatory requirements, or poor performance;
    3. Transition periods; and
    4. Intellectual property rights and procedures for return of information and/or materials to the broker dealer.

Section 7. IT Security and Business Continuity – Broker dealers shall take appropriate measures to ensure that:

a. Service providers have procedures to protect the broker dealers' proprietary and customer-related information and software;
b. Service providers have procedures to prevent the unauthorized access to and destruction, alteration and/or tampering of the broker dealer's data; and
c. Service providers have sufficient and up-to-date emergency procedures and disaster recovery plans.

Section 8. Client Confidentiality – Broker dealers shall ensure that service providers protect confidential customer and other proprietary information. In case the outsourcing arrangement involves the transfer of confidential customer and other proprietary information to the service provider, the broker dealer shall notify its clients, or secure their consent thereto when such is required by statutory and/or regulatory requirements, and the Commission thereof, including the steps undertaken to ensure confidentiality.

Section 9. Right of Inspection – The Commission, the broker dealer and its auditors shall have access to the records of service providers relating to the outsourced activities such as, but not limited to, the records and reports identified in SRC Rule 52.1(1) and (2), if applicable. The Commission shall, upon request, be granted information concerning activities which are relevant and proper to the conduct and exercise of its regulatory and supervisory powers. In case of a foreign service provider, the broker dealer shall be responsible for ensuring that originals, or certified true copies, of the books and records of the foreign service provider relating to the outsourced activities are maintained within the Philippine jurisdiction, which shall be accessible to the Commission; *Provided*, that records may be maintained and preserved on microfilm or electronic form; *Provided, further*, that in case of microfilm or electronic substitution, the requirements of SRC Rule 52.1(2)(F) shall be complied with.

If the records required to be maintained and preserved pursuant to the Books and Records Rule and Records Retention Rule of the SRC Rules are prepared or maintained by a service provider on behalf of the broker dealer, the service provider shall file with the Commission the written undertaking required under SRC Rule 52.1(2)(H).

The Commission shall have the right to hold the broker dealer liable for any failure of the service provider to provide copies of or access to the books and records required under this Section; *Provided*, that the foregoing shall be without prejudice to the broker dealer's right to proceed against the service provider.

Section 10. Duty to Report – The broker dealer shall promptly notify the Commission of any outsourcing arrangement involving the former, including any change in or termination of the same, within ten (10) days from the execution of the outsourcing contract or the approval of any amendment or termination thereof. The broker dealer shall, at the same time, submit a copy of the outsourcing contract, duly signed by the parties thereto, a certification that the outsourcing arrangement complies with the principles and standards herein, and its amended Written Supervisory Procedure which incorporates the nature of the outsourced activities and the safeguards and other processes or procedures adopted by the broker dealer in light of the outsourcing arrangement.

Broker dealers shall likewise notify the Commission of any contractual arrangement not falling within the definition of outsourcing, wherein the services of a third party is availed of to supplement the former's current employee or organizational structure, within ten (10) days from the execution thereof.

Section 11. Penalties – Violations of these Guidelines committed by a broker dealer or other registered person shall be penalized in accordance with Section 54 of the Securities Regulation Code. In accordance with Section 4(d)(i) above, it shall be the duty of the broker dealer to terminate the outsourcing contract in case of any failure, on the part of the service provider, to comply with Philippine laws and regulations. Moreover, the Commission is not precluded from initiating the proper action against a non-registered person acting as a service provider who violates a law or regulation.

Section 12. Transitory Provision – Within six (6) months from the effectivity of these Guidelines –

a. Broker dealers shall submit a list of all their existing outsourcing contracts, detailing the service providers involved, services outsourced, terms of the contracts, and such other information as may be necessary to show compliance with the provisions of these Guidelines; and
b. For outsourcing contracts not in accordance with the provisions of these Guidelines, broker dealers have the option to either:
    1. Preterminate the subject contract(s); or
    2. Renegotiate and/or amend the outsourcing contract to comply with the requirements of these Guidelines.

Section 13. This Memorandum Circular shall take effect fifteen (15) days following the completion of its publication in two (2) newspapers of general circulation.

11 February 2014, Mandaluyong City, Philippines.

TERESITA J. HERBOSA
Chairperson