

# K&LNGAlert

AUGUST 2005

## Investment Management

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

By Michael S. Caccese and Vivian Z. Wexler\*

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;

\* Michael Caccese is a partner in the Boston office of Kirkpatrick & Lockhart Nicholson Graham LLP. He works extensively with investment firms on compliance issues, including all of the CFA Institute standards. He previously was the General Counsel to AIMR and was responsible for overseeing the development of AIMR-PPS, GIPS and other standards governing the investment management profession and investment firms. He can be reached at 617.261.3133 and [mcaccese@kling.com](mailto:mcaccese@kling.com). Vivian Z. Wexler is an associate with K&LNG in the Boston office and can be reached at 617.951.9045 or [vwexler@kling.com](mailto:vwexler@kling.com).

- 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.

---

**Michael C. Caccese**  
 mcaccese@klng.com  
 617.261.3133

**Vivian Z. Wexler**  
 vwexler@klng.com  
 617.951.9045

If you have questions or would like more information about K&LNG's Investment Management Practice, please contact one of our lawyers listed below:

#### BOSTON

Michael S. Caccese 617.261.3133 mcaccese@klnng.com  
Mark P. Goshko 617.261.3163 mgoshko@klnng.com  
Thomas A. Hickey III 617.261.3208 thickey@klnng.com  
Nicholas S. Hodge 617.261.3210 nhodge@klnng.com  
George J. Zornada 617.261.3231 gzornada@klnng.com

#### LONDON

Philip J. Morgan 44.20.7360.8123 pmorgan@klnng.com

#### LOS ANGELES

William P. Wade 310.552.5071 wwade@klnng.com

#### NEW YORK

Robert J. Borzone, Jr. 212.536.4029 rborzone@klnng.com  
Jeffrey M. Cole 212.536.4823 jcole@klnng.com  
Ricardo J. Hollingsworth 212.536.4859 rhollingsworth@klnng.com  
Beth R. Kramer 212.536.4024 bkramer@klnng.com  
Richard D. Marshall 212.536.3941 rmarshall@klnng.com  
Keith W. Miller 212.536.4045 kmiller@klnng.com  
Scott D. Newman 212.536.4054 sneyman@klnng.com

#### SAN FRANCISCO

Jonathan D. Joseph 415.249.1012 jjoseph@klnng.com  
David Mishel 415.249.1015 dmishel@klnng.com  
Timothy B. Parker 415.249.1042 tparker@klnng.com  
Mark D. Perlow 415.249.1070 mperlow@klnng.com  
Richard M. Phillips 415.249.1010 rphillips@klnng.com

#### WASHINGTON

Clifford J. Alexander 202.778.9068 calexander@klnng.com  
Diane E. Ambler 202.778.9886 dambler@klnng.com  
Mark C. Amorosi 202.778.9351 mamorosi@klnng.com  
Catherine S. Bardsley 202.778.9289 cbardsley@klnng.com  
Arthur J. Brown 202.778.9046 abrown@klnng.com  
Arthur C. Delibert 202.778.9042 adelibert@klnng.com  
Jennifer R. Gonzalez 202.778.9286 jgonzalez@klnng.com  
Robert C. Hacker 202.778.9016 rhacker@klnng.com  
Kathy Kresch Ingber 202.778.9015 kingber@klnng.com  
Michael J. King 202.778.9214 mking@klnng.com  
Rebecca H. Laird 202.778.9038 rlaird@klnng.com  
Deborah A. Linn 202.778.9874 dlinn@klnng.com  
Cary J. Meer 202.778.9107 cmeer@klnng.com  
R. Charles Miller 202.778.9372 cmiller@klnng.com  
Dean E. Miller 202.778.9371 dmiller@klnng.com  
Charles R. Mills 202.778.9096 cmills@klnng.com  
Jean E. Minarick 202.778.9029 jminarick@klnng.com  
R. Darrell Mounts 202.778.9298 dmounts@klnng.com  
C. Dirk Peterson 202.778.9324 dpeterson@klnng.com  
David E. Pickle 202.778.9887 dpickle@klnng.com  
Alan C. Porter 202.778.9186 aporter@klnng.com  
Theodore L. Press 202.778.9025 tpress@klnng.com  
Francine J. Rosenberger 202.778.9187 francine.rosenberger@klnng.com  
Robert H. Rosenblum 202.778.9464 rrosenblum@klnng.com  
William A. Schmidt 202.778.9373 william.schmidt@klnng.com  
Lori L. Schneider 202.778.9305 lschneider@klnng.com  
Lynn A. Schweinfurth 202.778.9876 lschweinfurth@klnng.com  
Donald W. Smith 202.778.9079 dsmith@klnng.com  
Martin D. Teckler 202.778.9890 mteckler@klnng.com  
Robert A. Wittie 202.778.9066 rwittie@klnng.com  
Robert J. Zutz 202.778.9059 rzutz@klnng.com



BOSTON • DALLAS • HARRISBURG • LONDON • LOS ANGELES • MIAMI • NEWARK • NEW YORK • PALO ALTO • PITTSBURGH • SAN FRANCISCO • WASHINGTON

Kirkpatrick & Lockhart Nicholson Graham LLP (K&LNG) has approximately 1,000 lawyers and represents entrepreneurs, growth and middle market companies, capital markets participants, and leading FORTUNE 100 and FTSE 100 global corporations nationally and internationally.

K&LNG is a combination of two limited liability partnerships, each named Kirkpatrick & Lockhart Nicholson Graham LLP, one qualified in Delaware, U.S.A. and practicing from offices in Boston, Dallas, Harrisburg, Los Angeles, Miami, Newark, New York, Palo Alto, Pittsburgh, San Francisco and Washington and one incorporated in England practicing from the London office.

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

Data Protection Act 1988 - We may contact you from time to time with information on Kirkpatrick & Lockhart Nicholson Graham LLP seminars and with our regular newsletters, which may be of interest to you. We will not provide your details to any third parties. Please e-mail cgregory@klnng.com if you would prefer not to receive this information.