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Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
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Submitted via email to: fsb@fsb.org

08 January 2021

Dear Sir or Madam,

Re: AIMA response to the Financial Stability Board's discussion paper entitled "Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships"

The Alternative Investment Management Association (AIMA)¹ appreciates the opportunity to provide feedback in response to the Financial Stability Board (FSB) discussion paper entitled "Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships" and dated 9 November 2020.²

Investment managers have increased outsourcing of certain functions

Outsourcing is widely and increasingly used across the investment industry. With clear advantages including operational efficiencies and cost-effectiveness, it is highly unlikely that this trend will slow or reverse in the future. We appreciate, however, that if not properly managed then outsourcing can also entail challenges such as data protection and cyber security. Therefore, we support the FSB in its objective to facilitate a broader discussion on current regulatory and supervisory approaches to the management of outsourcing risks.

¹ 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's investment manager members collectively manage more than \$2 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 170 members that manage \$400 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

² Financial Stability Board Discussion Paper on Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships, November 2020 – available at: <https://www.fsb.org/wp-content/uploads/P091120.pdf>.



Given the relatively small size of most of our member firms, compared for example to a global bank or insurance company, a frequent method of accessing technologically sophisticated and cost-effective support is often to find high quality service providers. These service providers have expertise and scale to manage complex technology and train and retain staff with specialised skill sets. Outsourcing thereby allows investment managers to focus on investor appreciation, business strategies, scaling and other business objectives.

Our view is that the key to good outsourcing is appropriately managing the associated risks. In turn, allowing investment managers to benefit from economies of scale, specialisation, and access to an adequate pool of service providers. This is ultimately beneficial to the end investors. Introducing inappropriate restrictions on outsourcing could risk resulting in further frictions and costs in investment managers operations, which would be detrimental for the end investor, as well as in further fragmentation of the market.

Lessons learned from the COVID-19 pandemic regarding managing outsourcing and third-party relationships

The COVID-19 pandemic has demonstrated to many investment managers that not everything needs to be operated 'in-house'. In fact, some processes and functions might perform just as well or even better in a remote and virtualised environment.

AIMA recently conducted a Global Hedge Fund Survey,³ together with KPMG, that presented a number of questions related to outsourcing. Interestingly, 71 percent of the respondents agree that the current experience of working remotely has convinced them they could achieve better cost efficiencies if they outsource some of their operations.

Notably, the COVID-19 pandemic is catalysing investment managers to consider which functions are best performed in an office environment and which can continue to be managed remotely. Many are exploring various 'hybrid models' that allow some functions to work remotely irrespective of whether they are part of the firm or outsourced to a service provider.

Investment managers at larger, more established firms suggest that the COVID-19 pandemic has accelerated, but not changed, their existing outsourcing models and strategies. Smaller firms, on the other hand, seem to be more motivated about moving towards a more variable cost environment and are more confident in the strength and efficiency of the investment management eco-system, suggesting a broader adoption of outsourcing as a long-term business strategy.

The data from our Survey suggests that not all functions are being considered for outsourcing, however. For example, 61 percent of respondents say they are likely to outsource their administrative services and 55 percent say they will likely outsource their tax and accounting services. Yet less than five percent of respondents say they are likely to outsource their trading or CFO/treasury functions.

³ The report, *Agile and Resilient: Alternative investments embrace the new reality*, surveys 144 hedge fund managers globally, representing an estimated US\$840 billion in assets under management. The survey was conducted in real-time throughout the COVID-19 pandemic and the report also includes one-on-one insights from asset managers across the industry. https://www.aima.org/educate/aima-research/agile-and-resilient.html?dm_i=2LZ3,1ND2W,96M2Y5,5LB97,1.

The investment managers interviewed as part of our Survey seem focused on reducing the complexity of anything, they deemed non-core to their specific business. Although, they also understand that – while these functions can be outsourced – the responsibility and ownership remain with the firm. Simply put, it is the investment managers that will ultimately need to answer to any issues regarding non-compliance. We expect the role of the chief operating officer to expand even further as these senior managers oversee risks in sub-contractors and the broader supply chain.

The COVID-19 pandemic made the importance of having a strong technology backbone and infrastructure clear. Not surprisingly, therefore, the results from our Survey suggest that many investment managers and industry participants are placing significant focus into ensuring their IT and infrastructure continues to allow their people to deliver on their mission without distraction.

Half of all the firms in our research admit that, while their cloud technologies may have allowed them to operate effectively to this point in the pandemic, they are now re-evaluating their firm's cloud strategy to see how they can improve their use. Interestingly, almost 40 percent of firms say they are outsourcing their technology functions, with smaller firms almost 10 percentage points more likely than larger peers to consider this approach.

We hope that these data points provide useful context around the clear trend for increased use of outsourcing in the investment industry.

Key challenges and risk mitigants in managing outsourcing and third-party relationships

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.

We believe that 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. We believe that the investment manager's internal governance process may benefit from the preparation of such a checklist and help the investment manager be better prepared to address possible 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 service provider fails to deliver, the investment manager could 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 investment manager will suffer an operational failure causing loss to the investment manager and/or its clients; and/or
- the risk that the investment manager may be held liable for the acts and omissions of the service provider.

With respect to each existing and prospective outsourcing arrangement, we believe that it is sound practice for the investment manager to 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 might choose to 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, risk management obligations that generally apply to all outsourcing arrangements may be summarised as follows:

- 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;
- an investment manager and its senior management continue to be responsible/accountable for the outsourced services and activities;
- an investment manager should carry out due diligence before entering into any outsourcing arrangements, and thereafter, monitor performance and action any concerns;
- an investment manager should ensure any outsourcing arrangement clearly outlines the requirement for the service provider to disclose all sub-contractor relationships;
- an investment manager should ensure that the protection of client confidentiality and data protection are maintained regardless of the outsourcing;
- the outsourcing arrangement should be memorialised in a legally binding written document;
- an investment manager should ensure it gets rights of access to the premises of the service provider and the right to audit the service provider's books and records, and is able to perform the necessary supervision in due time and depth;
- 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 service provider;
- an investment manager should perform a detailed risk assessment process before entering any outsourcing arrangement; and
- a clear governance process should be in place both internally within the firm and directly with the service provider. Clear relationship contact points (both "service recipient" and "service provider") should be established for each outsourcing arrangement, which clearly outline roles and responsibilities. In addition, issue and escalation reporting lines should be defined.

We believe that it is sound practice for an investment manager to only enter into an outsourcing arrangement where the benefits to be achieved from the outsourcing outweigh the costs and additional risks associated with outsourcing.

The key to achieving the appropriate risk/reward balance in connections with outsourcing, include:

- maintaining oversight by the investment manager's governing body and senior management, as well as good governance generally;

- exercising sound risk management;
- developing and implementing sound internal controls; and
- periodic testing of operational resilience (or business continuity at a minimum) processes established for each outsourcing arrangement.

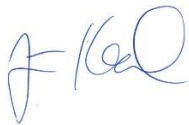
While regulators globally have published principles and best practices governing outsourcing arrangements which are of general application, these differ between jurisdictions and types of asset management activities. Typically, these are prescriptive as to the requirements to be fulfilled before outsourcing may be permitted.

AIMA's Guide to Sound Practices for Outsourcing

AIMA has published for its members a Guide to Sound Practices for Outsourcing by Investment Managers.⁴ This guide identifies suggested areas to consider, as outlined above, when outsourcing fund management operations while also referring to regulations in key jurisdictions that are relevant to outsourcing by investment managers.

We hope that you find our comments helpful and we would be happy to elaborate further on any of the points raised in this letter. For further information, please contact James Delaney, Director of Asset Management Regulation (jdelaney@aima.org).

Yours faithfully,



Jiří Król
Deputy CEO and Global Head of Government Affairs
AIMA

⁴ AIMA Guide to Sound Practices for Outsourcing by Investment Managers, February 2019 – available at: <https://www.aima.org/resource/guide-to-sound-practices-for-outsourcing-by-investment-managers.html>.