



REGULATORY

Delegation Without Abdication : The Regulatory Architecture of SEBI's Outsourcing Guidelines

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Introduction

The Securities and Exchange Board of India (“SEBI”), vide **Circular No. CIR/MIRSD/24/2011** dated December 15, 2011, issued comprehensive guidelines governing the outsourcing of activities by intermediaries registered under its regulatory purview. Promulgated in exercise of the powers conferred under Section 11(1) of the Securities and Exchange Board of India Act, 1992, this circular represents a landmark articulation of SEBI’s position on the permissible extent of outsourcing and the enduring accountability of registered intermediaries to their clients and to the regulator.

The circular was addressed to a wide spectrum of intermediaries, including:

- Merchant Bankers
- Registrars to an Issue and Share Transfer Agents
- Debenture Trustees
- Mutual Funds
- Portfolio Managers
- Venture Capital Funds
- Collective Investment Schemes
- Custodians
- Stock Brokers
- Depository Participants

Its issuance was predicated on SEBI’s observation that intermediaries were increasingly resorting to outsourcing arrangements, ostensibly to reduce operational costs and for strategic purposes, without commensurate **governance frameworks** to manage the associated risks.

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Regulatory Rationale and Definitional Framework

For purposes of the circular, **outsourcing** is defined as the engagement of one or more third parties, whether within or outside the group of the intermediary, to perform activities associated with the services offered by the registered intermediary. This definition is notable in its breadth, as it encompasses intra-group arrangements and thus subjects related-party outsourcing to the same rigour as arrangements with independent external entities.

The regulatory rationale is grounded in SEBI’s recognition that outsourcing, while commercially expedient, introduces a multitude of **risks to market integrity**. These encompass:

- Operational risk
- Reputational risk
- Legal risk
- Country risk
- Strategic risk
- Exit-strategy risk
- Counterparty risk
- Systemic risk

Drawing upon the principles advocated by the **International Organization of Securities Commissions (“IOSCO”)** and the experience of Indian capital markets, SEBI developed the present framework to address these concerns in a structured and binding manner.

Activities That Cannot Be Outsourced

The circular draws a clear and non-negotiable demarcation between activities that may be outsourced and those that constitute the **irreducible core** of an intermediary's regulated functions. Core business activities and compliance functions are expressly prohibited from being outsourced.

By way of illustration:

- The **execution of client orders** and the monitoring of trading activities constitute non-delegable functions for stock brokers.
- **Dematerialisation of securities** is similarly preserved as a core function for depository participants.
- **Investment-related activities** remain within the exclusive purview of Mutual Funds and Portfolio Managers.
- **Know Your Client (“KYC”) requirements** are separately governed by the SEBI KYC Registration Agency Regulations, 2011, and may not be circumvented through outsourcing.

The Eight Governing Principles

The substantive framework of the circular is contained in **Annexure I**, which sets out eight binding principles applicable to all outsourcing arrangements entered into by registered intermediaries.

Principle 1: Comprehensive Outsourcing Policy

The first principle mandates that an intermediary desirous of outsourcing any activity must have in place a **comprehensive outsourcing policy**. The Board of the intermediary (or its partners, as the case may be) bears overarching responsibility for its formulation, periodic review, and implementation. This principle firmly situates outsourcing governance at the apex of the intermediary's decision-making structure.

Principle 2: Outsourcing Risk Management Programme

The second principle requires the establishment of a **comprehensive outsourcing risk management programme**. Intermediaries must assess materiality and risk concentration in relation to each outsourced activity, with particular attention to the financial and operational capabilities of prospective third parties, the potential for conflicts of interest, and the sufficiency of backup arrangements.

Records pertaining to all outsourced activities must be preserved centrally and made available for corporate governance review.

Principle 3: Non-Diminution of Obligations and Accountability

The third principle enshrines the fundamental proposition that outsourcing does not diminish the intermediary's obligations to its clients or its accountability to regulators. The intermediary remains **fully liable** for outsourced activities to the same extent as if those activities had been performed in-house.

Investor rights against the intermediary are unaffected, and the intermediary bears full responsibility for the redressal of grievances arising from the conduct of third parties.

Crucially, **SEBI, its Self-Regulatory Organisations, and authorised auditors** retain unimpeded access to the facilities, premises, data, and records of third parties engaged in outsourced activities.

Principle 4: Due Diligence in Selection and Monitoring

The fourth principle imposes a duty of **due diligence** upon the intermediary in the selection and ongoing monitoring of third parties. This encompasses an assessment of:

- Financial soundness
- Compatibility of systems
- Market reputation
- Concentration risk
- In the case of foreign third parties, the regulatory environment of the relevant jurisdiction

Principle 5: Contractual Framework

The fifth principle governs the **contractual framework** that must underpin every outsourcing arrangement. Outsourcing relationships must be formalised through legally binding written contracts that comprehensively address:

- Service levels and mutual obligations
- Indemnities and liability for breach
- Sub-contracting conditions
- Confidentiality obligations (including post-contractual confidentiality)
- IT security protocols
- Disaster recovery arrangements
- Dispute resolution mechanisms
- Termination rights and exit strategies

Contracts involving foreign third parties must include **choice-of-law and jurisdictional provisions**.

Principle 6: Business Continuity and Contingency Planning

The sixth principle requires intermediaries and their third parties to establish and maintain **contingency plans**, including disaster recovery plans and periodic testing of backup facilities, to ensure business continuity in the event of operational disruption.

Principle 7: Confidentiality and Data Protection

The seventh principle obliges intermediaries to take appropriate steps to ensure that third parties protect **confidential and proprietary information**, with employee access to client data restricted strictly on a need-to-know basis.

Principle 8: Systemic Concentration Risk Safeguards

The eighth and final principle addresses **systemic concentration risk**, requiring that where a single third party is an outsourcing agent for multiple intermediaries, strong safeguards must be implemented to prevent co-mingling of information, documents, records, and assets.

Additional Regulatory Obligations

Separately, the circular provides that intermediaries shall remain responsible for reporting **suspicious transactions** to the Financial Intelligence Unit (“FIU”) or other competent authorities, notwithstanding that the relevant activities may have been carried out by a third party. This obligation reinforces the principle that the mantle of regulatory accountability cannot be transferred through outsourcing.

All intermediaries were further directed to conduct a **self-assessment** of their existing outsourcing arrangements within six months of the date of issuance of the circular, with a view to aligning such arrangements with the requirements of the guidelines.

Legal Analysis and Significance

The central legal proposition of SEBI’s outsourcing framework is the **doctrine of non-delegable accountability**. The circular categorically provides that an intermediary’s liability for outsourced activities is co-extensive with its liability for in-house activities.

This has significant practical implications: an intermediary cannot avail itself of the defence that a failure of service was attributable to the conduct or omission of a third party. The commercial allocation of risk between the intermediary and the third party, as provided in their contract, is a matter of private law and does not affect the intermediary’s regulatory and civil obligations

to its clients or SEBI.

Equally noteworthy is the treatment of **related-party outsourcing**. The circular expressly provides that risk management practices applicable to independent third-party outsourcing apply with identical rigour to arrangements with group entities or associates.

This prevents intermediaries from using intra-group structures as a mechanism to circumvent governance requirements, and ensures that the supervisory perimeter of SEBI extends to all entities performing regulated functions on behalf of intermediaries, regardless of corporate affiliation.

Conclusion

SEBI's Circular CIR/MIRSD/24/2011 constitutes a comprehensive and principled regulatory response to the growing phenomenon of outsourcing in the securities market. By anchoring accountability at the Board level, mandating strong contractual and risk management frameworks, preserving the rights of investors, and extending regulatory access to third-party operations, SEBI has ensured that the **operational efficiency gains** associated with outsourcing are not achieved at the cost of market integrity or investor protection.

For registered intermediaries, the circular is a clear reminder that the delegation of operational functions to third parties does not, in any circumstance, constitute an **abdication of regulatory responsibility**.

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