

Stricter controls for financial services outsourcing in Singapore?

Summary

In September 2014, the Monetary Authority of Singapore (“**MAS**”) issued a consultation on new standards and guidelines to ensure that financial institutions have sound risk management practices for outsourcing arrangements, which will include cloud services. We consider the impact of these proposals.

Consultation and binding force

The consultation is part of the MAS’ efforts to raise the standards of financial institutions’ risk management practices. The MAS is proposing to:

- issue a new notice on outsourcing management standards (the “**Notice**”); and
- revise the existing Guidelines on Outsourcing (last updated on 1 July 2005) (the “**Guidelines**”).

The introduction of the Notice would be significant as it would be legally binding. This is unlike the current regulatory regime (i.e. the Guidelines) which provides for “best practice” standards.

The risks to financial institutions for non-compliance will therefore be greater, including the imposition of criminal sanctions. The public consultation has now closed and there has been no indication by the MAS as to if and when the revised Guidelines and Notice will come into force.

Some of the more significant changes proposed under the new Notice are set out below. The revisions to the Guidelines provide financial institutions with guidance to ensure compliance with the obligations under the Notice.

Minimum standard for “material outsourcing arrangements”

The Notice imposes minimum standards for financial institutions in the management of all its “material outsourcing arrangements”. This is defined as an outsourcing arrangement which:

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- has the potential to materially impact an institution's business operations, reputation or profitability or adversely affect any institution's ability to manage risk and comply with applicable laws, in the event of a service failure or security breach; or
- involves customer information and, in the event of any unauthorised access or disclosure, loss or theft of customer information, may materially impact an institution's customers. "Customer information" refers to certain confidential information held by the relevant financial institution that relates to its customers, such as customers' transaction details and dealings.

The proposed revised definition of "material outsourcing arrangement" is broader than that in the Guidelines (which currently captures only outsourcing arrangements that, if disrupted, have the potential to significantly impact a financial institution's business operations, reputation or profitability). Expanding the scope to cover outsourcing arrangements involving customer information highlights the importance that MAS attributes to outsourcings involving customer information. This clarifies that financial institutions must carefully assess the potential impact of their outsourcing arrangements on their customers' information.

The minimum standards include establishing adequate risk management frameworks, systems, policies and processes to control and monitor the material outsourcing arrangements, and maintaining a central register of all material outsourcing arrangements.

Due diligence on service providers

The Notice obliges financial institutions to conduct due diligence on service providers in considering, renegotiating or renewing any material outsourcing arrangements. This must be documented and re-performed on an annual basis.

The due diligence should include assessing the service provider's corporate governance, risk management, security controls, audit, and financial strength and resources.

Audit rights

Under the Notice, service providers must not only give financial institutions the right to conduct audits, but must also allow the MAS to conduct audits where necessary or expedient. This requirement is presently found in the Guidelines and is proposed as a mandatory obligation under the Notice.

A financial institution must also indemnify the MAS for any losses to the service provider arising out of any action taken to access and inspect the service provider. The provision of this indemnity would be a new requirement that is not found in the Guidelines.

Protection of customer data

Where an outsourcing arrangement involves disclosure of customer data to the service provider, a financial institution is required under the Notice to protect that data, including:

- ensuring that the service provider isolates and clearly identifies the customer data belonging to the financial institution;
- engaging service providers that operate in jurisdictions which generally uphold confidentiality provisions and agreements;
- the inclusion of confidentiality provisions which address access to the information by the employees of the service provider, and restrictions against disclosure of such information; and
- imposing notification requirements on the service provider to notify the financial institution in the event of disclosure of customer information to third parties.

Termination and exit obligations

Certain termination provisions must be included in outsourcing arrangements, including the right for a financial institution to terminate the agreement in the event that the service provider undergoes a change of ownership, becomes insolvent, there has been a “*deterioration in the ability of the service provider to perform the service as contracted*”, the financial institution is prevented from conducting any audits or from assessing the service provider’s compliance with the outsourcing agreement, or where directed by the MAS. The scope of termination events previously existing under the Guidelines is proposed to be expanded under the Notice.

There are also notification obligations imposed on the financial institution to keep the MAS informed of such events.

Notification of material outsourcing arrangements to MAS

The new Notice and revised Guidelines would introduce more rigorous requirements on notifying material outsourcings to the MAS.

The Guidelines currently allow financial institutions to notify the MAS after they have already entered into material outsourcings. The revised Guidelines, however, would require financial institutions to notify the MAS before committing to any material outsourcings.

If the new Notice and revised Guidelines are issued in their current form, financial institutions will need to ensure that they have processes in place to engage with the MAS prior to entering into any material outsourcings.

Who is subject to these rules?

The new Notice and revised Guidelines, if issued in their current form, will apply to “financial institutions”, as defined in section 27A of the Monetary Authority of Singapore Act (Cap. 186) (the “**MAS Act**”), except that the Notice would not apply to certain institution classes described below.

The definition of “financial institutions” is wide and includes:

- any licensed bank under the Banking Act (Cap. 19);
- any approved financial institution under section 28 of the MAS Act, including merchant banks and money brokers;
- any licensed finance company under the Finance Companies Act (Cap. 108);
- any licensed money-changer or remitter under the Money-changing and Remittances Act (Cap. 187);
- any licensed insurer, or insurance intermediary regulated under the Insurance Act (Cap. 142);
- any licensed financial adviser under the Financial Advisers Act (Cap. 110);
- any licensed trust company under the Trust Companies Act (Cap. 336);
- any holder of a stored value facility under the Payment Systems (Oversight) Act (Cap. 222A);
- any trustee-manager of a business trust that is registered under the Business Trusts Act (Cap. 31A);
- any approved trustee of a collective investment scheme authorised under section 286 of the Securities and Futures Act (Cap. 289); and
- any approved holding company, securities exchange, futures exchange, recognised market operator, licensed trade repository, licensed foreign trade repository, approved clearing house, recognised clearing house, or a capital markets services licence holder under the Securities and Futures Act (Cap. 289).

As noted above, a number of institutions would not be subject to the Notice, although they may be subject to the revised Guidelines. These are:

- certain persons exempted from licensing for carrying on fund management business, such as a company registered with MAS to conduct fund management business for no more than 30 “qualified investors” under the Securities and Futures (Licensing and Conduct of Business) Regulations (“**SFR**”);
- certain persons exempted from licensing for carrying on trust business under the Trust Companies Act (Cap. 336), such as a private trust company;

- exempt corporate finance advisers relying on a licensing exemption for advising “accredited investors” (who are identified by certain net asset and income thresholds) under the SFR;
- exempt financial advisers relying on a licensing exemption for advising no more than 30 “accredited investors” under the Financial Advisers Regulations;
- captive insurers, marine mutual insurers, foreign insurers and authorised reinsurers regulated under the Insurance Act (Cap. 142);
- recognised market operators, recognised clearing houses, licensed foreign trade repositories and approved holding companies regulated under the Securities and Futures Act (Cap. 289); and
- trustee-managers of a business trust registered under the Business Trusts Act (Cap. 31A).

Impact on cloud and existing agreements

The proposed changes have potentially far-reaching consequences on the outsourcing portfolio of both financial institutions and service providers alike.

Some of these obligations (such as the audit requirements) are extremely intrusive. This is particularly the case for some commodity cloud providers who do not generally provide audit rights and instead ask customers to rely on their own security audits and certification. These proposals may therefore exclude some of such cloud providers from the market for financial services outsourcing in Singapore.

Should the Notice be issued, all affected parties will have a six month transitional period from the date of issuance to ensure compliance before the Notice comes into effect. Existing contracts will not need to be updated in accordance with the obligations, but any outsourcing agreements entered into or renewed on or after this six month transitional period will need to comply with the applicable provisions of the Notice.

Further information

If you would like to discuss the above, its implications for your existing practices and documentation, and/or any steps which ought to be taken as a result, feel free to contact **Adrian Fisher**, **Peiying Chua** or **Joel Cheang** or any of your other contacts in our Singapore office.

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