

Explanatory Statement to Superannuation Industry (Supervision) Modification Declaration No. 1 of 2007

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority

1. This Explanatory Statement accompanies Superannuation Industry (Supervision) Modification Declaration No.1 of 2007 (*MD1 of 2007*) made by APRA under section 332 of the *Superannuation Industry (Supervision) Act 1993 (the SIS Act)*. Section 332 of the SIS Act provides that APRA may, in writing, declare that a modifiable provision of the SIS Act is to have effect, in relation to a particular person or class of persons, as if it were modified as specified in the declaration. The modifiable provisions¹ include regulations made for the purposes of Part 3 of the SIS Act and therefore include regulation 4.16 the *Superannuation Industry (Supervision) Regulations 1994 (the SIS Regulations)*.

Background

Legislative background

2. Regulation 4.16 of the SIS Regulations (*the outsourcing standard*) sets out the operating standard for the outsourcing of material business activities by an RSE licensee. Subregulation 4.16(6) requires that a material outsourcing agreement between an RSE licensee and a service provider must provide that any agreement or arrangement which the service provider enters into with another service provider for the performance of a material business activity under the outsourcing agreement must itself comply with subregulations 4.16(4) and (5). This would include, for example, requirements that the arrangement between the service providers be in writing, contain liability and indemnity provisions, provide for business continuity planning and allow APRA access to the premises of, and information held by, the 'downstream' service provider.

Custodians

3. For the purposes of the SIS Act and SIS Regulations, a custodian is a person who, under a contract with a trustee or an investment manager of the entity, performs custodial functions in relation to any of the assets of the entity. An investment manager cannot appoint a custodian without the written consent of the trustee. A custodian must be a body corporate such as a trustee company, bank or specialist custodian company and must meet prescribed capital requirements or have the benefit of an approved guarantee.
4. A custodian may contract with a sub-custodian for custody services, e.g. where the custodian is required to hold assets in a number of different countries for clients (which may include superannuation trustees), the custodian may contract with a sub-custodian for the sub-custodian to hold those assets in a particular country on its behalf.

¹ *Modifiable provision* is defined in section 327 of the SIS Act.

5. APRA regards the custody of fund assets as a material business activity of a superannuation trustee and agreements between RSE licensees and custodians as material outsourcing agreements that are subject to the outsourcing standard. To the extent that agreements or arrangements between custodians and sub-custodians involve the performance of a material business activity, the agreements or arrangements would need to comply with the outsourcing operating standard, specifically subregulations 4.16(4) and (5).
6. On 29 June 2006, following representations to APRA by industry that it may not be practicable for an RSE licensee to require that agreements or arrangements between custodians and sub-custodians falling within the scope subregulation 4.16(6) comply with all requirements of subregulations 4.16(4) and (5), APRA made Superannuation Industry (Supervision) Modification Declaration No.2 of 2006 (MD2 of 2006). Compliance issues had been raised in the context of a custodian operating on a global basis or where a sub-custodian is located overseas. Examples of potential difficulties are that the agreement or arrangement entered into by the custodian with a sub-custodian must provide for the RSE licensee and APRA to have access to sub-custodian premises and documents held by the sub-custodian and for the RSE licensee and APRA to require that the material business activity being performed by a sub-custodian be audited by an independent auditor.
7. MD2 of 2006 exempts a material outsourcing agreement between an RSE licensee and a custodian from the obligation to comply with subregulation 4.16(6) in respect of a 'downstream' agreement or arrangement between the custodian and a sub-custodian that falls within the scope of the sub-regulation. MD2 of 2006 applies for the period up to 1 July 2007 and only where the agreement between the RSE licensee and the custodian provides for the custodian to accept liability for the failure of the sub-custodian to exercise reasonable care in the custody of assets of the registrable superannuation entity.
8. During 2006-07 APRA consulted with relevant industry organisations to assist in determining the appropriate regulatory treatment for custodian agreements in the longer term. The consultation indicated that it was appropriate that the relief provided by the modification declaration continue beyond 30 June 2007. Other than to incorporate minor amendments arising from the consultation, MD1 of 2007 provides the same relief provided by MD2 of 2006, but on a permanent basis.

Purpose of the instrument

9. MD1 of 2007 modifies regulation 4.16 by adding subregulations 4.16(6A) to 4.16(6D). Its purpose is to exempt a material outsourcing agreement between an RSE licensee and a custodian from the obligation to comply with subregulation 4.16(6) in respect of a 'downstream' agreement or arrangement between the custodian and a sub-custodian which falls within the scope of the sub-regulation. The exemption applies only where the agreement between the RSE licensee and the custodian provides for the custodian to accept liability for the failure of the sub-custodian to exercise reasonable care in the custody of assets of the registrable superannuation entity.

Operation of the instrument

10. Subregulation 4.16(6A) exempts a material outsourcing agreement between an RSE licensee and a custodian from compliance with subregulation 4.16(6) in respect of a 'downstream' agreement or arrangement between a custodian and a sub-custodian which falls within the scope of subregulation 4.16(6). The exemption applies only where the material outsourcing agreement between the RSE licensee and the custodian provides for the custodian to accept liability for the failure of the sub-custodian to exercise reasonable care in the custody of assets of the registrable superannuation entity. This requirement reflects the APRA Circular "Custodian Requirements for APRA Supervised Entities" released in November 2000 which set out APRA's views in relation to the acceptance of liability by a custodian. In the circular, reasonable care is based on the standards applicable to a custodian in the relevant market.
11. Subregulation 4.16(6B) ensures that the liability of the custodian to the RSE licensee is not dependent upon any recovery of losses by the custodian from the sub-custodian. This requirement also reflects the APRA Circular "Custodian Requirements for APRA Supervised Entities".
12. Subregulation 4.16(6C) provides a definition of a "sub-custodian". A sub-custodian does not include a "securities depository" as defined in subregulation 4.16(6D).

Consultation

13. During 2006-07 APRA consulted with industry bodies representing trustees of regulated superannuation funds and custodians on the operation of MD2 of 2006. All industry organisations which responded to the consultation supported the continuation of the relief provided by the modification declaration. MD1 of 2007 provides this ongoing relief and also incorporates some minor changes to make it clear that the relief extends to arrangements entered into between a sub-custodian and another sub-custodian. MD1 of 2007 also refers to a sub-custodian undertaking in terms of its undertaking custodial functions rather than holding assets. This reflects the SIS Act definition of custodian and recognises that custodians and sub-custodians may use wholly owned nominee companies to hold assets under custody.

Commencement

14. MD1 of 2007 comes into force on 1 July 2007.