



Negotiating investment management agreements

Best Practice Paper No. 12

September 2014

Association of Superannuation Funds of Australia





Association of Superannuation Funds of Australia Limited (ASFA)
Level 6
66 Clarence Street
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001
T +61 2 9264 9300
1800 812 798 (outside Sydney)
F 1300 926 484
W www.superannuation.asn.au

ABN 29 002 786 290 ACN 002 786 290

Disclaimer

This paper is intended as a guide only and is not intended to be used as a substitute for professional advice. Although verification of the accuracy of the information contained in this paper has taken place, liability is not accepted for any errors or omissions that may have occurred. ASFA expressly disclaims all liability and responsibility to any person who relies, or partially relies, upon anything done or omitted to be done by this publication.

About ASFA

ASFA is a non-profit, non-politically aligned national organisation that is the peak policy and research body for the superannuation sector. Our mandate is to develop and advocate for policy in the best long-term interest of fund members. Our members – which include corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider members – represent more than 90 per cent of the 12 million Australians with superannuation.

Enquiries are to be made to the Association of Superannuation Funds of Australia Limited.

© ASFA 2014

September 2014



Table of contents

Acknowledgement	5
Purpose of ASFA's Best Practice Papers	6
Part 1 – Investment management agreement: framework and principles	7
1. Setting the scene	8
1.1 Purpose and structure of paper	8
1.2 What is an investment management agreement?	8
1.3 The ASFA template IMA	9
1.4 In-house and intra-group investment management	9
2. Context	10
2.1 Regulatory environment	10
2.2 Making the investment decision	11
2.3 Risk management	12
2.4 Trustee obligations to APRA	13
3. The IMA	14
3.1 Negotiating the IMA	14
3.2 IMA stakeholders	14
3.3 Practical issues	15
3.4 Closing documents	17
3.5 Execution	18
3.6 Commencement date	18
4. ASFA template IMA: key matters	19
4.1 Appointment	19
4.2 Duties of the Manager	19
4.3 Consideration of environmental, social and corporate governance factors	20
4.4 Relevant Law	21
4.5 Professional standards for investment professionals	21
4.6 Powers of the Manager	21
4.7 Delegation by the Manager	21
4.8 Management of conflicts of interest and duty	22
4.9 Derivatives	22
4.10 Indemnities and trustee's limitation of liability	22
4.11 Management fees	23
4.12 Expenses and payments	24
4.13 Reports	25



4.14	Termination	26
4.15	Warranties and acknowledgements	26
4.16	Compliance with licensing regime	26
4.17	Investee company governance including proxy voting	27
4.18	Authorised persons and proper instructions	28
4.19	Insurance	29
4.20	Business continuity and disaster recovery	29
4.21	Intellectual property and data	29
4.22	Confidentiality, privacy and security	29
4.23	Dispute resolution	30
4.24	Governing law and jurisdiction	30
4.25	Risk management generally	30
4.26	Notices and other communications	31
<hr/>		
	Part 2 – Mapping of template IMA to regulatory requirements	32
1.1	Overview	33
1.2	<i>Superannuation Industry (Supervision) Act 1993</i>	34
1.3	APRA Prudential Standard SPS 231 – <i>Outsourcing</i>	35
1.4	APRA Prudential Standard SPS 232 – <i>Business Continuity Management</i>	40
<hr/>		
	Appendix – ASFA template investment management agreement	41



Acknowledgement

ASFA would like to recognise the contribution of the IMA Working Group members who have updated the paper. The IMA Working Group comprised:

- Richard Liebmann: Senior Partner, Norton Smith & Co. (Chair)
- Amy Ward: Governance Manager, AvSuper
- Christine Maher: Partner, Corrs Chambers Westgarth
- David Hartley: CIO, Sunsuper
- Janet Torney: Professional director and consultant
- Jason Cotter: Commercial Manager Investments, AustralianSuper
- Suzanne Morgan: Legal Manager - Investments, QSuper
- David Graus: Policy Adviser, Investments, ASFA.

In addition, our particular thanks go out to the lawyers and practitioners in the superannuation industry who reviewed drafts of the paper and provided valuable feedback.

Tony Keir

General Manager, Policy Operations
ASFA

Purpose of ASFA's Best Practice Papers

ASFA's Best Practice Papers series is intended to provide superannuation trustees, funds and their service providers with information about an array of concepts, processes and methodologies to address relevant issues.

Generally, ASFA Best Practice Papers are prepared in response to significant interest regarding the topic in question or in regard to issues that ASFA perceives need to be considered or addressed by the superannuation industry.

ASFA's Best Practice Papers are not intended to convey or mandate the only way to address an issue nor even the 'best' way. However, the consultative approach used to prepare ASFA's Best Practice Papers, which includes contributions from representatives of each of the various industry participants (such as trustees, fund executives, administrators, lawyers, actuaries and other key service providers) means that the findings, models and methodologies contained in them are representative of the highest (and most independent) thinking available from a diverse cross-section of the industry.

The concepts contained in this paper provide a considered analysis of the key issues, together with sound and prudent principles that can be developed and adapted to your organisation's particular situation. However, careful consideration should be given, including rigorous testing, before deciding whether or not to implement the processes outlined in this paper to ensure they are suitable and relevant for your particular circumstances.

Previous version

The previous version of this Best Practice Paper, dated July 2001, focused on the issues that arise from the external management of a fund's assets and then considered the role of an investment management agreement (IMA) with reference to the Standard Investment Management Agreement for Superannuation Funds released in June 2000 by the Financial Services Council (then the Investment & Financial Services Association).

Current version

The current version of this Best Practice Paper focuses on the responsibilities of superannuation trustees with respect to developing and negotiating legal agreements covering their assets. It provides a template IMA, based on the prudential and legal responsibilities, and the investment management requirements of asset owners. While the template ASFA IMA follows the roadmap laid down in the FSC Standard Investment Management Agreement, the template more specifically addresses the prudential and legal responsibilities, and requirements of asset owners, rather than asset managers.

The template also recognises the changes introduced by APRA's new Superannuation Prudential Standards and recent amendments to the *Privacy Act 1988*.

A checklist comparing the content of the template ASFA IMA against relevant regulatory requirements is set out in Part 2.

This updated version of Best Practice Paper No. 12: Negotiating investment management agreements is one of ASFA's key papers on the investment of fund assets, along with:

- Best Practice Paper No. 17: Active share ownership
- Best Practice Paper No. 26: Investment processes
- Best Practice Paper No. 34: Valuation and liquidity of unlisted investments
- Best Practice Paper No. 35: Managing superannuation fund liquidity risk
- ASFA Discussion Paper: Integration of environmental, social and corporate governance (ESG) factors into investment processes for trustees.

ASFA has also issued a number of papers, which are not specifically or uniquely directed at investing, but that should be taken into account as part of the investment process. These include:

- Best Practice Paper No. 7: Superannuation fund governance
- Best Practice Paper No. 15: Managing compliance in the context of outsourcing a delegation of trustee functions
- Best Practice Paper No. 19: A risk management framework for superannuation funds.



Part 1 – Investment management agreement: framework and principles



Part 1 – Investment management agreement: framework and principles

1. Setting the scene

1.1 Purpose and structure of paper

The trustee of a regulated superannuation fund is responsible for formulating and giving effect to an investment strategy for the fund. The trustee has a positive obligation to appropriately invest the assets of the fund and is directly accountable for the prudent management of those assets to members. That is, in its fiduciary role, the trustee is the asset owner. When trustees engage the services of one or more external investment managers to manage all or part of their fund's assets, they need to be aware of the nature and extent of their ongoing responsibility for the management of those assets. Most notably, they remain the ultimate owner of the assets and cannot outsource their fiduciary responsibility to any third party. They also need to assess the additional risks to which the fund may be exposed and establish how they may best manage that risk.

This Best Practice Paper (BPP) is divided into three sections:

- **Part 1** provides an overview of the key issues that underpin the compilation and negotiation of an investment management agreement (IMA) between a superannuation fund trustee and an investment manager
- **Part 2** provides a regulatory mapping checklist, which will assist trustees in ensuring that their investment management outsourcing agreements meet the particular requirements of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) and the APRA Prudential Standards including Superannuation Prudential Standard 231 *Outsourcing* (SPS 231)
- **The Appendix** provides a template IMA suitable for regulated superannuation funds.

This BPP (including the template IMA) is not intended to, and does not, constitute legal advice and should not be relied on as such. It is recommended that trustees, when negotiating and settling an IMA, seek professional legal advice.

1.2 What is an investment management agreement?

Underpinning the outsourcing of the management of the investment of a superannuation fund's assets to an external party is a legal agreement which, under section 124 of the SIS Act, must be in writing.

Where discretions are granted by a trustee to a third party in relation to investment management of a pool of fund assets, the general mandate given to the investment manager is typically referred to as a 'discretionary' investment mandate. This means that the investment manager has the right to select the particular investments in which the assets are invested, provided they meet the broad criteria in the mandate given by the trustee.

Alternatively, where a trustee has chosen to invest in a particular investment and appoints an investment manager to manage that asset, the mandate given to the investment manager is typically referred to as a 'direct' or 'non-discretionary' investment mandate.

Discretionary investment mandates are arranged under an IMA.

Direct investments are generally accessed by the trustee's direct acquisition of the relevant asset or through a special purpose investment vehicle such as a wholesale managed investment scheme, pooled superannuation trust, company or limited partnership. The trustee may also negotiate special terms with an investment manager in relation to the way in which the trustee's investment is managed with other investors through a side letter.



1.3 The ASFA template IMA

ASFA has developed a template IMA that is based on the prudential and legal responsibilities and the investment management requirements of regulated superannuation trustees. While its contents are similar to other template IMAs, it more specifically addresses the requirements of superannuation trustees.

The template IMA is most suitable for a discretionary domestic investment mandate, although it can be adapted with appropriate legal advice for a non-discretionary mandate or a global investment mandate.

While this BPP does not cover the specifics of the legal agreements/arrangements that may apply in relation to direct investments, the principles and issues that underpin them are largely common to the issues that arise in relation to a discretionary mandate. It would be good practice for trustees who use non-discretionary investment agreements/arrangements to still have documentation in place setting out the understanding between the investment manager and the trustee relating to all relevant matters. Such documentation could take the form of an exchange of letters or memorandums of understanding signed by both parties or an overlaying IMA based, in part, on the template IMA. If the template IMA is used, a number of changes will be necessary, including removing the right of the investment manager in clause 2.2(c)(iv) to give the custodian instructions in relation to transactions concerning the portfolio.

1.4 In-house and intra-group investment management

In recent years, the investment of superannuation fund assets has increasingly been undertaken by the fund itself or by associated entities. These typically take two forms:

- **in-house**, where an investment management team within a superannuation fund manages either part or all of the fund's assets; or
- **intra-group**, where the investment management is undertaken by another entity, business unit or division within a group of companies under one corporate umbrella. Large financial services and wealth management businesses typically operate with this type of structure, but more recently, superannuation funds have also started to outsource the investment function to a company that is wholly owned by the fund.

No matter what the business relationship between parties, to the extent that the trustee and the investment manager are different legal entities, the investment management arrangements should be documented in writing and subject to the same considerations and review as any external investment arrangements.

Any provision of investment management services by an associated entity should comply with the trustee's outsourcing policy. In APRA's opinion, a sound outsourcing policy would clearly outline whether outsourcing to associated entities is permitted and would also document any restrictions and/or additional expectations in relation to such arrangements. Where associated entities are involved, the policy is expected to cover additional concerns including the impact of group/related party expectations and how these other interests are managed when a trustee is considering the best interests of beneficiaries.¹

The trustee must also identify and address the risks arising from an associate arrangement itself and be able to demonstrate that the arrangement is conducted on an arm's length basis and in the best interests of beneficiaries.²

¹ APRA SPG 231 Clause 10.

² APRA SPG 231 Clause 9.



2. Context

2.1 Regulatory environment

IMAs are governed by both the law and the APRA prudential framework.

2.1.1 *Applicable law*

As a legal agreement, an IMA is governed by the law of contract and relevant federal, state and territory laws.

2.1.2 *Superannuation Industry (Supervision) Act 1993*

The SIS Act provides the legislative framework for the operation of a regulated superannuation fund.

Section 52 of the SIS Act contains the general obligations of trustees of super funds, including the requirement to appropriately manage the assets of the fund by, amongst other things, formulating and giving effect to an investment strategy for the fund and for each investment option offered by the trustee. This obligation remains with the trustee whether or not the investment is outsourced. Trustees need to consider the impact of their obligations under section 52 in making decisions about potential investment managers when negotiating the terms of IMAs, and, in particular, when deciding which of those provisions will be maintained as 'deal breakers' from which the trustee will not resile. Particular regard should be given to section 52(6), which specifies the trustee's investment covenants.

Trustee directors should also understand the consequences of their joint and several covenant when agreeing to an outsourcing arrangement, namely, *"to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity of which it is trustee and on behalf of the beneficiaries of which it makes investments"* (section 52(2)(b)).

The provisions of the SIS Act that apply specifically to the outsourcing of investment management are set out in Part 2 of this BPP.

2.1.3 *APRA Prudential Standards and Guidance*

APRA has issued 13 Superannuation Prudential Standards (SPSs), which govern the prudential regulation of APRA regulated superannuation funds. APRA also issues Prudential Practice Guides (SPGs), which provide guidance on APRA's opinion as to what is considered sound practice in particular areas.

While a number of SPSs govern the investing of superannuation fund assets, the most directly relevant standard applicable to IMAs is SPS 231 – *Outsourcing*, which regulates the outsourcing of material business activities.

Other APRA SPSs potentially relevant to investing superannuation assets include:

- SPS 530 – *Investment Governance*
- SPS 220 – *Risk Management*
- SPS 232 – *Business Continuity Management*
- SPS 510 – *Governance*
- SPS 521 – *Conflicts of Interest*.

Prudential Practice Guides particularly relevant to each of these standards are SPG 530 – *Investment Governance* and SPG 531 – *Valuation*.

Under SPS 231, an 'outsourcing' involves a trustee with a RSE licence entering into an arrangement with any party to perform, on a continuing basis, a business activity that currently is, or could be undertaken, by the trustee itself. Where the business activity that is outsourced is a 'material business activity'³, the requirements of SPS 231 apply.

³ A 'material business activity' is one that has the potential, if disrupted, to have a significant impact on an RSE licensee's business operations, its ability to manage risks effectively, the interests, or reasonable expectations, of beneficiaries or the financial position of the RSE licensee, any of its RSEs or its connected entities, having regard to such factors as:

- a) the financial and operational impact and impact on reputation of a failure of the service provider to perform over a given period of time;
- b) the cost of the outsourcing arrangement as a share of total costs;
- c) the degree of difficulty, including the time taken, in finding an alternative service provider or bringing the business activity in-house;
- d) the ability of the RSE licensee to meet regulatory requirements if there are problems with the service provider;
- e) potential losses to beneficiaries and other affected parties in the event of a service provider failure; and
- f) affiliation or other relationship between the RSE licensee and the service provider.



Whether or not an outsourcing is of a material business activity is determined by reference to a number of factors set out in SPS 231 at Clause 9. It is generally accepted that the appointment of an investment manager is the outsourcing of a material business activity and APRA SPG 231 at Clause 4 confirms that, in APRA's opinion, investment management functions under a formal agreement or mandate (including implemented asset consulting) are material business activities.

2.1.4 *Mapping to regulatory requirements*

In order to demonstrate how the template IMA complies with the relevant regulatory requirements and to provide a guide for trustees when reviewing their IMAs, ASFA has developed a regulatory mapping checklist. This checklist sets out the parts of the SIS Act and the APRA Superannuation Prudential Standards and Prudential Practice Guides that are relevant to negotiating and drafting IMAs.

The regulatory mapping checklist is included at Part 2 of this BPP.

The mapping framework developed can be used as a cross reference by superannuation fund trustees to assist them to ensure that their bespoke IMA is both the SIS Act and APRA compliant.

2.2 Making the investment decision

The requirement for trustees to negotiate an IMA should be preceded by a rigorous investment decision-making process. While this decision-making process is not within the scope of this BPP, the key elements that should be undertaken by the fund, either by its trustee, investment committee, investment executives and advisers or, any combination of them, include:

- determination of the superannuation fund's investment philosophy
- establishment and implementation of the fund's investment governance framework. This includes specification of the roles and delegations of the board, investment committee, investment executives and investment advisers
- determination of the fund's investment risk appetite and investment risk management framework
- establishment of investment objectives for all asset pools
- establishment and implementation of an investment strategy for each asset pool
- determination of the appropriate portfolio construction to deliver the investment strategy within an appropriate timeframe
- selection of the optimal investment manager and investment portfolio, underpinned by rigorous investment manager research and robust operational due diligence.

The other key decision that the trustee will have to make within its investment governance framework prior to negotiating an IMA is the appointment and ongoing monitoring of the appropriate investment advisers, including asset consultants.

In relation to the selection of a particular investment manager, a trustee must be able to demonstrate to APRA that, in assessing the options for outsourcing a material business activity and entering into an IMA, it has:

- prepared a business case for outsourcing investment management
- undertaken a tender or other selection process for selecting the investment manager
- undertaken a due diligence review of the chosen investment manager, including the ability of the investment manager to provide the investment management services on an ongoing basis
- taken into account the changes to the risk profile of investment management that arise from outsourcing the activity and how this changed risk profile is addressed within the trustee's risk management framework
- considered how, and to what extent, outsourcing of the investment management activity will assist the trustee in meeting the adequacy of resources requirement, and how these requirements will be monitored on an ongoing basis
- involved the board, board committee or senior manager with delegated authority from the board, in approving the IMA
- considered all the content required by SPS 231 that must, at a minimum, be included in the IMA





- established procedures for monitoring performance under the IMA on a continuing basis
- addressed the renewal process for the IMA and how the renewal will be conducted
- developed contingency plans that would enable the investment management activity to be provided by an alternative service provider or brought in-house if required
- determined that its conduct in relation to the outsourcing agreement is in the best interests of beneficiaries.⁴

2.3 Risk management

2.3.1 Additional risk related to external investment management

Under SPS 231, a trustee "...must identify, assess, manage, mitigate and report on risks associated with outsourcing to meet its obligations to beneficiaries..."⁵

A number of key risks are associated with the use of an external investment manager; they include:

- selection of inappropriate manager(s) or portfolio(s) for the fund
- inappropriate or conflicted investment decisions
- fraud by the manager, or the manager's employee or agent
- systems failures
- key man or key team risk
- insolvency of the manager.

Trustees must seek to manage and control these risks through the processes associated with the selection of the investment manager(s), their appointment and supervision, adequate risk management policies and procedures, and ensuring adequate and appropriate insurance cover of the investment manager.

When deciding on the appointment of an external investment manager it is essential that trustees not only conduct investment due diligence on the manager but also operational due diligence to ascertain the manager's ability to operate their business in an efficient and compliant manner. In its publication *Insight* (Issue 1 of 2014), APRA has stated that as part of APRA's ongoing supervision and risk assessment, it will assess trustees' compliance with the Prudential Standards and their management of both investment and operational risk. This will include, where warranted, an assessment of the processes around the operational due diligence of investment managers.

In relation to the question of adequacy of resources as part of the trustee's own risk management assessment, APRA requires that the trustee make an assessment that its service providers are financially sound and have the required resources to undertake the outsourced activity on a continuing basis. In assessing the financial soundness of an investment manager, the trustee is expected to consider the adequacy of the investment manager's capital, its insurance and/or guarantee arrangements and its ability to meet its liabilities on a continuing basis.⁶ The template IMA has a number of provisions including warranties and obligations to support the trustee's initial and continuing assessment as to the investment manager's financial soundness.

⁴ SPS 231 Clause 19.

⁵ SPS 231 Clause 11.

⁶ SPG 231 Clause 13.



2.3.2 Risk management by the investment manager

The trustee should ensure that its IMA requires that the investment manager has a demonstrated internal risk management policy relating to overall asset management and investment activities. The documentation should clearly set out the types of risks addressed by the policy, the manager's policy or policies in relation to the management of those risks and the specific processes and procedures that give effect to the policies.

The IMA should require the investment manager to demonstrate ongoing compliance with its risk management policy.

2.4 Trustee obligations to APRA

A trustee has a number of reporting obligations to APRA in relation to the appointment of an investment manager. These include the obligations set out in the table below. A trustee must consider these requirements during the due diligence and appointment phase and also during the term of the IMA.

Regulatory requirement	Source
Notify APRA as soon as possible after entering into an outsourcing agreement, and, in any event, no later than 20 business days after the execution of the IMA.	SPS 231 at Clause 26
When the trustee notifies APRA of a new outsourcing agreement, it must also provide a summary to APRA of the key risks involved in the outsourcing arrangement and the risk mitigation strategies put in place to address these risks. APRA may request additional material where it considers it necessary in order to assess the impact of the outsourcing arrangement on the RSE licensee's risk profile.	SPS 231 at Clause 27
Advise APRA of any significant problems that have the potential to materially affect the outsourcing arrangement and, as a consequence, materially affect the trustee's business operations, the interests of beneficiaries, or materially affect the fund or connected entities of the trustee.	SPS 231 at Clause 31
Notify APRA as soon as practicable when an IMA is terminated and provide a statement about the transition arrangements and future strategies for carrying out the outsourced material business activity.	SPS 231 Clause 32



3. The IMA

3.1 Negotiating the IMA

Negotiating the IMA should be part of the investment manager selection process. It should be raised at the beginning of the process and a trustee should have a clear understanding of the matters that are non-negotiable and include them in its list of threshold issues to ensure that the investment manager understands the trustee's minimum requirements. These are likely to include issues affecting exposure to risk, compliance matters, indemnification and issues affecting costs. If the manager cannot agree on these matters, then the trustee must be in a position to 'walk away' from the arrangement, otherwise the trustee has no, or only a limited, bargaining position prior to finalising the selection process.

In order to assist the trustee in negotiating an optimal IMA, the trustee should have its own template IMA, which should form the starting point for the negotiations with the investment manager. For funds that do not have their own template IMA, the template included in the Appendix to this BPP is an appropriate starting point for such negotiations.

3.2 IMA stakeholders

The negotiation of an IMA involves a significant number of stakeholders, due to its complexity and its broad scope across all areas of investment – from decision-making to operations to compliance and risk management.

For a superannuation fund, the people typically involved will be the trustee, possibly via the investment committee, the investment decision makers, who may be either executive staff or directors, the investment operations team, the investment compliance and risk teams and in-house or external legal counsel. A full legal and regulatory review is always required as part of the IMA negotiation.

A fund might also appoint advisers to assist in IMA compilation and negotiation. These may include:

- a legal adviser who will either advise on, or prepare the IMA, and assist in the negotiation of its terms
- a commercial business adviser who can advise on contract terms and pricing
- the fund's auditor, risk or compliance advisor, who can provide input on the risk and annual audit implications of any new appointment.

The two key external stakeholders are the investment manager and the fund's custodian. While the custodian is generally not involved in the negotiation of an IMA between a fund and an investment manager, it is essential that the proposed investment manager is aware of the fund's custodial arrangements and is able to operate within them. This is especially important when the underlying investment is either new or exotic, as it cannot be assumed that the custodian has the processes or coverage in place to cover all investments.

If a custodian is involved in discussions in relation to the IMA then these discussions should be quite detailed, with engagement with the custodian's fund reporting and accounting teams to ensure that the fund's specific requirements can be met in a timely manner. Again, such discussions with the custodian are especially important where the underlying investment is either new or exotic, as it cannot be assumed that the custodian has the processes or coverage in place to cover all investment contingencies.





3.3 Practical issues

The issues to be addressed when developing the IMA typically fall into the following categories:

- investment
- operational
- legal and regulatory
- risk management, compliance and reporting.

The specific provisions of the ASFA template IMA are discussed in section 4 of this Part 1 of the BPP. This section discusses some practical issues associated with negotiating IMAs.

3.3.1 *Investment issues*

Investment parameters

The IMA must specify all of the investment parameters in detail. These will include permitted asset classes, assets to be managed, investment objectives, authorised investments, mandate restrictions, exposures (geographic or sector), valuation processes, use of derivatives, benchmarks and performance hurdles.

As most of the investment details are specific to a particular mandate, investment parameters are typically included in the schedules to the IMA, not in the IMA itself. They are, however, a key part of negotiating an IMA and facilitate any necessary changes over time to the IMA.

The key investment parameters and investment objectives are specified in Schedule 2 of the template IMA.

International investment managers and offshoring

A trustee's outsourcing policy must set out specific requirements in relation to outsourcing to service providers where they are conducting the material business activity outside Australia.⁷

An offshoring arrangement can give rise to a number of additional risks. APRA has identified the following risks:

- country risk
- compliance (legal) risk
- contractual risk
- access and counterparty risk.

APRA expects that these and any other risks would be specifically addressed during the preparation of the relevant business case for the appointment of an international investment manager, when conducting due diligence and during the IMA negotiations. They are also risks which, in APRA's opinion, should be considered when conducting ongoing monitoring and control of the outsourced activity.⁸

When appointing international investment managers, trustees need to consider and, if necessary, include in their IMA, an array of additional matters including:

- the legal jurisdiction and relevant law applying to the IMA; and
- the ability to maintain and enforce, in that overseas jurisdiction, the security and confidentiality/privacy of information.

Most importantly, the trustee must consult with APRA prior to entering into an agreement where the investment management will take place outside Australia (offshoring) and advise the investment manager of this requirement.⁹

⁷ SPS 231 Clause 18.

⁸ SPG 231 Clauses 35 and 36.

⁹ SPG 231 Clause 34. APRA will satisfy itself that the impact of the offshoring arrangement has been adequately addressed as part of the trustee's risk management framework. If, in APRA's view, the offshoring agreement involves risks that the trustee is not managing appropriately, APRA may require the trustee to make other arrangements for the outsourced activity as soon as possible.





Other matters to consider include ensuring that the international investment manager:

- is appropriately licensed in its home jurisdiction
- has satisfied Australian financial services licensing requirements (see section 4.16 of this BPP) or, if the investment manager is located in a home jurisdiction which is recognised by ASIC as entitling the investment manager to obtain Class Order exemption relief from the need to be licensed, that such relief has been obtained before their proposed appointment is effective
- has custodial arrangements which align with local regulatory requirements and the requirements and capability of the trustee's custodian
- has considered the practical impact of time zone differences in order to effect efficient investment instructions.

As part of ongoing monitoring, APRA recommends that the trustee consider monitoring the economic, social and political conditions within the host country to assess the ability of the service provider to continue to adequately perform the contracted service (SPG 231 Clause 44).

3.3.2 Operational matters

Trustees need to decide which operational issues are included in the legal agreements and which are managed on a day-to-day basis. While inclusion in the IMA ensures legal certainty, it can limit flexibility, which is often crucial in operational matters. Again, trustees need to determine their threshold core service requirements.

Discussions should occur between the relevant experts from the investment manager, custodian, auditor and fund to ensure relevant and significant operational matters are appropriately specified in the IMA.

It is essential that the IMA empowers the trustee to require the manager to assist with mandatory reporting and disclosure. Such reporting and disclosure includes (but is not limited to) the following:

- APRA has introduced very extensive reporting requirements for superannuation funds to ensure transparency and accountability, and to support the implementation of Prudential Standards, MySuper products and SuperStream. At the date of issue of this BPP, APRA had released 37 Reporting Standards, seven of which relate to investments and a further three that relate to fee and/or performance information
- Trustees have detailed fee reporting and disclosure obligations for which they may need their investment manager's assistance to comply. Under ASIC's rules, fee disclosure in PDSs and periodic statements must include reporting of fees in underlying investments such as the hedge funds sitting within a fund of funds. Further, under APRA Reporting Forms SRF 702 *Investment Performance* and SRF 703 *Fees disclosed*, trustees must report fees and costs on a 'look-through' basis. Such disclosure and reporting may require the assistance of the investment manager and the IMA should empower the trustee to require the investment manager to provide such assistance and information that the trustee is legally required to disclose
- Section 29 QB of the SIS Act requires trustees to disclose a summary of proxy votes made in the previous 12 months
- From various dates in 2015 (depending on when ASIC licences a trade repository – see ASIC Class Exemption 14/0633) AFSL holders (which includes most trustees) will be required by ASIC to report all "over the counter" (OTC) derivative positions – and will need the investment manager's/administrators/custodian's assistance with this
- Possibly, from 1 July 2015, trustees will have to disclose details of all the assets the fund holds directly and indirectly (portfolio holdings disclosure).

The template IMA does not specifically refer to all of these obligations. Rather, with the exception of proxy vote reporting, it requires the manager to provide the relevant data and information that the trustee needs to comply with its reporting and other disclosure obligations to a standard that enables the trustee to meet those requirements (see clauses 4.1(g), 10.1(b), 10.1(c) and 10.3 in the template IMA). Clause 13.4 specifically addresses the question of proxy voting records.

Certain key operational matters, such as those referred to above, could be included in service level agreements (SLAs) between the trustee, the investment manager and the custodian or in side letters. Other operational matters such as frequency and content of reporting could also be included in an SLA. The suitability of utilising a SLA and its content can be determined in the IMA development phase.





As parties tend to underspecify the investment operational requirements, it is beneficial for trustees to be advised at the IMA development stage by either external or in-house specialists with both commercial and operational knowledge.

3.3.3 *Legal and regulatory*

While the IMA specifies the legal rights of all relevant parties, it is important that it reflects the requirements of the trustee in effecting its investment decisions. It also needs to afford the appropriate protections for the trustee.

The recent changes to the prudential framework for superannuation funds have resulted in increased requirements within the legal documentation governing the investment of a fund's assets. This notably applies to risk management, privacy, data protection and indemnities.

3.3.4 *Risk management, compliance and reporting*

The optimal, ongoing management of a fund's assets is heavily dependent on continuous risk management and compliance with all the agreed investment parameters. As well as requiring to be in receipt of, and updated on, changes to an investment manager's risk management framework, the trustee is also likely to require the annual presentation of an investment manager's GS007 audit and their Part B DRS audit (if applicable), and annual reporting on anti-money laundering and counter-terrorism financing (AML/CTF) requirements.

It is also important to ensure that the reporting on the management of a fund's assets comprehensively addresses the requirements of the trustee and APRA.

3.4 Closing documents

Prior to the signing of the IMA, trustees should require that the investment manager produce certified copies of the following documents:

- Manager's Australian financial services licence, or overseas equivalent if the manager is only investing overseas
- Certificate of currency of the agreed insurances
- Manager's Risk Management Policy
- Manager's GS007 audit regarding the existence of internal risk management policies and procedures and their effective operation
- Certification from the manager's external auditors regarding the manager's compliance with the trustee's APRA Risk Management Statement Part B, and confirmation of the existence and effective operation of an internal risk management policy
- Manager's Code of Professional Conduct (clause 4.7)
- Manager's Conflicts Management Policy (clause 5.5)
- Manager's Proxy Voting Policy (clause 13.3)
- Policies, including those relating to AML\CTF, block trades with counter parties or single counter party exposure
- Manager's Business Continuity Plan (clause 16.2)
- Other documents, as required and specified by the trustee.

In the case of an offshoring arrangement, APRA expects trustees to maintain copies of important documents relating to the arrangement, written in English and held at the trustee's Australian office. Such documents would include:

- a copy of the IMA
- a copy of the due diligence assessment
- a copy of the manager's business continuity management (BCM) documentation and details of the latest testing of BCM processes undertaken
- copies of documents the trustee considers critical to the ongoing monitoring and control (for example, financial statements and reports).¹⁰

¹⁰ SPG 231 at Clause 43.





3.5 Execution

The execution of an IMA must comply with the agreed delegation process of both the trustee and the investment manager. From the trustee's perspective, the people typically authorised to execute the IMAs should either have been included in the decision making process or, at least, be briefed as to the objectives/provisions of the IMA.

3.6 Commencement date

The IMA must be signed by all the parties before the outsourcing arrangement commences. This means the commencement date must postdate the execution of the document.¹¹

¹¹ SPS 231 at Clause 20.





4. ASFA template IMA: key matters

The template IMA included with this BPP is intended to be comprehensive, but it is drafted on the basis that it will primarily be used for a discretionary domestic investment mandate.

If a trustee is making a non-discretionary appointment, the IMA is limited to the management of a specific asset or the investment manager is providing the services in an offshore jurisdiction, then changes to the IMA will be necessary. Some, but not all, of the issues that would need to be considered in this case are discussed in this section.

The template IMA has been drafted from the superannuation trustee's perspective to protect the interests of their funds and members and, as such, sets a high threshold for investment managers to meet. While ASFA believes that this high threshold is reasonable for today's circumstances, the final outcome will depend on what the trustee is able to negotiate with the investment manager. This section of the BPP addresses the key matters associated with the clauses of the template IMA.

4.1 Appointment¹²

As it retains ultimate responsibility for the investment of members' assets, the trustee must formally appoint any third party in writing to undertake this function. This includes investment managers and the custodian with whom the investment manager must be able to work effectively.

It also includes the appointment of any delegate of the investment manager that is either specified in Schedule 1 of the IMA or is otherwise approved in writing by the trustee. Any delegation by an investment manager does not relieve it of its obligations or liabilities.

The IMA needs to be very clear on the line of delegation, especially for instructions to the custodian. The trustee must be able to provide any instruction to the custodian, although it may delegate to an investment manager the ability to instruct the custodian under the terms specified in the IMA.

The template IMA (Clause 2.2(b)(iv)) is drafted on the basis that the trustee is providing a 'discretionary mandate', that is, empowering the manager to provide instructions to the custodian without reverting to the trustee. Some trustees only provide 'non-discretionary' mandates and retain control over instructing the custodian. For a 'non-discretionary' mandate, this clause would need to change.

4.2 Duties of the manager¹³

The trustee will have an investment strategy for the whole of the fund, as required by section 52(6) of the SIS Act. The IMA will operate in respect of the implementation of that strategy and probably, in respect of a particular asset class. The IMA should clearly describe the investment manager's role in implementing the investment strategy by reference to the investment objectives set out in Schedule 2 and any specific instructions or limitations which the trustee imposes on the manager's investment discretions. While the investment objectives are not legally binding on the investment manager, the manager is required to use its best endeavours to comply with them in investing and managing the portfolio.

The specific investment instructions, which are normally set out as a schedule in the IMA (and are Schedule 2 Part A in the template IMA), should specify any parameters, benchmarks, limitations, conditions, exposures, valuation methodologies, and any prohibitions that apply to the particular investment mandate. These investment instructions are legally binding on the investment manager and, accordingly, the greater the detail in the investment mandate, the lower the chance for misinterpretation by either party.

¹² Clause 2 of the IMA.

¹³ Clause 4 and Schedule 2 of the IMA.





Specific areas where trustees may wish to apply restrictions or conditions to the investment mandate include:

- sector exposures
- geographical exposures (for example, regions and limits)
- exchange type
- use of derivatives
- type of securities
- foreign currency exchange arrangements
- allowance for securities lending
- limits on cash, liquidity, tenor, credit or issuer
- ethical investments
- voting instructions
- risk measures (for example, tracking error, benchmark relative risk).

The template IMA also imposes a number of requirements on the investment manager. The key requirements are:

- to act in the best interests of the management of the portfolio that is the subject of the IMA. (Clause 4.1(c). It is not reasonable to expect the investment manager to act in the best interests of the trustee or fund as a whole as they are unlikely to have the information or powers to meet such an obligation.
- not to keep any monetary benefits, fees or commissions received in relation to the investment of the portfolio other than the agreed fees and to account to the trustee for the same (Clauses 4.1 (w) and 5.2(c)). With trustee consent, approval may be granted, as long as the arrangements are to the benefit of the trustee, say to defray costs, but not to the benefit only of the investment manager.
- to exercise any purchase or sale of investments in such manner, as in the investment manager's reasonable judgement, offers the best price and market for the execution of each transaction (Clause 4.8). A key consideration of this is reliability of the broker services. This is an area where there has not always been great transparency and is key to ensuring that all transactions are undertaken to the benefit of members.
- in participating in any competitive behaviour, act in accordance with the investment manager's Code of Professional Conduct and Conflicts Management Policy and otherwise:
 - not give a benefit or advantage to any person to the detriment of the trustee, the fund or the portfolio
 - deny the trustee an opportunity to participate in an investment that the manager knows or should reasonably know is, or would be, appropriate for and beneficial to the portfolio (Clause 5.6).

4.3 Consideration of environmental, social and corporate governance factors

An increasing number of trustees are incorporating environmental, social and corporate governance (ESG) factors within their investment strategies and relevant policies and procedures.

For these trustees, the IMA will need to adequately reflect the ESG factors considered important by the trustee.

When drafting the IMA, the trustee may consider the following:

- whether the trustee has pre-determined exclusions that the investment manager must implement
- application of ESG factors such as whether the trustee requires the investment manager to consider and incorporate the trustee's ESG policies or allows the investment manager to apply its own ESG policy, analysis and framework
- the nature of any reports provided by the investment manager to ensure that the trustee can comply with its own requirements
- knowledge of whether the investment manager is a signatory to the UN Principles for Responsible Investing (UNPRI) and, if so, will it provide early disclosure consistent with UNPRI requirements
- any other factors that may impact the trustee's consideration of ESG matters.

The trustee's ESG requirements in relation to a portfolio that is covered by the IMA are typically specified in the investment mandate schedule of the IMA. This is Schedule 2 of the template IMA.





4.4 Relevant Law¹⁴

The investment manager has an obligation to comply with any 'relevant law', to the extent that it concerns the functions, powers and duties of the manager under the IMA. A broad definition of 'relevant law' is included in Clause 1.1. Where the trustee is also regulated by any particular state or territory legislation, that law should also be included in the definition.

4.5 Professional standards for investment managers¹⁵

Many of the investment professionals working in the superannuation and investment industries are members of professional associations, which have established high professional and ethical standards that govern the practice of their profession. For example, many in the industry are obliged to act in accordance with codes of professional conduct such as that issued by the CFA Institute.

Requiring adherence to these codes and attestation of such adherence can help to ensure that the manager acts in a highly professional manner.

The template IMA requires the investment manager to have its own Code of Professional Conduct so as to ensure the manager acts in a professional and fair manner and makes full disclosure to the trustee of key issues.

4.6 Powers of the Manager¹⁶

The manager has the powers of a "natural person" to do all things and execute all documents necessary to manage the agreed investment mandate. These powers will be subject, however, to the particular limitations and restrictions that the trustee places on the investment manager. Clause 5.2 of the template IMA sets out a number of limitations.

Key areas in respect of which the IMA requires the trustee's prior written consent include derivatives trading, securities lending, borrowing outside permitted short-term borrowing and performing a broking function in respect of the portfolio.

4.7 Delegation by the Manager¹⁷

The template IMA makes provision for the delegation by the investment manager to third parties who are named in Schedule 1 of the IMA.

Any other delegation without the prior written consent of the trustee is prohibited.

When delegating its obligations to a third party, the investment manager must exercise all due care, skill and diligence in selecting, appointing and monitoring the performance of a delegate in connection with the portfolio and remains responsible to the trustee for the acts and omissions of a delegate, including as required by APRA SPS 231 for liability for any failure on the part of the manager.

All delegations must be in writing and Clause 5.3(e) sets out minimum content requirements for these agreements.

¹⁴ Clause 4.4 of the IMA.

¹⁵ Clause 4.7 of the IMA.

¹⁶ Clause 5 of the IMA.

¹⁷ Clause 5 and 20.1 of the IMA.





The trustee must retain the right to approve or rescind any delegation by its investment manager as it retains ultimate responsibility for its fund's assets (Clause 5.3(b)). In reality, discussions between the two parties are likely before the rescission of a delegation would occur.

In the event that the investment mandate involves the appointment of an investment manager where the services are to be conducted outside Australia, APRA must be consulted before the appointment of the manager can be made. APRA expects that the same standards that apply to the trustee in respect of the appointment of an investment manager where any of the services are to be performed offshore, also apply to any subcontracting by the investment manager. Clause 20.1 addresses these issues.

4.8 Management of conflicts of interest and duty¹⁸

It is not unusual for a superannuation fund's assets to be consolidated with those of the investment manager's other clients for more optimal investment management. The trustee's requirements around the common investment of its funds are set out in Clause 5.7.

Similarly, it is reasonable to expect that an investment manager should have the power to perform similar investment management services for other clients and itself.

4.9 Derivatives

Derivatives are a common investment tool used by investment managers. Trustees need to be aware of the risks associated with the use of derivatives. If the use of derivatives is to be permitted, this will need to be explicitly stated in Schedule 2 of the IMA and the IMA should be quite specific as to their application within the portfolios (Clause 5.9 and Schedule 7). If derivatives are used, the investment manager must provide a risk management statement to the trustee in the format required by the trustee and which otherwise complies with all of APRA's requirements. Further, as stated previously, with respect to over-the-counter derivatives, there are ASIC reporting obligations which will have to be undertaken on behalf of the trustee.

4.10 Indemnities and trustee's limitation of liability¹⁹

The template IMA contains cross indemnities on the part of each of the trustee and investment manager for loss or liability.

In the case of the trustee, the investment manager must indemnify the trustee for loss or liability incurred in connection with any negligence, default, breach, fraud or dishonesty, or breach of duty of the manager and its employees, delegates and agents.

The indemnity does not extend to loss or liability caused by a class of the manager's agents identified as "Excluded Agents". Excluded Agents include:

- a clearing house or broker appointed in accordance with the requirements of Clause 5.4(b) of the IMA
- an agent, or a class of agents, nominated in writing by the investment manager to the trustee and agreed to by the trustee
- an agent that acts in accordance with the direction of the trustee.

¹⁸ Clause 5.5 of the IMA.

¹⁹ Clause 6 of the IMA.





However, from this class of Excluded Agent there are some exceptions and in this case even though an agent qualifies as an Excluded Agent, the investment manager can be liable for their conduct. The relevant agents in this case are:

- a broker or clearing house associated with the investment manager
- an Excluded Agent whom the investment manager, without the trustee's consent, appointed on terms which excluded or limited liability of the manager for wrongful acts.

The investment manager must assist the trustee in any action against agents and delegates appointed by the investment manager, including brokers. Managers may resist the inclusion of such a clause, particularly a requirement that they be forced to commence an action on behalf of the trustee, and may seek indemnification for costs.

In the event that the trustee has a liability under the IMA, it will be capped under Clause 6.1 up to a maximum liability in the aggregate of the value of the portfolio under the investment manager's management.

The trustee is not required to discharge this liability unless under Clause 6.9 the trustee is properly entitled to receive, and does receive, the relevant amount from the assets of the fund in the exercise of its rights of indemnity from the fund. This limitation will not be available where the trustee has lost its right of indemnity from the fund because of the trustee's breach of trust, breach of duty, negligence or fraud.

There is no limit to the investment manager's liability.

While there may be challenges in negotiating a non-reciprocal arrangement, we believe that it is appropriate in the circumstances.

4.11 Management fees²⁰

A key element of negotiating an IMA is the magnitude and structure of fees paid to the investment manager. Generally, fees are categorised as 'base fees' or 'performance fees'.

There is a wide variety of structures for base fees.

Performance fees are becoming increasingly common for certain types of investment mandates. Trustees should consider whether a structure that comprises a base fee and a performance fee is appropriate for the particular circumstances of their fund. Where periodic performance fees are part of the contract, it is important that an appropriate minimum hurdle applies for the calculation of manager performance. It is also appropriate to consider application of a cap on performance fees.

Where the investment manager has fallen behind the benchmark in any period, performance fees should not be payable until after the manager has made up for any under-performance in previous periods ('highwater mark'). When negotiating a performance fee, a trustee also needs to analyse the net effect for various levels of out-performance to ensure that the fee structure is appropriate from their perspective.

Given the complexity often associated with the calculation of performance fees and the risk of a misunderstanding occurring, it is essential that each of the parties is clear about how they actually work. For this reason, consideration should be given to the parties preparing and documenting worked examples of the calculation of the performance fees using various performance scenarios.

Section 29VD of the SIS Act requires a trustee of a regulated superannuation fund that has a MySuper product to ensure that any arrangement with an investment manager that provides for a fee, determined in whole or in part by reference to the performance of the investments made by an investment manager, complies with the following requirements in the section:

²⁰ Clauses 4.1(p), 8 and Schedule 4 of the IMA.





- the base fee must be set or adjusted to give an incentive to the investment manager to obtain the performance based fee;
- the period over which the entitlement to the performance based fee is determined must be appropriate to the kind of investment to which the fee relates;
- the performance of the investment must be measured by comparison with the performance of investments of a similar kind;
- for the purposes of working out the fee, the performance of the investment must be determined on an after-costs basis and, where possible, on an after-tax basis; and
- the fee must be calculated in a way that includes disincentives for poorly performing investments.

APRA's expectation is that a trustee will undertake a documented analysis to demonstrate that it has given due regard to these requirements.²¹

Other areas that the trustee may need to ensure are addressed and explicit in the IMA are:

- the scope of the management fee being wide, with elements not being attributed as an expense, rather than a management fee
- the calculation of management fees, including whether the valuation used is that of the custodian or the investment manager
- treatment of cash flows
- specification of the base currency
- issues arising from related party transactions, including provisions for fee adjustment to avoid double payment for single service
- specification of GST requirements on all parties.

For certain unlisted investments, the trustee should ensure that there is full negotiation of the appropriate fee up to the point of disposal of the asset by the investment manager (often called the 'closing cost allocation').

The template IMA provides for a transition period where there is a change of investment manager. Trustees must be cognisant that, during this transition period, fees may be payable to both the outgoing and incoming investment managers.

The trustee also needs to be cognisant of the tax consequences of an investment manager's style and related custodian fees. For example, a high trading investment strategy may imply both higher fees and different tax treatment.

4.12 Expenses and payments²²

The trustee is liable for a number of expenses related to the investment of the fund's assets. These include taxes, regulatory costs, custodian fees, broker fees, and costs or charges associated with the acquisition or sale of any particular asset. A number of these expenses may be contracted and paid by an outsourced service provider (for example, by the investment manager or custodian) on behalf of the trustee.

The trustee should ensure that it knows the full scope of its expenses and costs ahead of investment by an external party so that it has the ability to control these expenses. Further, the trustee should regularly review both the scope and magnitude of all investment expenses, especially broker fees, to ensure that they are appropriate for the investment and are market competitive. It should ensure that no external party, including the investment manager and brokers, are using soft dollar payments. If necessary, expenses should be adjusted pursuant to the IMA, the nature of the investment and competitive market pricing.

²¹ SPG 530 Investment Governance Clause 79.

²² Clause 9 of the IMA.





4.13 Reports²⁴

All service providers retained by a trustee should be subject to reporting requirements that allow the trustee to remain 'in control' of the fund for which they are responsible.

In the case of investment management, the reporting provided should enable the trustee to assess the capability and performance of their investment managers on an ongoing basis against agreed benchmarks as set out in the IMA.

To ensure that reporting by the investment manager meets regulatory and operational requirements, the trustee should ensure that the IMA clearly:

- sets out the reporting requirements, including types of report, levels of detail and frequency, as well as the mechanisms to be used
- defines the audit trails to be set in the financial reporting process, including the need for all reporting to be on a reconciled basis
- identifies the respective responsibilities of the investment manager and the custodian, if applicable in this regard.

In addition to investment reporting, the IMA should require the investment manager to report, within specified times, on any events or actions that may affect the fund's compliance status or security.

In particular, the investment manager should be required to inform the trustee in the case of events or actions that involve, or lead to:

- a breach of contract, including the investment mandate
- a breach of any relevant legislation
- other significant events that may affect the portfolio's financial position
- a notifiable event (see below).

This reporting obligation should extend to events that the manager is aware are likely to occur, as well as those that have already taken place.

It is also recommended that, as part of the annual reporting cycle, the investment manager be required to disclose any adverse comments it has received as part of internal or external audit activity. An overview of improvements being implemented to address such comments should also be provided.

These are events or potential events which, if not in themselves a breach of the contract, are serious enough to warrant early advice to the trustee, so that the trustee can monitor the situation and consider its position.

Schedule 3 of the template IMA contains examples of quarterly and annual reporting obligations, in addition to the positive obligations in the IMA to provide information and data to the trustee and the custodian. The suggested reports set out in Schedule 3 are examples only and need to be adapted for each fund having regard to the nature of the mandate and the fund's circumstances. Some funds may require monthly reporting in addition to quarterly and annual reporting.

²⁴ Clause 10 and Schedule 3 of the IMA.





4.14 Termination²⁵

The trustee must be able to terminate the manager without notice, and/or freeze a manager's duties immediately by authorised direction to the manager or custodian, in the case of default by the manager. This power is essential to protect the fund and the trustee in the case that the manager becomes insolvent or breaches a material provision of the IMA. In other situations, it is usual to see a reasonably short notice period of, say, five business days. In this circumstance, no reason for termination is required to be given. To ensure that terminations are effective, the IMA needs to specify the mode of notification of termination.

If a mandate is terminated, for whatever reason, transition protocols and obligations need to be adhered to by both parties. Where the trustee exercises the right to terminate a manager, professional indemnity insurance should have run-off protocols.

4.15 Warranties and acknowledgements²⁶

Both the trustee and investment manager need to provide warranties to each other regarding their ability to enter into and have ongoing compliance with the IMA and various other conditions. For the investment manager, these include:

- compliance with regulatory requirements in relation to its status as a body corporate and other matters
- appropriate skill, facilities capacity and staff to perform duties and obligations
- sufficient investment management experience and oversight
- co-operation with the custodian.

4.16 Compliance with the licensing regime²⁷

When appointing a domestic investment manager, the trustee needs to ensure that the manager holds an Australian financial services licence under Chapter 7 of the *Corporations Act 2001*, covering the financial services that the manager provides to the trustee.

Clause 12.2(d) contains a warranty and representation from the investment manager in relation to its compliance with the requirements of Chapter 7 of the *Corporations Act 2001*.

Under section 911D of the *Corporations Act 2001*, an international investment manager can be regarded as carrying on a financial services business in Australia and be required to be licensed in Australia, even though they may have no physical presence, if they intend to induce persons in Australia to use their financial services and act upon their advice.

When appointing an international investment manager, the trustee needs to be satisfied, therefore, not only that the manager is appropriately licensed in its home jurisdiction, but also, that Australian financial services licensing requirements have been met.

Under the Australian financial services regime, ASIC has issued conditional Class Order relief for investment managers who are regulated in certain home jurisdictions recognised by ASIC as entitling the investment manager to obtain class order exemption relief from the need to be licensed under the *Corporations Act 2001*. The relief is available to certain companies and corporations registered as a foreign company in Australia under the *Corporations Act 2001* and, otherwise being:

²⁵ Clause 11 of the IMA.

²⁶ Clause 12 of the IMA.

²⁷ Clause 12.2(d) of the IMA.





- an entity regulated by the Financial Conduct Authority (FCA) under the *Financial Services and Markets Act 2000* of the United Kingdom or dual regulated by the FCA and the Prudential Regulation Authority (PRA)²⁸
- a broker or dealer registered under the *Securities and Exchange Act of 1934* (US) and regulated by the Securities and Exchange Commission of the United States of America (SEC)²⁹
- an investment adviser registered under the *Investment Advisers Act of 1940* (US) and regulated by the SEC³⁰
- a bank holding company, a body the subject of a certificate from the Comptroller of the Currency of the United States (OCC) or an Edge corporation regulated by the United States Federal Reserve or the OCC³¹
- a Singaporean capital market services licensee, banking licensee or merchant bank approved as a financial institution by the Monetary Authority of Singapore³²
- a Hong Kong body corporate with current licence or certificate of registration under the *Securities and Futures Ordinance 2002* of Hong Kong and regulated by the Securities and Futures Commission of Hong Kong.³³

If an international manager is not licensed in Australia, then suitable warranties should be sought from the manager in lieu of the warranty in Clause 12.2(d) of the template IMA. A suitable example of a warranty to be used for an investment manager that is regulated by the FCA under the *Financial Services and Markets Act 2000* and relies on ASIC Class Order CO 03/1099 would be:

"It is exempt from holding an Australian Financial Services Licence but:

- it will during the term of this Agreement be the holder of any other licence or regulatory approval required in respect of its investment management business under the laws governing the activities of the Manager and this Agreement; and*
- it otherwise has obtained exemptive relief under ASIC Class Order CO 03/1099."*

Further warranties might be sought in respect of the investment manager's status under the legislative regime that ASIC recognises in CO 03/1099.

Where the relevant investment manager operates in a different jurisdiction, this alternate warranty should be adapted to recognise the relevant ASIC Class Order and its terms.

4.17 Investee company governance including proxy voting³⁴

The IMA should deal with the allocation of responsibility for corporate governance issues related to the companies in which the fund's assets are invested. This may extend to formal or informal discussions with the companies concerned, but, more commonly, concerns shareholder action such as proxy voting.

Best practice requires trustees to develop their own policy on the management of external corporate governance. This may include:

- the extent to which the trustee wishes to be actively involved in external corporate governance, if at all
- the way in which such involvement may be implemented
- how the investment manager's corporate governance policy may affect the above
- the extent and frequency of reporting expected from investment managers on their corporate governance actions, including proxy voting.

²⁸ ASIC Class Order CO 03/1099.

²⁹ ASIC Class Order CO 03/1100.

³⁰ ASIC Class Order CO 03/1100.

³¹ ASIC Class Order CO 03/1101.

³² ASIC Class Order 03/1102.

³³ ASIC Class Order 03/1103.

³⁴ Clause 13 of the IMA.





There is no one correct approach to these matters, other than that they should be considered before the engagement of an external investment manager.

The trustee's policy should be reflected in and supported by the provisions of the IMA such as:

- the trustee delegating voting powers to the manager, while reserving the right to direct if so minded
- opportunity for veto of, or positive input into, the manager's corporate governance actions
- prior advice to the fund or its representative regarding corporate governance actions being considered by the manager
- provision and annual attestation of the investment manager's proxy voting policy that ensures that all corporate governance actions in relation to the fund's shares remains within the purview of the trustee.

The template IMA contemplates the trustee authorising the investment manager to vote on its behalf and to appoint directors on its behalf or to so direct the custodian. The authorisation is subject to a number of restrictions set out in Clause 13.1 and requires the investment manager to provide the trustee with a copy of its proxy voting policy and record of any action taken.

If the trustee's policy is to retain the right to vote (or direct the investment manager on how to vote), alternate wording will be required. In this case, Clause 13.1 could be replaced by the following:

- "(a) The Manager does not have the authority (unless specifically instructed by Proper Instructions by the Trustee in a particular case) to exercise voting rights attached to any share or security forming part of the Portfolio or to provide Proper Instructions to the Custodian as to the exercise of voting rights or the completion of proxy votes.*
- (b) Notwithstanding clause 13.1(a) the Manager must provide the Trustee with its voting recommendations in respect of corporate actions concerning the shares or securities forming part of the Portfolio upon reasonable request by the Trustee from time to time. In the event that the Trustee requests the Manager to provide such recommendations, supporting analysis for that recommendation must be provided to the Trustee."*

4.18 Authorised persons and proper instructions³⁵

Both the trustee and the investment manager need to specify who is authorised to either make written communication or effect investment decisions or operations under the IMA. It is most likely that different persons will be authorised for different levels of transactions. The template IMA requires that a 'Proper Instruction' be provided by two 'Authorised Persons' (Clause 14.3(b)) and does not allow Proper Instructions to be provided by telephone (Clause 14.9). Clause 24 (Notices and Other Communications) also impacts how Proper Instructions are given.

It is incumbent on both parties to ensure that the lists of authorised persons are kept current.

It would be prudent for a trustee to ensure that proper instructions are:

- signed by two Authorised Persons. Given that much communication can be electronic, each trustee needs to determine what constitutes a signed instruction, with this being consistent with their overall governance for the authorisation of documents or instructions that legally bind the trustee
- given in a format that is consistent with the trustee's security and fraud provisions. Notably, the trustee must consider whether they will allow Proper Instruction to be given by telephone.

³⁵ Clause 14 of the IMA.





4.19 Insurance³⁶

Trustee best practice requires the investment manager to maintain, as a minimum, insurance covering the manager's liability in the areas of:

- Fidelity guarantee insurance
- Electronic and computer crime insurance
- Professional indemnity insurance (usually held for the whole financial group rather than the investment manager alone)
- Directors' and officers' liability.

The level of insurance cover should be linked to total assets under management or the size of the mandate, after taking into account the level of capital held within the investment management company, parent guarantees or other potential financial support. A certificate of currency should be provided by the investment manager as part of required documentation before the contract is signed and annually thereafter.

The IMA should provide that the level of such insurances cannot be lessened during the currency of the agreement without the trustee's agreement.

4.20 Business continuity and disaster recovery³⁷

The trustee needs to ensure that the business continuity and disaster recovery plans of an investment manager are consistent with its own such plans and the regulatory requirements that underpin them. It should require investment managers to annually test and review their business continuity and disaster recovery plans, with a report back to the trustee. Upon the occurrence of a disaster recovery event, the trustee must ensure that it receives immediate notification and then ongoing communication, that the investment manager's disaster recovery plan is fully implemented and that the investment management of the fund's assets continues to be prudently managed, having regard to the then prevailing circumstances.

At all times, the trustee should know the location and back-up arrangements for its data.

4.21 Intellectual property and data³⁸

Trustees need to be very clear about what constitutes the intellectual property of both the trustee and the investment manager.

The data that underpins the investment management of a fund's assets remains the property of the trustee and is confidential. While individual data should not be used by the investment manager for its own purposes, the trustee may wish to allow the use by the investment manager of a nominated group of data at a total portfolio level for analytical purposes such as analysis of risk, execution, transactions or for marketing purposes.

4.22 Confidentiality, privacy and security³⁹

It is essential that the IMA specifies that all information about the trustee and the fund's investments are treated with the appropriate confidentiality, privacy and security. Only by negotiation with the trustee, may any information about the trustee or the investments be used by the investment manager for its own purposes.

³⁶ Clause 15 of the IMA.

³⁷ Clause 16 of the IMA.

³⁸ Clause 21 of the IMA.

³⁹ Clause 22 of the IMA.



Investment managers must have policies regarding confidentiality, privacy and security and be able to demonstrate ongoing compliance.

4.23 Dispute resolution⁴⁰

While a dispute between the parties is not expected, it is best practice that the arrangements around such an occurrence are specified in the IMA. This includes formal notice of dispute, actions for resolution, payment of associated costs and continued performance under the IMA. Where an international manager is to be engaged, there is the need to specify the relevant law for international dispute resolution.

4.24 Governing law and jurisdiction⁴¹

The trustee should ensure that the IMA is very specific about the governing law and jurisdiction. Optimally, the governing law is that of the state or territory where the trustee's head office is based. The responsibility for clarifying legal jurisdiction is even more important for trustees when engaging an international investment manager.

4.25 Risk management generally⁴²

4.25.1 Adequacy of resources

APRA requires that, as part of the trustee's risk management obligations under SPS 232 to ensure the adequacy of resources obligation is met where the trustee proposes to outsource a material business activity, the trustee make an assessment that the service provider is financially sound and has the required resources to undertake the outsourced activity on a continuing basis.⁴³ The template IMA has a number of provisions including warranties and obligations to support the trustee's initial and continuing assessment as to the investment manager's financial soundness. These include:

- an obligation on the part of the investment manager to notify the trustee of any material change in ownership, management or organisational structure⁴⁴
- warranties from the investment manager as to the sufficiency of its skills, capacity and staff⁴⁵
- an obligation on the part of the investment manager to notify the trustee of any financial or capability problems that might impact on the manager's ability to perform its duties and obligations under the IMA.⁴⁶

4.25.2 Risk and control frameworks

When a trustee contracts with a third party to provide a material business activity, APRA expects the trustee to assess, as part of its necessary due diligence, what risk mitigants and controls, if any, the service provider has in place and then determine the extent to which the relevant measures can be relied upon.⁴⁷

The template IMA contains obligations on the part of the investment manager in relation to the adequacy of its internal controls and systems, risk management systems, and in relation to having its internal framework audited by a qualified independent expert annually.⁴⁸

⁴⁰ Clause 24 of the IMA.

⁴¹ Clause 30 of the IMA.

⁴² Clauses 4, 4.11 and 12 of the IMA.

⁴³ SPG 231 Clause 13.

⁴⁴ Clause 4.1(k) of the IMA.

⁴⁵ Clause 12.2(b) of the IMA.

⁴⁶ Clause 4.11 of the IMA.

⁴⁷ SPG 220 Clause 51.

⁴⁸ Clause 17 of the IMA.



4.26 Notices and other communications⁴⁹

The template IMA contemplates a cut off time for notices of 2pm (local time), meaning if a communication is received after 2pm, it is deemed to be delivered the following business day. Trustees will need to consider if that cut off time is appropriate for their and their custodian's operational circumstances.



⁴⁹ Clause 24 of the IMA.





Part 2 – Mapping of template IMA to regulatory requirements



Part 2 – Mapping of template IMA to regulatory requirements

1.1 Overview

This section of the Best Practice Paper outlines the specific regulatory requirements relevant to an IMA entered into by a registrable superannuation entity (RSE) licensee, and maps the relevant requirements in relation to the content of the template IMA. This checklist can be used by trustees to assist them to ensure that their IMA is compliant with the relevant law. All references in the mapping to a “trustee” are to be read as a reference to a RSE licensee.

There are three main sources of regulation relevant to an IMA:

- The SIS Act
- Superannuation Prudential Standard SPS 231 – *Outsourcing*, and the associated Superannuation Prudential Practice Guide 231
- Superannuation Prudential Standard SPS 232 – *Business Continuity Management*.

Other SPSs that are relevant to the investment management arrangements of a trustee but do not need to be explicitly mapped when compiling or negotiating an IMA are:

- SPS 220 – *Risk Management*
- SPS 510 – *Governance*
- SPS 521 – *Conflicts of Interest*
- SPS 530 – *Investment Governance*.

All RSE licensees must comply with a Superannuation Prudential Standard in its entirety.

APRA also provides guidance on its view of sound practice in particular areas in Prudential Practice Guides. Prudential Practice Guides (PPGs) do not themselves create enforceable requirements but they do provide assistance to trustees in complying with the requirements in the prudential standards. APRA has released PPG 231 – *Outsourcing*, which is a useful resource in assisting trustees manage their outsourcing arrangements.

1.2 Superannuation Industry (Supervision) Act 1993

Section no.	<i>Superannuation Industry (Supervision) Act 1993</i>	Clause reference in the template IMA
102	<p>Duty to seek information from investment manager</p> <p>(1) If the trustee of a superannuation entity enters into an agreement with an investment manager under which money of the entity will be placed under the control of the investment manager, the trustee must:</p> <ul style="list-style-type: none"> (a) ensure that the agreement contains adequate provision to enable the trustee to require the investment manager from time to time: <ul style="list-style-type: none"> (i) to provide appropriate information as to the making of, and return on, the investments; and (ii) to provide such information as is necessary to enable the trustee to assess the capability of the investment manager to manage the investments of the entity; and (b) whenever it is necessary or desirable to do so, require the investment manager to provide the information. 	<p>10.1</p> <p>10.2</p> <p>10.3</p> <p>4.1(e)</p> <p>4.1(g)</p> <p>4.1(h)</p> <p>4.1(i)</p> <p>4.1(j)</p> <p>4.1(k)</p> <p>4.1(o)</p> <p>4.10</p> <p>4.11</p> <p>13.4</p>
109	<p>Agreement between trustee and investment manager</p> <p>Despite anything in the governing rules of a superannuation entity, any provision of an agreement between a trustee of the entity and an investment manager that purports to exempt the investment manager from liability for negligence, or to limit that liability, is void.</p>	<p>Clause 6.2 requires the manager to indemnify the trustee for loss arising from the manager's or negligence or the negligence of the manager's officers, employees, delegates or agents.</p>
122(1)	<p>Investment manager must not appoint or engage custodian without the trustee's consent</p> <p>An investment manager of a superannuation entity must not appoint or engage a custodian of the entity without the written consent of the trustee, or the trustees, of the entity.</p>	<p>2.2(a)</p>
125	<p>Individuals not to be investment managers of superannuation entities</p> <p>A person must not intentionally be, or act as, an investment manager of a superannuation entity (other than a self- managed superannuation fund) if the person is not a body corporate.</p>	<p>12.2(f)</p>

1.3 APRA Prudential Standard SPS 231 – Outsourcing

Clause no.	APRA Prudential Standard SPS 231 – Outsourcing	Clause reference in the template IMA
Application		
2	<p>The Prudential Standard applies to all RSE licensees under the <i>Superannuation Industry (Supervision) Act</i>, in respect of the outsourcing of a material business activity.</p> <p>SPG 231 only relates to business activities that the trustee performs in its capacity as trustee (as opposed to its capacity as a corporate entity).</p>	N/A
Scope of the arrangement, services to be supplied and service levels		
21(a)	SPS 231 requires an IMA to address the scope of the arrangement and the services to be supplied.	2.1, 4, 5 and Schedules 2 and 3
21(e)	<p>SPS 231 requires an IMA to address service levels and performance requirements.</p> <p>APRA expects that an IMA would normally:</p> <ul style="list-style-type: none"> include the content, frequency and format of the services being provided state the timelines for receipt and delivery of work and specifying priorities; and contain performance benchmarks, including default benchmarks that, if not met, could result in penalties being applied or, in extreme cases, termination of the IMA (SPG 231 Clause 14). 	2.1, 4.1(a), 11.3 and Schedules 2, 3 and 7
Commencement and termination		
21(b)	SPG 231 requires an IMA to address commencement and end dates.	Definition of 'Commencement Date' in 1.1 and termination provisions in 11.1, 11.2 and 11.3.
21(k)	<p>SPG 231 requires an IMA to address default arrangements and termination.</p> <p>APRA notes in SPG 231 at Clause 19 that as a guide it expects that an IMA would set out:</p> <ul style="list-style-type: none"> possible reasons for termination procedures to be followed in the event of termination, including notice periods the rights and responsibilities of the respective parties; and transition arrangements. <p>Further, that transition arrangements would typically:</p> <ul style="list-style-type: none"> address access to, and ownership of, documents, records, software and hardware specify the time period over which the business activity would continue to be undertaken by the service provider the service provider's role in transitional arrangements if the activity is brought back in-house or outsourced to another service provider. 	11.1, 11.2 and 11.3 11.3, 11.4, 11.5, 11.6, 11.7, 11.8, 11.9 and 21



Clause no.	APRA Prudential Standard SPS 231 – <i>Outsourcing</i>	Clause reference in the template IMA
	<p>APRA expects the default arrangements in an IMA should typically clearly specify:</p> <ul style="list-style-type: none"> • what constitutes a default event • identify how it is to be rectified; and • specify any indemnity provisions (SPG 231 Clause 18). 	11.3, 4.2, 6.1 6.3
Review provisions		
21(c)	SPS 231 requires an IMA to contain review provisions.	7.1, 8.5, 11.2 and 29
Pricing and fee structure		
21(d)	<p>SPS 231 requires an IMA to include a pricing and fee structure.</p> <p>APRA envisages that an IMA will set out explicit pricing arrangements, covering issues such as frequency of payment, invoicing and payment procedures (SPG 231 Clause 20).</p>	8, 9 and Schedule 4
Form of data		
21(f)	SPS 231 requires an IMA to address the question of the form in which data is to be kept and to contain clear provisions identifying ownership and control of the data.	4.1(f), 10.7, and 21
Reporting requirements		
21(g)	SPS 231 requires an IMA to include reporting requirements, including the content and frequency of reporting.	4.1(g), 4.1(h), 4.1(i), 4.1(j), 4.3, 4.10, 4.11, 10 and 12.2(k) and Schedule 3
Audit and monitoring procedures		
21(h)	<p>SPS 231 requires an IMA to contain audit and monitoring procedures.</p> <p>APRA envisages that an IMA will clearly set out the procedures in place to enable the trustee to effectively monitor the performance of the service provider. This would typically include the extent to which the trustee’s internal or external auditors can obtain sufficient information (including through on-site inspections or the appointment of an external party) to satisfy themselves as to the adequacy of the investment manager’s risk management systems. APRA also recommends that consideration be given to including provisions allowing an annual review of the investment manager’s internal control systems by an independent expert (SPG 231 Clause 16).</p> <p>To support the audit function, the trustee should arrange for access to those records held by the investment manager that are necessary for audit trail purposes.</p>	<p>19</p> <p>17, 19.1, 19.2 and 19.3</p> <p>4.1(g), 10.3, 10.5 and 10.7</p>





Clause no.	APRA Prudential Standard SPS 231 – <i>Outsourcing</i>	Clause reference in the template IMA
Business continuity management		
21(i)	<p>SPS 231 requires an IMA to contain business continuity management (BCM) obligations.</p> <p>APRA envisages that an IMA would detail how BCM arrangements would ensure that acceptable service levels are maintained in the event of problems occurring with the investment manager. APRA also expects that an IMA will enable the trustee to request reporting or other documentary evidence on the investment manager’s business continuity plan (BCP). These requirements must also apply to any subcontracting or outsourcing by the investment manager (SPG 231 Clause 17).</p>	<p>16</p> <p>16.2</p>
Confidentiality, privacy and security of information		
21(j)	SPS 231 requires an IMA to address the issues of confidentiality, privacy and security of information.	22
Dispute resolution arrangements		
21(l)	<p>SPS 231 requires an IMA to contain suitable dispute resolution arrangements.</p> <p>APRA expects that the dispute resolution mechanisms, including conciliation and arbitration arrangements, enable the continued operation of the outsourced activity while specific issues are being dealt with (SPG 231 Clause 21).</p>	<p>23</p> <p>23.4(b)</p>
Liability and indemnity		
21(m)	<p>SPS 231 requires an IMA to address the issue of liability and indemnity.</p> <p>APRA expects that an IMA would typically specify:</p> <ul style="list-style-type: none"> the extent of liability for each party, and, in particular, whether liability for negligence is limited and any indemnities and provide details of insurance arrangements, <p>and that consideration is given to the extent of the liability to both the trustee and the investment manager in relation to subcontracting arrangements (SPG 231 Clause 22).</p>	<p>6</p> <p>6.1, 6.2, 6.3, 5.3(d), 5.3(e) and 15</p>
Insurance		
21(n)	<p>SPS 231 requires an IMA to address the question of insurance.</p> <p>APRA expects the trustee to consider the adequacy of the investment manager’s insurance and/or guarantee arrangements (SPG 231 Clause 13).</p>	<p>15</p> <p>15(a)</p>
Sub-contracting		
21(n) and 22	<p>SPS 231 requires an IMA to address the question of sub-contracting and specifically to include an indemnity to the effect that any sub-contracting by the investment manager of the outsourced function will be the responsibility of the investment manager, including liability for any failure on the part of the sub-contractor.</p> <p>APRA expects that the sub-contracting provisions would include specific</p>	<p>5.3, 5.3(d), 5.3(e)(iii) and 6.2</p>





Clause no.	APRA Prudential Standard SPS 231 – <i>Outsourcing</i>	Clause reference in the template IMA
Monitoring the relationship		
30	<p>The trustee must ensure it has sufficient and appropriate resources to manage and monitor each outsourcing relationship at all times.</p> <p>The type and extent of resources required will depend on the materiality of the outsourced business activity. At a minimum, monitoring must include:</p> <ul style="list-style-type: none"> • maintaining appropriate levels of regular contact with the service provider. This will range from daily operational contact to senior management involvement; and • a process for regular monitoring of performance under the agreement, including meeting criteria concerning service levels. <p>APRA expects a trustee to consider and take into account any actual or potential conflicts between the trustee and service provider that may impact the trustee’s monitoring of the service provider (SPG 231 Clause 40).</p> <p><i>SPG Clause 41 – As part of a monitoring framework the trustee should regularly satisfy itself that the data managed by the service provider is of high quality, is accurate and complete, and is consistent with the provisions of the agreement.</i></p>	<p>4.1(e), 4.2(c), 4.10 and 4.11</p> <p>5.5</p>



1.4 APRA Prudential Standard SPS 232 – Business Continuity Management

Clause no.	APRA Prudential Standard SPS 232 – Business Continuity Management	Clause reference in the template IMA
Business continuity plan		
24	Where material business activities are outsourced, the trustee must satisfy itself as to the adequacy of the outsourced service provider’s BCP - which includes crisis management and recovery of critical business activities - and consider any “dependencies” between the service provider’s BCP and the RSE licensee’s BCP.	16
27	Where material business activities are outsourced the trustee must satisfy itself that the outsourced service provider adequately reviews and tests its BCP at least annually, or more frequently if there are material changes to business operations, to ensure that the BCP can meet the business continuity management objectives of the trustee. The results of the testing, including any change to the service provider’s BCP, must be formally reported to the trustee by the outsourced service provider as soon as practicable.	16.5



**Appendix –
ASFA TEMPLATE INVESTMENT
MANAGEMENT AGREEMENT**





Association of Superannuation Funds of Australia Limited
Level 6, 66 Clarence Street, Sydney NSW 2000
T +61 2 9264 9300 or 1800 812 798 (outside Sydney)
F 1300 926 484
W www.superannuation.asn.au

