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Outsourcing, technology transformation and cloud in Asia: the legal and regulatory essentials 2021

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New operating models - new challenges

As businesses in Asia grow in scale and complexity, exploiting new digital channels and facing new cost-cutting pressures, they are increasingly turning to outsourcing and other forms of technology transformation, including the deployment of cloud technologies, to support their operations and gain competitive advantage.

The COVID-19 pandemic has also impacted, the way we do business giving organizations cause to look at new ways of reaching their customers, new ways of working and new ways of reducing their operating costs. In this environment, technology transformation takes many forms, but at its core, we see businesses focusing on leveraging technology to redesign operations to better support the achievement of business objectives. There is often an element of collaboration involved, with organizations turning to outsourced service providers and other partners to achieve transformations which they cannot achieve on their own. There is also often a pronounced focus on data – using innovative technologies to derive data-driven insights and using cloud based solutions to deliver data and services in real time to better serve customers and achieve higher productivity from resources. The business drivers towards technology transformation are clear, but equally so are the regulatory constraints. Some sectors have moved towards detailed outsourcing and technology risk management regulations. More broadly, the rapid expansion in recent years of comprehensive "European style" data privacy regulation and the emergence of cybersecurity regulation have all raised challenges to innovation. While much remains possible from a regulatory standpoint, stepped-up regulation is forcing Asia's regional businesses to evaluate their transformation and collaboration options more carefully, engage in more rigorous due diligence processes, manage an increased likelihood of regulatory change, and enter into more detailed and complex contractual arrangements in order to achieve compliance.

The challenges for legal counsel – increased regulation, increased risk

Organizations are faced with a number of challenges in this dynamic environment, in particular a need to negotiate and manage more detailed and complex contracting structures. This imperative is driven by growth in the scale of business risk, the sophistication of commercial objectives, and a need to deal with regulators' increasingly exacting expectations.

The consequences of not getting legal and compliance requirements right are increasing in Asia. With greater business automation and increased dependency on technology systems, project failure can be highly visible, both externally to customers and regulators and internally. Technology transformation exercises often involve longer term commitments, meaning that getting the contractual and regulatory requirements right is taking on a growing importance as a result.

How to prepare?

Organizations pursuing a large-scale technology transformation exercise will want to begin with an understanding of the nature and scope of the project, its objectives and who the relevant internal stakeholders are for the project.

Operations, IT, and procurement will typically be key stakeholders in sourcing and technology projects, but apart from legal and compliance, human resources (HR), finance, and tax will often play key roles in assessing risk, inputting the project business case, and formulating a structure for the commercial arrangements that optimize the economic benefits of the project. Early engagement with these stakeholders can be critical.

Once the right team is in place, reporting lines and internal approval requirements can be established. Finally, a project management structure that coordinates the various work streams is essential to the project success.

Regulation, regulation, regulation

The impact of regulation on collaborations, including cloud and outsourced service models in Asia, is significant and growing. While industries such as banking and financial services are typically the most heavily regulated, data privacy regulation, employment laws, and more recently, the emergence of cybersecurity regulation in Asia, have extended regulatory oversight across most if not all fields of business.

The threshold questions: Can you outsource? Can you use cloud?

In the most heavily regulated industries, such as banking and insurance, regulation will typically stipulate that “licensed business” or “core business” cannot be placed into the hands of an unlicensed outsourced service provider. Only a licensed insurance company, for example, can make an actuarial decision to write an insurance policy, not an outsourced service provider acting on its behalf. While these restrictions are most immediately relevant in the business process outsourcing (BPO) context, heavily regulated industries may also have restrictions on handing over core systems or data for third party processing, which may impact on the scope to deploy cloud and outsourced IT solutions. We are seeing the region's financial services regulators generally becoming more accepting of cloud based services, but the specific nature of the data and it’s processing remain important.

There are plenty of "grey" areas on this front, and part of the value in legal input can be in fine-tuning a service description to address issues that are front of mind for regulators, such as being clear that business discretion and engagement with customers remain in the hands of licensed businesses and explaining how business data and customer data are secure and remain readily available to the regulator.

Outsourcing regulations

Once the threshold question of whether or not the service scope and service model is feasible has been answered in the affirmative, there may be regulations or guidelines that stipulate how the business must evaluate and implement a proposed outsourcing or procurement. The outsourcing guidelines found in the banking and financial services industries across the region are leading examples. There is a threshold question here as well – if the arrangement would amount to an outsourcing, is it considered a "material outsourcing" that may require notification to or approval by a regulator?

For banks and financial services providers in particular, whether or not this notification or approval requirement is triggered will depend on the potential impact on the businesses’ ability to comply with regulatory requirements and its ability to provide services to its customers.

If outsourcing guidelines apply, business will be required to carry out an effective evaluation of the service model, the bidding vendors and the agreed contractual terms. If there is a notification or approval requirement, completing the regulatory process in good time means effective preparation and anticipating the questions that are likely to come. A framework for compiling the necessary information and linking contractual requirements to the working draft agreements is key to clearing the regulatory process as quickly as possible. We are currently seeing a stepping up of outsourcing regulations across the region and much closer compliance scrutiny. That said, the consolation seems to be in greater acceptance by regulators of cloud usage as the offerings have matured and risks have become better understood.

Data and cybersecurity

Recent years have seen an explosion of comprehensive “European style” data privacy regulation across the Asia region, with fresh impetus for tighter regulation in response to the EU General Data Protection Regulation (GDPR). The increasing number and sophistication of dedicated data protection authorities in the region has made the compliance burden significantly heavier. The public is now inundated with headlines reporting on data security breaches making for broader awareness of data rights and a pronounced movement by lawmakers towards tougher regulations.

Critically, in the outsourcing and technology procurement context, many of these new laws have data export controls that can raise obstacles or impediments to plans to consolidate databases, or at least require that steps be taken to make data exports compliant. Data localization requirements are also featuring in many of these laws, most significantly in relation to China's Cyber Security Law and India's revised Draft Personal Data Protection Bill, but also under similar legislation now being developed in Indonesia, Vietnam and other jurisdictions.

At the very least, data protection and cybersecurity regulation will necessitate an assessment of compliance risks and the agreement of appropriate secure processing undertakings with vendors. The dynamic regulatory landscape in this area also means that customer organizations are well advised to agree terms dealing with the possibility that regulations change, for better or for worse.

Data protection compliance is increasingly important to outsourcings and complex technology service arrangements, but it is now only part of the picture. With data becoming more sophisticated and ubiquitous, the success of many organizations and outsourcing providers, depend on their ability to gather vast amounts of data and carry out data analytics to make sense of it. As this trend continues to accelerate and evolve, with organizations mobilizing to make better use of data (whether personal data or otherwise), there is increased focus on commercial rights to use data arising from service delivery. "Ownership" of data is now a hotly contested topic that needs to be addressed head on in negotiations.

Technology Risk Management

In the financial services sector, in particular, there are increasingly complex regulations concerning the effective management of risks associated with outsourcing or technology transformation projects. These regulations require customer organizations to identify existing and emerging technology-related risks and set out principles on how these risks can be assessed and managed on an ongoing basis.

HR considerations

Outsourcings often involve the transfer of employees and the management of redundancies. The customer organization will want to ensure confidentiality and carefully plan internal communications about the project, but at the same time enable due diligence by the vendor as needed. There are very few "automatic transfer" regimes in Asia that will apply to transfer employment contracts to an outsourced service vendor by operation of law in the same way as Europe's Transfer of Undertakings Directive. As a result, an "offer and acceptance" procedure will typically be needed. The parties will need to agree, amongst other issues: (a) an allocation of responsibility for employer liabilities (for example, whether severance payment obligations arise and, if so, who will be responsible for paying them); (b) any sharing of funding responsibility for employee benefits and retention incentives; and (c) contingency planning to address situations in which not all in-scope employees accept their transfer offers. It goes without saying that retention of knowledge and skills can be key to the success of an outsourcing project and so these points merit close attention.

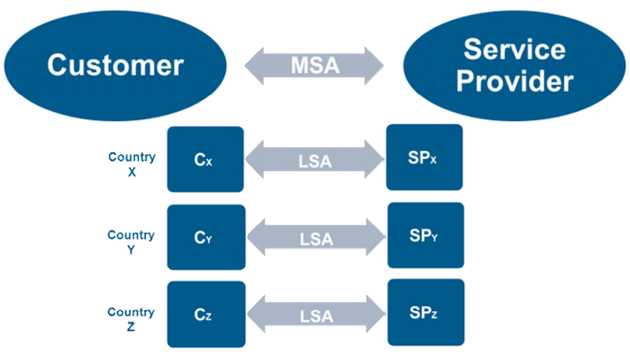
Asset and contract transfers

It is not unusual for assets and contracts to transfer to the service provider as part of an outsourced service arrangement. The service provider will need to be in a position to conduct due diligence on these assets and contracts, and the parties will need to agree commercial arrangements, including responsibility for any third party consents, tax liabilities, and other costs of transfer.

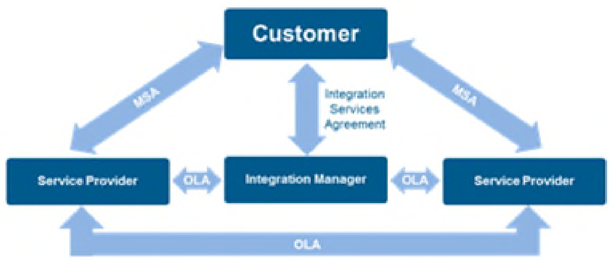
Likewise, if premises or facilities are to be made available to a service provider, terms will need to be agreed and documented. Depending on the circumstances, landlord consents and land use permissions may be needed.

Structural considerations

Contract structure, particularly in the context of multi-jurisdictional outsourcing and technology transformation projects in the Asia region, is critical. Many outsourcing arrangements in the region rely on a master services agreement – local services agreement (MSA/LSA) structure that involves contracting at a master level (typically backed up with a parent company guarantee) and implementing local "point-to-point" billing through LSAs so as to avoid withholdings and minimize taxes. LSAs may also be necessary in order to satisfy regulatory requirements.



The other key feature of contracting structure that requires careful evaluation is the extent to which the service function is dependent on performance by other vendors. If the outsourcing is a "multi-vendor" solution, then care will need to be taken to ensure that appropriate touch-points between vendors are recognized. It may be desirable to formalize these interdependencies through "operating level agreements" entered into between vendors. Above all else, the success of multi-vendor delivery models is dependent on there being a well thought out vendor governance structure.



The right contract

Outsourcing agreements, in particular, tend to be long term contracts that must support a complex relationship that will necessarily change over time.

In many cases, outsourcings are tendered, and so getting the right contract starts with the right tendering process. Parallel discussions with a number of vendors will create useful competitive tension that will drive better terms, but these advantages need to be balanced against the fact that extended parallel negotiations are time consuming and may strain resources.

Requiring bidders to mark up a select set of key legal terms as part of their request for proposal responses is often a useful middle ground, providing certainty of negotiated positions on critical issues but without requiring extensive parallel negotiations.

Long form agreements should take advantage of unique market conditions in Asia, which continues to produce more buyer-friendly outcomes. Similarly, market practice in the region tends to produce shorter "long forms" than are seen in the U.S. context, in particular.

The right vendor

Not all vendors will provide the same level of expertise and qualifications for the customer organization's specific requirements. There are a number of factors that determine the right vendor, such as reliability, experience and cost-efficiency, but as technology, disruption and globalization continue to drive changes, it becomes ever more important to work with vendor partners with a proven track record of delivering the specific business outcomes that the customer is seeking.

Markets are changing rapidly in Asia, as they are elsewhere, driven by changing customer demands. The COVID-19 pandemic has, for example, led to growth in demand for vendors specializing in automation, such as through the deployment of robotics and artificial intelligence. The high level of innovation being brought to technology transformation exercises can make the competing options difficult to assess and compare. Much still comes down to finding a partner that the customer organization can trust.

The right price

Negotiating the right price for technology transformations and outsourcings can be challenging. Some arrangements lend themselves to fixed fees or transaction-based pricing, but service providers may continue to press for resource-based, "cost plus" pricing models. These pricing models can reward inefficiency, and so should at least be supplemented with productivity improvement guarantees, specific agreement on transformation projects and corresponding price reductions and commitments by the vendor to move to transaction based pricing within a fixed period of time.

Third-party benchmarking reviews and "most favored customer" commitments are market practice in Asia for outsourced services. In relation to benchmarking, the key for the customer is to have a process which, once activated, runs as quickly and as "automatically" as possible. Breaking the service out into "commodity" elements will help make the benchmarked service more easily referable to comparison data.

The right service quality

The dynamics around service quality in outsourced services in Asia tend to track the same concerns seen with pricing. If the customer organization has not maintained reliable historic service quality metrics or if the project is "greenfield", vendors will be reluctant to commit to binding service level standards from the outset and may request a "baselining period" to validate the specific service scope.

Two immediate problems arising from this approach are: (a) How will service quality be addressed during the interim period before the baseline service levels are agreed? and (b) If service quality is left as an "agreement to agree", what leverage will the customer organization have in future to agree to satisfactory service levels and service credits for breach?

The answers to these questions will depend on the specific circumstances. It is clear that there must be some binding service quality standard in place from the start and there must be a clear process towards achieving a "steady state" level of service if it is not agreed at the outset.

Compliance, now and in future

As noted in the sections above, outsourced service models, including cloud services, raise significant regulatory issues. These requirements will not stop with contract signing. The service arrangements must contemplate a likelihood that applicable regulations will change.

Regulatory change in Asia is now coming at a rapid pace. The dynamic is amplified for projects that span multiple jurisdictions with potentially overlapping regulations. Given the significant consequences for non-compliance, it is critical for customer organizations to work effectively with their vendor partners in implementing a robust strategy to keep abreast of compliance updates and be agile enough to accommodate change.

The extent to which a vendor is held legally responsible for the customer organization's own regulatory compliance is typically a matter of fairly intense negotiation, particularly in BPO arrangements. In Asian markets there is, as yet, limited use of regulated third-party administrators under which vendors are licensed to carry out regulated service functions. Further, given the relative immaturity of the vendor market in Asia, there is reluctance amongst customer organizations in regulated industries to leave the interpretation of the customer's regulation to the vendor. At the same time, customer organizations will nevertheless expect to benefit from vendors' experience in this area, and the practical reality that there is economy of scale in implementing changes across their platform for multiple customer organizations.

Governance

Good communication with vendor partners is critical for any successful technology transformation. Establishing communication channels and protocols to ensure greater transparency and the free flow of information will help build a better working relationship.

This effort includes setting up appropriate committees, attended by the relevant personnel with the relevant expertise, reporting lines and guiding principles to set down how operational-level decisions are made. Having a regular feedback loop through the lifecycle of the project, through the implementation and development phases, through to ongoing transformation, allows for day-to-day resolution of issues and provides the customer organization with greater oversight of the project.

Accountability

Outsourcings and technology procurement entail significant risk for customer organizations. Damages will rarely be a completely satisfactory remedy from a business perspective, the objective of legal remedies under contract is to make the vendor sufficiently accountable to drive the right risk management behaviors and provide the customer organization with adequate financial recourse.

The approach taken to representations and warranties, service levels and service credits, indemnification, and other points of risk allocation should be tailored to the customer organization's specific business and its specific compliance and risk management requirements.

Limitation of liability is typically an area of intense negotiation. Market practice for information technology outsourcing arrangements is generally to permit the vendor to limit its liability to direct losses, subject to key exceptions for indemnified losses and breaches of terms in areas such as intellectual property rights, compliance with policies and applicable laws and confidentiality, and for liability for matters such as gross negligence and intentional breach. Industry practice in BPO arrangements in particular can, however, vary significantly, reflecting customer-side losses that can include loss of profits and opportunity costs suffered by investors.

Nonfinancial remedies are also important. Termination is obviously the ultimate recourse, but ending the service may be cold comfort to a customer organization that has just invested heavily in a new vendor relationship. There is often good reason to construct intermediate remedies that focus on recovering a faltering service arrangement rather than terminating it outright. Step-in rights, under which the customer organization itself provides or manages the provision of the services, are increasingly common in the Asian market. Other remedies can include a form of third party intervention, such as having an independent consultant review the service delivery arrangements and make recommendations that the vendor must accept and implement. Partial termination may also be useful as a remedy, effectively giving the customer organization the ability to weed out the underperforming areas of service, but there are risks here too. A halfway solution may leave the customer organization with yet more trouble, having to integrate in a new vendor and deal with potential diseconomies of scale arising from splitting the delivery platform into two or more pieces.

Creative solutions

The ultra-competitive business landscape has made it imperative for businesses to think creatively about how they do business, looking to better utilize assets and resources to generate value and competitive advantage, improve efficiency and cut operating costs.

Outsourcing and technology procurement is often associated with these efforts, including:

- **Joint venture models:** A more complex arrangement in which the customer organization contributes technology, operating procedures, knowledge capital, data, or other intellectual property (IP) to a joint venture with the service provider, the objective being to receive a wider economic benefit in addition to the basic benefit of an outsourced service. The critical downside is that the customer organization will likely be opening its IP up to its competitors and will likely lose at least some control of future development.
- **Incentives to innovate:** Innovation may be encouraged by agreeing concrete incentives for vendors. "Gain sharing", for example, is where the vendor takes a share of any cost reduction derived from service improvements developed by the service provider, ensuring that the improvements enhance the vendor's margins rather than simply reduce its charges.
- **Transformational outsourcing:** Asian businesses are increasingly leveraging outsourcing with a view to bringing about new, transformational ways of doing business rather than simply lifting out a static business function and transferring it to a service provider with a view to achieving a reduction in operating costs through consolidation. Transformational outsourcing may achieve institutional change more quickly and effectively than trying to manage change internally. Service providers may bring more sophisticated technology and more advanced operating procedures from other contexts. The likelihood of achieving transformation objectives is enhanced where specific transformation projects are agreed, committing the vendor to specific outcomes, such as service level improvements and price reductions. At the same time, there can be significant customer dependencies to achieving transformation objectives and so the contractual model needs to reflect the fact that the customer organization will need to do its share of the work.

Key takeaways

Outsourcing and other technology transformation exercises offer tremendous benefits to Asian businesses.

These opportunities do, however, come with significant challenges, and a need for careful planning and evaluation.

Key points to bear in mind:

- **The regulatory constraints are significant and growing:** The implications of industry regulation and data privacy, cybersecurity, employment, and tax laws must, in particular, be properly assessed and managed.
- **Contracting to maximize value and manage risk often gives rise to complexity:** There is a distinct need in Asia to contract for change: change in the customer organization business; group structure and geographic footprint; change to applicable regulations; and change in the market conditions for service.
- **Creativity can generate its own rewards:** The increasing scale of outsourcing and procurement arrangements in Asia generates opportunities to: improve how business is done; explore new business; and better capitalize on a business' knowledge capital and data.

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