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7 August 2017

Manager
Banking, Insurance and Capital Markets Unit
Financial System Division
The Treasury
Langton Crescent
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Dear Sir/Madam

Banking Executive Accountability Regime

We attach our submission on the Consultation Paper on the Banking Executive Accountability Regime. We apologise for submitting this late and thank you for considering it.

If you have any questions please contact Belinda Thompson on 03 9613 8667 or Michelle Levy on 02 9230 5170.

Kind regards

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Encl

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We appreciate the opportunity to provide a submission in response to Treasury's consultation paper on the Banking Executive Accountability Regime.

In our opinion, legislation needs to be clear and certain to be both fair and effective. We have very significant reservations about the proposed BEAR on both points.

Our specific concerns are, in summary:

- Duties to act with integrity and to be open and cooperative with the regulator may be desirable attributes, but what they require in any particular case will be uncertain and subjective. Legislation should impose obligations that are intelligible, clear and predictable, and individual liability should not turn on the exercise of discretion by a regulator.
- Many of the proposed obligations duplicate, although in slightly different terms, existing obligations. This is inconsistent with the Government's Cutting Red Tape agenda (which in our opinion deserves greater attention).
- Given the difficulty for a bank or an individual to determine what might be required in any particular case to act with integrity, and the overlap with existing obligations under the Banking Act, the Corporations Act, the general law and prudential standards, it is very unlikely that the regime will have a positive effect on conduct and combining an obligation to be open and cooperative with a regulator with very wide discretionary powers for the regulator may well have the opposite effect and will almost certainly make it harder for regulators, defendants and the courts to bring, defend and decide cases. Difficult and obscurely draft legislation leads to complex and lengthy judgments which turn on narrow points and lend themselves to appeal.
- In addition to our reservations about the regime as a whole, we have concerns about the application of the regime to the subsidiaries of banks. In our opinion this is inconsistent with the principles of competition law.

More detail is set out below together with our responses to some the specific questions in the paper.

Rule of law

Lord Diplock in a 1975 House of Lords decision said:

> The acceptance of the rule of law as a constitutional principle requires that a citizen, before committing himself to any course of action, should be able to know in advance what are the legal principles that flow from it.[1]

The European Commission of Human Rights makes the same point in the following statement:

> A norm cannot be regarded as a law unless it is formulated with sufficient precision to enable the citizen to regulate his conduct: he must be able - if need be with appropriate advice - to foresee, to a degree that is reasonable in the circumstances, the consequences which a given action will entail.[2]

And then, finally, the then Chief Justice of the High Court of Australia, Murray Gleeson in a speech at the University of Melbourne in 2001:

> The content of the law should be accessible to the public.

We do not consider that it is overly dramatic to say that the regime proposed by BEAR is inconsistent with these principles. While an obligation to act with integrity might be desirable and is easily expressed, its content and application to any particular circumstance is likely to be difficult to determine in advance and subject to opinion. The regime proposed by BEAR will combine uncertain obligations for banks and their executives with wide and discretionary powers for APRA to decide how banks and their senior executives and staff should behave. They can do that after the fact and with the benefit of hindsight. APRA will then have the power to seek very significant penalties based on APRA's views of how a bank and its executives

[1] Black-Clawson International Ltd v Papierwerke Waldhof-Aschaffenburg AG [1975] AC 591

[2] Sunday Times v United Kingdom (1979) 2 EHRR 245

should have acted in any specific situation. While we do not suggest that APRA would exercise its power arbitrarily, it would in fact be open to APRA to do so under the proposed regime.

Duplication and cutting red tape

The BEAR is intended to improve the conduct of banks and their executives by applying a heightened responsibility and accountability framework to executives. In addition to duties to act with integrity and to be open and cooperative with the regulator, the BEAR would impose an obligation on the accountable persons to act with due care, skill and diligence. However, the 'heightened responsibilities' appear to be nothing more than a repetition and restatement of existing obligations.

Banks and their regulated subsidiaries are already subject to very significant, overlapping and sometimes difficult to understand obligations. We frequently advise our clients and their executives on their obligations under legislation, prudential standards and the common law. In our experience they take these obligations seriously and there are serious consequences if they do not comply.

The Corporations Act and general law already require directors and other officers of a corporation (for example, the chief executive officer, the chief financial officer and the general counsel) to exercise their powers and discharge their duties with care and diligence. They must also exercise their powers and discharge their duties in good faith in the best interest of the corporation and for a proper purpose.

There is a significant body of case law that has considered these obligations. Those cases demonstrate that the obligations place material and meaningful obligations on the directors and officers of a company. They are sufficiently flexible to adjust to the different circumstances of a corporation and the role occupied by the director or officer. The proliferation and complexity of the case law on directors' duties also provides evidence of the cost of creating legal obligations that turn on matters of degree and judgment. We do not say that it is not necessary for legislation to be expressed in this way on occasion, but it is difficult to see how restating the obligations to act with care and diligence as part of the BEAR would do more than create additional complexity and more uncertainty for regulators bringing proceedings, defendants deciding whether to defend proceedings or to appeal an unfavourable decision, and the courts.

APRA's Prudential Standard CPS 520 Fit and Proper person requires a 'responsible person' to be 'fit and proper'. Before appointing a person to a responsible person role, an ADI must determine whether the person possesses the 'competence, character, diligence, honesty, integrity and judgement to perform properly the duties of the responsible person position' (paragraph 30(a)). The person cannot be disqualified under an applicable Prudential Act from holding the position and they cannot have a conflict of interest in performing the duties of the responsible person position, or if they do it would be prudent for the institution to conclude that the conflict will not create a material risk that the person will fail to perform properly the duties of the position (paragraph 30(b) and (c)).

The standard requires the assessment of the person to be made (ordinarily) prior to the appointment of the person to the responsible person position and annually (paragraphs 43 and 44). The institution must notify APRA of the appointment of a person to a responsible person's position and provide details of, among other things, the person's position and main responsibilities (paragraph 57).

The fit and proper person standard already imposes very high standards of competence and conduct on senior officers and employees of banks. It is difficult to see how the BEAR could add to these standards. In our experience, adding more and overlapping obligations to a long list is more likely to lead to compliance checklists than to better conduct. This appears to be one of the concerns of the Government's Cutting Red Tape project. One of its 10 principles is that: 'Policy makers must consult with each other to avoid creating cumulative or overlapping regulatory burdens.' The proposals in the consultation paper do not satisfy this principle. We are also concerned that they would not satisfy the first three principles:

- Regulation should not be the default option for policy makers: the policy option offering the greatest net benefit should always be the recommended option.
- Regulation should be imposed only when it can be shown to offer an overall net benefit.

- The cost burden of new regulation must be fully offset by reductions in existing regulatory burden.

There is nothing in the consultation paper that suggests that the additional regulatory and compliance burden would provide an overall net benefit to the community.

Open and Cooperative

The consultation paper says that an ADI and accountable persons:

> '…would be expected to…deal with APRA in an open and cooperative way.'

No detail or guidance is provided as to the hallmarks of what would, and would not, be considered to constitute dealing cooperatively and openly with APRA. In our opinion, one matter that ought not be considered to be inconsistent with meeting this expectation is the maintenance by an ADI of legitimate claims of legal professional privilege over documents and communications. The High Court has recognised that legal professional privilege is not merely a rule of substantive law – it is an important common law right or immunity. The maintenance by an ADI and its officers and senior employees of that fundamental right of immunity should not be viewed as a failure to co-operate or deal openly with APRA.

Penalties

The consultation paper says that the:

> 'application of civil penalties is primarily intended to deter ADIs and their groups and subgroups from acting in a way that does not meet the new expectations of the BEAR. The prospect of civil penalties should provide a strong motivation for ADIs and their groups to act appropriately.'

In our opinion, penalties are unlikely to be effective deterrents when they attach to nebulous and uncertain obligations. Each of the circumstances described in the paper in which APRA would be able to seek a civil penalty require APRA to form an opinion about the conduct of an ADI and to exercise a discretion:

- an ADI fails to meet the new expectations of an ADI under the BEAR;
- an ADI fails to hold accountable persons to account under the BEAR; and
- an ADI does not appropriately monitor the suitability of accountable persons.

The proposed penalties are very high and while the paper acknowledges that the maximum penalties may not always apply and that there should be proportionality between the seriousness of the contravention and the quantum of the penalty, the fact that any penalty should apply in circumstances where APRA decides that a bank has not met 'expectations' is inconsistent with the rule of law.

Removal and disqualification of responsible persons

We do not support the proposal that APRA be given the power to remove or disqualify an accountable person where it is satisfied an individual does not meet the new expectations under the BEAR. We also do not support the proposal that ADIs be required to inform APRA where individuals have been subject to internal disciplinary proceedings, including where they have been subject to dismissal, suspension or a reduction in variable remuneration for not meeting the new expectations under the BEAR.

In our opinion:

- a person's reputation, employment and livelihood should not be subject to APRA's view of what was required of the person in any particular situation; and
- given the lack of precision in the proposed expectations and the seriousness of the consequences of breaching those expectations, a decision that an accountable person has breached the law and a determination of the consequences should be a matter for the courts and not APRA. Providing APRA with the power to do so and then giving the individual a right of appeal is not an appropriate substitute because so much damage could be done to the individual during the process.

Again the proposal is based on the view that the prospect of punitive action by APRA against an individual would have a deterrent effect against poor behaviour. In our opinion, it is unlikely that imposing an obligation

expressed in uncertain and subjective terms and then threatening punitive action if the person does not comply with APRA's interpretation of what the obligation requires in a specific circumstance is unlikely to have any beneficial effect on an individual's conduct. The cases indicate that, with the exception of cases where a person acts fraudulently or otherwise dishonestly, officers of regulated institutions make mistakes and misjudgements, they do not act without integrity or without what they consider to be care, skill and diligence and it is with the very great benefit of hindsight that a court might determine they have not. Given this, it is difficult to see how the threat of APRA disqualifying the officer or senior employee would change their behaviour in a positive way.

Given each of these things, we would strongly oppose the proposal that accountable persons be denied cover under insurance policies for liability under the BEAR.

Accountable persons

The proposal is that the accountable persons covered by BEAR would be identified by a combination of prescription and principle. The reference to prescription refers to those people holding prescribed functions, which could include oversight functions and executive functions. In addition, the principles based element would capture other people who have significant influence over conduct and behaviour and whose actions could pose risks to the business and its customers.

We query whether there is any benefit in introducing another concept to the law in the term 'accountable persons'. The prudential standards already refer to and provide a regime covering 'responsible persons'.

A responsible person of an ADI is defined in CPS 520 as any person who is a director of the ADI, a senior manager of the institution, a person who performs activities for a subsidiary of the ADI where those activities could materially affect the whole, or a substantial part, of the business of the ADI or its financial standing, either directly or indirectly' (Appendix 1 to CPS 520). A subsidiary does not include an RSE licensee.

A senior manager is defined (in paragraph 25 of CPS 520) to include a person who makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the institution.

Again, given the significant overlap between the proposed definition of accountable person and the existing definition of responsible person, we suggest that any additional obligations that will be imposed by the BEAR apply to responsible persons under the prudential standards. If there is a gap between those people the Government consider should be covered and the existing responsible persons, the existing definition could be adjusted.

On a point of detail, the consultation paper refers to 'directors' being within the regime. However, it then later identifies the Chair and the Chair of the Board sub-committees as being subject to the regime. We assume that it is not intended that non-executive directors would in the ordinary course be subject to the regime merely by virtue of their office. Any legislation should make this clear.

Institutions to be covered by the BEAR

The proposal is for the BEAR to not only apply to an ADI but also to all of its subsidiaries, including those subsidiaries that are themselves APRA regulated entities. The Consultation Paper explains that the reason for including subsidiaries is because 'consumers will often associate the wide range of financial services and activities that are provided by subsidiaries with an ADI brand. Therefore, poor behaviour in the subsidiaries has the potential to undermine confidence in the ADI itself.'

The consequence of this policy would be to impose an additional regulatory burden on subsidiaries of banks that are not imposed on their competitors – namely other life companies, general insurance companies, superannuation trustees and advice licensees.

Competition in superannuation is the subject of an existing inquiry and, in our opinion, further regulatory burdens should not be imposed on one segment of the industry only prior to the conclusion of that inquiry.

Most policy-makers agree that competitive neutrality is beneficial to consumers. In superannuation, competitive neutrality is already a problem with industry funds benefiting from the award system. The current proposal would impose an additional regulatory burden on one part of this industry only. We also query the necessity of doing so, officers of RSE licensees are already subject to stringent conduct requirements.

Transition

Our alliance partners Linklaters acted for many clients in both the UK and Hong Kong on the implementation of their senior manager regimes. The UK provided a 3 year transition period in recognition of the very significant amount of work required by the regime. We submit that a similar period of time would be needed in Australia. We also note that while the implementation of the regimes in the UK and Hong Kong created a great deal of work for compliance teams and consultants and lawyers, it is far from clear that the work and expense for regulated institutions has had any real benefit to the community or consumers. We urge the Government to consider the effect the regimes have had on conduct, and the cost of those regimes, in other jurisdictions before adopting it in Australia.

If you would like to discuss any aspect of our submission, please contact Michelle Levy on 02 9230 5170 or Belinda Thompson on 03 9613 8667.

Yours faithfully

Allens