BANKING EXECUTIVE ACCOUNTABILITY REGIME

SUBMISSION

GLOBAL BANKS SECTOR GROUP

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By email

Dear Manager

Submission: Banking Executive Accountability Regime

This is our submission on the Government's Proposal Paper entitled 'Banking Executive Accountability Regime' dated July 2017 (**Consultation Paper**).

1 General observations

Our firm has extensively advised clients on the application of the Senior Managers Regime and related regulatory framework in the United Kingdom (**SMR**) and Hong Kong's Manager-in-Charge measures.

Drawing on this experience, we are grateful for the opportunity to provide submissions on the proposed Banking Executive Accountability Regime (**BEAR**).

This submission relates to certain issues canvassed in the Consultation Paper. It does not address each of the questions set out in the Consultation Paper.

We would be pleased to discuss any aspect of our submission with you.

2 Feedback on matters identified in the Consultation Paper

2.1 Consultation Paper Chapter 4 – Individuals to be covered by the BEAR

HSF Recommendation 1: The 'principles based' limb of the accountable person definition should be based around the concept of 'actual or effective responsibility for management and control of the ADI'.

While we accept the rationale for using a combination of prescription and principle to define who is an accountable person under the BEAR, care needs to be taken in formulating the principles-based limb. We understand that Treasury does not propose to utilise any of the existing definitions of 'responsible persons' or 'senior managers' and instead proposes to adopt a new test for the principles-based limb of the accountable person definition.

We agree that the 'accountable person' definition should be focussed on capturing the directors and most senior executives who have responsibility for management and control of the ADI, irrespective of their employer entity. This is analogous to the way in which the definition of 'key management personnel' operates under the Accounting Standards and *Corporations Act* 2001 (Cth) (**Corporations Act**), with the definition focussed on the responsibility and authority exercised by the person in practice.

However, the Consultation Paper suggests that the principles-based limb 'is intended to capture other individuals who have significant influence over conduct and behaviour, and whose actions could pose risks to the business and its customers'.

In our view, such a definition would arguably capture a far broader range of executives than what is intended, including for example, branch managers who influence the conduct and behaviour of their staff and have the capacity to influence customer outcomes. It

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would be preferable, and more aligned with the intent expressed in the Consultation Paper, to frame the 'principles based' limb of the accountable person definition around the concept of 'actual or effective responsibility for management and control of the ADI'.

2.2 Consultation Paper Chapter 5 - Expectations of ADIs and Accountable Persons under the BEAR

(a) Overview

> **HSF Recommendation 2:** Greater clarity should be provided around the presently uncertain obligations being placed on ADIs and accountable persons, noting the very significant consequences of breach.

The BEAR proposals include new statutory expectations of ADIs and accountable persons.

The proposed approach to these new expectations set out in the Consultation Paper is derived from a UK regime that has no history or common understanding in Australia. What is required is presently uncertain. We think the proposed formulation risks not achieving the stated intention in the Consultation Paper, namely "to make clear the expected conduct of ADIs and their accountable persons".[1]

In our view, greater clarity should be provided for the following reasons:

- ADIs wishing to meet the expectations of the legislation will only be able to do so if they have clarity of the conduct expected of them. If broad standards are to be introduced by the legislation, it will be critical for explanatory or other materials to spell out what is expected;
- failure to meet these uncertain expectations exposes an ADI to a new civil penalty regime with a maximum penalty of between $50-$200 million.[2] These penalties, if introduced, would be significantly greater than the existing maximum civil penalties in Australia, and so care needs to be taken to make sure that the expectations are known, given these serious consequences. It would be unfair to seek to penalise someone for breaching a standard that was unknown or unclear;
- legal obligations need to be framed with sufficient certainty so that they can be understood by those subject to them.[3] This is particularly true in the case of provisions leading to punitive consequences.[4] Indeed, a "law" can be so uncertain that it does not meet the basic requirements of being a "law".[5] In its current form, there is in our view a real risk that at least some of the obligations are so uncertain as to be unenforceable (again recognising that it may well be intended that more guidance will be provided in explanatory or other materials with the draft legislation).

In our view, elaboration and clarity are necessary prerequisites for the regime going forward, noting that there a number of ways in which guidance could be given and clarity achieved.

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[1] Consultation Paper, p. 14.

[2] Consultation Paper, p. 14.

[3] See, for example, *Merkur Island Shipping Corporation v Laughton* [1983] 2 AC 570 at 612. See also *Ex parte Zietsch; Re Craig* (1944) 44 SR (NSW) 360 (25 July 1944) at 365: "*a statutory regulation or order, to be valid, must be sufficiently certain, that is, clear enough to enable those to whom it is addressed to know the nature and extent of the legal duty which it imposes*".

[4] *R v Adams* (1935) 53 CLR 563 at 567–8; *Commonwealth Director of Public Prosecutions v Poniatowska* (2011) 244 CLR 408 at [44].

[5] See *Plaintiff S157/2002 v Commonwealth* (2003) 211 CLR 476.

Further, it is in our view critical that a materiality threshold is introduced (such as that contained in section 1317G of the Corporations Act), which establishes the harm caused by the failure to comply with the new expectations, before an ADI is exposed to quasi-criminal sanction in the form of the new maximum penalty of $50-$200 million. We develop this point further below.

(b) Standard of reasonableness

> **HSF Recommendation 3:** "Reasonableness" should be incorporated into the proposed duties, whether by having primary obligations to take "reasonable steps" or to have a "reasonable steps" defence to unqualified obligations. Section 32 of the *Life Insurance Act* 1995 (Cth) and the business judgment rule in s 180 of the Corporations Act provide examples of appropriate defences.

In our view, the BEAR should incorporate a reasonableness element in the key new duties.

A majority of the new duties already are expressed to be subject to reasonableness (in the form of an obligation to take reasonable steps).

Others are not so qualified (we refer to these as "unqualified obligations"). These include the obligations of integrity, due skill, care and diligence and dealing with APRA in an open and cooperative way. A reasonableness standard is consistent with the regime's aim to foster appropriate standards of conduct. Further, having the appropriate standard of conduct based on reasonableness correlates with the centrepiece of the SMR.

As a matter of principle, if an individual or an ADI has acted in a reasonable manner (which is an objective test), they should not be open to punitive measures.

It follows that all of these proposed obligations should either have the standard of reasonableness built into the obligation itself, or have an express defence where the relevant person has acted reasonably. To that end, we note that the first three obligations of an ADI (integrity, due skill and dealing with APRA) are not expressed as permitting any defence.

We think that this should be reviewed.

None of the relevant obligations should be cast as strict liability offences. Strict liability provisions are utilised sparingly in legislation and applied where the relevant obligation is straightforward, unambiguous and usually binary in outcome.

Reasonableness standard attaching to Accountable Persons

Treasury has requested that submissions include examples of appropriate and judicially considered phrases to be used in the draft legislation, including context for where these phrases have been used in the past.

As mentioned above, the formulation suggested in the Consultation Paper itself refers to a duty to take reasonable steps.

Given that the regime imposes substantial penalties, it is crucial that a suitable standard and formulation of reasonableness be established.

In our view, the "reasonable steps" formulation is appropriate for obligations attaching to individuals. This is because it equates to the exercise by the ADI of a reasonable degree of care and diligence for the purposes of ensuring that the ADI complies with the various obligations. The proposed formulation is akin to the obligation under section 344 of the Corporations Act for directors to "take reasonable steps" to comply with or secure compliance with the financial reporting provisions of the Corporations Act.

In a financial services context, "reasonableness" is also used in statutory formulations, including:

- section 52A of the *Superannuation Industry (Supervision) Act* 1993 in relation to the duties of a director of a registrable superannuation entity; and
- section 48(2) of the *Life Insurance Act* 1995 in relation to a statutory duty of directors in relation to a statutory fund.

Reasonableness standard attaching to the ADI

In our view, the reasonable steps formulation is also an appropriate standard for ADIs.

Reasonableness defence

In relation to the BEAR obligations which are not already expressed as subject to a reasonable steps qualification (ie what we have called the unqualified obligations), the reasonableness requirement should be included in a defence.

This type of defence would apply to unqualified obligations under BEAR by providing a safe harbour defence if the relevant conduct the subject of an ostensible breach was reasonably taken. The presence of such a defence would not undermine the policy considerations underpinning these unqualified obligations.

In our view appropriate judicially considered analogies are:

1. where an act, omission or decision of an entity would otherwise constitute the basis of a breach, it would not have this effect if it was reasonable to believe that the act, omission or decision was consistent with the relevant obligations (eg the duty to act with integrity is not breached on the basis of an action which is considered to be consistent with that obligation) (compare section 32 of the *Life Insurance Act* 1995).
2. the business judgment rule contained in section 180 of the Corporations Act.

Of these, either formulation could work provided it was suitably tailored; for example the last paragraph of the business judgement rule (in section 180(2)(d)) could be adapted to refer to a rational belief that the act, omission or decision was consistent with the relevant BEAR obligation.

Clarity of obligations

HSF Recommendation 4: Where possible, the conduct expectations be reformulated to link more closely to terms that have a greater level of judicial understanding in the Australian context.

In terms of the specific obligations:

- a duty to act “honestly” has meaning in Australia and could replace the uncertain proposed expectation of “integrity”.

- elaboration of what is meant by “open and cooperative” is required – these are highly uncertain obligations that in Australia, may cut across existing self-reporting obligations.

- it would be preferable for the expectation to take reasonable steps to maintain “a culture which supports the spirit of the [prudential] standards” to be reframed to refer to the objects of the prudential standards rather than the more difficult concept of “culture”.

It is our view that, where possible, the obligations should be expressed in terms which reflect existing statutory or known formulations.

For example:

(1) The obligation to conduct the ADI's business with **“integrity”**.

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This term is not conventionally used in Australian legislation to describe the conduct obligations of companies, officers or executives.[6] We recommend that "integrity" be replaced with "honesty", which has had meaningful judicial consideration that will be helpful in guiding an understanding of what is required.[7]

(2) "**Due skill, care and diligence**" – this phrase is similar to existing obligations owed by directors and officers of Australian companies, which should assist in providing guidance to accountable persons as to what is required. Section 180 of Corporations Act requires a company officer to act with the degree of care and diligence according to what a "reasonable person" would do in similar circumstances (by reference to the particular circumstances of the company).[8] This duty is subject to a number of "safe harbour" carve-outs, including protections where officers exercise "business judgment",[9] and an express ability to delegate powers and to rely on delegates for information or advice.[10] Similar provisions would be appropriate to include in the BEAR legislation.

In the case of an ADI, it is unclear what this expectation would require, or to whom such an obligation would be owed (ie to the shareholders of the ADI, or other potential stakeholders – for example, the Consultation Paper refers to "expectations of the community", an inherently uncertain concept). Further guidance on this point would assist ADIs to understand this expectation.

(3) The obligation to deal with APRA in an **"open and cooperative way"**.

This concept again encompasses honest and ethical behaviour. "Open" and "cooperative" are not themselves terms which, to our knowledge, frame compliance obligations in Australian legislation. It is difficult to say what these standards require, and that difficulty is troubling when there exists the potential for a $200 million penalty for a breach of them. We recognise that this is a phrase from the UK landscape. But in the Australian context, elaboration of what is intended would be helpful for those who will be regulated by the BEAR as it moves towards implementation. An alternate formulation, which may avoid some of these uncertainties, would be to require ADIs and accountable persons to deal with APRA in an "honest and constructive" way.

That general comment aside, there are two further issues we think should be carefully considered:

- whether this is intended to expand on the self-reporting obligations that already apply to APRA-regulated entities, and if so, how?[11]
- how this expectation would interact with the right of ADIs to maintain confidentiality and legal privilege when dealing with APRA. We expand on this important point at 2.2(c) below.

[6] It is used to a limited extent in the Australian prudential standards, but it is not used in Australian legislation . Accordingly, there is no judicial guidance on what it would require of ADIs. It is found in CPS 520 at paragraph 30 (although undefined) as part of a broader, composite phrase ("competence, character, diligence, honesty, integrity and judgement") which is one criterion in the test of whether a person is fit and proper to hold a responsible position.

[7] See, eg, *Belmont Finance Corporation Ltd v Williams Furniture Ltd* [1979] Ch 250, 267, 270, 274; *Macleod v The Queen* (2003) 214 CLR 230, 242; *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* (2007) 230 CLR 89, 126.

[8] See, eg, *Daniels v Anderson* (1995) 37 NSWLR 438; *Australian Securities and Investments Commission (ASIC) v Healey* (2011) 196 FCR 291 and *ASIC v Maxwell* (2006) 59 ACSR 373.

[9] See s 180(2) *Corporations Act 2001* (Cth) and *Re HIH Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* (2002) 41 ACSR 72.

[10] See ss 189 and 198 *Corporations Act 2001* (Cth).

[11] See, eg, s.29JA *Superannuation Industry (Supervision) Act 1993* (Cth), s.132A of the *Life Insurance Act 1995* (Cth), s. 38AA of the *Insurance Act 1973* (Cth), s.62A of the *Banking Act 1959* (Cth)

(4) The element of the expectation concerning prudential standards to take reasonable steps to maintain "**a culture which supports adherence to the letter and spirit of these standards**" is a difficult one. Those difficulties are similar to the ones involved in seeking to regulate an entity's "culture".[12] ASIC has recognised that it "*cannot regulate culture*"[13] and that "*it is ultimately an issue that organisations themselves must address*."[14] We have not located any examples of Australian laws which require compliance with the unspecified "spirit" of the law. The term "spirit" is inherently subjective and again, this is troubling given the potential consequences.

While still achieving what we think is the policy goal, it would be preferable to refer to the objects of the prudential standards, with the qualification that the objects should be clearly defined and articulated.

We recommend that where possible, the conduct expectations be reformulated to link more closely to terms that have a greater level of judicial understanding in the Australian context. However, if Treasury decides to proceed with the formulations suggested in the Consultation Paper, detailed guidance will be required (as has been provided in the UK) to ensure that these expectations are able to be clearly understood by ADI's and accountable persons.

(c) Privilege

HSF Recommendation 5: It should be confirmed that any duty to be "open" does not require the waiving of the fundamental right of legal privilege.

As noted above, it is proposed that the banks and accountable persons be "open" with APRA.

We assume that it is not intended that banks or relevant individuals would now be required to waive legal professional privilege.

It is hopefully without any serious question that the right to obtain privileged legal advice in circumstances where entities and people face significant liabilities and consequences is a fundamental one.

To quote but one of many examples of the High Court's views on the important role of legal professional privilege:

> *"The adequate protection according to law of the privacy and liberty of the individual is an essential mark of a free society and … the common law privilege attaching to the relationship of solicitor and client is an important element in that protection."*[15]

Any suggestion that there would not be a right to obtain advice in the face of very significant penalties would be a radical departure from this well-established principle.

We think it is important that the relevant legislation or associated explanatory material confirms clearly that the BEAR does not require the surrender of this fundamental right, given the proposed obligation to be "open".

[12] See the detailed discussion in the article by John Colvin and James Argent, "Corporate and personal liability for "culture" in corporations" (2016) 34 C&SLJ 30.

[13] Evidence to the Senate Economics Legislation Committee (Parliament of Australia, Canberra, 21 October 2015) 54 (Greg Medcraft); Evidence to the Parliamentary Joint Committee on Corporations and Financial Services (Parliament of Australia, Canberra, 16 October 2015) 18 (Greg Medcraft).

[14] John Price, 'The current state of corporate culture', speech delivered at the Governance Institute of Australia 33rd National Conference (Sydney, Australia), 28 November 2016, <http://download.asic.gov.au/media/4087635/john-price-speech-governance-institute-33rd-national-conference-published-28-november-2016.pdf>.

[15] "*Baker v Campbell* (1983) 153 CLR 52, 95 (Wilson J).

Under the SMR, privileged communications are specifically called out as protected items that a person cannot be required to produce or disclose.

Such was the importance of maintaining this fundamental right that the confirmation was enshrined in statute through section 413 of the *Financial Services and Markets Act* 2000 (UK) on the following terms:

413. Protected items

(1) A person may not be required under this Act to produce, disclose or permit the inspection of protected items.

(2) "Protected items" means—

(a) communications between a professional legal adviser and his client or any person representing his client which fall within subsection (3);

(b) communications between a professional legal adviser, his client or any person representing his client and any other person which fall within subsection (3) (as a result of paragraph (b) of that subsection);

(c) items which—

(i) are enclosed with, or referred to in, such communications;

(ii) fall within subsection (3); and

(iii) are in the possession of a person entitled to possession of them.

(3) A communication or item falls within this subsection if it is made—

(a) in connection with the giving of legal advice to the client; or

(b) in connection with, or in contemplation of, legal proceedings and for the purposes of those proceedings.

(4) A communication or item is not a protected item if it is held with the intention of furthering a criminal purpose.

This would provide a suitable template to be built into the Australian legislation.

2.3 Consultation Paper Chapter 6 – Remuneration

HSF Recommendation 6:

- The definition of 'variable remuneration' requires clarification and should reflect the way remuneration structures operate and are understood in practice.

- We propose a revised definition that '**variable remuneration'** is all remuneration which is at risk and subject to forfeiture based on fulfilment of a service and/or performance condition and does not include fixed annual salary, superannuation, statutory benefits and any non-monetary benefits to which the accountable person is entitled under their employment contract.

Guidance on typical remuneration structures

The Consultation Paper seeks guidance on the proposed changes to executive remuneration under the BEAR. To assist in drafting the proposed requirements, we set out below some guidance on typical remuneration structures, including typical remuneration structures we commonly see used to incentivise senior executives.

(1) *Short-term incentive remuneration* (**STI**): short term incentive plans focus on aligning the short to mid-term business strategy of the company.

STI is usually structured as providing a maximum opportunity (based on a percentage of the executive's fixed remuneration) available to the executive if performance conditions are met over a specified performance period (usually one year). At the commencement of the performance period the executive will be advised what the potential maximum STI award is, what the target STI award is and the applicable performance conditions. Following the applicable performance period, the company will then determine the overall award of the executive, based on their performance against performance conditions. The performance conditions are likely to be based on a combination of metrics such as:

- the short-term performance of the company measured for that financial year, based on various metrics relevant to the business, including metrics such as production; cash flow; capital expenditure; and culture; and
- individual performance for that financial year, based on key performance indicators set by the company in respect of each executive.

The actual amount of STI due to be awarded is determined following the end of the performance period/financial year. The STI award is then delivered. The STI award is either delivered in cash (paid) or may be delivered partly in cash and partly in equity. A component of the actual STI award delivered may be deferred over one or two years following the date of 'payment'. Usually the deferred component is delivered in the form of equity (for example, restricted shares). The deferral conditions are often service based (and subject to claw back, and forfeiture depending on the circumstances in which an executive ceases employment) rather than additional performance conditions. The deferred equity component of STI cannot be dealt with (sold) until the end of the deferral period.

As STI usually includes a personal component, it can be targeted to specific individual outcomes as appropriate.

(2) *Long-term incentive remuneration* (**LTI**): Long-term incentives are generally designed to align executive performance with shareholder interests such that executives will be rewarded where the company performs well comparative to the market over a 3-4 year period.

LTI is usually provided in the form of interests in securities, such as rights or options to receive shares in the company. LTI grants may be subject to shareholder approval (either voluntarily sought or due to the operation of the ASX Listing Rules). The size of the LTI grant is usually determined as a percentage of the executive's fixed remuneration. The equity grant is made around the commencement of the performance period. The achievement of the relevant performance conditions under a long-term incentive award is likely to be measured over a 3-4 year performance period, with vesting of incentives occurring at the end of that period. Performance is assessed over the performance period. The performance conditions imposed are usually based on company / group performance against group financial performance hurdles (with no individual performance conditions). Some of the performance conditions used by ASX-listed companies include:

- relative or absolute total shareholder return;
- earnings per share; and
- return on equity.

Following the end of the performance period, the performance conditions are tested and the LTI vests based on performance against those conditions. LTI is

generally awarded on a vesting 'scale' such that the award received by the executive increases according to the overall achievement against the performance conditions. The executive will only receive the maximum award opportunity if all of the performance conditions are met at their maximum target.

During, and following, the performance period, awards are also likely to be subject to clawback based on fraud, dishonesty, serious misconduct, at the discretion of the board.

(3) *Service / retention awards*

These awards are usually granted to secure the service of the executive, for example, in circumstances where the executive is an external appointment to a role and has had to forego LTI at their previous employment in taking the role, or where the CEO has changed or a change of control is being considered and the company wishes to provide key members of management with an incentive to remain. These awards are usually subject to service conditions only, with no performance obligations. Awards may be forfeiture depending on the circumstances in which an executive ceases employment.

Definition of variable remuneration

The Consultation Paper's proposed definition of 'variable remuneration' is broad. While the rationale for such a broad definition is understandable, further guidance that clarifies exactly what is caught by this definition would be required to facilitate its implementation in practice.

The meaningful differentiation between 'fixed' and 'variable' remuneration as understood in practice, is whether the remuneration is 'at risk' and potentially subject to forfeiture, based on service and/or performance. Fixed remuneration would normally be understood to include an executive's annual base salary, superannuation, statutory benefits and any non-monetary benefits to which the executive is entitled under their employment contract. Variable remuneration is normally understood to include all STI, LTI, retention payments and any other at risk payments that are subject to forfeiture if service or performance conditions are not satisfied.

The current emphasis that variable remuneration is 'conditional on performance' in the proposed definition suggests that 'at-risk' remuneration which is only subject to service conditions would **not** be caught by the legislation. This would mean that service-based LTI equity grants would not be captured by the definition, even though the actual value delivered to the executive on vesting is unknown at the time of grant and contingent upon satisfaction of vesting conditions. If Treasury's intention is for all service-based 'at risk' remuneration not subject to performance conditions to be captured under the legislation, a revised definition of 'variable remuneration' will be necessary.

Care should be taken in framing the definition of variable remuneration to ensure that it reflects the way remuneration structures operate and are understood in practice. In our view, a definition based on a technical interpretation of the Accounting Standards will not achieve this nor will the definition of base salary in Chapter 2D of the *Corporations Regulations* 2001 (Cth) (used to calculate the termination benefits that can be paid to certain individuals). Both these definitions have proven difficult to apply in practice and we would not recommend that they be used in this context.

The revised definition could be that '**variable remuneration'** is all remuneration which is at risk and subject to forfeiture based on fulfilment of a service and/or performance condition. This would exclude an accountable person's fixed annual salary, superannuation, statutory benefits and any non-monetary benefits to which the accountable person is entitled under their employment contract.

Deferral requirements

With respect to the operation of the deferral, it is our view that:

- the deferral requirement percentages should apply as a percentage of the executive's "at target" variable remuneration;
- the mandatory deferral percentages should apply to the variable remuneration granted in any particular year, not the total variable remuneration that may be on foot for a specific executive (which may include grants made in earlier years);
- the legislation should be structured such that the deferral period commences at the beginning of the performance period for the relevant component of remuneration;
- ADIs should be able to determine the make-up of the variable remuneration subject to deferral (provided hat the total satisfies the percentages specified in the legislation), for example, whether the deferral is satisfied solely by STI or LTI or partly by LTI and partly by STI.

In addition, Treasury will need to consider the interaction of the deferral requirements imposed under the BEAR with the taxation regime applying to employee equity arrangements. Currently, these provisions impose a taxing point on cessation of employment. If the deferral requirement imposed under the BEAR continues beyond cessation of employment, then under the current tax laws, the individual will be subject to tax on equity that remains subject to deferral and cannot be dealt with.

It is likely that ADIs will face pressure from executives in 'accountable person' roles to increase base salary to compensate for deferral of variable remuneration. The Consultation Paper contemplates that firms may adjust pay structures to shift the balance of payment from variable to base remuneration and suggests that this will have the advantage of reducing incentives for individuals to engage in short term risk taking. This would run counter to the generally accepted market view that well governed companies should structure their executives' remuneration to consist of a higher proportion of "at-risk" remuneration linked to performance, to better align the interests of executives with the achievement of company goals. Listed companies in particular will be constrained in reducing the proportion of executive remuneration that is variable, given the pressure from proxy advisors and other stakeholders in this regard, and the risk of strikes against their remuneration report.

2.4 Consultation Paper Chapter 7 - Implementation and Transitional issues

(a) Accountability mapping

HSF Recommendation 7: The 'map' should a high level document that only addresses specific prescribed responsibilities.

We understand that it is proposed that the definition of 'accountable persons' whose responsibilities must be mapped, will include a prescribed element and a principles based element. We further understand that it is proposed that an ADI's mapping system will be both prospective and continuous. ADIs will be expected to continuously update their map whenever there is a change in a role or position, or in the person who holds the role or position.

In our view, this continuous updating requirement supports a position that the 'map' should be high level document, so it is easy to update. We agree with that approach. A high level document that only addresses specific prescribed responsibilities will also be more useful for the ADI and the regulator to use to identify who is responsible for what within the ADI, and to identify any potential overlap in accountability for prescribed responsibilities. The elimination of overlap in accountability for prescribed responsibilities is a key feature of the SMR.

From a practical perspective, we expect that changes to the map will be easier to identify in practice where they concern a prescribed role or a prescribed responsibility. However,

it may be more difficult to prospectively identify persons who may only be caught by the principles based element of the definition. We suggest that the requirement that ADIs continuously update their map in relation be limited to prescribed roles and responsibilities. Any requirement for a principles based review to identify any shifts in influence not captured by the map after the initial development of the map, should only be required on a periodic basis.

(b) Insurance and indemnities

> **HSF Recommendation 8:**
>
> - Existing indemnity and insurance general law principles ought be applied in the same way to the BEAR as they do for other executive and company conduct.
>
> - In particular, an accountable person against whom a breach is asserted, should have access to insurance funds to enable him or her to defend those allegations.

The Consultation Paper has foreshadowed that the BEAR may prevent:

- "individuals from taking out insurance against removal and/or disqualification"; and
- "ADIs from taking out insurance against civil penalties".

In our view, it would be inappropriate to introduce a blanket prohibition of this kind. Care needs to be taken. This view is based upon the following key issues:

(1) the regime is broad in its scope – the proposed BEAR is a principles based regime. It is unlikely to contain prescriptive standards of behaviour, nor will it be limited in its application to deliberate or dishonest misconduct. Conduct which is merely inadvertent, or negligent or ultimately undertaken by someone else in the organisation, may potentially give rise to action being taken against an individual accountable person, as well as the imposition of a civil penalty upon the ADI;

(2) a blanket prohibition would represent a material departure from historically accepted principle – in other statutes analogous prohibitions upon the provision of indemnities or the procurement of insurance are reserved for behaviour of individuals which involves deliberate or wilful misconduct and only where such conduct has been established at law. By way of example, s199B(1) of the Corporations Act prohibits a company from paying a premium for a contract of insurance which purports to insure an officer against a liability arising out of conduct involving a wilful breach of duty in relation to the company, or a contravention of the duties to not improperly use a position to gain an advantage or cause detriment to the company. This approach reflects the general law position that has evolved over the past century;

(3) inconsistent outcomes may arise – under the BEAR a civil penalty may be imposed upon an ADI where an accountable person has failed to "take reasonable steps to ensure that … the activities or business of the ADI for which they are responsible comply with relevant regulatory requirements and standards". The breadth of this statement may mean that an ADI could potentially be in breach of its general obligations for which liability insurance may be available (eg misleading or deceptive conduct), and yet be prohibited from procuring insurance for the BEAR remedy consequent upon the same conduct. There is no rational explanation to explain why the same conduct could be insurable for one remedy, and uninsurable for another.

In these circumstances a blanket prohibition (particularly prior to the establishment of any misconduct) goes too far. An accountable person against whom a breach is asserted, ought properly have access to insurance funds to enable him or her to defend those

allegations. A blanket prohibition would unreasonably prevent this. Such a development is unwarranted.

Rather, the existing indemnity and insurance general law principles ought be applied in the same way to the BEAR as they do for other executive and company conduct. In this way, the availability or otherwise of insurance would depend upon the precise conduct involved and would avoid any unjust outcomes, nor any result which undermines the public policy objectives underpinning the BEAR.

(c) Options for APRA's removal and disqualification powers

HSF Recommendation 9: An efficient, transparent and consistent banking sector will be best achieved by a court-based regime in terms of the specific obligations to remove or disqualify accountable persons.

The BEAR proposals involve new administrative powers to remove or disqualify accountable persons who fail to meet the new expectations. APRA previously held similar powers to remove persons considered not to be "fit and proper", but these were removed in 2008 by legislation and replaced with a court-based process by which APRA would seek orders to disqualify individuals.[16]

Legislative explanations for this change included that it would "*improve the efficiency, transparency and consistency of the process for disqualifying individuals*" and "*enhance the accountability of the regulator for administrative decision-making*",[17] as well as addressing "*inconsistencies between the APRA-determined disqualification regime under the Prudential Acts and the court-based disqualification regime under the Corporations Act*".[18]

Those amendments occurred in circumstances where a significant number of APRA's disqualifications had been overturned by the Administrative Appeals Tribunal.

In our view, they should not be reversed. A court-based disqualification procedure best promotes an efficient, transparent and consistent banking sector. It is important that a disqualification regime remains transparent and robust given the serious punitive effects disqualification can have on the individual in question (which can be as serious, if not more serious, than civil or non-custodial criminal penalties).

In any event, many APRA-regulated entities are also subject to regulation under the Corporations Act, which already provides for court-based disqualification powers for directors.[19] From the perspective of an ADI seeking to comply with multiple overlapping regulatory regimes, maintaining the present alignment of the two regimes regarding disqualification of directors is desirable.

(d) Civil penalties

HSF Recommendation 10: Some materiality threshold for determining ADI liability is appropriate, consistent with other legislation, and noting the potential quantum of penalties. Further guidance would also be helpful on other aspects of the penalty regime (eg double jeopardy between APRA and ASIC actions).

Under the BEAR proposals, failure to meet the proposed expectations exposes the ADI to a quasi-criminal sanction, with very significant (indeed, unprecedented in Australia)

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[16] See *Financial Sector Legislation Amendment (Review of Prudential Decisions) Act 2008* (Cth).

[17] See Explanatory Memorandum to the *Financial Sector Legislation Amendment (Review of Prudential Decisions) Bill 2007* (Cth).

[18] Explanatory Memorandum to the *Financial Sector Legislation Amendment (Review of Prudential Decisions) Bill 2008*, Chapter 1.

[19] See Part 2D.6 of the *Corporations Act 2001* (Cth).

maximum penalties of between $50-$200 million.[20] The BEAR proposals do not contain materiality thresholds for determining the circumstances in which a breach of the new expectations would expose an ADI to the new maximum civil penalty of $50–$200 million.[21] This jeopardises the stated intention "*that there should be proportionality between the seriousness of the contravention and the maximum penalty*".[22]

A materiality threshold should be introduced, such as that contained in section 1317G of the Corporations Act, which requires the relevant contravention to "*materially prejudice*" the interests of the corporation, or the corporation's ability to pay its creditors", or be "*serious*" before a penalty can be applied.

It may be that a materiality threshold of some kind is what is anticipated by the indication in the Consultation Paper that penalties will apply to "*poor conduct or behaviour that is of a systemic and prudential nature*".[23] That phrase would benefit from further guidance as to what type (and degree) of conduct would be considered "systemic" and "prudential". "Systemic" conduct would appear to be repetitive or widespread. The "prudential" element suggests that the relevant conduct would have to materially impact upon the organisation's financial standing and the security of customers' deposits. This should be made express in the legislation. One option to reflect that intention would be to adopt language in section 11CA of the *Banking Act* 1959 (Cth), and reflecting the prudential nature of the BEAR proposals, would be to require the contravention to "materially prejudice the ADI's ability to meet its obligations to depositors, or cause or promote instability in the Australian financial system."

The BEAR proposals do not make clear how any civil penalty would be calculated or what considerations or factors would be open to APRA or the court when deciding to pursue or impose the new civil penalty.

There is also not yet any guidance on how regulators would coordinate their enforcement approaches for activities potentially falling under BEAR and existing regulatory regimes. For example, it is unclear how APRA's powers over "poor conduct" will sit alongside ASIC's powers, given the acknowledgement that ASIC will remain responsible in its role as "conduct regulator".[24] This may lead to "double jeopardy" style issues, where the same conduct falls under the purview of multiple regulators. It is critical that any legislation should specify how the civil penalty powers of APRA and ASIC (at least) will interact regarding the same or similar conduct.

(e) Transition Issues

HSF Recommendation 11:

- A long period of implementation will be particularly important if the legislation is enacted, to ensure that BEAR is effective and works well in the long run.

[20] Consultation Paper, p. 14.

[21] A "reasonable steps" standard applies to a few of the new expectations, including the expectations on ADIs to act in a prudent manner (and maintain a culture which supports adherence to the letter and spirit of these standards), to organise and control its affairs responsibly and effectively, and to ensure that these expectations and accountabilities of the BEAR are applied and met throughout the group or subgroup of which the ADI is parent. Similarly, accountable persons are expected to "take reasonable steps" in relation to the activities or business of the ADI for which they are responsible are "controlled effectively" and comply with relevant regulatory requirements and standards, in relation to ensuring delegations of responsibilities are to an appropriate persons and are discharged effectively, and in relation to ensuring that BEAR expectations are met in the activities or business of the ADI group or subgroup for which the accountable person is responsible.

[22] Consultation Paper, p. 14.

[23] Consultation Paper, p. 7.

[24] Consultation Paper, p. 7.

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> - We recommend a transition timeframe of 24 months following enactment of the BEAR legislation.

Considering the processes required to be undertaken by ADIs to comply with the BEAR requirements, and having regard to the time taken for implementing and embedding such processes in the United Kingdom, in our view, the transition period following enactment of the legislation needs to be one that allows for a sensible implementation.

While those who will need to implement these measures will have a better sense of exactly what that timeframe looks like, our view would be that a long period of implementation will actually help make sure that BEAR is effective and works well in the long run. This will be particularly important if the legislation is enacted swiftly.

In addition we note that a reasonable transition time will be of particular importance for areas for which additional supporting guidance will need be provided to achieve the necessary level of clarity. A key challenge in the efficient implementation of the SMR by UK entities was that the guidance provided came in waves rather than being provided substantially up front. Care should be taken to allow sufficient time to consult on and develop guidance that will meaningfully address necessary issues with as much clarity as possible up front, and for this guidance to be distributed.

A longer transition period will also be critical where the BEAR will require ADIs to implement new structures. ADIs may need to make changes to existing contracts and remuneration structures for affected executives which may require detailed negotiation and consent (recognising that on-foot variable remuneration may already have performance periods of up to 4 years that must play out before they can be fully replaced by grants that meet all the proposed requirements).

For these reasons we recommend a transition timeframe of 24 months following enactment of the BEAR legislation.

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