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Dear Mr McDonald

Exposure Draft Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017 (the Bill) and Explanatory Memorandum (EM)

AFMA is making this submission in relation to the draft Bill and Explanatory Memorandum on behalf of our members who are Australian-owned banks and branches of foreign banks who will be required to comply with the Banking Executive Accountability Regime (BEAR). Our comments are aimed at supporting the introduction of a regime that achieves the desired policy outcomes but also operates in a readily understandable way, is consistent with similar regimes in other jurisdictions to the extent this is appropriate, and affords individuals who are subject to the regime the level of rights and protections that are a common feature of the Australian legal system and regulatory regimes such as that administered by ASIC.

The provisions in the Bill and the EM that allow for a certain degree of flexibility in the application of the regime, but without comprising the intended outcomes of the regime, are a very welcome enhancement of the proposals and reflect many of the comments made by AFMA in our submission to the July consultation paper, and subsequent discussions with Treasury. Accordingly, the comments below relate only to outstanding matters, questions and points of clarification.

The timeframe imposed by Government for consultation on the Bill and the EM is highly regrettable. It remains our view that unintended consequences and complications will arise in relation to the implementation of the regime as a result, which could have been avoided by allowing sufficient time for industry to properly consider the legislation and provide more fulsome input. Consequently it will be left to APRA to try to resolve these

issues through guidance and the use of its modification powers. Any error in the legislation could hamper APRA in the exercise of appropriate flexibility and judgement.

The proposed effective date of 1 July 2018 is demanding for both industry and APRA. By way of comparison, the Senior Managers Regime in the UK was rolled out over a 3 year implementation timeframe. A phased approach should be adopted in the legislation that creates clear compliance obligations for ADIs and a clear timeframe for implementation of the components of the regime.

Given the size of the potential penalties for non-compliance with the regime, it is very difficult for ADIs to take the view that they are only required to satisfy their obligations under the regime at a high level on Day 1. As ADIs already operate under APRA's fit and proper regime, of which BEAR is described as an extension, it is not the case that there are significant regulatory gaps that need to be urgently closed through a rushed implementation.

If it is not possible to take a phased approach to implementation in the legislation, then APRA must articulate its expectations about compliance in guidance note or prudential standards as soon as possible, and well before the 1 July 2018 start date. APRA will also need to be appropriately resourced to provide the guidance that is needed, establish and administer the registration processes, deal with applications as envisaged under the legislation, and be properly equipped to exercise the investigation powers under new Division 2 of Part VIII.

Comments on the draft Bill and Explanatory Memorandum

1. Section 37 – Obligations of ADIs

(a) It has been noted that section 37(2)(b) could be read as meaning that if a foreign ADI operates a branch of the foreign ADI in Australia, then all of the activities of the foreign ADI in Australia are captured. The expression in the negative in subsection (2) "this section does not apply to.." and "except to the extent that.." may be the cause of this interpretation.

It would be helpful if the provision was re-stated in the positive to say that the regime applies only to the branch of a foreign ADI in Australia.

Alternatively, the wording could be amended to "a foreign ADI, except to the extent that it operates a branch of the foreign ADI in Australia, *in which case the section applies to those branch operations only."*

(b) The EM indicates that the offshore operations and locally incorporated non-ADI subsidiaries of foreign ADIs are not captured by the regime. It would be helpful to confirm, perhaps also in the EM, that subsidiaries that are NOT locally incorporated are also excluded. The uncertainty is demonstrated in the scenario set out in the appendix.

2. Section 37BA – Meaning of accountable person

Section 37BA says that a person is an accountable person of an ADI *or a subsidiary* (emphasis added) of an ADI if they have actual or effective responsibility for management or control of the ADI *or subsidiary* or management or control of a significant or substantial part or aspect of the ADI's *subsidiary operations*.

In our view the inclusion of the specific references to subsidiaries is not consistent with the policy intent of the regime as expressed in the EM. The regime should capture only those subsidiaries which are material or significant to the ADI. Materiality or significance of the subsidiary should be referenced to the potential impact on the prudential standing of the ADI. Alternatively, it should be made clear that the obligations do not apply in relation to a subsidiary where there is an accountable person at the ADI group level with responsibility for that subsidiary.

The emphasis of the regime should be on those individuals who have overall responsibility for the operations of the whole or a substantial part of the ADI group. They should have sufficient authority to effect significant systemic and prudential matters as they relate to the ADI group.

3. Section 37BA(3)(a)

Following on from the point made above, a member of a board of a subsidiary of an ADI cannot be held to be responsible for the oversight of the ADI. Therefore, the reference in subparagraph (a) to "or a subsidiary of the ADI" should be deleted.

4. Section 37BA(6) – Head of an Australian branch of a foreign ADI

The local Head of a Foreign Bank Branch is an accountable person under the regime. While it is assumed that the explicit reference to the head of an Australian branch of a foreign ADI in the legislation is intended to make it clear that this individual is the only person to whom the regime applies, it would be helpful to put it beyond doubt, perhaps through a statement in the EM, that the Senior Officer Outside Australia (SOOA) is not subject to the regime. It is understood that the SOOA will continue to be subject to APRA's fit and proper requirements.

5. Section 37FB – Accountability map

Following on from the point made above, it is assumed that even though a branch of a foreign ADI may have personnel in Australia who have the types of responsibilities listed in subsection 37BA(3), the accountability map requirements in section 37FB apply to the foreign ADI only in relation to the head of the foreign bank branch, because the other individuals who have those responsibilities are not accountable persons for the purposes of the regime.

6. Section 37C – Accountability obligations of an ADI

(a) Section 37C(a) says that the accountability obligations of an ADI are to conduct its business with *honesty and integrity, and with due skill, care and diligence* (emphasis added).

This language should be consistent with the language in Section 5 of the Banking Act in regard to the the conduct by an ADI of its affairs, namely that they be conducted with *integrity, prudence and professional skill*. No reasons have been articulated in the EM or elsewhere as to why the expected conduct of an ADI under BEAR should be any different to the general overall expectation about conduct under the Banking Act. The introduction of additional undefined concepts creates unnecessary complexity, particularly where the existing language is sufficient for the purposes of the BEAR regime, which will itself be part of the Banking Act.

(b) Despite the assertion in the EM at paragraph 1.49 that the meaning of the term "open, constructive and co-operative" is generally well understood, in our view APRA will need to provide substantive guidance about how it expects ADIs to meet the obligation in section 37C(b) and accountable persons to meet the obligation in 37CA(b). This is a matter that was the subject of detailed consideration in the implementation of the UK Senior Manager Regime, and is not to be dismissed as a minor issue. Accountable persons within ADIs have other statutory obligations and duties as directors and in other capacities that will need to co-exist with the obligation to be open, constructive and co-operative. AFMA raised this issue in our submission to the consultation paper but it has not been addressed in the Bill or the EM.

(c) Section 37C(c) refers to matters that would adversely affect the ADI's prudential standing or reputation. "Prudential standing" is not a defined term and should be replaced with the term "prudential matters" as defined in Section 5 of the Banking Act.

Similarly the "reputation" of the ADI could be inferred as relating to a very wide range of matters and it is unclear whose perspective would be relevant for this purpose. Reputation is a concept that varies over time and is impacted by many factors including political, economic and social climate, as well as subjective opinion. This should be re-stated as "reputation concerning prudential matters" or otherwise it should be deleted as being far too subjective and wide-ranging.

(d) Following on from the issue in 2. above, subparagraph (e) requires the ADI to take reasonable steps to ensure that each of its subsidiaries that is not an ADI complies with the accountability obligations as if the subsidiary were an ADI.

On the basis that it is not the policy intent to capture every single subsidiary of an ADI in the regime, the obligation in (e) should be limited to those

subsidiaries that are significant to the prudential standing of the ADI. This will be a matter that each ADI needs to determine, in consultation with APRA.

7. Section 37DA – People prohibited from being an accountable person

The reference to "filling a vacancy that was not foreseen at the time it arose" in subsection 37DA(2) could preclude vacancies that are generally foreseeable but their specific timing is not. Subsections 37DA(3) and (4) apply only in respect of vacancies that meet the description in subsection 37DA(2). It would be helpful if the legislation makes it clear that, in respect of persons who become an accountable person by filling any vacancy, paragraph 37DA(1)(a) does not apply for such period as APRA determines.

Section 37DA of the draft legislation currently requires registration of accountable persons within 21 days, although there is some flexibility granted to APRA to determine the period. A number of AFMA members conduct global businesses and this requires the ability to attract and utilise qualified senior personnel and the flexibility to move such employees across jurisdictions (at times at short notice) based on business demands. This may require the ability to appoint interim persons into roles, some of whom would be technically covered by BEAR. In order to avoid limiting this business flexibility, the regime should contemplate and acknowledge interim appointments, as currently exists under the CPS 520 *Fit and Proper* standard. It is suggested that persons holding an interim accountable person position should be excluded from the operation of BEAR for a period of at least 90 days (being the same timeframe that exists for interim appointments of responsible persons under CPS 520), after which they would be deemed to be permanent in the role and require registration under BEAR.

8. Subparagraph 37E(1)(b)(ii) – Deferred remuneration obligations of an ADI

In a situation where an accountable person has a contractual arrangement with an ADI under which that person is eligible for and may receive variable remuneration, as a matter of contract and employment law it will be extremely difficult for an ADI to decide to reduce the amount of variable remuneration because the person "is likely to have failed" to comply with their accountability obligations. "Is likely to.." is a very subjective test. An ADI will need to form a definitive view that the person has failed to comply with their accountability obligations, as per subparagraph (b)(ii), in order to reduce the amount of variable remuneration that is to be paid.

If a degree of flexibility is considered necessary to deal with situations where there is a concern that a failure has occurred but this has not yet been fully established, then it is appropriate that an ADI has the discretion to extend the deferral period, freeze vesting or the determination about vesting (or some other action). This will need to be established in, and agreed to by the parties to the contractual arrangement.

9. Section 37EA – Meaning of variable remuneration

(a) The language in subparagraph 37EA(1)(a) could be read as capturing base or fixed remuneration which is logically also broadly linked to the achievement of objectives. It would be helpful if the EM could explicitly state that base or fixed pay is excluded from the deferral requirements.

(b) For some ADIs there will be cases when it is appropriate to distinguish between the time the accountable person (ie. the country head) spends on exercising oversight over the ADI, and time spent on other functional duties which are not related to the ADI entity. It would be appropriate, and in line with the policy drivers of BEAR, if only that part of the variable remuneration that relates to the performance of the oversight of the ADI duties should be subject to the deferral provisions. This would also be in line with the approach taken under the UK SMR.

Part 37EA (1) (3) (b) of the Bill says APRA may, by written notice given to an ADI, or a subsidiary of an ADI, determine that remuneration of a particular kind, of one or more accountable persons of the ADI or subsidiary, is variable remuneration; or that remuneration of a particular kind, of one or more accountable persons of the ADI or subsidiary, is not variable remuneration.

We request that the EM addresses this point by indicating that APRA would, in principle, be willing to accept appropriate good faith pro-ration of the variable remuneration of relevant accountable persons.

10. Section 37EC – Minimum period of deferral

The minimum deferral period of 4 years stipulated in paragraph 37EC(1)(a) is out of line with the globally accepted, staggered approach adopted by other regimes similar to BEAR. No explanation has been provided as to why this fixed period is appropriate or why Australia needs to adopt a different approach to that taken by other regimes, even allowing for the fact that it is possible for APRA to approve a shorter period. Firms who operate in Australia and who have global deferment programs in place are likely to apply to have different arrangements approved by APRA because their global programs produce substantially the same outcomes as the BEAR regime and the ADI is able to be satisfied that it meets the conditions in paragraphs 37EC(2)(a) and (b). This will inevitably consume the ADI's and APRA's time and resources, which could have been avoided by adopting a more flexible, globally consistent approach in the legislation in the first place.

We urge the Government to consider expanding section 37EC so that APRA has a broader recognition power in relation to global deferment programs, provided that those arrangements achieve substantially the same outcomes as BEAR in terms of creating incentives for long term behaviour.

A strict 4 year deferment period (where 4 years is arbitrary in any event) does not create any additional incentive to accountable individuals to meet their

accountability obligations than an approach that allows the vesting of a certain proportion after say 2 years, with the remainder becoming payable in year 3 and year 4 or some other period.

A retention bonus is considered to be variable remuneration as per paragraph 37EA(1)(b). It has also been noted that deferral for 4 years has the following implications:

- It is unlikely to align with the timing of risk and performance which will be known much earlier;
- If the individual leaves the company as a result of a corporate action, for example, they will have potential tax consequences where equity is involved as termination is a taxing point;
- The long deferral period is likely to result in higher retention bonus levels to have the desired impact because of the long period to vesting.

11. Section 37ED – Exemption for small amounts of variable remuneration

It is not clear either in the legislation or the EM what happens if a small ADI becomes a medium ADI during the period after a decision is made to pay variable remuneration that is less than $50,000 and before the amount becomes payable. It would be helpful if the EM could clarify these types of transitional issues.

We would argue that if the ADI is small at a point in time and therefore entitled to make a decision to pay an amount less than $50,000 on an exempted basis, but subsequently becomes a medium ADI before the amount is actually paid, then the amount should be treated as exempt.

12. Section 37F – Notification obligations

The requirements in paragraphs 37F(1)(a) and (b) to notify APRA of any change to an accountability statement and an accountability map, respectively, should be amended to require notification of *material* changes. The requirement to notify any change is overly burdensome for both ADIs and APRA.

13. Section 37FA – Accountability statements

The language in subparagraph (a) about "effective management and control" is different to the language in subparagraph 37BA(1)(b) about "actual or effective responsibility". The language should be the same in both provisions. APRA will need to provide substantive guidance on the form of, and the depth of detail they expect to be included in, accountability statements.

14. Section 37FC – Events for which APRA must be notified

Subparagraph 37FC(d)(i) and (ii) should require *material* breaches by the ADI and *material* breaches by an accountable person to be notified to APRA.

15. Section 37G – Pecuniary penalty for non-compliance with [this Part]

In order to be consistent with the policy intent described in the EM, subparagraph 37G(1)(b) should state that an ADI is liable to a penalty if the contravention relates to *systemic* prudential matters.

16. Section 37H – Register of accountable persons

It would be preferable to insert a new paragraph between existing paragraphs (3) and (4) that states that the register is not public, in addition to the statement in paragraph 1.113 of the EM.

Further practical guidance from APRA in due course about how it expects ADIs to interact with it in terms of the registration process – for example, checking with APRA before a person is appointed to an accountable person role – will be very helpful in terms of the administration of the regime.

17. Section 37J – APRA may disqualify an accountable person

No provision has been made to allow for review on the merits by the Administrative Appeals Tribunal (AAT) of a decision by APRA to disqualify a person under section 37J. This omission does not have a policy justification and is inconsistent with equivalent provisions affecting individuals under conduct laws administered by ASIC.[1] The Australian legal and administrative framework does not operate in this way, and other regulators such as ASIC, which administers a regime under which individuals can be removed from an industry and have their livelihood taken away, have appropriate controls and processes in place to govern the use of these powers in the interests of good decision making.

APRA's proposed disqualification powers are significant and may have substantial, life-altering consequences for individuals. Disqualification is likely to have a permanent impact on an accountable person's ability to be employed in the financial services industry, beyond accountable person roles and beyond APRA's disqualification period. In light of this, it is absolutely imperative that a proper review and appeal process is in place.

It is a matter of fundamental importance that basic protections provided by the Australian legal and administrative framework are not ignored or disregarded. The AAT was established in 1975 to improve the accountability and transparency of government in a number of distinct but complementary ways. This was in order to give the individual citizen a range of options for seeking redress in relation to the decisions and processes affecting them. By providing individuals and others with a mechanism for challenging decisions that affect their interests, the AAT offers the

[1] This is in stark contrast to the right to AAT review of a decision made to APRA under section 23(2) of the Banking Act to remove a person from being a director or senior manager from an ADI.

The decisions that are reviewable with regard to those made by ASIC under the Corporations Act are set out under s 1317B, with a relevant parallel example being a decision to disqualify a person from managing corporations under s 206F of the Corporations Act

opportunity for a more just outcome in cases where the decision under review was not the correct decision. However, the AAT's role goes beyond justice in individual cases. The AAT's decisions provide guidance to decision-makers more generally in relation to the interpretation of law and policy for decisions that it reviews. The AAT's decision in one matter can be applied to future decision-making in the same area. While the Tribunal's interpretations of legislation are not binding on decision-makers in the same way that court decisions must be followed, the AAT's decisions are persuasive.

AFMA is highly concerned about the precedent that will be established if individuals who are subject to the BEAR regime do not have appropriate protections and rights of review. We are also concerned that similar regulatory regimes without sufficient protections and rights of appeal could be extended in the future to individuals who are less senior and have much less capacity to defend and protect themselves.

Review rights do not detract from the community expectation that the most senior individuals in ADIs will be held to rigorous standards as accountable persons and suffer harsh consequences for failure to meet those obligations. AFMA believes that a reasonable Australian person would assume and expect that an individual would not have their right to be heard and rights of review unfairly curtailed. The obligation on APRA in subsection 37J(7) to give a person and the ADI an opportunity to make a "submission" and for APRA to have "regard" to the submission [see ss37J(8)] is a basic component of procedural fairness, but it does not substitute for merits review once a decision is made.

This situation is exacerbated by the absence of any form of safe harbours analogous to those that exist in connection with the duties of directors and other officers in Division 1 of Part 2D.1 of the Corporations Act.

The EM states at paragraph 1.137 that decisions to disqualify an individual will be subject to ADJR. The most common grounds for judicial review by the Federal Court are:

- a breach of natural justice;
- an error of law; or
- a failure to take into account a relevant consideration.

Section 5 of the *Administrative Decisions (Judicial Review) Act 1977* (Cth) (ADJR Act) lists the grounds of judicial review, which largely reflect the common law grounds at both federal and state levels, as follows:

> *A person who is aggrieved by a decision to which this Act applies that is made after the commencement of this Act may apply to the Federal Court or the Federal Circuit Court for an order of review in respect of the decision on any one or more of the following grounds:*
>
> *a. that a breach of the rules of natural justice occurred in connection with the making of the decision;*
>
> *b. that procedures that were required by law to be observed in connection with the making of the decision were not observed;*

c. *that the person who purported to make the decision did not have jurisdiction to make the decision;*
d. *that the decision was not authorised by the enactment in pursuance of which it was purported to be made;*
e. *that the making of the decision was an improper exercise of the power conferred by the enactment in pursuance of which it was purported to be made;*
f. *that the decision involved an error of law, whether or not the error appears on the record of the decision;*
g. *that the decision was induced or affected by fraud;*
h. *that there was no evidence or other material to justify the making of the decision;*
i. *that the decision was otherwise contrary to law*.[2]

From a constitutional perspective, it is important to understand that merits review under the Administrative Appeals Tribunal Act 1975 is an exercise of the administrative power of the Commonwealth and not of the judicial power of the Commonwealth. This is so even though the President of the Tribunal is a judge of the Federal Court of Australia and other federal judges may be appointed as members of the AAT. The making of administrative decisions and the reviewing of them on the merits are functions regulated by Chapter II of the Constitution relating to the Executive Government and not Chapter III relating to the Judicature. Understanding this is fundamental to an understanding of administrative review.

By way of contrast, judicial review of administrative decisions involves an assertion by an applicant against a government respondent, which resists the claim, that an administrative decision is unlawful. There is only one answer. Either the decision is unlawful or it is not. In general, the court hearing the application has no power to consider the merits of the decision. If the decision is unlawful, it cannot be made lawful by a court engaged in judicial review. We remind the drafters that review under ADJR is about the process whereby the decision was made, and not the merits of the decision. ADJR is not a wholly appropriate or sufficient protection mechanism for an individual who is subject to a disqualification order.

Importantly, there is Commonwealth government policy that merits review of decisions affecting a person's interests be included in any Commonwealth legislation, as per paragraph 4.2.4 of the Commonwealth's Australian Administrative Law Policy Guide.[3] As those policies indicate, there are well-established circumstances in which merits review is not appropriate or should be excluded. None of these circumstances apply to decisions under proposed section 37J. It is not apparent what justification there is for departing from this policy which has been in place for a considerable period of time under Coalition and Labor governments.

[2] *www.lawhandbook.org.au/12_02_08_grounds_of_judicial_review*

[3] *https://www.ag.gov.au/LegalSystem/AdministrativeLaw/Documents/Australian-administrative-law-policy-guide.pdf*

AFMA strongly urges the Government to make any decision by APRA to disqualify an individual reviewable under Part VI of the Banking Act, in order to ensure that individuals have access to independent merits review and that appropriate protections are in place. Having this type of review process in place does not alter the policy outcome of the regime in terms of trust and confidence in the financial system, and will also provide the level of protection that any member of society would reasonably expect to have in situations where they are subject to the decision of a Government body.

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I would be happy to discuss any aspect of this submission with you. Please contact me on 02 9776 7997 or tlyons@afma.com.au .

Yours sincerely

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Head of Policy

Appendix: Scenario in relation to Section 37

XYZ Bank is a foreign firm. It has an Australian branch regulated by APRA as an ADI and regulated by ASIC as a registered foreign company. As such it will be subject to BEAR.

XYZ Bank is also the 100% owner of another foreign firm, XYZ Trust. It is not a bank. It conducts financial activities. It has an Australian branch but the branch is not regulated by APRA. The branch is regulated by ASIC as a registered foreign company.

The Bill is not clear as to whether XYZ Trust Australia Branch is caught by BEAR, even if read in conjunction with the EM.

Section 37 in Part 1 of the Bill says:

37 Obligations of ADIs

(1) An ADI must comply with:
- *(a) its accountability obligations under Division 2; and*
- *(b) its key personnel obligations under Division 3; and*
- *(c) its deferred remuneration obligations under Division 4; and*
- *(d) its notification obligations under Division 5.*

(2) However, this section does not apply to:
- *(a) an ADI:*
  - *(i) that the Minister has exempted under section 37A; or*
  - *(ii) that is included in a class of ADIs that the Minister has exempted under section 37A; or*
- *(b) a foreign ADI, except to the extent that it operates a branch of the foreign ADI in Australia.*

If section 37 is applied to XYZ Trust Australia Branch, it is a matter of plain fact that it is not a branch of the foreign ADI – instead, it is a branch of a subsidiary of the foreign ADI. It is not clear whether that leaves it in or out of the scope of BEAR.

Paragraph 1.31 of the EM says that a foreign ADI is not subject to the BEAR for its offshore operations or for any locally incorporated non-ADI subsidiaries. However, its Australian branch operations are obliged to comply with the BEAR.

Applying paragraph 1.31 to XYZ Trust Australia Branch:

- It is not locally incorporated so is not exempt under that heading;
- It is not the Australian Branch of XYZ Bank, so is not caught for that reason;
- It is not offshore, but is a branch of an entity that is offshore, so is it exempt under that heading?