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17 December 2021

Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By upload.

Dear Sir/Madam

Financial Accountability Regime Bill 2021 and

Financial Services Compensation Scheme of Last Resort Levy Bill 2021

The Australian Financial Markets Association (AFMA) represents the interests of over 120 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

AFMA has been an active contributor to the refinement of both the Financial Accountability Regime and the Compensation Scheme of Last Resort since their beginnings. This submission raises a number of matters in relation to each Bill.

Financial Accountability Regime Bill 2021

AFMA was closely engaged with the issues arising for members with regard to the implementation of the Banking Executive Accountability Regime (BEAR) and its oversight by APRA. We also provided a submission to Treasury in response to the January 2020 FAR proposals paper and the Exposure Draft paper.

The consultation program was constructive and AFMA is generally supportive of the final shape of the regime noting the reservations in our submission to the Exposure Draft consultation about the competitiveness with our regional peers of the settings around deferral, and other more technical concerns such as with the end-to-end product responsibility requirements.

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AFMA supported the removal of the originally drafted civil penalties for Accountable Person (AP) employee breaches of the accountability obligations from the FAR legislation.

AFMA understands from media reports that there is interest in some quarters in reintroducing the penalties for breaches without a requirement for intent by AP employees that were considered earlier in the consultation process.

Our view is that this is not necessary or appropriate as the Bill as introduced retains a substantial penalty regime.

The Bill as introduced retains a core requirement that employees that are categorized as Accountable Persons (AP employees) must keep their Accountability Obligations which include:

a) acting with honesty and integrity, and with due skill, care and diligence; and
b) by dealing with the Regulator in an open, constructive and cooperative way; and
c) by taking reasonable steps in conducting those responsibilities to prevent matters from arising that would (or would be likely to) adversely affect the prudential standing or prudential reputation of the accountable entity; and
d) by taking reasonable steps in conducting those responsibilities to prevent matters from arising that would (or would be likely to) result in a material contravention by the accountable entity of any of the following:
    i. this Act;
    ii. the *Banking Act 1959*;
    iii. the credit legislation (within the meaning of the *National Consumer Credit Protection Act 2009*);
    iv. the *Financial Sector (Collection of Data) Act 2001*;
    v. the financial services law (within the meaning of section 761A of the *Corporations Act 2001*);
    vi. the *Insurance Act 1973*;
    vii. the *Life Insurance Act 1995*;
    viii. the *Private Health Insurance (Prudential Supervision) Act 2015*;
    ix. the *Superannuation Industry (Supervision) Act 1993*;
    x. regulations, instruments, directions or orders made under a law referred to in any of subparagraphs (i) to (ix).

If AP employees fail to do so then the Bill requires that firms have a policy that the person's variable remuneration is to be reduced by an amount that is proportionate to the failure, per Section 25. In addition, such a failure may lead to disqualification of the ability of the employee to be an AP by the regulator under Section 42.

These provisions mean that AP employees face serious, potentially career ending, consequences for failures in departments of ADIs for which they are responsible. This creates parallel but more severe risks to those faced by Ministers in the course of their duties.

In AFMA's view this meets the aims of the Bill to create accountability for senior employees.

In addition to these proportionate responses to failures to meet the obligations, as introduced into Parliament there are extensive ancillary/accessorial liability provisions with heavy penalties for AP employees in the Bill:

(1) A person must not:

a) attempt to contravene a civil penalty provision of this Act; or
b) aid, abet, counsel or procure a contravention of a civil penalty provision of this Act; or
c) induce (by threats, promises or otherwise) a contravention of a civil penalty provision of this Act; or
d) be in any way, directly or indirectly, knowingly concerned in, or party to, a contravention of a civil penalty provision of this Act; or
e) conspire with others to effect a contravention of a civil penalty provision of this Act.

For the purposes of subsection (1), the maximum penalty amount for a contravention by a person other than a body corporate of a civil penalty provision of this Act is the greater of the following:

a) 5,000 penalty units; [$1,110,000 currently]
b) if the court can determine the benefit derived and detriment avoided because of the contravention—that amount multiplied by 3.

These ancillary liability provisions apply penalties for any *willful involvement* of an Accountable Person in breach of the accountability obligations by the firm including requirements:

a) to take reasonable steps to conduct its business with honesty and integrity, and with due skill, care and diligence; and
b) to take reasonable steps to deal with the Regulator in an open, constructive and cooperative way; and
c) in conducting its business, to take reasonable steps to prevent matters from arising that would (or would be likely to) adversely affect the accountable entity's prudential standing or prudential reputation; and
d) to take reasonable steps to ensure that each of its accountable persons meets their accountability obligations under section 21; and
e) to take reasonable steps to ensure that each of its significant related entities complies with each of paragraphs (a), (b), (c) and (d) as if the significant related entity were an accountable entity.

The level of these penalties for willful involvement in failures to meet accountability obligations are heavy at around double the highest monetary penalties in state criminal justice systems for serious (Level 2) crimes for which there is a monetary penalty available.[1]

When combined with the already serious consequences associated with non-willful breaches this is a very strong penalty framework that does far more than what is required to create a system of responsibility for AP employees.

[1] See https://www.sentencingcouncil.vic.gov.au/about-sentencing/maximum-penalties

The January 2020 consultation paper had proposed that AP employees, in addition to the potential for reduction in variable remuneration, disqualification from working as an AP, and being subject to the ancillary liabilities, would also be subject to civil penalties for breaches of their accountability obligations. The maximum penalties *per breach,* for AP employees was to be the greater of 5,000 penalty units (currently $1.11 million); or the benefit derived, or detriment avoided, because of the breach, multiplied by three.

The reintroduction of such personal penalties would:

- extend beyond the policy scope of the applicable Royal Commission recommendations (there was no suggestion in the recommendations of a requirement for increased penalties for AP employees); and
- create a work environment that puts AP employees at risk of significant financial harm for matters over which they may not have control.

Work environment that risks significant financial harm

The Corporations and Markets Advisory Committee (CAMAC) provided independent advice on legal and practice matters relevant to corporations and financial markets to the Australian Government. In its 2005 report *Personal Liability for Corporate Fault* it advised that corporate officers may be "deemed liable, and subject to penalties, for corporate conduct that they could not reasonably have influenced or prevented"[2].

The CAMAC Report sensibly insisted that individuals should not be held liable for corporate misconduct unless they were directly involved in or were accessories to the contravention. These types of involvement are already covered in the Bill under the ancillary liability provisions.

If the former penalty regime was reintroduced circumstances could readily arise that would go against the CAMAC-advised principle. For example, an AP employee could fail to meet the obligation to:

> [take] reasonable steps in conducting those responsibilities to prevent matters from arising that would (or would be likely to) adversely affect the prudential standing or prudential reputation of the accountable entity

This could occur due to inaccurate or poorly analysed information provided by others, or by poor implementation by others of directions given by the AP employee, or by failings of departments such as Audit, Risk and Compliance, in other words failures of the business as a whole.

The end-to-end product AP employees would have even higher exposure as, due to the nature of the manufacture of financial products, they would be reliant on many departments.

Reach of provisions

While we are opposed to the reintroduction of the original penalty regime in principle we also offer the following information on the range of employees that would be exposed to the risk of large fines. Most

[2] Corporations and Markets Advisory Committee (Cth), Personal Liability for Corporate Fault (Report, September 2006) ('Personal Liability for Corporate Fault').

ADIs are small to medium entities and average remuneration would make penalties a serious risk for these employees, noting again penalties are per breach.

There may be a misapprehension that AP employees are typically on million-dollar salaries. Indicatively around a quarter of employees in the various roles listed as AP in the draft regulations earn far less than a federal SES level 2 employee.

Beyond the creation of a work environment that would place AP employees at risk of financial harm for actions potentially beyond their control, introducing the risk of heavy penalties where there was no intent would put the Australian industry at a disadvantage regionally and domestically in its ability to attract the best and the brightest to these roles.

Compensation Scheme of Last Resort Bill 2021

The Compensation Scheme of Last Resort Bill 2021 creates a large compensation scheme that allocates the costs associated with compensation claims for individuals and small business (as defined in the scheme) where they cannot be paid by the at-fault firm to other firms in the sector that have not caused the harm.

AFMA has previously raised concerns with various aspects of the scheme but accepts that the Government has determined to proceed with the Bill and we focus our comments on ensuring the scheme does not grow further to become an onerous burden on industry and avoids creating moral hazards for investors.

Scheme cap

We understand that certain parties wish to raise the scheme cap on claims. In AFMA's view the cap is consistent with the aim of the scheme to provide some substantial but ultimately limited compensation where none is available from the firm that caused that harm. Putting to one side the general principle as to whether firms that have not caused harm and were not in a position to influence those that did should pay the compensation bill, there is a strong argument that they should not be liable for unlimited claims from each individual that has unsuccessfully pursued a claim against a (typically) failed firm.

The cap is designed to reflect the UK scheme cap (set at £85,000) and is intended to balance fairness to claimants with fairness to firms that are unconnected with the harm.

A lack of limits on claims makes actuarial calculations very difficult and may make the scheme less sustainable. Even the Financial Claims Scheme (FCS) which provides compensation for bank deposits in Australia (one of the safest investment types possible) puts a cap on claims of $250,000 per individual per ADI.

Managed Investment Schemes and other investment types

We note also some parties support the extension of the scheme to cover Managed Investment Schemes (MIS). AFMA strongly opposes extending the scheme to any category or set of categories of investment. To do so would create a major moral hazard for investors and have distortionary effects on markets, capital allocation and the economy.

If a particular investment type (such as MIS) was subject to the scheme it would place the downside risks for investors in this investment type on others (specifically firms supporting the CSLR) while keeping the upside risks – financial gains - for the investor. Investors would be strongly incentivized to take on any risk as long as it was packaged in the selected investment type (such as MIS), as these would be all reward no risk investments.

It is generally possible to package a wide range of underlying risks into any investment type (such as MIS). For MIS investments ASIC[3] lists the following as examples of the assets that might underlie a particular scheme:

- cash management trusts
- property schemes
- Australian equity (share) schemes
- international equity schemes
- exchange traded funds (ETFs)
- mortgage schemes
- agricultural schemes (e.g. horticulture, aquaculture, viticulture)
- horse-breeding and horse racing schemes
- time-sharing schemes
- serviced strata schemes

Many of these can be high risk investments (or speculations in some cases) that could be de-risked for the investor by MIS packaging. The downside risks would not disappear but rather would move to the industry via the CSLR.

Exposure to risk of claims associated with MIS inclusion could discourage AFCA membership and the provision of certain financial services.

This would encourage speculation (including as noted by ASIC's list potentially on horse racing) and discourage investment in assets that would not be MIS packaged (perhaps including bank deposits).

This would be unsustainable and a detriment to the Australian economy and business environment.

Cost to the business environment

We note that the UK scheme (which also covers bank deposits) has more than quadrupled its forecast *annual cost* to businesses to over £1,000,000,000 ($1,860,000,000[4]) since 2013.

[3] https://asic.gov.au/regulatory-resources/managed-investment-schemes/
[4] Exchange rate as at 14/12/2021.

There are substantial risks in the CSLR for scope creep and increasing direct financial costs to the business environment. This would particularly be the case in the event of a disrupted financial environment where there were one or more large collapses. The scheme would act in a procyclical way increasing costs on firms when they could least afford it.

We encourage the Committee not to make amendments to extend the scheme.

Conclusion

We thank the Committee for the opportunity to provide comment to the consultation on these Bills.

We would be pleased to provide further information to any questions the Committee might have.

Yours sincerely

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AFMA