# ATTACHMENT: BUSINESS COUNCIL OF AUSTRALIA COMMENT ON PROPOSED CPS511

## 1 Expanded scope of Board responsibility

The Business Council acknowledges and supports the recent calls for greater Board oversight and involvement in remuneration following the Hayne Royal Commission and the findings of recent regulatory investigations.[1]

In addition to having direct involvement in the remuneration of key management personnel, the Board is responsible for overseeing the performance management system and ensuring that remuneration outcomes are consistent with good culture, sound risk management and superior long-term company performance and creation of shareholder value.

The Business Council supports APRA providing principles-based guidance on the role of the Board (and Board Remuneration Committees) on remuneration related matters, provided that guidance is consistent with the oversight role of a Board and concurrent reform proposals. The Business Council agrees that Boards should:

- oversee the design, operation and monitoring of remuneration frameworks (which could require Boards to determine the appropriate balance of financial and non-financial metrics when determining whether to vest LTIs. The Business Council is of the strong opinion that Boards should retain the discretion to determine the appropriate mix rather than have prescriptive guidance from APRA (see further part 2));
- participate in decisions relating to variable remuneration of key staff including below the ‘c-suite’;
- establish processes for the risk function to enable risk outcomes to be reflected in remuneration outcomes;
- obtain appropriate and effective reporting; and
- periodically review remuneration frameworks.

However, the Business Council does not support the prescriptive approach taken by APRA on CPS 511 which may:

- subject directors to a greater level of responsibility than is required under directors’ duties;
- result in an inappropriate shift in the function of a Board from an oversight committee towards fulfilling the role of management by requiring Boards to ‘implement’ remuneration frameworks or take other action that falls within the purview of management. For example, the requirement for annual Board approval of remuneration for all senior managers, in addition to any employee with the potential to earn A$1m, will require a significant time commitment from a Board in addition to its current obligations, particularly in large institutions. This responsibility would be better delegated to management;

1 Relevant public reports include: the Hayne Final Report, the CBA Prudential Inquiry, APRA’s April 2018 Information Paper on ‘Remuneration practices at large financial institutions’, the 4th Edition of the ASX Corporate Governance Council’s Corporate Governance Principles and Recommendations, the ASIC Corporate Governance Taskforce’s report 'Director and officer oversight of non-financial risk report' and forthcoming report on remuneration practices.

- take a one-size-fits-all approach when assessing a Board's compliance with CPS 511. What CPS 511 requires of a Board should differ between organisations depending on a range of factors including the nature of the entity, its resources and levels of sophistication and the circumstances at play. For example, the value of requiring Board oversight on all remuneration arrangements may be questionable for some entities, particularly where there are remuneration arrangements which affect a limited number of employees or employees who do not pose a significant misconduct risk. Such remuneration arrangements would be more appropriately governed by management committees.

Whilst the Business Council generally supports the greater Board oversight and involvement in remuneration required under CPS 511, APRA should take a principles-based rather than prescriptive approach, and ensure requirements under the finalised CPS 511 fall within the current scope of directors' duties and the oversight role of Boards.

## 2 Proposed limits on financial performance measures

CPS 511 proposes a 50% weighting limit for financial performance measures and a 25% individual weighting limit for each individual financial measure.

The Business Council is strongly of the view that mandatory thresholds should not be set for financial and non-financial performance measures. Rather, Boards and delegated committees should retain responsibility for determining the type and composition of performance metrics that align with the company's unique objectives, risk appetite and shareholder interests. While principles-based guidance from APRA may be appropriate (such as requiring Boards to consider an appropriate mix of financial and non-financial metrics relevant to their organisation), prescriptive weighting limits are an unnecessary encroachment on Board discretion.

A primary concern for the Business Council is that the weighting of non-financial metrics prescribed by APRA may not be aligned with shareholders' interests. For example, payment of an award based on the satisfaction of non-financial metrics when certain financial targets are not met places directors of Australian listed entities in a precarious position, as under the two-strike regime, shareholders demanding financial performance may vote against a company's remuneration report at a general meeting (of which there has been an increasing trend in APRA-regulated companies). If two 'no' votes are received in consecutive years, a spill motion will be required. As such, the design of variable remuneration has serious implications for the Board and the stability and strategic direction of a company. Boards should therefore retain the flexibility to design remuneration structures that best address stakeholder interests.

Moreover, retaining Board discretion allows Boards to determine whether are there are other, more appropriate measures that companies can adopt to incorporate non-financial considerations into variable remuneration design. This includes using behavioural standards, risk management and compliance requirements as a 'gateway' to eligibility for the award of variable remuneration. Financial performance gateways can also be used to address the concerns of shareholders described above. Board discretion can also be used after awards have been made, to adjust unvested variable remuneration in part or in full to reflect the seriousness of non-financial management failures on a case-by-case basis, without being prescriptive. The Business Council understands that a number of banks have provided examples of ways non-financial gateways are used within a financial scorecard that are unique to their business.

Finally, APRA's proposals focus on the basis for the award of variable remuneration each year, rather than the tests that apply to vesting of deferred remuneration. The Business Council supports a focus on measures that align with shareholder interests for vesting long-term variable remuneration, which may take into account a range of factors that affect value.

For these reasons, the Business Council strongly recommends against APRA developing prescriptive requirements for remuneration design such as the 50% weighting limit for financial measures, and instead should allow Boards to retain the necessary discretion to design remuneration frameworks that best allow their company to respond to changes in the economic, regulatory and social environment and stakeholder interests.

## 3 Proposed deferral & clawback requirements for variable remuneration

CPS 511 proposes minimum deferral periods for variable remuneration of up to 7 years for CEOs of Significant Financial Institutions (SFIs) and 6 years for senior executives and highly paid material risk takers in larger, more complex entities.

SFIs must also subject the variable remuneration of senior managers or highly paid material risk takers to clawback for at least 2 years from the date of payment or vesting; or 4 years in circumstances involving a person under investigation.

*Proposed deferral periods are a significant departure from current market and international practice*

The Business Council is concerned that the proposed deferral periods vary significantly from current Australian market practice, the requirements under BEAR and international practice,[2] including Europe and the United Kingdom which are highly regulated jurisdictions. Although the Discussion Paper notes that member jurisdictions of the Financial Stability Board (FSB) have reported deferral periods of between 3 and 10 years,[3] in its latest progress report, the FSB provides that a 3 year deferral period for senior executives was the standard requirement as adopted by 15 FSB jurisdictions.[4]

Moreover, in jurisdictions such as the UK which have implemented minimum deferral periods of up to 7 years for certain managers,[5] there are key regulatory requirements which differ from CPS 511:

- In the UK, the definition of "senior manager" is significantly narrower than that proposed under CPS 511(the UK definition is more aligned to the definition of "accountable person" under the BEAR which concerns only the most senior levels of executive management).
- There are also significantly higher remuneration thresholds (minimum total remuneration of £500,000 compared to $50,000 of variable remuneration under CPS 511) that apply before an individual is subject to the deferral requirements in the UK.
- Most regulated employees in the UK (including "material risk takers") are subject to shorter deferral periods and pro rata vesting is permitted from year 1, rather than the end of the deferral period as proposed by CPS 511.

*Practical and legal implications of clawback*

There are also a number of practical and legal impediments to the effective use of clawback. [6]

The Business Council notes the practical difficulty of determining responsibility for complex historical matters which may have occurred up to 11 years earlier under CPS 511 in order to consider whether clawback is the appropriate form of consequence management; the difficulty of valuing the amount of remuneration to be recovered if the value of the security has changed over time; and the difficulty of recovering remuneration from an employee when it has already been spent.

Further, the interplay between CPS 511 and current legislation including the *Corporations Act 2001* (Cth) (Corporations Act) and *Fair Work Act 2009* (Cth) (Fair Work Act) is unclear. For example, whether a security that has been legally registered in the name of an employee can be recovered by a company is uncertain due to the provisions of the Corporations Act relating to the maintenance and integrity of share capital. Moreover, if a security can be recovered, any clawback that requires a transfer of a security from an employee back to the company must not infringe the requirements of the Corporations Act that apply to the acquisition by companies of shares in themselves and share buy-backs.

[2] Discussion Paper, page 30.

[3] Discussion Paper, page 35.

[4] Financial Stability Board's sixth progress report on Implementing the Principles for Sound Compensation Practices and its Implementation Standards, 17 June 2019 (FSB Progress Report), page 32.

[5] Discussion Paper, page 35.

[6] APRA has identified a number of limitations to clawback in its Discussion Paper at page 40.

There are also a number of prohibitions under the Fair Work Act 2009 (Cth) against making deductions from employee remuneration that are not for the benefit of the employee[7] or requiring an employee to pay its employer an amount of the employee's remuneration for the benefit of the employer.[8] Further, any contract term which permits such a deduction or payment (that could be required as a form of clawback) is deemed void.[9]

If clawback is to remain a requirement under CPS 511, further consideration of the practical and legal impediments is necessary to ensure Australian businesses can clearly determine when and how to lawfully apply clawback.

*Ability for Australian businesses to attract key talent*

The Business Council is also particularly concerned that the proposed deferral periods and clawback requirements – especially when added together to create a total at-risk period of up to 9 years for CEOs under normal circumstances – may have a negative impact on the ability of Australian companies subject to CPS 511 to recruit and retain key personnel with the adequate experience and risk appetite required for the ongoing success and competitiveness of the company. In particular, the Business Council notes:

- It may be difficult for companies subject to CPS 511 to recruit suitable CEOs both domestically and from overseas given the typical tenure of an Australian CEO is far shorter (approximately 3-5 years) than the proposed deferral period of 7 years, particularly when subject to a further 2 years of clawback. Whether an outgoing CEO will receive their fully vested reward after they leave a company is inherently uncertain, and will largely depend on the individual employment contract providing for 'good leaver' or other circumstances.
- The long deferral and clawback periods may also mean companies subject to CPS 511 may find it difficult to recruit key personnel who are essential to support the success of a business (such as digital or privacy specialists) from other Australian industries which are not subject to CPS 511 or experienced professionals from financial institutions overseas.
- Australian businesses may incur increased employment related costs (for example, higher fixed remuneration plans or employee specific allowances) to retain key staff who may be drawn to other industries or overseas jurisdictions such as Singapore that have less stringent restrictions on remuneration.

As such, the Business Council recommends that deferral requirements should not extend beyond the existing obligations under BEAR and deferral requirements in other highly regulated jurisdictions to ensure Australian companies are able to attract and retain key talent. Moreover, the requirement to exercise clawback should only apply if the legal and practical impediments set out above are addressed, all other adjustment tools have been exhausted or cannot be implemented, and then only in circumstances of serious malfeasance.

[7] Section 324 of the Fair Work Act.
[8] Section 235 of the Fair Work Act.
[9] See section 326(1) and 326(3) of the Fair Work Act.