HERBERT
SMITH
FREEHILLS

General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
PolicyDevelopment@apra.gov.au

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By Email

To Whom It May Concern

Submission on the 'Strengthening prudential requirements for remuneration' discussion paper and draft Prudential Standard CPS 511

This submission is made by the Head Office Advisory Team at Herbert Smith Freehills in response to the discussion paper dated 23 July 2019 outlining the Australian Prudential Regulation Authority's (**APRA**) proposed approach to strengthening prudential requirements for remuneration (**Discussion Paper**) and the draft Prudential Standard CPS 511 Remuneration (**CPS 511**).

We are supportive of APRA's objective of ensuring remuneration arrangements promote effective management of both financial and non-financial risks, sustainable performance and long-term soundness.

Based on our experience advising a number of large, medium and small APRA-regulated institutions and companies, there are a number of aspects to the proposal that we believe would benefit from refinement, clarification or guidance from APRA. We have explained these below.

1 Clawback and malus

CPS 511 sets out a number of clawback requirements for Significant Financial Institutions (**SFI**s). We make some observations and suggestions in relation to the extended clawback period and practical difficulties and legal uncertainties with implementing clawback mechanisms.

1.1 Extended deferral period

We note APRA's proposal to mandate a 7 year deferral period for 60% of a CEO's variable remuneration in the case of a SFI, and to mandate a minimum clawback period of 2 years from vesting or payment (or 4 years, where the CEO is under an investigation). The combined effect of these proposals is that the CEO's remuneration is at risk for between 7 and 11 years.

Having regard to the international practice detailed in Figure 6 of the Discussion Paper, it is clear that APRA's proposed clawback requirements are more onerous than other major jurisdictions. In our view, the position on mandatory clawback and deferral periods should not be more onerous in Australia than in the UK.

While we recognise the need to retrieve executive pay in some circumstances, this should be balanced against the need for certainty for CEOs. We suggest that deferral occur for a minimum of 4 years and then equity be released on a staggered basis with a complete release of vested equity occurring after 7 years. This means that the remuneration would be at risk for a total of 7 years. Companies could choose their own performance periods (e.g. 3 years) and apply a holding lock to vested equity for the remainder of the deferral period that is subject to malus or clawback provisions.

APRA should also consider clarifying paragraphs 53 and 54 of CPS 511, to make it clear that the phrase “vesting may only occur after four years” is not prescribing a four year performance period. Rather, it is prescribing a four year deferral period. This would reflect our experience. Paragraphs 53 and 54 of CPS 511 also refer to deferral beginning on “inception”. It is not clear what “inception” means and we recommend APRA explain or define this term as “the point in time at which the variable remuneration opportunity is offered”.

Our experience indicates that companies prefer to use malus provisions (rather than clawback provisions) due to the practical difficulties of implementing clawback. We have discussed this further in section 1.4 below. Ultimately, the guiding principle should be that companies have the flexibility to determine their own performance period, holding lock, malus and clawback arrangements, subject to APRA’s minimum deferral periods.

1.2 Consequences of new provisions

We note that one of the potential unintended consequences of these stronger regulations is that financial services companies will be at a disadvantage in recruiting talent, particularly talent that can work in other sectors outside the financial services sector (for example, IT, HR and risk professionals). It may also become more difficult to recruit bankers from foreign jurisdictions that do not have such onerous provisions. Similarly, Australian bankers may find it more attractive to work for foreign companies reducing the available pool of talent.

Many companies will also need to re-think remuneration, given the application of extended deferral obligations to senior managers. Not all financial institutions offer long-term incentives (**LTI**s) to executives below the senior/executive management team level. If long-term deferral of variable remuneration needs to be applied to lower levels of staff under CPS 511, then companies may need to start offering LTI grants to a broader group of employees than at present, which becomes costly.

We consider that the extended deferral and clawback periods will have an unfair impact on people close to retirement, as they would not be able to use their vested LTIs until the clawback period expires. CPS 511 impacts retirement planning for up to 9 years after leaving the workforce.

1.3 Taxing point issues

The taxing point laws in Australia provide that an executive is to pay tax on all of their restricted shares on cessation of employment, even those subject to a deferral period. This means that if a director or senior manager ceases employment during a deferral period, they will have to pay tax on shares they do not possess. Unless the Government changes tax laws to remove the taxing point on cessation of employment, companies may move away from shares as the preferred LTI instrument.

APRA could recommend that the Government remove the taxing point on cessation of employment or, alternatively, allow for the prescribed deferral arrangements to be lifted on cessation of employment, to the extent necessary to allow the individual to sell their shares and pay the applicable tax on the grant.

1.4 Practical difficulties and legal uncertainties

In discussing clawback and malus with our clients, the feedback has been that malus is the preferred mechanism for responding to poor executive performance. This is because there are a number of practical difficulties and legal uncertainties associated with implementing a true clawback once shares have been released (particularly where subsequently sold) or cash paid to an employee. These difficulties include the following:

- Clawback is difficult to implement as the company no longer has control over the shares (particularly where the shares have been sold) or cash payment. In our experience, this has often meant that companies are reluctant to use clawback other than where vested shares continue to be held in a share plan trust or in exceptional misconduct circumstances.

- We expect to see an increased likelihood of litigation commenced by executives against companies to fight clawback claims. Boards may be reluctant to use shareholder funds for such litigation at the risk of being seen to waste the company's money.
- There are potentially significant costs associated with seeking to enforce clawbacks in a court context. There is a risk that the legal cost of litigating a clawback claim exceeds the value of the remuneration itself.
- If litigation is a real possibility, then a true clawback would probably only be used if the executive had engaged in serious misconduct (as opposed to concepts such as 'clawback for general leadership accountability').

As a result of these difficulties and unless the legal status of clawback is clarified by Parliament or the courts, it is our view that in practice a longer period of deferral or malus is likely to be preferable to companies. Malus offers a higher level of certainty and is not subject to the same enforcement risks that apply to clawback provisions.

In terms of the appropriateness of the clawback triggers in paragraph 58, we suggest that APRA clarify "(d) failure of accountability or fitness and propriety". "Failure of accountability" is a loose term and APRA should explain whether this is intended to reflect accountability under the Banking Executive Accountability Regime.

2 Board oversight of remuneration

We agree with APRA's approach to try to encourage boards to be involved in remuneration oversight at all levels given the interplay between remuneration, culture and risk, however we consider that mandating board 'involvement' on an individual by individual basis (Discussion Paper, 27) in remuneration for persons in special role categories is a significant development. This is particularly the case for CPS 511 because the special role category includes anyone with a primary role in risk and financial control, which would capture a wide range of persons. Accordingly, the proposal would benefit from APRA's clarification as to which aspects of the remuneration regime the board can still delegate to management under CPS 511. For example, paragraph 48 of CPS 511 obliges remuneration committees to assess and make recommendations on the remuneration arrangements for individual senior managers and highly-paid material risk-takers.

Our view is that it is important to cascade remuneration oversight from the remuneration committee down to management so that the committee can focus on significant remuneration matters and the remuneration arrangements for executives with the most significant impact. Further, management should be trusted to consider and determine remuneration for the majority of staff without the need for board involvement.

The expansion of board responsibility to cover remuneration of a large number of special role staff poses a risk of the remuneration committee engaging in management. We have received feedback from one client that this would be over 100 people. In our view, the board does not need to monitor the line by line remuneration of every individual captured by the standard. It should suffice if the board oversees the overarching remuneration arrangements for each category of employee captured by the standard and the board receives exception based reporting on significant issues.

3 Non-financial metrics

We note APRA's proposal to require 50% of total measures for allocating variable remuneration be made up of non-financial measures. However, this could be a challenging proposal in the Australian market for APRA-regulated institutions that are listed on the ASX as proxy advisors have made it clear they are not in favour of non-financial metrics for LTIs. As APRA is aware, proxy advisers recommend to institutional shareholders that subscribe to their reports how to vote on resolutions at a listed company's annual general meeting, including remuneration-related resolutions.

In our view, proxy advisers will not accept 50% of LTI performance hurdles being non-financial metrics even if this is mandated by CPS 511. Accordingly, we believe it would be beneficial for APRA to communicate the importance of this development to proxy advisers before imposing CPS 511.

We think it would be helpful if APRA clarified that companies are allowed to structure their non-financial hurdles in any way they choose. One example of this would be a company using STIs with only non-financial hurdles and LTIs with only financial hurdles. Another example would be to have variable remuneration subject to financial hurdles, with an additional overlay of a non-financial gateway hurdle.

It would also be useful for APRA to consider:

- whether ASIC should be encouraged to make APRA-regulated entities exempt from the two-strikes provisions in the Corporations Act; and
- how the 50% non-financial hurdle will be calculated, whether on a 'rolling basis' or at a particular point in time, assessed on the grants made in a particular financial year. We have received feedback from our clients that the calculation of the 50% is unclear and we believe this would benefit from further guidance from APRA so that CPS 511 is effective from the outset and companies that CPS 511 applies to have certainty in how APRA expects the 50% weighting to be applied. This last point is particularly important given that prudential standards have the force of law and the potential significant consequences of breaching a prudential standard.

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We are grateful for the opportunity to make this submission and would be happy to discuss this with APRA further. Please do not hesitate to contact us.

Yours sincerely

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