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ASIC ENFORCEMENT REVIEW: POSITIONS PAPER 7 – STRENGTHENING PENALTIES FOR CORPORATE AND FINANCIAL SECTOR MISCONDUCT

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INTRODUCTION

We thank Treasury for this opportunity to make a submission regarding the 'ASIC Enforcement Review: Positions Paper 7 – Strengthening Penalties for Corporate and Financial Sector Misconduct' (October 2017). We are part of a group of academics currently undertaking an Australian Research Council-funded project (DP140102277) examining the regulation of illegal phoenix activity. Our aim is to devise ways in which this damaging behaviour can be most efficiently and effectively prevented and deterred, without damaging legitimate business activities to the detriment of the economy.

As well as a series of scholarly and professional publications, our research team has produced three major reports: Defining and Profiling Phoenix Activity (December 2014); Quantifying Phoenix Activity: Incidence, Cost, Enforcement (October 2015), and Phoenix Activity: Recommendations on Detection, Disruption and Enforcement (February 2017). Please click here to access these reports.

BACKGROUND ON PHOENIX ACTIVITY

The concept of phoenix activity broadly centres on the idea of a corporate failure ('Oldco') and a second company ('Newco'), often newly incorporated, arising from the ashes of its failed predecessor where the second company's controllers and business are essentially the same. Phoenix activity can be legal as well as illegal. Legal phoenix activity covers situations where the previous controllers start another similar business, using a new company when their earlier company fails, usually in order to rescue its business. Illegal phoenix activity involves similar activities, but the intention is to exploit the corporate form to the detriment of unsecured creditors, including employees and tax authorities. The illegality is generally as a result of a breach of directors' duties in failing to act properly in respect of the failed company and its creditors.

GENERAL COMMENTS

Imposing higher penalties on small companies could incentivise illegal phoenix activity

A number of the proposals outlined in the Positions Paper involve creating new penalties, or increasing existing penalties, that apply to corporations rather than individuals. We do not support creating any new penalties or increasing any existing penalties that apply to corporations that operate micro, small and medium enterprises (SMEs). Illegal phoenix activity predominantly occurs within the SME sector. In our view, imposing penalties on corporations

that run SMEs poses a significant risk of incentivising illegal phoenix activity aimed at avoiding payment by the corporations of the penalties. Imposing penalties on the individuals who control such corporations is a less risky, and potentially more effective, method of achieving general deterrence of corporate and financial misconduct within the SME sector. However, we do not express any opinion on the appropriateness of expanding and increasing penalties that apply to large corporations. This submission is exclusively concerned with the proposed changes to penalties as they apply to individuals.

There is a need to examine ASIC's enforcement practices against corporate and financial misconduct associated with insolvency and small businesses

The Positions Paper does not specifically address the issue of misconduct around the time of insolvency. We believe that this issue needs to be examined, for two reasons. First, the incidence of misconduct associated with insolvency appears to be growing. The percentage of external administrator reports that alleged misconduct has increased every year since 2008, from 66 per cent in 2008–09 (5,092 of 7,733) to 82 per cent in 2015–16 (7,797 of 9,465).[1] Second, despite this apparently growing incidence of misconduct associated with insolvency, ASIC takes compliance, surveillance, investigation or enforcement action in response to a very small proportion of these reports. Over the last ten years, ASIC has taken such action in response to an average of 2.79% of initial reports alleging misconduct and its response rate has not risen in proportion to the rising incidence of alleged misconduct. To the contrary, the average response rate over the past five years (2012–13 to 2016–17), at 2.09%, was lower than the average rate over the previous five years (2007–08 to 2011–12), at 3.48%.[2] This response seems inadequate to deal with the large and growing incidence of alleged misconduct associated with insolvency.

We also think that there is a need to examine ASIC's enforcement practices against misconduct associated with small businesses, which, again, is not specifically addressed in the Positions Paper. It appears that inadequate resources are allocated to regulating the 'Small Business Compliance and Deterrence' population. According to ASIC's 2015–16 annual report, only six 'surveillance resources' (which appears to refer to FTE personnel) were allocated to surveillance of this population, which included '11,494 companies identified for the potential to conduct illegal phoenix activity.'[3] This allocation was increased to nine 'surveillance resources' in 2016–17,[4] but this is still an inadequate level of surveillance for such a large number of companies. ASIC's draft 'Cost Recovery Implementation Statement: Levies for ASIC Industry Funding' (CRIS) suggests that a very small amount of funds will be allocated to surveillance and enforcement in relation to small proprietary companies in 2017–18. The CRIS accounts for 64% of ASIC's total budgeted resources for 2017–18,[5] yet only about $5 million is allocated to surveillance and enforcement to cover 2,409,919 small proprietary companies (i.e. about $2 per company, per year).[6] Given that illegal phoenix activity, which predominantly occurs in the small business sector, has been estimated to cost the Australian economy billions of dollars, this allocation of resources seems inadequate.

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1. This data was sourced from ASIC's insolvency statistics reports from 2007–2008 to 2015–16.
2. This data was sourced from ASIC's annual reports from 2016–17, 2014–15, 2012–13, 2010–11 and 2008–09.
3. ASIC, *Annual Report 2015–16* (14 October 2016) 22.
4. ASIC, *Annual Report 2016–2017* (5 October 2017) 22.
5. ASIC, 'Cost Recovery Implementation Statement: Levies for ASIC Industry Funding (2017–18)' (October 2017) [6].
6. Ibid [93], Table 6, Table 10.

Legislative reform is necessary but not sufficient of itself to reduce corporate and financial misconduct

It is important to note that having greater legislative powers to impose penalties does not automatically lead to greater general deterrence of corporate and financial misconduct. It is equally, if not more, important to examine whether the legislative powers that are already available are used frequently enough to deter corporate and financial misconduct. As discussed in the comment above, we have significant concerns that, in relation to misconduct associated with insolvency and small businesses, the existing legislative powers are not used enough.

If the existing legislative powers are not used frequently enough, it is questionable whether simply amending the legislation to expand and increase legislative powers to impose penalties will make any significant difference to rates of corporate and financial misconduct. While legislative reform may perhaps have some 'signalling' value, in the sense that it warns potential wrongdoers that stronger action *could* be taken against them (assuming they know about the reforms), this is unlikely to make much difference if stronger action is not *in fact* taken against wrongdoers on a frequent basis. A general deterrence strategy is very unlikely to work unless potential perpetrators perceive that there is a significant risk of being caught, and currently the risk of being caught, at least for wrongdoing associated with insolvency and small businesses, seems to be very low. The solution to this problem is to ensure that ASIC and other enforcement agencies are sufficiently resourced, competent and motivated to take enforcement action on a frequent basis. Amending legislative powers does not, by itself, achieve any of these objectives.

COMMENTS ON POSITIONS

Position 1: The maximum imprisonment penalties for criminal offences in ASIC-administered legislation should be increased as outlined in Annexure B

We support Position 1.

Position 2: The maximum pecuniary penalties for all criminal offences (other than the most serious class of offences – see Annexure B) in ASIC-administered legislation should be calculated by reference to the following formula:

Maximum term of imprisonment in months multiplied by 10 = penalty units for individuals, multiplied by a further 10 for corporations.

Subject to the qualifications discussed below, we support using the proposed formula as a general rule of thumb for setting maximum penalties for *individuals*. Regarding penalties for corporations, please see our general comments discussed at the beginning of this submission.

First, while we support a consistent ratio, it should not be assumed that the existing maximum imprisonment penalties for non-Annexure B offences are appropriate. The maximum pecuniary penalties should *not* be set simply by reference to the existing maximum imprisonment penalties, because the existing maximum imprisonment penalties might be outdated and inappropriate. The proposed formula should only be applied after conducting an independent assessment of whether the existing maximum imprisonment penalties are appropriate or not.

Second, the proposed formula could be used as a general rule of thumb, but it should not be rigidly applied, as it could result in maximum pecuniary penalties that are too low to achieve

their purpose. For example, two offences that are particularly important for detecting illegal phoenix activity and other insolvency related misconduct – ss 475(4) (relating to reports as to company's affairs) and 530A(6) (relating to provision of information and assistance to liquidators) of the Corporations Act – have very lenient maximum imprisonment penalties of six months and one year respectively. If these maximum imprisonment penalties were *not* increased, the proposed formula would result in maximum pecuniary penalties of 60 penalty units (currently $12,600) and 120 penalty units (currently $25,200) respectively. While these maximum penalties would be substantially higher than the existing maximum pecuniary penalties of 25 penalty units (currently $5,250) and 50 penalty units (currently $10,500) respectively, it is still questionable whether these higher maximum penalties would be adequate to deter directors from withholding information and assistance. Even if the maximums were imposed (which rarely happens in practice),[7] this would still be a low price for illegal phoenix operators to pay to ensure that liquidators are not able to collect any evidence that would be sufficient for ASIC or the CDPP to bring court proceedings against them for much more serious offences, like breaches of directors' duties, which could result in civil pecuniary penalties of up to $200,000, criminal pecuniary penalties of up to 2,000 penalty units (currently $420,000), or prison sentences of up to five years. As such, it is critical that the proposed formula not be applied too rigidly. There still needs to be an independent assessment of the maximum pecuniary penalties for each offence.

In light of the importance of conducting an independent assessment of both the maximum imprisonment penalties and the maximum pecuniary penalties, there is a question about the utility of a formula. A formula is only useful if there are not endless exceptions to the formula. However, provided that the formula is not rigidly applied, we do think that it may help to achieve greater consistency between criminal imprisonment and pecuniary penalties.

Position 3: The maximum penalty for a breach of section 184 should be increased to reflect the seriousness of the offence.

We support Position 3.

Position 4: The Peters test should apply to all dishonesty offences under the Corporations Act

We support Position 4.

Position 5: Remove imprisonment as a possible sanction for strict and absolute liability offences

We support Position 5, subject to two qualifications.

First, where imprisonment penalties are removed from very important strict liability offences, such as ss 475 and 530A of the Corporations Act, it is critical that the remaining pecuniary penalties are strengthened significantly to compensate for the potential loss of general deterrent effect resulting from removing the imprisonment penalties. The maximum pecuniary penalties under ss 475 and 530A, and the average pecuniary penalties imposed in practice, are manifestly too low to achieve general deterrence (see our response to Position 2).

[7] Our research indicates that, in practice, breaches of ss 475 and 530A rarely result in imprisonment penalties and attract an average pecuniary penalty of about $1,000.

Second, some offences, such as ss 206A (non-compliance with disqualification) and 588G(3) (insolvent trading) of the Corporations Act, provide that strict liability and absolute liability only apply to *some* parts of the offence. Clearly, ss 206A and 588G(3) ought to carry substantial maximum prison sentences given the seriousness of these forms of wrongdoing. However, there may be more borderline cases where it is difficult to determine whether the offence should be deemed 'strict liability' or 'absolute liability'. It will be necessary to have clear guidelines as to what proportion of the offence must be subject to these forms of liability in order for the entire offence to be a candidate for removing imprisonment as a sentencing option.

Position 6: Introduce an ordinary offence to complement a number of strict and absolute liability offences as outlined in Annexure C

We support position 6.

Our view is that the strict liability offences under ss 475(9) and 530A(6) of the Corporations Act should also be complemented by an ordinary offence. If company managers do not provide information and assistance to liquidators as required by ss 475 and 530A, it is almost impossible for regulators to detect illegal phoenix activity and other insolvency related misconduct. To curb these forms of wrongdoing, it is essential that ss 475 and 530A are rigorously enforced. Currently, prosecutions under ss 475 and 530A are quite frequent but the penalties are much too lenient – the average pecuniary penalty is about $1,000. While it may be difficult to obtain sufficient evidence to prove ordinary offences under ss 475 and 530A, it is important that regulators have as many tools at their disposal as possible to enforce these important provisions.

It is particularly important to introduce ordinary offences for ss 475 and 530A in light of Position 5, which proposes to remove imprisonment as a sentencing option for these offences.

Position 7: Maximum pecuniary penalties for strict and absolute liability offences should be a minimum of 20 penalty units for individuals and 200 penalty units for corporations

We support Position 7, subject to our concerns regarding penalties imposed on SME corporations discussed at the beginning of this submission.

Position 8: All strict and absolute liability offences should be subject to the penalty notice regime

We support Position 8.

Position 9: Maximum civil penalty amounts in ASIC-administered legislation should be increased, as follows:

Act	Provisions	Individual	Corporation
ASIC Act	Consumer protection provisions consistent with the Australian Consumer Law (apart from offences relating to substantiation notices)	2,500 penalty units (currently $525,000)	Greater of 50,000 penalty units (currently $10.5m), 3 times the value of benefits obtained or 10% of annual turnover.

Corporations Act, and Credit Act	All other civil penalty provisions	2,500 penalty units (currently $525,000)	Greater of 12,500 penalty units (currently $2.625m), 3 times the value of benefits obtained or 10% of annual turnover.

We support tying civil pecuniary penalties to penalty units and increasing the maximum penalties, subject to our general comments about penalties imposed on SME corporations discussed at the beginning of this submission.

However, our view is that consideration ought to be given to tailoring maximum civil pecuniary penalties to the seriousness of the wrongdoing prohibited by the particular provision, just as maximum criminal pecuniary penalties are tailored to the seriousness of the offence. There seems to be no reason why the maximum civil pecuniary penalties should be a fixed amount for all 'civil penalty provisions'.

The use of a fixed amount has resulted in an unjustifiable inconsistency, in that the civil penalty versions of different provisions carry the same maximum pecuniary penalty, while the criminal versions of different provisions carry different maximum pecuniary penalties. For example, the maximum civil pecuniary penalty for both breaches of directors' duties and market manipulation is $200,000, yet the maximum criminal pecuniary penalties for these offences are 2,000 penalty units (currently $420,000) and 4,500 penalty units (currently $945,000) respectively. The proposal in Position 9 retains this inconsistency. This problem could be avoided by tailoring civil pecuniary penalties to the particular provision. In the case of provisions that have both civil and criminal pecuniary penalties, a simple way to implement these tailored civil penalties would be to introduce a set ratio between the maximum pecuniary penalties for criminal offences and the maximum pecuniary penalties for their civil counterparts (a formula along the lines of that discussed in relation to Proposal 2).

Position 10: Disgorgement remedies should be available in civil penalty proceedings brought by ASIC under the Corporations, Credit and ASIC Acts

We support Position 10. In our view, the court's discretion in relation to the making of the payment and where it is to be paid should be restricted by a compensation priority requirement such as that proposed in Position 11. That is, the court should not be permitted to order that disgorged funds be paid into consolidated revenue where there are victims that could be compensated with those funds. Public authorities should not receive a windfall at the expense of private victims of corporate and financial sector misconduct.

Position 11: The Corporations Act should require courts to give priority to compensation

We support Position 11.

Position 12: Civil penalty consequences should be extended to a range of conduct prohibited in ASIC-administered legislation

Subject to the concerns we raised at the beginning of our submission regarding not imposing any additional penalties on SME corporations, we support Position 12. In response to the specific consultation questions, our view is that:

- all of the provisions in Table 6 should be civil penalty provisions;

- there should be an express provision stating that where the fault elements of a provision and/or the default fault elements in the Criminal Code can be established, the relevant contravention is a criminal offence;
- all of the provisions in Table 7 should be civil penalty provisions; and
- section 180 of the Corporations Act should be a civil penalty provision (please see our comments on this matter below).

Our support for expanding civil penalties in ASIC-administered legislation is premised on the assumption that such penalties will *supplement*, rather than *replace*, existing administrative and criminal penalties. Given that one of the purposes of these reforms is to enable ASIC to respond to corporate and financial sector misconduct in a flexible and tailored manner, it would not be appropriate to reduce the range of enforcement tools available.

In addition to the provisions mentioned above, our view is that consideration should be given to introducing civil penalty provisions to complement the criminal offences under ss 475, 530A, 206A and 596AB of the Corporations Act. Compliance with these provisions is critical in order to detect, disrupt and deter illegal phoenix activity. Currently, the enforcement of these provisions is either too infrequent or too lenient. Our research indicates that s 596AB has never been used, perhaps due to the difficulty of proving its fault elements to a criminal standard of proof (although we understand one case is currently on foot). Sections 475 and 530A are prosecuted quite frequently but the average criminal pecuniary penalty imposed is about $1,000, which is manifestly inadequate to deter the withholding of information and assistance that these provisions seek to deter. Section 206A appears to be used relatively infrequently – we were only able to identify 50 prosecutions under s 206A in all of ASIC's media releases (since 2001) and prosecution reports (2005 to 2011) – and the average criminal pecuniary penalty imposed in such prosecutions is about $3,500. Introducing civil penalties to complement these criminal offence provisions would have the potential to bolster the frequency and intensity of enforcement and greatly contribute towards curbing illegal phoenix activity and other relevant forms of corporate wrongdoing.

Consideration would need to be given as to the appropriate maximum civil pecuniary penalties that would apply to ss 475, 530A, 206A and 596AB. As discussed in response to Position 9, these maximum civil pecuniary penalties could be tailored to the seriousness of the wrongdoing that each of these provisions seeks to prohibit. There is no need for there to be a set civil penalty amount for all 'civil penalty provisions'.

We are strongly opposed to the proposal to remove civil penalties from s 180 of the Corporations Act. If civil penalties were removed from s 180, this provision could only be enforced via private litigation. However, empirical research on public and private enforcement of directors' duties suggests that private litigation may not be adequate to enforce s 180 and ensure that standards of care and diligence are maintained. A study of 145 privately and publicly enforced directors' duties cases in Australia from 2001 to 16 April 2013 found that private enforcement tends to target duties of loyalty/self-dealing more than duties of care/monitoring. It found that 57% of private enforcement cases involved duties of care and diligence, whereas 82% of public enforcement cases involved such duties.[8] Another empirical study on public enforcement of directors' duties in Australia from 2005 to 2014 found that s 180 is the most frequently enforced civil directors' duties provision. It was successfully

[8] See Jenifer Varzaly, 'The Enforcement of Directors' Duties in Australia: An Empirical Analysis' (2015) 16 *European Business Organization Law Review* 281, 308–9.

enforced almost twice as frequently (in 18 matters) as each of ss 181 (in 11 matters) and 182 (in 10 matters) of the Corporations Act.[9] These empirical results show that there is a need for public enforcement of the duty of care and diligence, the adequate enforcement of which performs a critical function in maintaining good standards of corporate governance.

The need for public enforcement of the duty contained in s 180 is reinforced by an examination of the enforcement record of the duties of directors contained in the UK Companies Act 2006. It has been argued by a number of commentators[10] as well as government reports[11] that enforcement of these duties, which relies on private action, has been largely ineffective.

Position 13: Key provisions imposing obligations on licensees should be civil penalty provisions

We support position 13, subject to our concerns discussed at the beginning of this submission regarding not imposing any additional penalties on SME corporations. Our view is that civil penalties should apply to all general obligations on licensees, except where this would cause inconsistency within or between the provisions of ASIC-administered legislation.

Position 14: Civil penalty consequences should be extended to insurers that contravene certain obligations under the Insurance Contracts Act 1984

We support Position 14.

Position 15: Infringement notices be extended to an appropriate range of civil penalty offences

We support Position 15. Our view is that all of the civil penalty provisions listed in Annexure D are suitable for infringement notices, where such notices apply to *individuals*. As discussed in our general comments at the beginning of this submission, we do not support imposing any additional penalties on SME corporations.

Position 16: Infringement notices should be set at 12 penalty units for individuals and 60 penalty units for corporations for any new infringement notice provisions

We do not support Position 16.

Regarding infringement notices for *individuals*, our view is that a graduated system of infringement notices, whereby the severity of infringement notices escalates in proportion to the individual's number of previous contraventions, would be more appropriate. This would discourage individuals from viewing low level infringement notices as the 'cost of doing business'.

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[9] Jasper Hedges, Helen Bird, George Gilligan, Andrew Godwin and Ian Ramsay, 'The Policy and Practice of Enforcement of Directors' Duties by Statutory Agencies in Australia: An Empirical Analysis' (2017) 40 *Melbourne University Law Review* 905, 945.

[10] See Andrew Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33 *Civil Justice Quarterly* 76. See also Arad Reisberg, *Derivative Actions and Corporate Governance* (OUP 2007).

[11] See, eg, UK Department for Business Innovation & Skills, 'Transparency & Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business' (Discussion Paper, July 2013) [8.13].

Regarding infringement notices for *corporations*, we refer to our general comments about penalties imposed on corporations discussed at the beginning of this submission.