

## ASIC, PHOENIX ACTIVITY AND THE VIEW FROM THE OUTSIDE

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This insolvency note considers some of the recent developments involving ASIC and its capability and enforcement practices. It also presents some of the findings of a survey we conducted of members of the Australian Restructuring, Insolvency and Turnaround Association (ARITA) and the Australian Institute of Credit Management (AICM). These surveys were part of our project investigating ways to regulate fraudulent phoenix activity.

Over the past couple of years, ASIC has faced considerable scrutiny. This is nothing new, as it is subject to regular parliamentary oversight<sup>1</sup> and occasional performance audits by the Australian National Audit Office.<sup>2</sup> Given ASIC's extensive responsibilities as a consumer credit, markets and financial services regulator,<sup>3</sup> this scrutiny is appropriate. In 2014, the Senate Economic References Committee report entitled 'Performance of the Australian Securities and Investments Commission' was released.<sup>4</sup> As part of its enquiry, the Senate ERC looked at the external administrator reporting of directors' wrongdoing within insolvent companies and ASIC's responses to those reports. It concluded that

[c]learly, many people who lodge complaints and reports of suspected corporate wrongdoing with ASIC, including Australia's key gatekeepers, are dissatisfied with ASIC's response. ASIC has left many with the clear impression that the regulator is unresponsive and indifferent to their concerns.<sup>5</sup>

ASIC's response to this comment referred to the volume of complaints it received, its need to follow due process, and its obligation to maintain confidentiality.<sup>6</sup> The Committee then noted that 'ASIC has acknowledged that it needs to act in a more timely way and focus on the key issues. It is clear that any improvements in this area should come from within ASIC itself.'<sup>7</sup>

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<sup>1</sup> *Australian Securities and Investments Commission Act 2001* (Cth) s 243 imposes a duty of oversight on the Parliamentary Joint Committee on Corporations and Financial Services.

<sup>2</sup> See for example, Australian National Audit Office, *ASIC's Processes for Receiving and Referring for Investigation Statutory Reports of Suspected Breaches of the Corporations Act 2001*, Performance Audit, (ANAO Report No. 18 of 2006–2007); *Administration of Enforceable Undertakings* Performance Audit, (ANAO Report No. 38 of 2014–2015).

<sup>3</sup> See further ASIC, *Our Role* <<http://asic.gov.au/about-asic/what-we-do/our-role/>>.

<sup>4</sup> Australian Government, The Senate, Economics References Committee, *Performance of the Australian Securities and Investments Commission*, June 2014 (ASIC Performance Review).

<sup>5</sup> *Ibid* [15.67].

<sup>6</sup> *Ibid* [16.40].

<sup>7</sup> *Ibid* [16.41].

In July, 2015, the government commissioned a forward-looking investigation by an expert panel into ASIC's capability,<sup>8</sup> including identifying future priorities and risks, resource issues, and skills, governance and cultural issues within ASIC. Its report was released in December 2015. One matter of relevance here was the 'expectation gap', which highlighted a wide disparity between the views of external parties and ASIC's own senior staff. This gap was wider than the expert panel had expected, even given the predicted 'negativity bias' of outsiders and 'positivity bias' of ASIC staff.<sup>9</sup> In some cases, the divergence was striking, with the following examples showing the external view first, contrasted with the views of ASIC's senior staff. 'ASIC is forward thinking' – 21%, 92%; 'ASIC uses its resources well' – 16%, 76%; 'ASIC is transparent in the way it operates' – 35%, 74%; and 'ASIC clearly communicates what it is doing' – 34%, 68%.<sup>10</sup>

Even within areas of 'alignment' of expectations, it is noteworthy how poor the expectations of both outsiders and insiders were. Only 23% of external parties believed 'ASIC acts quickly to investigate potential breaches of the law' compared to only 37% of ASIC senior staff. Relatively poor opinions were held by both as to whether 'ASIC provides effective surveillance' – 42%, 55%; and 'ASIC staff have necessary skills' – 46%, 55%. These pessimistic views may be accounted for by 'ASIC is sufficiently resourced to do its job' – 15%, 11%.<sup>11</sup>

The Capability Review expert panel made 34 recommendations to achieve the objective that ASIC is 'fit for the future'.<sup>12</sup> Many involved internal and external governance and staffing matters. Some addressed communications<sup>13</sup> so that external expectations better match what ASIC can reasonably be expected to do. While none of the panel's recommendations directly touched on the phoenix activity research project being undertaken by the authors, the panel made four relevant observations.

The first dealt with collaborative partnerships, or quasi-regulation alternatives, where the behaviour of industry participants is influenced by industry codes of practice.<sup>14</sup> It cited as an example 'the ARITA Code of Professional Practice, which establishes a standard for professional conduct in the insolvency profession.'<sup>15</sup> In the phoenix activity context, this would mean enlisting ARITA as an effective regulator and supervisor of insolvency practitioners engaged in the external administration of possibly phoenixed companies. It would involve a shift away from ASIC's current approach, which emphasises the role of insolvency practitioners as gatekeepers tackling corporate wrongdoing, and of ASIC as the supervisor of those gatekeepers. While acknowledging that these collaborative partnerships were not always appropriate,

the Panel has formed the view based on consistent stakeholder feedback and its own assessment that there remains scope to expand use of collaborative partnerships (co-

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<sup>8</sup> Australian Government, *Fit for the Future A Capability Review of the Australian Securities and Investments Commission A Report to Government*, December 2015 (Capability Review).

<sup>9</sup> Ibid 7.

<sup>10</sup> Ibid 51, Figure 15.

<sup>11</sup> Ibid 50, Figure 14.

<sup>12</sup> Ibid 13.

<sup>13</sup> Ibid 21, recommendations 17-19.

<sup>14</sup> Ibid 121-122.

<sup>15</sup> Ibid 122.

regulation, quasi-regulation, and self-regulation) to more effectively leverage private sector expertise to achieve better regulatory outcomes.<sup>16</sup>

The second was ‘Data Infrastructure’, where its additional heading ‘work underway but a long way to go’ is telling.<sup>17</sup> It listed numerous shortcomings, including reliance on out of date software and hardware, inconsistent data recording practices within ASIC, limited digitisation, multiple siloed databases and skills gaps. It also noted a reduced expenditure on IT investment within ASIC.<sup>18</sup> As a way of reducing the extent of illegal phoenix activity, we have recommended better information collection and sharing.<sup>19</sup> This includes directors being required to obtain a director identification number (DIN), after proper proof of identity. The DIN would be used for the incorporation of new companies and would be cited widely in corporate dealings. DINs would allow ASIC to create a valuable database of prior corporate histories, but clearly, ASIC first needs the computing capabilities to cope with the process.

The third observation was about ASIC funding. The Capability Review revealed a 12% decrease to ASIC’s core operational funding since 2004-2005, despite an expansion of its mandate. However, it noted ‘60 new expense measures ... many of which are ongoing’ and that these additional allocations of money accounted for about 19% of its total funding.<sup>20</sup> It concluded that ‘[i]n real terms, ASIC’s funding has increased with the expansion of its mandate.’<sup>21</sup> As an aside, according to the ASIC Annual Report from 2014-15, it raised \$824 million in fees and charges that financial year, and spent \$313 million.<sup>22</sup> This was an increase in revenue and a decrease in expenditure from the previous year.<sup>23</sup> If the government is serious about tackling the adverse effects of illegal or fraudulent phoenix activity, it must allow ASIC to invest in its capability to manage and police the two million plus companies it has registered.

The fourth observation was about regulator co-operation. According to the Review,

[c]ooperation between regulators can deliver enhanced regulatory outcomes, through encouraging information exchange, sharing best practice knowledge and reducing the regulatory burden on members of the regulated population.<sup>24</sup>

We strongly support this view in relation to phoenix activity. There is an Interagency Phoenix Forum and a related prescribed taskforce, and some of its purposes are to:

‘[r]eview appropriate intelligence reports from agencies and ensure all agencies harvest available intelligence’; ‘[e]ncourage creative and collaborative management of phoenix cases, supporting the best mix of treatments across agencies’; [and] ‘[w]ork collaboratively to achieve compliance outcomes’.<sup>25</sup>

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<sup>16</sup> Ibid.

<sup>17</sup> Ibid 128, [4.5].

<sup>18</sup> Ibid 129.

<sup>19</sup> See, eg, Helen Anderson et al, Submission to the Productivity Commission, in relation to ‘Business Set-up, Transfer and Closure, Productivity Commission Issues Paper December 2014’, February 2015.

<sup>20</sup> Capability Review, above n 8, 136.

<sup>21</sup> Ibid 137.

<sup>22</sup> ASIC, Annual Report, 2014-2015, [1.6.2] – [1.6.3].

<sup>23</sup> In 2013-14, ASIC raised \$763 million and spent \$405 million: ASIC, Annual Report, 2013-2014, 24.

<sup>24</sup> Capability Review, above n 8, 138.

<sup>25</sup> See ATO, *Inter Agency Phoenix Forum* <<https://www.ato.gov.au/General/The-fight-against-tax-crime/In-detail/Inter-Agency-Phoenix-Forum/Inter-Agency-Phoenix-Forum/?page=2>>.

ASIC is a member of the phoenix taskforce and states that the taskforce ‘facilitates information sharing that assists ASIC to identify phoenix activity.’<sup>26</sup> However, we understand there is a general lack of sharing of information about suspected phoenix operators between members of the forum which has frustrated its purposes. According to the ATO, the agencies that make up the taskforce are subject to confidentiality requirements that limit their ability to pass on information they receive to other agencies within the group. Taskforce status does not alter those requirements.<sup>27</sup> This led the 2015 Senate Economics References Committee Construction Insolvency Report to make a formal recommendation that ‘consideration be given to amending confidentiality requirements in statutory frameworks of agencies participating in the Phoenix Taskforce to permit dissemination of relevant information to the ATO.’<sup>28</sup>

ASIC’s response to the Capability Review generally supported the expert panel’s recommendations. It produced an eight point plan, including projects to transform and streamline information capture, sharing and use, and to better cooperate with other government agencies, including through intelligence gathering and sharing. ASIC supports the separation of its registry business, ‘allowing ASIC to focus on its core regulatory business’.<sup>29</sup> However, ASIC rejected the expert panel’s characterisation of its culture as defensive, inward looking, risk averse and reactive, due to a lack of meaningful evidence.<sup>30</sup> It should be noted that there were many submissions of a similar nature made to the Senate Economic References Committee inquiry into ASIC’s performance.<sup>31</sup>

ASIC also rejected the recommendation that it ‘rebalance our public and internal communications about our role as an enforcement agency [on the basis that] enforcement is often a reactive tool’. On the contrary, ASIC maintained that it had the right balance between enforcement and non-enforcement tools. According to ASIC’s response,

Credible deterrence is underpinned by strong public messaging about enforcement. According to IOSCO’s recent report, ‘public messaging can deter misconduct when would-be wrongdoers know that regulators will publicise enforcement outcomes and sanctions imposed against individuals and entities’. Our law enforcement capability is strongly influenced by our ability to effectively communicate a robust approach in this area.<sup>32</sup>

We turn now to our own attempts to gauge the view of those outside ASIC. Our surveys of ARITA and AICM members, conducted during 2015, were not in response to any of the reviews of ASIC discussed above. Rather, they were an integral part of our Australian Research Council grant, which began in early 2014, to investigate ways to regulate fraudulent phoenix activity. We considered that those working closely with creditors and insolvent companies would have valuable insights into possible solutions to the scourge of deliberate, costly phoenix activity. The survey was completed by 213 members of ARITA (response rate

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<sup>26</sup> ASIC, Report 479 ASIC Regulation of Registered Liquidators: January to December 2015, June 2016, (ASIC Report 479), [109].

<sup>27</sup> Australian Government, Senate Economics References Committee, *‘I just want to be paid’ Insolvency in the Australian construction industry*, December 2015, [5.64].

<sup>28</sup> Ibid [5.84], recommendation 12.

<sup>29</sup> ASIC Capability Review, above n 8, 172.

<sup>30</sup> Ibid 175.

<sup>31</sup> ASIC Performance Review, above n 4, [4.27]. See generally, chapter 16 regarding ASIC’s response to reports of wrongdoing.

<sup>32</sup> ASIC Capability Review, above n 8, 178.

of approximately 10%)<sup>33</sup> and 155 members of AICM (response rate of approximately 7%).<sup>34</sup> The members of ARITA and AICM answering the survey tended to have extensive experience. The average number of years the ARITA members had been practising in the insolvency field was 16 years, while the average number of years the AICM members had been working as credit professionals was 23 years.

We asked the members of ARITA how often they encountered liquidations where they believe phoenix activity has occurred. Fifty one percent of respondents answered ‘sometimes’ and a further 30% answered ‘often’. ARITA members held the following views in relation to questions that we asked in the survey. They overwhelmingly believed that ‘ASIC should add a tick box to external administration (EXAD) reports so liquidators can indicate whether they believe that breaches of civil or criminal obligations have occurred in the context of phoenix activity’ with 84% of the respondents agreeing or strongly agreeing with this statement; ‘ASIC should provide liquidators with information it holds about directors of failed companies at the start of a liquidation involving those directors’ (87% agreeing or strongly agreeing); and ‘ASIC should allow liquidators free use of its registers to enhance the quality of their investigations for the purpose of reporting to ASIC under ASIC Regulatory Guide 16’ (91% agreeing or strongly agreeing).

These are matters for government too, in light of the move to ‘user pays’ for ASIC services as well as information from July 2017,<sup>35</sup> and the privatisation of the ASIC registry which reaches its final bid stage at the end of August 2016.<sup>36</sup> Clearly the government, in acting on the recommendations of the ASIC Capability Review, needs to find ways to improve ASIC’s data management, but we urge the government not to lose sight of insolvency practitioners as gatekeepers against phoenix activity. Allowing insolvency practitioners better and freer access to information assists their work in detecting illegality, and in doing so, relieves some of the burden on ASIC to do so. However, it is equally important there is appropriate supervision and regulation of insolvency practitioners, who are sometimes found to be involved in facilitating illegal phoenix activity. ASIC’s surveillance of selected transactions carried out by registered liquidators reveals that 10%, 9% and 12% of transactions raised concerns about ‘phoenix facilitation’ in 2013, 2014 and 2015 respectively.<sup>37</sup>

The ARITA members also strongly supported the proposition that ‘[a]ll company directors should be issued with a Director Identification Number (DIN) enabling ASIC and the ATO to track directors of multiple failed companies’ (91% agreeing or strongly agreeing). This is a strong endorsement of our project team’s recommendation to introduce the DIN, which has also received the support of the Productivity Commission<sup>38</sup> and the Senate Economics References Committee’s inquiry into insolvency in the construction industry.<sup>39</sup>

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<sup>33</sup> A total of 2,155 members received the survey.

<sup>34</sup> A total of just over 2,300 members received the survey.

<sup>35</sup> The Hon Scott Morrison, ‘Turnbull Government bolsters ASIC to protect Australian consumers’, media release, 20 April 2016.

<sup>36</sup> See Australian Government, Department of Finance, *Australian Securities and Investments Commission (ASIC) Registry – FAQs* <<https://www.finance.gov.au/procurement/scoping-studies/asic-faqs/>>.

<sup>37</sup> ASIC Report 479, above n 26, Table 20, 42.

<sup>38</sup> Australian Government, Productivity Commission, *Business Set-up, Transfer and Closure Final Report*, September 2015 (2015 Productivity Commission Final Report), recommendation 15.6. Note that the Productivity Commission also endorsed the DIN in its report, *Workplace Relations Framework Inquiry Report* (21 December 2015) Vol 1, 48; Vol 2, 915 and 938.

<sup>39</sup> Senate Economics References Committee, *‘I just want to be paid’*, above n 27, recommendation 36.

Seventy six percent of ARITA members disagreed or strongly disagreed that ASIC was sufficiently resourced, a slightly more positive view than that cited by the ASIC Capability Review.<sup>40</sup> On the question of ASIC's competence, 45% believed it was competent, with 14% unsure, similar to the result reported by the Capability Review, where 46% believed ASIC staff had 'necessary skills'.<sup>41</sup>

The 'free comments' part of the ARITA survey indicated strong support for ASIC to be able to put some of the money it raises towards additional enforcement actions and liquidator funding. There were also many suggestions for the prohibition or regulation of 'turnaround specialists' and other pre-insolvency advisors, some of who strip companies of assets prior to the shell being placed into liquidation. ASIC has identified pre-insolvency advice as an area of focus, observing that it 'is a growing and largely unregulated, unlicensed market.'<sup>42</sup> Among other things, ASIC is concerned that 'some advisers may aid and abet directors in breaching their duties and promote illegal phoenix activity that will undermine market confidence and reduce the assets that might otherwise be available for creditors in a formal external administration.'<sup>43</sup> Other survey comments included better director education, similar names legislation,<sup>44</sup> verified independent valuations for related party asset transfers, and greater scrutiny of directors associated with multiple failed companies, including better tracking of directors, and harsher penalties.

We also surveyed credit managers who were members of AICM. They make decisions on behalf of their businesses about whether to extend credit to companies, whether by lending to them or through the supply of goods and services to them, and they deal with the losses caused by phoenix activity. We asked some of the same questions. In response, AICM members were not as convinced as ARITA members that ASIC is under-resourced (63% disagreeing or strongly disagreeing with the statement that ASIC is sufficiently resourced) and had a slightly higher view of ASIC's competence (47% agreeing or strongly agreeing with 17% unsure). The introduction of a DIN was supported by 97% of AICM members and a similar number wanted liquidators to have free access to director information held by ASIC. This demonstrates that creditors expect to benefit where liquidators are able to do their jobs most effectively and efficiently.

Necessarily, some of the questions we asked them were different. Almost all AICM members (95%) want access to ATO tax debt information. Unlike other unpaid creditors, the ATO cannot report publicly on unpaid taxes until a court judgment is obtained. We believe a good deal of deliberate phoenix activity is intended to avoid the payment of taxes, and credit managers believe their task of assessing credit-worthiness is impeded by lack of access to this information.

The 'free comments' part of the AICM survey mirrored many of the contributions to the ARITA survey. They broadly centred around better detection and enforcement by liquidators and ASIC, greater scrutiny of related party asset transfers, more publicly available

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<sup>40</sup> Above n 11.

<sup>41</sup> Ibid.

<sup>42</sup> ASIC Report 479, above n 26, [108]; see also CPA/ASIC, 'At What Cost? ASIC Is Concerned by the Proliferation of Pre-insolvency Advisers', *Inpractice* (November 2015).

<sup>43</sup> ASIC Report 479, above n 26, [108].

<sup>44</sup> This involves imposing liability on directors for the unpaid debts of a new company which becomes insolvent, where that company bears a similar name to that used by one previously managed by the same people.

information, harsher penalties, and restrictions on people becoming directors of new companies where they had multiple previous failures.

ASIC's response to the Capability Review maintained that it had the appropriate balance between enforcement and non-enforcement tools, and that publicising its enforcement activities deters would-be wrongdoers. It is possible that ASIC may be justified in coming to this conclusion regarding other areas of its jurisdiction. However, in the case of illegal phoenix activity, it was not the perception of many of the respondents to the ARITA or AICM surveys, nor does it reflect some of the submissions to the Senate Economics References Committee inquiry into ASIC's performance.<sup>45</sup> ASIC needs to take on board the views of people outside the organisation. Those dealing with insolvencies either as external administrators or credit managers do not believe that there is sufficient enforcement to deter the wrongdoing that they repeatedly see.

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<sup>45</sup> See for example the submissions to the ASIC Performance Review above n 4 by the Australian Manufacturing Workers' Union, (21 October 2013), Mr Peter Leech (21st October 2013) and Mr Jason Harris (21 October 2013). Submissions available at [http://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate/Economics/ASIC/Submissions](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/ASIC/Submissions). Jason Harris argued that '[t]here is a wholesale failure to address SME companies involved in important issues such as phoenix companies and rampant insolvent trading,' at p 3