AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

COST RECOVERY IMPLEMENTATION STATEMENT: LEVIES FOR ASIC INDUSTRY FUNDING (2017–18)

Submission by Professor Helen Anderson, Melbourne Law School
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I. INTRODUCTION

I thank ASIC for the opportunity to comment on its 'Cost Recovery Implementation Statement: Levies for ASIC Industry Funding (2017–2018)' (CRIS report). This is my third submission relating to the industry funding model. As with my first submission and second submission, this submission represents my own opinions.[1]

As I noted previously, I lead a group of academics currently undertaking an Australian Research Council-funded project 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 harming legitimate business activities to the detriment of the economy. We have now produced three major reports: Defining and Profiling Phoenix Activity; Quantifying Phoenix Activity: Cost, Incidence, Enforcement; and Phoenix Activity: Recommendations on Detection, Disruption and Enforcement.

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.

I have two serious concerns about the figures released by ASIC.

1. There is a seriously disappointing amount of money being spent on the regulation of small proprietary companies, where the vast majority of illegal phoenix activity is generally believed to occur.

2. The levy on registered liquidators is misguided and counter-productive.

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[1] I thank Research Fellow Jasper Hedges for his assistance in preparing this submission. The views it expresses are my own.

II. THE LEVY ON SMALL PROPRIETARY COMPANIES

Spending $7.548 million on 2,409,919 small proprietary companies is incomprehensible. This equates to $3.13 per company per annum. While the levies outlined in the CRIS report only account for 64% of ASIC's total budgeted resources in 2017–18,[2] my submission is made on the assumption that the figures in the CRIS report are at least roughly representative of the total amount that ASIC intends to spend on regulating each subsector in 2017–18. From a transparency perspective, it would have been useful to know how ASIC intends to allocate the remaining 36% of the budgeted resources.

The total of $7.548 million allocated to small proprietary companies is broken down as follows:

Expense	Cost	Amount per company
Stakeholder engagement	$71,000	2.9 cents
Education	$14,000	0.6 cents
Guidance	$82,000	3.4 cents
Surveillance	$455,000	18.9 cents
Enforcement	$4,511,000	$1.872
Policy advice	$67,000	2.8 cents
Financial capability work	N/A	N/A
Governance, central strategy and policy, and central legal functions	$462,000	1.9 cents
IT support	$471,000	1.95 cents
Operations support	$221,000	9.2 cents
Property and corporate services	$1,033,000	42.9 cents

In other words, even if every cent of the engagement, education and guidance expenditure was spent on informing small proprietary companies about illegal phoenix activity (itself unlikely), this would amount to 6.9 cents per company.

More concerning is that surveillance is $455,000 per annum, or 18.9 cents per company. Perhaps this explains the fact that less than $2 per company is then spent on enforcement ($1.87, for a total cost of $4.511 million). To be blunt, while I applaud the government's transparency in publishing its costing arrangements, these numbers will greatly reassure the potential illegal phoenix operators and their shady pre-insolvency advisors who assist them in their destructive schemes.

And they can also take comfort that despite the rhetoric of government in recent years about cracking down on illegal phoenix activity, the creation of the Phoenix Taskforce and similar developments, the cost of regulating small proprietary companies has apparently *decreased*. In ASIC's supporting attachment to the government's 2016 proposals paper, the levy was stated as $5 per company for a total revenue (based on 2.1 million small proprietary companies at the time) of $10.5 million. It was estimated that they would cost $9.7 million to regulate.[3] Yet the October 2017 CRIS report puts that cost at $7.548 million.

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2 ASIC, 'Cost Recovery Implementation Statement: Levies for ASIC Industry Funding (2017–18)' (October 2017) [6].

3 ASIC, 'Proposed Industry Funding Model for ASIC: Supporting Attachment to the Government's Proposals Paper' (November 2016) [65].

It would appear that the cost recovery system and subsequent budget have not considered the impact of illegal phoenix activity. ASIC's 2016 supporting attachment stated:

> The level of supervision depends on the scale of potential harm to investors or consumers and the impact on the integrity and reputation of Australian financial markets. For example, ASIC dedicates *a significantly large amount of regulatory effort to publicly listed, disclosing entities compared with small proprietary companies, as publicly listed, disclosing entities have the potential to cause greater harm to investors and the reputation of Australia's financial markets*.[4]

This statement ignores estimates such as the one by PwC in 2012 that put the cost of illegal phoenix activity at between $1.78 and $3.19 billion per annum.[5] It is also inconsistent with data showing that small and medium sized businesses have a significant impact on the Australian economy. Small businesses with fewer than 20 employees account for 34.9% of industry value added (IVA) and employ 44.3% of non-financial private sector employees (data from 2015–16).[6] Medium-sized businesses with 20 to 199 employees account for 22.5% of IVA (data from 2013–14)[7] and 24.3% of non-financial private sector employment (data from 2010–2011).[8] Together, small and medium sized businesses account for about 57% of IVA and 68% of non-financial private sector employment.

Given the significant economic influence of smaller businesses, it is not necessarily true that publicly listed entities have the potential to cause greater economic harm than smaller entities. It is true that a *single* public company has the potential to cause greater harm than a *single* smaller entity. However, in *aggregate* terms, the small-to-medium sector may have the potential to cause equally great, if not greater, economic harm, particularly given that this sector is subject to more lenient disclosure and reporting requirements, which makes any misconduct less visible.

It seems absurd that on one hand, the government is (rightly) lamenting the enormous amount of tax revenue lost to illegal phoenix activity per annum and the costly increased reliance on the Fair Entitlements Guarantee, then on the other hand, skimping on spending money where it has the greatest chance of stopping illegal phoenix activity in its tracks.

To say that this approach is penny-wise and pound foolish is an understatement.

III. THE LEVY ON REGISTERED LIQUIDATORS

In contrast to the 'hands off' approach taken to small proprietary companies – some of which are the actual *perpetrators* of illegal phoenix activity – the 711 registered liquidators are both

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4 Ibid [58] (emphasis added).

5 Fair Work Ombudsman and PricewaterhouseCoopers, 'Phoenix Activity: Sizing the Problem and Matching Solutions' (June 2012) iii.

6 Treasury (Cth), *National Small Business Statistics* (4 August 2017) <https://static.treasury.gov.au/uploads/sites/1/2017/09/SB_data_card.pdf>.

7 Parliamentary Library (Cth), *Statistical Snapshot: Small Business Contribution to Economic Performance in Australia* (2 December 2015) Note below Table 1 <https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/rp1516/Perform>.

8 Treasury (Cth), *Australian Small Business – Key Statistics and Analysis* (1 December 2012) Figure 11 <https://treasury.gov.au/publication/australian-small-business-key-statistics-and-analysis/>.

heavily regulated[9] and charged for the privilege. It is interesting to compare the regulation costs to small proprietary companies:

Expense	Total cost for liquidators	Total cost for small proprietary companies	Difference in total cost for liqs vs cos	Cost per liquidator	Cost per small proprietary company	Difference in cost per liquidator vs company
Stakeholder engagement	$150,000	$71,000	$79,000	**$210.97**	**2.9 cents**	$210.94
Education	$37,000	$14,000	$23,000	**$52.04**	**0.6 cents**	$52.03
Guidance	$198,000	$82,000	$116,000	**$278.48**	**3.4 cents**	$278.45
Surveillance	$1,094,000	$455,000	$639,000	**$1,538.68**	**18.9 cents**	$1,538.49
Enforcement	$3,666,000	$4,511,000	-$845,000	**$5,156.12**	**$1.872**	$5,154.25
Policy advice	$162,000	$67,000	$95,000	**$227.85**	**2.8 cents**	$227.82
Financial capability work	N/A	N/A	N/A	**N/A**	**N/A**	N/A
Governance, central strategy and policy, and central legal functions	$878,000	$462,000	$416,000	**$1,234.88**	**1.9 cents**	$1,234.69
IT support	$1,292,000	$471,000	$821,000	**$1,817.16**	**1.95 cents**	$1,816.96
Operations support	$631,000	$221,000	$410,000	**$887.48**	**9.2 cents**	$887.39
Property and corporate services	$1,622,000	$1,033,000	$589,000	**$2,281.29**	**42.9 cents**	$2,280.86

To highlight the most important of these statistics, the government is charging 711 registered liquidators $10.196 million, which is $2.648 million more than it is charging the 2,409,919 small proprietary companies. And on average, $5,156 per annum per liquidator is to be passed on to *all* registered liquidators for the costs of enforcement against a small handful of wrongdoers. The far right-hand column of the table above shows that, for every category of expense, the cost per liquidator is vastly more than the cost per small proprietary company.

I have three major concerns about an approach which seems to imply that focusing regulatory efforts on registered liquidators will tackle the wrongdoing of small proprietary companies when they are insolvent.

1. *Not all insolvent companies end up liquidated*
ASIC's senior executive leader in charge of insolvency practitioners, Adrian Brown, provided me with data that indicates that about 37,600 companies are deregistered by ASIC every year for failing to lodge documents and pay fees.[10] This dwarfs the number of companies that enter liquidation – for example, 6,235 companies in 2016–17.[11]

Illegal phoenix activity by its nature generally involves stripping assets out of a company and leaving it with no money to pay for a liquidator. It often involves throwing away books and records. Many of these companies are likely to be abandoned, as ASIC itself and even its

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9 *Insolvency Law Reform Act 2016* (Cth).

10 Email from Adrian Brown to Helen Anderson, 18 March 2016.

11 ASIC, 'Australian Insolvency Statistics: Series 1 – Companies Entering External Administration, January 1999–August 2017' (October 2017), Table 1.3 . This figure has been calculated by aggregating the annual figures for '[c]ourt wind-up', 2,432, and '[c]reditors wind-up', 3,803, in 2016–17.

predecessor two decades ago have both recognised.[12] Creditors are unlikely to throw good money after bad and pay for a liquidator, especially when they can guess that all the money is gone, so they walk away.

This leads to two conclusions:

- Liquidators are not to be blamed for illegal phoenix activity that occurs in these circumstances and the government cannot expect that an increased levy on liquidators will somehow make the abandoned company issue go away; and
- ASIC's small proprietary companies expenditure should be increased to make abandoned companies a focus of investigation and enforcement. These directors have breached their duties. Civil penalty actions are available. Use them.

2. *Not all pre-insolvency advisors are registered liquidators*

The CRIS report states that

> Our focus will be on independence (especially the adequacy of disclosure in declarations of relevant relationships), remuneration disclosure, and disrupting the activities of professional facilitators (including pre-insolvency advisers).[13]

The first two are legitimate matters, and there are undoubtedly some registered liquidators who have given improper advice that led to illegal phoenix activity. However, pre-insolvency advisors can also be:

- lawyers in firms, large and small – recall the case against Timothy Somerville as an accessory to directors' duties breaches, who was a lawyer;
- accountants in firms, large and small – the notorious Phillip Whiteman, raided by both ASIC and the ATO, ran AHW Solicitors, A&S Services, Bolton & Swan Solicitors and DNV Accountants; and
- completely unregulated and possibly unqualified 'business advisors' – note the case against Stephen Hall and 'Eagle Business Solutions', a thinly veiled reference to phoenix activity if ever there was one.

The aim of the industry funding model, which the CRIS report notes at [10], is to

> ensure that the costs of the regulatory activities undertaken by ASIC are <u>borne by those creating the need for regulation</u>, rather than Australian taxpayers.

Charging only registered liquidators with respect to the activities of all pre-insolvency advisors clearly does not reflect that aim, and is unfair.

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[12] Australian Securities Commission, 'Project One: Phoenix Activities and Insolvent Trading – Public Version' (Research Paper 95/01, 13 May 1996) 75: 'Importantly it would appear that approximately 92% of Phoenix companies are deregistered under the ASC's section 574 program [the predecessor to s 601AB of the Corporations Act]. **Effectively the ASC is unintentionally assisting Phoenix offenders to escape prosecution and detection by deregistering the company and closing off the trail.** This is particularly the case in circumstances where debts may be many, but small and no creditor action is taken to place the company under administration.'

[13] ASIC, 'Proposed Industry Funding Model for ASIC: Supporting Attachment to the Government's Proposals Paper' (November 2016) [107].

3. *The levy is counter-productive*
There are two reasons for this.

First, *every dollar liquidators pay to ASIC is one dollar less spent on doing their jobs.* It is hard to overstate this point. Unlike every other profession and every other category of regulated person covered by ASIC's cost recovery levy, *every client of a liquidator is insolvent.*

The capacity of liquidators to cross-subsidise assetless liquidations from those with some money is increasingly untenable because of the heavy focus of ASIC on liquidator remuneration. Liquidators faced with an administration with few or no assets simply cannot afford to do the degree of investigations that they would like. Nor does the law expect them to: s 545 of the *Corporations Act 2001* (Cth) makes it clear that apart from their statutory reporting to ASIC, liquidators are not obliged to do work for which they will not be paid.

Liquidators can ask for funding from the Assetless Administration Fund but need to do the investigative work first. How are they to pay for this? The AAF money is only to be spent on further work, not work already done. It is somewhat ironic that some of the increased funding of liquidators from the FEG Recovery Program (funded by taxpayers) may go to pay liquidators' levies to ASIC.

ASIC acknowledges, in fact demands, that liquidators be one of ASIC's 'gatekeepers' but they approach liquidators with mistrust and suspicion. ASIC needs to treat liquidators as its allies, not its enemies. Who could blame liquidators if they lose motivation to do investigative work 'on their own dime' under the current conditions?

Second, it is a fallacy to say that requiring liquidators to pay ASIC for their regulation will save taxpayers from having to do it. This implies that these costs and the consequences of paying the levy are somehow quarantined from the ordinary person. In the end, taxpayers and society as a whole pay dearly if illegal phoenix activity takes place because liquidators were not supported and resourced as they should be. Tax revenue is not collected; wages and superannuation are not paid, adding to the cost of FEG and the aged pension; law-abiding competitors are driven out of business.

IV. CONCLUSION

As I have pointed out before, ASIC earns about half a billion dollars for the government every year. According to ASIC's latest annual report, 'ASIC raised $876 million for the Commonwealth in fees and charges, an increase of 6.4% from 2014–15'. Its total operating expenditure was $371 million. **Why run the risk of interfering with liquidators' investigations of wrongdoing during insolvency for the sake of $10.196 million, when ASIC turns a profit of over half a billion dollars?**

Government needs to look at the money that is saved by taking a supportive and pro-active approach to illegal phoenix activity. Proper funding of liquidators is just part of this, and in my opinion, an increase in the liquidator levy is totally the wrong way to go. Even more important is the expenditure of decent amounts of money on the regulation of small proprietary companies. The current amount, $7.548 million, seem incredibly small, especially in the context of data showing that small and medium sized businesses together account for well over half of industry value added and non-financial private sector employment.