Chapter 27

Unresolved matters

27.1 This chapter addresses two important but unrelated questions the committee has encountered during this inquiry and previous inquiries. The first question is whether the current approach of products being available to unsophisticated retail investors regardless of the suitability of these products for those individuals is appropriate. The second relates to the regulation of the insolvency profession and the current laws governing corporate insolvencies; in particular, whether Australia's framework is appropriate for restructuring a large business and minimises value destruction.

27.2 These issues strike at fundamental aspects of Australia's financial services and corporate law frameworks. Addressing them in detail in this report would be beyond the scope of an inquiry focused on the performance of ASIC. Nevertheless, ASIC's performance and perceptions about its performance are clearly influenced by the laws in place. The submissions that have expressed the most dissatisfaction with ASIC's performance often relate to financial products that should not have been available to retail clients or badly managed liquidations. Similarly, other inquiries the committee undertakes often attract submissions that lead to these issues being discussed. Addressing the matters raised in this chapter could potentially lead to better outcomes for the entire economy and help protect individuals from suffering and distress.

27.3 Another important matter considered in this chapter relates to boiler room investment scams.

Unsafe financial products

27.4 In Chapter 20, the committee discussed some of the implications of the low levels of financial literacy in Australia. When this is combined with Australia's current disclosure-based regulatory approach, retail investors and consumers may be further disadvantaged when deciding on a financial product. In this context, the Consumer Action Law Centre cited a number of further complicating factors that pose a risk to the consumer. These included:

- extremely complex credit and financial products that non-experts would frequently misunderstand (including even the most important elements);
- people not necessarily choosing between products 'rationally', instead making quick decisions using mental shortcuts when dealing with unfamiliar topics or when limited by time; and

- people typically having trouble calculating costs and risks, especially when the cost or risk is temporally remote.[1]

27.5 The experiences of many of the investors or borrowers who wrote to the committee indicated that they had not been properly informed of, or understood, the complexity, or inherent high risk of their investment or loan.

27.6 The Financial Planning Association (FPA) noted that ASIC does not have legislative obligations for regulating financial products, only for the oversight of product providers. This responsibility focuses on 'matters of corporate governance and disclosure, and in the main not on the design and other issues related to the products they sell to consumers'. It suggested that:

> Problems with products should be addressed through product regulation. Legislation must enable ASIC to effectively and proactively regulate product providers and the products they develop and sell to consumers. Product providers should be held accountable for failing to deliver on product benefits due to dishonest conduct, fraud or insolvency, or if there are fundamental flaws in products.[2]

27.7 The Australian Shareholders' Association gave the example of the issuing of prospectuses where ASIC considers whether all relevant and required information is provided. According to the Association, it does not appear that ASIC checks or tests the information contained in the document 'resulting in outcomes which disadvantage investors'. It explained further:

> If claims are made in a prospectus or an advertisement we believe they should be tested and justified. ASA accepts that investors are responsible for their decisions but have less opportunity to carry out investigative work. It would appear that ASIC waits for complaints before it acts. While it is difficult to measure, ASA has the impression that overseas regulators are able to act more quickly to assess a situation, take action and reach a conclusion than in Australia where it seems litigation, or the threat of such, delays these steps. It appears actions such as withdrawing a product or suspending/banning an individual take too long.[3]

27.8 The Australian Shareholders' Association argued:

> If, in the view of ASIC, any matter which comes to their attention would impact on or influence investors or intending investors then that should be made known. Simply announcing that ASIC had asked for more information or was investigating a product or distribution channel would aid investors.[4]

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1 Consumer Action Law Centre, *Submission 120*, p. 7.

2 Financial Planning Association of Australia, *Submission 234*, p. 26.

3 Australian Shareholders' Association, *Submission 151*, p. 2.

4 Australian Shareholders' Association, *Submission 151*, p. 2.

27.9 Mr David Haynes, Australian Institute of Superannuation Trustees, referred to low-fee, no-fee products. He believed that ASIC should step in and be able to stop the promotion of such products. He explained:

> …because they [the fees] are hidden and they are significant, and because they involve a misrepresentation of the product to consumers, who think that they are getting something for nothing when clearly that is not the case.[5]

27.10 In his view, the appropriate response by ASIC to such products would be to say, 'We do not believe that the promotion of these products is consistent with the spirit of the law or appropriate consumer protection and should make representations along those lines up the tree to government'.[6]

27.11 The Consumer Credit Legal Centre (NSW) would like some sort of recognition of an essentially unsafe product. Mrs Cox explained that other areas of consumer protection have such recognition but not so in credit and financial services-type products.[7] She stated that one matter that was particularly discouraging over the years was the need 'to argue misleading and deceptive conduct':

> …when the problem is that the actual product is so poor that you would have to be misled to enter into it. I find it quite frustrating that we do not have more sophisticated tools for dealing with that situation.[8]

27.12 Mr Brody of the Consumer Action Law Centre very much agreed that unsafe products should be identified. He stated that in addition 'to having a blackout system, there could be a system to restrict access to particular types of challenging products'.[9]

27.13 The consumer advocacy associations agreed that unsafe products should be identified and 'there could be a system to restrict access to particular types of challenging products'.[10] The Consumer Action Law Centre favoured an approach that would empower ASIC to regulate financial and credit products, which in its view would give ASIC more power to respond quickly to emerging problems before widespread consumer detriment occurred. The Law Centre was of the view that investment lending has been instrumental in facilitating some spectacular investment failures with catastrophic results for many consumers. It suggested that ASIC could play a role in identifying the extent to which problems in this area persist, in order

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5 Mr David Haynes, Executive Manager, Policy and Research, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 20 February 2014, p. 25.

6 Mr David Haynes, *Proof Committee Hansard*, 20 February 2014, p. 35.

7 Mrs Karen Cox, Coordinator, Consumer Credit Legal Centre (NSW) Inc, *Proof Committee Hansard*, 20 February 2014, p. 41.

8 Mrs Karen Cox, *Proof Committee Hansard*, 20 February 2014, p. 40.

9 Mr Gerard Brody, Chief Executive Officer, Consumer Action Law Centre, *Proof Committee Hansard*, 20 February 2014, p. 41.

10 *Proof Committee Hansard*, 20 February 2014, p. 41.

to inform any future reform program.[11] It referred to the UK Financial Conduct Authority (FCA) model which allows the FCA to suspend or ban potentially harmful products.

27.14 Professor Dimity Kingsford Smith cited the Westpoint and Storm collapses and the associated investor losses from transactions that were relatively complex when analysed in full. In her view, 'in some other countries they would have been limited to sophisticated investors but in Australia they could be offered to consumers'.[12] She explained further:

> In particular, the Westpoint documentation contained omissions and inferences that only detailed further investigation could have uncovered the significance of, and which took legal training to fully understand. The Storm Financial statements of advice were very long and contained financial worksheets which were not easy to follow. In both cases the benefits of the investment were given much greater prominence than the risks. In both cases, as in the Opus [sic] Prime matter which involved a stock broker offering margin borrowing and stock-lending services, the types of transactions involved were traditionally seen as sophisticated or professional investor transactions, and not those usually recommended to retail investors. The risk levels, the complexity, the consequent opacity of the advice and the fact that investors did not really understand the significance of the recommendations for their longer term financial welfare, all diminished the capacity of investors to make good investment decisions with properly informed consent.[13]

27.15 Professor Kingsford Smith also cited the FCA. She noted that ASIC's powers were directed to regulating the conduct of licensees while the FCA was empowered to regulate financial and credit product themselves. In her submission, Professor Kingsford Smith noted that:

> In Britain the 'Treating Clients Fairly' program of the Financial Conduct Authority allows the regulator to intervene in the design of the product, not just place a stop order on disclosure. We think there is also room for ASIC to exercise powers to prohibit the issue of certain products in retail markets, if it is thought they are too complex, risky or leveraged to be appropriate.[14]

27.16 With the same idea in mind, the Law Council of Australia suggested that:

> …'merits' regulation of financial products for unsophisticated investors may need to be considered in Australia. That is, unsophisticated investors might need to have a limited range of investment choices that are limited to

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11 *Submission 120*, p. 8.

12 Dimity Kingsford Smith, 'ASIC regulation for the investor as consumer', *Company and Securities Law Journal* 29:5 (2011), p. 336.

13 Dimity Kingsford Smith, 'ASIC regulation for the investor as consumer', p. 336.

14 Professor Dimity Kingsford Smith, *Submission 153*, p. 8.

> investments that are appropriate to their needs and circumstances or that have been approved by a regulator such as ASIC.[15]

27.17 The Rule of Law Institute of Australia argued that it is 'insufficient for government regulators to tell consumers and investors to be careful and self-educate themselves in the complex area of financial services, particularly when the ASIC Act itself was nearly 400 pages in length'. It also referred to the information asymmetry between vulnerable consumers and large financial corporations, which in its view, was 'too great for this kind of approach'.[16]

27.18 The Financial Planning Association recommended that the laws be amended 'to oblige ASIC to take a larger role in the regulatory oversight of financial products before they are released for consumer investment'.[17]

27.19 Finally, Mr Richard St. John's report on compensation arrangements for consumers of financial services noted the new focus by the international regulatory community on the adequacy of conduct and disclosure regimes. He noted the consideration being given 'to the possibility of a more interventionist approach with product issuers'. In his words, the aim would be 'to catch problems early on in a financial product's life cycle as a means of preventing widespread detriment to consumers'.[18] He stated:

> More fundamentally, it may be timely to review the adequacy of the underlying conduct and disclosure approach to the regulation of financial product issuers as the means of protecting consumers. There has now been some ten years' experience of the current approach which relies largely on the disclosure of information to consumers and sets some standards for the quality of that information. Any additional measures would be aimed at reducing the risk to consumers that they acquire financial products that are not suited to their needs. They would be preventative measures that aim to reduce consumer loss, and the eventual need for consumer compensation.[19]

27.20 Mr St. John suggested that:

> As a matter of strategic approach, it would be timely to review the present light-handed regulation of certain product issuers, in particular managed investment schemes, including the possible need, in accord with

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15 Corporations Committee, Business Law Section, Law Council of Australia, *Submission 150*, p. 4.

16 Rule of Law Institute of Australia, *Submission 211*, p. 7.

17 *Submission 234*, p. 31.

18 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 104.

19 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, p. 104.

> developments at the international level, to move to a somewhat more interventionist approach.[20]

27.21 In his view, it would make sense in the course of any such review 'to direct more attention to the responsibilities of licensees who provide financial products for retail clients. He recommended that as a first step, consideration might be given to measures along the following lines by which product issuers would be expected to assume more responsibility for the protection of consumers of their products:

- Subject product issuers to more positive obligations in regard to the suitability of their product for retail clients. Such obligations might be applied in particular to managed investment schemes in issuing products to the retail market, and would apply at each stage of a product's life cycle including its distribution and marketing.
- Among other things, the product issuer might be required to state the particular classes of consumers for whom the product is suitable and for whom the product is unsuitable, and the potential risks of investing in the product.
- Consider the development of standardised product labelling so that financial products, particularly managed investment schemes, are described on a consistent and more meaningful basis.[21]

ASIC's response to product regulation

27.22 Mr Medcraft recognised the problem of innovation outstripping regulation. He noted that this innovation was in complex products that are often manufactured overseas and then distributed worldwide.[22] He said that ASIC would continue to take a harder line on operators that pushed complex products onto unsophisticated retail investors. In his view, the regulator would also be forced to take a more vigilant approach to market regulation as the complexity of the market had increased significantly with the advent of market competition.[23]

27.23 With regard to acting quickly to stop an unsafe product, Mr Medcraft explained that ASIC issues stop orders on prospectuses, where it determines that: 'Look, this isn't good enough. I'm sorry; you want to raise money but it is not good enough until you fix it'.[24]

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20 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, p. 123.

21 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, pp. 113–14.

22 *Proof Committee Hansard*, 19 February 2014, p. 36.

23 Thomson Reuters, *Special Report: ASIC: The Outlook for Enforcement 2012–13*, p. 10.

24 Mr Greg Medcraft, Chairman, ASIC, *Proof Committee Hansard*, 19 February 2014, p. 19.

27.24 ASIC accepted that there were inherent limitations in a regulatory approach that relies solely on disclosure to address some of the problems investors face in financial markets. The effectiveness of disclosure can be undermined because:

- people may not read or understand mandated disclosure documents, due to factors such as inherent behavioural biases or a lack of financial literacy skills, motivation and time; and
- the complexity of many financial products may mean that disclosure for such products can also be lengthy and complex, or excessively simplified and generalised.

27.25 ASIC noted that, internationally, regulators were looking for 'a broader toolkit' to address problems associated with the marketing of unsafe products to retail investors. For example, in some cases, action could involve 'merits' regulation of financial products. In this regard, ASIC understood that the UK FCA would continue with initiatives begun by its predecessor, the Financial Services Authority, towards 'product intervention'. The FCA would 'periodically review particular financial services market sectors and examine how products are being developed, and the governance standards that firms have in place to ensure fairness to investors in the development and distribution of products'. To assist this process, the FCA has a spectrum of temporary 'product intervention' powers, to address problems seen in a specific product. These may include rules:

- requiring providers to issue consumer or industry warnings;
- requiring that certain products are only sold by advisers with additional competence requirements;
- preventing non-advised sales or marketing of a product to some types of consumer;
- requiring providers to amend promotional materials;
- requiring providers to design appropriate charging structures;
- banning or mandating particular product features; and
- in rare cases, banning sales of the product altogether.[25]

27.26 According to ASIC, while these tools range in degrees of intervention and, in serious cases, could include a ban on products or product features, it understands that the use of the most interventionist tools is likely to be rare. According to the FCA, the extent and intrusiveness of the rules it would make would 'be based on finding the type of intervention best fitted to the problem' it identified. It would look to find a proportionate response to the problem, based on the perceived risk to:

- consumers;

25 Rules could apply to specific products, or a class of products, and may remain in place for 12 months. ASIC, *Submission 45.2*, pp. 55–56.

- competition failings; and/or
- market integrity issues.[26]

27.27 Having access to this range of different types of regulatory approaches, however, allows the FCA to design and implement targeted responses that are suited to achieving a particular market outcome. In ASIC's view, having a broader and more flexible regulatory toolkit would 'enhance its ability to foster effective competition and promote investor and consumer protection'. It noted that regulating product suitability was 'one type of approach that has been adopted internationally'. ASIC concluded:

> As the FCA's regulatory approach is relatively new, at this stage, it is difficult to draw any settled conclusions about the positive or negative aspects of such an approach. However, the Government may wish to consider whether such a broader regulatory toolkit would be appropriate in the Australian financial regulatory system.[27]

27.28 ASIC cited recent reforms to the Australian system of financial regulation, whereby the national consumer credit regime requires credit providers and intermediaries to assess the suitability of credit for consumers before lending takes place. A similar requirement applies under the financial services regime to margin lending facilities. ASIC suggested that the government may wish to consider extending such an approach more broadly, to encompass other financial products.

Committee view

27.29 The committee fears that Australia is out of step with international efforts to implement measures that would address problems associated with the marketing of unsafe products to retail investors. The evidence before the committee suggests strongly that urgent attention should be given to providing ASIC with the necessary toolkit that would, in Mr St John's words, 'catch problems early on in a financial product's life cycle as a means of preventing widespread detriment to consumers'.[28]

Recommendation 57

27.30 The committee recommends that the government give urgent consideration to expanding ASIC's regulatory toolkit so that it is equipped to prevent the marketing of unsafe products to retail investors.

27.31 As a first step in this staged process, the committee notes that the current Financial System Inquiry may have a role.

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26 ASIC, *Submission 45.2*, p. 56.

27 ASIC, answer to question on notice, no. 12 (received 21 May 2014), p. 11.

28 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 104.

Recommendation 58

27.32 The committee recommends that the Financial System Inquiry (FSI) carefully consider the adequacy of Australia's conduct and disclosure approach to the regulation of financial product issuers as a means of protecting consumers. In particular, the FSI should:

- **consider the implementation of measures designed to protect unsophisticated investors from unsafe products, including matters such as:**
  - **subjecting the product issuer to more positive obligations in regard to the suitability of their product;**
  - **requiring the product issuer to state the particular classes of consumers for whom the product is suitable and the potential risks of investing in the product;**
  - **standardised product labelling;**
  - **restricting the range of investment choices to unsophisticated investors;**
  - **allowing ASIC to intervene and prohibit the issue of certain products in retail markets; and**
- **assess the merits of the United Kingdom's Financial Conduct Authority model which allows the Authority to suspend or ban potentially harmful products.**

Wholesale and retail clients

27.33 The previous discussion about unsafe financial products being available to unsophisticated retail investors also highlights the importance of retail investors being classified appropriately. Professor Kingsford Smith suggested there is an 'urgent need to review the definitions of "wholesale investor", "sophisticated investor" and "retail investor" under the legislation, so that any changes to ASIC's toolkit in the retail area can be directed at the right class of investor'.[29] Professor Dimity Kingsford Smith also noted:

> Using wealth as a proxy of financial literacy is suitable in some cases but not in others. For example, individuals who suddenly acquire inheritance money or superannuation lump sums could be placed in a position where they might be legally classified as sophisticated clients, irrespective of their financial experience.[30]

29 Professor Dimity Kingsford Smith, *Submission 153*, p. 8.

30 Professor Dimity Kingsford Smith, *Submission 153*, p. 19.

27.34 In April 2014, Ms Joanna Bird of ASIC told the committee that there was 'significant legal uncertainty' about what constitutes 'wholesale'.[31] Indeed, more recently the Stockbrokers Association of Australia informed the Senate Economics Legislation Committee that the definitions of retail and wholesale clients are crucial to 'the whole structure of the regulation of financial services and financial advice'. It registered its concern that three years after submissions closed on an options paper, no final or interim proposals from the 2011 review have been announced.[32]

27.35 The committee sought ASIC's advice on the requirement for a consumer to be informed of their classification as either a retail or wholesale investor and the consumer protections that go with their classification. ASIC informed the committee that a client's awareness of such a status was an issue raised in Treasury's 2011 options paper *Wholesale and Retail Clients Future of Financial Advice*. ASIC suggested that this issue 'should be considered in any changes the government may make to the law in this area following the conclusion of this review'.[33]

Recommendation 59

27.36 The committee recommends that the government clarify the definitions of retail and wholesale investors.

Recommendation 60

27.37 The committee recommends that the government consider measures that would ensure investors are informed of their assessment as a retail or wholesale investor and the consumer protections that accompany the classification. This would require financial advisers to ensure that such information is displayed prominently, initialled by the client and retained on file.

Insolvency laws

27.38 Concerns about various aspects of the insolvency profession have been brought to the committee's attention during this inquiry and previous inquiries. Issues commonly raised relate to the independence of practitioners; their competence; the fees charged and whether they represent value for money; and concerns about related transactions. The committee conducted a comprehensive inquiry into the profession in 2010.[34] Particular liquidations and receiverships were also examined in the

31 Ms Joanna Bird, Senior Executive Leader, Financial Advisers, ASIC, *Proof Committee Hansard*, 10 April 2014, p. 97.

32 Stockbrokers Association of Australia, *Submission 4* to the Senate Economics Legislation Committee's Inquiry into the Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014 [Provisions], p. 4.

33 ASIC, answer to question on notice, no. 12 (received 21 May 2014), p. 12.

34 Senate Economics References Committee, *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework*, September 2010, Parliamentary Paper No. 179/2010,.

committee's 2012 inquiry into the post-GFC banking sector. However, concerns were again raised in this inquiry, this time coupled with concern about ASIC's approach to investigating allegations of misconduct. For example, the submission from Dorman Investments Pty Ltd alleged that a particular liquidator 'acted improperly' and asserted that ASIC's investigation was inadequate:

> All ASIC asked us for was correspondence between us and the liquidator…This limited amount of correspondence could in no way highlight the failure to follow procedure which resulted in the liquidator auctioning property which belonged to us and giving the proceeds to creditors.[35]

27.39 Of all the various groups of gatekeepers in the financial system, in a 2013 survey of ASIC's stakeholders insolvency practitioners received the lowest rating for perceived integrity.[36] The survey noted that small businesses 'were particularly negative about the integrity of insolvency practitioners'. When asked how well ASIC is holding insolvency practitioners to account, only 26 per cent rated ASIC positively. The survey results note that while there was a substantial 'don't know' response to that question (30 per cent), the 'poor' or 'very poor' rating was also the second highest.[37]

27.40 The committee received evidence on developments since the 2010 inquiry. In its main submission, ASIC outlined some of its recent activities that relate to the insolvency profession. In 2011 and 2012, ASIC completed 180 transaction reviews, 32 reviews of a registered liquidator's entire practice, 146 reviews of declarations of relevant relationships and 64 reviews of remuneration reports. An industry-wide review of professional indemnity insurance policies held by registered liquidators was also undertaken to assess compliance against ASIC regulatory guidance. Further, ASIC has commenced publishing a series of annual reports on ASIC's regulation of registered liquidators.[38] ASIC also summarised its enforcement action. During this period it has obtained court orders prohibiting a Melbourne liquidator from being registered as a liquidator for five years; taken action to cancel another liquidator's registration; and has accepted four enforceable undertakings from registered liquidators.[39]

27.41 The Australian Restructuring Insolvency and Turnaround Association (ARITA), previously known as the Insolvency Practitioners Association (IPA), also provided the committee with an update on the work it has undertaken since the committee's 2010 inquiry:

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35 Dorman Investments Pty Ltd, *Submission 246*, p. [1].

36 Susan Bell Research, *ASIC Stakeholder Survey 2013: Report to the Australian Securities and Investments Commission*, September 2013, www.asic.gov.au (accessed 7 May 2014), pp. 47–48.

37 Susan Bell Research, *ASIC Stakeholder Survey 2013*, p. 53.

38 ASIC, *Submission 45.2*, p. 43.

39 ASIC, *Submission 45.2*, pp. 29, 43, 119–120.

> …we have this year (2013) conducted a second major review of our IPA Code of Professional Practice, which was first issued in 2008, and which was reviewed for its second edition in 2011. This review for the 3rd edition followed an extensive consultation with our members, AFSA and ASIC, and the ATO, and other government and industry stakeholders. The Code continues to provide detailed guidance on remuneration, independence, communications, timeliness etc, which apply to all our members whether they work in corporate or personal insolvency or both. We had particular regard to recommendation 16 of the Committee's 2010 report, and have revised our remuneration report template and otherwise continued to refine our guidance to members on remuneration claims.[40]

27.42 KordaMentha advised the committee that it believes there is adequate regulation and scrutiny of registered liquidators at present. However, it added that it would support changes to ASIC's powers to act on complaints against registered liquidators or to enhance the registration process if there were identified limitations to or inadequacies with these processes.[41]

27.43 The committee received submissions that called for more fundamental changes to how large corporate insolvencies are undertaken. Levitt Robinson Solicitors argued that Australia should adopt the US framework known as chapter 11[42] that 'puts recovery ahead of burial'. Levitt Robinson provided the following description of the process:

> Under the US Bankruptcy legislation, using Chapter 11, the directors of an insolvent company may submit a Plan of Reorganisation to the unsecured creditors to be approved by the US Bankruptcy Court. The Court then supervises compliance with the Plan. So long as the security of the secured creditors is protected, the secured creditors (usually banks) are bound by the Plan of Reorganisation and have to stand back.
>
> Where the Plan of Reorganisation fails, a trustee may be appointed in Chapter 7, to assume a role like that of a liquidator. Even then though, the trustee is more regularly and genuinely accountable to the Courts than an Australian liquidator is in practice.[43]

27.44 The chairman of ARITA, Mr David Lombe, noted that the previous government considered some reforms intended to harmonise regulation and give more powers to creditors. However, he commented that the proposal did not deal with significant issues, such as whether a chapter 11 framework should be considered in Australia, or ipso facto clauses in contracts that can prevent an insolvent business

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40 Insolvency Practitioners Association (now ARITA), *Submission 202*, p. 2.

41 KordaMentha, response to *Submission 276*, correspondence to the committee dated 10 December 2013, p. 2.

42 Chapter 11 refers to chapter 11 of the United States Bankruptcy Code, which provides for the reorganisation of a corporation or partnership.

43 Levitt Robinson Solicitors, *Submission 276*, p. 1.

from being sold or restructured.[44] In his view, major insolvency reform proposals 'could be higher on ASIC's list of things that they are looking at'.[45]

27.45 At a Senate estimates hearing conducted while this inquiry was underway, ASIC was asked about the chapter 11 framework. Mr Medcraft described chapter 11 as 'a very good system':

> Having lived for a decade in the United States and worked as a banker, I will say that basically the difference between our current regime, fundamentally, and chapter 11 is that chapter 11 retains management with the company, as opposed to handing the management to an insolvency expert. It also means that basically everything is frozen—labour contracts, financial contracts—such that the company's management can go away and negotiate and try to put the company back on a solid footing…frankly, I believe it is a very good structure. I have always been a supporter of it, because I think it significantly mitigates the loss of value that results from essentially going in and just selling up whole entities. Also, I think it is far less harmful in terms of job losses and general destruction of value…But the most important thing is that you retain the management. Often we see with companies that the issue is its financial structure, not necessarily its management. And I know from my time as a banker that often the company may be being lumbered with too much leverage or contractual commitments. This gives a chance for that to be sorted out.[46]

27.46 Mr Medcraft added that an impediment to considering a framework based on chapter 11 in Australia was the court system, as the courts would need judges with 'good commercial experience to be able to undertake this'.[47] The chairman of ARITA, however, disagreed with the assessment about the court's expertise:

> I would refer you to a matter that I was involved in. The organisation was called United Medical Protection, which was a medical insurer who insured about 60 per cent of Australian doctors. Basically, medical services ceased at that particular point. In relation to that matter, it was a chapter 11 in Australia, being run by me as a provisional liquidator using the provisional liquidation regime and being carried out by a Supreme Court judge, Justice Austin. That was very much a situation where, effectively, for all intents and purposes you had a chapter 11 running in Australia…I have found first hand, in dealing with Justice Austin, that our judges are very capable of

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44 Mr Lombe explained that ipso facto clauses in contracts can 'cause the liquidator or the voluntary administrator to lose the power to have a lease in respect of a store or a property, which then means that you cannot sell the business or restructure it'.

45 Mr David Lombe, President, ARITA, *Proof Committee Hansard,* 2 April 2014, p. 31.

46 Mr Greg Medcraft, Chairman, ASIC, *Senate Economics Legislation Committee Hansard*, Estimates, 26 February 2014, p. 30.

47 Mr Greg Medcraft, Chairman, ASIC, *Senate Economics Legislation Committee Hansard*, Estimates, 26 February 2014, p. 30.

> dealing with it. In the US they have a separate bankruptcy court, but I do not believe that that is a major issue.[48]

27.47 ARITA outlined some of the arguments commonly made against a chapter 11 framework, with its chairman noting that chapter 11 was 'not necessarily a popular thing' in Australia's insolvency profession. Potential problems include that the chapter 11 process can be very expensive. Also, different attitudes to corporate failure in Australia compared to the US may make it difficult to leave a company in the hands of the existing management or directors, the people clearly associated with the company's difficulties, while restructuring occurs.[49] However, in Mr Lombe's view, the process could work effectively in Australia and that 'we do not need to adopt holus-bolus the situation in the US'.[50]

27.48 Possible options for improving the operation of the current regulatory regime were also suggested. ARITA argued that inconsistencies in the approach of the two regulators most relevant to its members, ASIC and the Australian Financial Security Authority (AFSA), should be addressed. ARITA provided the following insight into insolvency practitioners' experience in dealing with ASIC and AFSA:

> In daily practice, around 200 of our members are regulated by AFSA in relation to personal insolvency, and around 600 of our members are regulated by ASIC in relation to corporate insolvency. A significant portion of these members are regulated by both ASIC and AFSA. Each regulator has its own guidance and regulatory requirements, which are not necessarily consistent, or at least which are issued without reference to the other. Our members are the subject of separate file audits and review by each of ASIC and AFSA.
>
> While this is to an extent dictated by the separate laws that Australia has for personal and corporate insolvency, many of the regulatory issues are common to both, for example remuneration, independence and communications with creditors. It is also a regulatory burden on our members.[51]

27.49 Another issue raised was the fees charged by liquidators. Mr Medcraft recently suggested that there is 'a lot of logic' to capping fees charged in relation to small businesses. He explained:

> At the big end of town it is about basically trying to avoid destruction of value. I think at the small end of town it is about making sure small creditors are protected…[I]t is a matter of policy for government…But I think some form of scaled fees should be something that should be considered, because, when you think about it, any bankruptcy is a function

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48 Mr David Lombe, President, ARITA, *Proof Committee Hansard*, 2 April 2014, p. 32.

49 Mr David Lombe, President; Mr Michael Murray, Legal Director, ARITA, *Proof Committee Hansard*, 2 April 2014, p. 32.

50 Mr David Lombe, President, ARITA, *Proof Committee Hansard*, 2 April 2014, p. 32.

51 Insolvency Practitioners Association (now ARITA), *Submission 202*, p. 3.

> of the size of assets, the number of employees. If you look at it, there is clearly correlation between what should be the activity that is undertaken and what you have to deal with. So I think there should be some analysis, and I think if you have scaled-free arrangement, then you have swings and roundabouts for insolvency practitioners. They might not make a lot of money on one, and they might make money on the other. But at least that gives some certainty to creditors that there is some form of rationale to the fee. And I think also it encourages efficiency in terms of the process. And we have scaled fees in other areas, so I do think it is something that is worth examining. Frankly, it is not rocket science. You should be able to work out a scaled fee based on the main metrics related to the work. It is sort of common sense.[52]

Committee view

27.50 Clearly, the conduct of liquidations in Australia is still subject to strident criticism and the source of much dissatisfaction. In response to a 2010 inquiry into insolvency practitioners conducted by this committee, the previous government prepared draft legislation aimed to modernise the current regulatory framework. The committee urges the current government to progress these reforms and to consider whether further legislative changes are required.

27.51 In addition, the committee is of the view that further consideration should be given to the overall structure and intent of Australia's corporate insolvency laws and whether the current laws are appropriate for encouraging turnarounds and restructuring in large corporate insolvencies. Particular consideration should be given to elements of the chapter 11 regime in place in the United States that could work in the Australian environment, and whether it would be desirable to adopt some of that framework here.

Recommendation 61

27.52 The committee recommends that the government commission a review of Australia's corporate insolvency laws to consider amendments intended to encourage and facilitate corporate turnarounds. The review should consider features of the chapter 11 regime in place in the United States of America that could be adopted in Australia.

52 Mr Greg Medcraft, Chairman, ASIC, *Senate Economics Legislation Committee Hansard*, Estimates, 26 February 2014, p. 31.

Boiler room scams

27.53 The committee received a number of submissions from victims of boiler room scams that operated from overseas jurisdictions. One victim, Mr Ian Painter told the committee:

> My funds were lost as part of a scheme run by a Group known as the Brinton Group which operated very successfully until they were subject to a raid by Thai SEC authorities on 26 July 2001. Official estimates of losses for the Brinton Group scam alone were in excess of $100 million. Based on the work done by me the number is much greater than this and is, in my view, probably well in excess of $200 million.[53]

27.54 The Brinton Group were cold calling victims in Australia and selling them non-existent shares. Payment for the shares were made to an account in Hong Kong.[54] Most of these victims never saw their money again.

27.55 ASIC was first made aware of the Brinton Group in 1999 and did take a number of steps to warn the public about this and other boiler room scams. These included issuing 18 media releases between 1999 and 2002, attending investment expos and working with overseas authorities in Thailand, Hong Kong and the United States to encourage them to take action against those responsible for the scams.[55]

27.56 Despite these measures there is a perception among some victims that ASIC could or should have done more to assist in the investigation and the recovery of lost funds. These concerns were discussed during the committee's public hearing on 10 April 2014:

> Senator XENOPHON: What my constituent told me, and I think he spent a lot of time on this, is that he managed with a group of private individuals who were scammed in the Brinton scam to get the funds frozen in Hong Kong and he ultimately received some of the lost funds back, along with the group of people who worked together. I guess their complaint that has been put to me, and I want to put this fairly to you, is that they managed through their own efforts to recover some of the funds but they felt that ASIC was unwilling or unable to do so. That is the nature of the criticism. I wanted to put that to you so that you could have a chance to respond to it.
>
> Mr Mullaly: I think perhaps the critical word that you used there is 'unable' as opposed to 'unwilling'. Our view and the view on advice that we received was that we were unable recover the funds from Hong Kong. That has been the case in other matters as well. As I say, we investigated another quite sophisticated cold-calling scam between January 2006 and March 2007 in which the perpetrators opened up seven different entities to undertake the

53 Mr Ian Painter, *Submission 167*, p. 1.

54 Mr Adrian Cox, *Submission 91*, p. 3.

55 Mr Peter Kell, Deputy Chairman, ASIC, *Proof Committee Hansard*, 10 April 2014, p. 99.

> fraud. In that matter we were able to freeze money in Australia and we were able to get people arrested in various countries, including in Hong Kong. We were able to recover some money from Singapore and from Malaysia but we were not able to recover the funds that were frozen in Hong Kong.[56]

27.57 ASIC explained that a major impediment to it taking action to recover money on behalf of the victims is the requirement that only parties to a contract have standing to bring a civil action in Hong Kong.[57]

27.58 It is understandable that victims, particularly those of the Brinton Group, would be frustrated to see ASIC recovering funds in some instances but not in others. Victims were further frustrated that no attempts were made to extradite those responsible for the fraud so that they would face criminal or civil charges in Australia.[58] As expressed by Mr Painter:

> I have corresponded with many authorities worldwide in my pursuit of the Brinton Group (and others) and there is a common theme that due to the cross jurisdictional issues and a lack of desire for the authorities to work together in the pursuit of these perpetrators, it seemed to be just too hard for the various authorities to pursue prosecution.[59]

27.59 ASIC also told the committee 'it is very difficult to take effective enforcement action in these matters because the acts occurred in a number of different jurisdictions'.[60]

27.60 Victims and ASIC alike appear to be frustrated by the difficulties in pursuing those responsible for fraud when multiple jurisdictions are involved. However, given the increasing ease with which financial transactions can take place between different countries, it is likely more Australians will fall victim to scams such as the Brinton Group in the future. Mr Painter sounded this ominous warning:

> …until ASIC or some other Australian authority takes action to pursue the perpetrators of cold calling and other scams, Australia will continue to be ripe pickings for such criminals.[61]

Committee view

27.61 Greater consideration must be paid as to how ASIC can improve its ability to assist victims of international fraud by way of fund recovery and extradition.

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56 Mr Tim Mullaly, Senior Executive Leader, Financial Services Enforcement, ASIC, *Proof Committee Hansard*, 10 April 2014, pp. 100–01.

57 Mr Peter Kell, ASIC, *Proof Committee Hansard*, 10 April 2014, p. 101.

58 Mr Adrian Cox, *Submission 91*, p. 6.

59 Mr Ian Painter, *Submission 167*, p. 3.

60 ASIC, answer to question on notice, no. 11, received 21 May 2014, p. 16.

61 Mr Ian Painter, *Submission 167*, p. 8.