Law Council
OF AUSTRALIA
Business Law Section

Mr David Murray AO
Chair
Financial Services Inquiry
GPO Box 89
Sydney NSW 2001
Via email: fsi@fsi.gov.au

26 August 2014

Dear Mr Murray,

Disclosure Regulation and Sanctions Submission to Financial System Inquiry

I have pleasure in enclosing a submission which has been prepared by the Business Law Section of the Law Council of Australia ('BLS') on aspects of the Interim Report of the Financial Systems Inquiry.

The topics covered by the submission are those aspects of the Interim Report relation to:

. financial product intervention powers for complex and more risky products;

. the mandate and powers of ASIC; and

. enforcement powers available to ASIC.

If you have any questions regarding the submission, in the first instance please contact the Chair of the BLS Corporations Committee, Bruce Cowley, on 07-3119 6213 or via email: bruce.cowley@minterellison.com

Yours sincerely,

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Acting Chair, Business Law Section

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Disclosure Regulation and Sanctions Submission to Financial System Inquiry

The Business Law Section of the Law Council of Australia ("**BLS**") makes this submission on certain aspects of the Interim Report of the Financial System Inquiry (July 2014) **("Interim Report")**. The topics covered by this submission are those aspects of the Interim Report relating to:

- financial product intervention powers for complex and more risky products;[1]
- the mandate and powers of ASIC;[2]
- enforcement powers available to ASIC.[3]

In that regard the BLS notes and comments on the April 2014 Australian Securities and Investments Commission ("**ASIC**") Financial System Inquiry Submission[4] **("ASIC Submission")** and the March 2014 ASIC Report 387 on Penalties for Corporate Wrongdoing **("Penalties Report")**. The BLS further notes and comments on the June 2014 Senate Economics References Committee Report on the Performance of ASIC **("Senate Report")**.

While these aspects of the Interim Report are relatively confined, the BLS believes they raise important issues that should be the subject of further FSI consideration and recommendations.

As a general comment the BLS believes that the development and deployment by ASIC of a more nuanced regulatory enforcement pyramid in the years leading up to the Wallis inquiry[5] has proven to be a very positive force in curbing corporate wrongdoing and building investor confidence in the integrity of Australian capital markets. Enforcement tools introduced in that period such as the civil penalty regime[6] have subsequently proven to be a flexible and effective enforcement tool for ASIC.[7]

However there have been a number of developments in the business landscape since the time of the Wallis inquiry that the BLS considers should be carefully reviewed[8] including:

- lessons from the corporate collapses following the tech bubble of 2002, the retail mezzanine finance company collapses of 2005 and the global financial crisis of 2007;
- the proliferation of class actions and the friction costs those class actions are increasingly imposing on business activity;
- the development of fines and enforceable undertakings as a regulatory enforcement tool.

An effective corporate watchdog is critical to the operation of Australia's financial markets. Effective, transparent and fair sanction regulations are important to the smooth functioning of those financial markets. An ongoing willingness to consider appropriate regulatory change is critical for the integrity and competitiveness of the Australian financial system over the next decades.

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[1] Interim Report pages 3-58 to 3-62.
[2] Interim Report pages 3-122 to 3-129.
[3] Interim Report pages 3-124 to 3-128.
[4] 'Financial System Inquiry: Submission by the Australian Securities and Investments Commission', April 2014.
[5] Calls for the development of a regulatory enforcement pyramid came out of corporate collapses at the end of the 1980's – see for example R. Tomasic "Sanctioning Corporate Crime and Misconduct Beyond Draconian and Decriminalisation Solutions" (1992) 2 AJCL 183.
[6] Part 9.4B of the Corporations Act.
[7] See also Chapter 4 of the Senate Report.
[8] See also paragraphs 4.41-4.44 of the Senate Report.

It is the view of the BLS that ASIC should be encouraged to actively seek to enforce the law, especially where guidance may be given by the courts in interpreting difficult provisions. The BLS believes that particular regard should be given to ensuring that the sanctions applied are appropriate and proportionate to the culpability of the conduct in question and that lesser sanctions are not applied to more significant violations of law so that appropriate deterrence is advanced. That is a critical consideration where a regulatory enforcement pyramid exists.

The BLS makes the following specific suggestions for areas of focus to achieve the objectives of improving ASIC's role, enhancing sanction regulations, minimising red tape and increasing transparency.

1 Product intervention/banning powers

The Interim Report requests views on whether ASIC should be provided with additional powers such as product intervention powers for complex or more risky products and a power to temporary ban products where there is a significant likelihood of detriment to consumers.[9]

The BLS is very concerned that giving ASIC product intervention powers of the sort proposed in the Interim Report would effectively delegate to ASIC the power to regulate how financial products are designed, developed and distributed, with likely very significant unintended consequences. In the BLS's view, this would be a fundamental change in ASIC's role, making it a "merits" regulator as well as a "conduct and disclosure" regulator. This would go well beyond simply enhancing ASIC's "regulatory toolkit" - it would be a very significant change in the regulatory architecture. In the BLS's view, the case for this change has not been made out.

In making this submission, the BLS is not suggesting the existing disclosure regime is always effective in meeting its objectives. Clearly, that is not the case. And the BLS acknowledges it may be appropriate to consider the adoption of new regulatory tools designed to protect the interests of unsophisticated investors.[10] However, the BLS has a number of serious concerns in relation to any proposal to grant ASIC product intervention powers along the lines set out in the Interim Report. If some form of "merit" regulation were to be explicitly considered in Australia, that would be a very significant step and one requiring extensive consideration and consultation, rather than being introduced indirectly through a product intervention power.

The BLS makes the following more detailed comments.

a) The nature and extent of the powers

The Interim Report suggests the objective of product intervention powers may be "to ensure fairness to consumers",[11] which could potentially allow ASIC to intervene on a wide range of grounds, including price and value for money. Indeed, it could even go so far as to allow ASIC to impose new forms of prudential regulation (e.g. by banning the sale of particular products by persons who do not satisfy specified prudential requirements).

Even if it is intended that ASIC's formal product intervention powers would only be exercised in limited circumstances, the BLS believes the mere existence of those powers would be sufficient to draw ASIC into a wider role of effectively "approving" financial products for retail customers. In the BLS's view, there would be a very real risk product issuers would begin to seek informal "pre-clearances" from ASIC when they launched new products so they could be assured those products would not subsequently be subject to adverse intervention. And ASIC may also be tempted to use the threat of invoking its formal powers in order to influence the behaviour of

[9] Interim Report at pages 3-60 to 3-62.
[10] The BLS made a submission to the Senate Economics References Committee Inquiry into the Performance of ASIC to this effect.
[11] Interim Report page 3-61. It is suggested ASIC might need to "demonstrate that a significant number of consumers are being caused significant detriment", but this does not reduce the overall scope of the powers.

market participants in a wide range of circumstances. While ASIC may have suggested the power to ban product features or products is one that would only be used "in extreme cases",[12] the BLS believes the power's very existence would have consequences that would be both widespread and profound.

b) **ASIC's capabilities/biases**

The Interim Report questions whether ASIC currently has the cultural and skills mix, and the resources, to carry out its existing responsibilities. Indeed, it suggests ASIC may already have too many regulatory functions and that it may benefit from a narrower mandate.[13]

The BLS is concerned that expanding ASIC's mandate by granting it product intervention powers would compound this problem. The task of anticipating potential problems before they arise and devising proportionate responses that do not interfere unduly with normal market behaviour or impose unwarranted regulatory burdens on business is fundamentally different from anything ASIC currently does and would require skills and resources ASIC does not currently possess.

There are also inherent risks in giving ASIC these powers as the Report of the Taskforce on Reducing Regulatory Burdens on Business noted in 2006:

> *"Given the key role the financial and corporate sectors play in the performance of the economy, it is crucial that regulation is designed, implemented and administered effectively. In particular, regulation should:*
>
> - *seek to maintain an appropriate balance between achieving safety and investor protection and ensuring that regulated entities are not unduly constrained in conducting business;*
> - *be applied flexibly in recognition of the diversity within the sectors and the pace of structural change and innovation; and*
> - *allow for decision-making to occur within a framework that promotes transparency and public confidence."* [14]

Even if ASIC were provided with additional resources to meet its expanded responsibilities, the BLS is very concerned that ASIC might adopt an overly risk-averse approach in carrying out this balancing exercise. Its incentives may lead it to give much greater weight to "safety and investor protection" than to the implications of market participants being "unduly constrained in conducting business". There is also a risk ASIC's inevitable biases as a regulator (given its asymmetric incentives) might inappropriately skew its decisions in exercising its new powers to the ultimate detriment of consumers.

The mere fact financial products may perform poorly as a result of the crystallisation of market risk should not, in and of itself, be a reason for regulatory intervention. Innovation in financial markets, including the development of complex products, may often be beneficial because it results in more efficient allocation of resources and a higher level of capital productivity and economic growth. But ASIC may view things differently.

While ASIC has stated that it is aware of these issues,[15] its attention is naturally focused primarily on the risks for investors and their potential consequences. In the current disclosure based regulatory regime, this may be appropriate. But if ASIC were to be equipped with powers to intervene proactively in the product development process, the outcomes may be very different. There is a risk that arming ASIC with an ability to "shoot first" may in fact lead to unwanted casualties.

[12] ASIC Submission page 37.
[13] Interim Report pages 3-123-124.
[14] "Rethinking regulation: Report of the taskforce on Reducing Regulatory Burdens on Business" page 89.
[15] See Penalties Report page 4.

c) **The impact on innovation and competition**

There is a risk that product intervention powers will reduce innovation for a range of reasons

- Product issuers may be unwilling to undertake the high cost of developing new products (including increased regulatory costs) if there is a risk of those products being banned or their sale being restricted.
- Product issuers may be concerned about the risk of reputational damage if it they are the subject of an intervention.
- A product issuer may be may be unwilling to be first to market with an innovative product for fear of regulatory intervention.
- There may be confusion about what is needed to comply with the regime.
- An issuer may be concerned ASIC will take a different view about the risk of consumer detriment arising from a financial product, the value for money offered by the product, or the target market for the product.
- A culture may develop in which issuers are only willing to introduce new products if they have received an ASIC "sign-off".
- Issuers may decide to limit their offering to "vanilla" products, thereby restricting consumer choice and "infantilising" retail investors who may be capable of assessing their own risk appetite.

Once again, this may ultimately not be in the best interests of consumers.

d) **Potential moral hazard**

The traditional role of ASIC has been that of an oversight body. It has never been a guarantor of last resort nor has it been set up to prevent losses or collapses. The success or failure of a particular investment has always been regarded as a matter for the market. This system and approach has been well understood by institutional investors, although it seems to have been less well understood by some retail investors. Indeed, following some of the corporate collapses that occurred during the GFC, a number of retail investors complained ASIC should have acted earlier to prevent the losses they suffered.

In recent years, ASIC has taken significant steps to close this "expectation gap" by educating retail investors about risk and emphasising there are no "safe" investments. It has also highlighted the difficulties a regulator faces in acting pre-emptively. As a former ASIC Chairman has observed:

> *"[Y]ou get with the benefit of hindsight calls that ASIC was aware that Storm Financial was in the market and we should have closed it down. ... At the height of the stock market, investors with margin loans were in the 'black'. How would they have reacted to ASIC (if we had the power, which we do not) seeking to close them out?*
>
> *It also disregards the complexity of the schemes that may go wrong. We saw in the United States the proliferation of complex CDOs and CDO squareds, which were put together with lawyers, accountants, valuers and others. Simply being aware of a product in the market does not mean that you can assess its legality. These products are developed over years by the investment bankers, lawyers and accountants with huge investment."*[16]

Giving ASIC product intervention powers would be a significant retreat from this approach. Once ASIC was armed with preventative powers, retail investors might reasonably expect that ASIC would use those powers to prevent consumers suffering losses. As a result, ASIC may increasingly be seen as a "guarantor" of last resort. And, correspondingly, retail investors may consider there is less need for them to understand and manage the risks associated with their investments for themselves. Rather than addressing the major factors that prevent disclosure from

[16] "Responding to the global financial crisis: the ASIC story", a speech by Tony D'Aloisio, Chairman, Australian Securities and Investments Commission http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/speech-responding-global-crisis-nov-2011.pdf/$file/speech-responding-global-crisis-nov-2011.pdf

enabling informed consumer decision making, this approach would be likely to compound the problems caused by disengagement, low financial literacy and poor consumer choices.[17]

e) **Increased costs for consumers**

The new regime may lead to material increased costs (direct and indirect) that will ultimately be borne by consumers.

f) **Due process requirements**

Market participants may suffer significant harm as a result of the exercise of product intervention powers. Product intervention would result from a regulatory decision based on policy grounds rather than the breach of any applicable legal requirement. Accordingly, affected persons will need to be afforded procedural fairness in the decision making process. It is unclear how the interests of market participants who may be adversely affected by the exercise of ASIC's powers will be protected (particularly if ASIC perceives a need for urgent action).

In these circumstances, the BLS believes it would be inappropriate for ASIC to be able to exercise product intervention powers unilaterally. Rather, the powers should only be exercisable by an independent body on ASIC's application.

In this respect, the BLS believes the powers exercisable by the Takeovers Panel under Division 2 of Part 6.9 of the Corporations Act provide a useful precedent. Earlier versions of these powers were originally exercisable by ASIC's predecessors and this led to widespread concern that the regulator was acting as "policemen, prosecutor, judge and jury". To address these concerns, the powers were transferred to the Takeovers Panel as an independent decision maker.

Not only would this approach ensure greater independence in the decision making process, it would also ensure ASIC could not use the powers as a "big stick" to influence behaviour without complying with applicable procedural requirements.[18]

g) **There may be better alternatives**

Once the various costs and risks are taken into account, there may be better ways to address the perceived regulatory concerns[19], including:

i. **Enforcement** - Greater enforcement of existing regulatory requirements.[20]
ii. **Education** – Extending ASIC's educational activities, including its financial literacy work.

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[17] See Interim Report p. 3-57.

[18] When it was proposed that the "unacceptable conduct" power be transferred from ASIC's predecessor (the NCSC) to the Takeovers Panel, the NCSC Chairmen at the time argued the existing regime allowed the NCSC to use the threat of exercising the power to reach commercial settlements with parties. He gave evidence that people changed their behaviour because they "believe there is a high probability that something nasty will happen to them if they do not conform to what we ask" *[Report of Edwards Committee 13.70].* He also stated the power was used this way about 50 times a year even though the power was only formally exercised a little over once a year. While there is no doubt ASIC is a much more disciplined and professional body today, a regulator will always be tempted use the tools available to it to secure the outcomes it considers desirable.

[19] It should be noted the Future of Financial Advice ("FOFA") reforms have already been implemented to address some of the regulatory concerns referred to in the Interim Report, such as conflicts of interest.

[20] The ASIC Submission identified three main reasons consumers experience financial loss:

a. crystallisation of market, credit and/or operational risk;
b. inappropriate conduct, often driven by conflicts of interest; and
c. outright criminal misconduct.

See ASIC Submission page 101. Post-FOFA, each of these is susceptible to enforcement activity under existing laws and regulations.

iii. **Guidance on disclosure** –ASIC could continue to build on its work in guiding industry participants to provide more meaningful disclosure about the risks commonly misunderstood by retail investors (such as RG 69 in relation to debentures and REP 365 in relation to hybrid securities).

iv. **Guidance on product design** – ASIC could also build on its work in this field in order to improve product design and reduce the risk of mis-selling (as in REP 384 in relation to complex products).

v. **Reliance on the market** – While financial market outcomes may sometimes depart from the theoretical ideal, there are still many decisions that should be left to the market and determined by competition.

If, notwithstanding these views, a decision were to be made to introduce some form of product intervention powers, the BLS believes there would need to be extensive consultation on the design of the regime. Among other things, this would need to consider issues such as:

- The scope of the proposed powers. For example should any or all of the following be included/excluded?
    - Require advice to be provided before products are sold (and potential for new adviser requirements)?
    - Require products to be sold through particular channels?
    - Require products to be marketed in a particular way or restricted to particular types of investor?
    - Require issuers or intermediaries to carry out suitability tests?
    - Ban features of products?
    - Intervene in product design process (and potential for pre-notification and pre-approval requirements)?
    - Ban products?
    - Price interventions?
    - Increased prudential requirements?
    - Declare arrangements unenforceable?
    - Order compensation?

- The pre-conditions to the exercise of the powers:
    - Evidence of detriment (and its scale) and how assessed.
    - Intervention is a proportionate and deliverable means of addressing the detriment (risk of unintended consequences assessed).
    - Intervention is consistent with other relevant objectives (e.g. the promotion of competition).
    - Other measures to address the detriment not adequate.
    - Proper and transparent consultation (including in relation to costs of compliance).
    - No discrimination.
- Appropriate procedural requirements.
- Duration/sunset requirements; and
- Post implementation reviews.

BLS Recommendations:

- ASIC not be given product intervention powers
- Focus instead on disclosure, education and financial literacy

2 ASIC's use of infringement notices – "taking the easy way out"

The Interim Report poses the question of whether the infringement notice regime of the Corporations Act should be expanded to cover more contraventions.[21]

The BLS is of the firm view that the infringement notice regime of the Corporations Act should not be expanded to cover more contraventions and that further work must be undertaken in relation to the current use by ASIC of infringement notices. This is especially the case given the fact that the government at the time the infringement notice regime was introduced into the Corporations Act, stated that a review of the infringement notice regime would occur within two to three years of its introduction – this review was commenced but the outcome of the review was never made publicly available.

The infringement notice regime was introduced on the presumption that the regime would be one to deal with minor potential breaches of the legislation on a timely and efficient basis. Instead, it appears that ASIC has used the infringement notice regime in cases where it does not wish to risk time, money and potential loss in the courts in pursuing alleged breaches of legislation.[22] Further, ASIC has taken on average almost 250 days from the time of an alleged contravention to the issuance of an infringement notice.[23] If ASIC believes a significant breach of the continuous disclosure regime has occurred then ASIC should pursue the relevant entity in the court system.

In 2007, the Law Council of Australia made a submission in response to the Treasury's Discussion Paper on the Operation of the Infringement Notice Provisions of the Corporations Act. In that submission, the Law Council of Australia submitted that infringement notices do not serve a sensible or useful purpose and that continuous disclosure regulation is inappropriate for the use of infringement notices because:

(1) breaches of continuous disclosure are quite serious (reflecting that information which is material for investors has not been or is inadequately provided); and

(2) alleged breaches of these provisions require significant investigation and are not the type of strict liability offences for which infringement notices are generally used.

The BLS continues to support this submission.

Infringement notices encourage targeted entities to take the opportunity to get rid of the matter without having the burden (time wise and cost wise) of having to fight a case in the courts. But if the matter is so significant in the eyes of the regulator, and involves a particularly important area of the law, its response should be to ensure that the law is enforced and appropriate court cases are brought.[24] The time taken, and the impact of a successful piece of litigation would have in the market, is significantly more relevant than a tame notice to the effect that a company has agreed to "settle" a dispute with a regulator and agreed to pay a nominal fine. Indeed, the relatively low cost of the fine will inevitably be lower than cost of fighting the matter in court (in terms of management time and financial resources), even if the company's position is ultimately upheld.

The use of the infringement notice regime also increases the possibility of class actions being commenced on behalf of investors who may believe that they have suffered a loss as a result of the possible non-compliance by a company. This is the case even if the company does not believe the issuance of the infringement notice was justified but does not have the time, the resources or the inclination to contest the infringement notice.

In mid-2012, the Corporations Committee undertook a survey of interested persons on the operation of the continuous disclosure infringement notice regime. The report relating to the outcomes of that

[21] Interim Report at page 3-128.
[22] Bob Baxt *"A fundamental principle of English and Australian common law – why the presumption of innocence must be retained at all costs!"* (2012) 5 Australian Business Law Tracker 1 at 2
[23] Aakash Desai and Ian M Ramsay "*The use of infringement notices by ASIC for alleged continuous disclosure contraventions: Trends and analysis"* (2011) 39 ABLR 260 at 260
[24] See footnote 22 at 4

survey are attached as Annexure A. In summary, the results of that survey showed that the use of infringement notices as a regulatory mechanism to enforce continuous disclosure remains a contentious issue.

Whilst continuation of the infringement notice regime was largely accepted by survey respondents, there was strong support for a review and overhaul of the system. Only 14% of survey respondents indicated the regime requires no change with 75% calling for change. Some of the areas of concern with the current regime were as follows:

- the public portrayal of fines: over two thirds of survey respondents indicated they were concerned with ASIC's use of media releases in relation to infringement notices (31% were very concerned) and 65% of survey respondents indicated that ASIC should have greater restrictions imposed upon it about what it can publicly say in relation to the acceptance of an enforceable undertaking;

- the type of breach that infringement notices were used to pursue: 59% of survey respondents indicated that ASIC has used infringement notices to pursue serious breaches of the infringement notice regime (rather than less serious breaches only);

- time taken to issue infringement notices: 82% of survey respondents indicated the time period taken by ASIC to issue infringement notices were of concern (50% were greatly concerned) and 79% of survey respondents agreed that ASIC should have a 6 month or shorter time period in which to issue an infringement notice;

- the guidance offered by infringement notices: more than 66% of survey respondents indicated that infringement notices do not provide clear guidance on appropriate continuous disclosure practices; and

- the requirement that enforceable undertakings should contain an acknowledgement from the company that ASIC's views in relation to the company's misconduct were reasonably held: 69% of survey respondents indicated concern with this requirement.

Most survey respondents also indicated that the impact of the fines levied as a result of an enforceable undertaking being issued had no or only a mild impact on corporate conduct.

BLS Recommendations:

- Not expand the areas that can be resolved through infringement notices
- Review the operation of the existing infringement notice regime

3 A comprehensive review of class actions

The BLS submits that there is an urgent need to consider the interaction of regulatory sanctions and the way in which securities law class actions[25] are pursued. The BLS notes that this was not an area specifically addressed in the Interim Report but suggests it is an area that warrants inquiry.

Class actions involving securities law claims, particularly allegations of continuous disclosure violations of law, have been an increasing feature of the business landscape over the last decade. Class action settlements involving securities law claims now exceed $1.1 billion. It is extremely rare that class actions are resolved by trial decisions, meaning that the merits of claims brought in securities law class actions are rarely tested. While class actions do provide a public benefit in acting as a private enforcement mechanism to encourage compliance with law and allow small investor to

[25] Being class actions involving the financial and securities markets. This of course is only one area that class actions extend to. This submission should not be seen as relevant to other forms of class action (mass torts, product liability, etc).

recover losses suffered in an efficient and cost effective manner, the friction costs associated with class actions are huge, with litigation funders typically charging between 25-40% of settlement amounts. This means that a large part of settlement proceeds do not reach the investors who have suffered loss and there is a risk of distortion in behaviour through conflicts of interest between investors and litigation funders and plaintiff law firms.

The BLS believes there is an urgent need to undertake a holistic review of the experience of securities law class actions to determine if reforms to the current practice are desirable. Much of the recent debate has related to the question of whether litigation finders should be required to hold Australian Financial Services Licences pursuant to the Corporations Act.[26] To be sure issues of managing conflicts of interest and financial substance are important issues relating to litigation funding but the policy issues surrounding class actions are much broader than that topic. While the work of the Productivity Commission on aspects of this topic as part of its Access to Justice review is most welcome,[27] the issues surrounding securities law class actions should be reviewed on a much more general and complete basis. Having regard to the remit of the FSI the BLS calls on the FSI to recommend a broad reaching review of securities law class actions and their impact on the efficiency and productivity of the financial system.

At a narrower level and to illustrate some of the additional issues that should be reviewed the interaction of class actions with other regulatory sanctions needs review and redesign. The more important of the concerns that arise in this area are as follows:

- **ASIC investigations and class actions**

  The plaintiffs in many class actions seek access to ASIC investigation results as a shortcut to prove evidence of wrongdoing. Class actions in most cases are preceded by ASIC investigations into relevant conduct. ASIC will typically use its powers to require production of documents pursuant to sections 30 and 33 of the ASIC Act and to take evidence pursuant to section 58 of the ASIC Act. The powers of compulsion given to ASIC under those provisions provide an important public function in aid of ASIC's enforcement powers. The nature of those powers are set forth in a carefully balanced regime that balances ASIC's need to perform a public investigation function with the private rights of individuals and corporations (privacy, privilege, self-incrimination, etc.). The BLS believes that it is inappropriate that the output of such a process should be available to a civil litigant to pursue a personal claim. Such access undermines the balance of requirements of proof between plaintiffs and defendants in civil proceedings.

  Under section 25 of the ASIC Act, ASIC is given specific power to provide copies of records of examination to a lawyer if the person satisfies ASIC that the person is proposing to carry on a proceeding. In that regard ASIC has frequently indicated that it supports private action through class actions as an aid to its enforcement strategies. However, the BLS believes that view does not have sufficient regard to the structural costs associated with class actions under the current regime.

- **Civil penalty proceedings and class actions**

  The civil penalty proceeding remedy available to ASIC pursuant to Part 9.4B of the Corporations Act has become a very important regulatory tool for ASIC over the last decade. It provides a much more effective regulatory tool than criminal prosecutions. However the design of the sanction now discourages settlements through the interaction of the regime with potential class actions. This issue arises because settlement of a civil penalty prosecution requires approval of the court if sanctions are to be imposed. The imposition of a sanction is predicated on a declaration of contravention being made by the court[28] with that declaration

[26] Arising initially as a result of the decision in Multiplex Limited v International Litigation Funding Partners Pte Limited [2009] FCAFC 147.
[27] Productivity Commission Draft Report "Access to Justice Arrangements" April 2014.
[28] Section 1317E.

being conclusive evidence of the violation of law.[29] Only then can the penalties of pecuniary penalties, compensation orders or banning orders that may be the subject of an agreed settlement with ASIC can then be made. Where there is a risk of a class action that will discourage a corporation from settling with ASIC as the declaration of contravention will essentially underwrite the success of a class action. Discouragement of settlement is not in the interests of the efficient operation of justice. Further the regime might for example encourage resolution of an investigation through, for example, imposition of a fine which does not involve an admission of contravention.[30] That might result in fines being levied for conduct that is not "less serious", the purported policy basis for which the fining power may be used.[31]

The BLS notes that in 2011, the Law Council Directors adopted a Position Paper on 'Regulation of Third-Party Litigation Funding in Australia'. The Position Paper outlines the Law Council's policy that litigation funders should be subject to an appropriate licensing regime and be supervised by an appropriate regulator, most likely ASIC.

Since that position was adopted, the previous Federal Government established an administrative framework under which litigation funders are required to demonstrate that they have adequate arrangements in place to resolve conflicts of interest in order to enjoy an exemption from the requirements of Chapters 5C and 7 of the Corporations Act. However, the Law Council maintains that it would be more appropriate to require litigation funders to be licenced, subject to appropriate transitional arrangements.

The Law Council also maintains that litigation funders provide an important means for consumers to obtain access to legal remedies. Any regulatory arrangements established in the future should be designed to provide a degree of certainty to the industry, encourage new entries by responsible players in order to promote greater competition, and provide a mechanism to moderate funders' success fees.

BLS Recommendations:

- A comprehensive and holistic review of the issues surrounding class actions be undertaken
- The interaction between class actions and regulatory powers and other sanctions to be reviewed

4 Improving "regulatory design"

One of the key findings in the ASIC Penalties Report was that "non-criminal monetary penalties – including administrative penalties and disgorgement – are not as widely available and are lower in Australia when compared with the overseas jurisdictions surveyed."[32] ASIC's recent FSI submissions also echoed this key finding: "other jurisdictions surveyed have greater flexibility to impose higher non-criminal penalties and scope to use non-criminal penalties against a wider range of wrongdoing."[33]

The BCA considers that prosecutors should have at their disposal a wider range of options to prosecute corporate financial crime. The BLS believes that inquiry should be broader than non-criminal penalties and extend to the broad ambit of enforcement techniques that are proving to be effective enforcement tools in overseas jurisdictions.

One example of a new remedy that might be considered is the introduction of deferred prosecution agreements ("**DPAs**"). DPA's are increasingly being used as an effective enforcement tool in areas of

[29] Section 1317F.
[30] Section 1317DAF(4).
[31] Penalties Regulatory Guide 73.4.
[32] Penalties Report 387, page 15.
[33] ASIC Submission at 47.

corporate crime and associated areas such as bribery. If implemented, DPAs would - in appropriate circumstances - allow prosecutors a more effective means of addressing corporate financial offences.

In practical terms, DPAs would sit alongside other civil and criminal penalties.[34] Under the terms of a DPA, a prosecutor would be able to lay (but not immediately proceed with) criminal charges against a company, provided that key requirements under the DPA were met.[35] Such requirements could include restitution for victims, financial penalties, disgorgement of profits and other measures to deter and prevent future offending.[36]

DPAs were recently introduced in the United Kingdom. In the United Kingdom, DPAs were introduced primarily to drive behavioural change amongst participants in financial markets.[37] Other justifications for their introduction included potential reduction in time and cost in completing complex investigations, and boosting Treasury revenue to in turn enhance funding for future prosecutions.[38]

While the United Kingdom experience with DPAs has been limited to date,[39] in the United States, over $1.8 billion in penalties have been levied against banks in relation to the LIBOR scandal alone – with a negotiated settlement being executed in each case.[40] Although a number of concerns have been expressed in relation to the United States DPA regime,[41] the United Kingdom has taken steps to attempt to "improve the accountability of deferral"[42] having built in structural differences in their approach.[43]

In developing a regime in an area such as DPAs, care would need to be given to addressing some of the policy issues that similarly arise in the area of enforceable undertakings that are addressed below.

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[34] 'Consultation on a new enforcement tool to deal with economic crime committed by commercial organisations: Deferred prosecution agreements', United Kingdom Ministry of Justice, Consultation Paper CP9/2012, May 2012, page 3, available online at https://consult.justice.gov.uk/digital-communications/deferred-prosecution-agreements/supporting_documents/deferredprosecutionagreementsconsultation.pdf.

[35] 'Consultation on a new enforcement tool to deal with economic crime committed by commercial organisations: Deferred prosecution agreements', United Kingdom Ministry of Justice, Consultation Paper CP9/2012, May 2012, page 4, available online at https://consult.justice.gov.uk/digital-communications/deferred-prosecution-agreements/supporting_documents/deferredprosecutionagreementsconsultation.pdf.

[36] 'Consultation on a new enforcement tool to deal with economic crime committed by commercial organisations: Deferred prosecution agreements', United Kingdom Ministry of Justice, Consultation Paper CP9/2012, May 2012, page 4, available online at https://consult.justice.gov.uk/digital-communications/deferred-prosecution-agreements/supporting_documents/deferredprosecutionagreementsconsultation.pdf.

[37] 'Deferred Prosecutions in the Corporate Sector: Lessons from LIBOR', 2014, J O'Brien and O, Dixon, Seattle University Law Review, Volume 37, page 476.

[38] 'Consultation on a new enforcement tool to deal with economic crime committed by commercial organisations: Deferred prosecution agreements', United Kingdom Ministry of Justice, Consultation Paper CP9/2012, May 2012, pages 12 and 17, available online at https://consult.justice.gov.uk/digital-communications/deferred-prosecution-agreements/supporting_documents/deferredprosecutionagreementsconsultation.pdf.

[39] The provisions in the United Kingdom Crimes and Courts Act 2013 relating to DPAs came into force on 24 February 2014.

[40] 'Deferred Prosecutions in the Corporate Sector: Lessons from LIBOR', 2014, J O'Brien and O, Dixon, Seattle University Law Review, Volume 37, page 476.

[41] 'Deferred Prosecutions in the Corporate Sector: Lessons from LIBOR', 2014, J O'Brien and O, Dixon, Seattle University Law Review, Volume 37, pages 477, 481, 482, 490, 492 and 509.

[42] 'Deferred Prosecutions in the Corporate Sector: Lessons from LIBOR', 2014, J O'Brien and O, Dixon, Seattle University Law Review, Volume 37, page 509.

[43] 'UK Issues Guidelines for Deferred Prosecution Agreements', 11 March 2014, Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, accessed online at www.skadden.com/insights/uk-issues-guidelines-deferred-prosecution-agreements

BLS Recommendation:

- Consider introduction of new sanctions that have been proven to be effective in overseas jurisdiction
- Consult with relevant stakeholders regarding the introduction of DPAs into Australian law.

5 Quantum of Sanctions

The BLS supports ASIC's submissions that sanctions for corporate wrongdoing be consistent with those in comparable legislation and other jurisdictions. The BLS would support such a review being undertaken.

One specific area for attention is the quantum of financial penalties in the civil penalty provisions of the Corporations Act.[44] A decade has now passed since Justice Finkelstein made the following comments in the Vizard proceedings:[45]

> *"The proposed penalty is certainty low. Left uninstructed I would have imposed a higher penalty, but not substantially different from that suggested. If this penalty is insufficient, parliament should increase the maximum. The current amount has been in place for more than 13 years and may require review."*

The BLS agrees with these comments.

BLS Recommendations:

- Sanctions for corporate wrongdoing to be reviewed to ensure consistency with comparable legislation and jurisdictions
- Civil penalty maximum pecuniary penalties for corporations and individuals to be substantially increased

6 The use of Enforceable Undertakings

A contentious issue coming out of the Senate Report is ASIC's use of enforceable undertakings as part of its tool kit. . The Interim Report requests views on whether ASIC's current enforcement regime is adequate. Enforceable undertakings are one important part of ASIC's enforcement tool kit and may be entered into pursuant to s93AA of the ASIC Act 2001 (Cth). ASIC uses enforceable undertakings across the full range of its regulatory mandate, including for matters relating to corporate insolvency, auditing, credit licensing, financial services licensing, as well as for market misconduct matters such as for misleading or deceptive conduct in relation to financial products and continuous disclosure.

Enforceable undertakings can be cost effective and efficient regulatory sanction that may deliver faster outcomes compared with going through the court system. Enforceable undertakings also offer the benefit of allowing more flexible outcomes than a court determination will typically provide. For example, it is common for enforceable undertaking to include measures aimed at changing the compliance culture within the promisor's institution. Measures can be included in enforceable undertakings to target the future conduct of particular individuals, which can provide a direct accountability mechanism to ensure that appropriate changes are made to address regulatory concerns. Furthermore, enforceable undertakings commonly provide for compensation for those adversely affected by the conduct that gave rise to the undertaking. Such compensation will be

[44] Part 9.4B.
[45] ASIC v Vizard [2005] FCA 1037

available much faster than if the matter were resolved by the courts, particularly if appeals are involved.

However, concerns have been raised about ASIC's use of enforceable undertakings by a number of commentators as well as by the Senate Report. These concerns include questions about whether ASIC is using enforceable undertakings so as to achieve a quick outcome in circumstances where more substantive action may have been warranted. ASIC has been under considerable criticism for its perceived lack of willingness to challenge potential contraventions of the law by major corporations in the courts. The use of enforceable undertakings in recent times to address potential contraventions by major financial institutions, and for continuous disclosure breaches, has been criticized in the media. The BLS supports the continued use of enforceable undertakings, but not in circumstances where substantial contraventions of the law are alleged.

ASIC's use of enforceable undertakings has also been criticized on the basis that the content of some undertakings is vague and lacks concrete promises to address the concerns. It is important that enforceable undertakings contain clear statements of the conduct and what will be undertaken by the promisor to address the concerns. Statements such as 'take remedial action' are insufficiently clear and call into question the efficacy of the enforceable undertaking and ASIC's enforcement approach and should be avoided.[46]

If enforceable undertakings are to be an effective enforcement tool, in terms of specific and general deterrence, both ASIC and the promisor must be accountable for their implementation and their ultimate success or failure. Enforceable undertakings frequently fail to provide accountability measures such as independent reviews by qualified and independent experts.[47] The effectiveness of enforceable undertakings, and ASIC's accountability in using them, would be improved by better reporting of how they are used, if/when they are contravened, when court action is taken to enforce them and what areas of regulatory responsibility they are used in. Enforceable undertakings are publicly available, but only for individual download through the ASIC website. ASIC reports on the total numbers of enforceable undertakings each year in its annual report, but does not specify what areas the undertakings are used for. ASIC's half yearly enforcement reports do set out the broad areas where enforceable undertakings are used (such as 'corporate governance' or 'financial services') but these are grouped with negotiated outcomes and further details of the contraventions are not provided. Furthermore, ASIC does not report on trends in the use of, or compliance with, enforceable undertakings. This makes it difficult to determine whether they are being used effectively and whether the promisors are changing their behaviour. This adds to public criticism of the efficacy of ASIC's enforcement strategies and a lowering of investor confidence in the regulatory framework.

[46] See further O'Brien and Gilligan, submission to the Senate References Committee 'Inquiry into the Performance of ASIC', submission 121.
[47] See further Marina Nehme, "Monitoring compliance with enforceable undertakings" (2009) 24 *Australian Journal of Corporate Law* 76.

BLS Recommendations:

- Enforceable undertakings continue to be used by ASIC for low level, less serious contraventions of the law
- Enforceable undertakings not be used for serious or egregious contraventions
- The language of enforceable undertakings should contain clear statements of the behaviour that gave rise to regulatory concerns and what steps will be taken to address those concerns
- Enforceable undertakings should contain strong monitoring and accountability mechanisms, including the use of independent experts to monitor and report on their implementation
- ASIC should regularly report on the use of enforceable undertakings to show what specific areas/contraventions they are being used for, to what extent they are being complied with and what trends the data on their use shows regarding compliance over time across areas of ASIC's responsibility.

7 Whistleblowers

A key recommendation of the Senate Report is that the whistleblower provisions of Australian law be reviewed.[48] The BLS strongly supports that recommendation.

The BLS agrees that there are inadequate mechanisms surrounding the protection of corporate whistleblowers and these mechanisms should be brought into conformity with the protections surrounding public service whistleblowing[49] and the practice of corporate whistleblowing increasingly normalised (for instance through standardised reporting). The BLS agrees that ASIC's procedures around whistleblowing should be reformed.[50]

The BLS believed the possibility of reforms around rewards based incentives for corporate whistleblowers are more contentious.[51] Reform in this area should only be introduced following a detailed review of the policy considerations for and against such a regime, including lessons learned from the introduction of such regime in other jurisdictions (the United States for example). A less controversial and potentially effective intervention would be the introduction of some regulatory support for the wider application of existing good whistleblowing program practice, of the kind already demonstrated by some top 20 ASX companies.

BLS Recommendations:

- Comprehensive review on whistleblowing laws
- Ensure consistency of treatment across whistleblowing laws
- Ensure reforms identify and provide regulatory support for existing good corporate whistleblowing practices

[48] See Senate Report Recommendations 12 to 16.
[49] Senate Report Recommendation 15.
[50] Senate Report Recommendation 13.
[51] Senate Report Recommendation 16.

ANNEXURE A – Report relating to outcome of survey on continuous disclosure infringement notice regime