ASIC
Australian Securities & Investments Commission

Productivity Commission: Review of Barriers to Business Entries and Exits in the Australian Economy

February 2015

Contents

Executive summary

1 ASIC is Australia's integrated corporate, markets, financial services and consumer credit regulator.

2 ASIC's fundamental objective is to allow markets to allocate capital efficiently to fund the real economy and, in turn, economic growth. Markets cannot achieve their fundamental purpose in funding the real economy if investors, financial consumers and issuers do not have trust and confidence in them. Making sure Australians have this trust and confidence is at the heart of everything we do.

3 To support our fundamental objective, we have three strategic priorities:

(a) Priority 1: Investor and financial consumer trust and confidence

(b) Priority 2: Fair, orderly and transparent markets

(c) Priority 3: Efficient and accessible registration

4 In meeting our strategic priorities, we carry out work in a number of areas including, importantly, facilitating business. We proactively look for ways to save businesses time and money across their entire life-cycle; from registration to winding-up or de-registration.

5 Accordingly, we welcome the opportunity to make a submission to the Productivity Commission inquiry into business set-up, transfer and closure. We have focused our submission on those issues which fall within ASIC's remit; namely, business set-up, financial market competition, market-based funding and business transfer and closure.

A Barriers to business set-up

Deregulatory initiatives: business set-up

Question 7

Are there specific examples where governments and/or regulators have reduced or removed the regulatory barriers to set up or acquire a business?

6 ASIC's mandate under the *Australian Securities and Investments Commission Act 2001* (ASIC Act) specifically requires us to strive to reduce business costs and administer the law effectively with a minimum of procedural requirements. We have recently made significant progress in reducing the burden of red tape for business and individuals to set up or acquire a business.[1]

7 The following ASIC initiatives are examples that have reduced or removed the regulatory barriers to business including starting up or acquiring a business:

(a) improving our guidance and communication, including the launch of a new online hub dedicated to small business;

(b) improving the AFS licence application process;

(c) simplifying business names registration; and

(d) issuing regulatory guidance and relief from the law to reduce the regulatory burden for business.

Online hub for small business

8 We recently launched a range of tools specifically designed for small businesses, including guides, newsletters, and a dedicated online hub.

9 The new online hub was launched in November 2013. The hub provides relevant information for small business operators in a format that is easy to access and understand. The hub includes 'one-minute guides' to various compliance topics, answers to frequently asked questions and acts as a signpost to more detailed information contained in other parts of our website. Small business owners can also subscribe to an eNewsletter, sent out on a quarterly basis. Since its launch, the small business hub has been accessed more than 13,000 times and the feedback from small business owners has been positive.

[1] We note that there are currently very few barriers to registering a company. For example, directors of a prospective companies are not required to provide proof of identify. In addition, directors are not subject to formal training requirements.

10 We have also released a practical guide about small business compliance obligations, *Your obligations as a small business operator*, which is available in hard copy and online. Approximately 10,000 hard copies have been distributed and the feedback from small business owners has been positive.

11 We have also recently launched our second Small Business Survey. While we undertake regular surveys of our regulated population, we appreciate that small business operators can have different experiences in dealing with us and complying with their obligations compared to other entities that we regulate. This survey will give a voice to small business operators and facilitate continuous service improvement in our interactions with these very important stakeholders.

Improvements to the AFS licence application process

12 In early 2012, we reviewed the AFS licence application and our internal process to assess applications for AFS licences. We amended the online licence application form by removing 46 questions and simplified the wording of a majority of the remaining questions.

13 We also removed some of the certifications required when submitting supporting documents and enabled applicants to submit the supporting documents to an email account rather than in hard copy. This means the 1,300 or so AFS licensees or potential licensees who use this form each year can use it more easily and more quickly.

14 We estimate that this initiative has saved more than 10,000 hours of compliance time each year for potential AFS licensees.

Simplification of business names registration

15 The Business Names Register, launched in May 2012, replaced eight state and territory systems and simplified business registration in Australia by offering a single online service to register, renew and search business names.

16 Businesses can apply to register or renew a business name online any time, including after business hours, and in most cases receive confirmation of their registration straight away. As a consequence, 99.9% of business name registrations are completed online and costs for registering a business name have come down.

17 There is also a joint process for registering for an Australian Business Number (ABN) and a national business name, the two most common registrations when starting a business. ASIC also introduced use of the AUSkey for our business name register. AUSkey is a single credential for businesses to use to log in when interacting with Government.

18 We estimate that ASIC's Business Names Register has already saved business over $79 million in reduced fees to register or renew business names, in its first two years of operation. We expect that it will save business over $209 million in its first five years.

Regulatory guidance and relief

19 As well as specific deregulatory projects, much of our business-as-usual work reduces the regulatory burden for businesses complying with the legislation we administer. For example, our regulatory guidance helps businesses comply with their obligations, and in many cases we have the power to grant waivers from the law to facilitate business.

20 For example, we updated *Regulatory Guide 107 Fundraising: Facilitating electronic offers of securities* to facilitate and encourage the use of the internet and other interactive media for making offers of securities. The updated policy benefits companies looking to raise capital quickly and gain market opportunities, and recognises that there are many advantages to using the internet and other electronic means to distribute disclosure documents and application forms (e.g. information can be easier to access, read and understand for investors).

Scaleable obligations

Question 9

How do these regulatory barriers differ with the size of the business? To what extent do these regulatory barriers provide incentives or disincentives for businesses to be set up in a particular form, for example as incorporated or unincorporated structures? Do differing regulatory barriers provide incentives or disincentives to setting up businesses in particular jurisdictions within Australia?

21 In our role as the financial services regulator ASIC does not take a 'one size fits all' approach to regulation. For example, ASIC acknowledges that there are many different kinds of Australian Financial Services (AFS) licensees providing a diverse range of financial services. Therefore, what a AFS licensee needs to do to comply with their general obligations under s912A(1) of the *Corporations Act 2001* (Corporations Act) will vary according to the 'nature, scale and complexity' of their business.

22 The 'nature, scale and complexity' of the AFS licensee's business includes factors such as:

(a) the products and services offered;

(b) the diversity and structure of the licensee's operations (including the geographical spread of their operations and the extent to which they outsource any of their functions);

(c) the volume and size of the transactions the licensee is responsible for;

(d) how many of the licensee's clients are retail and how many wholesale;

(e) whether the licensee gives financial product advice and, if so, whether it is personal or general advice;

(f) whether the licensee's main business is the provision of financial services; and

(g) the number of people in the licensee's organisation.[2]

23 For example, ASIC assess compliance with the organisational competence obligation under s912A(1) of the Corporations Act by looking at the knowledge and skills of the AFS licensee's responsible managers. The nature, scale and complexity of the AFS licensee's business will affect who the licensee can nominate as a responsible manager and how many the licensee will need.[3]

24 Similarly, the obligations imposed on credit licensees under the *National Consumer Credit Protection Act 2009* (National Credit Act) are scalable. For example, the National Credit Act (s47(2)) states that when considering whether compliance is adequate, the nature, scale and complexity of the credit activities that are engaged in by the licensee must be taken into account in relation to four of the general conduct obligations.[4]

Access to markets

Question 11

Which particular sectors have restrictive barriers to entry that exclude new set-ups and potential competitors and what is the nature of these barriers? To what extent are these barriers, in their current form, necessary to meet broader welfare objectives?

25 Competition has a fundamental role to play in ensuring the efficiency, integrity and growth of the financial system. When markets, participants and financial services providers compete vigorously with their rivals, conditions are optimal for efficiencies, innovations and cost savings to emerge,

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[2] See *Regulatory Guide 104 Licensing: Meeting the general obligations* for ASIC's guidance on what we look for when we assess compliance with the general obligations under s912A(1) of the Corporations Act.
[3] See *Regulatory Guide 105 Licensing: Organisational Competence*.
[4] See *Regulatory Guide 205: Credit Licensing: General conduct obligations* for ASIC's guidance on complying with the general conduct obligations under s47(1) of the National Credit Act.

encouraging confident and informed participation by investors and financial consumers.

26 However, competition policy has traditionally been applied cautiously within the financial system. Special features of financial markets and perceived tensions between competition and financial stability have been thought to require a cautious approach to the pursuit of competition.[5]

27 Attitudes towards the role of competition policy in the financial system have begun to change over the past two decades. In particular, views on the relationship between competition policy and financial stability have become more balanced. There is also now some empirical evidence to suggest that regulatory restrictions on competition do not benefit stability.[6]

28 The global financial crisis highlighted the need to reconsider the role of competition policy in the financial system. The Organisation for Economic Co-operation and Development (OECD) has observed that, in response to the global financial crisis, a 'number of government actions that may harm competition among financial firms have already occurred'.[7] Evidence from previous financial crises suggests that restrictions on competition policy and enforcement can interfere with the process of recovery.[8]

Consumer protection

29 While market problems such as informational asymmetries are a feature of many different types of markets, there are specific features of financial products and services that make informational asymmetries particularly difficult to overcome. This means that there is a higher risk than in most markets for mis-selling (i.e. that an investor or financial consumer will acquire a product not aligned with their financial situation, risk profile, objectives and needs) due to the investor or financial consumer's own choices alone, or as a result of the exploitation of informational asymmetries by service providers due to conflicts of interest or outright misconduct.

30 These factors may make it more difficult for competition to effectively operate in markets for financial services and products.

31 The importance of encouraging competition in the financial system as well as maintaining consumer protection can be illustrated by two examples:

(a) the introduction of competition in exchange markets (see paragraphs 32-38); and

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[5] Organisation for Economic Co-operation and Development (OECD), Competition and financial markets (DAF/COMP(2009)11), pp. 33 and 42.
[6] OECD, Competition and financial markets (DAF/COMP(2009)11), p. 42.
[7] OECD, Competition and financial markets (DAF/COMP(2009)11), p. 54.
[8] OECD, Competition and financial markets (DAF/COMP(2009)11), pp. 49–50.

(b) the regulation of the consumer credit market (see paragraphs 39-46).

Competition in exchange markets

32 The introduction of competition in exchange markets represents one of the most significant structural changes to Australia's financial system in recent years. Since its formation, ASX has held a virtual monopoly over exchange market services. In mid-2011, Chi-X Australia Pty Ltd (Chi-X) was granted a licence to operate an Australian financial market and commenced operation in October 2011 as an alternative trading venue for ASX-listed securities.

Note: Prior to the introduction of competition, responsibility for the supervision of markets was transferred from ASX to ASIC. In April 2011, ASIC published market integrity rules to provide a framework for competition in exchange markets and to regulate the operation of Chi-X.

33 Prior to the introduction of competition in exchange markets, the Government stated that:

> competition between financial markets operating in Australia is an important step in ensuring that Australia's financial markets are innovative and efficient, now and into the future.[9]

34 Following the Government's announcement, ASX substantially reduced fees in areas that would be subject to competition. Trade reporting fees have continued to be contested, resulting in significant fee reductions and delivering reduced costs to market participants.

35 Competition in exchange markets has helped to deliver new trading technology and innovative order and trade types. For example, ASX has launched Centre Point, which has captured a 5% market share, the PureMatch order book and has trialled intra-day auctions as an initiative to improve liquidity. Chi-X has introduced market-on-close orders and hidden orders in the central limit order book. These developments have benefited investors by providing new ways of transacting and, in some circumstances, offering better prices.

Note 1: ASX Centre Point orders offer execution at the prevailing mid-point of the national best bid and offer. Centre Point orders can only interact with other Centre Point orders or ASX sweep orders. ASX PureMatch is an alternative order book established by ASX to trade a subset of ASX-listed securities and targets investors and participants who are latency sensitive by offering a faster operating platform. The intra-day auction trial involved participating securities conducting scheduled auctions throughout the day to encourage liquidity to pool around auction periods with the aim of increased turnover.

Note 2: Chi-X market-on-close orders can only match against other market-on-close orders. They are available throughout the trading day yet the reference price is only

[9] The Hon Chris Bowen MP, then Minister for Financial Services, Superannuation and Corporate Law, Media Release No. 032, Government announces competition in financial markets, 31 March 2010.

determined by the ASX closing auction. Chi-X hidden orders are non-transparent orders that can interact with all Chi-X orders, both lit and other hidden orders.

36 ASIC appreciates that, at a practical level, the regulatory changes that accompanied the introduction of competition in exchange markets had a significant impact on the day-to-day operations of many businesses. Competition has also fragmented liquidity across the two markets, potentially making liquidity harder to find.

37 A report recently concluded that:

> [w]ith no change in market integrity and a positive change in market efficiency (both transaction costs and price discovery) [...] the introduction of competition has improved the quality of Australian equity markets. More specifically, the implicit benefits of these costs far outweigh the costs of competition, at least as compared to the monopoly provision of secondary securities market trading.[10]

38 The same report said that, for market participants alone, the net benefits of exchange market competition (e.g. reduced transaction costs and market spreads minus the costs associated with implementation) have been estimated at between $36 million and $220 million in the first year after the introduction of exchange market competition.[11]

Regulation of consumer credit

39 Australia's non-bank lending sector began emerging in earnest in the early 1990s. Largely relying on a funding model involving residential mortgage-backed securities (a form of securitisation), these lenders distributed their products through brokers. To a limited extent, banks began adopting a similar funding and distribution model in response to increasing competition from non-bank lenders. For consumers, this meant easier access to credit and lower borrowing costs.

40 The shift away from traditional models of lending resulted in an increase in the number of intermediaries (e.g. mortgage brokers and finance brokers) as new entities have required alternative distribution channels to compete with networks owned by ADIs. Many consumers use brokers to select and obtain a loan that suits their specific circumstances. This not only assists the consumer obtaining the loan, but can also benefit other consumers, through market competition, by ensuring that business is directed to credit providers whose loans better meet consumers' requirements.

41 The period leading up to the global financial crisis was characterised by strong competition among lenders for market share and high levels of

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[10] M Aitken, H Chen and S Foley, How beneficial has competition been for the Australian equity marketplace?, working paper, 2013

[11] M Aitken, H Chen and S Foley, How beneficial has competition been for the Australian equity marketplace?, working paper, 2013

available funds to lend. Lenders competed with one another using a mixture of increasing commission payments, product innovation and relaxed lending standards on some products. Resulting problems in this market were exacerbated by poor standards of conduct among under-regulated brokers, and included the churning of consumers among products to increase commissions, and high exit fees preventing consumers from exercising choice. These problems were sufficiently significant to require new regulation to address them.

42 Subsequent events have shown that some loans made during this period were unaffordable for the borrowers involved. The lending was, at least in that sense, excessive.

43 Before 1 July 2010, consumer credit was primarily regulated by the states and territories under the Uniform Consumer Credit Code (UCCC). The UCCC was developed before non-bank lending, securitisation and the use of brokers became common features of the residential mortgage market. As a result, it did not address many of the issues arising from these developments and, most particularly, it did not regulate the intermediary and advice role played by brokers.

44 In 2010, licensing and responsible lending obligations were introduced for lenders and intermediaries under the National Credit Act and primary responsibility for consumer credit regulation was transferred to ASIC. These reforms have gone a long way to addressing many of the issues that were prevalent in the credit industry before 2010.

45 Data collected by APRA shows that the responsible lending obligations have had a positive impact on the credit industry.[12] For example, since legislation implementing the credit reforms was first introduced and read into Parliament on 25 June 2009, the amount of new approved low doc loans issued by ADIs[13] declined 89.52% from approximately \$4.8 billion on 30 June 2009 to \$0.5 billion on 30 September 2013.[14] As a percentage of all new household loans approved per quarter, the proportion of low doc loans fell from 6.95% to 0.66% over the same period.

> Note: It is possible that the number of loans that are truly 'low doc' is even lower, as some loans include a verification component but are reported to APRA as low doc due to lenders' historical naming conventions.

46 The state of competition in the consumer credit industry remains dynamic. The period after the global financial crisis saw a marked reduction in non-

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[12] APRA, Quarterly authorised deposit-taking institution property exposures: September 2013, 26 November 2013

[13] By those ADIs with greater than \$1 billion of residential term loans between March 2008 and September 2013 (on average, capturing data on 26 entities per quarter).

[14] On the assumption that the introduction of the bill itself may have resulted in some behavioural modification and reduction in low doc loans by ADIs as they adjust their compliance frameworks before the requirements fully commenced on 1 January 2011.

bank lending activity. A number of non-bank lenders were unable to access the same level of funds through securitisation. Banks became increasingly active in the mortgage broking industry through outright ownership or significant shareholdings in some of the larger mortgage broking entities. With non-bank lenders now re-entering the mortgage market, competition for borrowers again appears to be increasing.

Access to finance

Questions 17 - 19

Are there changes that could be made that would make access to finance easier for business set-ups?

Are the existing regulatory settings able to incorporate and regulate new and innovative financing methods, such as crowd source funding and peer to peer lending, into Australia's financial system?

Are there other innovative financing methods that are excluded by the current regulatory settings?

How efficient are Australian security exchanges in providing start-up companies with access to debt and equity capital?

What reforms would improve access to capital and reduce costs?

Are there examples of superior practices in other countries?

47 Market-based financing is increasing and is now seen as a key source for funding business start-ups and, more broadly, economic growth. This structural change is being driven by:

(a) Increasing banking regulation internationally. New rules to strengthen the banking system internationally are imposing higher capital and liquidity requirements. The net effect of this is often decreased access to debt capital and an increased cost to business. As a result, many businesses are turning to market-based financing to source their funds.

(b) The growth of the pension and superannuation sectors, much of which is invested in debt and equity capital markets.

Note: market-based funding refers to the use of debt and equity capital markets and the funds management sector to raise capital – rather than traditional bank lending.

48 As market-based financing is one of the major ways to fund future economic growth, this makes securities regulation even more vital. In order for market-based financing to be effective, markets must be fair, orderly and transparent, and investors need to be confident and informed.

49 Emerging sources of funding often used by business start-ups include:

(a) crowd funding; and

(b) peer-to-peer lending.

More traditional sources of funding for business include debt and equity market funding. These sources of funding are considered in further detail below.

Crowd funding

What is crowd funding?

50 Crowd funding refers to the raising of funds from a large number of people using the internet and social media. Typically, the amount of funds raised from each person is relatively small. The use to which the funds are put and the 'reward' for contributing will vary depending on the type of crowd funding being undertaken. Common categories of crowd funding include:

(a) donation based – funds raised are used for charitable, community based or artistic ventures and participants generally contribute for altruistic purposes.

(b) pre-purchase of goods/services – funds raise are used to produce goods or services, typically a new product or service. Participants contribute as consumers to obtain the product or service once produced; and

(c) crowd sourced equity funding (CSEF) – funds are raised typically by entrepreneurs or start-up companies to help establish their business. Participants, who are typically small investors, receive equity in the company in return for their contribution. CSEF is most likely to be regulated by ASIC.

What are the risks of crowd funding?

51 CSEF raises a number of risks, including:

(a) Fraud – the risk that money raised is not used for the intended project. It could also involve CSEF website being used fraudulently to obtain funds from investors.

(b) Failure – the risk of start-ups failing due to mismanagement, poor business models or misadventure, notwithstanding the business operator's good intentions. This risk is more significant for CSEF funded start-ups because the business model is typically unproven, the operator may lack experience and may not have been able to raise funds more traditionally from a bank, angel investors or elsewhere due to the high risk nature of the venture or poor creditworthiness.

52 Other risks to investors include a lack of liquidity, the difficulty of valuing assets due to the lack of transparency and non-traditional business models involved in CSEF. These risks may be amplified by the lack of knowledge

and experience that investors need to assess the suitability of the CSEF investments.

How is crowd funding regulated?

53 The current Corporations Act settings for fundraising were developed before CSEF emerged as a potential new source of funding for business. Accordingly, ASIC provided guidance, in August 2012, on how CSEF would be regulated under the current regulatory regime. According to the guidance, depending on the CSEF business model adopted, the promotor or issuer could be required to:

(a) provide a prospectus or offer information statement and meet the ongoing corporate governance and financial reporting requirements for an unlisted public company; or

A proprietary company structure may not be suitable for CSEF because a proprietary company may have no more than 50 non-employee shareholders and is generally prohibited from engaging in any public offer of its equity or other securities.

(b) hold an appropriate AFS licence authorisation, register a managed investment scheme and provide investors with disclosure documents including a Financial Services Guide and a Product Disclosure Statement.

54 The operator of the CSEF website may require an Australian market licence or an AFS licence.

55 Some argue that the current law imposes prohibitive compliance obligations and costs on issuers/promoters and operators of CSEF websites and that a stand-alone regime, designed to facilitate CSEF, should be implemented in Australia (as has occurred in New Zealand, the United States, the United Kingdom and Canada (Ontario).

56 The appropriate regulatory regime for CSEF is currently the subject of consideration by the Government and the International Organisation of Securities Commissions (IOSCO).

57 In 2013, the Government requested that the Corporations and Markets Advisory Committee (CAMAC) review the regulatory settings for CSEF in Australia. CAMAC reported to Government in May 2014. In December 2014, the Government released a Discussion Paper, *Crowd Sourced Equity Funding*, seeking feedback on proposals for a regulatory framework to facilitate the use of CSEF (and crowd sourced debt funding) in Australia. ASIC made a submission in response to the Discussion Paper, which is **attached**.

58 The Government is also considering its response to the final report of the Financial System Inquiry, which recommended that:

Government continue its current process to graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.

59 In February 2014, IOSCO published a Working Paper, *Crowd-Funding: An Infant Industry Growing Fast,* which provided an overview of:

(a) the key benefits and risks of CSEF; and

(b) the regulatory regime in different jurisdictions.

Peer to peer lending

What is peer to peer lending?

60 Peer to peer (P2P) lending platforms are developing as a form of investment (for both retail and wholesale investors) and as a source of credit for consumers and small business.

61 P2P businesses generally operate by providing an online platform through which:

(a) potential borrowers register an offer to borrow specifying the amount, and in some cases the acceptable interest rate (e.g. best available rate or a specified lower rate);

(b) investors register an interest in investing funds and specify the interest rate at which they are willing to lend; and

(c) the platform matches the loan offers with one or more investors to fill the loan amount sought.

62 There are two main investment models used for P2P platforms:

(a) collective investments under which the operator of the platform contracts with both the investors and the borrowers, and enters the loans as the credit provider (as trustee for the investors that have contributed to the loan);

(b) direct loan agreements between the borrower and investor or investors, under which the investor is the credit provider (the platform operator acts as agent for the investors in entering into the contracts to preserve anonymity between the borrowers and investors).

How is peer to peer lending regulated?

63 If operated using the collective investment model, P2P platforms are likely to require registration of a managed investment scheme, an AFS licence and a credit licence.

Note: www.ratesetter.com.au was launched in Australia in 2014. Ratesetter operates using a managed investment scheme structure, which allows investors to invest in the scheme that lends the invested money to retail consumers. Ratesetter holds an AFSL and a credit license.

64 If operated using a 'direct loans' model, the investors will be credit providers, and may be required to hold a credit licence if they meet the business test in the National Credit Code.

Note: In Phase 2 of the credit reforms, amendments have been considered to extend the licensing exemption that applies to securitisation entities so that it will also cover 'credit activity investors'. This exemption contains a requirement that the credit provider be a member of an external dispute resolution (EDR) scheme to ensure that consumers continue to have access to contract-based remedies through EDR. FOS has raised concerns about this requirement in the context of credit providers who have a 'retail profile'.

If small amount credit contracts are offered in this context, provisions in relation to these contracts will need to be considered (e.g. presumption of unsuitability where a single loan amount is constituted by more than one credit contract that is more expensive).

65 If the platform is facilitating debt financing of small business by issuing debentures that are then offered to investors through the platform the operator may be required to hold an Australian Market licence. Depending on whether the operator has an ongoing role after the debentures are issued, for example in relation to payment instalments or bad debt recovery, it may also be regarded as operating a managed investment scheme.

66 To the extent that regulatory reform is considered necessary to facilitate P2P (and CSEF) lending to business in Australia it is important for the new regulatory settings to appropriately balance the need of issuers, website operators and investors.

Debt market financing

What are debt markets?

67 Debt markets allow debt instruments to be traded (i.e. instruments that require a fixed interest payment to the holder). Debt markets provide a mechanism for companies to retain funding that does not dilute their equity.

68 Australia’s corporate bond market has been active since the early 20th century. As at June 2013, in the Australian retail market, $300 million of corporate bonds were on issue. In the international wholesale market, Australian corporate entities had bonds worth $612.4 billion on offer.[15] However, corporate bonds represent only 0.1% of the total fixed interest securities listed on the ASX and only 0.8% of the total private sector fixed interest securities listed on the ASX (as at June 2013).

[15] Bank for International Settlements, *BIS Quarterly Review*, December 2013, www.bis.org/publ/qtrpdf/r_qt1312.htm.

69 The development of a deep and more liquid corporate bond market has the potential to assist businesses (by allowing them to diversify funding sources) and investors (by providing them with access to direct investment in fixed interest securities).

Further development of the bond market: is regulatory change required?

70 A key impediment to the development of a deep and more liquid corporate bond market is the willingness of companies to issue bonds in the domestic bond market. This is driven by the cost and availability of bank loans, which compares favourably to the cost of issuing bonds.

71 Banks may have better knowledge of a company's financial profile and may, therefore, be better able to assess the risk involved; investors, without that knowledge, may require a higher rate of return. In addition, in an environment where there is reduced demand for external funding, bank loans with low interest rates may be considered more attractive to companies than issuing bonds.

72 Other impediments include:

(a) international debt markets, which continue to be an attractive and competitive source of debt funding for domestic companies that may otherwise rely on issuing bonds in the domestic market; and

(b) tax arrangements that are neutral or favour equity investments over debt, such as the availability of franking credits.

73 These impediments are therefore unlikely to be resolved simply through changes to the regulatory framework.

Reduced disclosure for simple corporate bonds

74 The Australian Government has sought to stimulate the corporate bond market by passing the *Corporations Amendment (Simple Corporate Bonds and Other Measures) Act* 2014, which streamlines the disclosure regime for simple bonds.

Simple Corporate Bonds

The *Corporations Amendment (Simple Corporate Bonds and Other Measures) Act* 2014 and associated Regulations commenced on 19 December 2014, aimed at developing the retail corporate bond market in Australia. The key measures of the amendments include introducing a streamlined disclosure regime for simple corporate bonds and removing the presumptive civil liability for directors of issuers of simple corporate bonds under a defective prospectus.

Streamlined disclosure

Simple Corporate Bonds

Offers of simple corporate bonds to retail investors will be subject to a new two-part prospectus regime (consisting of a base prospectus and an offer-specific prospectus) instead of a full prospectus.

The base prospectus will contain general company information. It will be valid for three years and must be available on the issuer's website for the whole of that time. It will not be required to be updated; and

The offer-specific prospectus will be issued for each new offer of bonds. It must outline the key details of the offer and may modify or supplement the base prospectus. It will have an expiry date, which must be no later than 13 months after the date the document is lodged with ASIC, and must be available on the issuer's website during the offer period.

Simple corporate bonds

To be considered 'simple' the debt securities must satisfy certain criteria, including that:

- the securities are quoted on a prescribed financial market (e.g. ASX);
- the fixed term of the securities does not exceed 15 years; and
- the securities meet certain conditions about repayment, interest rates and payment of interest.

75 Some argue that disclosure requirements should be further reduced, and that listed issuers should be able to issue corporate bonds directly to retail investors without the need for a prospectus. This is akin to the s708AA prospectus exemption (see paragraph 92).

76 While listed issuers generally keep the market well informed through continuous disclosure, there are relevant distinctions between the current provisions for rights offerings and the policy option of extending such a regime to corporate bonds. These differences heighten risks associated with offering retail bonds without a prospectus. These differences are as follows:

(a) *Rights offerings are to existing shareholders, whereas bond offerings would be to new retail investors.* Existing shareholders have a history with, and a level of knowledge about, the issuer and the particular security, because they already hold that security. New retail investors would have no prior knowledge of the security or the issuer.

(b) *Rights offerings are of a class of equity securities that are already in the market and already have a market price.* An offering of bonds to retail investors would be a new offering and there would not be a market price for that product. Disclosure documents are useful because they bring together all relevant information about a security for market participants to assess in determining what price they are willing to pay for that security.

(c) *The continuous disclosure regime is, in practice, focused on announcements relevant to the value of equities.* While an issuer's obligations under the continuous disclosure regime apply not only to listed equity securities, but also to listed and unlisted debt securities, continuous disclosure announcements are typically framed to highlight the potential impact on the market price of the issuer's ordinary shares.

Most information that could affect the price of an issuer's ordinary shares will also affect the price of its debt securities. However, the assessment of materiality for each purpose is different. It cannot be assumed that all material information disclosed under ASX Listing Rule 3.1 will necessarily include all information that is material to the price of debt securities.

Note: ASX Listing Rule 3.1 provides that once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information.

77 ASIC considers that reducing or eliminating minimum disclosure requirements for corporate bonds will disproportionally increase the risks to investors with marginal benefits to issuers. Retail investors would struggle to assess the issuer and the security without a disclosure document; information available through continuous disclosure (and presumably supplemented by a cleansing notice) is diffuse and much more difficult to assess.

78 The Australian Government has sought to stimulate the corporate bond market by passing the *Corporations Amendment (Simple Corporate Bonds and Other Measures) Act* 2014, which also streamlines the disclosure regime for simple bonds.

Equity market financing

What are equity markets?

79 Equity markets facilitate the issuing and trading of equity (i.e. shares), allowing companies to raise funds to conduct their business and investors to own a part of a company, with the potential to realise gains based on the future performance of the company or from trading the shares. Equity markets are an important part of the economy as they allow a company to acquire funds without incurring debt.

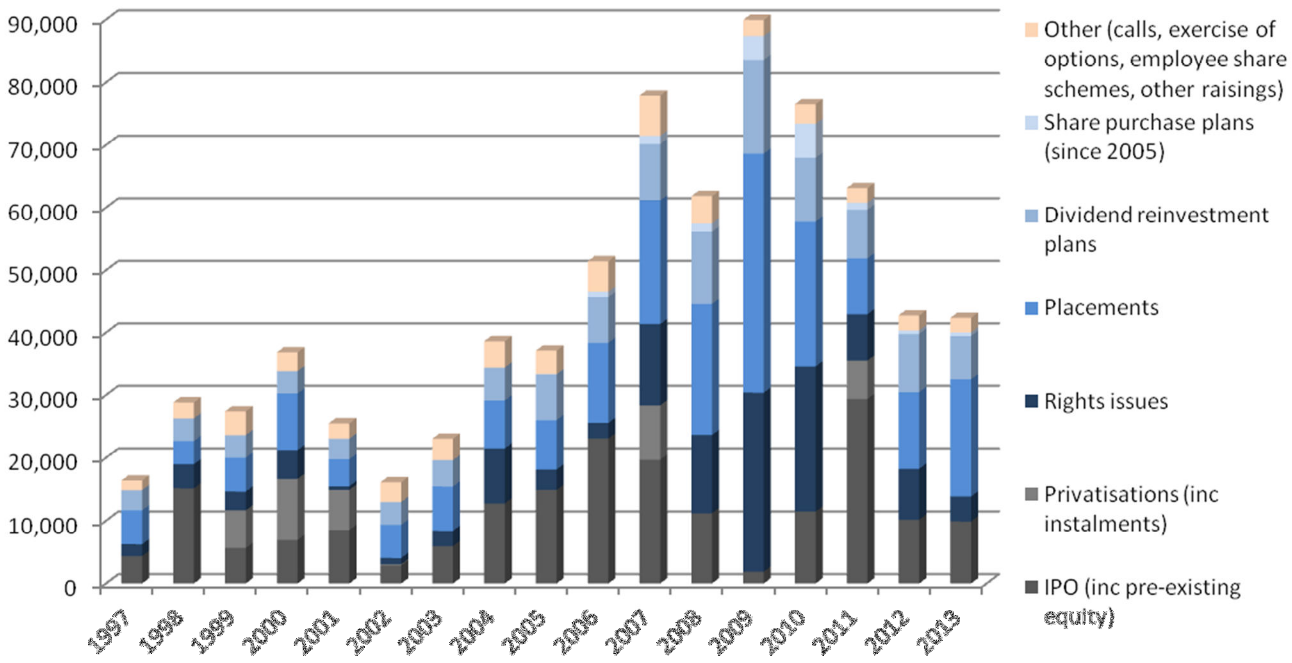
80 Australia enjoys a robust equity market that compares favourably with international markets in terms of comparative size and capacity to raise capital.

Equity markets: funds raised

81 Equity markets are an important source of funding for Australian companies and economic growth. Figure 1 shows the total value of securities quoted on ASX in connection with both initial public offerings and secondary capital raisings between the 1997 and 2013 financial years by method of raising.

Note: The ASX Group is the dominant exchange market group in Australia in terms of overall activity. On 30 June 2013, there were 1,989 companies listed on the ASX with quoted securities.

Figure 1: Value of initial public offering and secondary capital raised on ASX (financial years 1997–2013) ($m)



Source: AFMA Australian Financial Markets Reports 2001–2013 (based on ASX data).

82 Secondary capital raisings by listed entities played a particularly important role in securing funding for domestic companies during the global financial crisis, a time of dramatically tightening conditions and uncertainty in wholesale debt and credit markets. Australia's relatively flexible framework regarding the method of raising secondary capital has been cited as a significant contributor to the ability of equity markets to address capital needs during this period.

Regulation of equity markets: opportunities for reform?

83 The increased share of household wealth linked to equity markets underscores the importance of ensuring investors are adequately informed when making investment decisions and have confidence that markets operate fairly and efficiently. A high standard of integrity in the financial markets on which equity is quoted is vital to maintaining confident investor participation in the market and, in turn, enabling business to reliably access equity capital at the lowest possible cost.

84 Regulatory requirements in the Corporations Act and market listing and integrity rules aim to:

(a) promote investor and financial consumer trust and confidence; and

(b) ensure fair, orderly and transparent markets

Relaxing the disclosure document requirements

85 As a general rule, if a public company wants to raise funds by offering securities (e.g. shares) for sale, it must provide a disclosure document of some sort to potential investors.

There are three types of disclosure documents: a prospectus, an offer information statement and a profile statement. A prospectus is the standard disclosure document and has the broadest information requirements.

86 Some argue that the requirement to prepare a prospectus may discourage some small- and medium-sized enterprises from seeking equity financing.

87 However, ASIC considers that lowering the standard of disclosure required for capital raisings would be unlikely to significantly stimulate equity investment in smaller companies, for a number of reasons:

(a) *Prospectuses have multiple purposes*—Issuers will often consider it necessary to provide a level of up-to-date information that is generally similar to that required under the short-form prospectus to:

(i) ensure investors have confidence that they have been given all material information relating to the investment decision, in order to encourage participation in the offering and enhance and protect their corporate reputation; and

(ii) take advantage of relevant due diligence defences available under the prospectus regime.

(b) *Flexibility of the current prospectus regime*—The existing prospectus regime already allows ASX-listed small- and medium-sized enterprises to adapt their disclosure documents to reflect the commercial circumstances of the offering. For example, a prospectus is not required where securities are sold to sophisticated investors.

(c) *Preference for prospectuses*—ASIC's internal figures indicate that, in the 2013–14 financial year, 62% of all disclosure documents lodged with ASIC were aimed at raising less than $10 million (this number falls to 49% when compliance prospectuses are excluded). Offer information statements made up less than 10% of these disclosure documents. This suggests that the requirement to prepare a prospectus is not disadvantaging companies wishing to undertake small-amount equity raisings.

Table 1: Prospectuses lodged in 2013–14

	Prospectus	Offer information statement
Number relating to offers to raise <$10m	292	30

	Prospectus	Offer information statement
Number relating to offers to raise >$10m	532	N/A

Note: This table excludes disclosure documents lodged with ASIC that do not seek to raise funds under the documents (e.g. compliance prospectuses).

88 ASIC considers that that the risks of further lowering the standard of disclosure required for capital raisings (principally, a lower level of protection for investors) may be disproportionate to the benefits associated with such a change (marginally decreasing the costs associated with conducting a successful fundraising).

89 One option for lowering the standard of disclosure required for capital raisings is to increase the thresholds for using an offer information statement or changing the content of an offer information statement (e.g. by excluding the requirement for financial reports).

> An offer information statement (OIS) has lower disclosure requirements but can only be used for fundraising up to $10 million in aggregate; that is, including any earlier fundraising under an OIS. If a company wants to use an OIS it must include with it a copy of an audited financial report with a balance date within the last six months.

90 A further option for lowering the standard of disclosure required for capital raisings is to extend the 20/12 exemption.

> Under the 20/12 exemption, a prospectus is not required where the offering is limited to 20 people in 12 months up to a value of $2 million, or for offers of up to $10 million with an offer information statement[16].

91 Extending the 20/12 exemption may have unintended consequences though; in particular, it may undermine the objective of the s708AA prospectus exemption in the Corporations Act.

> Note: Under the 20/12 exemption, a prospectus is not required where the offering is limited to 20 people in 12 months up to a value of $2 million, or for offers of up to $10 million with an offer information statement: s708(1).

92 The s708AA exemption allows an entity to forgo preparing a prospectus for rights offerings in circumstances where a cleansing notice has been given to the relevant market operator. A cleansing notice contains information regarding the potential effect of the rights issue on the control of the issuer and the consequences of that effect. It also contains all information previously withheld from disclosure to investors on the basis of exceptions to the continuous disclosure obligations contained in ASX Listing Rule 3.1A.

93 The objective of the s708AA prospectus exemption is to encourage the use of pro rata offerings by allowing offers to existing shareholders under a

[16] s708(1) of the *Corporations Act 2001*.

cleansing notice. This objective may be undermined if the 20/12 exemption is extended—that is, if (on the basis of limited or no disclosure) more money can be sourced from more persons, who are not necessarily existing shareholders.

Multi-tier listing

94 Some jurisdictions (including the UK[17] and China – see below) have sought to cater for the financing needs of small and medium sized enterprises (SMEs) by developing multi-tier capital markets.

95 A multi-tier capital market is an exchange market which consists of different 'boards' catering to enterprises of different size, quality and risk profiles. The aim of this structure is to facilitate capital raising by SMEs and development projects and to cater to investors with varying risk appetites.

96 Typically, regulatory standards for the SME and development boards of these markets are reduced. For example, lower entry criteria, financial requirements and disclosure standards may apply to listing entities of these boards and to those seeking entry. A corollary of this is that access may be limited to certain classes of investors e.g. sophisticated investors, who are more likely to be aware of the risks associated with investing in less mature markets.

China's multi-tiered capital market structure

China has developed a relatively comprehensive multi-tier capital market structure consisting of a number of different boards, including:

- SME board – established in 2004 as an independent part of the Main Board of the Shenzen Stock Exchange (SZSE). The SME board has the same entry criteria as the main board and mainly caters to companies in a relatively mature stage of development. Manufacturers account for 75% of the companies listed on the SME board;[18]
- ChiNext – established in the SZSE in 2009, this board caters to innovative and high-growth businesses in a wide range of areas (e.g. technology, management processes and business models) and has lower entry criteria than the Main Board, although quality requirements remain;[19]
- 'Third board' – formerly known as the National Equities and Exchange Quotations, the Third Board (so-called because it is China's third national equity exchange after the Shanghai and Shenzhen stock exchanges) was started as a regional pilot in 2012 and expanded nation-wide in 2013. The third board offers services for innovative, start-up or growing micro, small and medium-sized

[17] AIM is the London Stock Exchange's international market for smaller and growing companies. It was launched in 1995, see: http://www.londonstockexchange.com/companies-and-advisors/aim/aim/aim.htm
[18]Shenzhen Stock Exchange, 'Listing Q & A', <http://www.szse.cn/main/en/ListingatSZSE/ListingQA>/
[19]Shenzhen Stock Exchange, 'Listing Q & A', <http://www.szse.cn/main/en/ListingatSZSE/ListingQA>/

enterprises. It is also the only OTC market regulated by the China Securities Regulatory Commission. Access is restricted to qualified investors; and

- regional equity markets – these market provide equity and bond financing for local enterprises, especially micro, small and medium sized enterprises.

97 In Australia, we do not currently have different boards within the one market. The ASX has previously considered and decided against operating a second board for smaller companies.

98 Other Australian exchanges, such as APX and NSX, apply different listing requirements regarding the financial size of the entity, so in that respect they could be said to serve a similar to that of a second board (although in other respects their listing rules are similar to the ASX so there are no lower on-going requirements).

B Barriers to business transfer and closure

99 ASIC's comments are confined to the questions that relate to ASIC's responsibilities. The Australian Financial Security Authority, the regulator of the personal insolvency regime, is better placed to comment on barriers to the transfer and closure of business conducted by individuals.

Background

100 A well-functioning financial system should provide for an efficient process of corporate external administration to facilitate the reallocation of scarce resources to those who can better use them.

101 Any changes to the law to facilitate corporate rehabilitation or business transfer/closure should consider that issues impacting large proprietary and public companies are different from those impacting small enterprises where often there is not a viable business worth saving. For these small failed companies, an effective streamlined system of external administration is needed which minimises cost and maximises the return to creditors while at the same time deterring misconduct.

102 One observer identified a number of behavioural differences between directors of large proprietary and public companies and those of small to medium corporations.[20] These are outlined below.

103 In general, large proprietary and public companies:

(a) have independent directors who have limited, if any, personal financial exposure to the business in the event of financial failure (but who face damage to reputation);

(b) have ready access to external experts and internal resources to inform and advise them;

(c) are subject to greater public scrutiny and reporting;

(d) often have significant exposure to banking syndicates; and

(e) have directors who are more likely to be aware of their duties and responsibilities, seek advice and act quickly to mitigate personal reputation risk in circumstances where the company is approaching financial distress.

104 In general, small companies:

(a) are funded or capitalised through directors who have provided personal assets as security for the company's borrowings;

[20] Parbery, Stephen, *Assessing voluntary administration in Australia: including suitability for workouts, turnaround and pre-packs, 2010,* Paper written for the 2010 Supreme Court Annual Corporate Law Conference.

(b) have directors who are personally exposed in the event the company fails;

(c) have directors who often have limited business education and access to internal or external advisors and experts to guide them; and

(d) have financiers who, due the size of the exposure, often show limited interest in the ongoing financial position of the company and rely on real property given by the directors as security for loan facilities.

105 Policy settings should enable reasonable risk taking to facilitate the reorganisation or reconstruction of large proprietary and public companies. However, for smaller enterprises, a streamlined process is needed to minimise cost and maximise the possible return to creditors.

106 The Financial System Inquiry Final Report noted that submissions to the FSI indicated that Australia's corporate external administration provisions work well and do not require wholesale revision. The final report recommends the Government consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial distress.[21]

Question 28

To what extent do the existing insolvency arrangements facilitate or hinder business closure? Are these arrangements a disincentive to business set-up? How do these arrangements affect the choice of business structure?

107 Subject to our comments below, ASIC is not aware of evidence that suggests the existing insolvency arrangements directly hinder business closure or are a disincentive to business set-up. Current law:

(a) facilitates a director readily commencing a formal external administration (either a voluntary administration or creditors voluntary winding up). Such appointments can be made relatively quickly. However, if the company has limited assets, a registered liquidator may require an indemnity for costs before consenting to act. This might act to inhibit or delay formal appointments;

(b) gives standing to a creditor who is owed money to apply to court for an order winding up a company. However, applying to court for the appointment of a liquidator can be a lengthy and expensive process with no certainty of a return; and

(c) provides a framework to regulate the conduct of a controller appointed by a creditor with a security interest in property of the company.

108 ASIC is aware of the following issues that are claimed to hinder business transfer or closure:

[21] Commonwealth of Australia 2014, *Financial System Inquiry: Final Report*, November 2014; p.265

(a) the claimed severity of our insolvent trading laws;

(b) destruction of value by *ipso facto* clauses;

(c) a lack of formal pre-pack regulations;

(d) the inability to bind third parties in the voluntary administration process; and

(e) the lack of a streamlined external administration process for small business in financial distress.

109 ASIC, in principle, considers these matters worthy of further consideration but notes they have proved contentious in the past.

Insolvent trading laws and the lack of a 'safe harbour'

110 Concerns have been raised that our insolvent trading laws impede restructuring, or the efficient transfer of a business or its assets, thereby destroying value.

111 A director has a duty to prevent insolvent trading. Failure to do so may result in personal liability for the debts incurred. Current insolvent trading laws are designed to ensure directors:[22]

(a) actively monitor the company's affairs;

(b) seek advice when there are signs of financial distress; and

(c) act in a timely manner on the advice received.

112 The appointment of an external administrator protects the directors from personal liability for insolvent trading. It has been argued that these laws may cause companies to be placed into external administration, (in circumstances where external administration is not appropriate), because directors fear personal liability if the company incurs new debts while they attempt a restructure or a transfer of the business. This may be the case for large proprietary and public companies but may not be true for small enterprises where the director, arguably, has "nothing more to lose" by continuing to trade and the cost to bring an action for insolvent trading is often prohibitive.

113 Further, it is arguable that insolvent trading laws act as a disincentive to business set-ups because they negatively impact on the willingness of directors to engage in entrepreneurial activity.

114 Conversely, the insolvent trading laws have a legitimate policy objective aimed at promoting economic activity by protecting the interests of creditors and, therefore, the cost and availability of credit.

[22] Regulatory Guide 217 *Duty to prevent insolvent trading: Guide for directors*; *Corporations Act 2001*: Section 588G

115 In January 2010, the Government released a consultation paper, *Insolvent trading: A safe harbour for reorganisation attempts outside of external administration*. The paper set out the advantages and disadvantages of informal workouts, in the context of Australia's insolvent trading laws. The paper consulted on three options for reform: (a) no change to the current law—that is, directors must ensure that there company is solvent while attempting to reorganise outside of external administration; (b) a modified business judgement rule in respect of a director's duty to avoid insolvent trading; and (c) a moratorium, which directors could invoke, from the duty not to trade while insolvent while they conducted an informal workout.

116 The Government determined not to proceed with a change of law primarily because of a lack of empirical evidence demonstrating a need for a change of law (see paragraph 139 for a discussion of safe harbour reforms). ASIC acknowledges the difficulty in obtaining empirical evidence due to, at the least, a desire of parties not to publicly disclose that particular entities faced financial distress and underwent restructuring.

Ipso facto clauses

117 An *ipso facto clause* in a contract allows one party to terminate the contract upon the insolvency of the other. It is argued that *ipso facto* clauses in contracts hinder business restructuring, or the efficient transfer of a business or its assets. The issue of *ipso facto* clauses forms part of the wider issue of the extent of any moratorium on creditors enforcing rights when a company might become, or is, insolvent.

118 The inclusion of an *ipso facto clause* in a contract means that a viable but financially distressed company which enters into a voluntary administration to maximise the chances of the company, (or as much as possible of its business) continuing in existence, would be in default allowing a party to terminate the contract. The contract may be with a critical trade supplier or financier meaning that there may no longer be a business to restructure or an opportunity to organise a sale of business.

119 The 2004 CAMAC Report, *Rehabilitating large and complex enterprises in financial difficulties* and the 2004 PJC *Report Corporate insolvency laws: A stocktake,* comprehensively cover the arguments for and against a moratorium on *ipso facto* clauses.

Lack of pre-pack asset sales

120 Australia lacks formal 'pre-pack' regulations that may assist in a quick and less costly transfer of a viable business or maximise the sale value of assets. A 'pre-pack' is an arrangement to sell a company's assets and business before the company enters formal external administration. The external administrator carries out the sale following their appointment. The United

Kingdom and the United States have laws or standards governing pre-pack arrangements.

121 Table 2 and Table 3 summarise the claimed advantages and disadvantages.

Table 2: Advantages of pre-pack asset sales

Reduces cost	The procedure may result in a quick and less costly transfer of a viable business.
Preserves value	The business has a better opportunity to maintain goodwill as a sale is negotiated without the stigma of insolvency. Value is also potentially preserved through not triggering *ipso facto* clauses.
Preserves limited funds	In circumstances where the company has little funds available for the costs of trading on in the context of external administration, it might be that such transfers avoid an immediate winding up.
Avoids regulatory hurdles	Some businesses (e.g. building companies), are subject to state-based regulations which make the transfer of the business difficult within the terms of the formal external administration procedures. A pre-pack procedure can preserve the value of the business by avoiding formal insolvency arrangements and transferring the relevant licence prior to an appointment being made.

Table 3: Disadvantages of pre-pack asset sales

Lack of transparency for unsecured creditors	Trade creditors often don't know that a sale of the business is underway and can't take steps to minimise their exposure. There can be a suspicion that the external administrator, appointed by directors, favours the interests of directors and secured creditors.
Lack of scrutiny and approval	The Corporations Act does not recognise or regulate pre packs. The Corporations Act provides for business preservation through the voluntary administration and deed of company arrangement process, which provides for creditor scrutiny and approval.
Market for assets not fully tested	A pre-pack sale may not offer the assets widely for sale- say by public auction- and assets are often purchased by related entities. A sale not at arm's length can adversely affect creditor confidence that the sale is in their best interests.
Illegal phoenix facilitation	Pre-pack sales are frequently viewed with suspicion as being a step toward asset stripping a company to re-emerge debt free without creditor sanction and with creditors receiving little or no return.
Conflict of interest	Frequently, the administrator eventually appointed to the company is suspected of assisting the formulation of the pre pack procedure to favour interests other than those of creditors

Open to abuse	Management might plan a pre-pack with a view to maintaining control of the company without properly marketing the assets for sale at full value and failing to provide all of the funds received to the external administrator for the benefit of unsecured creditors

122 ASIC notes the findings of the Graham report[23] in the United Kingdom which found that "pre-packs" did have cost advantages over formal administrations. The report referred to empirical research conducted at the University of Wolverhampton which noted that:

(a) in the majority of cases they reviewed involving a "pre-pack" creditors received no distribution. When distributions were made, they were generally small; and

(b) there was a high failure rate in the new business following the "pre-pack" sale; particularly where the sale of the company's business was to a related party or the purchase price involved deferred consideration.

123 ASIC also notes that, if the law supported a wider creditor moratorium encompassing restrictions on *ipso facto* clauses, the need for pre-pack arrangements diminishes given the moratorium would likely preserve the value said to be lost because of the lack of a pre-pack regime.

Binding third parties

124 The inability of voluntary administrations and deeds of company arrangement to bind parties who are not creditors of the company and bind a creditor to give up a claim against a third party inhibits restructuring.

125 In *Lehman Brothers Holdings Inc v City of Swan* [2010] HCA 11, the High Court confirmed that creditor' claims against persons other than the company the subject of a DOCA cannot be released or extinguished by the deed. That is, Part 5.3A of the Act directs attention to the relationship between the subject company and its creditors only.

126 In *Re Opes Prime Stockbroking Limited (receivers and managers appointed)(in liquidation)* VID 222 of 2009, Finkelstein J approved schemes of arrangement which had the effect of binding creditors in relation to debts owed by persons other than the company. This was subsequently challenged in *Fowler v Lindholm* 178 FCR 563 and the Federal Court of Australia decided that a scheme of arrangement under Part 5.1 of the Act could bind creditors in relation to debts owed by persons other than the company.

[23] Graham Review into Pre-pack Administration: Report to The Rt Hon Vince Cable MP; June 2014

Streamlined process for small business

127 ASIC is aware of the view that the statutory reporting and process obligation imposed on liquidators may not be appropriate for small business. It is argued that the increased costs of liquidation erode or eliminate the assets of a small business. Proponents of this view argue that a streamlined process should be introduced for small business.[24]

128 The statistics set out in Appendix 1 (Table 5) show that the vast majority of external administrations in Australia involve small to medium size enterprises.

129 Further, these statistics - on companies entering into voluntary administration and those that execute a deed of company arrangement - show that many companies that enter voluntary administration end up in liquidation. This is supported by research[25] which shows that a large majority of companies entering into voluntary administration end up being wound up. This raises a question whether the voluntary administration process is achieving its policy objectives.

130 ASIC observes that many of the companies in external administration involve minimal assets, low numbers of employees and relatively small deficiencies. This suggests that, generally, small to medium size enterprises are not candidates for restructuring because there is not a viable business worth saving. It also suggests a low level of complexity in externally administering many of these companies. However, that is not to say that complex matters of law and commerce do not arise.

131 In principle, ASIC considers there is merit in reviewing options for streamlining external administrations for small to medium size enterprises, including a review of fee-setting mechanisms for registered liquidator remuneration: see paragraphs 157- 161.

132 ASIC supports a streamlined system that minimises costs and maximises the return to creditors while at the same time deterring misconduct. However, ASIC would be concerned if a streamlined liquidation process was introduced at the expense of liquidators properly performing their important function as gatekeepers of the financial system; for example, detecting and reporting on directors and others who engage in illegal phoenix activity, which can harm small business. Illegal phoenix activity is said to cost the Australian economy between $1.78 billion and $3.19 billion per annum.[26]

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[24] See for example Australian Restructuring Insolvency and Turnaround Association, *A Platform for Recovery 2014 Dealing with Corporate Financial Distress in Australia: A Discussion Paper at p. 23.*
[25] Wellard, M; *A sample review of Deeds of Company Arrangement under Part 5.3A of the Corporations Act*, May 2014
[26] PricewaterhouseCoopers, *Phoenix activity: Sizing the problem and matching solutions report for the Fair Work Ombudsman,* June 2012, piii.

Winding up of managed investment schemes

133 ASIC notes the complexity of the current framework for how the affairs of managed investment schemes may be externally administered. This has been subject to a number of reviews and inquiries.[27]

134 In March 2014, CAMAC released a discussion paper, *The establishment and operation of managed investment schemes*. In the discussion paper, CAMAC canvasses whether:

(a) takeover laws applying to companies and listed schemes should be extended to large unlisted schemes, and asks if there should be a statutory procedure for reorganising schemes similar to that used for company restructures under Pt 5.1 of the Corporations Act; and

(b) liquidators should have a statutory right to claim remuneration and expenses for their work in winding up a scheme. CAMAC continues to support the introduction of voluntary administration procedures for insolvent schemes comparable to Pt 5.3A of the Corporations Act.

135 The Financial System Inquiry (FSI) recommended that the Government progress its review of the CAMAC recommendations on managed investment schemes. The Government is considering its response to the FSI.

Impact on the choice of business structure

136 ASIC is not aware of any evidence about the impact of the existing insolvency arrangements on the choice of business structure; for example, whether a business start-up may favour a sole trader structure because of the perception that the personal insolvency regime is less complicated than the corporate insolvency regime. We are aware of anecdotal evidence that the choice of business structure is influenced by current insolvency arrangements to the extent that a person might elect to operate through a corporate structure for the protection from personal liability and to safeguard personal assets in the event of business failure.

Question 29

Is the underlying incentive structure within the corporate and personal insolvency arrangements able to effectively and efficiently facilitate business closure without discouraging new business set-ups? Where

[27]The legislative framework for managed investments has undergone numerous reviews and inquiries, including:

- a review of the *Managed Investments Act 1998*, commissioned by the Government in 2001;
- the 2009 Ripoll Inquiry, which covered managed investment schemes, among other matters;
- the 2009 Parliamentary Joint Committee Inquiry into agribusiness managed investment schemes;
- the 2011–12 Parliamentary Joint Committee Inquiry into the collapse of Trio Capital; and
- the 2012 CAMAC Report, *Managed investment schemes*.

should the balance lie between creditors and debtors in the arrangements? Are there feasible alternatives to the existing corporate insolvency arrangements? Is the use of safe harbour provisions for firms seeking to restructure a feasible alternative?

Incentive structure and corporate insolvency

137 ASIC is aware of the difficulty in balancing the various stakeholder interests in corporate insolvency while at the same time seeking to promote economic activity. We acknowledge the important focus of the Issues Paper in addressing impediments to closing or transferring a business and the impact on economic activity. However, we are also aware of the importance of maintaining creditor and market confidence in the insolvency regime and the impact this has on the perception of credit risk and the availability and cost of credit in the economy. We believe that the incentive structure needs to balance creditor interests, including deterring misconduct.

Alternatives to the existing insolvency arrangements and safe harbour

138 We have identified opportunities to consider reforms to the existing corporate insolvency arrangements at question 28 to facilitate restructuring or business transfer, including:

(a) a moratorium on *ipso facto* clauses

(b) 'pre-pack' reforms for asset sales;

(c) streamlined arrangements for small business; and

(d) reforms to address the inability of voluntary administrations and deeds of company arrangement to bind third parties

139 Not all companies in financial distress are genuine candidates for restructuring. Opportunity also exists to consider a framework which promotes a rescue culture for legitimate corporate restructuring. This might involve a so-called, 'safe-harbour' to facilitate the restructure and provide appropriate protections for creditors etc. When restructuring is not feasible, a streamlined process of external administration for small enterprises that facilitates business transfer or closure is worthy of further consideration.

140 The claimed advantages of providing protection from insolvent trading laws are that it may:

(a) encourage formal and informal work-outs;

(b) protect enterprise value;

(c) provide flexibility to financially troubled companies;

(d) provide protection for directors where solvency is uncertain;

(e) allow companies to trade out of insolvency in appropriate circumstances;

(f) lessen director uncertainty; and

(g) ensure creditors retain the ability to apply to the court for the moratorium to be lifted

141 The claimed disadvantages of providing protection from insolvent trading laws are that it may:

(a) increase strain on the court system;[28]

(b) result in weak businesses staying in business when they should really be allowed to fail, thus perpetuating inefficiencies in the market;

(c) result in higher costs or conditions of credit, a lower willingness to provide credit and higher counter-party risk;

(d) provide an opportunity for directors of a financially distressed company to divest assets to related parties; and

(e) encourage illegal phoenix activity.

142 To support a safe-harbour, changes might also be considered to suspend the operation of *ipso facto* clauses in contracts in a formal insolvency administration where a restructure is proposed.

143 ASIC believes there is also merit in considering reforms to specifically address illegal phoenix activity – current law, like section 596AB of the Corporations Act, has had limited effectiveness to date. Further, bringing action under sections 180-184 or s588G of the Corporations Act can be costly.

Alternatives to the existing insolvency arrangements – increased efficiency

144 ASIC supports reforms that promote increased efficiency in insolvency administration. Reforms to fee setting and that streamline the insolvency process for small business (see paragraphs 157-164) may: promote competition in the market for insolvency services; place downward pressure on the price of the service; and promote innovation.

145 ASIC's experience shows that misconduct and/or inefficiencies arise as follows:

(a) Pre-appointment - at times, advisers might aid and abet company officer offences under the Corporations Act by facilitating arrangements which

[28] If necessary, this might be mitigated by restricting this option to companies above a certain size (as is the case in Canada, although the Canadian threshold of $5m is probably too low). This issue is most appropriately a policy decision for Government.

defeat the creditors' interests; for example, by facilitating illegal phoenix activity;

(b) Appointment - it is vital that an independent liquidator acts only in the creditors' interests and in a way which properly scrutinises pre-appointment transactions and reports alleged offences to ASIC. A streamlined process might consider the liquidator's appointment other than through the current referral process to promote independence and, therefore, confidence in the process.[29] This has downstream efficiency benefits in reducing complaints and regulatory cost;

(c) A need exists for better standards governing record keeping, investigation and documentation in external administration. Standards might reflect an efficient and cost effective approach to winding up a small company and, one which promotes confidence in the process no matter which liquidator performs the work. This might be achieved, not so much through more regulation, but better regulation.

(d) Improper gain. There is scope to reform remuneration practices to reduce cost to creditors; for example, use of hourly rates can drive inefficiencies.

146 We note that one of the policy objectives of the current proposed reforms to the insolvency regime[30] is to promote market competition for insolvency services.

Question 30

How should the sanctions in personal insolvency or bankruptcy apply to individuals? For how long should these sanctions around bankruptcy apply? Are these sanctions a disincentive for entrepreneurial activity? Is there adequate enforcement of the existing sanctions? Are there feasible alternatives to the current bankruptcy process?

147 ASIC's submission does not address issues relevant to personal insolvency. The Australian Financial Security Authority, the regulator of the personal insolvency regime, is better placed to comment on barriers to the transfer and closure of business conducted by individuals.

[29] Registered liquidators develop relationships with lawyers, accountants and pre-insolvency advisers who might refer work to them. There can be a tension between the registered liquidator's duty to creditors and a desire to maintain referral relationships. For further discussion, see the decision in *ASIC v Franklin (liquidator) & Ors, in the matter of Walton Constructions Pty Ltd* [2014] FCAFC 85.

[30] See *Exposure Draft: Insolvency Law Reform Bill 2014*

Question 31

Are the insolvency arrangements able to transfer assets and capital effectively? Are insolvency procedures timely to ensure assets do not become 'stranded' and unable to be used elsewhere?

148 The current insolvency regime does not prevent the transfer of assets; in fact, the property of the company may be sold in any manner whatsoever (see s477(2)(c) of the Corporations Act). There are, however, constraints on the exercise of this power. For example, receivers and controllers must take all reasonable care to sell the property at not less than market value or the best price that is reasonably obtainable (see s.420A). Similarly, a liquidator exercising the power to dispose of company property is subject to fiduciary duties at general law and the duties as an officer of the company under the Corporations Act.

149 Further, the transfer of assets during a formal external administration can often be completed expeditiously, even if the external administration of the company's affairs is protracted.

150 The courts have been prepared to be flexible in allowing liquidators to transact sales of a company's assets, provided the transactions aim to achieve the best possible price and the most effective realisation of the assets for the benefit of the creditors and contributories.[31]

151 The transfer of assets can also occur prior to the commencement of a formal external administration. Provisions in the Corporations Act permit an external administrator to bring proceedings to recover assets not transferred for fair value.

152 ASIC believes that these mechanisms are an important protection for stakeholders and achieve a good balance between facilitating the transfer of assets and protecting creditors.

153 While ASIC in principal supports reforms to facilitate the efficient transfer of assets that do not disadvantage other stakeholders, like creditors, we are concerned that any reforms also specifically address illegal phoenix activity.

Question 32

Is the insolvency process unnecessarily costly and lengthy? How might this additional cost be measured? Is it simply a transfer between participants in the process or does it represent a loss in the overall efficiency of the economy?

154 A company's external administration can be complex and require the exercise of a high level of commercial and professional judgement. This is

[31] See for example *Wentworth Metals Group Pty Ltd v Leigh* [2013] FCA 349.

particularly so for large proprietary and public companies but not necessarily true of small enterprise.

155 Available assets, time to complete, the amount of liabilities and the external administrator's remuneration are key determinants of what creditors might receive by way of dividend.

156 ASIC believes that an efficient and effective insolvency regime is essential as it affects the prospects of recovering capital from failed businesses and helps to detect corporate misconduct. The costs of the insolvency process are necessary for insolvency practitioners to properly perform their role as gatekeepers in promoting a fair, orderly and transparent market and ensuring investors, including creditors, maintain confidence in the insolvency regime. We are mindful of the impact this has on the perception of credit risk and the availability and cost of credit in the economy. We do, however, believe that there is an opportunity to consider reforms to fee setting and the insolvency process for small enterprises that may help to address the cost and length of the insolvency process.

Fee setting

157 ASIC is aware that external administrator remuneration is often a contentious issue and one that gives rise to reports of misconduct and complaints to ASIC by creditors. This is not surprising. For creditors, it remains difficult to determine value for service. For external administrators, it is difficult to convey to creditors the value they receive for their services.

158 Arguably, there is no major incentive for registered liquidators to drive efficiency in their administrations where there are available funds. Australian registered liquidators predominantly use hourly rates as the basis to calculate their remuneration notwithstanding other bases provided for in the Code of Professional Practice for Insolvency Practitioners issued by the Australian Restructuring Insolvency and Turnaround Association (for example, fixed fee). Hourly rates can lead to inefficiencies.

159 In July 2013, The UK Insolvency Service commissioned a review of insolvency practitioner fees in the UK. In February 2014, the UK Government released a consultation paper which proposed options for changing the way that insolvency practitioner fees are set to seek better returns for unsecured creditors.[32] The consultation paper proposes removal of the option to propose time and rate as a basis for remuneration except in cases in which there is tight control over the work being done (that is, oversight is maintained by a creditors' committee or secured creditors). The

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[32] The Insolvency Service, *Strengthening the regulatory regime and fee structure for insolvency practitioners – consultation,* 2014.

paper proposes that insolvency practitioners receive a percentage of realisations or a fixed fee except in certain cases.

160 The issue of external administrator remuneration has been considered by the courts. Recent decisions have held that calculating remuneration using hourly rates is not be appropriate in all instances and that remuneration claimed should be proportionate to the nature of work undertaken.[33]

161 ASIC notes that proposed reforms in the *Exposure Draft Insolvency Law Reform Bill 2014* provide for a greater level of scrutiny and review of the costs of external administration.

Streamlining for small to medium size enterprises

162 Many companies in external administration have minimal assets, low numbers of employees and relatively small deficiencies: see paragraphs 127-131.

163 Current insolvency laws currently take a, "one size fits all" approach; with the same duties and obligations imposed on the external administrator regardless of the size and complexity of the external administration. Industry has argued that the cost of administering small- to medium- size enterprises is high and often the external administrator is required by current law to undertake tasks (investigations and reporting to creditors and ASIC) in circumstances where there are insufficient assets to pay the costs of this work.

164 ASIC submits that opportunity exists to improve and streamline the external administration of small- to medium- size enterprises and their regulation, so as to reduce the cost of external administration and encourage competition without undermining confidence in the insolvency regime.

Loss to economic efficiency

165 Over-servicing by external administrators to maximise their fee revenue would deprive creditors of their proper dividend. In that sense, there is a loss to the economy. It is also a loss in terms of economic efficiency because of the time and costs it takes to deal with the loss – for example, creditors and or ASIC may take action against the external administrator. This time and cost could be allocated to more profitable activities involving those not privy to the original loss.

[33] See AAA Financial Intelligence Ltd (In liq) [2014] NSWSC 1004

Question 33

Are there legal impediments to reforms in this area, such as relying on alternative forms of dispute resolution (appellable administrative decisions, tribunals or alternative dispute resolution based solutions) for simple or uncontested matters? Are there any barriers to innovation by insolvency practitioners?

166 ASIC supports consideration and consultation on reforms that promote an efficient external administration process that reduces costs and facilitates the reallocation of scarce resources to those who can better use them.

167 We are not aware of legal impediments to streamlining the external administration processes to reduce the cost of administration or facilitate the transfer of assets or business closure.

168 However, reforms must include relevant safeguards to ensure maintenance of confidence in the insolvency regime. For example, if a safe harbour is given to facilitate informal corporate restructure, appropriate safeguards are required to ensure protection of the interests of the company and all its creditors. Further, a streamlined process to wind up the affairs of a small enterprise requires some investigation and reporting to deter misconduct and promote confidence in the insolvency regime.

169 The costs and resources required to implement some reforms may be an impediment for small firms to innovate. For example, promoting the greater use of technology to communicate with stakeholders may streamline the external administration process, reduce the cost of an external administration and promote price competition but the cost of establishing and maintaining a website for communication with creditors may be beyond the resources of a small firm. There may be an opportunity to consider the feasibility of a central website, similar to the published notices website, for this purpose.

Question 34

How have these employee safety net schemes impacted on business closure? How have these schemes operated alongside the insolvency arrangements? Do these schemes present a moral hazard problem?

Employee entitlements

170 The Australian Government provides financial assistance to cover certain (but not all) unpaid employment entitlements to eligible employees who lose their job due to the liquidation of their employer. This help is available through the General Employee Entitlements and Redundancy Scheme (GEERS) if their employer went bankrupt or entered liquidation before 5 December 2012, or through the Fair Entitlements Guarantee (FEG) if their employer went bankrupt or entered liquidation on or after 5 December 2012.

171 If a director has abandoned a company without paying outstanding employee entitlements, ASIC has the power to wind up the company under s489EA of the Corporations Act so that employees can claim an advance for unpaid entitlements under the Fair Entitlements Guarantee Act. This is required because access to FEG or GEERS is only available if the company is wound up. It is not available to other formal insolvency administrations.

172 The circumstances under which ASIC may exercise its power to wind up a company are set out in *Regulatory Guide 242 ASIC's power to wind up abandoned companies.*

173 The cost of winding up is partially funded through the Assetless Administration Fund (AA Fund). The Australian Government established the AA Fund to fund a range of preliminary investigations, reports and liquidator actions for assetless administrations. ASIC administers the AA Fund. We will consider how best to prioritise and administer the AA fund across the various activities it is intended to support, which includes winding up of abandoned companies.

Moral hazard

174 Access to FEG or GEERS funding to pay outstanding employee entitlements may present moral hazard; with directors potentially:

(a) continuing to trade a business and eroding a company's assets; or

(b) transferring the company's assets without paying employee entitlements; or

(c) abandoning an assetless company;

with the knowledge that, if the company is subsequently wound up (by a creditor or ASIC), certain of those outstanding employee entitlements will be paid.

175 FEG and GEERS provide a significant taxpayer funded safety net scheme. Advances made under these schemes are provable debts in the liquidation; afforded the same priority in repayment that the employee would have had. However, we understand that recovery of these advances is relatively low and concerns exist around validating claims.

Appendix 1: Overview of corporate insolvency in Australia

This section provides an overview of corporate insolvency in Australia, including a profile of the population of registered liquidators. We note that:

- there were 705 registered liquidators as at 31 December 2014;
- 38% of registered liquidators operate in small firms with four or less practitioners;
- most insolvency appointments involve small-to-medium proprietary limited companies; and
- 86% of companies in external administration have assets of $100,000 or less and 97% pay a dividend of less than 11 cents in the dollar to unsecured creditors.

Table 4: Number of registered liquidators and official liquidators as at 31 December 2013

	Registered liquidators				Official liquidators			
	2011	2012	2013	2014	2011	2012	2013	2014
Registered at 1 January	668	671	682	689	517	525	557	583
Registered during year	29	43	40	32	25	48	47	31
Cancelled during year	(26)	(32)	(33)	(16)	(17)	(16)	(21)	(12)
Registered at 31 December	671	682	689	**705**	525	557	583	**602**

Note: Official liquidators are registered liquidators who have made a separate application to ASIC to be registered as official liquidators so that they can conduct court appointed windings-up. Therefore, all official liquidators are registered liquidators but a registered liquidator may not be an official liquidator.

Figure 2: Number of registered liquidators by region as at 31 December 2014

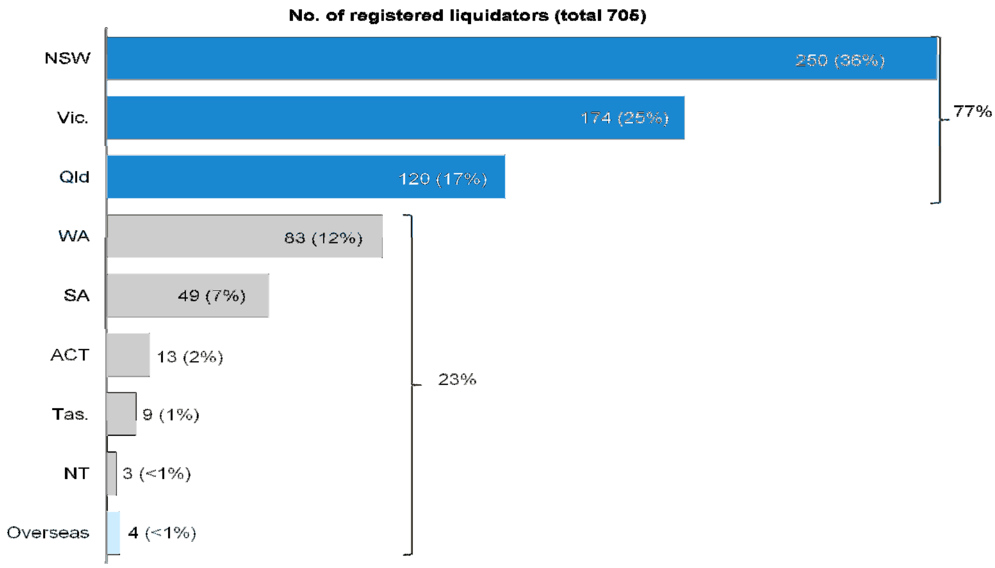

Figure 3: Number of registered liquidators by firm size as at 31 December 2014

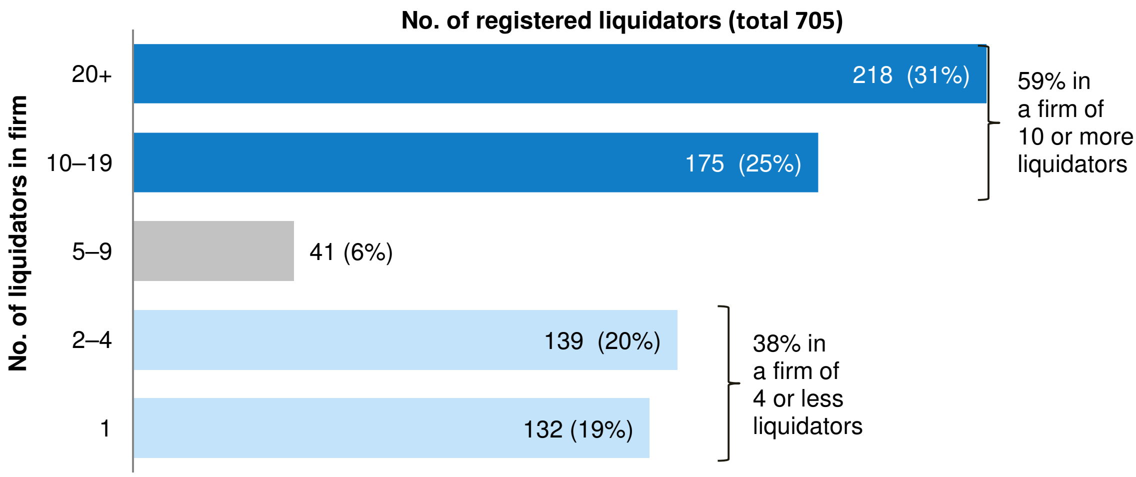

Table 5: Summary of the profile of external administrations—Initial external administrators' reports (2010–11 to 2012–14)

Description	Percentage of companies			
	30 June 2011	30 June 2012	30 June 2013	30 June 2014
Companies with less than 20 full-time equivalent employees	78%	78%	81%	81%
Companies with assets of $100,000 or less	84%	85%	85%	86%
Unsecured creditors owed $250,000 or less	44%	42%	43%	43%
Asset deficiency of $500,000 or less	65%	64%	65%	65%
Dividends to unsecured creditors of less than 11 cents in the dollar	97%	98%	97%	97%

Appendix 2: Insolvency appointments for the period 2008 to 2014

The following table shows the number of insolvency appointments recorded for the period 2008 to 2014 categorised by type of appointment.

Note: As a company can be under more than one form of insolvency appointment at any one time and can progress from one type to another, a company can be included in these statistics more than once.

Period	Provisional wind-up	Court wind-up	Creditors wind-up	Receiver appointed	Controller (except receiver or managing controller)	Managing controller (except receiver & manager)	Receiver manager appointed	Scheme administrator appointed	Voluntary Administration	Deed Administration	Foreign/RAB wind-up	Total
2008-2009	46	3,708	6,200	152	971	9	1,487	25	2,258	711	0	**15,567**
2009-2010	27	2,935	6,430	131	1,096	12	1,223	4	1,657	541	0	**14,056**
2010-2011	21	3,304	6,476	133	1,148	20	1,348	5	1,614	497	0	**14,566**
2011-2012	28	4,000	6,818	95	1,040	20	1,248	0	1,615	552	0	**15,416**
2012-2013	20	3,494	7,698	91	1,270	13	1,167	0	1,644	418	0	**15,815**
2013-2014	22	3,625	6,291	98	1,288	78	862	2	1,307	410	0	**13,983**

Source: ASIC, 'Insolvency Statistics – Series 2 insolvency appointments'