ASIC
Australian Securities & Investments Commission

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Our Reference:
Your Reference:

30 January 2018

Legal and Constitutional Affairs Legislation Committee
Attn: Committee Chair – Senator MacDonald

By email: legcon.sen@aph.gov.au

Dear Senator

Inquiry into the Bankruptcy Amendment (Enterprise Incentives) Bill 2017

ASIC welcomes the opportunity to make a Submission to the Legal and Constitutional Affairs Legislation Committee in relation to the Bankruptcy Amendment (Enterprise Incentives) Bill 2017 **(Bankruptcy Amendment Bill)**.

This letter is ASIC's Submission. Our comments are directed less to a shortened period of bankruptcy and more to the potential consequences of bankrupt persons being able to act as directors of a company within one year.

1. ASIC's Submission - context

ASIC has noted that one of the measures in the Bankruptcy Amendment Bill is to reduce the default period of bankruptcy from three years to one year. ASIC supports the policy objective, set out in the Explanatory Memorandum, of encouraging innovation and business-start-ups.

Enforcement Review

A review is currently being undertaken into ASIC's enforcement powers and the penalties regime we administer as recommended by the Financial System Inquiry. That review has been completed and the recommendations are presently with Treasury. It may be prudent that the current proposal be considered in the context of this enforcement review so as to minimise the risk of inconsistent policy and law reform outcomes.

We consider that this current proposal may well be relevant to ASIC's enforcement activities as:

(a) under s.206B(3) of the *Corporations Act 2001* **(Corporations Act)** a person is disqualified from managing a corporation if they are an undischarged bankrupt, so that the Bankruptcy Amendment Bill would have the effect of reducing that period of disqualification from three years to one year;

(b) there may be a policy question as to whether a one year disqualification period is appropriate to protect creditors, consumers and financial investors. Businesses regulated by ASIC (which offer financial products and services to the public) often fail because the owner/manager lacks the necessary business acumen and fails to keep adequate accounts and records. A question therefore may arise as to what is an appropriate period to allow a businessperson, whose business fails and is disqualified as a director, to undertake appropriate education and skills development training to reduce the risk of future failures;

(c) there may be a policy question about whether a shortened period of director disqualification could have an unintended consequence (in the absence of further safeguards) of promoting excessive risk-taking to the detriment of financial consumers.

We also note that only a small percentage of total bankruptcies are business related, so that the benefits of a reduced period of director disqualification for innovation and business start-ups may be limited[1].

ASIC enforcement

The enforcement decisions that ASIC presently makes often take into account that a person who has been made bankrupt will be disqualified from acting as a director for three years. This will often mean that ASIC does not identify any requirement to take separate enforcement steps against that person, the period of automatic disqualification being sufficient in the circumstances. If the bankruptcy period is reduced to one year then ASIC anticipates that it may well be required to take steps to disqualify relevant persons as directors more frequently. This would typically be pursuant to ASIC's powers at s.206F Corporations Act. Where ASIC takes this step, it is required to prepare a detailed brief of evidence and arrange a hearing. The hearing is conducted by an independent ASIC delegate and provides the person with an opportunity to make submissions, with legal representation. A decision to disqualify a person as a director can be appealed to the Administrative Appeals Tribunal (and after that to the Federal Court).

It is possible that a reduction in bankruptcy (and disqualification) period will mean that ASIC's resources will be diverted into additional enforcement activity in director

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[1] Personal insolvency statistics published of the Australian Financial Security Authority disclose that 16.9% of personal insolvencies for the period 1 July 2014 to 30 June 2017 were business related insolvencies

disqualifications. To that extent ASIC enforcement activity in other areas may be reduced.

2. Other potential safeguards

In the event that the period of bankruptcy is shortened then further reform might be considered to address the adverse impacts that may arise (and are described above), as follows.

Minimum director requirement

(a) Pursuant to s.201A(a) of the Corporations Act a proprietary company is required to have at least one director. If a proprietary company has as its *sole* director a person who was made bankrupt little more than 12 months ago then risks such as inadequate skills and excessive risk-taking within the company are exacerbated. This is particularly the case in relation to phoenix activity. A potential reform that may mitigate this concern would be to amend s.201A so that persons made bankrupt within the last three years cannot be included for the purpose of satisfying the minimum director requirement. In that way:

- bankrupt persons would, consistent with the objectives of the Bankruptcy Reform Bill, be able to act as directors within 12 months, upon discharge; but
- the management of the company would be shared with at least one third party who would (by virtue of also being a director) also be responsible for the company's actions and be subject to the care and diligence obligations set out at s.180 Corporations Act;
- the activities of the ex-bankrupt person may be subject to some degree of supervision; and
- the ex-bankrupt person will have three years (as currently) to acquire the skills and training that may be necessary to be the *sole* director of a proprietary company.

Appendix A discusses further the information available in relation to the risks that particularly attach to small proprietary companies, as opposed to large proprietary and public companies.

Training and disqualification length

(b) Pursuant to s.206F of the Corporations Act ASIC may, in defined circumstances, disqualify a person from managing corporations for up to 5 years if the person has been an officer of 2 or more corporations that have been wound up in the previous 7 years and, in each case, the liquidator has lodged a report under s.533(1). ASIC suggests the following amendments to that section be considered:

- expanding the scope of ASIC's powers under this section to allow it to direct the person to take specific actions (e.g. corporate and financial management training) before they take part in the management of a corporation;

- increasing the maximum length of disqualification under s.206F from 5 years to 7 years, to enable ASIC to more effectively deter phoenix activity;
- making disqualification automatic (rather than requiring an ASIC hearing) in cases where the director has been an officer of 4 or more corporations that have been wound up in the previous 7 years and, in each case, the liquidator has lodged a report under s.533(1). This would be subject to the same condition precedent as already provided for in s.206F(2)(a), namely that the 4 companies would not be "*related*". Put another way; if the 4 (or more) companies are in the same group of companies then they would count as 1 company for this purpose. However, where the liquidations have occurred as a result of separate trading activity, then it is proposed that the disqualification be automatic.

Extending automatic disqualification period

(c) As stated above, pursuant to s.206B(3) of the Corporations Act a person is automatically disqualified from managing corporations if they are an undischarged bankrupt. Section 206BA empowers ASIC to apply to court to extend the period of automatic disqualification (to up to 15 years) if a person has been convicted of a relevant offence. Pursuant to s.206BA(5) the Court has a broad discretion to take any appropriate matters into account. Consideration might be given to extending the scope of this section so that ASIC could also apply to extend the period of automatic disqualification where the person is an undischarged bankrupt. This would be in circumstances where ASIC can demonstrate to the Court that that there are serious concerns as to the capacity of a person to manage a corporation.

If you have any questions regarding the issues raised in this Submission please contact me on or email

Yours sincerely

George Stogdale
Senior Executive, Corporations and Corporate Governance Enforcement

Appendix A

1. ASIC believes that there are a number of behavioural differences between (1) directors of large proprietary and public companies and (2) directors of small proprietary companies.

2. 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 and have significant exposure to banking syndicates;
   d) 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.

3. In general, small proprietary companies:

   a) are partly funded through directors who have provided personal assets as security for the company's borrowings and so are personally exposed if the company fails;
   b) have directors who often have more limited business education and access to internal or external advisors and experts to guide them;
   c) have a reduced financial reporting regime (s.292 Corporations Act).

4. ASIC's insolvency statistics *ASIC Report 456: Insolvency statistics; External administrators reports (July 2014 to June 2015)* bear out this distinction. This report was compiled from the statutory reports lodged with ASIC by liquidators, receivers and voluntary administrators. It shows that the vast majority of these external administrations in Australia involved small to medium enterprises - 79% concerned companies with less than 20 employees.