ASIC

Australian Securities & Investments Commission

Corporate wrongdoing: ASIC's enforcement role

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1. Introduction

The scope of this paper is to examine ASIC's role in taking enforcement action in the same landscape in which shareholder class actions are likely to occur. The typical scenario will be a listed company that has collapsed or suffered a serious diminution in value following a capital raising under a regulated disclosure document where there is some suggestion of wrongdoing. There are, of course, many variations on that scenario.

We will look at these issues, bearing in mind ASIC's role as a 'conduct and disclosure' regulator, across a very broad territory and with relatively limited resources.

2. Class actions landscape

Australia has experienced a rapid increase in the number of people investing in shares and now has the largest proportion of shareholders in the world.[1] Today, 55% of Australian adults own shares, either directly or indirectly, in the form of private investments or in managed funds or superannuation[2].

44% of Australian adults own shares directly[3], with the result that shareholders are expressing a greater interest in company affairs, often termed 'shareholder vigilance'[4]. Shareholder vigilance is evident on examining the number of shareholders now participating in board elections and, most recently, non-binding votes on the directors' remuneration report[5]. As the primary stakeholders of the company, shareholders are eager to play an active role in order to protect and enhance the performance of their investments.

In exercising shareholder vigilance, shareholders are particularly concerned with the implementation of corporate governance principles, the absence of which is often symptomatic of corporate collapse resulting in losses to shareholders.

Traditionally, shareholders have not been perceived as creditors and therefore have enjoyed a very limited ability to recover losses. Also, shareholders have faced

1 ASX, Australia's Share Owners, An ASX study of share investors in 2004
2 ASX, International Share Ownership (Comparison of Share Owners) Key highlights, September 2005
3 *Ibid*
4 Jason Betts, Senior Associate, Freehills, The rise of shareholder class actions in Australia, 14 April 2005
5 An example being the recent voting by Novogen shareholders – see ASIC [MR 05-346]

various legal obstacles including *Houldworth's principle*; the doctrine preventing shareholders from suing a company for damages if they have not 'renounced' their holdings.

Other obstacles include the inability of shareholders to raise the funds required for litigation, coupled with the need to identify a class within Part IV of the *Federal Court Act*, as well as the need to prove the commonality of the cause of action relied on by group members.

The evolution of shareholder class actions, in conjunction with the protection afforded to shareholders under the *Corporations Act* and *ASIC Act,* has helped address these obstacles.

3. Where does ASIC sit in this landscape?

ASIC's primary function is to regulate the equity capital markets in order to promote confidence and integrity that encourages both domestic and foreign investment. A key part of this role is surveillance, enforcement and, where appropriate, prosecution of contraventions of the *Corporations Act* and *ASIC Act*. Where shareholders have suffered loss, ASIC's most direct concern is the regulatory effect on the market and action taken by ASIC is generally geared towards minimising these effects and preventing further occurrences. Most often, ASIC seeks to carry out this role by taking action against the individuals responsible, which sends a strong warning to other market players. However, ASIC acknowledges that the need to protect consumers also plays an integral part in fulfilling its regulatory role in order to promote market confidence and integrity.

ASIC can exercise various powers under the *Corporations Act* and *ASIC Act* in order to protect shareholders. At the same time, it needs to be stressed that various provisions of the *Corporations Act* increasingly empower shareholders to seek their own recourse.

Where shareholders lack the ability and funds required to redress the loss suffered by taking their own action, ASIC can exercise various regulatory powers in order to reduce the regulatory impact and protect consumers.

I would like to discuss some of those avenues, but first I will deal with some of the key questions about how ASIC is dealing with the growth in shareholder class actions.

4. Access to our records of interview

Section 25 of the *ASIC Act* allows ASIC to give s 19 transcripts to a lawyer who is carrying on, or contemplating in good faith, proceedings about something to which the examination related.

We expect that the increase in shareholder class actions will give rise to an increase in requests for such records where we have already carried out an investigation and have examined company officers. We will not give access where it would interfere with or prejudice any ongoing work we are doing.

5. Our amicus curiae (friend of the court) policy

Currently, ASIC has an ad hoc policy on becoming involved in litigation on an amicus basis. We will participate in proceedings as amicus curiae where the issues raise relevant regulatory or consumer protection issues that we think are important. We simply weigh up the regulatory policy considerations against the availability of resources. We get somewhere between 5 and 10 requests a year and they generally relate to the interpretation of legislation that we administer. We will nearly always brief counsel and often incur quite significant expense which we must bear.

A recent examples of where ASIC has acted in this capacity is the *Concept Sports* case.

The next level of involvement entails actual intervention in the proceedings as a party.

6. When do we intervene in proceedings as a party?

Under s 1330 of the *Corporations Act*, ASIC can intervene in any proceeding relating to a matter arising under the Act.

Under Policy Statement 4, Intervention, ASIC is reluctant to undertake civil proceedings, where there is a potential plaintiff with sufficient funds to bring those proceedings, but is not prepared to do so.[6]

ASIC is generally concerned about the following side effects of intervention:

[6] Policy Statement 4 Intervention at [PS 4.4]

- becoming subject to subpoenas, FOI requests etc;
- liability to cost orders; and
- prejudice to other ASIC activities; and
- opportunity cost.

A recent example of this type of intervention is Aevum Limited – a company that operates retirement homes - that found David Tweed making 'low-ball' offers to its shareholders during a demutualisation and ASX listing process. The company commenced proceedings against Mr Tweed's company, but ASIC then intervened alleging misleading and unconscionable conduct. The proceedings ultimately led to a decision of the Full Federal Court[7] which I will discuss in more detail later on.

7. Criminal action

ASIC prosecutes serious offences through the Commonwealth Director of Public Prosecutions (**CDPP**). Each year, we also summarily prosecute about 800 less serious breaches (eg failure of an officer to assist a liquidator[8]) without referring them to the CDPP.

Section 1317P of the *Corporations Act* now allows us to commence criminal proceedings notwithstanding that ASIC has already achieved a civil outcome in relation to the same or substantially similar conduct. This has been relevant in HIH (civil proceedings were taken against Messrs Williams and Adler, which was then followed by criminal action) and potentially in relation to the civil penalty proceedings already taken against Steve Vizard.

Under the MOU between ASIC and the CDPP signed in 1992, criminal proceedings are always the preferred course where the evidence justifies a criminal, rather than a civil, proceeding.

8. Injunctive relief

Under s 1323 of the *Corporations Act*, ASIC (and other aggrieved persons) can seek an injunction preventing the person against which ASIC has commenced an

7 *ASIC v National Exchange Pty Ltd* [2005] FCAFC 226
8 Section 530A of the *Corporations Act*

investigation or against which a prosecution or civil proceeding has commenced, from disposing of or transferring assets.

The benefit to shareholders, is that relevant assets are preserved, enabling damages to be paid should they be awarded once the proceeding is decided. The operation of this provision effectively freezes the status quo, ensuring that the relevant person does not divest the relevant property to the detriment of shareholders.

Because aggrieved persons can also exercise this power themselves, ASIC is seldom required to intervene. Nevertheless, ASIC retains the power to seek an injunction under s 1323.

Similarly, ASIC, or a person whose interest have been, are or would be affected by the conduct, may seek an injunction under s 1324 to prevent a person from continuing to engage or proposing to engage in conduct that constituted, constitutes or would constitute a contravention of the *Corporations Act*.

ASIC recently used the power in s 1324(10) to ask the court for damages for an alleged breach of the prospectus provisions by Fincorp Investments Limited which I will explain in more detail.

9. Misleading prospectus – refund for debenture holders

Fincorp[9] was required to offer certain investors who invested in Fincorp debentures in 2004 all of their money back, including accrued interest, following legal proceedings initiated by ASIC.

Fincorp raised approximately $75 million in funds under a 2004 prospectus and had to make the offer, potentially amounting to as much as $20m, to investors who still held their investments. ASIC estimated that more than 1,000 investors were potentially affected.

ASIC initiated proceedings against Fincorp in March 2005 alleging that the 2004 prospectus was misleading and omitted information required by the *Corporations Act*. Fincorp consented to a New South Wales Supreme Court declaration that the prospectus did not adequately disclose information about the security obtained for,

[9] ASIC media release [MR05-290] – 22 September 2005.

and risks associated with, loans for property developments by companies associated with Fincorp.

The 2004 prospectus said that Fincorp's funds were invested in a range of residential and commercial mortgages. In fact, the vast majority of the money was invested in property development activities carried on by parties related to Fincorp.

This result follows the earlier enforceable undertaking Fincorp gave to ASIC under which it agreed to correct certain newspaper and radio advertisements that ASIC said were misleading.

10. Illegal schemes

ASIC has had particular success in relation to illegal investment schemes. Over the past financial year, we have seen a 25% increase in ASIC actions to close down illegal investment schemes, having closed down illegal investments involving more than 2,100 investors who invested a total of $220m. We have closed down 76 schemes and obtained protective court orders in many other matters, pending further action. A further five promoters of illegal investments are serving jail sentences for dishonesty associated with the investments they offered.

Let me give you the example of our recent action against Craig McKim and Pegasus Leveraged Options Group Pty Ltd[10].

ASIC took civil action to ban McKim from being a company director and to close down an unlawful scheme promoted by him and his company, Pegasus, when it became clear to us that they had breached the *Corporations Act*. The court found that Mr McKim and Pegasus were operating an unregistered managed investment scheme, had engaged in misleading or deceptive conduct and had made misleading statements in order to entice investors into the scheme.

Mr McKim and Pegasus promoted one illegal scheme that promised to trade in foreign currency and make a profit for investors, while another scheme offered investment in US Treasury Bonds. Investors were offered what the court referred to as "astronomical returns" of 5% per week and even 8% per week and provided investors with a certificate of guarantee issued by a fictitious " International

[10] See ASIC media release [MR05-341]

Investment and Securities Commission" signed by its non-existent chairman. The investment in Pegasus was promoted in seminars all around Australia by wealth creation-type promoters during 2000–01 and raised at least $3.7m from 90 investors. Approximately $2m of this was lost through Mr McKim's own gambling.

Criminal charges were ultimately laid by the CDPP and as a result Mr McKim was convicted and jailed for 8 years. As part of the criminal case, the Australian Federal Police also laid 2 additional charges under the Commonwealth Criminal Code for forgery offences.

This particular enforcement matter was successful from ASIC's point of view, essentially because we were able to shut down illegal operations that would have continued to grow, sucking more and more investors into this scheme.

In taking these actions, however, ASIC is rarely thanked by individual investors. As is the nature of illegal investment schemes, investor funds are often already lost by the scheme operator. ASIC is therefore often only able to stem the flow of losses and prevent other investors from being lured into such investments.

11. Section 50 actions

As you all know, under the *ASIC Act*, ASIC can cause civil proceedings to be brought on behalf of shareholders. In order to exercise this power, ASIC must have undertaken an investigation or s 19 examination. The action must also appear to be in the public interest. In determining this, the Commission may consider:

- the regulatory effect of successfully bringing an action;
- strength of cause of action and ability to identify plaintiffs and obtain consent to bring proceedings;
- whether shareholders are able to bring an action;
- the ability of the defendants to pay the damages sought; and
- the prospects of winning.

Notably, s 50 is not worded such as to allow ASIC to continue to carry on a proceeding, which for one reason or another, has already commenced. Also, the decision of Lindgren J in *Deloitte Touche Tohmatsu v Australian Securities*

Commission No 2[11] established that a decision of the Commission to commence litigation under s 50 is also reviewable under the *ADJR Act* and there were many challenges made against the ASC in those proceedings.

Given its limited resources, ASIC carries out a cost/benefit analysis in deciding whether to allocate finite resources to commence an action under s 50. As well as the risk that the action may not succeed and ASIC will bear the costs, arguably, the greatest cost is the opportunity cost of resources that are diverted from other potential enforcement actions that ASIC might otherwise have taken. Where ASIC exercises its powers under s 50, shareholders reap the advantages from the representation of a single, specialised body, with economies of scale and vast experience in securities fraud.[12] For these reasons, it is no coincidence that ASIC has only undertaken a s 50 action about 15 times in its history.

The ambit of proceedings that may be carried out under s 50 extends beyond a contravention of the *Corporations Act* and includes proceedings in order to recover damages for fraud, negligence, default, breach of duty, or other misconduct, committed in connection with a matter to which the investigation or examination related, or recovery of property of the person. This power enables ASIC to exercise a fundamental part of its regulatory role, by protecting consumers and seeking recourse in order to make a regulatory example of the responsible parties, while recovering the loss to investors, otherwise not capable of doing so.

In order to commence proceedings under s 50, consent of the relevant parties is required. If the person is a company, ASIC can bring the proceedings in the company's name; otherwise, ASIC may only commence proceedings with the person's written consent. Because the consent of each affected individual is required in writing under the requirements of s 50, this can be a headache and sometimes means that proceedings are impracticable. Conversely, the requirements to commence representative proceedings under the *Federal Court Act* are less onerous as, subject to a number of exceptions, a person's consent is not required for that person to be a

11 (1995) 13 ACLC 783 at 786

12 Julian Donnan, Class Actions in Securities Fraud in Australia, Company and Securities Law Journal, Vol 18 82 at 85

group member in proceedings commenced under the Act[13]. Rather, group members retain a right to opt out of the representative proceedings by providing written notice before the date fixed.[14]

The increase in shareholder vigilance, coupled with the emergence of shareholder class actions, means that ASIC is better able to focus on its surveillance and enforcement functions while shareholders play a proactive role in protecting their interests.

ASIC cautiously welcomes these developments.

12. Unconscionable conduct – Aevum Limited

ASIC's powers under the *ASIC Act* are another means by which ASIC can seek to protect shareholders from corporate wrongdoing.

In November 2004, ASIC commenced proceedings in the Federal Court alleging that National Exchange contravened the *Corporations Act* in making unsolicited offers to Aevum's shareholders.

ASIC also alleged National Exchange made a misleading or deceptive statement in the unsolicited offers and engaged in unconscionable conduct.

The case involved 'off-market' offers made by National exchange to Aevum shareholders in October 2004 of 35 cents per Aevum share. The fair estimate of value of these shares was $1.29 per share. ASIC led evidence that 45 per cent of the shareholders were over 70 years old.

In December 2004, the Court handed down its judgment, finding that the offer contravened the legislation essentially because National Exchange was required to ensure the offer was open for at least one month and it did not do so. However, the Court declined to find that the offer was misleading or deceptive, or unconscionable.

Both parties appealed and in its judgment handed down last Friday, the Full Court found that the Aevum shareholders were:

13 s 33E *Federal Court Act 1976*
14 s 33J *Federal Court Act 1976*

> vulnerable targets and ripe for exploitation [and that the conduct of National Exchange was] predatory and against good conscience…designed to take advantage of inexperienced offerees.[15]

The Court found that National Exchange's offers were unconscionable, but that they were not made for the 'purpose of trade and commerce' as required by s12CC of the *ASIC Act*. The Court therefore dismissed ASIC's appeal against the original finding that the offers were not misleading or deceptive, and dismissed the cross-appeal filed by National Exchange, with costs.

In their judgment, their Honours said that, 'if ASIC wishes to control conduct like that of Tweed in the present case, it is necessary to consider different language to that selected in the present legislation to ensure that such conduct is prohibited'[16].

The finding of the Full Court of the Federal Court suggests that some reforms to the current legislation might be required. ASIC generally supports this view, and will be discussing this issue with the Federal Treasury to determine whether law reform is appropriate.

13. Infringement notice regime

At the bottom of the disclosing entity enforcement 'food chain' that applies to continuous disclosure breaches is the infringement notice regime in Part 9.4AA of the *Corporations Act*.

ASIC has issued only one such notice against Solbec Pharmaceuticals Limited[17] in relation to a disclosure about the results of certain trials on laboratory mice.

The purpose of the regime is substantially "educative" because compliance is effectively voluntary. I have described the issue of a notice as a "chess" move which sets in train a series of strategic decisions on the part of both ASIC and the company involved. I say this because ASIC cannot enforce the notice itself (ie sue to recover the amount of the penalty or take any action in relation to a failure on the part of the company to respond to the notice per se). Let me explain a bit about how the regime works:

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15 at [43]
16 at [50]
17 See ASIC media release [MR 05-223]

There are fixed penalties under the infringement notice regime:

- $33,000 up to $100m market capitalisation (Tier 3);
- $66,000 for $100m to $1,000m market capitalisation (Tier 2); and
- 100,000 for over $1,000m market capitalisation (Tier 1).

An unlisted disclosing entity is only ever subject to a maximum penalty of $33,000. A "prior breach" will increase a Tier 3 to 2 and increase a Tier 2 to Tier 1 penalty. A Tier 1 entity with prior form (ie having been involved in a previous continuous disclosure breach) is likely to be outside the regime altogether and would be probably subject to civil or criminal penalties. One feature of the regime is that a court can always impose higher penalty if ASIC decides to proceed against an entity that does not pay a penalty.

ASIC has stated that the following matters are relevant in deciding whether a breach warrants more serious intervention of falls within the infringement notice regime:

- price sensitivity of information – how many securities were traded?;
- materiality of information to entity;
- negligent, reckless or deliberate?;
- adequacy of internal controls; and
- was professional advice sought and what corrective steps have been taken?

There is a similar scheme in the UK, administered by the UK Listing Authority (ie the Financial Services Authority), but there it applies to directors as well.

On the subject of administrative review, an infringement notice is not subject to a merit review by the Administrative Appeals Tribunal, principally because it does not amount to a "decision" until ASIC takes the next step (ie by taking enforcement action following non-payment by the disclosing entity). However, an ADJR review would be available on the decision to issue and for the conduct of the hearing.

Technically, ASIC can seek civil penalty orders against officers even if the notice is complied with by the entity, but the s 674(2B) due diligence defence would potentially be available to them.

How do the hearings work?:

- Companies are allowed representation;
- They are non-technical;
- ASIC would usually use an expert witness;
- Rules of evidence do not apply;
- The proceedings are fact finding and not adversarial; and
- ASIC is bound by the ASX guidelines on interpreting the ASX listing rules.

The protections under Pt 9.4AA are that:

- The hearing can't be used as an investigative tool;
- There is an immunity for the disclosing entity on compliance;
- The evidence and submissions in the hearing can never be used against the entity; and
- Judicial review (ie *ADJR Act*) of the issue of notice or hearing eg bias, error of law or natural justice issues.

If an entity complies with a notice, it is immune from ASIC proceedings (civil & criminal) except where a public interest and other limited exceptions apply – 1317DAF(6). Its officers are not immune, but their evidence and submissions cannot be used against them. There is no immunity from third parties seeking compensation against the entity.

If an entity does not comply, then ASIC must decide what to do next. Options include:

- commencing civil penalty proceedings under Part 9.4B of the *Corporations Act* against the entity seeking a declaration that the entity has breached the provision specified in the infringement notice. We might also seek a pecuniary penalty order;

- we might commence proceedings under section 1324B of the *Corporations Act* to seek certain information be disclosed to the market; and

- lastly, we might also seek recovery of the costs of our investigation under section 91 of the *ASIC Act*.

14. Conclusion

ASIC cautiously welcomes the emergence of the shareholder class action in Australia as a "self-help" mechanism whereby shareholders are able to seek damages for loss incurred at the hands of directors and advisers who negligently or dishonestly cause loss to those shareholders.

The current prospectus regime (under which a range of parties face potential personal liability for loss suffered by investors) was introduced in 1991. I might be wrong, but I can't think of any litigation by investors that has resulted in a successful judgment awarding damages, for a defective prospectus. There have certainly been some claims and a few settlements, but surprisingly few when there have been countless examples where one would have thought a valid claim existed.

There are, of course, a number of such claims currently on foot and it is expected that this hiatus in the capital raising system is unlikely to continue.

Nonetheless, often the biggest challenge facing shareholders is the inability to identify a defendant with sufficiently "deep pockets". This affirms the importance of the preventative role shareholder's play in demanding compliance with corporate governance principles and the role that ASIC can play in proactive regulation and managing corporate behaviour.

Vigilant shareholders and a vigorous, but appropriately balanced, shareholder class action landscape, will play an important part in maintaining the integrity of the equity capital markets in years to come.

