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Question: ***Can the role of ASIC be interpreted as passive or reactive when managing corporate governance in the financial services sector, given recent collapses in that industry sector. A discussion with reference to the most recent events.***

The role of the Australian Securities & Investment Commission is defined as follows: "ASIC is the independent Commonwealth statutory body responsible for maintaining, facilitating and improving the performance of Australia's financial system and the entities within that system. It is also responsible for promoting the confident and informed participation of investors and consumers in the financial system. ASIC regulates Australian companies, financial markets, financial services organizations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit."[1]

In this context ASIC regulates using the following legislation[2];

- Corporations Act 2001
- Australian Securities and Investment Commission Act 2001
- Financial Services Reform Act 2001
- Insurance Contract Act 1984
- Superannuation (Resolution of Complaints) Act 19993
- Superannuation Industry (Supervision) Act 1993
- Retirement Savings Accounts Act 19997
- Life Insurance Act 1995
- Medical Indemnity (Prudential Supervision and Products Act) 2003

In parallel with the above legislation ASIC has entered into a Memorandum of Understanding with the following other regulatory bodies;

- Australian Competition and Consumer Commission (ACCC)
- Australian Prudential Regulation Authority (APRA)
- Australian Securities Exchange Limited (ASX)
- Australian Taxation Office(ATO)
- Director of Public Prosecutions (DPP)
- Financial Reporting Council (FRC)
- Members of the Council of Financial Regulators
- Reserve Bank of Australia (RBA)

The importance of the above lists will be revealed in the discussion to follow, but it must be said that this list clearly defines the reach of ASIC as a regulator and the consequential influence it has and has had in the market place.

[1] ASIC preamble in a public advertisement seeking members to ASIC [AFR 30/10/09]
[2] ASIC website; www.asic.gov.au/asic/About ASIC/The laws ASIC administers

This body of work will focus on the role of ASIC and the breaches of duty by various corporations and their Officers and Directors, within the context of specific legislation namely;

- Corporations Act 2001
- Australian Securities and Investment Commission Act 2001
- Financial Services Reform Act 2001 (FSR Act)
- Trade Practices Act 1974[3]

It is intended that the discussion in this work will deliver sufficient evidence to draw a conclusion as to whether ASIC has performed sufficiently well in the delivery and administration of its regulatory powers as defined in the ASIC Act 2001[4].

The role of ASIC in the last four years has been intensified by both Ministerial and Public scrutiny, this has then been accentuated by Consumer groups and their supportive legal advisors into questioning ASIC's effectiveness in keeping ethical and responsible those who have either mislead investors and caused them to suffer losses or indeed have actively misappropriated their invested funds.

This paper also considers what role does ASIC have in monitoring the public reporting processes of collapsed organizations, in particular the fact that in some cases they managed to submit misleading financial reports. Furthermore these organizations have been a challenge to ASIC as far as the manner in which they operated, which was not always within the Corporate Governance requirements of conducting a properly managed business[5].

This will be magnified as we look at the mismanagement of finances and the consequential losses to investors to whom the gravity of the situation was misrepresented[6].

Moreover we will need to explore the role of ASIC within its regulatory framework and its capacity to deliver in light of Financial Services Reform[7], particularly in reference to the ordinary small time investors seeking financial advice[8].

This regulatory framework had its beginnings in 1999 with the introduction of the FSR Bill which was then passed as an Act and was introduced, after much industry consultation and feedback, on March 12th 2001. This was a great leap forward from the reforms suggested by the then Minister for Financial Services Joe Hockey, known as CLERP[9]. It was in this evolutionary process as a driver of legislation that ASIC, I believe, began to play the hybrid role of compliance coach and educator to what was then a suspicious and reluctant financial services industry. This first foray into what the industry considered was onerous legislation

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[3] TPA not within jurisdiction of ASIC, however significant in the prosecution of some cases.
[4] ASIC Act 2001 (Cth), S1, S8,S11,S12A, powers and reach therein defined.
[5] Corporations Act 2001, Part 2.1D Duties & Powers S180 to S185, in general
[6] Centro Properties, Centro Property Trust and Centro Retail Trust will be the focal example.
[7] FSR Act 2001 (Cth)
[8] Storm Financial and Westpoint will be focal examples.
[9] CLERP was the first major step toward altering the financial planning environment.

impacted the industry greatly and we saw many well publicized exits by small and large firms in the industry. Many thought that FSRA was overkill for the industry and would get in the way of giving investment and financial planning advice to clients, who after all were seeking simplicity not complexity in the advice & products they were buying into.

In the period between 2004 and 2009 (timeline of this paper) ASIC has been under the spotlight for its role not only as a regulator but also as an enforcer of those regulations. It has had a great many critics ranging from financial planning bodies such as the FPA[10] to Corporate Law advisors and Financial Services License holders[11] and their respective lobby groups.

It has on a number of occasions exercised its powers under s50 of the ASIC Act[12] as a consequence of acting upon breaches with considerable public exposure.

Who collapsed and why they did;

Generally all of the collapses in the period of 2004 to 2009 of financial products or financial entities have come about because of a severe abuse of the "business judgment rule"[13] as interpreted by the Corporations Act. This is basically the obligation of a Director or Officer of a corporate to manage the business in the best interest of its shareholders and stakeholders with regard to risk, losses and profits in a balanced manner[14].

The **first** of the notable collapses that I would like to review is Centro Properties (all its related entities included)[15], where not only did a corporation suffer losses due to inadequate Corporate Governance but also as a result of it being an ASX listed entity a great many individual and Institutional investors incurred severe losses though the plummeting of its share price.

The share price fell in March 2009 from $10.06 to $0.04 due to the company not being able to manage its debt driven strategy to grow globally and overpaying for assets in the USA[16]. The company collapse resulted from a misstated balance sheet disclosure whereby current liabilities were expressed as non current liabilities and the said debt was due for re-financing from short term to long term loans, however the Directors and Management were not adequately prepared, this was compounded by the effects of the Global Financial Crisis (GFC) which was evolving at the time.

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[10] Financial Planning Association of Australia, represents Financial planner giving advice as CFP's Certified Financial Planner an education based accreditation.

[11] Dealer Groups who own CFP firms or offer franchise arrangements and Fund Managers who produce many of the investment products offered by such planners.

[12] ASIC Act 2001, s50, "ASIC may cause civil proceedings to be begun'

[13] CA 2001 s180

[14] Discussed in various corporations literature and paraphrased by writer. S180 CA duty of care skill & diligence.

[15] Centro Properties, Centro Property Trust and Centro Retail Trust

[16] Namely the United States REIT and New Plan Realty purchases in 2007

Centro like many other financial managers was working in a booming economy where growth, and rapid growth at that, was considered a measure of success. In this case the ascent by Centro was based on high levels of debt in what started as a low interest market with generous lenders. In other words the capital raising market was blissfully proactive.

Corporate Governance aspects of collapse;

The buoyant market gave rise to creative accounting whereby Directors and CEO's alike who dared, could push profit margins and share prices up by using sophisticated financial engineering, which was made famous by another collapsed entity and its founder in Allco Finance (David Coe- Executive Chairman)[17].

But in the case of Centro the failing was not as sophisticated as first thought and in fact it came about as a result of bad auditing by PWC[18] and a willingness by Directors to sign off on such poor standards of work.

Centro directors it is alleged, knew full well what constituted current and non-current liabilities and therefore have little or no grounds to claim reliance on expert opinion. In fact it was the Directors and the CEO who held a strong appetite for debt funded growth during a buoyant market.

The CEO of Centro (Mr. Andrew Scott) was granted interest free loans (of $10.5m)[19] to buy Centro shares with a loan agreement stating that the loan was not repayable if the share price was to collapse. This has non-disclosure and conflict of interest has its fundamental flaw. Mr. Scott had no risk in his concept of rapid growth for the group and he was safe in his thinking that his losses were limited.

The intent to mislead investors was escalated in a quote from the CEO during a newspaper interview[20] wherein Andrew Scott said "the Board considers the organisation is still solvent and that remains so at least until the completion of the February review', the review he was referring to was to be conducted internally on the state of its finances and debt levels. In that same interview he blamed the collapse of the sub-prime market for their problems in short term funding. That review revealed the incorrect financial reporting as a fact, with reasonable assumption, that Mr Scott must have been aware of this as CEO. The club like nature of the Board (a board made up of like minded people with previous relationships with one another) and what seemed to be total trust for Mr Scott was another strong indicator for regulators to look closer.

The irony of the misconduct in this case is that there is no law against over paying for an asset or even having to borrow excessively in order to do so, but reporting to misstate and therefore mislead stakeholders and shareholders is a breach, simply because disclosure in financial statements must be full and completely transparent.

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[17] Allco Finance collapsed in 2008 due to such a concept and misstated financial reports
[18] Price Waterhouse Coopers were the auditors and have been named in the class action pending
[19] The Australian, article by Anthony Klan , Jan 15th 2008
[20] The Australian, John Durie article on 17th December 2007

ASIC in its actions alleged that Centro's directors failed to comply to perform their duties with due care and diligence in their approval of the financial reports for the whole of the Centro Group. They in fact were negligent by not correcting or questioning what seemed to be gross misstatements, in particular the relevance and amount of interest bearing liabilities (debt funding as stated earlier), which were wrongly classified as non –current liabilities[21]. This in itself was no small matter as it involved an amount of some $1.54 Billion which were current debts as at 30 June 2007. ASIC has gone forward by exercising its rights under s50 of the ASIC Act and has taken civil action against the Directors and Officers at the centre of this debacle.

Centro Directors are not being charged for mismanagement or poor *business judgment* but in fact are in trouble because they provided inaccurate and misleading information to shareholders in their duty to disclose.

The action now taken by ASIC is post collapse and I would submit that ASIC should have been part of the February internal review[22] of the company debts and finance levels or at least asked to see any reports coming from such reviews, and not wait till the tabled financial accounts from PWC. In its role as regulator ASIC would have had every right to get involved immediately. The broker fraternity had been heavily criticizing Centro and its Board for the "lack of disclosure to the market about gearing levels, particularly given the current parlous state of credit markets".[23] Brokers went on to comment that in one week Centro's market value plummeted from $4.8billion to $1.35 billion after having reached an all time high of $10billion in May 2007[24]. Again, another reason for ASIC to demand answers[25]. This in fact has shadows of the HIH debacle, where many knew something was not right but no one moved to do anything about it.

ASIC Passive or Reactive is a question worth asking in light of the above discussion, because in fact ASIC did come into the picture purely as an observer at first and only when the damage was done and investors lost considerable value of their investments, it moved to sanction the misleading statements of the Board. In this way and in this case ASIC was not totally passive but can be said was reactive after the fact.

ASIC is now seeking recourse on all of the Directors[26] plus the CEO and the CFO for their negligence[27]. Further to that it has not ruled out taking civil action against auditors Price Waterhouse Coopers as they also failed to adequately disclose the debt levels in their 2007 audit. Their role, as with any auditor, is to independently verify the accuracy of the financial

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[21] ASIC , Media Centre Press release 09-202AD at www.asic.gov.au at 21/10/09
[22] Referred to in John Durie article in The Australian, 17Dec 2007
[23] Sydney Morning Herald, Business page article on 17th December 2007
[24] Op cit. article 17th December 2007
[25] CA 2001 s247A
[26] Listed in ASIC Media Release 09-202AD 21st October 2009
[27] The first hearing on the matter will be November 2oth 2009 in the FCA

statements prepared by companies- a duty clearly enshrined in the Corporations Act.[28] The action against PWC is justified and will by all reports proceed. The level of success remains undetermined at this date.
ASIC now seeks to implement similar sanctions to those in the James Hardie case with Director disqualification and heavy monetary penalties, criminal prosecution is unlikely as civil action is likely to yield greater success, a strategy repeatedly used by ASIC. Reliance on auditors as an argument to defend the Directors is at best shaky as they should have been skilled and informed enough to detect issues.

The **second** of the notable collapses that I would like to review is one of the first corporate governance related collapses in the financial services sector to cause major losses to retail investors. The collapse of Westpoint a Western Australian based financial services company investing once again in property, was a mezzanine finance based collapse and it first attracted ASIC attention in 2004[29]. It was then noted that the company was marketing its product via a select group of financial advisors, in return for fairly high commissions[30] on sales made. The money was mainly invested through mezzanine products which lure investors with higher rates of return than normal, but at the same time ranks them well down the list of creditors in the case of a collapse. At the time Mr Lucy was quoted as saying "it is not up to ASIC to say whether such commissions are too high, but only to ensure that they are duly disclosed to investors"[31], his message to investors was that they remain vigilant of such products and management fees.I recall that financial planners and accountants flocked to Westpoint and actively promoted its benefits based on reports issued by the company via its Directors and Management. Some 4,300 investors were attracted to the product and it raised some $393 million of funds to be invested in a number of Mezzanine projects as identified by ASIC[32]as at January 2006. Claims for losses were likely to be up to $245m.

Corporate Governance aspect of collapse;

This was a case of blatant breach of duty of care as defined in the Corporations Act. The Directors and officers as trustees of these investment vehicles failed to disclose, with accuracy, the gearing levels of each project and the risks which that gearing represented. Further more another auditor was brought into the negligence action when it became apparent that KPMG was negligent in its conduct of the audits in the Westpoint Group as well as each of the eight (8) Mezzanine projects. This was a repeated breach of duty.[33] The Directors and

[28] CA 2001 (Cth) s307 through to s312 clearly sets out duties
[29] The commissioner at the time was Jeffrey Lucy reputed more aggressive then D'Aloisio
[30] Commissions to advisers and the company were as high as 10% of the amount invested, normal being 1-2.8%.
[31] This is part of the Statement of Advice requirements with FSR Act 2001.
[32] ASIC Media release 07-291 ASIC to pursue compensation, issued 8th Nov 2007.
[33] CA 2001 Auditors Duties s307 to s312 op.cit.

Officers were also in breach of the Corporations Act in as so far that it was established that they continued to operate the Westpoint Group while it was insolvent and were fully aware of that fact. In so doing they also breached FSR Act as they operated the schemes via entities which did not hold a financial services license.

ASIC in its actions[34] has moved to pursue KPMG for a breach of its duty of care in performing as an auditor, while also pursuing each of the eight Mezzanine companies that were managed by Westpoint Group[35] , the latter are being prosecuted for misleading disclosure of financial reports and for operating an insolvent company which was clearly evident once inter company loans and the use of a group "treasury model'[36] to disguise shortfalls became public knowledge.
All of the five Directors have been prosecuted under s50 of the ASIC Act with notable press and unfortunately little was recovered in the first attempt as they all filed for bankruptcy, as a means of protection. This is bad news for the investors more so than for ASIC.

The role of ASIC is open to question in relation to the Mezzanine finance schemes have been prevalent in the Australian economy for some considerable time. They have attracted particular attention in recent years only because they have been promoted via financial planners/advisors and accountants at a consumer retail level. So ASIC chairman D'Aloisio "[ASIC] sees a clear public interest in using its powers to pursue compensation for the benefit of Westpoint investors".[37] Once again given the high profile of these schemes in the financial services sector one has to question why ASIC has acted in recovery mode rather than prevention. The FSR Act does monitor the behaviour of advisors and their licensees and in fact in this case one such advisor[38] received a 12 month suspended sentence while another in WA[39] is currently the subject of civil proceedings to recover $14m of lost investor funds.

The **third and final** of the notable collapses is Storm Financial Limited. This firm was placed into liquidation by order of the Federal Court on 26th March 2009 and Worrels Forensic accountants appointed as liquidators, CBA (Commonwealth Bank) with which Storm had dealings also appointed KordaMentha as liquidators at about the same time.
The story here is basically that the two Directors Emmanuel Cassimatis and Julie Cassimatis are both Directors of Emmanuel Cassimatis & Associates Pty. Ltd and associated company Storm Financial Limited. In their role as Directors, it is alleged that they, firstly failed in their duty of care as Directors in advising regulators that the company was in the brink of financial

[34] ASIC Act s50 op.cit
[35] Directors and Officers of holding company are repeated in each of the mezzanine companies.
[36] This concept in plain english is an accounting method that uses one set of funds on balance sheets of numerous entities.
[37] ASIC Media release, 08-207 at op.cit 13th October 2008
[38] Neil Burnard in District Court of NSW – for promoting Westpoint with misleading non disclosure
[39] Brighton Hall Securities - as per ASIC Media release 09-194AD, 7th October 2009

collapse as a result of pending margin calls on leveraged loans granted by CBA and in smaller amount by Bank of Queensland[40]. These loans were geared against properties owned by their investor clients to whom they also owed a duty of care and disclosure (in their position as financial advisors). It is further alleged that the Directors transferred an excessive amount of funds[41] to their holding company and then intended to transfer them to their family trust. The Directors failed in their duty to disclose to clients that margin lending loans had the potential to be *called up* should the value of the underlying investments drop below a given level, hence creating a real loss to investors as opposed to a paper loss, as loans would have to be repaid at call to the banks.

The severity of this collapse rests in the fact that the majority of clients were middle class investors who offered their homes as security against the margin loans they then used to make equity investments. The collapse of the value of their shares triggered the margin calls and hence the financial calamity, which led to financial distress as a result of forced selling at bottom of the market..

Corporate Governance aspect of collapse;

These breaches relate to both the Corporations Act and the FSR Act.

In the first case there was misleading information about the financial position of the company. The type of breach involves withholding critical information from stakeholders as to the imminent risk of their investment. The legitimacy of the call has been a subject of complex debate which is beyond the scope of this paper[42]. The duty of Directors was to ensure that the financial advice they were promoting included full and ongoing disclosure and appropriate risk management. They failed in that duty and consequently investors have lost large amounts of money as equity markets collapsed and margin loans were *called up*. Remembering, that the majority of investors were middle class Australians, who had in most cases, taken out mortgages as security against the said margin loans. Pressure from these groups has demanded that ASIC perform as a regulator and enforcer.

ASIC in its actions, has chosen to pursue the Storm and its Directors in particular with regards to misappropriation of funds post announcement of losses[43] and the demise of funds relating to some 3,000 clients. The investigation as been going since that announcement and has yet to have definite conclusions, however ASIC has not been silent in its intent. In February 2009 ASIC obtained Supreme Court[44] (Qld) orders to freeze a payment of $2million

[40] Many of these loans were based on Low Documentation criteria and approved with limited serviceability testing.
[41] Estimated at $2m just prior to the collapse
[42] CBA and Storm Financial are at odds as to whether the margin call was premature and implemented without due care by the Bank, similar applies to BoQ.
[43] ASIC Media release, AD08-89 Storm Financial at 24th December 2008
[44] ASIC Media release, AD09-11 Storm Financial at 4th February 2009

which was transferred from a bank account of Storm Financial Limited on 15th December 2008, as payment to the Directors of that company, via their family Trust.

In March 2009 ASIC used its statement on Storm Financial to a recent parliamentary hearing[45] to warn that its interest in Storm would be likely to have more far reaching implications for the rest of the financial services industry. ASIC was adamant that its investigations would not only work to compensate Storm investors but would also be a basis from which to provide guidance for the future of the financial advisory industry. One would assume from this that ASIC is asking whether the problems found in Storm could be extended to other financial services providers, in particular it (ASIC) was quoted as saying "it has concerns with aggressive leverage models being more widely used in the industry".[46]

ASIC passive or reactive, is in question again, in the aftermath of Storm it has been proactive in providing more resources[47] to investigate leveraging models in finance. It has been active in taking some corrective actions but as always comes in once the damage has been well and truly done.

The CBA has been very vocal in its criticism of ASIC in this regard; particularly given that it is also a focal point of investigation for ASIC (in the Storm case). What the CBA is asking is for ASIC to consider being proactive in performing "risk analysis" on AFSL models[48]. The CBA has made recommendations to a parliamentary enquiry[49]that AFSL's be required to report to the regulator on various aspects of their businesses. This should have been an initiative from ASIC long ago, when instead it chose to over regulate the giving of advice process through FSRA. I am in agreement here as I see advisory firms as corporate businesses first and advisors second, hence they have a duty to proper Corporate Governance.

CBA has exposed ASIC as reactive in this case in that it has chosen to name the corporate regulator along with itself and Storm the key stakeholders involved in the circumstances leading up to the hardship suffered by investors.[50]

In this case again ASIC has come along in the aftermath as a regulator choosing to prosecute rather than prevent.

Opportunity gaps for ASIC are many and varied and not only in the context of the cases discussed thus far. This is made more evident by a recent statement from ASIC Chairman Tony D'Aloisio[51] that the regulator will "inevitably only step into play after a company collapse has occurred", is this the best use of such a regulator?

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[45] Reported in Money Management Issue No.7 March 5th 2009 to Senate Standing Committee on Economics, pg.4

[46] Wetspoint was in fact a wholesale version of this retail problem

[47] ASIC 2008-09 Annual Report, at www.asic.gov.au , Pg 58 "increased numbers in Financial Economy Teams"

[48] Australian Financial Services Licensee

[49] Bernie Rippol MP, "Parliamentary Joint Committee on Corporations and Financial Services" 2009

[50] Money Management Issue No.29 13th August 2009, P.13

[51] Reported in Money Management Issue No. 29 op.cit Pg.13

In a subsequent article[52] criticism was again leveled at ASIC by commentary that Governance principles should become the foundation for obtaining a license (AFSL) to distribute and advise in financial services products. The submission makes claims that the existing regulatory regime encourages a tick-the-box approach to compliance without promoting and ethical culture which emanates from having to comply with the Corporations Act and its corporate governance principles. Its recommendation is that financial services organizations be made to build and maintain procedures that are fully in line with Corporate Governance Principles[53].

The question I pose is who would challenge ASIC if it was to stretch the Corporations Act into the FSRA legislation and in so doing used both to take up a more "interventionist" approach to the issues that led to the financial collapse of Westpoint and Storm and even Centro.

ASIC has made a submission to the Joint Parliamentary Committee (JPC) canvassing legislative and regulatory changes that would actually see it take a more "interventionist" approach. In that submission ASIC believes that the long term benefits of increased market intervention might significantly outweigh the deficits.

In defense of its role thus far it has stated in its submission[54] "ASIC, has within the regulatory framework, discharged its responsibility effectively and efficiently" nowhere in that submission has it admitted that it was always within its discretion to interpret the legislation or its role as a regulator to be more pro-active.

One of ASIC's plans to help investors avoid future calamity is to introduce the concept of "swimming between the flags"[55] thereby guiding investors not to venture too far outside the conventional investment product range (ASX, bank deposits, managed Funds) and seeking appropriate advice. Hopefully this informative program will make investors less likely to get involved in risky investments.

ASIC could also deliver more effort and control in promoting a stronger "disclosure focus"[56] which has been exposed as a major gap in the fallout from the Global Financial Crisis. I tend to agree with this approach, as it seems that non disclosure or at least wrongful disclosure has been the root cause evil of a great many of the collapses of the last decade.

ASIC has submitted to the JPC that in an effort to increase its reach and ability in dealing with issues before they occur it be allowed to consider such extensions to its powers as;

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[52] Money Management issue No.30 20th August 2009 Pg.6 based on comments filed by Argyle Lawyers to the Joint parliamentary Enquiry

[53] MM op.cit.

[54] ASIC submission to "Joint Parliamentary Enquiry", op.cit 2009

[55] Mr Jeremy Cooper, Deputy Chairman ASIC, "Investing in 2009" speech at Naval Military and Air force Club Adelaide 11th March 2009

[56] Ms Belinda Gibson , ASIC Commissioner paper delivered to AICD Conference 2009

- Ability to move to strike or remove an AFS license when it believes a “breach" may occur.
- Implementation of finance resources requirements as part of obtaining an AFSL, showing solvency strength and reserves (as Banks do with the RBA).
- Ability to ban individuals involved in a breach of obligations by another person, deleting the safe haven of associated entities.
- Clarifying the duty of care owed by advisors to act in the best interest of the client and not their own.
- The prevention and removal of remuneration structures that might create conflicts of interest[57]

These suggested reforms are by no means extensive and conclusive but could go a long way toward strengthening the preventative role of ASIC in future collapses.

In conclusions it is clear to see that a “watch and wait” for a collapse approach is less than adequate for any regulator, especially given the growing numbers of special financial instruments and financial products.
It is therefore imperative that ASIC as the cornerstone regulator of the regulatory regime for entities dealing in financial services and markets be proactive at the very front end of the process and take up a more preventative role as opposed to one of remedy after the fact.
It seems to me that even escalation to civil and onto criminal proceeding seems to do little for the greed and deception growing out of the financial markets, especially in times of boom.
Retail and institutional investors need to be able to find security and at some reliability in the fact that ASIC is monitoring processes early on and not playing a role pure post disaster.
One of the basic rules taught in financial services to managers is to “manage risk as early as possible no matter how remote it may seem”.

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[57] This was a driving factor in the majority of financial services collapses between 2005-2009

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