HERBERT SMITH FREEHILLS

CONSULTATION ON ASIC'S DIRECTIONS POWERS
SUBMISSION

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ASIC Enforcement Review
Financial System Division
The Treasury
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By Email

Dear Sir / Madam

Submission: ASIC's Directions Powers

This is our submission on the ASIC Enforcement Review's Position and Consultation Paper 8 concerning ASIC's Directions Powers (**Consultation Paper**).

1 General observations

Our firm has extensively advised clients on the extent and width of the investigatory and administrative powers of ASIC and other regulators and how to respond to the exercise of those powers. Drawing upon this experience, we are grateful for the opportunity to provide a submission on the Consultation Paper.

We agree with the need to promote public confidence in the financial sector. We also agree that ASIC, as a regulator of Australia's financial system, requires certain powers to be able to maintain the transparency and efficiency of that system. In this regard, we are generally supportive of the proposal in the ASIC Enforcement Review's Position Paper 7 to strengthen penalties for corporate misconduct.

However, it is our position that ASIC, as an unelected regulator, should not be able to exercise its powers arbitrarily. We consider that forcing compliance *"in real time"*, solely on the view of the regulator and without recourse to an appeal mechanism, would lead to serious risks of undermining confidence in the regulatory system.

In our view, the additional powers proposed in the Consultation Paper are radical and will result in ASIC acting as both investigator and judge, without the checks and balances required for an accountable regulator. At a minimum, the Paper concedes the power may operate as an *in terrorem* threat to encourage licensees to agree to ASIC's proposals.

We would be pleased to discuss any part of our submission with you.

2 Feedback on matters identified in the Consultation Paper

2.1 Position 1: The proposed directions power

HSF Recommendation 1: The proposal to enable ASIC to direct Australian financial services (**AFS**) or Australian credit licensees in the conduct of their business where necessary to address or prevent compliance failures should not be adopted.

If the directions power is adopted, the directions that ASIC can make should be prescribed by the legislation, with no ability to extend the list by regulation. The directions power should not be drafted broadly.

In our view, the proposal to enable ASIC to give a direction to an AFS or credit licensee is disproportionate, unnecessary and enlivens the potential for arbitrary use of power.

The Consultation Paper notes, by way of comparison, the power of the Australian Prudential Regulation Authority (**APRA**) to give a direction to an ADI where a direction is necessary in the interests of depositors, or the ADI is conducting its affairs in an improper or financially unsound way. However, the fact that APRA has certain powers does not (of

course) necessarily mean that ASIC should have these powers (or vice versa), given that those regulators have separate functions and jurisdictions.

The power to make directions is eminently logical and necessary in a prudential context. APRA must have the power to pro-actively intervene in order to prevent mismanagement in the event of possible collapse. In this context, it makes sense for a regulator to have tools for early intervention to take control of ADIs and prevent a crisis.

ASIC, on the other hand, does not operate in a regulatory context where it would be appropriate to interfere in the commercial decisions of regulated entities on a discretionary basis.

Further, in our view, ASIC already has sufficient powers to fulfil its functions. The Consultation Paper argues that ASIC's power to vary, suspend or cancel an Australian Financial Services Licence (**AFSL**) is hindered by the procedural fairness requirements which accompany the power. In our view, it is necessary to maintain and uphold those procedural fairness requirements to avoid arbitrary decisions concerning the variation, suspension or cancellation of an AFSL. Administrative efficiency should not be pursued at the cost of accountability, which is a real possibility if procedural fairness safeguards are not applicable to the exercise of ASIC's proposed directions power.

The recommendation of the Financial System Inquiry (referred to at p.15 of the Consultation Paper) was that ASIC should have more capacity to impose licence conditions to address concerns about *"serious or systemic non-compliance with licence obligations (including expert reviews)"*. That recommendation does not imply or require the introduction of a broad-ranging and new directions power. Indeed, in recent times, there are a number of instances where ASIC has imposed additional licence conditions requiring, among other things, expert reviews.[1]

In addition to the power to vary, suspend or cancel AFSLs, ASIC already has wide powers to apply to a court for an injunction, issue infringement notices, direct an AFSL holder to provide a written statement and agree an enforceable undertaking. Further, as the Consultation Paper notes, ASIC will shortly have a product intervention power (in relation to which there has been extensive consultation). We do not agree that the asserted saving of time, resources and costs involved in preparing evidence to support these administrative actions is a valid justification to introduce an unchecked directions power. While we acknowledge that administrative speed and efficiency is an important consideration, the removal of the need to substantiate allegations with evidence would only serve to diminish the accountability of the regulator in the eyes of consumers and investors. Accountability enhances an efficient, transparent and consistent financial services sector.

We also hold serious concerns as to the nature of the types of directions ASIC could potentially make, as listed in the Consultation Paper. Some are potentially Draconian (e.g. directing a licensee to cease accepting new clients), representing an unprecedented power for a regulator to interfere in commerce. Others (such as the requirement for the licensee to establish a compensation program) raise challenging issues regarding interference in third party rights.

Further, if the proposed legislation includes an avenue to extend the list of directions ASIC can make by regulation, this would grant ASIC an effectively limitless power to control AFSL holders without any recourse to procedural fairness safeguards for the target AFSL holder. If there is a power to make directions, the scope of that power should be clearly defined by the legislature and not open to extension by way of regulation.

[1] See, e.g., ASIC's media release on 1 October 2015 concerning Total Financial Solutions Australia Ltd; media release on 13 December 2016 concerning Open Markets Australia Ltd.

2.2 Position 2: The proposed trigger for the directions power

HSF Recommendation 2: If a directions power is introduced, the proposed trigger enlivening the directions power should be revisited. There is a need for further clarification on the type of circumstances in which ASIC will be considered to have "reason to believe" that an AFS or credit licensee has engaged in contravening conduct. Moreover, an additional condition for exercise of the power should be introduced, to the effect that there must be an imminent risk to the financial system or to the financial viability of the licensee.

The Taskforce proposes that the directions power should be triggered where ASIC has *"reason to believe"* that an AFS or credit licensee has, is or will contravene financial services or credit licensing requirements (including relevant laws). In other parts of the Consultation paper, a potentially different trigger is suggested *("where necessary to address or prevent compliance failures"*).

In our view, *"reason to believe"* that an AFSL holder has or will contravene a relevant law is not a satisfactory condition precedent for a power to make directions with immediate effect. This threshold is both unclear and far too low to trigger a power as wide as the directions power proposed. That is especially the case given the imprecise and general nature of some of the obligations on licensees, such as under section 912A of the *Corporations Act*.

The danger of ASIC pursuing action against an AFSL holder without sufficient evidence is a real one. Like any regulator, ASIC sometimes makes mistakes, with substantial real world consequences for individuals and entities.[2]

It is unclear what would constitute a triggering circumstance for ASIC to exercise its discretion to make a direction which would interfere with the commercial activity of an AFSL holder. APRA's power to make written directions to an ADI is contextualised with the inclusion of "certain circumstances" in the *Banking Act,* including where there has been a *"material deterioration in the ADI's financial condition"*, or the ADI is *"conducting its affairs in an improper or financially unsound way"* or *"in a way that may cause or promote instability in the Australian financial system"*.[3] ASIC's proposed directions power would need to be contextualised in a similar manner. For example, ASIC's *"reason to believe"* could be qualified by the existence of imminent danger to the viability of the licensee. The Consultation Paper, in parts, appears to acknowledge that the directions power should only be exercised where *"urgent action is required"* (p.24). If, contrary to our primary position, a directions power is introduced, that requirement of urgency should be reflected in the legislation.

We endorse the process contemplated for the exercise of a directions power in [11] of Section 5 - Solution.

2.3 Position 3: Court enforcement in the event of non-compliance with a direction

HSF Recommendation 5: Position 3 should be revisited to include an appeal mechanism from the underlying decision of ASIC to make a direction.

[2] A recent example can be seen in the case of *Hill v Australian Securities and Investment Commission* [2017] AATA 352. In that case, ASIC made a banning order pursuant to s 206F of the *Corporations Act 2001* (Cth) disqualifying Mr Hill from managing a corporation for one year. The AAT set aside ASIC's decision, finding that none of the breaches of directors duties alleged by ASIC could be supported by evidence. The AAT was very critical of ASIC in its decision, noting that the regulator's "attack" overlooked the difference between a facility to borrow and actual borrowing, and that allegations that Mr Hill's conduct contributed to the liquidation of several companies were completely unfounded.

[3] *Banking Act,* section 11CA(1).

The Taskforce has suggested in Position 3 that ASIC should be able to apply to a court to obtain an order requiring an AFS or credit licensee to comply with the direction and/or take administrative action if a licensee does not comply with a direction made by ASIC.

Position 3 outlines briefly a process whereby ASIC would set out its reasons for making a direction, but that process does not appear to contemplate an avenue to challenge those reasons, before a court order is sought ordering compliance.

It is crucial that an AFSL holder has an avenue to challenge ASIC's claim of the existence of the relevant triggering circumstance for the power. At a minimum, merits review in the Administrative Appeals Tribunal should be available. That is the position with respect to ASIC disqualification and banning orders.[4] It reflects the position with respect to APRA's directions power.[5] It is also consistent with accepted wisdom (contained in prior reports of parliamentary inquiries and the Australian Law Reform Commission) that public accountability in relation to the regulatory decisions is critical, and administration is improved as regulators learn from tribunal decisions.

As previously noted, administrative speed and efficiency should not be valued over the accountability of the regulator in the eyes of the public.

3 Contact details

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[4] See section 1317B of the *Corporations Act.*

[5] See, e.g., section 11CA(5A) and Part VI of the *Banking Act.*

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