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Review of Sanctions in Corporate Law

# Submission

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# Review of Sanctions in Corporate Law Submission

The broad strategy to reduce the regulatory burden and achieve simpler and more effective regulation needs to approach corporate regulation as a balance:

- to provide proper rules for the acceptable conduct of corporate officers
- to reduce the administrative and regulatory burden on them.

The *Review of Sanctions in Corporate Law* correctly considers the difficulty in the balance between acceptable conduct and regulation, and the extent to which intervention is needed by corporate regulation. The focus on penalties is appropriate as corporate officers need to have signals to monitor their behaviour and the conduct of their corporations in their community of operations. Too often corporate officers operate their businesses with limited attention to corporate compliance and they are often reluctant to seek legal advice at the time when issues are deliberated and decisions made.

## Submission overview

This submission provides additional issues for discussion that will influence the approach taken in *Review of Sanctions in Corporate Law*. It is proposed that the review consider the array of penalties that apply to activities in the *Corporations Act 2001* to regulate corporations and recommend that these be revised to remove certain penalties as the activities do not require this level of intervention. There are many provisions in the Corporations Act that deal with essentially the same matter but they impose multiple penalties. The intervention by the Corporations Act into the business affairs of corporations can be reduced, leaving corporate managers and directors to self-regulate their own activities to achieve a higher purpose compliance requirement under the law.

I have pursued issues in relation to corporate wrongdoing and the approach taken by the courts to deal with it and their approach taken for "white collar" crime. These issues are covered in papers presented at the New South Wales State Legal Conference fora and they are packaged as White Papers on my website at [www.iantunstall.com](http://www.iantunstall.com).

The immensity of regulation is compounded where the corporation is also a financial institution that is regulated by the Australian Prudential Regulation Authority (**APRA**). The need in Australia for two separate regulators, one regulator dealing essentially with conduct regulation and the other regulator dealing with prudential regulation, is overregulation<sup>1</sup>. I have also written about the overregulation in a blog on financial markets accessible through my website.

### **Regulation under the Corporations Act**

The submission will highlight some of the matters in the Corporations Act that can be rationalised to reduce the regulatory burden imposed by its provisions. The Corporations Act needs to empower corporate directors and management to manage their corporations properly for sound economic reasons. The sanctions imposed under the Corporations Act need to apply to those corporate officers who need to be dealt with under the law for deliberate or intentional wrongful activities. This should flow onto better qualified directors and executives who must comply with the law and ensure that their corporations also comply with the law. The compliance culture would be part of their corporate governance processes. The notions of corporate governance could be enhanced to enable liability issues to be incorporated in corporate management so that these could be regulated more effectively.

### **Regulation under the Australian Securities and Investments Act**

The regulation of corporate wrongdoing requires effective prudential and conduct regulation. The approach of the Australian Securities & Investments Commission (**ASIC**) to have corporate officers comply with the law with the least amount of regulatory intervention is commended.

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<sup>1</sup> My view about this overregulation has been expressed in "Overregulation has a very high cost" *Australian Financial Review* 26 May 2006.

While ASIC is responsible for conduct regulation its approach to regulating the corporate sector has allowed some prudential regulation by appealing to corporate officers to create a good corporate culture through good corporate governance and ensure that adequate measures are taken to protect consumers.

ASIC needs effective regulatory measures including sanctions to deal with civil and criminal wrongdoing but these need to be used to deal with wrongdoing rather than creating a regulatory culture where corporate officers fear the potential risks of non-compliance. The regulatory culture needs to encourage entrepreneurialism within a corporate culture of compliance because it is a sound business strategy. Its powers under the *Australian Securities and Investments Commission Act 2001* are broad and enable ASIC to respond appropriately to wrongdoing. However, more flexible measures to allow ASIC to identify and respond more effectively would complement its range of regulatory supervision. ASIC will need to guard against "capture" by not succumbing to the desires of corporations to lessen the appropriate regulatory response under the Corporations Act to corporate wrongdoing.

### **Wrongful activities of corporate officers**

The wrongful activities of corporate officers must be corrected and punished where this is the appropriate outcome. The regulation of wrongful activities needs to occur on the basis that the few who participate in wrongful activities are punished, and not punish all corporate officers by imposing more regulation by more law. Most corporate officers comply with the law and conduct their businesses in a legally proper manner. But the few wrongdoers receive the attention through inquiries, high profile court cases and the media and this affects changes to the Corporations Act that punishes all corporate officers. The approach taken by the Commonwealth Government<sup>2</sup> in response to *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme* in relation to AWB Limited to establish a task force of competent persons is a better regulatory response than merely inserting more regulation into the Corporations Act. Dealing with the specific wrongdoing is more economic and provides better outcomes for the whole corporate community.

There is a range of wrongdoing involving civil and criminal actions to respond to them. These have been increasingly inserted into the Corporations Act and further powers have been given to ASIC through both the Corporations Act and the Australian Securities and Investments Commission Act.

The Corporations Act has grown significantly over the past ten years and the pending outcomes of recent inquiries into corporate wrongdoing will no doubt impose more regulatory burden on corporations and their officers who comply with the law. However, severe wrongdoing needs to be dealt with by imposing serious penalties including imprisonment.

Despite the existing penalties applying to serious corporate crime, future cases will arise. The seeds of the next round of corporate misdeeds are contained in the current buoyant economic business climate where profits are being made and concern for compliance is receiving less attention. This scenario is based in the experience of the past where the corporate culture in some corporations contributed to wrongful activities throughout the corporation. This was identified in the *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme* in relation to AWB Limited. On a personal note, my publisher has commented to me that interest in corporate compliance texts has declined significantly in recent times. This is likely to be the response of corporate officers who are busy making profits in their businesses and they are focusing their attention on this outcome.

Corporate Australia is experiencing corporate wrongdoing by some corporations and entities such as the Fincorp Investments Limited<sup>3</sup>. Other persons conduct insider trading activities and some are caught<sup>4</sup>.

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<sup>2</sup> The Attorney-General, "Cole Inquiry Task Force Established", *Media Release 254/2006*, 20 December 2006.

<sup>3</sup> "Crash! A Second Property Empire Falls", *Australian Financial Review*, March 31-April 1, 2007 at 20-21.

The Director, Division of Enforcement, United States' Securities and Exchange Commission said in relation to the sentencing of the former chief executive officer of Enron Corporation<sup>5</sup>:

"In this scandal as in others, we are by now all too familiar with the phenomenon of executives who put themselves at the center of what would appear to be great corporate achievements, but who then loudly proclaim their ignorance when the appearance of success gives way to the reality of corruption. Let there be no mistake that today's enforcement action against Mr. Skilling places accountability exactly where it belongs."

The Director also said:

"No matter how comprehensive our laws and regulations, there will always be individuals who believe - whether because of arrogance, greed or a failure of integrity - that the rules do not apply to them or that they won't get caught if they break them. As our enforcement efforts in the Enron matter reflect, these individuals should think again."

The task force model was used in building the prosecution cases against former officers of the Enron Corporation and other corporations<sup>6</sup>. The comment by the SEC's Director is reflected in ASIC's Media Release<sup>7</sup> about the insider trading case of Ms Margot McKay where the Executive Director of Enforcement said:

"Insider trading undermines investor confidence in the fairness and integrity of the market and continues to be a priority area for ASIC. Anyone trading, or procuring another to trade, while in possession of inside information faces serious criminal and civil sanctions."

The warning against insider trading and the use of serious criminal and civil sanctions is real as ASIC has access to both civil and criminal sanctions provisions. Also, ASIC has the support of the courts in the manner in which they are increasingly recognising the serious nature of "white collar" crime and significant civil actions where defendants are ordered to make compensation and be banned from office for significant periods.

## Civil and criminal sanctions

For serious wrongdoing the separation of civil and criminal sanctions is becoming blurred. The difficulty of proving beyond reasonable doubt in criminal matters is giving way to significant civil sanctions where a person may be barred from corporate office for lengthy periods. The resort to the civil proof on the balance of probabilities is easier to establish a case in court. For lesser wrongdoing ASIC has powers to impose lesser sanctions without having to obtain a court order.

The blurring of criminal and civil proceedings was considered in *ASIC v Petsas*:

"Acts which were prosecuted by the criminal law were punished, while those who transgressed civil laws were made to pay compensation. The distinction is the root cause of the fundamental differences developed by the common law for criminal and civil proceedings, especially in the rules for discovery, the burden of proof and the admissibility of evidence. For some time, however, the reasonably clear line between the civil and criminal law has been collapsing. So great is the collapse that in 2003 Hayne J was able to say that the distinction between civil and criminal proceedings "is, at best, unstable": *Chief Executive Officer of Customs v Labrador Liquor Wholesale Pty Limited* (2003) 216 CLR 161, 200."

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<sup>4</sup> ASIC, "Former Aristocrat media relations consultant jailed for insider trading", *Media Release 07-83*, 30 March 2007. The insider trading provisions are complex and better drafting would make clearer the nature of insider trading for compliance and surveillance within a corporation.

<sup>5</sup> Cutler SM, Director, Division of Enforcement, US Securities and Exchange Commission, "Statement Regarding SEC Action Against Ex-Enron Officer Jeffrey K. Skilling", February 19, 2004, Washington, D.C.

<sup>6</sup> See Tunstall I, "Skilling scores 24/185 for corporate fraud: The rise of severe punishment for corporate wrongdoing", White Paper at [www.iantunstall.com](http://www.iantunstall.com).

<sup>7</sup> ASIC, "Former Aristocrat media relations consultant jailed for insider trading", *Media Release 07-83*, 30 March 2007.

The application of both civil and criminal sanctions in the Corporations Act for the same subject-matter is contributing to the unstable distinction. The reasons for this were identified in *ASIC v Petsas*:

1. civil remedies are now available to supplement criminal sanctions
2. civil remedies are being chosen as alternatives to the criminal law, especially in the area of so called "white collar" crime
3. civil remedies may be chosen by the enforcing authority as an express alternative to a criminal prosecution.

Civil proceedings encourage regulatory authorities to be more inclined to take action in doubtful, or potentially doubtful, cases if there is a greater likelihood of a conviction being obtained. The civil standard of proof makes this process an easier one to secure sanctions. The court in *ASIC v Petsas* recognised the difficulty for the courts arising from the blurring of criminal and civil proceedings:

- how a sentencing judge should go about determining an appropriate civil penalty for an essentially criminal offence
- what is a judge to do when required to impose a civil remedy (for example, a fine) when on the same facts in a criminal court the very same offender would have been imprisoned
- should the judge attempt to achieve an equivalence
- should the judge simply ignore the fact that on another day before a different judge the offender would have been incarcerated
- is there something in between.

The review of sanctions under the Corporations Act should consider the implications for the courts as well as the administration of sanctions by regulatory authorities. Overcoming the difficulties faced by judges could be assisted by the law by setting broad principles to guide them in the sentencing process or in awarding damages. These principles would also assist the regulator. However, some principles have been developing in the common law and in equity and the question is whether these general law principles are sufficient or sufficiently broad to allow for their use in future cases. Alternatively, broad principles of policy might be considered necessary and these prescribed in the Corporations Act or regulations.

In addition to the unstable situation between criminal and civil proceedings for sanctions under the Corporations Act there are the issues of the protective qualities of sanctions and their punitive value. Where they are punitive, general law privileges apply such as the privilege against exposure to penalties which is one of three privileges that are similar to the privilege against incrimination and have some bearing on it. The privilege against exposure to forfeiture and the privilege against exposure to ecclesiastical censure are the other two privileges. The privilege against exposure to penalties applies in relation to the disqualification of persons from managing corporations according to the High Court in *Rich v ASIC*. The privilege against exposure to penalties has evolved to the point that it "now serves the purpose of ensuring that those who allege criminality or other illegal conduct should prove it."<sup>8</sup>

Sanctions under the Corporations Act need to clearly express the nature of the sanction imposed as protective or punitive or both. This needs to overcome uncertainties as shown in court decisions leading to *Rich v ASIC* in the High Court. The review needs to consider whether general law privileges should apply or be dealt with in a similar manner as the privilege against self incrimination under the Corporations Act.

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<sup>8</sup> *Rich v ASIC* (2004) 220 CLR 129 referring to *Trade Practices Commission v Abbco Iceworks Pty Ltd* (1994) 52 FCR 96 at 129 per Burchett J.

In addition to the order imposing sanctions there is the ongoing monitoring by ASIC to ensure compliance. ASIC's Executive Director Compliance has indicated that ASIC "will consider criminal proceedings against anyone who fails to abide by their disqualification" under its surveillance initiative "to ensure that company officers banned from managing corporations comply with their disqualification."<sup>9</sup> Assistance to ASIC in the Corporations Act or the Australian Securities and Investments Commission Act to manage the administrative arrangements for disqualification from office would make the process more efficient and effective. Disqualification from office is a serious sanction applied in civil proceedings. The nature of disqualification is punitive and compliance with the disqualification order is not dissimilar to a sentence applied in a criminal matter. Consequently, effective enforcement of the disqualification order is needed. ASIC should possess effective powers to deal with the enforcement in an administrative manner without resorting to court enforcement.

## **Rationalising the penalty provisions of the Corporations Act**

The penalty provisions of the Corporations Act have grown significantly. There are too many such provisions. The reason for this is the approach taken by the legislature to intervene in the affairs of corporations and other entities regulated under the Corporations Act. While the provisions are present in part to protect investors and members, and in cases of insolvency or potential insolvency, the creditors of the corporation, a higher level of sanctions could be applied to allow corporations to choose the methods and processes to meet these higher compliance requirements.

An example of a higher provision is the matter of keeping financial records and preparing financial statements and other documents containing financial information. Chapter 2M of the Corporations Act regulates these matters in addition to auditing and other reporting requirements. The example refers to the provisions under Parts 2M.1 and 2M.2. The obligation to keep accounting records could be deleted. The obligation should be to make true and fair view financial statements. The corporation's directors and managers should be required to make true and fair view financial statements using whatever records they consider necessary to achieve this standard. This is to some extent the focus of section 285(1). This provision is sufficient to regulate a corporation's financial structure. The table in section 285(1) does not refer to accounting records but requires that attention be given to the quality of reports and statements. The obligation imposed under section 286 is not necessary. This should be a matter for the corporation or other entity required to make financial statements and other reports in relation to the financial situation. The attention given in Part 2M.2 is sufficient to regulate financial reporting. This part might be amended to ensure that the documents and information used to make reports and statements are available for inspection by regulatory authorities.

The disclosure requirements for financial statements, audit reports and directors' reports could be less prescriptive. The requirements under Part 2M.3 could be replaced by provisions similar to sections 710 and 711 in relation to the disclosure requirements for prospectuses but dealing with the disclosure of financial matters. The details of financial reporting and the keeping of financial accounts would be the responsibility of directors and managers of corporations and their advisers. The Corporations Act just needs to express the standard of reporting required and corporations need to meet that standard. There is no need for the Corporations Act to intervene in the business and operational affairs of corporations and other entities. The focus of the standard is to ensure that investors, members and other persons interested in the corporation have relevant and appropriate information to assess its financial performance. Failure to comply would attract an appropriate penalty.

Other provisions in the Corporations Act could receive similar attention to rationalise the volume of intervening provisions and to raise the level of regulation to an acceptable standard that is sufficient for the requirements of persons interested in the corporation and its activities. Relevant criminal and civil penalties can be applied to these new provisions and the burden of proof rest with those proving compliance. Serious wrongdoing would be interpreted as serious non-compliance with the standard for the particular regulated activity.

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<sup>9</sup> O'Donnell J, "Assetless Administration Fund starts to bite", *Australian Insolvency Journal*, 2007 Vol 19 No 1 42 at 43.

By lessening the regulatory provisions and removing the existing regulatory burden on corporations and other entities while inserting provisions expressing an acceptable standard for the actions required by law, directors and other managers of corporations should become less inhibited to take manageable risks for the corporation. They can work to the standard set in the Corporations Act without worrying if particular regulatory requirements are met. This will reverse the current trend to discourage risk taking and other actions to advance the corporation and its business by needing to look at the regulatory strictures and consequent sanctions.

A major risk of not rationalising the provisions of the Corporations Act is that this Act will become like the Income Tax Assessment Acts and that the fear by directors of sanctions will increase as provisions become more complex and complicated. This complexity makes the legislation difficult to understand even for legal advisers. This is a wrong objective in legislative drafting. It is not economic law. It should fail a regulatory impact assessment.

## Regulatory approach by ASIC

ASIC appears to be taking a broader approach to the administration of the Corporations Act and the imposition of sanctions. The former Chairman of ASIC said in a speech<sup>10</sup> to the Australian Institute of Company Directors that ASIC's approach to regulation is to start with the premise that directors are expected to comply with the law.

ASIC's Deputy Chairman observed<sup>11</sup> that directors of large public companies "feel somewhat besieged by regulatory change, complexity and a perception that there is an ever increasing risk of personal liability. On these issues, perception is reality because what directors believe will affect the way they behave. In a number of areas, excessively cautious and risk-averse behaviour is creating regulatory challenges." He also said:

"When it comes to company directors, ASIC is really in the behaviour management business. We are seeking to have directors comply with the law with the least possible intervention from us....There are, of course, times when we do take enforcement action directly against directors, such as in the *OneTel* proceedings, but this is where no other regulatory response is thought to be appropriate."

The Deputy Chairman said<sup>12</sup> that one of the key areas for ASIC is to listen "more closely and intimately to what company directors think." This involved establishing a consultative panel that meets three or four times a year. The panel is intended to operate on a confidential and informal basis. The panel complements other consultation mechanisms with industry bodies, professional associations and direct contact with corporations. Despite the confidential nature of these meetings ASIC needs to be reasonably transparent in its deliberations with the corporations it deals with to show that ASIC has not been captured by these relatively few corporations represented at the meetings. In view of ASIC's professionalism in administering the law and in its dealings with those regulated by it, being an arm's length dealing, the community can be assured that ASIC would not be captured.

This approach to corporate regulation can be effective despite the possibility of ASIC being captured by the corporate sector through its association with business councils and other industry bodies. It seems clear from this approach that ASIC is responsible and the risk of capture is low. The focus on promoting a positive corporate culture will reap regulatory rewards as ASIC will benefit from information about cases and circumstances of non-compliance or other wrongdoing. Just as ASIC benefited from the assistance given by Mr Howard in relation to the HIH Insurance Limited and related companies' litigation<sup>13</sup> close attention to corporate activity will alert ASIC to wrongdoing by corporate officers.

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<sup>10</sup> Lucy J AM, "Directors' Responsibilities: The reality vs the myths", Australian Institute of Company Directors, 17 August 2006, Melbourne Australia.

<sup>11</sup> Cooper J, "Working with Australian company directors", Federal Court of Australia/Law Council of Australia Joint Corporations Law Seminar, Sunday 26 March 2006, Federal Court, Sydney.

<sup>12</sup> Cooper J, "Working with Australian company directors", Federal Court of Australia/Law Council of Australia Joint Corporations Law Seminar, Sunday 26 March 2006, Federal Court, Sydney.

<sup>13</sup> *R v Howard* [2003] NSWSC 1249.

ASIC not only needs to be informed and to comprehend the extent of corporate wrongdoing but it needs to act in a proactive manner to avoid wrongdoing as far as practicable. This is a difficult issue for which ASIC receives media criticism at times. This could be a practicable approach despite the difficulties. The approach taken by the United States' Securities and Exchange Commission (SEC) by auditing corporations and entities on introducing the Sarbanes-Oxley Act of 2002<sup>14</sup>. This Act seeks to raise the quality of financial reporting by corporations and other entities. An analysis of the substantive reforms under the Sarbanes-Oxley Act can be seen in *Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002*<sup>15</sup>. This approach could be used by ASIC as a proactive measure to inform the corporate community about their level of compliance and to provide individual corporations with specific compliance errors that need to be corrected within a specified time period as given in the advice from ASIC. The corporation would then be required to report to ASIC by the specified time or a later time if allowed by ASIC by providing an independent audited report. The auditors of the corporation would need to explain to ASIC why the errors were not detected and the measures put in place to avoid further errors in the future. The crafting of a statutory provision or the administrative prescription should not cross over or overtake the auditing requirements under the Corporations Act.

This approach by ASIC would probably be more effective than the consultative panel approach. It would have more information across a range of corporations that are strategically chosen for audits by ASIC. ASIC could engage a team of auditors from the profession to conduct these inspections subject to risks of conflict of interest and any other apparent risks that would undermine the quality of the reports. Corporations as a whole would tend to welcome this approach as it would assist in identifying particular errors that can be corrected and cause corporations to become more vigilant in preventing future errors by improving corporate governance arrangements. It may be possible to make these corporate governance measures a part of the Corporations Act to provide a liability for lack of or inappropriate corporate governance in relation to financial reporting. Inspections of corporations' financial reporting based on their chosen form of accounting records using accounting standards could be made using the ASX Corporate Governance Council's [Principles of Good Corporate Governance and Best Practice Recommendations](#) and other mechanisms used for corporate governance.

The reports received by ASIC or those generated by ASIC would provide valuable information for administering the law for corporations and financial markets but it would assist policy makers and the legislature to improve the quality of the Corporations Act. The provisions of the Corporations Act would not be allowed to grow on the basis of a few corporate wrongdoings or on information that is not widely tested or provide for sanctions and measures to intervene in the management and operations of corporations without a proper regulatory impact assessment.

## Summary

Lessening the current regulatory requirements under the Corporations Act is essential for good regulatory practice. ASIC needs appropriate measures to not only deal with corporate wrongdoing as it is detected but also to administer the law in a proactive manner. They are providing an "intermediary" level of civil-criminal sanction that does not require the criminal level of proof and penalties can range from civil type penalties including compensation to criminal-like penalties such as disqualification from office.

The penalty provisions under the Corporations Act are proving to be an effective measure for ASIC to deal with corporate wrongdoing and they may need adjusting on the considerations of evidence put to the Inquiry. The urgent need is to reshape the Corporations Act to make it less like the Income Tax Assessment Acts in size and volume of provisions, to be less interventionist in corporate management and operations, allow for more self-regulation by corporations and industry associations, and be easier to read and used by non-lawyers and non-accountants. It needs to be a more practical code that can be applied by a reasonable person with sufficient knowledge of corporate management and operations.

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<sup>14</sup> See for example *Report pursuant to Section 704 of the Sarbanes-Oxley Act of 2002* available on the SEC's website at <http://www.sec.gov/news/studies/sox704report.pdf>.

<sup>15</sup> Available on SEC's website at <http://www.sec.gov/news/press/4-497/sorego031505.pdf>.

Corporate governance needs to be incorporated into the Corporations Act. This will raise the level of corporate governance and its recognition in law as a measure that needs to be complied with by managers of corporations (the board of directors and executives). Broad principles and policies can be drafted into the Corporations Act to provide for corporate governance measures. Sufficient information is available in the market and experience within corporations to codify corporate governance that can be applied in a flexible manner within the governance arrangements of each corporation and other entity. However, these provisions would include a sanction or sanctions for breach depending on the severity of the breach and the willingness to correct errors and breaches.

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