Association of Litigation Funders of Australia

SUBMISSION TO TREASURY: INDEPENDENT REVIEW OF CHANGES MADE BY THE *TREASURY LAWS AMENDMENT (2021 MEASURES NO. 1) ACT 2021*

1 December 2023

Association of Litigation Funders of Australia

Submission to the Independent Review of Changes Made by the *Treasury Laws Amendment (2021 Measures No. 1) Act 2021*

Executive Summary

1. The *Treasury Laws Amendment (2021 Measures No. 1) Act 2021* (**2021 Amendments**) amended the continuous disclosure obligations and the misleading and deceptive conduct provisions of the *Corporations Act 2001* (the **Act**) and the *Australian Securities and Investments Commission Act 2001* to remove strict liability for companies and officers that fail to disclose market sensitive information.

2. The 2021 Amendments have weakened Australia's continuous disclosure regime and should be repealed. This is because:

   a. they have introduced significant and unreasonable complexity and confusion to the operation of the regime. This increased complexity and confusion can only lead to a decrease in market efficiency, effectiveness and integrity, and an increase in costs to investors and corporations;

   b. despite being one of the stated reasons for introducing the 2021 Amendments, there is insufficient data to support the proposition that class actions commenced under the previous regime were a significant factor driving up the cost, and decreasing the accessibility, of D&O insurance, or that the 2021 Amendments address these concerns; and

   c. in reducing market integrity and diluting the continuous disclosure regime, the 2021 Amendments have taken Australia out of step with major overseas markets including because they have diminished the Australian Securities and Investments Commission's (**ASIC's**) ability to pursue legitimate enforcement action.

Introduction

3. The Association of Litigation Funders of Australia (**ALFA**) welcomes the opportunity to respond to the questions posed by Treasury's consultation paper on the independent review (**Review**) of changes made by the 2021 Amendments.

4. ALFA is a professional body established in April 2018 to enhance the Australian litigation funding market by:

   a. providing education, training and information about litigation funding and the litigation funding market;

   b. engaging with government, legislators, and other policymakers to help shape the legal and regulatory framework of litigation funding in Australia; and

   c. promoting best practice and ethical behaviour amongst litigation funders in Australia.

5. The Funder Members of ALFA are Balance Legal Capital, CASL, Court House Capital, Fortress Investment Group (Legal Assets), Hartwell Funds, Ironbark Funding, Litigation Lending, Premier Litigation Funding and Southern Cross Litigation Finance.

6. This submission is made on behalf of ALFA's Funder Members and represents their collective views, but it does not necessarily represent the individual views of each member.

Impact on market efficiency and effectiveness

7. In its June 2021 submission to the Senate Economics References Committee on the then-proposed 2021 Amendments (**ASIC Submission**), ASIC explained the importance of robust continuous disclosure obligations as follows (citations omitted):

   "Markets cannot operate with a high degree of integrity unless the information critical to investment decisions is available and accessible to investors on an equal and timely basis. That is why market cleanliness and continuous disclosure are essential to investor confidence. Price discovery in a clean market is efficient. Asset prices react immediately after new information is released through appropriate channels and thereby more closely reflect underlying economic value."[1]

8. At this early stage, ALFA does not hold detailed empirical data about the impact of the 2021 Amendments on the effectiveness or efficiency of the Australian securities market, nor the level of information available to the market. This is particularly because:

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1 ASIC Submission, at p 19.

a. there have been no relevant decisions in respect of any shareholder class actions commenced after the 2021 Amendments; and

b. ASIC's last report on the 'cleanliness' of the Australian financial markets (which is measured by low levels of information asymmetry between participants) was published on 31 July 2019, well before either the 2021 Amendments or the identical but temporary measures that preceded them came into force.[2]

9. Therefore, the following points in support of our view that the 2021 Amendments have resulted in the Australian market being materially less efficient, effective, and well-informed are necessarily made at a high-level, and are based on ALFA's principles-based assessment of the operation of the 2021 Amendments.

10. ALFA disagrees with the former government's position that the previous continuous disclosure regime encouraged *"opportunistic shareholder class actions"*, and the accompanying implication that corporations were being unduly penalised by plaintiff-friendly legislation.[3] To the contrary, the previous regime contained appropriate safeguards against unnecessarily harsh or unreasonable disclosure obligations, while maintaining the central regulatory purpose of ensuring market integrity.

11. Under the previous section 674(2B) of the Act, the continuous disclosure obligations of listed disclosing entities were linked to the ASX listing rules, because they were only engaged when the entity 'had' information that the listing rules obliged it to disclose.[4]

12. As to when an entity will 'have' information, Listing Rule 3.1 states that "*once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information.*" Listing Rule 19.12 defines awareness by reference to both actual and constructive awareness, stating that: "*An entity becomes aware of information if, and as soon as, an officer of the entity (or, in the case of a trust, an officer of the responsible entity)*

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2 See ASIC's Report 623 '*Review of Australian equity market cleanliness*' (https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-623-review-of-australian-equity-market-cleanliness-1-november-2015-to-31-october-2018/).

3 Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, '*Litigation funding and the regulation of the class action industry*' (Report, December 2020) at p 349 (**Joint Committee Report**).

4 See ss 674(1) and 674A(1).

has, or ought reasonably to have, come into possession of the information in the course of the performance of their duties as an officer of that entity."[5]

13. Because entities were obliged to disclose information they 'had', meaning information they were aware of, the pre-existing regime already required plaintiffs to prove either actual or constructive knowledge of the relevant information (i.e., a fault element). The materiality of that information would then be objectively ascertained by the Court.[6]

14. Consequently, it has been suggested that the previous regime only took a strict liability approach at the final step, after the plaintiff had established that the entity was actually or constructively aware of information that was objectively material, but nevertheless decided not to disclose that information.[7] In our view, strict liability at this point is entirely appropriate for the purpose of ensuring market integrity and cleanliness, while ensuring that listed entities are not unfairly penalised.

15. On the other hand, the 2021 Amendments deepen the information asymmetries between an entity and its shareholders, such that even legitimate actions may be stymied, if not stifled. This is because shareholders, and especially retail investors, typically have no meaningful engagement with the entity or its internal processes. This puts them at an inherent forensic disadvantage: they have to prove not only that the entity was aware of material information, but also that the entity's state of mind amounted to knowledge, recklessness, or negligence as to the materiality of that information.

16. It must be asked, where is a retail investor to obtain the documents or information that will support such an allegation, even if there is merit to it? By their nature, publicly available documents are unlikely to assist, and discovery processes will not be available if shareholders are unable to commence a claim because they do not have a proper basis for alleging the fault element. Preliminary discovery processes are also unlikely to be available if the shareholders cannot demonstrate, due to this same information

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[5] In *ASIC v GetSwift Limited (Liability Hearing)* [2021] FCA 1384 at [1082], Lee J noted that any information which an officer ought to have come into possession of, can constitute information that the entity is 'aware' of. Following the decision of the Full Court of the Federal Court in *Larry Crowley v Worley Limited* [2022] FCAFC 33 (***Crowley v Worley***), the current state of the authorities is that an entity may also be constructively aware of an opinion, whether or not it was in fact formed.

[6] *James Hardie Industries NV v ASIC* (2010) 274 ALR 85 at 111 [527] per Spiegelman CJ, Beazley and Giles JJA.

[7] Michael J Duffy, "Modifications to continuous disclosure requirements and the role of corporate knowledge, intent, recklessness, and negligence in breaches: a discussion" (2021) 38 CS&SLJ 138 at 142-143.

imbalance, that they hold a reasonable belief that there has been misconduct.[8] In this regard, it is telling that ASIC (which is in a far better position than a retail investor) has *never*[9] instituted a criminal proceeding for breach of the continuous disclosure regime. Like the 2021 Amendments, a criminal prosecution under section 1311 of the Act would also require proof of intention, knowledge, recklessness or negligence.[10]

17. Further, as noted in the submissions by Maurice Blackburn[11] and the Law Council of Australia[12] to the 2021 Inquiry, the 2021 Amendments arguably allow entities to pass responsibility off to their advisers. For example, accounting or legal advice as to materiality that leads to misstatements or material non-disclosures could arguably be used to shield the entity against a claim. And since liability is accessorial, even if the advisor was negligent, shareholders could not proceed against the advisor under section 674A of the Act because there would be no contravention by the entity that could ground a related claim against the advisor. This leaves shareholders without recourse for their losses, no matter their genesis.

18. In addition to watering down the continuous disclosure regime, the 2021 Amendments have also created significant confusion because they still incorporate the objective test of materiality in the Listing Rules, through section 674A(2)(b) of the Act. This appears inconsistent with the subjective fault elements of knowledge, recklessness, or negligence that now overlay the materiality analysis in section 674A(2)(d) of the Act. It is difficult to see in what circumstances an entity can 'have' (in the sense of being aware of, under Listing Rules 3.1 and 19.2) information that is *objectively* material (i.e., any reasonable person considering that information would expect it to be material) but nevertheless go on to form a subjective state of mind about its immateriality that is *not* knowing, reckless or negligent. This adds uncertainty and risk to the regime, for both plaintiffs and defendants. Further, since the company's subjective views on materiality (that were held

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8 See *Bonham v Iluka Resources Limited* [2017] FCAFC 95 at [90].

9 ASIC Submission, at p 15.

10 Albeit to the criminal standard of proof – i.e., beyond reasonable doubt.

11 Submission 11, at [13]-[20] (**Maurice Blackburn Submission**) (https://www.aph.gov.au/DocumentStore.ashx?id=cebf1cad-d40e-4d69-99cb-4fe65fac6f05&subId=703342).

12 Submission 21 (**LCA Submission**), at [94] (https://www.aph.gov.au/DocumentStore.ashx?id=6a626c7b-e849-4718-b161-d3bb21bd9969&subId=703532).

at the relevant time) are part of the factual matrix that Courts will consider under the objective test, it is unclear what the new fault-based test of materiality seeks to cure.[13]

19. We also adopt the comments made by ASIC,[14] the Law Council of Australia,[15] and Maurice Blackburn[16] in their respective submissions to the 2021 Inquiry in relation to the likelihood that the 2021 Amendments will introduce uncertainty as to how to attribute the requisite state of mind to a breaching entity. Under the common law, the attribution of a corporate state of mind is often limited to the corporation's board and senior executives. Therefore, the fault elements in the 2021 Amendments may permit corporations to raise defences, including in relation to misleading and deceptive conduct, that are based on a lack of knowledge where relevant information has not been presented to the board. As noted by ASIC,[17] this does not sit comfortably with the actual and constructive knowledge standard in Listing Rule 19.2, which was recently reinforced by the Full Court of the Federal Court in *Crowley v Worley*. In that case, the Full Court found that even opinions which ought to have been – but were not – formed by an officer of an entity, can be constructively held by that entity.[18] At best, this apparent divergence introduces uncertainty into the regime, and at worst, it permits corporations to rely on their own poor reporting and information management to avoid liability.

20. ALFA also relies on paragraphs 62 – 71 of its submissions to the Senate Economics Legislation Committee Inquiry into the *Treasury Laws Amendment (2021 Measures No.1) Bill 2021* (**2021 Inquiry**), in relation to the amendment of the misleading and deceptive conduct provision in section 1041H of the Act. A copy of these submissions has been annexed as Appendix A. In particular, ALFA reiterates that it is inappropriate to impose a fault element on shareholder claims for misleading and deceptive conduct arising from breaches of the continuous disclosure regime. This aspect of the 2021 Amendments has put the protections in the Act out of step with the general protections in the *Australian Consumer Law*, and has further diminished the integrity of the market.

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13 Above n. 6.
14 ASIC Submission, pp 9-10.
15 LCA Submission, p 24 at [95].
16 Maurice Blackburn Submission, p 7.
17 ASIC Submission, p 10 at [27]-[28].
18 *Crowley v Worley,* at [173], [182].

21. Even if the uncertainty and forensic imbalance created by the 2021 Amendments does not unduly prevent the bringing of shareholder class actions, we expect that it will increase the complexity (and, therefore, costs) of litigation and add uncertainty and risk on both sides. Ironically, this is likely to further incentivise the very high rate of settlement of funded class actions, rather than their final determination by a Court, which was one of the issues raised during the Australian Law Reform Commission's (**ALRC**) inquiry into class action proceedings and third-party litigation funders.

Impact on the nature and quality of disclosures by disclosing entities

22. ALFA is not in a position to obtain detailed data required to provide a specific response to question 2 of the questions in the consultation paper. However, as to question 3, we refer to the matters set out above in support of the broader proposition that the 2021 Amendments negatively impact the level of information available to the market. This must in turn necessarily reduce the ability of investors to make informed investment decisions.

Impact on class actions

23. It has been argued by some commentators that there has been a significant increase in class action filings in Australia in recent years. The perceived increases in the volume of class action proceedings are overstated. It needs to be viewed in an appropriate context, which includes, *inter alia*, litigation concerning the extraordinary findings of the Financial Services Royal Commission. Further, claims may have been double counted where separate proceedings are commenced in respect of the same matter. Having regard to that context, the evidence indicates that the number of class actions in Australia has been relatively stable in recent times. In support of this statement, we refer to submission 3 in ALFA's Submission to the Parliamentary Joint Committee on Corporations and Financial Services (**Parliamentary Inquiry**) which makes it clear that there has not been an explosion of class action claims, but instead a relatively consistent but slow increase in filings. A copy of these submissions has been annexed as Appendix B.

24. As noted above, there have been no relevant determinations in respect of shareholder class actions commenced after the 2021 Amendments came into effect, and limited empirical data is available. Professor Vince Morabito has identified a significant

decrease in the number of shareholder class actions filed in 2019 (the last year before the identical precursor to the 2021 Amendments came into effect)[19]. This decrease continued in 2020 and 2021, but appears to have reversed in 2022, rising from 15% of all class actions filed in 2021 to 24.2% of all class actions filed in 2022.[20]

25. However, the overall number of class actions (regardless of subject matter) filed each year has also declined since 2020, as has the number of funded class actions.[21] In 2022, only 33 class actions were filed, 8 of which were shareholder class actions. This being the case, it is difficult to comment on whether or not the relative decline in shareholder class actions since 2020 can be attributed solely or even predominantly to the 2021 Amendments (and their temporary precursor).

26. There have been a number of significant economic matters that have arisen since the 2021 Amendments which may have had an effect on the number of shareholder class actions. To properly understand the impact of the 2021 Amendments, the Review should analyse the claims that litigation funders and plaintiff law firms chose not to pursue in the courts, and the reasons for that outcome. There are many reasons why a litigation funder and/or plaintiff law firm will not proceed with a claim. Legal liability is just one aspect of the due diligence and overall risk assessment undertaken.

27. In speaking with litigation funders and plaintiff law firms, ALFA is not aware that the enactment of the 2021 Amendments has been the sole cause, or even a significant cause, of any change to the number or type of class actions that have been or will be brought. The more significant issue in recent years has been the spectre of competing class actions and the costly and inefficient process of a "beauty parade".

28. ALFA is of the view that repealing the 2021 Amendments (of themselves) would not materially impact the number or type of class actions against disclosing entities. However, we consider that a repeal would have a materially positive impact on the integrity of the Australian share market. In this regard, we refer to our submission to the 2021 Inquiry, which sets out in detail the reasons why ALFA opposed the proposed

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19 A drop to 20.3% of all class actions filed in 2019, down from 39.3% the preceding year and 44.8% in 2017. See Vince Morabito, 'Empirical perspectives on twenty-one years of funded class actions in Australia' (April 2023), (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4422278), at 19-20 (**2023 Morabito Report**).

20 Ibid.

21 2023 Morabito Report, at 12.

amendments to the continuous disclosure obligations and the misleading or deceptive conduct provisions.

29. We also note that for the reasons given at paragraphs 11-21 above, a repeal of the 2021 Amendments would promote the bringing of legitimate proceedings where there has been corporate misconduct, and reduce complexity and uncertainty in the continuous disclosure regime, thereby contributing to the overall integrity of the market.

Impact on D&O insurance

30. ALFA is unable to comment with specificity on the impact of the 2021 Amendments on the availability and/or cost of D&O insurance as:

    a. it is not actively involved in the business of providing or obtaining D&O insurance; and

    b. there have been a number of other significant economic matters that have arisen since the 2021 Amendments which may have affected the cost and availability of D&O insurance. These matters make it difficult, without a dedicated inquiry that is outside the scope of this submission, to determine any impact the 2021 Amendments may have had on the cost of D&O insurance.

31. However, at a high level, we note that even if (which is denied) class actions were the sole factor in cost increases and availability difficulties, securities class actions by their nature are not brought without a proper basis. We are unaware of any frivolous or vexatious claims supported by litigation funders, who are subject to careful court oversight and who, for obvious commercial reasons, follow a rigorous investment review process. Against this landscape, any increase in the cost of D&O insurance or decrease in its availability is ultimately caused by corporate misbehaviour. Class actions, together with any attributable rise in insurance premiums, are simply a necessary consequence of that corporate misbehaviour; without corporate wrongdoing, there would be no class actions.

32. Given this, ALFA would welcome a comprehensive review and detailed inquiry that takes into account the following matters which have been cited as making a material contribution to the alleged increase in the cost of D&O insurance premiums and decreased availability of coverage over the last three years:

a. the normal business repositioning of risk and pricing for insurance (arguably, D&O insurance in Australia has been significantly underpriced for many years);[22]

b. an increase in merger activity;

c. the cost of regulatory investigations and the payment of fines and penalties as a result of these investigations (including but not limited to the Hayne Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry);

d. a significant rise in insolvent trading claims, employment wage underpayment claims and cybersecurity/data breach claims;

e. the economic environment post-pandemic; and

f. securities class action claims.

33. Any review of the legal and economic impact of particular legislation should also consider the extent of legal fees and disbursements required to bring claims under these regimes, the role of defence costs, and the impact of those costs on insurance.

Consistency with other markets

34. The 2021 Amendments have made Australia's continuous disclosure regime more lenient than major overseas markets. Of the five major international jurisdictions considered by the Joint Committee Report,[23] three (Canada, Hong Kong, and South Africa) have adopted a strict liability test for public and private enforcement actions against corporations breaching their continuous disclosure obligations. The specifics of each of these regimes is set out in detail in the attachment to the AICD's submission to the Parliamentary Inquiry.[24]

35. Hong Kong, which has one of the largest securities markets in the world, takes the strictest approach, with no mental elements required to be proven and no defences available to listed companies (although they are available to individual directors). Rather, companies can avail of safe harbour provisions, which appear to be similar to

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[22] XL Catlin/Wotton + Kearney white paper, "*Show me the money*", September 2017, at page 15 (https://axaxl.com/-/media/axaxl/files/pdfs/insurance/professional-liability/directors-and-officers/white-papers/xlcatlindo-securities-class-actionswp2.pdf).

[23] Joint Committee Report, at p 88 (Table 17.2).

[24] Submission 40 (https://www.aph.gov.au/DocumentStore.ashx?id=2bf0b119-d92d-4507-b518-4b97a383d440&subId=684625), at pp 20 – 55 (Appendix 1).

the circumstances carved out of Australia's Listing Rule 3.1 (for example, where the information is a trade secret or disclosure would amount to a breach of a relevant law).[25] South Africa has also chosen not to provide defences for breaches by listed companies.[26] The Canadian regime includes various defences that go to the corporation or relevant person's state of mind.[27] However, as the corporation typically bears the burden of establishing these defences, they would not unduly stultify an information-poor plaintiff's ability to raise a legitimate claim.

36. Although the United Kingdom (**UK**) and the United States of America (**US**) have incorporated fault elements which must be proven by plaintiffs, there are key distinctions between those regimes and the 2021 Amendments. In this regard, ALFA agrees with ASIC that regulators in the UK and the US have more robust enforcement powers.

37. Under the 2021 Amendments, ASIC can only apply a strict liability threshold when issuing an infringement notice for breach of section 674 of the Act. However, entities do not have to comply with an infringement notice. If the entity does not comply and ASIC wishes to pursue further enforcement action, it must commence either a criminal or civil proceeding. If it pursues a civil penalty, then it must establish fault under section 674A of the Act.

38. In contrast, in the UK, the Financial Conduct Authority (**FCA**) can strictly enforce the obligation to disclose 'inside information'[28] (which is broadly the equivalent of material information under the Australian continuous disclosure regime) under section 123(1)(b) of the *Financial Services and Markets Act 2000* (**FSMA**). All the FCA needs to prove, in relation to the listed entity, is that there has been a contravention of the obligation to disclose inside information.[29] The FCA can also seek restitution for affected investors under section 382 of the FSMA. Similarly, the Joint Committee Report accepted that

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25 Ibid at pp 12 – 15 of Appendix 1.
26 Ibid at pp 16 – 19 of Appendix 1.
27 Ibid at pp 7 - 10 of Appendix 1.
28 See the definition of 'inside information' in Article 7(1) of Regulation (EU) 596/2014 (**Market Abuse Regulation**): "*information of a precise nature, which has not been made public, relating directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.*"
29 Contained in Article 17 of the Market Abuse Regulation.

securities regulators in the US are not encumbered by the fault elements investors must establish in private actions.[30]

39. ALFA considers that repealing the 2021 Amendments would have a materially positive impact on the competitiveness of Australia's equity markets. The introduction of a corporate mental element at the stage of the materiality analysis in section 674A of the Act has made the Australian market more lenient than the major overseas markets discussed above. This is compounded by the fact that, unlike in the UK and the US, ASIC's public enforcement powers do not offset the dilution of investors' ability to institute private actions. While repealing the 2021 Amendments may make Australia less attractive to listing entities in the short term, unenforceable breaches of continuous disclosure obligations will undeniably erode investor confidence and reduce the availability of capital. Ultimately, this will have a greater impact on the ability of the Australian market to attract new listings, than any perceived leniency in enforcement.

Compliance and enforcement

40. At this early stage, ALFA is not in a position to comment on changes in the number and/or effectiveness of enforcement actions by ASIC since the 2021 Amendments came into effect.

41. However, as discussed at paragraphs 36-38 above, the operation of the 2021 Amendments pose a legislative barrier to effective enforcement by ASIC. Further, the uncertainty the 2021 Amendments introduce into the regime (discussed above at paragraphs 17-20) also cause practical problems which mean that any investigation and subsequent litigation will be time, cost, and resource-intensive. Given that ASIC has finite resources which it must dedicate to competing enforcement priorities, these practical barriers are also likely to reduce ASIC's capacity to effectively enforce the regime, and ASIC's own submissions to the 2021 Inquiry make this clear.[31] On that basis, ALFA considers that repealing the 2021 Amendments would have a materially positive impact on ASIC's capacity to take effective enforcement action against disclosing entities.

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30 Joint Committee Report, at p 88 (Table 17.2).

31 ASIC Submission, pp 9 – 10.

Other matters

42. As noted in ALFA's submission to the 2021 Inquiry (annexed at Appendix A), the 2021 Amendments were made without undertaking any unbiased, evidence-based review of the pre-existing regime, as recommended by the ALRC. In ALFA's view, the 2021 Amendments should be repealed. However, if this Review concludes, as the ALRC did, that there were aspects of the previous regime that warranted amendment, any amending process only be undertaken in accordance with the recommendations of an independent inquiry, which should consider, *inter alia*:

    a. the effect that breaches of market protection legislation have on the cost and availability of capital in Australia;

    b. the diminished returns on investment caused by misallocation of capital resulting from market misbehaviour; and

    c. the additional costs involved in ASIC enforcing the continuous disclosure obligations if fewer ASX shareholder claims were brought.

    In other words, the cost to the ASX and market participants of breaches of the continuous disclosure laws and the deterrent effect of class actions.

Association of Litigation Funders of Australia

1 December 2023