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Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

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Dear Sir/ Madam,

Litigation funding and the regulation of the class action industry

CPA Australia represents the diverse interests of over 166,000 members working in over 100 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

We thank the Committee for the opportunity to make this submission and confine our remarks chiefly to Terms of Reference 5, 6 and 10 dealing respectively with the Australian financial regulatory regime and factors driving class action proceedings in Australia. In doing so we consider the current 'state of play' of three pillars of the Corporations Act 2001, namely; Chapter 6CA – Continuous Disclosure, Chapter 7 - Financial Services and Markets and Section 1041H – Misleading and Deceptive Conduct. Each of these was introduced with effect in March 2002 via the Financial Services Reform Act 2001 as part of CLERP 6.

We remark also at the outset that many of the matters canvassed across the Inquiry's Terms of Reference are dealt with in depth in the Australian Law Reform Commission's (ALRC's) Report No. 134 *Integrity, Fairness and Efficiency – An Inquiry into Class Action Proceedings and Third-Party Litigation Funders* (December 2018). It is understood that the Government has yet to responses to the Report's 24 detailed recommendations. CPA Australia believes that as a matter of sound public policy, an analysis of such depth and comprehensives, as undertaken by the ALRC, should provide the primary insight into possible law reforms, particularly given the subject matter spanning numerous areas of both procedural and substantive law, and the wide economic and social consequences.

Terms of Reference 10 probes the effect of unilateral legislative and regulatory changes to class action procedure and litigation funding. We reference here the Treasurer's announcement of 22 May 2020 that litigation funders would, through removal of the exemption provided under the Corporations Amendment Regulation 2012 (No 6), be required to hold an Australian Financial Services Licence (AFSL) and comply with the managed investment scheme regime. This measure has received a good degree of support from a number of prominent law firms and segments of the business community. Nevertheless, CPA Australia urges significant caution in the pursuit of these measures, which should be clearly understood with reference to, at a minimum, the following three criteria:

- Are the measures fit for the scale of any actual or perceived regulatory, market or access to justice failures?
- In developing these measures, is there ample recognition of potential adverse consequences and measures of mitigation? and

- Do the measures either obscure or negate the effective addressing of wider factors warranting analysis and potential law reform?

Clearly, following the Full Federal Court decision in *Brookfield Multiplex Limited v International Litigation Funding Pte Ltd*[1], litigation funders undertaking a common enterprise of a commercial character which uses the Court's processes in pursuit of mutual benefits for each of the group members, the funders and solicitors[2], are providing financial services meeting the definition laid out in section 911A of the Corporations Act. The ALRC Report No 134 emphasises the extent to which litigation funders are subject, notwithstanding the afore mentioned exemption, to regulatory requirements, perhaps most notably consumer protection provisions of the Australian Securities and Investment Commission Act 2001 (ASIC Act).The Committee will be aware of the ALRC having canvassed the possibility of amendment to the Corporations Act requiring litigation funders to obtain and maintain a licence, yet concluded in its Final Report that it:

> *…… is not satisfied that the benefits of a licensing regime outweighs the regulatory costs of imposing a licensing regime with minimum capital adequacy requirements on litigation funders.*[3] *[And further] a licence is unlikely to improve regulatory compliance in the third-party litigation funding industry in the short to medium term.*[4]

Of relevance also is ASIC's submission to the ALRC on the matter:

> *….. the existing mechanism for the court to order security for costs is a more targeted and effective way to address the risk that a litigation funder will not have adequate resources to meet an adverse cost order. By contrast, the AFS licensing requirements are not designed to act as a security to meet particular liability, nor are they intended to protect against credit risk more generally.*[5]

Two interrelated matters can be drawn from the ASIC view.

The first concerns the operation, and the apparent robustness, of the Federal Court of Australia Act 1976 (FCA Act) in enabling courts to adjudicate effectively and swiftly on matters concerning the fairness and reasonableness of litigation funding commissions. The recent judgment of Murphy J in *Endeavour River Pty Ltd v MG Responsible Entity Limited*[6] (the matter concerning Murray Goulburn Co-operative Co. Ltd) is highly salient with the relevant principle stated by His Honour:

> *The principle to be applied in a settlement approval application under s 33V*[7] *are uncontroversial, and have been set out in numerous cases.*[8] *It suffices to note that the Court's fundamental task is to decide whether the settlement is fair and reasonable having regard to the interests of the class members who will be bound by it, including as between class members. The Court assumes an onerous and protective role in relation to class*

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[1] (2009) 180 FCR 11
[2] Refer ALRC Final Report [2.74]
[3] [6.34]
[4] [6.41]
[5] [6.23]
[6] [2019] FCA 1719
[7] Settlement and discontinuance – representative proceeding
[8] Citations omitted.

> *members' interests which is not unlike the role the Court assumes when approving settlements on behalf of persons with a legal disability*.[9]

Furthermore, specifically with reference to funding commissions:

> *In* Money Max Int Pty Ltd (Trustee) v QBE Insurance Group Limited *[2016] FCAFC 148 the Full Federal Court said that there is no reason in principle for the Court to treat litigation funding costs incurred to achieve a settlement differently from legal costs incurred to achieve settlement*.[10]

Both the targeted judicially overseen process examined in this case, along with the outcome ultimately favouring the class action claimants over the funder on the key matter of commission, pose serious questions as to whether the contemplated licensing arrangement would add anything to the existing objects set out in the FCA Act to achieve in civil practices and procedures just resolutions reached quickly, inexpensively and efficiently as possible.[11] Moreover, that Act presents as the most straight forward and directly available statutory mechanism of either improving outcomes or removing anomalies in class action arrangements, particularly given the operation of Part IVA.[12] In these regards many of the recommendations in the ARLC Report seem well targeted and proportionate, most notably those analysed and presented in Chapter 6 *Regulation of Litigation Funders.*

The second matter stemming form the ASIC response, relevant to the licensing proposal, concerns respective intent in the enactment of the statutes under consideration. In a recent article, *Will 2020 mark the beginning of the end of class actions in Australia?*[13] reflecting on the decision in *Brookfield Multiplex* that the actions of litigation funders came with the ambit of managed investment scheme arrangements[14], Professor Vincent Morabito, a member of the ALRC Inquiry expert academic panel, noted the outcomes of a roundtable of experts convened by Treasury:

> *A clear majority of the participants at this roundtable concluded that placing class actions funded by litigation funders (and plaintiff solicitors) under this regime would be inappropriate and undesirable in light of the simple fact that its drafters did not envisage or intend that this regime would be applicable to funded class actions*.

Regardless of concerns as to ASIC's capacity (along with its willingness and resources) to effectively supervise and regulate this market, there arises fundamental questions of appropriate legislative purposes, and thus potential negative consequences, of a wholesale retrofitting of litigation funders into financial services and markets law – such as stifling legitimate access to justice in matters outside of class action claims by shareholders and investors. Also, in terms of this later 'controversial' category of claimant, the role performed in driving the proper discharge of directors' duties[15] and exercise of powers.

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[9] At [4]
[10] At [26]
[11] Refer Federal Court of Australia Act 1976 section 37M
[12] Representative proceedings
[13] Lawyerly. May 27, 2020
[14] Corporations Act 2001 Chapter 5C
[15] The Committee may find of broader value analysis undertaken by the Commonwealth Climate Law Initiative (CCLI) examining the extent to which in four relevant jurisdictions (Australia, UK, Canada and South Africa) the prevailing directors' duties regimes are all conceptually capable of being applied to governance failures in the identification, assessment, oversight and disclosure of climate-related financial risks. The CCLI's 'synthesis report' provides some insight commentary (page 18) in which Australian directors are seen as facing the greatest potential for liability in relation to the impacts of climate change on their business; amongst which litigation funded support of securities class actions for misleading disclosures causing a significant stock loss, is

That the licensing arrangements can be readily achieved though legislative amendment to the 2016 *Regulation,* does not, in CPA Australia's view, obviate the need to carefully consider both potential negative outcomes and the presence of underlying factors that would point to alternative more effective law reform measures.

As to the appropriateness of availing of the extensive and complex rules in Chapter 7 of the Corporations Act, the following brief observations are made. As an example of effective drafting that Part commences in section 760A with a statement of object:

> *The main object of this Chapter is to promote: confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services.*[16]

CPA Australia is of the view that it is worthwhile contrasting this with the first of three Overarching Principles used to formulate the ARLC's Recommendations:

> *It is essential to the rule of law that citizens should be able to vindicate just claims through a process characterised by fairness and efficiency to all the parties, that gives primacy to the interests of the litigants, without undue expense or delay.*

Between the two statutes concerned there are fundamentally different purposes and matters of causation dealt with. The federal class action regime operating by Part IVA of the FCA Act deals with a wide spectrum of rights, wrongs and remedies. Claims would not arise but for an alleged harm or loss. Financial products and services, on the other hand, are offered and accepted as commercial transactions within overarching principles of consumer protection and market transparency. If corporate law is inappropriate, or at best of limited value, in giving effect to public policy around access to justice, it does not mean that there that there are absent challenges in the litigation funding market centred on the commercial nature of third-party litigation funders and the orientation of actions towards claims by shareholders and investors.[17]

Where then should the focus of law reform potentially considered by the Committee be directed? Again, CPA Australia urges that much of this can be informed by the ALRC Final Report, particularly Chapter 9 *A Review of the Substantive Law that Underpins Shareholder Class Action Proceedings?*

Rational economic behaviour points to a propensity for 'third-party litigation funders necessarily being drawn to those class actions that have the greatest degree of certainty of outcome in order to secure their requisite return on investment'.[18] The ALRC provides particularly valuable analysis of a cause of action which was not yet developed

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one of a range of factors. https://ccli.ouce.ox.ac.uk/wp-content/uploads/2019/10/CCLI-Directors%E2%80%99-Liability-and-Climate-Risk-Comparative-Paper-October-2019-vFINAL.pdf

[16] Section 760A(a). (b) through (c) go on to address behavioural matters of market participants, which we have urged in relation to litigation funder are best addressed through the courts and powers established in the Federal Court of Australia Act, along with aspect of market efficiency, again matters which CPA Australia believes should undermine the paramountcy of access to justice.

[17] The Committee will no doubt review the extensive statistical analysis provided in Chapter 3 (Incidence) of ARLC's Final Report. Attention is also directed to the above mentioned article by Professor Morabito in which a trend analysis is presented showing both a plateauing of the instances of federal class actions and a downward trend in the percentage funded. This, of course, adds emphasis to the need for any regulatory reforms to both targeted and proportionate.

[18] [2.68] see also as relevant the ALRC's summation of the earlier 2014 Productivity Commission report on access to justice where it is stated that "the matters that are funded are self-selecting: high costs, large payouts and low risk which was unlikely to improve access to justice in relation to rights-based, non-monetary claims." [1.75]. Importantly, the Productivity Commission concluded that this did not give rise to unmeritorious claims.

at the time in which Part IVA of the FCA Act was enacted – market-based causation theory. To a large degree centred on alleged breach of the continuous disclosure obligations contained in the Corporations Act, the securities class action focuses on identifying a significant drop in the value of securities caused by the late revelation to the market of material information.

Both interrelated aspects of continuous disclosure and market-based causation are further explored by the ALRC in Chapter 9 of their Final Report. Concerning the later they observe:

> *The fraud on the market theory is 'in essence a shortcut for causation': it presumes that shareholders rely on the integrity of the market price in making their investment decisions such that a misleading statement or omission affects all shareholders through the share price*.[19]

The ALRC continues with reference to submissions to their inquiry, which suggested appropriate review and potential legislative intervention to remove uncertainty around this aspect of the law. It may also seem that, as suggested by the ALRC earlier in Chapter 2[20], this contentious issue is unlikely to be fully settled soon by an appellate court. Thus, the 'more direct path' has, in CPA Australia's view, significant merit.

The continuous disclosure regime sits alongside and interacts in a complex manner with provisions in the Corporations Act (s 1041H amongst others) and in the ASIC Act 2001 (refer section 12DA) that prohibit a person from engaging in conduct that is misleading or deceptive, or is likely to mislead or deceive, and to which there are differing defences. The ALRC notes[21] the well understood (though to reiterate, complex) outcome that these provisions are modelled on section 52 of the Trade Practice Act 1974 (now s 18 of the *Australia Consumer Law),* whereas continuous disclosure is based on the economic concept of the efficient market hypothesis.[22] Each though are characterised as substantive law.

The ALRC in discussing law reform options, places particular emphasis on the distinction between procedural and substantive law:

> *The ALRC does not consider that it is appropriate to assess many of these matters [the proliferation of securities class actions] solely through the lens of what is, in essence, a procedural law [referring to Part IVA of the FCA Act]; nor are they likely to be resolved by the procedural law*.

Further:

> *The ALRC concurs with the view expressed by the Productivity Commission in 2014 when it noted that, 'public debate about the underlying law is clearly more appropriate that attempting to stifle a mechanism ...' by which class actions are prosecuted*.

As such, implementation of the ARLC's Recommendation 24 is, in CPA Australia's view, absolutely pivotal to progressing matters at the heart of the Parliamentary Joint Committee Inquiry's Terms of Reference. This would avoid either distortions and united negative consequences associated with pursuing wide-ranging measures through either procedural law (Part IVA in particular), or substantive laws designed for unrelated purposes (notably

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[19] [9.69] pp 278 – 279. This contrasts with actual reliance as a necessary component where negligent or fraudulent misrepresentation is pleaded (refer [9.71]).
[20] Set in the context of 'opening up' closed class proceedings, ARLC noted that "The threat of 're-opening' the class if the matter does not settle at mediation looms large with respondents." [2.73] p 67.
[21] [9.14] p 261
[22] [9.6] p 259

Chapter 5C and 7 of the Corporations Act). Furthermore, implementation would bring to the fore overdue analysis of complexities where disclosure obligations interact with measures to combat misleading and deceptive conduct.

As to the shape of any such review, the ALRC provides the following pointer, having in preceding paragraphs [9.12 – 9.19] of its report summarised development of the continuous disclosure regime and the evolving approaches to the right to sue the company and upon whom the disclosure obligation rests – directors of the disclosing entity or the entity itself. Each of these are economic considerations along the development of any suitable 'safe harbour'; all matters than can be developed without stifling the class action procedural mechanism.

> ……. *the emerging issues that were said to arise out of the inter-relationship between the class action regime and aspects of the corporate law appear to the ALRC to require consideration of the substantive law on which shareholder claims are typically based, and more importantly, require a* ***thorough economic analysis*** *of the assertions that have been put in by particular stakeholders. (Emphasis added)*

Finally, CPA Australia does not, in this submission, address the issue of Directors' and Officers' insurance other than to point to the wide diversity of opinion on the matter, as highlighted in the ALRC Final Report.[23] Nevertheless, it may well be that progress on the substantial law reform matters referred to above – namely market-based causation and continuous disclosure – could in time lessen these stresses.

If you have any queries do not hesitate to contact Dr John Purcell FCPA, Policy Adviser ESG at CPA Australia at john.purcell@cpaaustralia.com.au or on 03 9606 9826.

Yours faithfully

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[23] Para. [9.81] to [9.87]