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CFOs building better businesses

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Parliamentary Joint Committee on Corporations and Financial Services
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CANBERRA ACT 2600

Inquiry into Litigation Funding and the Regulation of Class Action

The Group of 100 (G100) welcomes the opportunity to contribute to the Joint Committee's Inquiry into Litigation Funding and the Regulation of Class Action (the Inquiry).

The G100 is the nation's peak body for CFOs and leading finance professionals in many of Australia's largest businesses. Our purpose is to create better businesses for tomorrow, and part of how we deliver this is to pro-actively contribute on a business-to-government level on matters affecting business regulation, financial reporting, corporate governance, capital markets, taxation and financial management.

The G100 supports a strong market disclosure regime. We also recognise the importance of class actions in providing redress for shareholders that do not have the capability to take action on their own. However, the current class action system is leading to adverse outcomes for Australian businesses and shareholders and requires significant reform. Our key points are summarised below and expanded on in the body of the submission:

1. *there has been a dramatic increase in the cost of D&O insurance;*
2. *the consequence is poor corporate governance and difficulties in attracting and retaining company directors; and*
3. *the solution is greater regulation of litigation funders and reforming continuous disclosure laws.*

1. There has been a dramatic increase in the cost of D&O insurance.

The Directors and Officers (D&O) insurance market has deteriorated markedly in recent years, with rapid increases in premiums and lower limits and higher retentions. Further, insurers are increasingly unwilling to provide D&O cover with several effectively exiting from the Australian market. Insurers and brokers consistently cite securities class actions as the most significant driver for the increased cost of D&O insurance in Australia and restricted availability, including litigation funding driving increased shareholder claims.

According to insurance broker Marsh, in the past seven years prices have accelerated by about 250 per cent, with premium increases for ASX listed entities of 75 per cent in the first three quarters of 2019, and accelerations of 88 per cent on average in 2018.[1] Companies that renew existing cover are paying considerably more for the same level of cover, and in some cases for less cover.

The failure of any class actions – until the recent Myer decision – to proceed to final judgment has also left the scope of disclosure laws unsettled and resulted in a desire to settle rather than pursue a court determination. According to insurance broker AoN, the average settlement amount (excluding defence costs) for publicly announced securities class actions since 2012 is circa $45 million.[2]

The D&O insurance market was challenging heading into 2020 and has become even more so because of COVID-19. The impact of the COVID-19 pandemic on businesses and the economy has created a very uncertain environment where it is difficult for companies, directors and insurers to quantify and mitigate risk. As a consequence, extreme growth in premiums is expected to continue. Marsh were recently quoted in the media saying that in the first five months of 2020, increases have been 371 per cent.[3]

2. The consequence is poor corporate governance and difficulties in attracting and retaining company directors.

Company directors in Australia are exposed to potential liability under more than 600 pieces of legislation. Australia is now the most likely jurisdiction, outside of the United States in which a corporation may face significant class action.[4] D&O insurance is an important part of strong corporate governance, ensuring the sustainability of boards and organisations as a whole.

Australian boards are generally conservative and risk averse. The main reason given for this is the excessive focus on compliance over performance. This constrains innovation and productivity, which is particularly problematic given the need to foster economic growth. Australia's regulatory environment creates a strong incentive for conservatism and risk-aversion in boardrooms.

In 2018, the AICD commissioned law firm Herbert Smith Freehills to undertake a review of international continuous disclosure and liability regimes.[5] The legal analysis reveals that Australian listed company boards are faced with higher reputational and personal liability risks from disclosure-based shareholder class actions than boards in the world's major capital markets, including the UK and US.

It is very difficult for Australian companies to ensure ongoing comprehensive compliance with Australia's strict continuous disclosure regime, which requires immediate disclosure of price sensitive information. Combined with Australia's relatively facilitative class action law, this creates a constant risk for listed companies that a class action can be brought whenever there is a significant decline in share price. By way of contrast, in the US and the UK, the link to liability under legislation is more remote, requiring an element of misleading conduct or misbehaviour on the part of the company and its officers.

The consequence is poor governance with shareholder returns constrained by an unsustainable compliance regime and a risk adverse culture. The inability to secure adequate D&O coverage can expose company directors to personal liability. This makes it difficult for companies to attract and retain directors, leading to further deterioration in corporate governance.

[1] Marsh JLT Specialty, December 2019. The D&O Insurance Wave: Staying Above Water. at https://www.marsh.com/au/insights/research/directors-and-officers-hard-market.htm.
[2] Aon, 'D&O Market Update - March 2020', at https://aoninsights.com.au/wp-content/uploads/DO-MarketUpdate-March-2020-Final-1.pdf.
[3] AFR 18 June 2020.
[4] Allens, Shareholder Class Actions in Australia, February 2017, page 2.
[5] https://aicd.companydirectors.com.au/membership/company-director-magazine/2018-back-editions/december/class-actions-freehills

3. The solution is greater regulation of litigation funders and reforming continuous disclosure laws;

The Attorney-General of Australia in December 2017, citing the increasing prevalence of both shareholder class actions and the third-party funding of such actions, asked the Australian Law Reform Commission (ALRC) to investigate "whether and to what extent class action proceedings and third-party litigation funders should be subject to Commonwealth regulation".

In its report, the ALRC made 24 recommendations, including that amendments be made in the law to limit the number of competing class actions, and that litigation funders be subject to greater oversight. The Government has not yet responded in full to the reports 24 recommendations. Given the complexity of the issues we encourage the Government to use the ALRC Report as input to future reforms, including ensuring consistency across jurisdictions.

In May, the Federal government announced that it will require litigation funders operating in Australia to hold an Australian Financial Services Licence (AFSL) and to conduct class actions as a managed investment scheme. Litigation funders are currently exempt from holding an AFSL and as a result, they do not face the same regulatory scrutiny and accountability as other financial services organisations. The amendments to the regulations will take effect in August 2020. How these amendments are put into effect will be critical to the effective regulation of litigation funders.

Australia is at odds with many jurisdictions by having a continuous disclosure regime that imposes liability without intention or fault the absence of a fault element in the Australian continuous disclosure regime has been brought into sharper focus by the recent changes to the continuous disclosure laws made in response to COVID19. For the period of 26 May to 26 November 2020, the continuous disclosure laws have been amended so that a listed entity only commits a breach if it "knows or is reckless or negligent with respect to whether" the information, which allegedly should have been disclosed, would have a "material effect" on its share price.

One approach to addressing the increase in litigation and costs is to promote public enforcement of the relevant disclosure obligations by ASIC, and to remove the right for private actions to be brought. This is the case in Hong Kong, for example, where the continuous disclosure laws are not linked to a class actions regime.

In conclusion the G100 strongly believes that Australia's securities class action market requires reform. The current regime is leading to adverse outcomes for Australian businesses and shareholders and is out of step with other jurisdictions, leading to a growing market for litigation funders to bring securities class actions that are motivated by profit over the public interest.

If you require any further information, please contact Stephen on 0413 318 455 or swoodhill@group100.com.au

Yours sincerely
Group of 100 Inc

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