Omni Bridgeway Limited

omnibridgeway.com

1 March 2021

Mr Mark Fitt
Committee Secretary
Senate Economics Legislation Committee

By email: economics.sen@aph.gov.au

Dear Mr Fitt

Inquiry into Treasury Laws Amendment (2021 Measures No. 1) Bill 2021

Thank you for your letter of 22 February 2021 inviting Omni Bridgeway Limited (Omni Bridgeway) to make a submission in relation to the *Treasury Laws Amendment (2021 Measures No. 1) Bill 2021* (Bill).

As you note, the Bill amends the *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001.* Omni Bridgeway is pleased to have the opportunity to make comments on Schedule 2 of the Bill which seeks to alter the continuous disclosure and misleading or deceptive conduct provisions so that civil penalty proceedings commenced under those provisions must prove that an entity or officer acted with 'knowledge, recklessness or negligence' in respect of an alleged contravention.

In the limited time available, Omni Bridgeway has formulated this brief submission on Schedule 2 of the Bill reflecting our views that:

1. Such fundamental changes are premature given the lack of consultation on the topic to assess the impact on the capital markets and to fully explore the purported justification for the changes.

2. The changes proposed extend beyond the modification to continuous disclosure recommended by the Parliamentary Joint Committee on Corporations and Financial Services (PJC) inquiry into class actions and litigation funding, and would also affect misleading or deceptive conduct.

3. The Bill would create the perverse outcome of two regimes for misleading or deceptive conduct, one for directors and one for companies.

<u>About Omni Bridgeway</u>

Omni Bridgeway is an ASX-listed company which is a global leader in dispute finance, financing disputes from inception through trial, appeal, enforcement and recovery. We assess investments and enforcement opportunities arising in most regions around the world including Africa, Asia, Australia, Canada, Europe, Latin America, the Middle East, the UK and the US.

Omni Bridgeway has funded hundreds of cases to completion, offering disputes financing and judgment enforcement capability and experience that is unsurpassed in the industry.

Omni Bridgeway participated in the recent PJC inquiry and believes the inquiry was valuable in explaining and demystifying the way litigation funding of class actions operates. It also provided an opportunity to identify areas for improvement in the sector, most of which represent standards of practice already in place at Omni Bridgeway.

Existing Regulatory Framework and Rationale for Reform

It is widely recognised that that the continuous disclosure obligations and misleading or deceptive conduct provisions play an essential role in the ongoing success of Australia's financial markets and, therefore, the broader Australian economy. These obligations protect investors and are fundamental to the perception of Australia's financial markets as efficient, fair, and exhibiting the highest integrity. The substantial economic benefits that flow from this existing framework are well set out in in the submission of the Australian Securities and Investment Commission (ASIC) to the Australian Law Reform Commission (ALRC) in the context of its 2018 inquiry into class action proceedings and third-party litigation funders[1].

In our view, reform to the existing continuous disclosure and misleading or deceptive conduct provisions should only be considered if it can be established there is substantial, clearly demonstrated benefit that exceeds the actual or potential cost of diluting the efficiency and integrity of Australia's financial markets.

On 25 May 2020, the Treasurer introduced a temporary measure in the context of the ongoing COVID pandemic to amend the continuous disclosure provisions so that entities and officers would only be liable under this framework if they did so with a fault element (i.e. 'knowledge, recklessness or negligence'). Omni Bridgeway supported this measure based on the rationale of the increased difficulty of assessing information material to the value of an entity's securities over this extraordinary period.

The basis for making this temporary relief permanent, and extending this to also cover the misleading or deceptive conduct provisions, seems to be:

- Reduced regulatory costs for entities and officers, due to less financial risk from failure to comply with these provisions (i.e. securities class action proceedings) and less time spent on compliance and resourcing of these activities.

- Significant savings on the cost of directors and officers insurance[2].

[1] ASIC, https://www.alrc.gov.au/wp-content/uploads/2019/08/72_australian_securities_and_investments_commission.pdf, pages 6 to 13.
[2] Explanatory Memorandum, *Treasury Laws Amendment (2021 Measures No. 1) Bill 2021*, page 4.

Omni Bridgeway's view is that this rationale is flawed and not supported by the available evidence.

Prevalence of Securities Class Actions

The scale of the 'problem' of securities class actions in Australia has been overstated by those advocating change and this is restated in the Explanatory Memorandum for the Bill. In the authoritative work in this area conducted by Professor Vince Morabito (2019), he identifies 122 such cases since 1992[3]. He found that over that time only 63 companies or group of companies have had class actions filed against them on behalf of shareholders. This compares with the estimated 2,200 companies listed on the ASX. Professor Morabito says:

> *"The shareholders of 34 companies or groups of companies filed class actions in the period from 1 July 2014 to 30 July 2019. That provides an annual average of 6.6 companies or groups of companies whose shareholders resorted to the class action device.*
>
> *"In light of the information provided above, it can be confidently concluded that there has been no explosion of shareholder class actions in Australia either over the last 27 years or so or in recent years[4]."*

Professor Morabito also finds that shareholder class actions are declining as a proportion of total class actions.

> *"In the 2016-2017 financial year shareholder class actions constituted 44.7% of all the class actions filed in Australia in those 12 months. This percentage went down to 42.8% in the following 12 months and 32.2% in the last financial year[5]."*

Professor Morabito found that total recoveries in all shareholder class actions since 1992 were $889 million on behalf of 94,984 shareholders. These recoveries compared with the current capitalisation of the 2,200 companies listed on the ASX of approximately $1.7 trillion. It is not credible to suggest, therefore, that class actions are causing economic damage to long-term shareholders, diverting company resources from investment opportunities to pay legal costs and distracting boards from their core duties.

Rising Cost of Directors and Officers Liability Insurance

On the issue of directors and officers insurance liability insurance, there is no doubt that there has been an increase in the cost of this product over recent years and this has certainly placed a burden on some smaller companies in particular. While the number of class actions is one factor in this increase, it is apparent that there are also other

[3] Professor Vince Morabito, *"Shareholder class actions in Australia – myths v facts",* November 2019, at page 15.
[4] Ibid, page 16.
[5] Ibid, page 16.

significant factors at play including a correction to years of "chronic under-pricing"[6], global trends in the commercial insurance market (including in markets where securities class actions cannot be considered the primary driver) and evidence of corporate wrongdoing, which increases the risk of regulatory and legal action against companies and directors and, as a result, increases insurance premiums.

One of the outcomes of the Hayne Royal Commission's findings was that ASIC would take a 'why not litigate?' approach to regulation of the financial services law. In January 2019, the findings of the Hayne Royal Commission were said to be the cause of "*pushing up already rocketing D&O premiums – doubling the cost on average – and increasing the excess payable by several times*[7]."

> *"The fallout from the (Royal Commission) has increased premiums for professional indemnity insurance up to 400 per cent and prompted some insurers to exit that segment of the market altogether*[8]*."*

XL Catlin and Wotton + Kearney in a joint white paper concluded that a principal driver of the sustained and growing unprofitability of the D&O market in Australia is the *"chronic under-pricing of ABC D&O business by insurers since at least 2011*[9]*."*

In evidence presented to the ALRC review, Norton Rose Fulbright noted the tripling in D&O insurance premiums between 2011 and 2018 and concurred that it was "an overdue and necessary reaction to the realities of the Australian market[10]."

The ALRC Final Report says:

> *"Despite the concerns of insurers and brokers, Norton Rose Fulbright argued that 'there is presently no evidence to suggest that insurance is unaffordable or that there is a material underinsurance risk requiring policy intervention'. They expressed the view that: the recent increase in premiums for D&O cover is an overdue and necessary reaction to the realities of the Australian market. We also consider that the increase in pricing is one which the market can and will absorb*[11]*."*

The Australian experience is not unique. The Marsh *Global Insurance Market Index* has tracked rising commercial insurance premiums worldwide in the past year. It found financial and professional liability insurance, including D&O, rose 23 per cent in the first

[6] XL Catlin / Wotton + Kearney white paper, "*Show me the money*", September 2017, at page 15.
[7] https://www.afr.com/companies/financial-services/royal-commission-fears-spark-mass-insurance-exclusions-20190102-h19mz1
[8] Ibid.
[9] Catlin / Wotton + Kearney, at page 15.
[10] Norton Rose Fulbright, *"Submission to the ALRC: Inquiry into Class Action Proceedings and Third Party Litigation Funding"*, July 2018, at page 9.
[11] Australian Law Reform Commission, *"Integrity, Fairness and Efficiency – An Inquiry into Class Action Proceedings and Third-Party Litigation Funders"*, ALRC Report 134, tabled in parliament on 24 January 2019, at [9.86].

quarter of calendar 2020 in the US, 46 per cent in the UK, 12 per cent in Continental Europe and 33 per cent in the Pacific, including Australia[12].

It is also worth noting that D&O liability insurance policies do not just cover class actions but respond to a wide range of single and multi-party claims against directors and officers of a company. Directors and officers of companies in Australia are subject to common law and statutory duties and they face a range of claims giving rise to civil and criminal liability for breaching those duties. Directors and officers may incur civil liability for damages or civil penalties to many parties, including their company, another director or officer of the company, a shareholder, employee, creditor or customers of the company or a regulator. The amount of these civil liabilities can be millions of dollars. Directors and officers may also be liable to pay a significant amount in criminal fines and penalties[13].

Based on the above, the price of D&O liability insurance reflects this multitude of claims faced by directors and officers as well as the significant costs incurred in the defence of such claims. In fact, class actions rarely target directors. Professor Morabito's research found that:

> *"in just over three out of every four shareholder class actions no action was taken against the individual directors".*
>
> *"This practice has become even more prevalent in recent times. For instance, in only 10% of the shareholder class actions filed in the 2018-2019 financial year were directors included among the respondents/defendants[14]."*

The reality is that the increase in the cost of D&O liability insurance is indicative of the extent of the wrongdoing, which historically companies have been reluctant to attempt to defend at trial. The appropriate response to increasing evidence of breaches of the law causing losses to Australian investors is not to curtail their ability to access the law, especially at the behest of insurers. The profitability of D&O liability insurance would increase if there was broader compliance with the continuous disclosure laws.

Other Perceived Negatives of Securities Class Actions

The Explanatory Memorandum for the Bill also makes reference to the issue of circularity and raises this as a negative of these class actions[15]. The fact is that the investor base of a listed company changes on a continuous basis and there are also ongoing changes to a company's board and senior management. A cause of action will arise at a particular point in time relating to those who are then holding shares.

[12] Marsh, *Insights: Global Insurance Prices Continue to Rise for Tenth Consecutive Quarter*, May 2020.
[13] Directors' and officers' liability insurance in Australia, Practical Law Dispute Resolution.
[14] Morabito, November 2019, at page 20.
[15] Explanatory Memorandum, page 39.

In addition, the Explanatory Memorandum cites the fact that almost all continuous disclosure actions rely on a litigation funder which therefore means that shareholders relinquish a significant amount of the settlement to the third party funders[16]. This is a statement of fact that reflects the reality that litigation is highly expensive, time consuming and risky; in the vast majority of these securities cases, the involvement of a litigation funder is the only basis on which claimants are able to seek redress. The alternative is that claimants will not be able to test their claim and receive no settlement whatsoever.

Misleading or Deceptive Conduct Provisions

The changes to misleading or deceptive conduct provide that "conduct" which contravenes the continuous disclosure provision in s674 (where an entity is liable if a reasonable person would expect the relevant information to be material) but does not contravene s674A (where any entity is only liable if the entity knows, or is reckless or negligent, in *its* assessment of materiality) does not contravene the misleading or deceptive conduct provisions.

The prohibition against misleading or deceptive conduct includes an obligation to avoid misleading conduct by omission and to avoid misleading conduct through the making of a positive statement. It is possible to see how the "conduct" in misleading by omission neatly aligns with the "conduct" of not disclosing information. However, it is difficult to see how making a positive misleading statement is "conduct" related to a failure to disclose.

If there are to be changes to the misleading or deceptive conduct provisions, they should be limited to circumstances where the conduct is a failure to say something. This is where there is an overlap between misleading or deceptive conduct and the continuous disclosure provisions. Therefore, "conduct" in the revised s1014H should be limited to conduct by omission.

Please let me know if Omni Bridgeway can be of further assistance to the Committee.

Yours sincerely,

Andrew Saker
Managing Director & CEO

[16] Ibid.