20th May 2021

Committee Secretary

Senate Economics References Committee

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Parliament House
Canberra ACT 2600

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

Dear Committee Secretary,

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

We are grateful for the opportunity of making a submission to the Senate Economics Legislation Committee on the provisions of the Treasury Laws Amendment (2021 Measures No.1) Bill 2021 (Bill). Our submission focuses on the proposed amendments to continuous disclosure laws (Schedule 2). Before delving into our submission, we would like to convey that the views provided here are our own and do not necessarily reflect those of our respective institutions.

Background

Schedule 2 Changes

Schedule 2 of the Bill amends Section 674 of the Corporations Act to replace the *reasonable person standard*. Under the pre-COVID test, civil liability arises where an entity fails to disclose non-public information, and a reasonable person would expect that information, if disclosed, to have a material effect on firm value. Under the proposed change, a *state of mind* element will be considered. The requisite mental test for establishing a contravention of continuous disclosure rules is that companies (and their officers) have acted with 'knowledge, recklessness, or negligence' in failing to adhere to these rules. The Bill seeks to make permanent, relief measures afforded to entities and officers throughout the COVID-19 period (the Corporations (Coronavirus Economic Response) Determination (No 2) 2020 (Determination No.2). It accordingly follows recommendation 29 of the report by the Parliamentary Joint Committee on Corporations and Financial Services inquiry to Litigation Funding and the Class Action Industry (PJC report).

Responding to Recent Assertions from the Second Reading ("Second Reading") Speech for the Bill[1]

- *"These reforms will…**provide regulatory relief for businesses** and will safeguard the capacity of business to drive Australia's economic recovery without the **prospect of opportunistic class actions**."*

The opportunity to pursue reforms to remove existing distortions, ameliorate perverse risks, and curtail systemic threats to financial stability offers considerable upside to business. But while it is critical that legislators focus on delivering economic policy priorities, officials must ensure that sufficient consideration is given to whether appropriate protections are in place for all relevant stakeholders. In this instance, do the reforms outlined in Schedule 2 adequately safeguard investors (shareholders) from excessive managerial risk taking and fraudulent behaviour?

To preserve the efficiency and integrity of Australia's financial markets, strict obligations to disclose material information on a timely basis is required from listed and other disclosing entities and their officers. These longstanding continuous disclosure obligations are found in ASX Listing Rules (3.1) and Chapter 6CA of the Corporations Act gives these rules legislative backing. The main aim of continuous disclosure rules is to enhance confident and informed participation by investors in the Australian financial market. Having an informed market is central to this premise. Continuous disclosure is also central to corporate governance and investor protection by minimising opportunities for insider trading and market manipulation.

Corporations owe their shareholders specific duties and rights. Failure to deliver on these obligations gives aggrieved shareholders the right to bring private actions to recover damages caused by breaches. These breaches typically centre on continuous disclosure requirements and misleading and deceptive conduct.[2] Beyond facilitating improved access to justice, and avenues for compensation in relation to breaches of corporate responsibilities, where regulators have failed to act or individuals would be unable to economically pursue legalisation, there is a significant body of literature that suggests that the class action mechanism helps to facilitate good corporate governance. Firms subject to shareholder class actions typically exhibit the key symptoms of poor corporate governance, having a high degree of informational asymmetry and elevated agency costs (Karpoff and Lott 1993). As such, the threat of litigation is perceived as a critical corporate governance mechanism in addressing these underlying managerial dysfunctions (Becht et al. 2005). As shareholders represent continual (and economically invested) monitors of managerial performance (Romano, 1991), these securities class actions can be viewed as an essential supplement to public enforcement.

Despite support for the benefits of shareholder class actions within the academic literature, there remains a polarity of public views on the issue. The present debate in Australia mirrors a review conducted in the United States in 2015. During a United States Senate Judiciary Committee, Chairman Chuck Grassley noted that '[securities] litigation is expanding at an alarming rate…the impact they are having on our civil justice system is not fully known'. With a string of proceedings commenced against, QBE Insurance Group (QBE); Slater and Gordon (SGH); Macmahon Holdings Ltd (MAH); Sirtex Medical Ltd (SRX); Myer Holdings (MYR), many of which are household names, there is considerable temptation to conclude that our system is not operating in as the manner intended. Morabito (2019), however, shows that in nearly three decades of activity, 122 SCAs have been filed by shareholders and

[1] Treasury Laws Amendment (2021 Measures No.1) Bill 2021 – Second Reading, Sukkar, Michael, MP
[2] Varzaly (2021) estimates that approximately 40% of securities current class actions are the result of disclosure breaches.

this relates to only 63 companies (or groups of companies). Of similar note, is the result that only 1 in 5 actions included multiple respondents/defendants, meaning that company directors were rarely targeted during action suits.[3] Therefore, despite mounting fears that litigation has become a blight on corporate Australia, a view prominently ricocheted from Australian boardrooms and certain news media outlets, there is no evidence to suggest a sustained rise in shareholder class actions. Nor is there any evidence to support the claim of an impending wave of opportunistic "nuisance" suits. It is further unclear that shareholder lawsuit penalties actually harm investors. If the penalties are sufficiently high to motivate the company to remediate problems, strengthen internal controls, and prioritise accountability, then these are likely to lead to better future outcomes for the firm and its shareholders.[4]

- *"The threat of these actions makes it **considerably more difficult for companies to release reliable forward-looking guidance** to the market. Without a higher level of protection, companies may choose to withhold forecasts of future earnings or other forward-looking estimates, thereby limiting the amount of information available to investors.*

To establish a shareholder class action in the United States, plaintiffs must credibly allege that the defendant made a material misstatement with intent causing damage to investors. The required intent is 'scienter', which is similar to recklessness. Before 1995, concerns that securities class actions were discouraging managers from providing forward-looking information, similar to those currently being expressed in Australia, were widely held. In enacting the Private Securities Litigation Reform Act (1995) ("PSLRA"), Congress addressed the issue by create a safe harbour, protecting statements that are identified as forward looking and accompanied by meaningful cautionary statements.

Since this time, a well-developed literature has formed around the role of these protections and the impact on shareholders. We briefly summarise the significant findings from this literature below. Critically, it shows that - 1) the debate around litigation and disclosure is complex, and not nearly as straightforward as set in the Second Reading; 2) If we are looking to maintain a fair and informed market then we must not impede on shareholders' ability to bring class action lawsuits.

Critical Findings from the Academic Literature

In one of the earliest examinations of how changes in legal rules impact on the filing and resolution of shareholder claims, Johnson et al. (2007) show that the higher bar for pleading a securities fraud (established under the PSLRA), causally led to a shift away from litigation based on forward-looking (voluntary) earnings disclosures. Though consistent with Congress' goal in adopting the forward-looking safe harbour to reduce the incidence of nuisance suits, Choi (2006) argues that it additionally worked to reduce meritorious litigation. Behaving more as a burdensome tax than a magic bullet, Choi (2006) shows the cost imposed due to reduced meritorious suits measured almost six times the benefit from the reduction of frivolous suits. Focusing on the enactment of universal demand (UD) laws in the US, which further raises procedural hurdles for shareholders to file derivative lawsuits against managers and directors who allegedly breach their fiduciary duties, Bourveau et al. (2019) find

[3] In the most recent year of acquired data, Morabito (2019) shows that only 10% of shareholder class actions filed in the 2018-2019 financial year were directors included among the respondents/defendants.
[4] Aspris and McAlpin (2020), for example, show that firms which have benefited from corrective actions associated with shareholder class actions will experience long-term price outperformance.

that the change resulted in higher rates of voluntary disclosure. The authors attribute this result to increased shareholder demand for monitoring of managers.

The quality of these shareholder outcomes, however, stands against a wall of less desirable corporate outcomes. A number of recent studies present evidence of more aggressive financial reporting (earnings management) when there is a reduction in litigation risk (Hopkins, 2018; Huang et al. 2020; Basu and Liang, 2019). Huang et al. (2020), for example, present evidence which is consistent with litigation deterring real earnings management by constraining managers' ability to issue optimistic and misleading disclosures that can conceal the myopic and opportunistic motives. Other studies find that weakening the litigation environment (following the enactment of UD Laws) results in poorer firm performance (Appel, 2019); decreased investment efficiency (Li, Monroe, and Coulton, 2018); increased cost of debt (Ni and Yin, 2018) and increased cost of equity (Houston, Lin, and Xie, 2018). There is further evidence of increased managerial entrenchment (Bebchuk, Cohen, and Ferrel, 2009); and the level and profitability of insider trading cases increases significantly (Boone, Fich, and Griffin, 2019). Manchiraju et al. (2021) show that firms with specific short-term incentives for aggressive accounting – such as those narrowly beating benchmarks, those with abnormal insider trading, and those likely to violate debt covenants – weakly governed firms with high ex-ante litigation risk decrease accounting conservatism (i.e., statements become less reliable).

Recommendation

If we are going to consider the benefit (and cost) to shareholders of greater protection for companies and their officers, then we need to consider all the benefits (and costs).

The issue of forward-looking guidance is complex. Although forward-looking guidance to the market, where the statements contain value relevant information for investors is useful, seeking greater protections for firms and their officers from litigation as a means of achieving this is not. Absent the threat of shareholder class actions, shareholders face substantial principal-agent problems which may in turn lead to poorer operating performance and managerial entrenchment.

It has been established in the literature that corporate governance influences companies' decisions to voluntarily disclose, such that better corporate governance improves reporting practices. If it is our goal to improve the quality of disclosures, thereby ensuring that investors are well-informed and protected, then we should consider more wide-ranging measures (and incentives) to allow this to happen. Corporate culture starts at the top, and there is a strong need to incentivise companies to foster a culture of compliance – not misconduct.

Before making these temporary measures permanent, a thorough analysis of the effect of the temporary COVID-19 changes should be performed to assess whether key objectives were achieved during this period of uncertainty.

- *"**Raising the liability standard** so that companies only face civil penalty actions where they have acted with knowledge, recklessness or negligence allows companies and their officers **to more confidently provide guidance** to the market **without exposing themselves to the risk of opportunistic class actions**".*

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There are four parts to this statement that warrant further consideration: 1) Are we witnessing 'opportunistic' shareholder class actions? 2)Do entities and their officers face such a risk? 3) What role does litigation risk play in firm guidance statements? 4) Does raising the liability standard come with associated costs?

Opportunistic Securities Class Actions

Given the rise in security class actions in recent years, there is a temptation, especially from targeted parties to attribute this to 'opportunism'. As previously discussed, we have witnessed an increase in the overall number of securities class actions over the last five years. There is very little, however, to suggest that we have reached a new permanently high plateau. Morabito (2019) shows that across the spectrum, only 5.1% of shareholder class action claims have been summarily dismissed. This casts doubt over opportunism claims.

Are directors and officers at risk of opportunistic shareholder class actions?

This point has been addressed judiciously in previous submissions, with many having focused on whether there is already a safe harbour in place or whether persons can already apply for relief for having acted honestly. Another approach would be to ask - Have directors and officers been opportunistically targeted in the recent wave of shareholder class actions? In the 2018-2019 financial year, Morabito (2019) shows that only 10% of shareholder class actions included directors among the respondent/defendants. Varzaly (2021) state that there is a "0.22% probability that a publicly listed company will have a class action filed against it, and a 0.04% probability that a publicly listed company will have one of its directors named a defendant in a filed case." Such evidence suggests that the risk to directors and officers is fundamentally negligible, putting into question the rationale for making such exemptions permanent.

Litigation Risk and Firm Guidance

Affording officers and directors greater protection so that they may more confidently issue guidance to the market ignores consideration for the fact that managers have incentives to adopt optimal voluntary disclosure policies because of the array of potential benefits. These include: decreased costs of capital ((Botosan 1997; Botosan and Plumlee 2002; Easley and O'Hara 2004; Lambert, Leuz, and Verrecchia 2007); increased stock liquidity (Diamond and Verrecchia 1991; Healy et al. 1999); new or informed investors ((Lang and Lundholm 1996; Healy et al. 1999; Bushee and Miller 2012; Kirk and Vincent 2014); and even reduced litigation costs ((Skinner 1997; Field, Lowry, and Shu 2005).

On the point of reduced litigation costs, Field et al. (2005) show that the conventional view (that higher rates of disclosure trigger more litigation) could be driven by the endogeneity between disclosure and litigation. Consider a situation where a firm has especially bad news. Managers have stronger incentives to disclose the bad news early to reduce the expected legal costs. At the same time, the firm faces a higher probability of litigation. The result is that it causes a spurious positive relation between disclosure and lawsuit probability, potentially masking the deterrence effect that is associated with shareholder class actions. Field et al. (2005) find no evidence that disclosure triggers litigation – in fact, their evidence suggests that increased disclosure deters securities litigation.

Costs to Shareholders of Raising the Liability Standard

Litigation risk can discipline managers' real actions by tightening the constraints on managers' ability to issue misleading disclosures. Hopkins (2018) and Chen (2018) provide evidence that lessening the threat of litigation affects managerial attempts to mislead investors. Hopkins (2018) examines whether an unexpected change in the risk of securities class actions affects the incidence of misreporting. The author finds that the likelihood of a restatement to financial accounts increased after a decline in the risk of securities class actions following a U.S. circuit court ruling which made it easier for public corporations to defend against SCAs. Further, the highest level of financial restatements was concentrated in firms with the highest ex-ante risk of facing a meritorious securities class action. Huang et al. (2020) conclude that "*In the presence of short-term goals and managerial opportunism, reduced securities litigation risk can increase myopic real action accompanied by misleading disclosures to conceal the true intent of those actions*".

- *"**Reforming continuous disclosure obligations** will allow business to reallocate resources towards **improving efficiency and output**. This will make it easier for businesses to invest, create jobs and ultimately grow the economy".*
- *"Businesses should be able to **pursue commercial growth without being impeded by legal actions** that undermine their capacity to focus on their core operations".*

Australia's continuous disclosure obligations are world leading. They facilitate confidence in our market and allow the ASX to punch above its weight in the global market for listings and generally protect investors. Regular policy and procedural reviews should be conducted to ensure that the balance between efficiency and fairness strikes a sensible balance. In recent years, a plethora of new risks such as cybersecurity and pandemic threats have added to the growing operational and financial risks that entities and their officers must address. Given the widening spectrum of risks, there must be greater accountability and prudence displayed by officers and directors to ensure that investors are well-informed and protected. These are simply the costs of doing business in an international marketplace. If we are determined to ensure that businesses thrive, then we must also ensure that investors can confidently assess individual risks, that there are sufficient deterrents for critical breaches of continuous disclosure, and that where these breaches occur, there is access to justice.

Responding to Comments in the Explanatory Memorandum (EM) presented to the House of Representatives (HOR)[5]

Compliance Cost Financial Impact

The explanatory memorandum presented to the HOR details the compliance cost impact resulting from Schedule 2 amendments. It concludes that regulatory savings will be in the order of $912.5 million per annum. This saving is calculated from an assumed fall in director and officer (D&O) premiums which is linked to a higher standard of proof (acting with 'knowledge, recklessness, or negligence') in respect of an alleged contravention.

This analysis is not credible.

Neither the rise in D&O insurance costs, nor the growing number of litigations, or the higher average settlement sizes are facts in dispute. However, higher D&O insurance costs correlating with rising rates of securities litigation and larger average settlement sizes **does not imply causation**. Therefore, assuming that restraints on securities litigation will contribute to lower D&O premiums is just logical fallacy.

Risks currently being borne by shareholders are far more diverse and extreme than at any point in history. Consider cybersecurity risk, pandemic risk, climate risk, and more generally environmental, social, and governance risks (ESG). Many of these risks were unheard of several years ago, and where risks like used to fall into ethical investments, it is now well understood to have important financial implications for all corporate entities.[6] Companies are now actively competing for capital based on ESG performance and so a failure by entities and their officers to properly manage such important risks will affect the propensity to litigate. Rising D&O premiums reflect greater litigation risk, but these costs are symptomatic of greater systemic risks. Entities and their directors hold the responsibility of remaining informed and, where appropriate, disclose these material risks in a timely manner.

ASIC Administrative Actions - To suggest that ASIC administrative actions will not have the same effect of driving up D&O insurance for companies because penalties are smaller is also misleading, since public enforcements often serve to inform private litigation.

The estimate - The 'back of an envelope' premium savings analysis presented before parliament[7] should not be considered. Where no consideration is given to the individual risk factors that drive D&O premiums, then no insight can be gleaned from a cost-benefit analysis. Exercising a historical trend to construct hypothetical future cost savings from proposed legislative changes is both short-sighted and reckless. This is as much conceded in the explanatory memorandum which notes "…this is likely to be a dramatic overestimate…".

Bushfires and Shareholder Class Actions – Rising Premiums

Personal insurance premiums have risen over the last few years, partly because of the devastation of bushfires across the country. Securities litigation risk, like bushfires are not random events. Bushfires are linked with higher temperatures, humidity, wind speed, dryness, and fuel from the ground.

[5] Treasury Laws Amendment (2021 Measures No.1) Bill 2021 – Explanatory Memorandum (Link)
[6] Recently mining company Rio Tinto (ASX:RIO) destroyed a 46,000 year old sacred Aboriginal site in Western Australia's Juukan Gorge so that it could mine iron ore. It is widely reported that following this incident "Rio Tinto has suffered considerable damage to its reputation, trust, and social license to operate'. (Link)
[7] Link

However, underlying causes include climate change and poor planning (and coordination) at higher levels. Suggesting that litigation risk has caused premiums to go up is like suggesting bushfires alone are the problem behind premium increases. Climate change has contributed to more extreme weather patterns rendering premium increases higher for longer in the same way that the pool of risks that face shareholders (from cybersecurity risks to ESG risks) has affected D&O premiums. The inclusion of a fault element in civil proceedings will do little to mitigate ex-ante securities litigation risk, if the underlying factors driving this risk remain unaddressed. To treat the cause, we need to deal with director and officer education, firm governance issues, supervision, and regulatory oversight. Only then can we hope to make any in-roads into the cost of D&O insurance.

Closing Remarks

Continuous disclosure rules aim to protect outside investors from being misled by managers. In so doing, it facilitates the efficient allocation of capital. Enforcement of these rules relies on public oversight from regulatory bodies (like ASIC) supplemented by private enforcement through securities litigation by investors via Australia's court system. The interaction of these institutions serves as the basis for deterring negligent and fraudulent behaviour, while also promoting justice for those adversely affected.

Much has been written about litigation that is brought by shareholders and driven by litigation firms and class action funders. Securities lawsuits are often frowned upon for being costly and involving substantial attorney fees. They are further chastised for diverting management time away from more productive efforts. But private enforcement is unquestionably vital for well-functioning capital markets and there is mounting evidence to support this statement. Unfortunately, bad information continues to be parlayed with unbridled enthusiasm, and this can lead to bad regulation which can further result in unnecessary burdens and result in a failure to address real problems and mitigate harms.

Before we can decide on the benefits of the proposed change to continuous disclosure rules, we must bear in mind both the limitations of public enforcement and the strategic interactions between it and private enforcement. Public agencies have resource constraints and employees inevitably suffer from numerous incentive problems which has been well documented in the literature (e.g. Faccio, 2006, Tahoun and Ven Lent, 2019). Private litigation, beyond simply working to deter negligent and fraudulent conduct, notably helps to mitigate the moral hazard problem in public enforcement, because it can effectively serve to monitor the enforcer. The strength of the private litigation regime also matters in terms of the impact of public enforcement. While stronger public enforcement will lead to greater uncovering of breaches, it may also weaken the effectiveness of private litigation due to the crowding-out effect (Schantl (2020)). That is because in a strong litigation regime, the investor is very likely to sue, and public enforcement plays only a minor role for deterrence. Consequently, strengthening public may serve to weaken private enforcement and overall deterrence, inducing higher levels of both misfeasance and malfeasance.

In order to protect investors and promote our capital markets, we need regulations to be considered and applied in a manner that promotes fairness. This will in turn promote growth and success. The Treasury Laws Amendments, specifically, those outlined in Schedule 2, have been designed to address a symptom – higher levels of litigation and higher director and officer insurance fees. It is our opinion that any such changes will not have the desired outcome and are likely to generate negative welfare outcomes for all investors. The changes affect the stability of our regulatory and enforcement system which has allowed markets to prosper and undermines the reputation Australia has cultivated as a pillar of excellence in having fair and efficient capital markets. This reputation has allowed our country of just over 25 million people to develop a capital market with over 2,000 listed securities representing the 15th largest exchange by market capitalization in the world. The proposed changes threaten to damage our capital markets, destroying a significant amount of economic activity and wealth creation.

We welcome the opportunity to discuss this submission with the Committee.

Sincerely,

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