Regulation impact statement – regulating litigation funders under the Corporations Act

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Background

On 22 May 2020 the Government announced that litigation funders would be subject to greater oversight by being required to hold an Australian Financial Services License (AFSL) and comply with the managed investment scheme (MIS) regime, to take effect three months from the date of announcement.

Litigation funders partly or wholly fund the costs of litigation in return for a portion of the proceeds if the action is successful. Their use in class action claims, particularly those in which shareholders are bringing claims against companies and their directors for alleged failure to comply with continuous disclosure obligations, has grown strongly in recent years. From 1992 to 2013, class actions filed in the Federal Court were funded by third parties in 15 per cent of cases. From 2013 to 2018, 64 per cent were funded by third party litigation funders.

The service of litigation funding has been variously classed as a 'financial product' or 'credit facility' in different judicial decisions. A 2009 Federal Court ruling in the case of Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd found that the litigation funding scheme under consideration represented a MIS in the Corporations Act. Without a legislative response, a consequence of this ruling would have been that entities responsible for operating such arrangements would have to register their MIS with ASIC if certain requirements were met, and hold an AFSL. General obligations that would have applied to captured businesses included a requirement of registration; disclosure obligations (including a requirement to issue Product Disclosure Statements); adhering to dispute resolution mechanisms; and increasing levels of professional competence, training and resourcing. Additionally, litigation funders would be subject to ASIC regulatory oversight, with penalties attached to instances of compliance failure. ASIC subsequently introduced a series of Class Orders to exempt litigation funders from the MIS framework and the requirement to hold an AFSL. The former Government exempted litigation funders from these regulatory requirements in 2013.

1. The problem

Third-party litigation funders are currently not regulated as a financial service provider as they hold a regulatory exemption from the requirement to hold a financial service licence. The exemptions that litigation funders have from holding an AFSL and product disclosure obligations in *Part 7.9* of the *Corporations Act 2001*:

- Creates risks for consumers that arise from inadequate or inconsistent product disclosure by service providers; and
- Does not hold litigation funding entities to account for failures to meet obligations associated with acting as a financial intermediary for litigation funding activities.

The following reasons provide evidence supporting these observations, and why immediate government action is needed.

1. Addressing the risk arising from a large number of new funders – including those based outside Australia – that have shown insufficient transparency and accountability regarding their business models, competence and finances, alongside increasingly diverse and opaque funding arrangements.

The risks of unregulated growth in the sector have grown significantly since Treasury conducted its 2015 Post Implementation Review into the regulatory exemptions that litigation funders were given

from holding an AFSL and being categorised as a MIS. The ALRC Report found that the number of class actions funded by litigation funders grew from 40 per cent of finalised Federal Court class actions from 2008 to 2012 to 77 per cent of class actions finalised in the Federal Court from 2017 to 2018.

The ALRC also found that the constitution of law firms and litigation funders participating in class action proceedings is more diverse than it has been in the past. As of the Report's release in December 2018, there were 33 litigation funders operating in Australia but only 17 at the time Treasury conducted its Post Implementation Review. It is important these additional providers ensure the maintenance of minimum professional standards in the delivery of financial services.

2. Improving product disclosure would among other things assist in:

    2.1. Informing class action claimants that they may have to meet a potential adverse cost order, by a court, if litigation funders do not hold sufficient capital in the event a class action fails.

The ALRC review noted that a litigation funder does not ultimately bear the risk of an adverse court order as class action plaintiffs bear those costs if the class action fails and the litigation funder does not hold sufficient capital. Unregulated growth of the sector could increase the risk that class action plaintiffs find themselves in a litigation funding scheme that sees an adverse cost order. Greater transparency on the risks associated with litigation funding services is needed to ensure consumers are aware of the possible pitfalls of the service they consume.

    2.2. Informing class action claimants that litigation funders' incentives may not be directly aligned with their own, given the latter's primary objective is to ensure an outcome from a class action that provides the best financial return for their investment. This can lead to litigation funders encouraging claimants to a class action to seek a settlement, to avoid the risk of an adverse court finding.

The ALRC report found that funded matters rarely go to trial, and that funded matters were more likely than unfunded proceedings to resolve by settlement. The enforcement of legal rights by plaintiffs may be best fulfilled by pursuing an adverse finding against the defendant or pressing for a higher settlement figure. However, this may run counter to the interest of a litigation funder to minimise risks and costs.

3. Making the penalties sufficient to ensure compliance with regulatory obligations.

    3.1. Currently litigation funders only face penalties of up to 500 penalty units ($105,000) for body corporates and 50 penalty units ($10,500) for individuals if their approach to managing conflicts of interest is found to be inadequate. However, other financial services licensees – both individuals and body corporates - face significant criminal and civil penalties for breaches of financial services obligations and financial services laws, following the introduction of the Strengthening Penalties Framework (SPF) that was legislated in February 2019.

Under the SPF, body corporates face penalties of up to $10.5 million, three times the benefit derived (or detriment avoided) by the contravention, or 10 per cent of annual turnover for breaches of their financial services licence obligations. Individuals also face criminal penalties for providing defective or misleading information in product disclosure documents.

These reforms were implemented following the 2017 ASIC Enforcement Review Taskforce which found that existing penalties did not establish a credible deterrent against misconduct or meet community expectations in relation to the seriousness misconduct in the sector.

2. Case for government action/objective of reform

Given the problems identified above do not show any evidence of resolving themselves through a market solution, and are instead becoming more pronounced over time, government intervention is needed to ensure their resolution.

The litigation funding market, without legislative clarity as to which regime it is subject to, would be subject to certain obligations as a financial product, or as a credit product, depending on the structure of any particular agreement. Financial product and credit laws are broad and flexible in their application in order to capture an appropriate range of arrangements – litigation funding arrangements may be subject to these laws in the absence of specific regulatory intervention. The legal framework for services deemed to be offered as part of a managed investment scheme or other financial product was set up to protect the interests of investors in a broad range of circumstances. Consideration by government of regulation for litigation funding schemes is appropriate.

Desired outcomes

The primary outcome to be achieved through this government intervention in the litigation funding market is to subject litigation funders to greater regulatory oversight that ensures they meet certain standards in how they operate their businesses and their schemes, on a systemic level, beyond the powers exercised by courts over litigation funders on a case-by-case basis.

The Government is committed to ensuring that the litigation funding regime provides fair and equitable outcomes for all Australians. This regulatory oversight aims to provide increased transparency for plaintiffs, with particular regard to the commissions, fees and arrangements plaintiffs may enter into with litigations funders.

Investor protections, most notably for class action plaintiffs, will be enhanced through requiring the provision of more information to them on the schemes that they are entering into. Ensuring that litigation funders have to meet specific standards of competence and resourcing will align the industry with other businesses providing financial products in the market. Standards of conduct for litigation funders, such as acting honestly, efficiently and fairly, that apply to other providers of financial products, would also benefit investors. It will also add additional protections in relations to the interaction with potential class members.

Potential defendants to class actions will also be better protected through government intervention. Defendants to class actions may be disadvantaged if litigation funders do not meet conduct standards such as acting honestly and fairly. While litigation funders have a role to play in Australia's legal framework, it is also important that there is not undue disruption to businesses where an action is brought without proper standards of accountability applying to the third party funder of the action. This concern is particularly acute as businesses affected by the COVID-19 pandemic seek to navigate a course to recovery.

There are some barriers to achieving these outcomes, which will be expanded upon in the Risks section below.

A successful government intervention will see a transparent litigation funding regime that works to provide fair and equitable outcomes for all Australians. Litigation funders would be required to meet the minimum standards outlined above to ensure transparency and accountability for parties to the litigation, including their plaintiffs, as well as the courts and investors.

3. Policy options

Other policy options for addressing some of the problems identified above have been suggested that sit outside the Treasury portfolio. The ALRC also made recommendations in regards to litigation funders that address different underlying issues. This RIS does not consider those options. The Government is preparing its response to the ALRC Report and these recommendations will be considered as part of its response. The Government has also referred an inquiry to the Parliamentary Joint Committee on Corporations and Financial Services to examine whether or not Australia's litigation funding and class action regime is providing fair and equitable outcomes for all Australians, with particular reference to the quantum of fees charged and commissions earned by litigation funders.

The ALRC Discussion Paper proposed that the *Corporations Act 2001* should be amended to require third party litigation funders to obtain and maintain a 'litigation funding licence' to operate in Australia. However, this proposal was not fully developed, given that it was raised in the discussion paper, and was not recommended as part of the final report. Without design details on how this bespoke regime would operate, it is not possible to fully analyse this option. The ALRC used the AFSL regime as the basis of its suggested licensing approach. Without the distinguishing elements of the proposed litigation funding licence fully developed, its regulatory impact cannot be assessed differently from the option to impose the AFSL regime.

The Government has announced that it is proceeding with the regulation of litigation funders under the AFSL and MIS regimes, to be achieved through the removal of existing regulations that exempt them from these provisions. Consultation will therefore not be targeted at different policy options, but rather at the policy design that can most appropriately capture the activities of litigation funders that need to be captured under the AFSL and MIS regimes in order to achieve the desired outcomes outlined earlier in this RIS.

Policy design

Given the option that has been chosen, there are two key design issues that have been identified in ensuring that it most appropriately targets the problems identified earlier in the paper:

- Which litigation funders and which litigation funding schemes/arrangements should the regimes be applied to?
- What transitional arrangements, if any, should apply in removing the AFSL and MIS exemptions?

Regarding the first question, there are three types of action that litigation funders are involved in: class action proceedings; liquidation proceedings on behalf of creditors; and private actions. The problems identified through the ALRC report and by the Government are chiefly concerned with class actions, and the policy has been designed to focus on these.

There will need to be transitional arrangements, so as not to disrupt class actions that are currently underway until the liquidation funders involved can comply with the new requirements. This could have the negative outcome of plaintiffs being forced to cover legal costs and any adverse court

orders. The regulatory impact will be minimised by avoiding retrospectivity for all actions and arrangement entered into before the amending regulations come into effect. The regulatory impact would also be minimised by the provision of a transitional period during which a litigation funder can apply for an AFSL and ASIC can process licensing applications.

These design issues, and how they are being approached, are discussed at greater length in the risks section.

4. Impact analysis

Option 1: Status quo

Litigation funders

In the absence of bespoke regulation, and with the existing exemptions from financial product and credit product legislation, regulatory obligations on litigation funders are less than for many other industries engaged in the sale of investment products, particularly those who sell financial products to unsophisticated investors as part of potentially complex arrangements. The regulation litigation funders face as entities currently depends on the corporate structure they adopt. The ALRC identified publicly listed corporations, private companies, private equity firms and hedge funds as amongst the structures that litigation funders are using.

It is apparent from the growth in the industry, and the ability for overseas-based litigation funders to be active in the Australian market, that there are not particularly high barriers to entry or exit for litigation funders. To the extent that the litigation funding industry is operating as intended, this would be evidence of a healthy market. However, given the problems identified with some of these entrants and the schemes they enter into, it has been decided it is necessary to impose some regulatory safeguards that leave the barriers as low as practicable while meeting the objectives of protecting other parties to the litigation funding deals and the legal actions they fund.

Class action plaintiff members

Ensuring access to justice, as well as fair and equitable outcomes, for plaintiffs to funded class actions is one of the key objectives in the regulation of the litigation funding market. It is clear that in recent years there has been a rise in the number of class actions being brought in Australia, connected to the growing presence and activity of litigation funders.

However, there is growing evidence that while there are more cases, the outcomes for plaintiffs are not necessarily more favourable. They may not have complete understanding of the arrangements they are entering into and may be left with an adverse costs order they did not anticipate as a possible outcome of the arrangement. There is also a risk that the manner in which the matter is conducted (including in relation to key decisions such as those concerning settlements) may be unduly influenced by the commercial incentives of funders. Plaintiffs are likely to receive a smaller portion of any resolution or settlement in their favour than they would have in absence of a litigation funding arrangement. The ALRC found that the median return to group members in funded matters was just 51 per cent, whereas in unfunded matters the median return was 85 per cent of the settlement award.

Defendant entities

The status quo is not necessarily operating in the best interests for entities who are, or may be, the subject of litigation funded class action proceedings. Defendant entities have a proper interest in the conduct of litigation funders to the actions that are brought against them, especially as many of the entities who are subject to class actions are highly regulated companies themselves. There is a great burden for the defendants in any action, such as the costs and time taken to defend a matter,

diversion of attention and resources from ordinary business activities, and reputational damage. As such, it is proper that all parties involved in an action, including the litigation funders, are subject to appropriate regulatory standards, and at present there is a possible mismatch in the laws to which litigation funders are subject and those to which the defendants to class actions are subject.

Option 2: Repeal the exemption for litigation funders from the MIS and AFSL regimes

The Government announced on 22 May 2020 that it would regulate litigation funders under the *Corporations Act 2001*, by requiring them to hold an AFSL and comply with the MIS regime. The amendments are to take effect from three months from the date of the announcement. This option involves repealing certain regulations within the *Corporations Regulations 2001* that exempt certain litigation funding schemes from being MISs and from the AFSL obligations involved in managing a financial product. There is a well-established body of law underlying the AFSL and MIS regimes, though there may be a period of uncertainty as to how the full range of litigation funder practices will fit into the regimes. The Full Federal Court in *Brookfield* found that nothing about the nature of the litigation funding scheme in that case meant that it was exempted at law from being a MIS, which would come with all the associated regulatory obligations for the operator of the scheme and the protections that are afforded members of a MIS. Interests in a MIS being a financial product, it would also follow that the operator of the MIS would be required to hold an AFSL. The MIS regime is designed to appropriately protect members in schemes that meet certain characteristics, and litigation funding schemes that meet those characteristics will now be subject to those protections.

Litigation funders

The regulatory burden of this change will fall squarely on litigation funders of class actions, who will be required to obtain an AFSL if they do not have one already, and familiarise themselves with the obligations that fall on AFSL holders. The AFSL regime is designed to be appropriate for a range of operators, from large operators through to individuals, so while its imposition is a burden on those who have to be licensed, it has been judged as appropriate in spite of the regulatory costs in many other situations. Given the typical sophistication of litigation funders, whose business models involve taking financial risks by funding class actions with potentially large resolutions, the requirement to obtain an AFSL is not expected to impose any undue regulatory burden.

The average annual regulatory compliance burden of complying with AFSL requirements for all affected litigation funders is estimated to total around $1.1 million.

Litigation funding schemes that have more than 20 members will also have to register as a MIS and issue Product Disclosure Statements. Any litigation funder operating a registered MIS will be required to establish a public company that will be the responsible entity operating the MIS. This will affect the corporate structure of many of the litigation funders currently operating in the market. The MIS regime is narrowly targeted, and the potential to have to register a MIS where there are more than 20 investors reflects the particular structure of some litigation funding agreements, such as the one in the *Brookfield* case. The burden of imposing this regime must be weighed up against the benefits to class action plaintiffs and the other parties in a class action proceeding, which are discussed below.

The average annual regulatory compliance burden of complying with the MIS regime for all affected litigation funders is estimated to total around $2.1 million.

While there may be transitional uncertainty as litigation funders establish what kind of arrangements will have to be registered as a MIS, imposing the AFSL and MIS regimes should not affect the ability for most class action proceedings to be brought. The regulatory burden being imposed is not disproportionately large for the entities in the litigation funding industry, and the

claims that are already being brought for class actions are of a quantum that is significantly larger than the regulatory costs being imposed through AFSL and MIS compliance.

These changes could have an effect on the ease of entry and exit from the market, particularly for international litigation funders who will have to register for an AFSL and potentially register MISs. However, given the large number of litigation funders currently operating, this is not expected to have any marked impact on competition in the industry, and the effect is more likely to be on those litigation funders who may be in breach of the minimum standards that this regulatory intervention seeks to address.

Class action plaintiffs

As highlighted in the desired outcomes section, the selected option should not impose such a burden as to prevent individuals or groups being able to access justice where they do not have the resources to finance an action themselves. In order to have efficient access to justice, it is important that class action proceedings can still be brought, and the regulatory burden on litigation funders should not be such as to prevent this.

The increased availability of litigation funders to finance class actions must also be weighed against the interests of plaintiff members in entering any arrangement. A number of problems that may negatively affect the class action plaintiffs in a given action were highlighted above.

This option addresses these issues by:

- The requirement to hold an AFSL brings litigation funders under ASIC's supervision, with obligations to act honestly, efficiently and fairly. It also means that litigation funders must meet specific levels of competence and organisational resourcing. These requirements reduce the risk that class action plaintiffs will find themselves involved in an action where the risk-reward ratio does not justify their involvement, and for which they may face outcomes, such as an adverse court order, that they are not prepared for or able to manage.
- Where a litigation funding scheme constitutes a MIS that must be registered, a Product Disclosure Statement will ensure that the members of that MIS, the class action plaintiffs, are more aware of the risks of engaging in that action. They will also be more aware of the arrangements in case the action succeeds, such as the share of the settlement or resolution sum that will accrue to the litigation funder. Disclosure requirements could facilitate plaintiffs 'shopping' for litigation funders that offer a better deal to these plaintiffs.
- The requirements of the responsible entity of a MIS also entail acting in the best interests of members and treating the members of different classes fairly. This should act to make the interests of the plaintiff members the primary concern in class actions, so that settlement options are dictated by their interests rather than those of the litigation funders.

Defendant entities

Entities that are potentially the defendants in class action proceedings could also benefit from the removal of the exemption for litigation funders from the AFSL and MIS regimes. AFSL and MIS requirements could raise the standard of litigation funders' conduct in relation to class actions.

Greater transparency and oversight by the regulator will also mean that litigation funders who do not meet particular standards face consequences such as significant pecuniary penalties or being barred from the market. Such consequences help to regulate conduct of litigation funders and improve the quality and standing of the services provided by the industry.

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in cost
Total, by sector	$3.19	$0	$0	$3.19

5. Risks

There are some risks attached to the proposed policy, with the two most likely being:

- Some litigation funding businesses exit the market, reducing competition and allowing the remaining firms to initiate extra-marginal pricing; and
- The increased compliance costs are passed on to consumers through a reduction in risk appetite – with firms limiting the amount of funding they supply and restricting themselves only to the 'safest' actions – or price increases.

The risk that the changes will affect access to justice must be balanced against the risk to uninformed consumers resulting from participation in class actions undertaken not in their best interests, such as having to meet cost orders or receiving smaller amounts from a successful action due to the funder pursuing a settlement prematurely or retaining overly high commissions. Additionally, restricting the new regulations only to funders that are involved in class actions should limit the potential for the changes to reduce access to justice for those not directly involved in such actions. On balance, the proposed changes should ensure that litigation funders involved in class actions pursue higher standards and more transparent dealings with prospective claimants. This will in turn increase the confidence of claimants when dealing with funders and may lead to a greater willingness to engage with their services. It is unlikely that the changes will result in otherwise meritorious proceedings being abandoned outright.

There is the additional risk of disrupting existing class actions. The proposed regulatory changes are scheduled to commence on 22 August 2020 and it may not be possible for all firms to have successfully applied for an AFSL and registered as a MIS (if required) by that date. This generates a risk that actions funded by newly non-compliant firms will be stayed, resulting in adverse consequences for the claimants, including the requirement to pay costs in full. The proposal seeks to manage this risk by exempting proceedings that have commenced on or before the date the instrument is registered, which ensures that any proceeding currently underway is protected.

Given the complexity and broad reach of the MIS framework, as well as the diversity of litigation funding businesses, there is the risk that the proposed changes have unintended consequences. First, it may be the case that the changes affect a larger set of businesses than was originally intended. Second, there may be fewer litigation funding business than expected that are required to register as a MIS, due to conditions such as the exemption from registration for schemes that have less than 20 members.

By restricting the new regulations only to third-party litigation-funded class actions, and retaining exemptions for arrangements that involve a single plaintiff or creditor-funded insolvency activities, there is a substantially reduced likelihood that the impact will be broader than intended. To the extent that a smaller cohort of funders is captured by the changes than is preferable, there is scope for the Parliamentary Joint Committee inquiring into litigation funding and the class action industry to recommend further changes when it reports in December 2020.

6. Consultation plan

In settling on its approach, the Government has been informed by the extensive consultation that the ALRC undertook with ASIC, the litigation funding industry, business groups, law firms and other representative groups.

Consultation participants' views on the ALRC proposal to extend licensing requirements were mixed. The Australian Institute of Company Directors, for example, strongly favoured a 'robust licensing system', suggesting that it be similar in approach to the existing AFSL regime. This is in line with the new regulations announced by the Government.

Australia's largest litigation funder, Omni Bridgeway, also supported a licensing regime for litigation funders. Omni have also issued a press release since then supporting a regime that would include disclosure obligations and reporting standards.

ASIC were more circumspect regarding licensing, suggesting that while they supported better regulation of litigation funders, the AFSL regime may not be the most appropriate mechanism. The Association of Litigation Funders of Australia (ALFA) shared this perspective, though it should be noted that they did not oppose further licensing as long as it was appropriately targeted to a specific policy problem, such as poor business practices in the litigation funding industry. Both ASIC and ALFA held that the main problem identified by the ALRC – funders maintaining inadequate financial security to meet adverse costs orders – was not most effectively addressed by the AFSL regime.

While acknowledging ASIC and ALFA's perspectives, the proposed regulatory changes are intended to address a broader range of concerns than that of inadequate security. In addition to security, the Government has a broader set of goals including increased regulatory oversight, greater transparency and higher professional standards for litigation funding businesses. Considering these goals, alongside ease of implementation and the ability to target only those funders involved in class actions, the announced proposal is considered to be the best option.

7. Implementation and evaluation/review

The chosen option will be implemented by amendment to regulations by 22 August 2020. It will only be implemented on class actions that commenced after the regulatory amendments are registered. This ensures that arrangements that have been entered into on the basis of existing law are not affected, and rights to action are not prejudiced by unpredictable law change.

ASIC will register MISs formed by litigation funding schemes that meet the requirements for having to be registered, and process AFSL applications once the regulatory amendments have been made.

As part of the Australian Government's Regulatory Impact Analysis requirements, Treasury will prepare a Post-Implementation Review of the regulatory changes within two years of the changes having taken effect.