Supplementary analysis on options for introducing a fault element to continuous disclosure

Background

On 25 May 2020, the Treasurer, under the temporary *Corporations (Coronavirus Economic Response) Determination (No. 2) 2020* (Determination No. 2), amended the continuous disclosure provisions for a period of six months. The temporary amendment meant that companies and officers would be liable for a breach of the provisions only if they had acted with knowledge, recklessness or negligence – a 'fault element' – in failing to update the market with price sensitive information.

These changes were made so that firms would be able to release forward-looking guidance to the market during a period of heightened economic uncertainty due to the COVID-19 crisis. The potential for a firm to be subject to a class action seeking up to hundreds of millions of dollars, in circumstances where they had acted without knowledge, recklessness or negligence, would otherwise act as a deterrent to put out forecasts that are valuable for investors.

Due to ongoing economic uncertainty expected to continue into 2021, the Treasurer extended these amendments until 22 March 2021 through *Corporations (Coronavirus Economic Response) Determination (No. 4) 2020* (Determination No. 4).

On 13 May 2020, the House referred to the Parliamentary Joint Committee on Corporations and Financial Services an inquiry into 'Litigation Funding and the Regulation of the Class Action Industry' (the PJC Report). The PJC Report examined the market for class actions and litigation funders, and included an extensive discussion of the continuous disclosure regime, culminating in a recommendation that "the Australian Government permanently legislate changes to continuous disclosure laws in Determination (No. 2)".

The PJC Report analysed continuous disclosure in the broader context of class action litigation. Evidence to the committee focused on the 'ease with which shareholder class actions may be triggered by an alleged breach of Australia's continuous disclosure provisions'. The committee found that 'reform is required to continuous disclosure laws' due to their increasing prevalence in shareholder class actions.

This analysis is intended to supplement the analysis in the PJC Report for the purpose of consistency with the *Australian Government Guide to Regulatory Impact Analysis*. It considers the impacts of two policy options that were not recommended by the PJC report:

- Retaining the existing ability for the regulator to issue infringement notices and undertake non-penalty proceedings against entities and officers without having to prove knowledge, recklessness or negligence; and
- Introducing a fault element to private actions for misleading and deceptive conduct in relation to alleged failures to keep the market fully informed.

Impact analysis

Option 1: ASIC's use of infringement notices and non-financial enforcement action will remain as is

Most of the focus on the effectiveness of continuous disclosure laws by the PJC Report, and the prior Australian Law Reform Commission's Inquiry into class actions and third-party litigation funders, was centred on class actions funded by third parties. The Australian Securities and Investments Commission also brings actions under the *Corporations Act (2001)* continuous disclosure rules.

ASIC's civil actions include those seeking penalties through the courts, which can be for up to the greater of $10.5 million or ten per cent of the entity's annual turnover. It also includes civil actions that do not seek financial remedies, such as seeking a court order for an entity to disclose information it should have disclosed under the continuous disclosure regime. Lastly, ASIC also has available administrative penalties via the infringement notices regime, which are capped at $100,000 for entities with market capitalisation of over $1 billion, and capped at lower amounts for smaller entities. This option considers imposing a fault element for ASIC's civil penalty proceedings (those with financial impact), but not requiring fault for the use of non-financial enforcement or administrative penalties.

Many of the arguments made by the PJC Report in favour of making permanent reforms to continuous disclosure were made in regards to the cited negative impacts of class actions. Some of the negative effects of shareholder class actions that were highlighted in the PJC Report which are not applicable to infringement notices and non-financial enforcement are:

- The circularity of shareholder class actions – where the incidence of an action brought by shareholders will often be borne by a group of shareholders with whom there is significant overlap, given the action will negatively affect the value of the securities they hold.
- The reliance on litigation funders in almost all continuous disclosure class actions means that shareholders relinquish a significant amount of the settlement to the third party funders, in addition to the amount being paid in legal fees.
- The effect on the price of directors and officers insurance. Submissions to the PJC Report regarding the effect of class actions on the cost of directors and officers insurance costs attribute the increase to the increased prevalence of class actions. This can be attributed to the increased frequency of these actions and the amount that they settle for.

ASIC has different considerations when choosing whether to pursue infringement notices or non-financial enforcement action in relation to breach of these laws than do private actors or litigation funders that finance them. ASIC considers the nature and seriousness of misconduct, the behaviour of the offender, the expected level of public benefits of pursuing enforcement, any mitigating factors, and the strength of the case and evidence available.

Retaining the 'no-fault' standard for infringement notices will allow ASIC to utilise them for more minor infractions. ASIC will retain the ability to seek more significant penalties in circumstances where they can demonstrate the entity or officer acted with 'knowledge, recklessness or negligence'. ASIC tends to use infringement notices for less serious breaches as a fast and effective regulatory response that is proportionate and proximate in time to the alleged breach.

According to ASIC Enforcement Report records, they have had enforcement outcomes on sixteen infringement notices in the last five years.

The accompaniment of ASIC using infringement notices on the 'no-fault' standard, plus the threat of more significant financial penalties or class actions where an entity or officer has acted with fault, creates a complementary regime where the actions brought and potential outcomes are more proportionate to the behaviour of that entity or officer.

We anticipate officers and entities will be more confident issuing forward guidance while still being subject to regulatory discipline. The success of this approach will be evaluated with respect to the degree to which this is achieved.

Option 1:	
Benefits	**Costs**
• It is clear to companies and officers that there has been no change in the standard that they are expected to uphold, as ASIC will still continue to issue administrative penalties and have available non-financial enforcement tools on a 'no-fault' standard. • ASIC administrative action does not have the same effect of driving up directors and officers insurance for companies as the penalties available through this regime are significantly smaller than other actions seeking financial penalties or remedies. • ASIC can still use infringement notices to penalise entities and officers for minor infractions of the continuous disclosure rules, without having to undertake lengthy proceedings.	• Entities and officers may be concerned that they can still face action in circumstances where they have acted with no fault. However, they will only face administrative action with penalties that are proportionate to their infringement.

Option 2: The fault element also applies for misleading and deceptive conduct

Stakeholders who favoured introducing a fault element to the continuous disclosure regime commonly cited a desire for an at-fault element to apply to misleading and deceptive conduct. This was expressed in submissions to the PJC Report, as well as in feedback to the Government on the effectiveness of the temporary instruments.

Stakeholders raised concerns with issues related to misleading and deceptive conduct rules on two grounds. The first of these is that entities and officers can be found to have misled or deceived the market through their statements without proof that they did so with knowledge, recklessness or negligence. This is a separate policy issue to continuous disclosure and not considered through this supplementary analysis. The second is that actions for continuous disclosure are usually accompanied by actions for misleading and deceptive conduct on the same factual circumstances. Litigants can claim an entity or officer misled or deceived the market by failing to disclose information, which is very similar to the continuous disclosure requirement. The concern is that introducing a fault element to continuous disclosure will be ineffective without also introducing this requirement to misleading and deceptive conduct, as there will remain an alternate action available to litigants without a fault standard.

Misleading and deceptive conduct is one of the key provisions of the *Corporations Act 2001* that is used in a range of circumstances that go beyond those under which continuous disclosure arises, so the introduction of a fault element is limited to those circumstances in order to avoid unintended flow-on effects.

In the Australian Law Reform Commission (ALRC) Inquiry the committee looked at continuous disclosure and misleading and deceptive conduct hand-in-hand in the final chapter, culminating in a recommendation that "the Government should commission a review of the legal and economic impact of the operation, enforcement and effects of continuous disclosure obligations and those relating to misleading and deceptive conduct…". The PJC Report also noted the submissions relating to misleading and deceptive conduct, but declined to present a view on whether there should be any changes, stating at 17.121 "the committee does not have information on what proportion of shareholder class actions rely on continuous disclosure versus misleading or deceptive conduct laws, and whether there were any differences in the outcomes of those cases".

It is evident in the 2019 Federal Court decision in *TPT Patrol Pty Ltd as trustee for Amies Superannuation Fund v Myer Holdings Ltd* that continuous disclosure and misleading and deceptive conduct were considered and adjudicated on very similar bases, and again in the 2020 decision in *Crowley v Worley Ltd*. It is clear from reviewing a number of continuous disclosure actions that the two are commonly brought together. Given that there have only been two judgements in class actions for continuous disclosure, it is not yet conclusively established whether or how the courts may apply different standards to the two. However, it is clear that changing the standard for both continuous disclosure and misleading and deceptive conduct circumstances related to continuous disclosure will achieve the policy intent of amending the continuous disclosure provisions as recommended by the PJC.

Identified risks from proposed options

Risk
Entities and officers do not meet the same standards of disclosure.

Under Option 1 there remain a number of enforcement possibilities for private actors and ASIC. Both private litigants and ASIC can seek civil financial penalties – principally in the form of compensatory damages for private litigants – for breaches of the continuous disclosure rules by entities and their officers. However, they will only be able to do so by proving that the entity acted with knowledge, recklessness or negligence. ASIC will be able to utilise infringement notices and non-financial enforcement proceedings, such as obtaining a court order requiring an entity to disclose information, without having to prove knowledge, recklessness or negligence. Private litigants may also seek injunctions without proving fault.

Infringement notices are an enforcement tool with a cap on the penalty that can be administered. If the party that is receiving the infringement notice does not challenge it, then it does not need to go through the court system. This makes it suitable for a quick regulatory response that does not warrant harsher enforcement measures and which the party receiving the notice is unlikely to challenge.

There are other enforcement options at ASIC's disposal that do not require proof of knowledge, recklessness or negligence, such as seeking an order from the court that an entity must disclose

information. This will continue to be part of ASIC's regulatory options to encourage compliance with the continuous disclosure obligations.

When combined with the existing threat of class actions and more punitive enforcement measures by ASIC where an entity or officer has acted with 'knowledge, recklessness or negligence', entities will remain sufficiently deterred from seeking to flagrantly breach their continuous disclosure obligations. Any serious misconduct will still be subject to the threat of class actions or significant civil penalty proceedings brought by ASIC where there is a suggestion that the entity acted with knowledge, recklessness or negligence. The risk of a deliberate change by an entity to be more disposed to disregarding their continuous disclosure obligations is therefore considered to be low.

Risk
That the application of a fault element to misleading and deceptive conduct is unnecessary or does not achieve the intended outcomes from adding a fault element to it and the continuous disclosure rules.

The option to extend a fault element to misleading and deceptive conduct is based on two Federal Court judgments, as well as the opinions of stakeholders expressed in targeted consultation on the temporary instruments.

Treasury undertook targeted consultation with key stakeholders on the effectiveness of the first temporary instrument in August 2020. Among the stakeholders that supported the instrument, the biggest concern expressed was that it would not be effective in materially lowering the threat of class actions because it did not also apply to misleading and deceptive conduct.

The recent *Myer* and *Worley* cases support this proposition, as the findings on misleading and deceptive conduct (in so far as they relate to allegations that the defendant misled or deceived the claimant by failure to update the market with price-sensitive information) were considered closely with the findings on continuous disclosure. While there will not be a definitive verdict on the extent of the distinction between the two provisions unless there is a specific set of facts before the court that highlights that distinction, it is clear enough that if a fault element is not added to misleading and deceptive conduct alongside the fault element added to continuous disclosure that there is a significant risk that the fault element added to continuous disclosure will not serve its intended purpose.

The ALRC did not have the benefit of either Federal Court decision above when preparing their recommendation on continuous disclosure. The PJC had the *Myer* judgment available, but submissions had closed when the *Worley* judgment was handed down. This new jurisprudential evidence provides a basis for extending the application of the fault element to misleading and deceptive conduct in limited circumstances as outlined above.

Regulatory Burden Estimate

This regulatory burden estimate covers the policy settings for continuous disclosure recommended by the PJC Report and both options 1 and 2. This means that private litigants and ASIC must prove a fault element in civil penalty proceedings under continuous disclosure, that ASIC retains the ability to issue infringement notices and undertake non-financial civil enforcement without proving fault,

and that there is a fault element for misleading and deceptive conduct where it is alleged an entity failed to disclose price-sensitive information to the market.

Directors and officers insurance

The main impact we anticipate is in relation to premiums for directors and officers insurance.

Many businesses take out directors and officers insurance to insure against the risk of adverse findings or settlements under the continuous disclosure regime. This cost has risen significantly in recent years and, for those companies that take out insurance rather than face the risk of paying out of company resources for a loss on a case, is the biggest cost for businesses associated with the regime.

Based on evidence presented to the PJC by providers of the insurance, the cost of this insurance has risen dramatically over recent years. According to Marsh Australia, for their ASX200 clients, the cost of premiums rose by 250 per cent from 2011 to 2018, and an additional 118 per cent in 2019. This does not include the increased excess that the company must cover or any restriction in the coverage offered by the insurance.

The extreme volatility over the past decade means there is no reliable historic average to apply when establishing a benchmark cost of insurance going forward. For the purposes of illustrating the limitations of using the past decade as an indication, if it is assumed that premiums over the next decade mirror the rises for ASX 200 companies from 2011 to 2018 per the information above, the savings attributable to the decline in directors and officers insurance would be in the magnitude of $9 billion per year. This is likely to be a dramatic overestimate as these premium increases do not account for the rebalancing of the premium pool that is likely to occur in the coming years.

Therefore, to arrive at an estimate of the regulatory benefit owing to decline in directors and officers insurance premiums, we have made an illustrative assumption of an average of ten per cent growth in premiums without the continuous disclosure reforms, and five per cent growth in premiums if the reforms take place.

Directors and officers insurance covers a range of circumstances other than legal action for alleged continuous disclosure breaches. Insurers have not revealed commercially sensitive information on how the breakdown of each risk factor contributes to the price of premiums, however, submissions to the ALRC and PJC have been consistent that is has been the single biggest contributing factor to its increase in price. On this basis, the illustrative example is that the annual increase in premiums will be five percentage points higher each year versus what it would have been in the absence of this policy change.

For the purpose of our example, we have made assumptions on the coverage of directors and officers insurance and the cost of premiums based on insurer submissions to the ALRC and PJC Inquiries and their publically available materials, included those issued to business about the state of the market. On the basis of these, it is assumed that all companies with market capitalisation over $10 billion have directors and officers insurance, with decreasing coverage on a sliding scale down to companies with market capitalisation of less than $100 million, where it is held by 30 per cent of companies. The premium for large caps has been estimated at $5 million, down to $625,000 for micro caps.

The costing only accounts for premiums. It does not account for excess in case of a settlement or action against the company.

In this example, it is estimated that the average annual regulatory save as a result of the decreased expenditure on directors and officers insurance will be $912.5 million.

Average annual regulatory saving (from business as usual)				
Change in costs ($m)	**Business**	**Community organisations**	**Individuals**	**Total change in cost**
Total, by sector	$912.5	Nil	Nil	$912.5