ASIC

Australian Securities & Investments Commission

Australian Law Reform Commission Inquiry into class action proceedings and third-party litigation funders

Submission by the Australian Securities and Investments Commission

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Overview

1 ASIC welcomes the opportunity to provide this submission in response to the *Inquiry into class action proceedings and third-party litigation funders: Discussion Paper 85* (discussion paper), published by the Australian Law Reform Commission (ALRC) in June 2018.

2 We have confined our comments in this submission to the sections of the discussion paper that directly relate to ASIC's functions or responsibilities.

Review of the continuous disclosure obligations and misleading and deceptive conduct provisions

3 The discussion paper suggests a review of the legal and economic impact of the continuous disclosure obligations and the misleading or deceptive conduct provisions in the *Corporations Act 2001* (Corporations Act) and Australian Securities and Investments Commission Act 2001(ASIC Act) (Proposal 1-1). While any potential review is a matter for Government, based on the observations made in the discussion paper, we do not see a need for such a review.

4 The continuous disclosure obligations are critical to protecting shareholders, promoting market integrity and maintaining the good reputation of Australia's financial markets ($1.84 trillion market capitalisation with an average turnover of $5.9 billion a day). The economic significance of fair and efficient capital markets dwarfs any exposure to class action damages.

5 The regime has provided significant benefits including increased investor participation and investment, higher liquidity, and lower transaction costs. It is also the anchor point for other elements of Australia's regulatory regime (including low document capital raising through rights issues).

6 Further, while Australia's main listing venue is operated by the Australian Securities Exchange (ASX), ASX is not the only listing market for securities. There are two other smaller listing markets for equity securities. In addition, securities listed on the ASX are traded in the secondary markets operated by the ASX and by Chi-X. There are a number of other markets where the nature of the listed securities, the integrity of the market for these securities and the regulatory regime that applies to them have an impact: for example futures over listed equities or equities indexes on the ASX 24, equity contracts for difference (CFDs), equity derivatives traded on over-the-counter and other markets, as well as related products sold on other ASX and Chi-X markets such as options, warrants and ETFs.

Note: By way of example, in terms of volume, turnover on the SPI contract for 2017 was notionally $1.8 trillion or 12.2 million contracts; and equity CFDs account for around $2.3 trillion in annual turnover.

7 It is important to recognise that the continuous disclosure regime and misleading or deceptive conduct prohibition that apply to securities apply equally to these other listed markets and any new listed markets, impact on current products sold across all markets and may impact on future product development and market innovation.

8 Any adjustment of this key regulatory setting would need to consider the broader impact on Australia's overall regulatory architecture, our product and market mix and our competitiveness as a capital market.

9 The misleading or deceptive conduct prohibition is also fundamental and applies very broadly beyond market disclosures and class actions to conduct in relation to financial products or services and conduct in trade and commerce generally.

10 We do not see any evidence that supports a government review of the continuous disclosure and misleading or deceptive conduct regimes. In our view, any call for a review should demonstrate that there are significant deficiencies with the regime that require scrutiny by government.

Additional regulation of litigation funders

11 The Corporations Act provides clear avenues for shareholders and consumers to take legal action to enforce their rights. Where private action can achieve a similar outcome to that which action by ASIC could achieve, it allows ASIC to allocate its enforcement resources to other priorities.

12 Shareholder class actions provide a number of benefits to consumers and financial markets and play an important role in improving shareholder access to justice.

13 We support the Inquiry's aim of ensuring that litigation funders are appropriately regulated. However, ASIC questions whether regulation of litigation funders under ASIC's Australian Financial Services (AFS) licensing regime would address the regulatory risks perceived to be associated with litigation funders (Proposal 3-1, Proposal 3-2, Question 3-1, Question 3-2 and Proposal 4-1).

14 In our view, such risks as may exist in relation to litigation funders are better addressed through other mechanisms — for example, court-ordered security for costs. Consistent with other jurisdictions, litigation funding should be regulated as a legal service.

15 We would add that, without clear evidence of harm, additional regulation of litigation funders should only be considered where it is supported by evidence-based analysis of deficiencies in the current regime and is likely to result in a net benefit.

A federal collective redress scheme

16 The potential establishment of a new federal collective redress scheme (Proposal 8-1) is a matter for government.

17 In principle, a well-designed collective redress scheme could potentially complement the broader financial services compensation framework. However, we would need to see further details of the proposal before providing more substantive comments.

18 Any proposal for a redress scheme as applying to the financial services sector should be considered against the background of the existing consumer redress and compensation framework in Australia, currently undergoing extensive reform.

A Continuous disclosure and misleading conduct (Proposal 1–1)

Key points

The continuous disclosure obligations and misleading or deceptive conduct provisions are critical to Australia's market integrity regime, increase the attractiveness of investment in Australia and anchor many other elements of the Australian regulatory regime.

Shareholder class actions can provide an effective accountability mechanism that helps address the power imbalance between shareholders and defendants.

We have not seen any evidence that would suggest a review of these provisions is necessary.

19 Any potential review of the legal and economic impact of the continuous disclosure obligations and the misleading or deceptive conduct provisions in the Corporations Act and ASIC Act is a matter for Government. However, based on the content of the discussion paper, it is not clear to us that there is a need to review Australia's continuous disclosure obligations and misleading and deceptive conduct provisions at this stage.

20 These provisions exist to protect shareholders, market integrity and the good reputation of Australia's financial markets. In ASIC's experience the provisions are working well and operate to increase the attractiveness of Australian markets for investors. The economic significance of fair and efficient capital markets dwarfs any exposure to class action damages. Continuous disclosure and misleading or deceptive provisions anchor many other elements of the regulatory regime for financial markets, including low document capital raisings.

21 Any call for a review of the regimes should demonstrate that there are significant deficiencies that require scrutiny and reform.

Rationale for Australia's continuous disclosure regime and misleading and deceptive conduct provisions

22 Australia's continuous disclosure regime has been refined and adapted over a period of 20 years since the ASX's listing rules first obtained legislative backing in 1994. During this time, the regime has been the subject of ongoing review and has been responsive to the needs of the market. As a key component of Australia's regulatory regime, the provisions are designed to, and do, operate far more broadly than just in the class action context.

23 We also note the misleading or deceptive conduct provisions are fundamental to ensuring consumers are adequately protected and market integrity is maintained and apply across financial products and services and trade and commerce generally. We see no justification to amend these provisions. It is fundamental that investors can rely on disclosures to the market, that information provided to them is accurate and investors and the market are not led into error.

Continuous disclosure is critical to market integrity

24 The continuous disclosure obligations and misleading or deceptive conduct provisions are critical to the integrity and reputation of Australia's capital markets.

25 Market integrity is fundamental to investor confidence and a well-developed financial market. Financial markets cannot fund the economy without trust and confidence. As set out at paragraph 2 of Report 487 *Review of Australian equity market cleanliness* (REP 487), confidence in market integrity:

a) encourages investor participation;

b) contributes to liquidity;

c) stimulates more competitive pricing; and

d) leads to a lower cost of capital.

26 Financial markets can only operate fairly when the information they rely on is accurate, useful and available to all. If investors perceive they are not being appropriately informed or that they are at an exploitable information disadvantage, they tend to protect themselves by reducing their exposure to the market. They also demand a higher return or invest in other markets with better integrity and fair access to information.

27 Research on the relationship between information asymmetry and market participant behaviour has found that participants 'would withdraw from a market if they faced severe information disadvantages—leading to lower asset valuation, liquidity and, in the most extreme cases, market failure'.

Note: See paragraph 8 of REP 487 and GA Akerlof, 'The market for 'lemons': Quality uncertainty and the market mechanism', *The Quarterly Journal of Economics*, vol. 84, 1970, pp. 488–500.

28 The continuous disclosure obligations recognise that companies will not always have incentives to voluntarily disclose price sensitive information to the market. This is most relevant in relation to information that may have adverse implications for the price of a company's securities.

29 These provisions are also the anchor point for many other aspects of Australia's regulatory regime for financial markets, particularly low document secondary capital raising (e.g. share placements and rights issues).

Market cleanliness in Australia

30 An effective continuous disclosure regime should minimise the potential for insider trading and other forms of market abuse that may stem from companies withholding or selectively disclosing materially price sensitive information.

31 Therefore, the timely release of information by companies is critical. If regulation requires public announcements by entities earlier, then this leaves less time for holders of inside information to misuse the information and harm investors and market integrity. This assists the market to trade in a more informed state. In a clean market, security prices should instantaneously react to new information released through the proper channels.

32 Given the significance of market integrity to financial markets and the broader economy, we think it is important to measure the extent to which information leakage is impacting on prices and traders' behaviour for securities on listed markets. Measures of this type are known as market cleanliness measures.

33 Research undertaken by ASIC looked at possible insider trading and information leakage ahead of material, price-sensitive announcements by examining abnormal pre-announcement price movements or shifts in trading behaviour before these announcements.

34 Our research found that over the past ten years, there has been a sustained improvement in cleanliness of Australia's listed equity market. It suggests that insider information and the loss of confidentiality ahead of material announcements has declined. Around 95% of material announcements exhibited no (or negligible) anomalous trading patterns ahead of an announcement in the period 1 November 2014 to 31 October 2015.

Note: See ASIC Report 487.

35 We note the discussion paper at page 29 comments that Australia's continuous disclosure requirements have "peculiar characteristics". While the discussion paper does not detail what these "peculiar characteristics" are, it seems to suggest that Australia's disclosure regime compares unfavourably to other international jurisdictions.

36 In contrast, we note independent international research consistently ranks Australian market cleanliness favourably compared to other developed equities markets.

Note: See Intralinks, *Intralinks M&A Leaks Report*, 2015 and 2017 (the Intralinks reports).

37 Commissioned by Intralinks and conducted by the M&A Research Centre at Cass Business School, the 2015 Intralinks report examined more than 4,475 mergers and acquisitions from 2009–14 for evidence of information leakage about the deals before their public announcement.

Note: the data below is from the 2015 Intralinks report referred to in REP 487. The 2017 Intralinks report has no major differences on the key points of principle.

Note: See also Philip Whitchelo, *Globally, M&A deal leaks are at a six-year low*, Intralinks, 20 November 2015.

Chart 1: Percentage of leaked deals in target primary listing countries

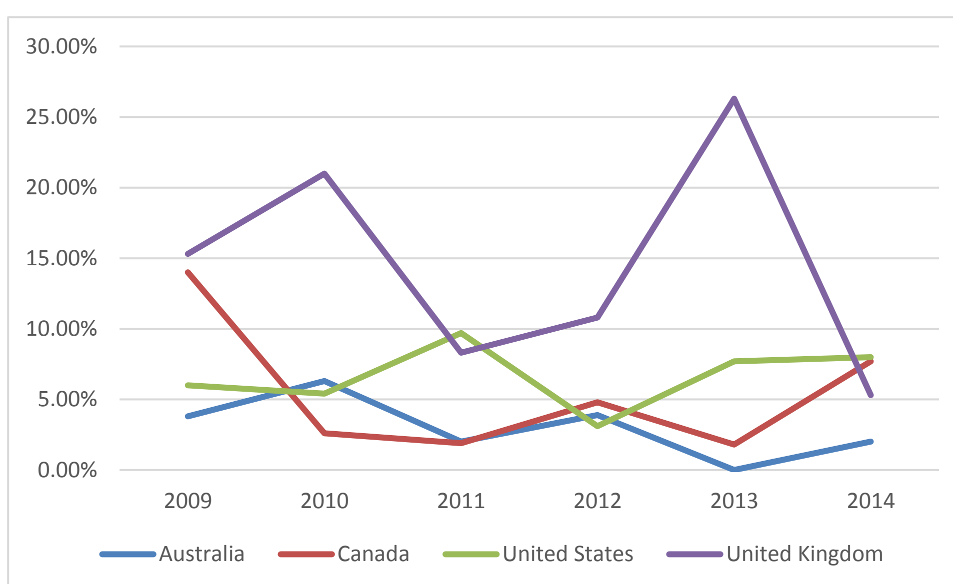

Table 1: Percentage of leaked deals in target primary listing countries

Target primary listing country	2009	2010	2011	2012	2013	2014	Avg.
Australia	3.80%	6.30%	2.00%	3.90%	0.00%	2.00%	3.50%
Canada	14.00%	2.60%	1.90%	4.80%	1.80%	7.70%	5.60%
United States	6.00%	5.40%	9.70%	3.10%	7.70%	8.00%	6.60%
United Kingdom	15.30%	21.00%	8.30%	10.80%	26.30%	5.30%	14.10%

Note: See the Intralinks report for more information on the data contained in Chart 1 and Table 1 above.

38 The study found a general improvement in market cleanliness over the six-year sample period, with Australia having one of the lowest indicators of information leakage ahead of mergers and acquisitions compared to other international jurisdictions. Australia had the lowest average percentage of leaked deals over the period, at 3.5%, while the United States, at 6.6%, had

the median percentage of leaked deals. We consider a key factor in these results to be the strength of Australia's continuous disclosure regime.

Benefits of Australia's continuous disclosure regime

39 Australia's disclosure regime and market cleanliness levels have played a key role in the strength of financial markets and the attractiveness of investment in Australia.

40 Australian markets have a total $1.84 trillion market capitalisation with an average turnover of $5.9 billion a day. Despite being a comparatively small economy, Australia is one of the top 20 global destinations for foreign direct investment. In 2017, Australia saw foreign direct investment inflows double to $48 billion.

Note: See United Nations Conference on Trade and Development, World Investment Report 2017, Annex Table 01 page 196.

41 This is no coincidence. Australia's continuous disclosure regime supports investor participation and confidence in markets which in turn has helped increase market turnover, lower transaction costs and the cost of capital and improve the efficiency of capital allocation within the market.

42 This is important as a small change in the cost of capital can significantly affect listed companies' valuations and cost of funds. An increase in the cost of capital would lead to real impacts for real people, especially through the pool of over $2.6 trillion in assets held in superannuation funds that is currently invested in various Australian markets.

Note: Australian Prudential Regulation Authority, Statistics: Quarterly Superannuation Performance, March 2018 (29 May 2018) page 8.

43 Capital raising in Australia is vigorous. Throughout 2017, there were 145 Initial Public Offerings (IPOs). Over the year to September, the average amount raised per offering was $44 million. Another positive feature of the Australian IPO market is the growth in foreign listings on the ASX, which totalled 39 in 2016-17.

Note: see IPO Society.

44 In addition, because of continuous disclosure, listed entities can raise secondary capital (e.g. by rights issue) without a full prospectus based on an informed market and a reliable share price. During the Global Financial Crisis, ASX reported that when other sources of capital had dried up, 2009 was a record year for secondary capital raisings of $98.6 billion.

Note: ASX Information Paper *Capital raising in Australia: experiences and lessons from the Global Financial Crisis* (2010) p18.

45 This data is testament to the strengths of Australia's market integrity regime and the continuous disclosure and market cleanliness measures that underpin it. We are concerned about the potential for broader unintended consequences for Australia's regulatory regime that may stem from a review of the continuous disclosure regime without any clear benefits.

Shareholder class actions

46 Shareholder class actions can play an important and complementary role in improving shareholder access to justice and fostering accountability.

47 The Corporations Act provides clear avenues for shareholders and consumers to take legal action to enforce their rights. It was clearly not intended that the regulator should have a monopoly on legal action. Where private action can achieve a similar outcome to that which action by ASIC could achieve, it allows ASIC to allocate its regulatory resources to other priorities. ASIC encourages investors to consider private legal action where appropriate to obtain compensation for losses investors may have suffered: see Information Sheet 151 *ASIC's approach to enforcement* (INFO 151) at p. 6.

48 Shareholder class actions help to democratise access to justice by addressing the power imbalance that exists between shareholders and defendants. Often, the only practical means for shareholders to enforce their rights is through a funded shareholder class action, as individual losses are too small to justify pursuing individually.

49 In addition to promoting access to justice, class actions can spread the risks of complex litigation and improve the efficiency of litigation by introducing commercial considerations that may reduce costs.[1] The prospect of a shareholder class action can also serve as a positive influence on a firm's governance and culture, improving accountability.

50 Often, the main threat to shareholder investments stems not from the market reaction to a disclosure or a class action, but from the misconduct of companies themselves. We do not see a problem with shareholders seeking to enforce their right to a remedy nor have we seen any evidence that directors are being inappropriately held to account.

Shareholder class actions data

51 According to academic research, there have only been 58 funded shareholder class actions in Australia. While there has been an increase in the number of

[1] *Fostif Pty Ltd v Campbell's Cash & Carry Pty Ltd* (2005) 63 NSWLR 203; 218 ALR 166; [2005] NSWCA 83 at [100]; *QPSX Ltd v Ericsson Australia Pty Ltd (No 3)* (2005) 219 ALR 1; 66 IPR 277; [2005] FCA 933 at [54].

such actions in recent years, the evidence suggests it has been limited to "a very small number of companies and a miniscule proportion of all publicly listed companies". Over the last 25 years, shareholder class actions have been filed with respect to, on average, 1.88 companies every year, with around five companies a year impacted on average over the last five years.

Note: See Vince Morabito An Empirical Study of Australia's Class action Regimes – Fifth Report, 2017, pages 29, 31 and 34.

52 Given there are thousands of publicly listed companies, these numbers are clearly very small, and there appears to be a disconnect between some perceptions of shareholder class actions and the data.

53 These numbers also contrast with other jurisdictions such as the United States for example. Analysis by the Productivity Commission suggests that companies listed in the United States are fifteen times more likely than Australian companies to face class actions.

Note: See Productivity Commission, *Access to justice arrangements: Inquiry report No. 72*, September 2014, vol. 2, p. 620.

54 An increase in the frequency of class actions is not of itself indicative of a problem with the regime. There are many factors that may drive an increase in the number of class actions, including the incidence of misconduct by firms. We see no evidence that the existing regime is failing to protect shareholders, harming Australia's market integrity or the reputation of Australia's markets.

55 The discussion paper also appears to suggest that the propensity for shareholder class action claims to settle outside of court before judgment is indicative of a need for review of the provisions. Research suggests there is nothing unusual about the settlement rates of shareholder class actions. We note data that indicates such actions have had a settlement rate of 64%, behind mass tort (70%) and equal to industrial class actions (64%). The average duration of settled class actions has been 962 days, only 16 days less than the overall average of 978 days.

Note: See Morabito page 30.

56 Further, the fact that a case settles before a final hearing does not suggest that the claim is without merit or that there are problems with the existing law. As the Productivity Commission notes 'the prevalence of settlements is not unique to shareholder claims … less than 3 per cent of matters that reach supreme and district courts are resolved through final judgment'.

Note: See Productivity Commission, *Access to justice arrangements: Inquiry report No. 72*, September 2014, vol. 2, p. 620.

57 There are a range of factors that influence whether parties to litigation proceed with court action. Defendants to shareholder class actions are

sophisticated parties who possess the ability to consider 'whether a settlement is "fair" compared to the expected judgment, and have the resources to proceed if they consider it is not'.

Note: See Productivity Commission, *Access to justice arrangements: Inquiry report No. 72*, September 2014, vol. 2, p. 620.

58 The existence of a comparatively small number of class actions, and their settlement or otherwise, should not form the basis for a review of the well-established and effective continuous disclosure and misleading or deceptive conduct regimes that serve an important broader function.

Director's and officer's insurance

59 In relation to directors' and officers' insurance, we note that while the United States has a much more vigorous class action market, there do not appear to be any major concerns about the ability to obtain insurance for directors. We do not consider anonymous and anecdotal suggestions from companies considering moving offshore as sufficient evidence to reconsider continuous disclosure and misleading or deceptive conduct regimes that have improved the attractiveness of investment in Australia, made our markets cleaner and helped protect shareholders.

B Regulating litigation funders (Proposal 3–1 and Proposal 4-1)

Key points

We question whether licensing by ASIC is an effective mechanism to address the regulatory risks perceived to be associated with litigation funders, particularly the risk that a litigation funder has inadequate resources to meet an adverse costs order.

The AFS licensing regime is focused on the conduct of financial services, and the activities of litigation funders do not sit neatly within the regime. A requirement that a litigation funder obtain an AFS license will not of itself mean that the funder will be adequately capitalised to meet adverse costs orders, continue to fund litigation or distribute funds to shareholders.

More broadly, ASIC is not a prudential regulator and does not administer a regime that goes to the continued overall financial health of an organisation.

Consistent with other jurisdictions, in our view litigation funding should be regulated as a legal service.

60 While law reform to introduce ASIC licensing of litigation funders (Proposal 3–1) may appear attractive at first glance, we question whether this approach would be effective to address the risk that funders will be unable to meet their liabilities when due.

61 We do not see clear benefits for consumers that would justify the regulatory costs associated with a mandatory annual reporting regime in relation to conflicts of interest (Proposal 4-1).

Adequate financial resources

62 It appears that the main risk sought to be addressed by Proposal 3–1, which suggests licensing of litigation funders, is the risk that a litigation funder does not have adequate financial resources and may not be able to meet adverse costs orders.

63 This risk was identified by the Productivity Commission in its report *Access to justice arrangements: Inquiry report No. 72*. In response to this risk, the Productivity Commission recommended that litigation funders should be licensed to ensure that they hold sufficient capital to meet their financial obligations.

64 Licensing by ASIC would not adequately address the risk that funders will be unable to meet their liabilities when due.

65 The AFS licensing regime is focused on the conduct of financial services, and the activities of litigation funders do not sit neatly within the regime. A requirement that a litigation funder obtain an AFS license will not, without significant changes to other aspects of the Corporations Act, necessarily mean that the litigation funder will be adequately capitalised to ensure it can meet adverse costs orders, continue to fund litigation or distribute funds to shareholders.

66 Currently, all AFS licensees not regulated by the Australian Prudential Regulation Authority (APRA) are required to have adequate financial resources to provide the financial services covered by their AFS licence: see s912A(1)(d) of the Corporations Act Regulatory Guide 166 *Licensing: Financial requirements* (RG 166). Entities that are regulated by APRA, those subject to an alternative form of foreign prudential regulation, and market and clearing participants are generally exempted from the financial requirements in s912A(1)(d).

67 The purpose of these financial requirements is to ensure that non-APRA regulated AFS licensees have: sufficient financial resources to conduct their financial services business in compliance with the Corporations Act; a financial buffer that decreases the risk of disorderly or non-compliant wind-up if the business fails; and incentives to comply with the Corporations Act through the risk of financial loss.

68 These AFS licensee requirements are not focused on ensuring that licensees meet their financial obligations to clients. They also do not seek to manage the credit risk of licensees, prevent businesses from failing due to poor business models or cash flow problems, or aim to provide compensation to consumers who suffer a loss, for whatever reason. They are not intended to address the risk of an adverse costs order in legal proceedings.

69 We note that Proposal 3-1 suggests a custom licence for litigation funders. Under the existing AFS licensing regime, ASIC is highly unlikely to have power to impose a licence condition that sets prudential-like standards. This is because it is likely that such a condition would go beyond the purpose for which the power to impose conditions is given. That purpose can be discerned from the statutory context and includes, relevantly, a requirement that licensees have adequate resources (including financial resources) to provide the financial services covered by the licence: see s912A(1)(d). This falls well short of having enough capital to meet all obligations under a financial product at the time it is issued or all financial commitments.

70 In our view, the existing mechanism for the court to order security for costs is a more targeted and effective way to address the risk that a litigation funder will not have adequate resources to meet an adverse cost order. Security for costs is intended to directly address the credit risks imposed on

the defendant and the representative party. Security is paid by the funder in a manner acceptable by the courts (e.g. a bank guarantee).

71 By contrast, as noted above, the AFS licensing financial requirements are not designed to act as security to meet a particular liability, nor are they intended to protect against credit risk more generally.

ASIC is not a prudential regulator

72 Any proposal that would see ASIC ensuring that a litigation funder is able to meet its financial obligations would effectively amount to prudential regulation.

73 Under Australia's 'twin peaks' model for regulation of the financial system, ASIC is not the prudential regulator and does not administer a regime that goes to the continued overall financial health of an organisation. We do not monitor the capital requirements of AFS licensees, nor impose requirements that would reflect the credit risks that might be inherent in litigation funding.

74 As the Financial System Inquiry (FSI) noted, ASIC does not have a formal mandate for financial stability (prudential regulation); and prudential regulation is most focused on the parts of the financial system where the consequences of an institution failing are generally highest.

Note: See FSI, *Financial System Inquiry: Final report*, November 2014.

75 Any proposal that would seek to effectively impose prudential responsibilities upon ASIC would be contrary to, and blur, the twin peaks model.

The appropriate regulator

76 It appears that the absence of a federal regulator for legal services (apart from the Federal Court) may have led to the suggestion that ASIC become the principle regulator for litigation funders. We consider the courts are better placed to regulate litigation funders, through court rules and procedure, oversight and security for costs. The implementation of a number of proposals in the discussion paper, for example, Proposal 6-1, Question 6-1, and Proposal 5-3, would further strengthen court oversight of class actions and litigation funders.

Overseas approaches

77 Regulating litigation funders as a legal service rather than financial service is consistent with the approaches undertaken by overseas jurisdictions.

78 For example, the United Kingdom has adopted an approach where litigation funders are self-regulated by the Association of Litigation Funders under powers granted by the Ministry of Justice, through the Civil Justice Council. At the same time, Singapore has opted for a test enshrined in legislation rather than a licensing scheme: see amendments to the *Civil Law Act* (Singapore) and the Civil Law (Third-Party Funding) Regulations 2017 (Singapore).

Characterisation as a financial product

79 There is also considerable uncertainty about whether litigation funding can be characterised as a financial product.

80 There is no evidence to indicate that Parliament intended third-party litigation funders to be regulated as a financial product under the Corporations Act. We note that in many respects the managed investment scheme regime was not conceived with class actions in mind and thus does not operate in a meaningful way when it is applied to class actions. As Treasury notes, this view is supported by stakeholder responses to the regulations.

Note: See Treasury, *Post-Implementation Review: Litigation funding, Corporations Amendment Regulation 2012 (No. 6)*, October 2015, pp. 12 and 15.

81 This position was also supported by the recommendation of the Turnbull Review of the Managed Investments Act to explicitly exclude class actions and costs paid for legal proceedings from the definition of managed investment scheme for reasons of clarity and certainty.

Note: See M Turnbull, *Review of the Managed Investments Act 1998: Final report*, December 2001, p. 89. We also note that the review found 'matters relating to the conduct and funding of class actions are more appropriately dealt with under the Rules of Court': see p. 89.

82 Litigation funding should be regulated as a legal service, as it is more closely aligned with the provision of legal services and the administration of justice.

83 It has been argued that the role of a litigation funding firm is similar in many respects to a legal practice: see the Office of the Legal Services Commissioner, *The regulation of third-party litigations funding in Australia*, March 2012. For example, before deciding whether to fund a matter, the litigation funder must undertake a detailed due diligence of the case. This will include an assessment of the likelihood that the statutory breaches or

contraventions the subject of the action will be successfully established, including examining:

a) the elements of the alleged causes of action;

b) the likely defences;

c) any likely cross-claims;

d) the documentary and oral evidence available for the elements of the cause of action; and

e) the expected costs of the proceedings, including the costs of any security for costs required.

84 The litigation funder must also consider which lawyers to engage, which clients to support and what litigation tactics should be followed. It is therefore not surprising that litigation firms are largely staffed by people with legal qualifications and extensive legal experience.

85 Litigation funders provide support for legal services, an undertaking more closely aligned with the administration of justice, than with the provision of financial products and services.

86 A bespoke licensing scheme for a potential regulated population of approximately 25 litigation funders would in our view, sit oddly with the AFS licensing regime, given the differences in focus, services provided and expertise. Further, given ASIC's risk-based approach to regulation, it seems unlikely such an area would be a main focus of our work even if we had jurisdiction for it.

Qualifications for licensees (Question 3-1)

87 As the discussion paper notes, a critical element of the competence requirement for a litigation funder is that the funder has the necessary legal skills to understand litigation and court rules and processes: see p. 53.

88 Assessing the character and qualifications for what is predominantly a legal service would be outside ASIC's main expertise.

Conflict of interest reporting (Proposal 4–1)

89 Overall, we do not administer a regime that relies on mandatory annual reporting by our regulated population on their compliance with their obligations.

90 However, credit licensees have an obligation to lodge an annual compliance certificate. The annual compliance certificate has the purpose of ensuring a

focus at the licensee's senior level on ensuring the adequacy of their processes and systems for complying with the law going forward.

91 AFS licensees are required to report to ASIC significant breaches of their obligations as soon as practical after becoming aware of the breach. This obligation is the subject of law reform recommendations by the ASIC Enforcement Review that have been accepted in-principle by Government.

92 We also note the obligations for litigation funders to have appropriate conflict of interest procedures contained in Reg 7.6.01AB of the Corporations Regulations 2001. Regulatory Guide 248 *Litigation schemes and proof of debt schemes: Managing conflicts of interest* (RG 248) sets out our approach to how a person subject to Reg 7.6.01AB may satisfy this obligation. This guidance is not exhaustive nor is it prescriptive, but is intended to set out what we would view as a minimum level of compliance with the regulations.

C A Collective Redress Scheme (Proposal 8–1)

Key points

In-principle, a well-designed collective redress scheme may have the potential to complement the broader financial services compensation framework.

Any proposal for a federal collective redress scheme would need to carefully consider the possible benefits against the regulatory costs, both to the regulator and the regulated population.

93 While any proposal for establishing a broader federal collective redress scheme is a matter for Government, in principle we believe that a well-designed collective redress scheme may have the potential to complement the broader financial services consumer redress and compensation framework. However, we would need to see further details of the proposal before providing more substantive comments.

94 Any proposal for a redress scheme as applying to the financial services sector should be considered against the background of the existing consumer redress and compensation framework in Australia, currently undergoing extensive reform.

Consumer redress in the financial system

95 Consumer redress in the Australian financial services setting includes:

(a) Firm led redress at Internal Dispute Resolution (IDR) where a consumer makes a complaint and the firm determines that a loss has been suffered and provides compensation or where a firm decides to conduct its own review to identify affected customers and compensate them;

(b) External Dispute Resolution (EDR) scheme led redress (where a complaint is unresolved at IDR and escalates to EDR) and the scheme awards compensation;

(c) EDR led redress in the context of a systemic issues investigation. This occurs where the scheme identifies that a problem may affect a broader group of consumers (who will generally not have made a complaint and directs the firm to identify affected consumers and compensate them);

(d) ASIC led redress where in response to an ASIC investigation or enforcement outcome, most commonly Court Enforceable Undertakings, a firm agrees to identify and compensate consumers affected by the misconduct. In many cases, the terms of these Court Enforceable Undertakings may require the firm to appoint an external

third party to oversee and report on the progress and effectiveness of the remediation.

96 IDR and EDR provide an accessible alternative to the courts for most consumers and small business to resolve individual financial services complaints, subject to scheme jurisdiction including applicable monetary limits.

97 Where the conduct involves an individual firm, the systemic issues role of the EDR scheme also provides an effective framework for redress. Similarly, ASIC may negotiate Court Enforceable Undertakings with an individual firm which may include broad based remediation to affected customers.

98 However, where there may be broader systemic misconduct involving a few firms and affecting many consumers, we consider that a collective redress scheme could play a role.

99 Following a comprehensive review by the Ramsay Review, the government announced the establishment of the Australian Financial Complaints Authority (AFCA), a single external dispute resolution scheme for the financial system. While AFCA is an EDR scheme, not a redress scheme, it is the principal forum for achieving redress for consumers and small business in the financial services sector. AFCA will commence operations from 1 November 2018.

Remediation approach and policy settings

100 Ensuring consumers receive redress where a financial firm has engaged in misconduct has been an important focus for ASIC in recent years.

101 Our approach is driven by:

(a) a view that proper remediation is a feature of a well operating market;

(b) the failure of firms (especially large firms) to implement appropriate remediation programs; and

(c) the reality that the amounts paid in remediation are in many cases likely to be considerably larger than any penalty obtained through enforcement action.

102 On 15 September 2016, ASIC released RG 256 *Client review and remediation conducted by advice licensees*, which sets out some principles for the development of remediation arrangements principally in the financial advice context.

103 ASIC’s regulatory experience, particularly in the context of financial advice, was that large scale remediations can be very complex in design and implementation, resource intensive and time consuming and most critically may not deliver consistent outcomes for consumers.

Gaps in the framework

104 We consider that a well-designed redress scheme may potentially supplement existing redress arrangements in the financial services sector, particularly in cases of broader market misconduct or misselling.

105 We note that the Ramsay Review also recommended the establishment of a limited, carefully targeted compensation scheme of last resort restricted, in the first instance, to financial advice failures. Such a scheme would ensure consumers are compensated in circumstances where a regulated firm fails to pay compensation awarded to a client in circumstances of insolvency or where a private indemnity insurance policy failed to respond. The Government has said it will consider it in the context of the findings of the Financial Services Royal Commission.

Note: See Review of the financial system external dispute resolution and complaints framework, Final Report, Supplementary Final Report and the Hon Kelly O'Dwyer MP, Minister for Revenue and Financial Services, *Putting consumers first – improving dispute resolution*, media release, 14 September 2017.

106 Law reform efforts currently underway, especially the proposed directions power, will further assist with ASIC's remediation processes.

Redress in listing markets

107 We note that, where there is misleading conduct or problems with disclosure in securities markets, the types of security holders who are impacted can be many and varied. For example, most securities in the ASX 200 are held by institutional investors (both domestic and foreign institutions), and thus introduction of any consumer redress scheme would be more challenging than for retail financial services, where the retail investor is typically or predominantly a local individual.

108 In addition, there is a broad range of people with interests in securities who may be impacted beyond those registered as the owner – for example people who have a short position, investors in referenced products (such as futures over the ASX 200 index, warrants over a specific stock or basket of stocks, other derivatives such as equity derivatives), custodians who stock lend, employees in restricted securities programs.

109 In our view these complexities must be considered further, as they would be critical to the potential development of any viable alternative scheme.

Further empirical work warranted

110 We suggest that further empirical work is warranted, to determine whether the cost of redress through class actions has already been effectively priced into the market, and assess the extent of this cost.

111 If this cost could be estimated, it would provide a helpful benchmark to understand whether there is a meaningful cost to participants in our markets from the current regime, and that cost could be compared against benefits such as market cleanliness.

112 Finally, while it would depend on the model, a federal collective redress scheme is likely to impose additional resourcing requirements for regulators. Without appropriate resourcing, there is the risk that further adding to ASIC's responsibilities has the potential to affect ASIC's ability to target the greatest threats of harm in the financial system. Any examination of a proposal for a collective redress scheme would need to carefully consider the possible benefits of such a scheme against the likely regulatory costs.