MinterEllison

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Australian Law Reform Commission
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Dear Commissioner

Further Submission to the Australian Law Reform Commission Inquiry into Class Action Proceedings and Third-Party Litigation Funders

In MinterEllison's submission to the Australian Law Reform Commission (**ALRC**) on 30 July 2018, we supported Proposal 1-1 in the ALRC's discussion paper '*Inquiry into Class Action Proceedings and Third-Party Litigation Funders*' dated June 2018.

MinterEllison considers that those who oppose Proposal 1-1 appear to have mischaracterised the nature of the review proposed by the ALRC. The ALRC is not recommending a review into the application and possible '*watering down*' of the continuous disclosure regime, nor does it propose to review the ASX and/or ASIC's powers under the continuous disclosure regime in the context of a more general inquiry into the enforcement of Australia's market disclosure laws.

Rather, the proposed review will consider how private rights created by those laws are being invoked in shareholder class actions, in a specific and rapidly developing model of litigation, which generates a significant burden on Australia's judiciary and court system, and the significant financial impacts on corporate defendants, their shareholders and its D&O insurers.[1] It is undeniable that the current model of shareholder class actions was never contemplated when the ALRC released its Grouped Proceedings report in 1992, nor when the continuous disclosure provisions were enshrined in Australian law via the ASX Listing Rules and corporations legislation.

MinterEllison generally refers the ALRC to Law Firms Australia's submissions on this issue (to which MinterEllison contributed), but wishes to address one particular objection raised by opponents of Proposal 1-1, where those opponents have emphasised positive outcomes for shareholders in shareholder class actions, such as delivering access to justice, which is generally accepted as the overriding justification for Australia's class action regime. MinterEllison considers that the invocation of rewards to shareholders needs closer examination, first, in relation to the impact on shareholders who hold shares in the company at the time of the class action proceedings, and secondly, in relation to short sellers, who increasingly regularly seek to participate as part of the class in shareholder class actions.

Impact on current shareholders

Most of those who oppose the review emphasise the benefit to shareholders who are eligible to participate in class actions, and overlook the impact on those shareholders who hold shares in the company as at the time of the class action proceeding being on foot (**current shareholders**).

Detrimental financial impacts on current shareholders as a result of class actions being prosecuted against the company include defence costs incurred by the company while an insurance deductible is being eroded, increased D&O insurance premiums required to be paid by the company, and direct contributions from the company towards any settlement (to the extent not covered by insurance). Share prices may also be detrimentally affected as a result.

[1] For more details on the impact of D&O insurance pricing, see, for example, submissions of the LFA the Insurance Council of Australia, Australian Institute of Company Directors, Zurich Australia Insurance Limited.

Less tangibly, current shareholders will be adversely affected by company management distraction as a result of having to manage and assist in the company's defence, difficulties in attracting experienced and high quality directors, and potentially, inhibited decision-making caused by increased risk aversion. These issues are absolutely fundamental to the conduct of business in Australia and underscore the necessity for the review proposed by the ALRC to be undertaken.

Class composition and short sellers

In relation to shareholders who purchased shares during the period of alleged corporate non-disclosure who seek to be group members in a class action, MinterEllison considers that any review of shareholder class actions should also look closely at short sellers' increasing number of claims for compensation in shareholder class actions. The actions of short sellers in seeking to recover purported loss or damage from the company do not, in MinterEllison's view, sit easily with the 'access to justice' arguments invoked by opponents of the proposed examination of the interface between Australia's continuous disclosure laws and shareholder class actions.

A traditional investor class member in a shareholder class action will allege that they have made a loss due to a declining share price, by purchasing shares which were inflated as a result of negative material information that was not disclosed by the company to the market. When that material information is ultimately disclosed to the market later down the track, shareholders claim that any share price drop in reaction to that disclosure means that they 'overpaid' for those shares. They say that the company deceived the market by not disclosing that information after becoming aware of it, in breach of its continuous disclosure obligations.

By contrast, short sellers make claims for compensation even though they tend to profit from share price declines. Briefly, short selling is a series of transactions where the short seller sells shares first and buys shares later. Typically, a short seller will agree with Shareholder X to acquire its shares, and will then sell those shares on the market. The short seller returns the equivalent number of shares to Shareholder X at some point in the future, by purchasing the number of shares originally acquired, on the market.

If short sellers have predicted the market correctly and the share price drops, then they will ideally buy back the shares at a lower price than the price they sold them for – known as closing one's position – and return them to Shareholder X. This transaction results in a profit to the short seller. If they've read the market wrongly and the share price rises, they still need to close their position and may do so at a loss. There is nothing inherently wrong with the short selling model – many investors make profit in this way by forecasting, through their own research, that a company's share price will decline.

While traditional investors in a class action complain about a share price drop, short sellers often welcome it, as they are betting on the company performing poorly. If the company has failed to disclose negative material information, this may actually assist the short sellers' investment strategy. Given that short sellers therefore often hope for, and profit from, a share price decline, any review into continuous disclosure and shareholder class actions might usefully evaluate whether it is fair and appropriate for short sellers to participate and claim loss in class actions brought as a result of a share price decline.

No Australian court has examined this issue. Short sellers, here and in the US, contend that they should be able to participate as class members. MinterEllison's view is that short sellers' attempts to, effectively, 'double-dip', have the potential to cause an injustice to traditional investors participating in class actions and also to the companies being sued. Certainly, when plaintiff law firms are asked whether short sellers are included in the class, or asked to explain the basis upon which short sellers rightly form part of the class and how they have suffered the alleged harm, those firms do not usually engage on that issue (presumably to avoid the risk of reducing the overall claim size of the class).

From MinterEllison's perspective, there is a primary question as to whether short sellers should be allowed to rely on the class action mechanism of market-based reliance to claim loss. Typically, when participating in a class action, shareholders argue that they can recover loss because they traded in reliance on the defendant company's share price, which they are entitled to assume has been accurately set by a market which possesses all material information about the company.

By contrast, short sellers do not rely on such an assumption. Their business model is premised upon the share price set by the market actually being inaccurate. If the market has got it wrong, and a price correction occurs which causes the share price to drop, the short seller will profit. Some US courts have therefore

denied short sellers the opportunity to participate in class actions because they made their investment decisions without relying on the accuracy of the market price.

There are also serious questions concerning whether short sellers have actually suffered a loss. Controversially, for example, short sellers argue that while they may have made a profit, they did not achieve as high a level of profit as they could have, due to the inflated price at which they have had to buy their shares to close out their position. Short sellers therefore seek to make their money twice – first from profiting from a short sale which takes advantage of the inflation in the share price allegedly caused as a result of the company's misconduct – and then complaining about that inflation as justification for extracting compensation from the company in a class action.

A further problem is that some active short sellers may have actually caused or contributed to the company's share price drop, for example, by causing the market to have less confidence in the company. If a company has a high proportion of short seller trading, this may send a message that there are traders who believe that the company's prospects are poor. Even worse are instances of active public criticisms of the company made by short sellers, who then benefit from the market reacting negatively. There has been much publicity and controversy in relation to short seller activities in relation to Quintis Limited and Blue Sky Investments Limited, as direct examples of this. Each of these entities is facing at least two shareholder class actions.

Finally, traditional investors might also ask whether it is fair that their portion of any global settlement sum should be reduced by the claims made by short sellers. This is particularly so given the significant recent attention by the courts as to the reasonableness of certain class action settlements in light of overall returns to group members. Therefore, close scrutiny should be given to short seller participation in class actions having regard to the purpose of the regime and the purpose of continuous disclosure laws. This issue should also be included in the scope of the review proposed by the ALRC.

We welcome the opportunity to answer any queries the Commission may have in relation to our Further Submission. For further information, please contact:

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