

Comments and Recommendations on the Adoption of Market-Based Causation in Australian Securities Fraud Class Actions

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Abstract. In Australia, the test for proving causation in securities fraud class actions is controversial. The Australian courts have partially accepted market-based causation. This essay argues that this mechanism is not applicable to the current Australian legal framework. Accordingly, Australian legal system should be adapted to accommodate this mechanism, and until then, direct reliance should be the primary option.

Keywords: causation; securities fraud class actions; market-based causation.

1. Introduction

The object of this essay is to discuss the suitability of market-based causation for use in current Australian securities fraud class actions. The first section defines the “securities fraud class actions” discussed in this essay and explains the role of the “market-based causation” in it. The second section of this essay sets out the arguments in favor of the use of this mechanism in Australia and counters them with some alternative positions. The third section of this essay critically focuses on the reasons why this mechanism is unsuitable for Australian securities fraud class actions and considers potential weaknesses in the argument and alternative explanations. The fourth section of this essay offers some suggestions for the approach to proving causation in current Australian securities fraud class actions.

2. Definitions and Background

The "securities fraud class action" discussed in this essay refers to a legal proceeding brought by a group of investors who have suffered financial losses because of the defendant's misconduct. Such “misconduct” specifically refers to securities-related fraud, including a company's failure to disclose material information in breach of its disclosure obligations, or providing false information to mislead or deceive investors. The analysis in this essay does not include other misconduct that may affect the value of securities.

In this type of action, the burden of proof rests with the plaintiff (the investors). To succeed in their claim, plaintiffs may need to quantify their losses, prove that the defendant engaged in misconduct, the effectiveness of the market, and the causal link between the defendant's misconduct and the plaintiff's losses. Typically, the core issue in these actions is how to prove that causation. Traditionally, each investor must prove that they directly relied on the company's misrepresentations or omissions in deciding to buy or sell a security. Such individual reliance is difficult to prove and, because of the large number of investors that need to be considered in class actions, such individual proof of reliance can be very burdensome. However, in current cases in Australia, some courts have adopted the “market-based causation”.

"Market-based causation" assumes that the misconduct of company is reflected in the market price of the company's securities. Investors rely on the integrity of this market price when making investment decisions. Therefore, when market prices are distorted due to the misconduct, any investor who buys or sells the securities at the distorted price is considered to be harmed, regardless of whether they directly relied on the misconduct. It simplifies the process of proving causation in securities fraud class actions.



In Australia, the concept of "market-based causation" was first recognized and applied in the case of *Campbell v Backoffice Investments Pty Ltd* [1]. The court held that in an efficient market, the price of a company's securities reflects all publicly available information, including any false or misleading statements. The company's misleading statements artificially inflate the market price of its shares. Consequently, investors who purchases shares at an inflated price can be presumed to have suffered loss. Therefore, the court recognized market-based causation a valid basis for establishing causation in securities fraud actions.

Therefore, under this mechanism, plaintiffs could argue that they relied on the integrity of the market price, which is presumed to reflect all publicly available information. The burden of proof might then shift to the defendants, who would have to prove that individual class members would have purchased shares at the same price even if they had been aware of the undisclosed information or had actually known of the undisclosed information.

Currently, Australian courts have recognized market-based causation in individual cases, but have not yet fully embraced it in class actions. Australian courts have been considering whether to adopt this mechanism to balance the interests of investors, companies, and the securities market. Next section discusses specifically whether it is reasonable for Australian courts to adopt this mechanism.

3. Rationale in Favor of Market-based Causation and its Potential Weaknesses

This section analyses three cases in support of market-based causation and presents some of the arguments in favor of it, illustrating the benefits of its implementation and critically analyzing them from a few alternative standpoints.

In Australia, three emblematic cases have upheld market-based causation, provided a basis for this mechanism, or directly recognized that plaintiffs can prove causation under this mechanism.

First, in *Australian Securities & Investments Commission v Adler* [2], ASIC alleged that the directors and officers of defendant engaged in misleading conduct and breaches of their duties, which led to the collapse of HIH Insurance. This case highlighted the impact of misleading information on the market price of securities, laying groundwork for market-based causation

Secondly, in *Caason Investments Pty Ltd v Cao* [3], the full court of the Federal Court of Australia recognized that the plaintiffs could bring a claim based on market-based causation under s 729 of the *Corporations Act*, with Edelman J noting that reliance was not a necessary element of the causation test for a claim under s 729. The judge noted that market-based causation had not been "expressly rejected" or "impliedly endorsed as arguable" in recent cases. The market-based causation in relation to the misconduct was also accepted as arguable [4]. The court recognized market-based causation, allowing investors to claim losses based on the presumption of trading at inflated prices.

Thirdly, in *TPT Patrol Pty Ltd v Myer Holdings Ltd* [5], TPT Patrol alleged that Myer Holdings made misleading statements about its financial performance, which inflated its share price. The court recognized market-based causation, facilitating investors' claims of losses based on the presumed integrity of the market price. It is worth noting that Beach J rejected the requirement of reliance as a constitutive element of an actionable disclosure.

The most obvious advantage of this mechanism is that it provides a lower threshold for proving causation than proving direct reliance [6], simplifying the process of proving causation and losses for plaintiffs in securities fraud actions, which saves significant cost and time [7]. While it is true that this mechanism simplifies the proof of causation, it needs to be considered whether plaintiffs' quantification of their losses can also be simplified by this mechanism, and whether this simplification of the quantification of losses may results in an imbalance of interests between the plaintiffs and the defendants.

Another advantage of this mechanism is that it focuses on the whole market impact, rather than each investor's reliance on misconduct. This allows the use of this mechanism to transform each member's

individual reliance into a common proof of causation in class actions, which greatly improves the efficiency and reduces the costs [8], which equates to making it possible for more plaintiffs to join the class actions without worrying about financial unaffordability. However, this argument ignores a very serious premise, which is whether current Australian legislative purpose allows the scrutiny of each investor's direct reliance to be transformed into a focus on the whole security market. If such a transformation defeats the purpose of the legislation, then this mechanism will cause even more damage.

Another argument in favor of this mechanism is that, as it matures, it could be extended to other areas of the disclosure system under *Corporations Act*, potentially simplifying the requirements of proving causation in a wider range of securities cases. If it is assumed that this mechanism would be similarly applicable to the causation proving requirement in other range, the crux of such an argument is whether the statute of other sections under *Corporations Act* would allow causation to be proved by non-direct reliance, especially market-based causation.

The arguments in favor of this mechanism also include the protection of other securities market participants. Small investors, who rely heavily on the integrity of securities market prices, are often at a disadvantage because they are vulnerable to attack in a manipulated market [9]. Prices in securities markets are often assumed to reflect all relevant and important information, so small investors are always at an informational disadvantage relative to the whole security market [10]. On the other hand, if markets are manipulated, divestment of investors is often accompanied by losses suffered by all participants. Market-based causation, on the other hand, allows all those who suffered losses during the relevant period to be redressed, which protects the interests of all securities market participants. This view analyses the merits of this mechanism from a broader perspective. But one question that needs to be asked is whether all securities market participants need to be protected. If some market participants need to be eliminated according to the rules of market, then the artificial protection is in fact an intervention in the rules of market. That is, the protection may be excessive and unreasonable.

In addition, it has been argued that because this mechanism aggregates the effects of misconduct on market prices, and distorted market prices affect all transactions during the period of misconduct, plaintiffs can obtain a higher assessment of losses under this mechanism and receive more redress. On the other hand, this mechanism would provide plaintiffs with a greater likelihood of success, which would help to increase the number of securities fraud class actions, acting as a deterrent to misconduct by listed companies [11]. Obviously, this argument considers the protection of investors' interests, but the fact that investors receive more benefits represents an unjustified detraction from the company's interests, which is detrimental to a healthy market. Therefore, this standpoint lacks consideration of all interest groups.

Taken together, the above analyses show that there is a great deal of support for this mechanism, as it can indeed increase the efficiency and reduce the cost of actions, and contribute to the protection of the interests of investors. However, the weaknesses in these supporting reasons mentioned above are also clear, which will be analyzed in detail in the next section

4. Arguments against Market-based Causation and its Critical Counterarguments

4.1. The purpose of the statute

The legislation requires that redress under the statute is available only if the investor has made an investment decision based on what is targeted by the provisions of the relevant statute [12]. It is therefore necessary to examine market-based causation in the context of the legislation itself and its purpose.

S 674 of the *Corporations Act* establishes a system of sustained disclosure, which is intended to promote market transparency and create an informed market in which all participants have equal

access to material information that may affect their investment decisions [13], thereby promoting an informed and transparent market and supporting informed decision-making.

S 1041H of the *Corporations Act* prohibits misleading or deceptive conduct. The purpose of it is to protect investors from being misled by ensuring that the information they rely on in making investment decisions is accurate and complete. It aims to ensure that information provided to the market is accurate and reliable, to protect the interests of investors by preventing the dissemination of false or misleading information, and to maintain the integrity of the market.

It can be seen that both statutes share the common objective of enhancing market transparency, protecting investors and promoting market integrity by providing for the accurate and timely disclosure of information, enabling investment decisions to be made on reliable data [14]. The above analysis concludes that the statutory objective is to "ensure that investors make informed decisions based on accurate information".

Based on this objective, the use of market-based causation seems less appropriate. The legislation is designed to maintain an informed market, meaning that only those directly affected by misconduct can claim losses. But this mechanism that replaces individual reliance on misconducts with the effect of the misconducts on the market price, and thus removes the need to prove individual reliance, would result in plaintiffs being able to claim losses without proving that they directly relied on the misconduct. This would undermine the importance placed on accurate information disclosure and undermine the legislative purpose of informed decision-making.

The weakness and limitation of this analysis is that the analyzed legislative purpose is not the statute itself, and the statute does not expressly exclude the use of this mechanism. However, in the absence of an explicit recognition of this mechanism in the statute, the interpretation of the legislative purpose is the closest to the meaning of the statute itself. Therefore, if the process of justifying the purpose of legislation is rigorous, the mechanism may be considered to be contrary to the legislation.

4.2. Conflation of different plaintiffs

Based on the above analysis, the disclosure system requires the informed participation of investors. *Basic Inc v Levinson* and *Halliburton II* indicate that market-based causation may result in the withdrawal of investments by investors who were uninformed when they invested, therefore placing informed investors in the same position as uninformed investors, which is contrary to the objective of creating informed and efficient markets as required by the disclosure system.

On the other hand, available research suggests that institutional and retail investors will use different investment methodologies when evaluating potential investment opportunities [15]. In securities fraud class actions, the question of whether an individual's loss was caused by misconduct is essentially an individualized question of whether there is a causal link between a particular person's particular loss and the relevant misconduct. The market-based causation, however, assumes that securities market is efficient and that the misconduct results in a distorted market price for the defendant's shares, which would result in institutional and retail investors being treated equally, thus leading to a generalization of the individualized causation proving issue.

It suggests that this mechanism would mix informed and uninformed investors, institutional and retail investors, placing them in the same litigation position. However, given their different knowledge and positions in the market, it is clearly unfair to put them in the same legal position. Some might argue against this on the basis that the legislative purpose of *Competition and Consumer Act* is to enhance the welfare of Australians. However, it is clearly untenable to explain this conflation by investor protection, as overprotection of vulnerable investors is equivalent to unfairness to strong investors, who are similarly targeted for protection under *Competition and Consumer Act*. Therefore, a reasonable distinction between different investors is necessary.

4.3. Conflation of legal issues

In the proceedings, whether the defendant breached a statutory provision and whether the breach caused losses are two separate issues. The former is a question of fact, while the latter of causation. In the proceedings, the court should first determine whether a breach has occurred and then consider whether that breach has caused specific losses. The defendant may have breached the law, but it may not necessarily have caused losses of the plaintiff, or the losses may not have occurred as a direct result of the defendant's breach. Therefore, these two issues need to be discussed separately.

Market-based causation, however, only requires proof that the misconduct affected the market price. Under this assumption, the two issues are conflated. This conflation not only mixes the legal issues theoretically, but also lead to the confusion of the remedies corresponding to these two issues, the conflation of redress and compensation, which in turn may lead to excessive penalties or insufficient redresses.

This argument may have the problem of being used too narrowly. In most cases, redresses for investors is reasonable. One might counter this by claiming that courts can make fair and reasonable judgements even without sorting out issues of fact and causation. However, this argument clearly fails to consider all the circumstances and returns to the discussion of legislative purpose. As Giles JA observes s 1005 of *Corporations Act*, this does not warrant compensating investors regardless of the effect on their decision-making of the misleading conduct [16].

Therefore, the two issues should be treated differently to ensure fairness and consistency with the statutory purpose. Conflating them could blur the necessary legal analyses, leading to an unjust result.

4.4. Undermining the security market

According to the general rules of the financial markets, decisions in the investment market reflect the assessment and weighing of risks and rewards [17]. That is, in investing, if the risk is greater, the corresponding reward will be higher, and vice versa.

However, under market-based causation, an investor does not need to prove direct reliance to recover any losses caused by the defendant's misconduct. This results in investors not needing to assess the risk of their investment before investing because their expected return will never be negative. This leads to a breakdown in the relationship between risk and return mentioned above. Considering that the price of a security reflects the available information about the company [18], this breakdown of the risk-return relationship would undermine the market's function in allocating capital, which is the purpose of the *Australian Securities and Investments Commission Act*

It needs to be acknowledged that a potential weakness of this argument may be that it focuses too much on the function of markets, ignoring the fact that markets are actually made up of investors and companies. One might counter this argument on this basis that if the cost of maintaining a healthy market is that it is in fact detrimental to the interests of investors, then such a market is not worth maintaining, or that such a market cannot be considered as a healthy market. However, it is important to note that the protection of the interests of a wider range of investors is premised on the openness and transparency of market information, so that the protection of market functioning itself is the protection of investor interests.

4.5. Quantification of losses

Investors have an overall expectation of return when deciding to invest, which involves their judgement on the market and their reliance. The quantification of losses therefore implicitly requires investors to rely on the misconduct. This is reflected in the process of quantifying losses in specific securities fraud actions, which requires the use of statistical or economic models to determine the expected return on an investment [19]. And expected returns are compared to actual returns [20]. The difference between these values is the result of a combination of factors in the market, which surely include the reliance of misconduct.

If the market-based causation is used, then individual reliance is not required for the proving of causation. However, the methodology for quantifying losses assumes that at least some shareholders' reliance is required. This results in a serious legal inconsistency at trial. It may be argued on this point that reliance can be disregarded in proving causation and taken into account in quantifying loss. This argument is untenable because if reliance can be proved, then there is no need for market-based causation to prove causation.

Additionally, objections to this mechanism include the fact that the litigation costs may remain high due to the need for expert evidence and statistical analyses to determine market impact. Complex financial analyses may be required to prove the relationship between misconduct and market prices, which is currently highly controversial. The redress available to plaintiffs may also be affected by the lack of direct reliance. On balance, there are serious and non-negligible problems with the application of market-based causation, which may even be contrary to the current Australian legal framework.

5. Recommendations for Proving Causation

In summary, market-based causation is contrary to the legislative purpose of "ensuring investors make informed decisions based on accurate information". If the Australian courts consider accepting this mechanism, then legislative reform or statutory interpretation would be required to establish a statutory doctrine or regime to resolve the conflict of purpose.

On the other hand, consideration should be given to introducing a system of expert evidence on possible biases in quantification of losses, statistical analyses of market impacts, and financial analyses of the price of securities, with additional expert advice or an innovative set of specialized methodologies for the calculation of losses to balance the interests of the parties.

In addition, it is necessary to protect the "informed decision-making market". At least distinguishing the status of the conflated plaintiffs in proceedings through a rigorous review system, to give the securities market an orientation that promotes investors' active access to information and protects the informed market.

6. Conclusion

Whether courts could use the market-based causation to prove causation in securities fraud class actions remains highly controversial. This essay acknowledges the significant advantages of this mechanism, particularly with respect to investor protection. However, the shortcomings of it are more fatal, undermining the legislative purpose of informed decision-making, being unfair to defendants and other plaintiffs, and damaging the "informed decision-making securities market".

Therefore, the use of this mechanism needs to be complemented by legislative and judicial adjustments. In any case, direct reliance remains the most appropriate, and should be the primary, method of proving causation in securities fraud class actions.

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