Chapter 5

Is current regulation of private equity adequate to protect the economy and the national interest?

5.1 This chapter looks at whether the current regulatory framework governing private equity activity in Australia is adequate to protect the Australian economy, sectors of the economy and the national interest. Most witnesses downplayed concerns that private equity activity may injure either the economy or the national interest. They variously cited the rigour of existing reporting obligations for unlisted companies under the *Corporations Act 2001*, the small scale of current private equity activity in Australia, the difficulty defining which sectors are nationally significant and the power vested in Australian shareholders. The witnesses who expressed concern about the impact of private equity activity on national interest grounds claimed existing reporting requirements are inadequate and the need to regulate private equity ownership of key public services to guard against their failure.

The Reserve Bank of Australia's view

5.2 The Deputy Governor of the Reserve Bank of Australia (RBA), Mr Ric Battellino, told the committee that the spike in leveraged buy-out (LBO) activity in 2006 was the result of 'very unusual circumstances' in Australian capital markets, associated with the low cost of debt. He argued that the influence of these circumstances is—at least anecdotally—waning[1] and that some of the 'covenant-lite' loans are not being accepted by the market. Asked whether there is a need for any regulatory or legislative changes, Mr Battellino replied:

> No, I think that from our point of view we certainly do not see a case for regulatory change in this area. As I say, it was the outcome of a very unusual set of circumstances. Those circumstances are closing, and I do not think there is a lasting problem here at all.[2]

5.3 Mr Battellino suggested that the fundamental structure of capital markets in Australia is unlikely to change significantly. Institutional investors will still favour the liquidity advantages of equity and their debt-based investments will continue to be reinvested on the stock exchange.[3] For this reason, he explained, Australians' savings

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1 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 3.

2 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 22.

3 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 8

in superannuation are not at serious risk.[4] Further, Australian banks have very low exposure to private debt financing activity and are protected from a private equity buy-out.[5] Mr Battellino concluded that 'the overall exposure of the economy to this particular form of financing is quite low'.[6] He added: '…from our perspective, as a general macro picture, I do not think there is anything worrying the Reserve Bank here.' As the body principally responsible for the systemic stability of the Australian economy, this is a significant statement.

The financial regulators' view

5.4 ASIC and APRA also downplayed any threat that private equity might pose to the Australian economy. In their evidence to the committee, both regulators reiterated the RBA's observations of the small scale and relatively low exposure of private equity activity in Australia. ASIC's Deputy Chairman, Mr Jeremy Cooper, emphasised that the current size of the private equity market in Australia was small compared with the total value of the listed equities market. He also noted that Australian superannuation funds are aiming to maintain their exposure to private equity at about four or five per cent.[7] APRA's Executive General Manager, Mr Tom Karp, told the committee that Australia's five largest domestic banks have private equity and leveraged lending exposure limits of $1 billion to $3 billion, which represents less than five to ten per cent of the total capital for a bank.[8] He estimated that the private equity exposure of Australian super funds regulated by APRA is around one per cent of total assets.[9]

5.5 Both regulators also expressed confidence that the current regulatory framework for private equity activity was adequate to safeguard institutional investors. Mr Cooper noted that the merit of Australia's financial regulation framework is that 'it is flexible and can deal with private equity without having to write a new chapter of the Corporations Act for private equity'.[10] He added that private equity is already 'quite comprehensively regulated' with disclosure obligations for

4 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 19.

5 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 14; Mr John Broadbent, Head, Domestic Markets, Reserve Bank of Australia, *Committee Hansard*, 25 July 2007, p. 19.

6 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 14.

7 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, 25 July 2007, p. 26.

8 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 41.

9 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 42.

10 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, 25 July 2007, p. 28.

private companies not listed on the ASX.[11] Further, he argued that the current size and nature of private equity activity in Australia does not warrant further powers of new regulation.[12] Indeed, Mr Cooper described private equity in Australia as 'a healthy development' which has forced Australian institutional investors to focus more closely on the value of their investments in listed entities.

5.6 Mr Karp told the committee that the banks' internal mechanisms, combined with APRA's prudential framework, are an effective strategy for dealing with private equity's risks. He told the committee that the banks have their own policies for leveraged lending with formal credit approvals and ongoing monitoring. Lending for private equity is assessed as a higher level of risk given it typically has a higher level of gearing than other investments. Mr Karp also observed that Australian banks' approach to lending for private equity appears to be 'fairly cautious' compared to international banks. In addition, APRA has its own credit risk management processes to ensure that banks hold capital against potential losses.[13] He concluded that 'we do not see any significant prudential risks in private equity to the banks'.[14]

5.7 Mr Karp expressed similar confidence that APRA has appropriate supervision and monitoring of superannuation funds' investments in private equity.[15] In the event that super funds' exposure to private equity continues to grow to become a 'major asset class':

> …that has to be separately identified in annual reports to members so that people are aware of it. We [APRA] would be tracking the returns on it and people would be aware of that.[16]

5.8 Significantly, neither APRA nor ASIC identified any prospect that the banks, superannuation funds or retail investors' current exposure to private equity would have serious ramifications for the Australian economy. Rather, APRA noted that publicly listed companies are also exposed to risks and prone to failure.[17] While high levels of leverage and over-reliance on private equity activity are factors of potential concern to

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11 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, p. 26. See also Mr Malcolm Rodgers, Executive Director, Regulation, Australian Securities and Investments Commission, *Committee Hansard*, 25 July 2007, p. 31.

12 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, 25 July 2007, p. 28.

13 These processes have also been noted by the RBA. See Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 71.

14 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 42.

15 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 43.

16 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 52.

17 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 48.

the regulators, there is no evidence that private equity activity in Australia is currently engaged in these levels of risk.[18]

The adequacy of existing regulations for unlisted companies

5.9 Several witnesses addressed concerns that private equity activity in Australia can escape public scrutiny. Mr David Love, Manager of Treasury's Prudential Policy Unit, told the committee that a private company has the same obligations under the Corporations Act to report its financial position as a publicly listed company. The only difference is that listed companies are subject to the ASX continuous disclosure rules, aimed at determining price signals on a daily basis.[19] Mr Battellino told the committee that the financing of private equity activity is 'all public information' and that 'people are overestimating the amount of secrecy' that happens in private equity deals.[20] The same observation was made by Mr Cooper who described the disclosure obligations of the Corporations Act as 'quite comprehensive'.[21]

5.10 The law firm, Allens Arthur Robinson, also argued that there is already appropriate regulation and laws relating to private equity transactions. Its submission summarised the current arrangements:

> Chapter 6 of the *Corporations Act* provides a comprehensive regime for the regulation of Australian public company takeovers. This regime, in combination with Australia's detailed insider trading, conflict of interest and directors' duties laws, provides an appropriate and satisfactory framework for private equity acquisitions.
>
> The Treasurer, with the support of the Foreign Investment Review Board, has broad ranging powers under the *Foreign Acquisitions and Takeover Act* to review proposed acquisitions which fall above the relevant thresholds. If the Treasurer considers a proposal to be contract to the national interest, the power exists (and has been used) to veto such an acquisition proposal.
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> The *Foreign Acquisitions and Takeovers Act* law and policy framework has been criticised in the past as unduly fettering foreign investment into Australia. Nevertheless, that framework (together with the 70 per cent debt funding/thin capitalisation rules) remains in force for acquisitions by foreign interests, and governs private equity acquisitions along with all other acquisitions.

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18 This is not to discount the substantial risks in high levels of debt leveraging. See the comments made by Standard and Poors in Chapter 4.

19 Mr David Love, Manager, Prudential Policy Unit, The Treasury, *Proof Committee Hansard*, 26 July 2007, p. 3.

20 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 14; Mr John Broadbent, Head, Domestic Markets, Reserve Bank of Australia, *Committee Hansard*, 25 July 2007, p. 13.

21 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, 25 July 2007, p. 26.

> No further regulation is required to protect Australia's national economic or strategic interest. [22]

The Takeovers Panel's Guidance Note

5.11 The role of the Takeovers Panel is to consider the process under which takeover bids are conducted in Australia, consistent with section 602 of the *Corporations Act 2001*. In particular, the Panel is responsible for making declarations of circumstances that are unacceptable to the purposes of section 602.[23] Mr Nigel Morris, Director of the Takeovers Panel, told the committee:

> The panel's concern is the takeovers process. Our concern is an efficient, competitive and informed market. Our concern is information to target shareholders. Our concerns would be that the people who accepted were going to get paid and that the people who did not accept or were thinking of not accepting were aware of the level of gearing and what the consequences for them as future shareholders might be.[24]

5.12 In this context, the Takeovers Panel has this year issued Guidance Note 19, a copy of which was reproduced in its submission to the inquiry.[25] The Guidance Note was issued in relation to insider participation in control transactions (takeovers). It provides takeover market participants with guidance on situations where there is involvement or potential involvement by the management, directors or external advisers of a target company with the bidder in a takeover bid or potential bid for the target company. These situations include potential conflicts of interests, provision of information to potential rival bidders and disclosure to shareholders.

5.13 Mr Morris told the committee that 'the issues in relation to takeovers that private equity raised were in fact issues that are seen in a lot of other buyer types'.[26] He further explained that the Panel's process is qualitatively no different between a publicly listed company by a private firm and a public company takeover of a public company. Failure to comply with the Guidance Note will risk a 'declaration of unacceptable circumstances and orders'.[27]

5.14 Mr Morris was asked whether any further regulatory changes are needed, given that the Corporations Act already enforces comprehensive conduct and disclosure rules on both target corporations and bidders. He replied:

> Based on our experience so far, we do not see any particular need. We will continue to look. At least since the guidance note was published, we have

22 Allens Arthur Robinson, *Submission 7*, p. 3.

23 Takeovers Panel, *Submission 8*, p. 2.

24 Mr Nigel Morris, Director, Takeovers Panel, *Proof Committee Hansard*, p. 26.

25 Takeovers Panel, *Submission 8*.

26 Mr Nigel Morris, Director, Takeovers Panel, *Proof Committee Hansard*, p. 21.

27 Mr Nigel Morris, Director, Takeovers Panel, *Proof Committee Hansard*, p. 23.

> not seen any matters come before us that have caused us concerns...One of the things about the Takeovers Panel is that it is not just ASIC that can bring applications before it. Rival bidders, unhappy shareholders as well as ASIC can bring issues before the Takeovers Panel. There are additional layers of surveillance and scrutiny with other people out there acting in their own commercial interests. At the moment—touch wood—it seems to be adequate.[28]

The power vested in shareholders

5.15 Shareholders remain the ultimate arbiters of whether a listed company is taken over. A private equity bid fails if sufficient numbers of shareholders do not sell their shares.[29] The details of the offer are the responsibility of the board, which clearly has a powerful role in terms of relaying information to shareholders and recommending or rejecting the takeover offer. It should be noted that there can be strong financial incentives for the various stakeholders to accept the terms of the private equity offer.[30]

5.16 Mr David Jones, Chairman of the Australian Private Equity and Venture Capital Association (AVCAL), was asked whether there was anything to stop a large flow of funds from the United States taking over blue chip Australian companies. He replied:

> …I am really not concerned about that…No-one can just come in and say, 'I will buy your business.' The directors on behalf of the shareholders and then ultimately the shareholders need to form a view about value. We have almost seen here a bit of a reaction where people are going, 'Well, if these private equity guys think this thing's valuable maybe it is.' And you get a rerating and a reassessment.[31]

5.17 Mr Jones also noted that of the 80 companies taken off the Australian Stock Exchange in 2006, only two were privatised through private equity. He added that in terms of fears of a flood of private equity funds into Australia, 'there is just nothing to show'.[32] Further, he noted that Myer, currently owned by a private equity consortium, is opening new stores, attracting capital, lowering costs and increasing profits.[33]

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28 Mr Nigel Morris, Director, Takeovers Panel, *Proof Committee Hansard*, p. 28.

29 Colin Galbraith, 'Changing control can cause conflicts', *Company Director*, April 2007, p. 31. See attachment to AICD submission, *Submission 2*.

30 These include the promise of higher executive remuneration and 'break fees' which are paid to the private equity consortium in the event that the bid is rejected.

31 Mr David Jones, Chairman, Australian Private Equity and Venture Capital Association, *Proof Committee Hansard*, 25 July 2007, p. 74.

32 Mr David Jones, Chairman, Australian Private Equity and Venture Capital Association, *Proof Committee Hansard*, 25 July 2007, p. 74.

33 Mr David Jones, Chairman, Australian Private Equity and Venture Capital Association, *Proof Committee Hansard*, 25 July 2007, p. 76.

Concerns about the existing regulatory framework

5.18 The committee received comment that current reporting arrangements relating to non-listed companies operating in Australia should be strengthened. The National Institute of Accountants (NIA) identified its main concern with private equity as:

> …the lower degree of transparency in terms of public accountability that may result when an economically significant entity shifts from a status of being either proprietary public company into another corporate structure such as a trust. [34]

5.19 The NIA explained that the current system of reporting requirements is based on who owns the company, rather than the substance of the entity's activities. As a result, a private equity structure is a means by which entities can avoid public reporting obligations. Mr Tom Ravlic, a Policy Adviser with the NIA, told the committee that the accounting profession had argued 'for many years' that reporting requirements should be standardised based on the nature of the company's activity rather than its ownership structure.[35] He contended that it is in the public interest to ensure that all 'economically significant' industries—such as utilities and major transport entities—be required to report publicly. This would give the public confidence and trust in all these industries, irrespective of their ownership.

5.20 In its submission, the NIA recommended that the parliament determine what types of entities should be regarded as economically significant. It should then establish a mechanism for these companies to prepare and lodge publicly available financial statements. The NIA suggested that this could be done through an amendment to the *Corporations Act 2001* providing Treasury with the authority to identify economically significant industries. Alternatively, industry-based legislation could be amended to ensure that all industry players comply with disclosure requirements 'irrespective of ownership structure'.[36]

5.21 Another precautionary approach to national interest concerns was suggested by Associate Professor Frank Zumbo from the School of Business Law and Taxation at the University of New South Wales. He put two proposals to the committee to safeguard the national interest in cases where a private equity entity is seeking a leveraged buyout in a sensitive industry. The first was that consideration be given to either restricting the involvement of private equity firms in sensitive industries on a case by case basis, or by placing restrictions on the level of debt that these firms can accrue in a strategic Australian company. The second proposal was to require private

34 National Institute of Accountants, *Submission 4*, p. 1.

35 Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 73.

36 National Institute of Accountants, *Submission 4*, p. 2. See also Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 79.

equity entities to lodge a security bond to cover any costs or losses arising from the disruption of essential services.[37]

The difficulty defining industries of economic significance

5.22 The committee highlights the difficulty in establishing a basis for what constitutes an industry of economic significance. Mr Ravlic himself conceded that outside of utilities, defining an industry of 'economic significance' is a 'woolly area'. When asked to give an example of a sector or industry that is not of economic significance, he replied:

> We would regard any entity which falls under the 'small proprietary company' test in the Corporations Act as not being economically significant. We will fall back to the Corporations Act definition of 'small proprietary company,' because it is extremely difficult once you move out of the area of utilities to begin to pick off entities that are not economically significant.[38]

5.23 He explained that the size of the entity should be a consideration in whether it is economically significant because reporting requirements for small companies may become burdensome. It was not clear whether a small company that is a utility would be subject to the NIA's proposals for stricter financial reporting.

The health and aged care sector

5.24 The committee received comment that private equity activity in not-for-profit and community based organisations was counter to their service-based objectives. This view was put by two submitters—Ms Marie dela Rama from the UTS Centre for Corporate Governance and Dr J Michael Wynne.

5.25 Dr Wynne argued that national interest grounds should apply to protect the health care industries because of the adverse consequences from private equity involvement in the sector. Citing examples from the US, he claimed that the focus on financial outcomes rather than service delivery inherent in the private equity model was unsuited to the health sector, which relied on attention to proper process, probity and an understanding of the community they are providing for.[39] The committee is unconvinced, however, that private equity activity in Australia's health care sector has contributed in any substantive way to problems that have arisen in the provision of private health care services. The connection claimed by Dr Wynne is unclear. The case for greater regulation of private equity activity in the Australian health care sector on national interest grounds is thereby also unclear.

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37 Associate Professor Frank Zumbo, School of Business Law and Taxation, University of New South Wales, *Submission 23*, p. 18.

38 Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 80.

39 Dr J Michael Wynne, *Submission 3*, pgs. 7 and 9.

5.26 Ms dela Rama's submission highlighted the growing role of private equity in the aged care sector in Australia. It noted that private equity entities have 'turfed out' traditional non-profit organisations as they compete for the same pool of government funds and subsidies. The traditional organisations are now service providers rather than the owners and operators, and their benevolent role has been reduced. Ms dela Rama explained in her submission that the aged care sector is now:

> …an unbalanced, unequal playing field where the short-term investment horizon of private equity investment has placed these players at an unfair advantage against traditional non-for-profit participants. It is a matter of grave concern that a substantial part of the aged care sector is now in the hands of fund managers with little hands-on experience of the aged care sector.

She also expressed concern that government policies do not distinguish between private equity investors and not-for-profit participants in terms of their means or their motives.[40]

5.27 By way of remedy, Ms dela Rama proposed that short-term private equity investors should lengthen the term of their investments, and that government aged care subsidies provided to private equity owned facilities should be reassessed. She concluded that 'the presence of private equity in the sector ought to attract continuous and close vigilance'.[41] These arguments were put to the NIA. Mr Ravlic agreed with the need for stricter reporting in the sector, albeit for different reasons:

> I think we would support the idea that governance in that area [the health sector] would need to be scrutinised or at least monitored a bit more going forward because of the fact that a lot more people are getting older and a greater number of people in the Australian community will be using the services of these entities.[42]

5.28 On the question of differentiating public funding for profit and non-for-profit investors, the NIA simply stated that 'it would be a policy decision for the government'.[43]

Benefits to the Australian economy

5.29 The committee received a submission and took evidence from AVCAL on the benefits and impacts of private equity on the Australian economy. Unsurprisingly, AVCAL identified several benefits from private equity for the wider local economy. Among these are increases in employment, the funds management industry,

40 Ms Marie dela Rama, UTS Centre for Corporate Governance, *Submission 5*, pp. 1–2.

41 Ms Marie dela Rama, UTS Centre for Corporate Governance, *Submission 5*, p. 13.

42 Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 83.

43 Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 84.

productivity and innovation, superannuation savings and business revenue and exports. The following section looks at aspects of the impact of private equity activity on employment levels and the superannuation industry.

Employment effects

5.30 The impact of private equity activity on employment levels is contested. AVCAL's submission cited a 2007 international study by A. T. Kearney which concluded that on average, private-equity financed firms generate employment at a much faster pace than comparable, traditionally financed firms. It found that the average annual employment growth of private equity backed firms was higher in the European Union, the United Kingdom, the United States and Germany. AVCAL also cited a 2006 Australian study by Pricewaterhouse Coopers which concluded that 76 per cent of private-equity backed companies are expecting to hire additional workers in 2007.[44]

5.31 The committee heard anecdotal evidence that the net employment impact of private equity on the company itself is also positive. Mr Brian Hodges, Managing Director of foundry and heavy engineering group Bradken, told the committee:

> …in the years up to and including 2001 where there were roughly 1,450 employees, we retrenched 1,000 people. That was the phase of getting good, where we shut down a number of plants. We had no capital to spend, but we became more efficient through work practices and a lot of change.
>
> Nobody ever made a big company without increasing employment, I think. You can make a better company by having some initial reduction in staff, which we did. We lost 1,000 staff out of 1,400 so that was quite a lot. From that 2002 year on, we have increased staff levels. Today we are just tipping 3,000 staff. We have not had any further reductions in staff.[45]

5.32 Not all the evidence on the employment impact of private equity is positive. In its submission to the committee, the Australian Manufacturing Workers' Union (AMWU) expressed concern that:

> …the very high rates of return required to finance private equity debt driven buyouts can threaten target companies' long-term interests and provision of decent employment conditions and security for employees.[46]

However, the submission did not provide an example of private equity activity affecting AMWU members. Instead, its criticism relied on the UK experience of job cuts and worker protests.[47]

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44 This study was commissioned by AVCAL.

45 Mr Brian Hodges, Managing Director, Bradken, *Proof Committee Hansard*, 26 July 2007, p. 33.

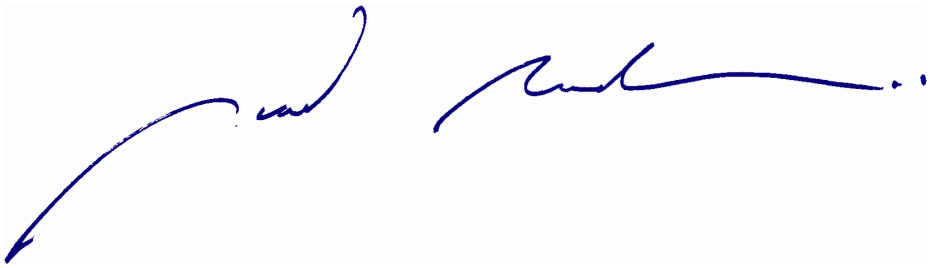
46 Australian Manufacturing Workers' Union, *Submission 16*, p. 3.

47 Australian Manufacturing Workers' Union, *Submission 16*, p. 8.

Conclusion

5.33 The committee does not consider that any convincing case has been made for any further regulation of private equity activity in Australia at this time. It recognises and endorses the ongoing watching brief maintained on this issue by the Treasury, the RBA, the ACCC, ASIC and the FIRB. The requirements of Chapter 6 of the Corporations Act, the conflict of interest rules, sector-specific legislation and the FIRB guidelines offer appropriate and adequate protection for Australian companies and the Australian public. The activities of both private and listed Australian companies will continue to be reported under the Corporations Act and through the international accounting standards set by the Australian Accounting Standards Board. Private equity consortiums will themselves be guided in their decision-making by prospects for economic success and growth.

5.34 The committee believes it is important to continue to attract foreign investment into Australia and does not accept the narrowly held view that some sectors of the national economy should be protected from private equity activity. The committee views private equity as an opportunity to reinvigorate underperforming public companies, which will subsequently benefit Australian consumers, shareholders and workers. It does not see the market imperative that drives foreign investors to buy out Australian companies as being inconsistent with the national interest and notes the protections already afforded under foreign investment policy and the *Foreign Acquisitions and Takeovers Act 1975*.



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Chair