Allens Arthur Robinson

27 April 2007

ABN 47 702 595 758

530 Collins Street
Melbourne VIC 3000
Australia
Tel 61 3 9614 1011
Fax 61 3 9614 4661

Correspondence
GPO Box 1776Q
Melbourne VIC 3001
Australia
DX 30999 Melbourne

www.aar.com.au

Mr Peter Hallahan
Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By Email

Dear Mr Hallahan

Submission to Senate Inquiry into Private Equity Investment

Allens Arthur Robinson welcomes the opportunity to make a submission to the Inquiry by the Senate Standing Committee on Economics (the ***Committee***) into private equity investment and its effects on capital markets and the Australian economy.

Introduction

Our submission includes some general commentary in response to the Inquiry's terms of reference, but focuses primarily on paragraphs (d) and (e) of the terms of reference, viz:

(d) an assessment of whether appropriate regulation or laws already apply to private equity acquisitions when the national economic or strategic interest is at stake and, if not, what those should be; and

(e) an assessment of the appropriate regulatory or legislative response required to this market phenomenon, if any.

The substance of our submission is that the ***existing regulation and legislation in Australia is appropriate and satisfactory*** to deal with private equity acquisitions and that ***no further regulatory or legislative intervention is necessary or desirable***.

The *Corporations Act* and the *Foreign Acquisitions and Takeovers Act*, when combined with specific industry legislation, such as the *Financial Sector (Shareholdings) Act*, and the general law provide an appropriate and satisfactory framework for the regulation of private equity acquisitions in Australia.

Our views are based on our firm's active involvement as a legal adviser in the private equity market, and in the M&A market generally.

Our views are also supported by the Financial Stability Review published by the Reserve Bank of Australia in March 2007 (**FS Review**), on which we have relied significantly in framing this submission.

We also note that our submissions gain significant support from the findings of a European Central Bank report released on 18 April 2007, which concluded that private equity poses only a 'remote' risk to financial stability and capital markets.

Nevertheless, although we do not support further regulatory involvement in private equity activities, we do encourage a full and frank ongoing discussion of both the risks and the benefits of the rapidly changing area of business which is private equity. For that reason, we applaud the work of the Committee in its current Inquiry.

Why further regulation is *not* required

1. Australia's national interest is already adequately protected

Paragraph (d) of the Inquiry's terms of reference asks, in effect, whether there is already appropriate regulation and laws applicable to private equity acquisitions when the national economic or strategic interest is at stake. In our view, the answer to this question is an unequivocal 'yes'.

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 Takeovers Act* to review proposed acquisitions which fall above the relevant thresholds. If the Treasurer considers a proposal to be contrary to the national interest, the power exists (and has been used) to veto such an acquisition proposal.

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% debt funding/thin capitalisation rules) remains in force for acquisitions by foreign interests, and governs private equity acquisitions along with all other acquisitions.

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

2. The existing rules cover any market misconduct by private equity participants

It has been suggested that the conduct of some private equity players is more aggressive than other participants in the traditional M&A market, and there is an increased likelihood of sharp practice or market misconduct. Although we do not share this view, our response is that the existing Australian corporate law protections apply across the board to transactions by private equity players in Australia, just as they do to other transactions.

For example, there are detailed rules of conduct and disclosure rules that apply to directors, officers and others under the general law, under the *Corporations Act* and (where

applicable) under the rules of the ASX (including the corporate governance best practice guidelines). The *Corporations Act* also regulates in detail the M&A process, whether the private equity transaction is effected through a takeover or a scheme of arrangement. The *Corporations Act* also provides for a stringent licensing regime which regulates financial intermediaries and advisers.

On the issue of advisers, it is acknowledged that conflicts of interest between the various parties involved in private equity deals need to be dealt with carefully. This is an area which has gained the attention recently of media commentators, as well as the regulators. The Takeovers Panel recently distributed its issues paper on 'Insider participation in control transactions'. Full and free discussion on the question is to be encouraged – but to date there is insufficient evidence that the existing system is faulty. In addition, the market has shown an ability to itself respond to the increased level of private equity activity; for example the development by Australian target companies of practices such as the appointment of board committees comprising independent directors to assess a bid.

No further regulation is required, given the existing protections of the *Corporations Act* and other laws (for both private equity transactions and other transactions). ASIC is continuing to monitor developments in the private equity market.

3. Anti-competitive conduct is already regulated

Private equity bidding processes have been criticised as being anti-competitive and possibly in breach of the *Trade Practices Act*. In particular, allegations have been made of collusion between bidders to reduce takeover competition for a particular target, and of attempts to 'corner the market' for advisers or debt providers.

Considerable doubt remains as to the extent that such practices exist, and as to their likely effect on competition given the global nature of the relevant markets. In Australia, an ability for market forces to minimise the likelihood of abuse, and for self-regulation to occur, has become apparent in recent times. For example, the response of the Coles Group, to concerns about cornering the market, was to impose their own bidding guidelines to restrict cornering the market.

On the topic of self-regulation, we note that the British Venture Capital Association is drawing up a voluntary code to negate the need for further external regulation. This could be a useful lesson for Australia.

On the positive side, the involvement of a variety of members in a consortium bid can benefit capital markets, by diversifying financial risk and pooling management expertise.

In any event, the *Trade Practices Act* and other competition laws administered by the ACCC apply equally to all businesses in Australia, including where private equity is involved.

No additional regulation is required for private equity.

4. No adverse effect on public capital markets

It has been suggested that the growth in private equity has had a detrimental effect on the public capital markets (ie the ASX). However, it is submitted that this is not the case, at least not in Australia. There have been reports that the stock market capitalisation in various overseas jurisdictions has fallen in 2006 and in the United Kingdom the inflow into private equity funds in the first half of 2006 exceeded the IPO capital raisings on the London Stock Exchange. However, according to the FS Review, this has **not** been the experience in Australia, where in 2006 inflows into private equity funds of $3 billion were exceeded by new capital of $8 billion raised in IPO's on the ASX.

In any event, any negative impact on the public capital markets may be only temporary, given that private equity funds often realise their investments, after (say) 3 to 5 years of improving profitability, by re-listing on the ASX or trade sale to a listed company.

In short, there is no adverse effect on public capital markets which would justify regulatory intervention.

5. Corporate debt levels are not excessive

Despite occasional headlines suggesting the contrary, corporate gearing in Australia is still relatively low on a global basis. According to the FS Review, interest payments by Australian companies are currently equivalent to approximately 18% of profits (less than half the equivalent figure at the end of the 1980s) and 'the current level of corporate gearing does not appear to represent a significant risk to the health of the Australian economy'. The RBA will continue to monitor the aggregate levels of corporate gearing.

For the individual companies involved in LBO's initiated by private equity, clearly their risk profile changes. However, the directors of these companies continue to be obliged to meet their duties as directors (both at common law and under the *Corporations Act*), as well as being subject to the existing creditor protection and insolvency provisions of the *Corporations Act*. Severe civil and criminal consequences for breach are already legislated for and are effectively policed by ASIC.

One should also not forget that the banks themselves impose a financial discipline in their lending processes, including due diligence, credit analysis and diversification of risk.

The existing regulation and legislation is sufficient, and no extra regulation is required.

6. Private equity has important market benefits

At the broadest level, private equity plays a vital role in promoting the efficient allocation of capital.

According to Thomson Financial, private equity net returns outperformed the S&P 500 14% to 9.7% for the past 20 years. It appears that public markets are failing to allocate capital efficiently.

The efficient allocation of capital is promoted by the possibility of takeovers by private equity. Takeovers (or other M&A activities such as schemes of arrangement) encourage

existing management to optimise usage of the company's assets and also provide a means for private equity investors to assume control of an underperforming company.

Private equity can lead to capital market efficiencies in various ways, including:

- widening availability and source of capital;
- increasing the accuracy of company valuations by factoring in their growth potential;
- enhancing the efficiency of corporate capital structures; and
- facilitating corporate development and transformation.

From the perspective of an individual company, another benefit of private equity is that private ownership often leads to better management of that company, due to (among other things):

(1) an absence of the 'short termism' which is a feature of today's public markets;

(2) less distraction by bureaucracy and governance requirements from the main focus of running the business; and

(3) a greater ability to give ownership and incentivisation to management, along with the business expertise which experienced private equity players can provide.

It was only recently that a number of these issues were raised by the Chairman of Qantas, whilst recommending a private equity bid for her company, and lamenting the constraints which are often faced by listed companies in the public market context.

In short, as the FS Review states (at page 66), 'private equity can help to promote an efficient, dynamic and innovative business sector in Australia'.

In conclusion, for the various reasons summarised above, we submit that the existing regulation and legislation in Australia is appropriate and satisfactory to deal with private equity acquisitions and that no further regulatory or legislative intervention is necessary or desirable. In short, 'if it ain't broke ...'.

We would be pleased to respond to any queries the Committee may have in relation to this submission.

Yours sincerely

Steve Clifford
Partner
Steve.Clifford@aar.com.au
61 3 9613 8997

Jon Webster
Partner
Jon.Webster@aar.com.au
61 3 9613 8832