Corporate & Market Regulation
An ASIC Update

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There are five corporate and market regulation issues I would like to talk about today:

- Private equity
- Disaggregation relief for fund managers
- Continuous disclosure
- Retail participation in the market
- Insider trading

1. Private equity

Keeping it in perspective

It's hard to remember what newspapers wrote about before the private equity phenomenon. Private equity has certainly become a hot issue in Australia in the last six months. Interest has been sparked both by the arrival of global private equity players in Australia, KKR, TPG, CVC, and by a number of bids for iconic Australian companies like Qantas, Myer and Coles.

Sentiment about private equity is mixed. While there are certainly risks associated with private equity, there is also a positive side. As Nick Minchin was quoted[1] last year as saying:

> …..the very possibility of private equity coming in is a stimulus to good management of existing entities.

While there's no doubt we will continue to see big bids from private equity players for Australian companies, it is important to keep private equity in context.

Private equity is still a very small asset class in Australia. Funds held by private equity firms only equate with roughly 1.75% of the value the Australian listed equities.[2] Last financial year, new equity raisings on the Australian Securities Exchange were approximately $51 billion, while private equity raisings were estimated at $4.1 billion.[3] While approximately 50% of private equity funding comes from super funds, individual super funds have a fairly conservative 4-5% exposure to private equity.

Recent developments

It seems that with every passing week there is a new development in the private equity arena.

For one, deal sizes just keep getting bigger. Two years ago, a private equity deal of $10 billion was considered outlandish. In February 2007, we saw the $44 billion leveraged buy-out of TXU and industry executives are saying a $100 billion deal will soon be possible.

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[1] *Private equity Not Alarming Australian Government*, Barbara Adam and Lyndal McFarland, Dow Jones Newswires, 12 October 2006

Estimates are that private equity funds under management are approximately $26 billion and the value of stocks listed on the ASX is a bit over $1.3 trillion

[3] Source: Australian Securities Exchange Limited

The issue of insider participation in deals won't go away. Last month, Dow Chemicals sacked two directors it accused of holding "unauthorised" discussions with a private equity consortium about a possible bid. While the pair are threatening to take legal action for unfair dismissal, the episode raises the question of when private equity talks cross the line. In Australia, the Takeovers Panel has recently sought to throw some light on this issue by releasing a draft guidance note entitled *Insider Participation in Control Transactions*.

Institutions, particularly in Australia, are starting to play a much more active role in opposing private equity transactions. In the recent APA bid for Qantas, some institutions spoke out against the bid and finally rejected it. With relatively limited public 'blue chip' investment opportunities, compared to out growing pool of superannuation savings, this sort of activism seems likely to be a continuing trend in Australia.

The OECD has just released a report on private equity. While the report concludes that private equity plays a valuable role in helping transform under-performing companies, it also notes that, as private equity matures, strong investor demand coupled with readily available finance, will increase the pressure to find new deals and will eventually drive down yields.

And how could a round-up of recent developments be complete without considering what Warren Buffet had to say about private equity. In response to a recent investor question, Buffet said:

> Private equity isn't a bubble that bursts. If you buy businesses that aren't priced daily, even if you do a poor job, it takes many years for the score to come up on the board and for investors to get out of the firm. The investors can't leave, and a scorecard is lacking for a long time. What will slow down the activity is if yields on junk bonds became much higher than yields on high-grade bonds. Right now the spread is down to a very low level. History has shown that, periodically, the spread widens dramatically.
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> One other aspect, if you have a $20 billion fund and you're getting a two percent fee, you're getting $400 million a year. You also have a lot of money in that fund you need to invest, and you can't start another fund with a straight face until you've got that money invested. So there is a great compulsion to invest very quickly so you can get another fund.

Is private equity good or bad?

From a macroeconomic perspective, private equity has its advantages. As the UK Financial Services Authority (FSA) said:[4]

> Private equity can significantly enhance capital market efficiency by widening the availability of capital, increasing the effectiveness of company valuations, identifying companies with growth potential and facilitating their transformation.

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4 *Private equity: a discussion of risk and regulatory engagement* – UK Financial Services Authority, November 2006

Returns and the secret of 'governance arbitrage'

In terms of investor returns, a recent McKinsey report entitled *What public companies can learn from private equity* shows that only the top 25% of private equity firms persistently outperform relevant stock market indices.

According to McKinsey, today's successful private equity firms exploit 'governance arbitrage' rather than financial engineering or price arbitrage.

Governance arbitrage involves active ownership control over management with successful private equity partners devoting half their time to the company during the first three months after a deal, while less active and less successful deal partners only spend about 15% of their time in this way.

The report also makes a number of interesting comments about pay. In the private equity deals reviewed, top managers typically owned 5% to 19% of the equity and had invested a substantial amount of personal net worth to obtain that equity. Not surprisingly, this incentive structure was seen as positively aligning the interests of owners and managers and as a contributing factor to the success of private equity over a typical public company structure.

From a regulatory perspective, private equity raises a number of interesting issues.

Increased leverage

In 2006 in Australia, buyout firms are borrowing an average of 6.5 times the target company's annual EBITDA, up from 5 times a few years ago.[5] In the UK, the figure was a very similar 6.41 times in the 12 months to 30 June 2006.[6] Figures suggest that the average multiple in United States transactions is now 8 times, up from 6 times in 2000.

RBA data suggests that debt accounts for around 70% of funding used in LBO transactions. This, of course, means that equity accounts for the remaining 30% of the purchase price and leads to a debt-to-equity ratio[7] of around 235%. This equates to the general gearing of listed non-financial entities of around 65%.[8]

If market conditions change, there is a risk that highly leveraged vehicles, dependent on economic buoyancy to meet their covenants, could fail. This would not only adversely affect lenders, but could have knock-on effects to superannuation funds and ultimately to retail investors. Westpac CEO David Morgan, was quoted [9] as saying:

> We are very, very wary about the private equity segment and have very low exposure to it…The only way they can get economic value is through excessive gearing and excessive gearing

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5 *Private Wealth Strategy Management – Investment Strategy Bulletin 2*, Goldman Sachs JBWere, November 2006, page 5

6 FSA discussion private equity (see note 1) at page 7

7 Total financial debt divided by shareholders' equity expressed as a percentage.

8 RBA Financial Stability Review, March 2007 p60-61 quoting various sources of data

9 Report by Rebecca Thurlow, Dow Jones newswire 2 November 2006

> involves a lot of risk and generally as a debt provider, you can't get the return on that debt to compensate you for the risk of that very high gearing.[10]

Current RBA data shows that the average listed non-financial company in Australia spends around 18% of profits on interest payments.[11]

Reduction in capital market liquidity and efficiency

There has been a concern, expressed in some quarters, that the quality, size and depth of the listed equities market might be damaged by the expansion of private equity in other words that a large part of the market might disappear into private hands (ie 'go dark'). This is offset by a key feature of private equity: the re-listing of a transformed business and is also not supported by any empirical data[12] which shows that approximately 40% of exits from private equity in the year ended 30 June 2006 involved an IPO (which requires an active and liquid equities market).

A related concern is that regulation is driving listed businesses into private structures. This needs to be tested further. It has also been refuted by a recent study.[13]

Exhausted returns – no extra value to be added

There has also been a concern, expressed by some commentators, that the growth potential of private equity companies that return to the market by way of IPO might, in some cases, have already been fully exploited.

Recent research, however, paints a different picture. A US study which looked at nearly 500 US companies that were acquired by private equity firms and later re-listed found that, on the whole, the companies' share prices outperformed the broader equities market in the five years following their IPO. Interestingly, most of this out-performance was driven by larger companies – the median share price return was below that of the broader equities market.[14]

Impact on consumers – mis-pricing of risk

If private equity debt is repackaged and sold to retail consumers, the risk might be mis-priced leaving consumers with no upside and the risk of loss of capital.

Conflicts of interest

Conflicts of interest arise in the private equity sphere, as in many other situations in the financial markets. In many offers made by private equity buyers, it is important for existing management to be retained. Therefore, bidders will offer equity and other rewards to existing managers. This creates a conflict between the interests of those

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10 NAB CEO John Stewart was also quoted as saying that "Everyone feels private equity is going to end up in tears. The only question is when." *The Australian Financial Review*, 27 November 2006

11 RBA Financial Stability Review, March 2007 p66 quoting various data

12 RBA Financial Stability Review, March 2007 p68 quoting ABS data

13 *Corporate Law Reform and Delisting in Australia* – N Lew and I M Ramsay, Centre for Corporate Law and Securities Regulation – The University of Melbourne 2006

14 *The performance of reverse leverage buyouts*, Cao J and Lerner J, Harvard Business School Working Paper, 2006

managers in wanting the transaction to proceed and the interests of the existing shareholders (owners).

Because of the large debt raisings involved, advisers to transactions need to manage the conflict between advising a buyer or seller and also arranging the debt funding for the buyer. So-called 'staple financing' can create very real conflicts.

Lack of transparency

Some commentators have expressed concern that there is a reduction of the public reporting obligations of private equity companies vis-a-vis listed companies, including:

- the continuous disclosure provisions no longer apply;
- half-yearly financial reporting is not required (annual reporting obligations remain); and
- some disclosure requirements in financial statements no longer apply (for example, director and executive remuneration provisions).

However, private equity does not occur in a totally unregulated space and firms under private equity ownership are still required to report regular and detailed financial information to their owners and lenders.

Unclear ownership of economic risk

Private equity structures are often complex and it can be difficult to identify who ultimately owns the assets and bears the economic risk associated with LBOs.

In a recent Standard & Poor's report on *Leveraged Buyouts in Australia – Who really bears the risks?* concerns are raised over who bears the risk of debt-laden private equity transactions and whether the risk takers are being appropriately compensated and rewarded for the downside risks involved.

According to S&P, the global experience of LBOs shows that the credit ratings of acquired companies typically falls to B or low BB speculative grade ratings. At these ratings, the probability of default increases substantially with a B rated issuer historically having a one in three probability of default over a 10 year period.

Although senior secured lenders often enjoy reasonably strong recovery prospects, the situation for junior secured and subordinated debt holders is substantially weaker.

Risks also increase with cross border insolvency as enforcement becomes more difficult.

So what's ASIC's view?

Like regulators around the world, ASIC has been having a close look at private equity. Last year, the Council of Financial Regulators, which comprises ASIC, APRA, Treasury and the RBA conducted an in-depth study of private equity that culminated in the release of the RBA's *Financial Stability Review March 2007*.

The main conclusions of the Review were:

- Private equity can play an important role in ensuring an efficient and dynamic business sector;

- The threat of a takeover by a private equity fund helps ensure that the existing managers of firms have a strong incentive to manage the assets under their control as efficiently as possible; and

- Increased leverage does not appear to represent a significant near-term risk to either the stability of the financial system, or the economy more broadly. The exposure of the Australian banking sector to private equity is well contained and both the leverage and the debt servicing ratios for the corporate sector, as a whole, remains relatively low.

Given the potential implications of private equity activity for the depth and integrity of public capital markets, as well as the importance of investors understanding the risks they are taking on, ASIC, as well as the other agencies making up the Council of Financial Regulators will continue to monitor developments closely.

Is the regulation of private equity in Australia going to change?

The Senate recently referred an inquiry into private equity to the Standing Committee on Economics. The inquiry is being headed by Democrat Senator Andrew Murray and its terms of reference are:

(a) An assessment of domestic and international trends concerning private equity and its effects on capital markets;

(b) An assessment of whether private equity could become a matter of concern to the Australian economy if ownership, debt/equity and risk profiles of Australian business are significantly altered;

(c) 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 should those be; and

(d) An assessment of the appropriate regulatory or legislative response required to this market phenomenon.

To date, the Committee has received 21 submissions including from the Law Council, Allens Arthur Robinson, Unisuper, the Australian Institute of Company Directors, the Takeovers Panel, the National Institute of Accountants, SDIA and the Council of Financial Regulators (attaching the RBA's financial stability review). On the whole, submissions do not seem to favour a change in the regulatory regime.

The Committee is expected to report back to the Senate by the end of June 2007.

2. Disaggregation and the takeover threshold

Some investment funds have recently applied to ASIC for 'disaggregation' relief because their aggregate group holdings in companies are close to the 20% takeover threshold and therefore further acquisitions are very limited if they do not wish to make a takeover bid.

ASIC could exercise its power to give 'disaggregation' relief so that the holdings of investment funds in an independently operated business unit are treated separately (disaggregated) from the holdings of the rest of the group for the purpose of the 20% takeover prohibition in section 606 of the *Corporations Act*.

ASIC consulted on disaggregation relief for investment funds in 2001-2.[15] There were strong views both for and against giving the relief. In the end, ASIC decided not to give broad relief and referred the matter to Treasury.

ASIC is currently considering whether to revisit the issue of disaggregation relief for the following reasons:

- ASIC has continued to receive applications for relief from large Australian and foreign financial services groups;
- the size and number of investment funds within many financial services groups has increased, for example because of consolidation of financial services groups and growth in superannuation; and
- overseas investment funds are increasingly seeking to invest in Australia, possibly expecting that takeover requirements comparable to those applying in their home jurisdictions will apply to them here.

Earlier this year, ASIC staff met with several Australian and overseas financial groups to try to determine the need for disaggregation relief for investment funds within those groups. In particular, ASIC sought information concerning the level of group holdings that were close to the 20% takeover threshold.

The key points coming out of that consultation were:

- Five financial groups supported relief and considered that the 20% limit restricts the ability of their investment funds to invest. The other two financial groups thought that the 20% limit was generally not an issue for them and that the 20% threshold did not impact their investment decisions;
- The 20% threshold was a particular issue for one fund manager whose top 10 holdings averaged over 18% and whose top 20 holdings averaged 16%;
- Two groups said that they generally operate within a 15% limit to ensure that they do not inadvertently approach the 20% takeover threshold; and

[15] Initiated by an ASIC discussion paper entitled *Investment funds: takeover and substantial holding relief* (November 2001).

- One foreign group said it had no holdings over the 15% threshold currently set by the *Foreign Acquisitions and Takeovers Act 1975* (Cth) and three holdings between 10% and 15%.

It is clear, from the applications for relief and from ASIC's preliminary consultation, that the total holdings of some financial groups are already close to the takeover threshold.

When the aggregate voting power of a group in a company is close to the 20% threshold, compliance with section 606 is difficult without ceasing to trade in shares of the company. Where group entities operate independently, there is a risk that more than one entity acquires securities in a company on the same day, unaware of acquisitions by others in the group.

Investment funds argue that restrictions on their ability to invest in certain securities disadvantage fund members since fund members do not get exposure to potential returns from those securities. This increases the risk that the members' return is below the market return. In addition, there are potentially wider implications for the economy if we assume that investment funds will withhold further investment once the aggregate voting power of the group approaches 20%.

On the domestic front, many Australian investment funds prefer to invest in Australian assets. As the volume of funds increases over the medium term, investment funds might be forced to apportion more of their portfolio funds than they would prefer to international assets, solely because of the current restrictions. Similarly, foreign investment might be reduced as investment funds are deterred by the 20% cap.

The problem created by investment funds approaching the 20% takeover threshold is expected to increase with increasing domestic 'investment' through superannuation and the likelihood that foreign investment funds will seek to increase their investment in Australian companies and schemes.

ASIC is currently considering whether it is time to consult the market again as to whether some form of disaggregation relief is appropriate.

3. Continuous disclosure

When it comes to dealing with continuous disclosure breaches, ASIC has a wide range of regulatory options. Three recent matters highlight our different tools and approaches, depending on the nature of the breach.

Harts Australasia Criminal Action

In May 2000, Harts Australasia Limited listed on the ASX after raising $30 million. At the time, the prospectus forecast a net profit after tax of $12.381 million for the year ended 30 June 2001.

In January 2001, Harts released a revised financial forecast of a half-yearly loss of $9.7 million to 31 December 2001.

ASIC has alleged that, in failing to keep the market informed of the company's true financial state, two executives of the company were knowingly concerned in the company's breach of its continuous disclosure obligations. ASIC has brought criminal prosecutions in this case; the first time that executives have been prosecuted for a continuous disclosure breach.

Multiplex enforceable undertaking

In December 2006, ASIC accepted an Enforceable Undertaking (**EU**) from Multiplex relating to the company's failure to disclose a material change in profit on the Wembley National Stadium project in London.

The EU secured a $32 million compensation fund for those investors affected by the failure of the Multiplex Group to meet its continuous disclosure obligations.

The disclosure issue in question related to the 2 February 2005 meeting of the Multiplex Board, where the Board decided to adjust the profit forecast from the Wembley project from £35.7 million to zero. However, this material change in financial position was not disclosed to the market until 24 February 2005.

When the announcement was finally made on 24 February, the Multiplex share price dropped from the 23 February price of $5.57 (Volume Weighted Average Price) to $4.76 (VWAP) on the day of the announcement.

ASIC contended that the Multiplex Board's decision was price sensitive and should have been disclosed to the market before the commencement of trading on 3 February 2005, immediately following the resolution of the board at its meeting on the afternoon of 2 February 2005.

The EU was been entered into without admission by Multiplex. Multiplex contended that until its external auditors had completed a review of the adoption of a zero profit margin for the Wembley project, it would not be possible to issue a general statement on the profit on the Wembley project.

ASIC regarded the acceptance of an EU as an appropriate regulatory outcome in this case rather than a civil penalty order because:

- A civil penalty would be confined to pecuniary penalty order of a maximum $1 million, with compensation not automatically following;
- The undertaking produced a guaranteed and swift result that offers compensation to those who have suffered loss. Successful litigation would require a court to be convinced that a contravention of the law had occurred and that damages had resulted; and
- The EU provides for Multiplex's disclosures policies to be consistent with industry best practice and monitored by an independent expert.

As part of the EU, Multiplex also agreed to improve compliance measures that will assist the company in meeting its continuous disclosure obligations going forward.

Multiplex agreed to commission an independent review of its disclosure policies and procedures and agreed to implement recommendations generated from that independent review to ensure compliance with industry best practice.

Multiplex also said it would try to move to a majority of independent directors within 12 months.

The Multiplex EU provided a swift and fair result that balanced the regulatory imperatives, the interests of investors and acknowledged the willingness of Multiplex to offer a constructive response to ASIC's concerns.

Promina infringement notice

Promina Group Limited recently paid a $100,000 fine following an investigation by ASIC into an alleged failure to comply with its continuous disclosure obligations.

ASIC issued the infringement notice because it believed Promina had received a proposal from Suncorp-Metway Limited to acquire Promina.

According to ASIC, Promina first became aware of the proposal at about 6:00pm on 10 October 2006 and became obliged to disclose the proposal to the market at 12:03pm the next day, following publication of a Dow Jones Newswire article which read:

> Suncorp (SUN.AU) is looking to buy Promina (PMN.AU) for A$7.50/share, according to talk circulating amongst hedge funds...

ASX formed the view that the article contained reasonably specific speculation about the proposal and that, as a result, the proposal ceased to be confidential for the purposes of ASX listing rule 3.1A(2) and referred the matter to ASIC.

Promina did not make an announcement about the proposal until 8:29am on 12 October 2006. While ASIC recognises that companies in merger negotiations might be put in a difficult position, once the confidentiality of any negotiation has been lost, the ASX listing rules require that material information be disclosed to the market regardless of whether or not the negotiation is complete.

Following the release of the announcement, Promina’s share price increased significantly from the previous day’s trading. Promina’s share price opened at $7.69 (up $1.21 from the previous day’s close) and closed at $7.30. More than 45 million Promina shares were traded on the day.

4. Retail participation in the market

As you all know, the ASX recently released its *2006 Share Ownership Study* and you will all be familiar with the key findings, so I will not labour them here. There were, however, a couple of rather interesting statistics that I did want to expand on.

Value invested

The first statistic is that the amount invested directly in shares by the average investor in 2006 was $190,600. Given that this does not include superannuation savings or

managed fund investments, it is a surprisingly high figure, even when compared to the current size of the average home loan in Australia of $229,200.[16] From what we know about margin lending, this growth does not reflect a big increase in gearing, but will be a combination of a rising market and increased investment.

Margin lending

According to the latest RBA data[17], there were 170,000 investors owing $30.3 billion[18] in margin loans at March 2007, a 41% increase year-on-year. The current average size of a margin loan is therefore around $178,000, but this is somewhat skewed by high net worth investors who might have loans of $10 million or more.

The average level of gearing of the average investor's portfolio rose slightly from 39% to 41% in the same period. The average frequency of margin calls in the March 2007 quarter (0.35 calls per day per 1,000 clients – ie 60 a day on current loan numbers) was slightly higher (up from 0.28 a year earlier), but still far lower than the most recent peak of 6.01 per 1,000 in the March 2003 quarter.

While the gearing levels and the proportion of debt to the overall value of retail participation in the sharemarket is still relatively conservative, it is interesting to note that the S&P/ASX 200 grew by around 23% in the year to March 2007, a bit less than half the rate of increase in margin lending over the same period.

Direct holdings of shares listed on overseas exchanges

Another surprising aspect of the study was that 19% of direct investors have some of their directly-owned portfolio invested in overseas equities.[19] While this might reflect a good geographic diversification of investments, it gives rise to a very interesting question about where investors are getting their advice. What, in effect, this means is that nearly one in five share investors needs advice about foreign equities and the consequences of investing in them. I would be surprised if one in five Australian financial advisers were qualified to give advice about direct ownership of foreign shares, or was giving, advice on them. This calls for further research to understand how investors are getting advice about foreign equities.

A healthy picture

Overall, the participation of retail investors in the sharemarket looks pretty healthy. The market is operating well and investor confidence is high. That is not to say that share prices will continue to go up, it is more that those investors who participate in the market seem broadly aware of what they are dealing with.

By contrast, retail participation in unlisted products (particularly property-related fixed interest securities not issued by major financial institutions or their affiliates) continues to be more of a concern. Because there is no secondary market for trading in these

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[16] Average loan size for owner-occupied housing for the March 2007 quarter – Housing Finance, ABS

[17] RBA Statistics Bulletin 31 March 2007

[18] These figures include protected loans, but do not include the exposure of retail investors to the leverage inherent in products such as CFDs, warrants and the like.

[19] Shares listed on an overseas exchange (not being part of a fund).

products, there is no price transparency or 'marking to market' of the risk attaching to them. This also means that the products are not on the 'approved product lists' of financial advisers and they often do not carry any form of credit rating. The lack of a liquid market also means that investors are locked into their investments for the duration. Lastly, there is an all too frequent misperception on the part of retail investors that, because these fixed interest products are property-related, they are inherently secure and akin to a bank deposit.

In the year ahead, we will be looking at additional ways to help retail investors, particularly in relation to this type of product. Some focus areas will be on better disclosure by issuers, quality advice and investor education on things such as asset allocation and assessing risk and rewards, particularly in pricing the risk attaching to unlisted debt products.

5. Insider Trading

As a postscript, ASIC's new Chairman, Tony D'Aloisio, announced at a Senate Economics Committee Budget Estimates hearing last week the creation of a new ASIC taskforce to tackle insider trading and market manipulation.

The special taskforce is being established to determine what additional actions ASIC, in cooperation with the ASX, can take in the areas of insider trading, market manipulation and continuous disclosure. Part of the taskforce's work will be to assess new investigation techniques building on best practice overseas. The taskforce's remit will be broad and it will cover both exchange-traded products and over-the-counter markets for equities, derivatives and other financial products.

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