A CHRONICLE OF A DEATH FORETOLD: THE CORPORATE GOVERNANCE IMPLICATIONS OF THE GLOBAL PRIVATE EQUITY BOOM

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In the aftermath of the first leveraged buyout boom it was argued that we were witnessing the demise of the public corporation. Private equity providers have once more become increasingly influential actors. Once again, its proponents claim to have solved the perennial core governance problem associated with the separation of ownership and control. Private equity generates its own potentially systemic problems, however, not least of which is the partial bypassing the elaborate corporate governance, financial reporting and disclosure obligations imposed on public corporations in the aftermath of scandal. Regulators in the United States, Australia and the United Kingdom have expressed concern that unrestricted expansion increases the risk of market manipulation and macro-economic instability. The paper evaluates whether such concerns are justified by investigating the impact of the asset class across a number of critical pressure points within the corporation and between it and those providing the intermediating services required to remain or exit the public market. It concludes that while the risks are real, the changed dynamics of regulatory policy severely hamper capacity to address them.

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I INTRODUCTION

The seemingly unstoppable global rise in private equity continued in 2006. The alternative asset class accounted for twenty five per cent of the mergers and acquisitions market in the United States alone.[1] With demand outstripping supply in fund

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development, subscription and acquisition targets, the main providers reached out to new and potentially lucrative markets. None appeared more so than Australia, which registered the most spectacular growth. It has now become the third biggest private equity arena outside the United States and the United Kingdom. The combined value of planned and executed transactions in 2006 totalled AUS $27 billion, a significant spike on the previous five-year average of AUS $1.5 billion.[2] Although this represents a fraction of the global total, it is difficult to overstate the impact on the domestic corporate firmament. A senior partner in the Sydney office of Ernst & Young captured the mood with a colourful, if mixed, metaphor. The Australian corporate market, he reported, 'is being trawled for fallen angels and there are no sacred cows.'[3]

The leveraged buyout component of private equity ranks as arguably the most politically controversial asset class.[4] Concern radiates from potential (or actual) conflicts of interest among managers involved in market exit proposals, to potential (or actual)

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[1] US $1.56 trillion was expended in mergers and acquisitions activity in the US market alone last year, 25% of which came from private equity investments. This represented a 300% increase on 2005 figures, see Greg Ip and Mark Whitehouse, 'Market's Fall May Auger a Falling Appetite for Risk', *Wall Street Journal* (New York), 1 March 2007, A2.

[2] Reserve Bank of Australia, *Statement on Monetary Policy*, 12 February 2007, 45.

[3] Ernst & Young, 'Mergers and Acquisitions Index' (Press Release, 5 December 2006). Most were strategic realignments in response to regulatory change (Channel 7 and Channel 9) or partial divestiture of non-core business units (the sale of Myer by the Coles Group). More problematically, the two largest planned transactions involved existing senior management (Qantas and Alinta). The single hostile bid saw Kohlberg Kravis Roberts target Coles Group. The bid was rebuffed twice but was ultimately unsuccessful. Four months after the initial approach, Coles capitulated, see Simon Coles, 'Coles Starts $20bn Auction as Sales Dive', *Australian Financial Review* (Sydney), 24-25 February 2007, 3.

[4] Unlike hedge funds, which tend to operate largely beyond public consciousness, the direct connection between private equity financing and managerial decision-making makes it much more visible. Private equity disperses technical and material capital at all stages of the investment process. The provision of venture capital in exchange for equity is relatively unproblematic. Facilitating start-ups and job creation underpin many of the normative claims of the industry, see, for example, British Venture Capital Association, *A Guide to Private Equity* (2003). The focus of present article is on Leveraged Buy Out (LBO), which is the main mechanism used to exit the market. Within the paper the terms private equity and LBO are used interchangeably and refer to market exit unless otherwise specified.

abuse of fiduciary duty from those providing corporate advisory services, insider trading and market manipulation. The private equity industry thrives at times of high liquidity, cheap debt and low levels of corporate default, structural conditions that pertain on global markets presently. The very illiquidity of private equity, however, raises concern that instability could arise if sentiment changes and trading commitments entered into now are insufficiently hedged. This in turn brings us back to the target company, which could find it difficult to obtain or retain financing in a more risk-averse climate. The volatility seen in global markets in February provides financial barometrical indicators that the second Perfect Storm to hit the market in seven years could be brewing.

What is particularly striking is the commonality of concern across regulatory jurisdictions. It suggests neither enabling nor mandatory governance frameworks are necessarily sufficiently robust. The Department of Justice in the United States is investigating allegations of collusive activity. This issue was also identified but side-stepped by the Takeover Panel in Australia on mandate grounds.[5] Instead the Panel concentrated on articulating a series of protocols, a process that highlighted the extent of the loopholes available to insiders involved in exit strategies.[6] The Financial Services Authority in London characterises the risk of insider trading market abuse from the failure of financial intermediaries to manage conflicts of interest to be high.[7] At a broader

[5] Explanatory notes accompanying draft guidance suggested that collusion, along with the risk of insider trading, was beyond its mandate, see Takeover Panel, *Insider Participation in Control Transactions*, Issue Paper 19 (2007) [48]; see also below n 63-67 and accompanying text.

[6] See below n 59-63 and accompanying text.

[7] Financial Services Authority (London), *Private Equity: A Discussion of Risk and Regulatory Engagement*, Discussion Paper 06/06 (2006) 9. It also recognises the value of ‘a compelling business model with significant potential to enhance the efficiency of companies both in terms of their operation and their financial structure’: at 5. In the United States, the Securities and Exchange Commission in Washington has gone from concern to action. It has filed papers claiming that insider trading preceded the announcement of

systemic level, the Reserve Bank of Australia hints that financial risk could, in the longer-term, threaten macro-economic stability.[8] To date, US regulators have staved off demands for greater regulation of hedge funds or private equity, preferring instead to rely on market discipline conditioned by a clearly expressed preference for providers to tighten financing terms.[9]

Supporters of private equity counter these risks are overblown. Instead, what we are witnessing, it is argued, is the delayed actualisation of a paradigmatic shift first identified two decades ago.[10] Leveraged Buyouts (LBOs) resolve (ostensibly, partially and temporarily) the central conundrum of corporate governance.[11] If the LBO offered a true and lasting solution, its remarkable renaissance should be uniformly welcomed. In reality, however, the locus of the principal-agent conflict is displaced to a largely unregulated arena. While the recombination of equity and control unquestionably limits managerial discretion, governance arbitrage raises a series of critical oversight questions. These exist and play out in multiple levels within the corporate governance matrix.

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the proposed takeover of TXU, a Teas Utility Company, see Dennis Berman, 'TXU Trading Ahead of Deal is Scrutinized,' *Wall Street Journal* (New York), 3 March 2007, A3. If the deal goes ahead it will be the most expensive private equity transaction in history, see below n 51-2 and accompanying text.

[8] Reserve Bank of Australia, above n 2, 46.

[9] Presidential Working Group and US Agency Principals, *Agreement on Principles and Guidelines Regarding Private Pools of Capital* (2007), 3. <http://online.wsj.com/public/resources/documents/principles/20070222.pdf>. While the FSA recognises that even a highly leveraged collapse will in itself can be contained by limited liability, the real risk is the signalling impact such a collapse may have on other high yield investments, see FSA above n 7, 62.

[10] Michael Jensen, 'The Modern Industrial Revolution: Exit and the Failure of Internal Control Systems' (1993) 48 *Journal of Finance* 831, 869-70.

[11] By resolving the principal-agent conflict caused by the separation of ownership and control in the modern corporation, see Michael Jensen, 'Eclipse of the Public Corporation' (1989) 67 *Harvard Business Review* 61; for original conceptual formulation, see Adolf Berles and Gardiner Means, *The Modern Corporation and Private Property* (1932).

Contestation over their independent or integrated solution drives the calibration of wider regulatory policy.

The rise of private equity is itself seen in some quarters as an unintended consequence of changed enforcement priorities.[12] In the United States, for example, regulators are under increasing pressure not to exercise instruments of control introduced in the aftermath of financial reporting scandal. Creative enforcement mechanisms, such as mandating governance change in exchange for a decision to stay or drop corporate prosecutions are presented, with partial judicial justification, as the illegitimate exercise of prosecutorial discretion.[13] More generally, the costs (generated primarily by the audit profession itself) of validating internal control processes are blamed (on the Securities and Exchange Commission) for driving business off-market and offshore. On this

[12] McKinsey Report, *Sustaining New York's and the US' Global Financial Services Leadership* (2007) (criticising 'the multi-tiered and highly complex nature of the US legal system… [along with] the lack of coordination and clarity on the ways and means of enforcement… [leads to a perception that it is] neither fair nor predictable': at 17). The McKinsey report endorses the findings of a separate investigation, see Committee on Capital Markets Regulation, *Interim Report* (2006) (which suggested the 'criminal enforcement system needs better balance': at xii. Both feed into and amplify warnings by the US Treasury Secretary to policymakers not to create or maintain that 'a thicket of regulation', see Hank Paulson, 'Remarks on the Competitiveness of US Capital Markets' (Speech delivered at National Economic Club of New York, 20 November 2006). Paulson's speech follows exactly the template offered two week's earlier by the principal figures pf the Committee on Capital Market Regulation, see Glenn Hubbard and John Thornton, 'Is the US Losing Ground', *Wall Street Journal* (New York), 30 October 2006 (Online Edition); For how these reports and the remarkably similar rhetoric and policy prescription influence regulatory policy calibration, see below Section V.

[13] The Securities and Exchange Commission in Washington has adopted a rules-based protocol system, see SEC, *Rules of Practice* (2006) <http://sec.gov/about/rulesprac2006.pdf>. The Financial Services Authority in London frames its enforcement agenda around generic statements of regulatory principles, including efficiency and economy, the role of management, proportionality, international coordination and need to safeguard competition, see FSA, *Principles of Good Regulation* (2006) <http://www.fsa.gov.uk/pages/About/Aims/Principles/index.shtml>. In essence, the principles differ little from guidance already offered by US counterparts, see, in particular, Department of Justice (Washington DC), *Principles of Federal Prosecution of Business Organisations* (2003). What does differ is the extent to which the default mechanism for securing behavioural change in the United States is enforcement rather than consultation driven, see John Coffee, 'Law and the Market: The Role of Enforcement' (Paper presented at the Dynamics of Capital Market Governance Workshop, Australian National University, 14 March 2007).

account, the private equity reprise is an efficient and rational response to ill-considered political interference in the market for corporate control.[14]

Ascertaining how and why private equity has expanded is not just an important empirical question on its own terms, therefore. Explication allows for a more granular explanation of what drives the dynamics of capital market governance. The paper has three components. First, the changing structural determinants of the private equity market are mapped. Second, it identifies and assesses the existence and extent of latent and extant risks across and between critical nodes in the corporate governance matrix. Third, it evaluates differential regulatory responses to the rise of private equity, with particular reference to the management of conflicts of interest. It concludes that not only are the risks real but that the dynamics of governance militate against the kind of concerted regulatory action necessary to minimise them.

II A CHRONICLE OF A DEATH FORETOLD

In a seminal article on the rise and initial fall of the leveraged buyout movement, Michael Jensen prophesised 'the eclipse of the public corporation'.[15] He argued 'a social invention of vast historical importance' had outlived its utility. In a subtle and subversive

[14] The presentation of this evidence has prompted considerable candour from the Securities and Exchange Commission, see Christopher Cox, 'Opening Remarks' (Speech delivered at the Practising Law Institute's SEC Speaks Series, Washington DC, 9 Feb 2007). Cox argued: 'People don't like to be accused of securities fraud - especially when it's true. So the fraudsters fight back. Sometimes they are rich and powerful. Sometimes they have friends in high places, in the government and in the media. And when they fight back, the more clever among them cloak their true motives by appropriating the high-minded concerns of the free market economist or the civil libertarian": at 3 <http://www.sec.gov/news/speech/2007/spch020907cc.htm >; see also however, Stephen Labaton, 'Is the SEC Changing Course', *New York Times*, 1 March 2007 (reporting that the SEC chairman would be a keynote speaker at a conference at which the Chamber of Commerce releases a report calling for an end to criminal prosecution of corporations); see further below n 80 and accompanying text.

[15] Michael Jensen, 'Eclipse of the Public Corporation' (1989) 4 *Harvard Business Review* 60.

revision of the classic Schumpeterian account of how to mediate technological change, the article applauded capitalism's capacity to destroy outmoded modes of corporate organisation.[16] Discontinuity generated 'real, enduring and productive' change. In a key passage, he outlined the case with almost messianic zeal:

> Overleveraging creates the crisis atmosphere managers require to slash unsound investment programs, shrink overhead and dispose of assets that are more valuable outside the company. The proceeds generated by these overdue restructurings can then be used to reduce debt to more sustainable levels, creating a leaner, more efficient and competitive organization.

The article captures nicely the zeitgeist of the leveraged buyout.[17] It also delineates sharply the appropriate range of normative concerns within the corporate finance literature. This emasculated conception of governance has survived largely intact.[18] Now, as then, proponents of private equity point to four interlinked advantages associated with (even a temporary) exit from the public markets. First, irrespective of the precise mechanism deployed, the LBO recombines equity, knowledge and control. Due

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[16] The original formulation contended that the defining feature of capitalism is disequilibrium; the central policy question is how to mediate 'the creative destruction' wrought by this process, see Joseph Schumpeter, *Capitalism, Socialism and Democracy* (1942). In a move that seamlessly progresses from description to policy prescription, the phrase has since been deployed to justify unbridled market operation, see, for example, Richard Foster and Sarah Kaplan, *Creative Destruction* (2001).

[17] For overview of the industry, see Paul Gompers and Josh Lerner, *The Money of Invention: How Venture Capital Creates New Wealth* (3rd Edition, 2004); Josh Lerner, Felda Hardymon and Ann Leamon*, Venture Capital and Private Equity: A Casebook* (3rd Edition, 2004). For pen profiles of major institutional actors and their investment philosophies, see Jennifer Hewett, 'Private Lives', *Australian Financial Review Magazine* (Sydney) February 2007, 44-53; Henry Sender, 'Inside the Minds of Kravis, Roberts', *Wall Street Journal* (New York), 3 January 2007, A1; see more generally, 'The Uneasy Crown', *Economist* (London), 10 February 2007, 69-71; Katie Benner, Telis Demos, Corey Hajim and Jia Lynn Yang, 'The Power List,' *Fortune* (New York), 5 March 2007, 45-50.

[18] For practitioner focus, see Philip Yea, 'Do We Condemn or Cheer the Flight to Private Equity', *Financial Times* (London), 15 February 2007, 15 (Yea, who is chief executive of Europe's largest private equity fund, 3i, was unapologetic: 'While it may seem unfair that the private equity model has the advantage, that surely is the point of capitalism - that those with the advantage win': at 15).

diligence undertaken in advance of an acquisition generates superior technical and market intelligence and, therefore, better oversight than can be provided by reliance on part-time non-executive directors. The key to success is not simply financial engineering but rather, it is claimed, a superior governance model.[19] Post purchase, constant review of each business unit and product line further concentrates focus on the financial bottom line. This perspective is particularly propagated in the retail arena, where frontline workers are often provided with profit-sharing incentives.[20] Second, the incentive structure for senior executives is explicitly linked to actual rather than relative performance. Third, the LBO generally allows for a longer term planning process. Most portfolio companies are held for at least three years before being re-listed in an Initial Public Offering or on-sold.[21] This shift gives temporary relief from earnings management imperatives associated with the public markets. Should market conditions change, it is argued that proximity of the owner to the decision-making process allows for strategy reformulations to be agreed and

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[19] See Andreas Beroutsos, Andrew Freeman and Conor Kehoe, 'What Public Companies Can Learn From Private Equity' (2007) Winter *McKinsey on Finance* 1, 3 (reviewing 60 deals from the top 12 private equity firms. The report concludes success is linked to active engagement, particularly in the first three months after deal consummation: at 5). See also FSA above n 7, 5 (noting the compelling case it offers). .

[20] Fiona Tyndall and Allan Jury, 'My Store', *Australian Financial Review Boss Magazine* (Sydney), February 2007, 17-20 (reporting the staff had been energised. Rather than viewing the changes with suspicion, they had acted like 'a whole bunch of unshackled horses': at 17).

[21] If market conditions permit, LBO funds will re-list very quickly. The most glaring example involved the car rental company, Hertz. It was bought in December 2005 by a consortium representing, the Carlyle Group and Merrill Lynch Global Private Equity Partners, six months after Ford decided not to proceed with its own IPO. The investors paid a total of $14bn for the company, $2.3bn in cash, the remainder leveraged. George Tamke, a Clayton Dubilier & Reid partner named Chairman of the Board of Directors opined: 'the company's underlying strengths -- an exceptional global brand, premium pricing supported by superior customer service and a history of industry innovation -- form a strong platform on which to pursue further growth initiatives' CD&G (Press Release, 12 September 2005) <http://www.lexdon.com/article/Clayton_Dubilier_&_Rice_The/8365.html>. The LBO group took on a further $6bn loan, paid out a $1bn dividend and announced an intention to re-float seven months later. The partnership received a further $500m bonus payment on completion of the offering on 15 November 2006. See generally, David Henry and Emily Thornton, 'Buy It, Flip It, Then Strip It', *Businessweek* (New York), 7 August 2006, 28-31. Although share prices have been sustained and marginally increased, so too has the level of the market making it difficult to ascertain whether real value has been generated.

implemented quickly. Fourth, exiting the public market reduces the regulatory and tax burden. In strict financial terms, therefore, it appears to offer a more efficient organisational form. Appearances, however, can be deceptive. An inordinate focus on increased deal scalability (and the additional buying power provided by leveraging) risks misconceiving the dynamics of the private equity market. Size is not necessarily an accurate indicator of performance.[22]

A *Inside the Alchemist Workshop*

Despite the exponential increase in the number of private equity investment vehicles, the operating structure remains remarkably homogeneous. The archetypal private equity fund coalesces around a limited liability partnership model.[23] Each fund has a finite operating lifespan, normally ten years. The private equity provider serves as General Partner. It decides strategic focus and portfolio balance. It conducts due diligence on planned acquisitions, recruits or disposes operational management, and decides divestiture policy. Operational discretion is limited only by the size of the capital initially raised, extent to which this can be leveraged and any contractual restrictive covenants negotiated by the Limited Partners.[24]

[22] Neil Harper and Antoon Schnneider, 'Private Equity's New Challenge', *The McKinsey Quarterly*, August 2004, 2 (reporting that only top quartile of US funds out-performed market 1986-2003: 17.5% return compared to 17.1%; the average private equity fund performance was 12.4%. European private equity performed much better, with a minimum return of 23% among the top quartile and an average of 19% against an equity market return of 12.3%) <http:///www.mckinseyquarterly.com/article_page.aspx?ar=1475&L2=5&L3=5>.

[23] Some holding funds do trade publicly in their own right, for example, Kohlberg Kravis Roberts in the United States and 3i in the United Kingdom.

[24] FSA, above n 7, 59-60 (suggesting a loosening of restrictive covenants linked to perception that the corporations targeted are much more profitable and thus less likely to default: at 59. The study also found that relationship banking has declined and an increase in competitive auctions for financing: at 60). The loosening of contractual obligations and the competition in lending disproportionately benefit the private

The Limited Partner commits a specified percentage of overarching capital, which is then drawn down as required by the General Partner but normally within the first five years of the fund to ensure the maximisation of returns before the contractual basis of the fund elapses. The General Partner has a vested interest to close the fund well in advance of this. In so doing it demonstrates a return on investment and makes it easier to secure the investment to start a further fund. Management fees are normally pegged at between 1 and 3 per cent of the total committed (although they may be front-loaded). The maximum return on investment is normally capped at 80%, net of specific transaction fees and the purchase of technical legal and accounting advice.[25] Known as 'carried interest' this premium may, however, be subject to the fund passing pre-determined success rate (e.g. a certain percentage return). Access to this most illiquid of asset classes is restricted to institutional and accredited investors and a limited number of high net worth individuals. The approach is carefully calibrated to take advantage of disclosure exemptions.[26] As a consequence, ascertaining relative value is fraught with difficulty.[27]

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equity fund. While the immediate financial risk to the lender can be partially offset by securitising the debt obligation the asymmetrical power balance generates additional potential oversight problems. These include, for example, investment bankers offering sub-prime loans at below competitive rates to secure personal performance bonus. It is notable that the international investment bank, Credit Suisse dropped out of plans to market the sale of Qantas, ostensibly on grounds that the restrictive covenants were too weak, see, Editorial, 'Six Banks Win Mandate for Loose Covenant Qantas LBO,' *Euroweek*, 986, 12 January 2007 http://www.euroweek.com/default.asp?Page=1&PUB=3&ISS=23275&SID=670889&Country=&SM=ALL&SearchStr=qantas. For further details, see below n 54-7 and accompanying text.

[25] Joseph Bartlett and W. Eric Swan, 'Private Equity Funds: What Counts and What Doesn't' (2001) 26 *Journal of Corporate Law* 393, 398.

[26] In the United States, disclosure exemptions apply from three critical interlinked pieces of the New Deal regulatory architecture: *Securities Act 1933*; *Investment Company Act 1940* and *Investment Advisors Act 1940*. As long as the securitised facilities are non-public offerings, the Securities Act does not apply. As long as the partnership comprises only accredited investors and up to 35 sophisticated investors, the Investment Company Act does not apply. In addition, exemption from the Investment Advisors Act pertains if a single partner does not interdict with more than 15 clients. See generally, Steve Hurdle, 'A Blow to Public Investing: Reforming the System of Private Equity Fund Disclosures' (2005) 53 *UCLA Law Review* 239, 244-50. For the regulatory framework in the United Kingdom, see FSA above n 7, 79-93 (the

While it is understandable that private equity funds wish to maintain discretion in order to safeguard trading strategies,[28] an unavoidable corollary is that this reticence makes it difficult to ascertain the adequacy of the existing regulatory framework. The lack of transparency provides an opening for fund managers to castigate governance and regulatory arbitrage. The chief investment officer of Fidelity International, Michael Gordon, caused consternation recently with a scathing rejection of the private equity model:

> Institutions and their advisers are choosing to move into a form of investment that provides little real diversification from equities over time; comes with higher risks because of leverage; has far less transparency than a portfolio of listed stocks - and for which the institution has to pay premium fees. Am I the only one struggling to make sense of this.[29]

If capital investment return is a debatable advantage for all but the top quartile of private equity funds, what other factors need to be taken into consideration. Does

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introduction of the Markets in Financial Instruments Directive in November 2007 will end some of the exemptions provided by the current regime by designating the provision of financial advice as a core service. If a firm is regulation under the MiFiD, it is automatically governed by the Capital Requirements Directive, which came into force on 1 January 2007.

[27] Steve Kaplan and Antoinette Schoar, 'Private Equity Performance: Returns, Persistence and Capital Flows' (2005) 60 *Journal of Finance* 1791; Josh Lerner, Antoinette Schoar and Wan Wang, 'Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle' (Research Paper No 4523-05 Sloan School of Management, MIT, 2005). For empirical study suggesting major overvaluations linked to calculation based on gross rather than net returns, see Ludovic Pahalippou and Oliver Gottschalg, 'The Performance of Private Equity Funds' (Working Paper, EFA Moscow Meetings 2005, INSEAD, Paris, 2006) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=473221>.

[28] Recent research suggests increased disclosure could enhance deal flow by making the asset class more attractive to a greater range of risk averse institutional investors, see Douglas Cumming and Sofia Johan, 'Regulatory Harmonisation and the Development of Private Equity Markets' (Law and Economics Workshop No 13, University of California, Berkeley, 2006), 28. With demand already outstripping supply, the marginal benefits are, however, negative. In addition, disclosure could reduce the barrier to entry that reinforces the dominance of already (apparently) successful funds and justifies the managerial fees.

[29] Michael Gordon, Letter To the Editor, *Financial Times* (London), 31 January 2007, 14. Open contestation within the City of London about asset class utility and how to regulate it is not only unusual, it inevitably politicises the issue, see generally, Michael Moran, *The British Regulatory State* (2002).

regulatory flight have greater explanatory force? Or, more problematically, given the increasing dominance of investment banking within the industry, is the LBO merely a loss leader to gain access to lucrative transaction fees throughout the investment cycle? To answer these questions it is necessary to disaggregate a series of conflicting and conflating preferences. The governance problems identified by this mapping exercise will then be explored more fully below.

B *The Bankers Join the Party*

Earlier periods of sustained merger and acquisition activity tended to be concentrated, particularly when sector-specific shocks occurred, such as deregulation, privatization or maturation.[30] Evidence from the LBO boom in United States and the United Kingdom, and, more recently, Australia cannot be so readily explained. Likewise, tracing a direct connection with differential regulatory responses offers an incomplete and potentially misleading explanation. The cost associated with compliance is regularly cited as a determining factor.[31] The empirical evidence demonstrates that a light-touch principles-based approach to regulation does not necessarily guarantee the maintenance of public ownership. The City of London, for example, has also seen an exponential increase in private equity activity. Funds raised through initial listing were outstripped by private buy-outs in 2006. The result has been a reduction in share availability and concomitant reduction on the total value of the London market.[32]

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[30] Mark Mitchell and John Mulherin, 'The Impact of Industry Shocks on Takeover and Restructuring Activity' (1996) 41 *Journal of Financial Economics* 193.

[31] See McKinsey, above n 12, 83, 87; Committee on Capital Markets Regulation above n 12, 116-34.

[32] See Financial Services Authority, above n 7, 3.

The expansion of the asset class is linked, in part, to changed ideational perceptions of utility by leading institutional actors. It is no longer perceived as the domain of corporate extortionists, a characterization graphically depicted in the quintessential account of the chaotic RJR Nabisco takeover battle won by Kohlberg Kravis Roberts (KKR) in what was then the largest single leveraged buy-out.[33] Linguistic change underscores the ideational transformation. The corporate raider has transmogrified into the ‘sponsor’ of ‘portfolio companies’ not target acquisitions. Chrematistic financial engineering has morphed seamlessly into governance arbitrage, with the recruitment of many senior banking and managerial executives into consulting positions.

The frenetic pace of change is encapsulated in the fact that nine of the ten largest LBOs took place in the past eighteen months.[34] The record set in the RJR Nabisco takeover stood for seventeen years. In 2006, KKR broke the record by acquiring HCA, a US-based healthcare corporation, for US$33 billion. Its private equity rival, Blackstone Partners, eclipsed this with the purchase of Equities Office Property Trust for US $38.9

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[33] Bryan Burroughs and John Helyar, *Barbarians at the Gates* (1990).

[34] ‘Will Street Pity the Fools’, *Wall Street Journal* (New York). 5 January 2007, C14. As demand for private equity placements increase so too do the wider risks. This occurs because although access to the fund is limited the debt itself has been increasingly securitised, see FSA, above n 7, 13 (reporting survey evidence from the most active banks operating in London. Equity financing mushroomed from EUR 58bn to EURO 67.9bn between June 2005 and July 2006. It also found, however, that the risk was quickly parcelled out to other lenders. The evidence suggests that bank exposure is reduced to 19.4% of original investment within 120 days: at 14. Two further factors are apparent In the Asia Pacific region. Firstly, liquidity has increased dramatically as a consequence of IPO activity among the largest Chinese corporations on both the Hong Kong and to a lesser extent London markets. The additional income cannot be repatriated into China because of the potential impact on domestic fiscal policy. As a result, this capital is put increasingly into securitised private equity debt, see Anothy Neoh, ‘China’s Financial Markets – Growth Opportunity and Challenge,’ (Speech delivered at ASIC Summer School, Sydney, 5 March 2007). It is unclear to what extent the providers of this debt owe a specific duty of care to explain the risks, Interviews, Sydney, 5-7 March.

billion (including debt). Now even that looks likely to be surpassed with the planned acquisition of the utility company, TXU.[35]

The transformation of the investment banks from passive providers of capital or advisory services to active fund managers represents a significant recalibration of the integrated banking model. It also marks a structural change within the global financial markets. One general counsel for a global investment bank remarked sardonically in a recent interview that private equity has reconfigured power relations in such a profound manner that the critical question has arisen: 'Who Runs Wall Street?'[36] Goldman Sachs recently announced plans to launch a US $19 billion superfund. Merrill Lynch Global Private Equity Partners already controls one of the top ten private equity funds. Both saw overall profits increase dramatically last year.[37] Merrill Lynch's unit reported a 300% increase in profits for the second quarter in 2006, in part because of the profits accruing from the Hertz 'flipback'.[38] The contribution these units make to group profits demonstrates their critical importance. One Capital Partners, the private equity arm of J P Morgan, contributed US $550 million of the US $3.5 billion profit announced in 2006. The rise in proprietary trading (and related captive transaction work) increases, however, the potential conflict between the general and the limited partners.

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[35] The deal is valued at $32bn and is being managed by a consortium including KKR, Texas Pacific and Goldman Sachs, see Rebecca Smith, Susan Warren and Dennis Berman, 'In TXU Deal, Texas Regulator Has Few Levers to Pull', *Wall Street Journal* (New York), 26 February 2007, A3.

[36] Interview, Sydney, 5 March 2007.

[37] Heidi Moore, 'Revenue Gap Widens', *Financial News Online*, 26 February 2007 (Goldman profits increased by 52%; Merrill Lynch 37%).

[38] On Hertz deal, see above n 21; on profits, see Thomson Financial <http://online.wsj.com/public/resources/documents/info-YE_PEQUITY06.html>.

III BARBARIC TRIUMPH OR HUBRISTIC INTERLUDE?

The enhanced scalability of the deals, the availability of cheap credit and propensity of institutional investors to forsake traditional holdings has generated multiple areas of contestation. Part of the problem is that private equity has not quite lost the asset stripping reputation accrued in the 1980s.[39] Its re-emergence and enormous fees commanded for unlocking growth has reignited the old enmity. As a result, the pressure on private equity has been building incrementally for some time. In a highly charged editorial, the *Financial Times* noted in December 2005 that 'the private equity "barbarians" are back. Only this time they are not at the gate. They are inside the castle and holding a banquet fit for a king.'[40] A year on, the paper counselled the industry to 'exercise discretion'.[41] This can be attributed, in part to the exigencies of the electoral calendar. In part, however, the private equity providers have only themselves to blame. Conspicuous consumption at this stage in the electoral cycle is an unadvisable public relations strategy.[42]

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[39] Bryan Burroughs and John Heylar, above n 32; Connie Bruck, *The Predators Ball, The Inside Story of Drexham Burnham and the Rise of the Junk Bond Raiders* (1989); John Stewart, *Den of Thieves* (1993); see also, however, Michael Jensen with Donald Chew, 'US Corporate Governance: Lessons From the 1980s' (1997) <http://papers.ssrn.com/abstract=146150> (characterizing the rise in leveraged buyouts as an overdue attack on entrenched and profligate management which had been deliberately misunderstood by a populist media unable to rise above simplistic 'moralism'); for opposition in the UK, see below n 43 and accompanying text.

[40] Editorial, 'While the Sun Shines', *Financial Times* (London) 3 December 2005, 14.

[41] Editorial, 'Private Equity Should Beware its own Success', *Financial Times* (London), 22 December 2006, 14.

[42] For the United States, see Alan Murray, 'Private Equity's Successes Stir Up a Backlash That May Be Misdirected', *Wall Street Journal* (New York), 9 February 2007, A9 (quoting David Rubinstein of Carlyle Group saying private equity had done "an awful job" in public relations terms because of a tendency to "brag about how much money we make": ibid). The presentational difficulties are magnified when the financial press headline conspicuous spending, see 'Mine's a Ferrari', *Australian Financial Review* (Sydney), 19 January 2007, 1; see also Hewett, above n 17. Her profiles of 'the new princes' of private equity' emphasised family values and the work ethic. Unfortunately, in presentational terms the effect was marred by an advertisement on the previous page carrying the legend 'the essentials of imaging'. The

A *Market Mores and Political Referents*

Opposition to private equity occurs at multiple levels. Funds tracking equity markets fear capital flight and the emergence of unbalanced portfolios if blue-chip investments continue to de-list. Within the City of London, leading financiers attempt to blunt political sensitivity by expressing concern about worker and wider stakeholder rights.[43] The increased traction is inextricably linked to a contest for the Deputy Leadership of the governing Labour Party, itself a rehearsal for the transfer of power from the British prime minister to his long-serving chancellor later this year. The political changing of the Labour guard provides space and rationale for policy refinement. Job losses at high-profile acquisitions such as the Automobile Association and Birds Eye in the United Kingdom have galvanised union opposition into a dominant political force. The rhetoric has not quite descended to that heard in Germany, where private equity funds have been castigated as 'locusts' but it has come close.

The private equity fund Permira has been subject to a virulent campaign of abuse. This included parading a camel outside a church service attended by its chief executive, Damon Buffini. The insult relates to a Bible parable that it is easier for a camel to pass through the eye of a needle than get into heaven.[44] The General Secretary of the Trades

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accompanying sombre (and somewhat austere) portraits jarred with the lavish birthday celebrations for Stephen Swartzmann, the co-founder of the Blackstone Group. The party, featuring performances by Rod Stewart and Patti LaBelle, fuelled unease and envy, always a noxious cocktail for Wall Street, see Nelson Schwartz, 'Wall Street's Man of the Moment', *Fortune* (New York), 5 March 2007, 40-43. There is no suggestion whatsoever that the event was in any way inappropriate (e.g. Dennis Kozlowski's use of Tyco money to hold a party in Sardinia for his wife). The point is that enhancing visibility in such a manner generates questions about how the money is made.

[43] Jim Pickard and Peter Smith, 'Myners Warns of Risks from Private Equity', *Financial Times* (London) 20 February 2007, 1 (concern that private equity threatened job security and benefits); for opposition within industrial conglomerates, see Joe Ashworth and A Heath, 'The Barbarians Back at the Gate', *The Business* (London), 3 February, 2007, 18-20.

[44] See Profile, 'Damon Buffini', *MoneyWeek* (London), 23 February 2007, 40.

Union Congress, Brendan Barber, has called for UK governmental intervention to limit "amoral asset-strippers after a quick buck; casino capitalists enjoying huge personal windfalls."[45] Here in Australia, the Treasury minister, Peter Costello, has announced an inter-agency review to examine the structural determinants of the industry.[46] With superannuation funds in Australia now flush with increased revenue because of changes to their underlying tax structure, Costello warned there was a need to resist siren calls of private equity. Superannuation funds, he said, had a primary duty to look after the interests of their investors. That precluded taking inordinate risks to "get into the money".[47] In the United States, the debate is still carried out largely on a technocratic basis.[48] The Department of Justice investigation noted above has not uncovered evidence of actual malfeasance or misfeasance. Wall Street, however, is uniquely susceptible to inter- and intra-party contestation.[49] Any hint of a scandal is likely to reignite moral panic as the long march to the White House begins in earnest.

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[45] Christopher Adams and Peter Smith, 'TUC Chief Attacks Private Equity Industry', *Financial Times* (London), 20 February 2007, 1. Barber further claimed the industry was "pretty much allowed to operate with impunity": ibid.

[46] Peter Costello, 'Opening Address' (Speech delivered to ASIC Summer School, Sydney, 5 March 2007). Treasury and the peak regulatory authorities - Australian Securities and Investments Commission, Australian Prudential Regulation Authority and the Reserve Bank of Australia – will conduct the review. Its terms of reference mirror that set out by the FSA discussion paper, see FSA above n 7.

[47] Ibid. The Australian Prudential Regulation Authority primarily regulates the superannuation industry. As its name suggests, APRA adopts a much more facilitative less directly confrontational approach to regulation than ASIC, the securities regulator. It has, however, adopted a much more sceptical approach to industry entreaties in recent years, see Justin O'Brien, 'Trading at the Frontier: Global Markets, Regulatory Enforcement and the Dynamics of Corporate Crime,' (2005) 18 *Australian Journal of Corporate Law* 201.

[48] See Presidential Working Group, above n 9; for suggestion of agency capture, see Labaton, above n 14.

[49] Steve Fraser, *Wall Street, A Cultural History* (2005).

The industry has become increasingly cognisant of the need to manage outside constituencies. [50] The consortium bidding for control of the Texas utility company, TXU, used concern about climate change, for example, to justify a commitment to rescind plans to build 11 new coal-fired power stations. This environmental altruism served an undeclared dual purpose. First, it neutralised the environmental lobby.[51] Second, it justified an immediate retrenchment on capital investment.[52] While, if successful, the TXU will become most expensive LBO in history, the battle for control of Qantas in Australia is arguably the most defining, both for the industry and its regulation. Just as Sarbanes-Oxley can be seen as a strategic congressional calculation to neutralise corporate scandal in advance of the 2002 mid-term elections,[53] the pending federal election in Australia has brought the private equity industry to a potential tipping point.

B *Charting an Icarian Flight Path*

The Qantas board has advocated the acceptance of an AUS $5.60 per share offer. While the bid represents a significant premium over market trading, it also involves the

[50] Although undaunted by the camel stunt, Buffini has shifted approach, see Lionel Barber and Peter Smith, 'Permira Accepts Need to Be More Open', *Financial Times* (London), 22 February 2007, 1.

[51] The proposed deal did cause some infighting among environmentalists after the event but not enough to scupper the initial support, see Rebecca Smith and Jim Carlton, 'Environmentalist Groups Feud Over Terms of TXU Buyout,' *Wall Street Journal* (New York), 3 March 2007, A1.

[52] Andrew Ross Sorkin, 'A Buyout Deal That Has Many Shades of Green', *New York Times* (New York), 27 February 2007, B1; see also Editorial, 'The New Greenmail', *Wall Street Journal* (New York), 27 February 2007, A16 (noting the public relations coup in enlisting the support of the environmental lobby but pointedly seeing an emergent alliance that could be detrimental to shareholders).

[53] See generally, Peter Gourevitch and James Shinn, *Political Power and Corporate Control* (2005); Donald Langevoort, The Social Construction of Sarbanes-Oxley' (2006) 105 *Michigan Law Review* 8; Roberta Romano, ''The Sarbanes-Oxley Act and the Making of Quack Corporate Governance' (2005) 114 *Yale Law Journal* 1521; see also Melvin Dubnick, 'Sarbanes Oxley and the Search for Accountable Corporate Governance' (Paper presented at Dynamics of Capital Market Governance Workshop, ANU 14-15 March).

airline accruing AUS $8 bn dollars in debt (see Figure 1 below). Predictably enough, the proposed offering also within the fair price range calculated by independent advisors retained after the board endorsed the buyout.[54] The consortium, Airline Partners Australia, balanced domestic and international private equity funds. It recruited Macquarie, the pre-eminent Australian investment bank. It also proposed retaining the existing senior management team along with the longer-term strategic plan already approved by the Qantas board. It highlighted potential synergies, such as Macquarie's active management role in Sydney airport. Just as significantly, it downplayed the vested interest of its dominant partner, Allco Finance, whose core business is aircraft leasing. The economic and voting interests were carefully aligned to avoid triggering formal regulatory or political scrutiny (see Figure 1).[55]

Partner	Equity Provision	Economic Interest	Voting Interest
Allco Finance	300	27	35
Allco Equity Partners	956.1	8	11
Macquarie Bank	525.5	15	15
Texas Pacific Group	891	25	15
Onex Partners	445.5	12.5	9
To be distributed	409.9	11.5	15

Figure 1: The Qantas Control Play.

[54] Qantas, *Target's Statement*, 9 February 2007, 39 <http://www.qantas.com.au/infodetail/about/investors/targetsStatement.pdf>

[55] Allco Finance subsequently changed its constitution to ensure that its ownership structure mirrored that imposed on Qantas itself by limiting foreign ownership in both absolute and aggregate terms.

A credible media and lobbying campaign was introduced, involving regular commutes to Canberra. In addition, the consortium voluntarily (if belatedly) submitted to a Foreign Investment Review Board adjudication to demonstrate good faith (while protesting that it was unnecessary). In the event it was not careful enough. The proposed market exit of an (albeit privatised) island economy icon was always going to generate the traction to question whether the proposed sale was in the national interest. This was the sole subjective criterion on which the government can block the sale. The Qantas Sale Act (1992) legislation imposes strict conditions on the beneficial ownership of the airline. It requires that Australian citizens dominate the board and that the operational domicile be based on Australian territory, all of which were complied with by Airline Partners Australia.

Tough talking by the Treasury Secretary, Peter Costello, that the government would ensure that the bid satisfied all legal requirements, was, however, just that. In a media conference announcing the decision to allow the bid to proceed, Mr Costello claimed the government had secured from the consortium a raft of additional restraints:

> Given this legally enforceable deed, which the Commonwealth can enforce, which guarantees the continuation of Qantas in Australia, the regional network, Qantas continuing its frequent flyer programs, Qantas remaining an integrated service, guaranteeing in the articles of association majority Australian ownership, majority Australian directors, principal place of operation in Australia, the government will allow the bid to go to the existing shareholders.[56]

[56] Statement by Treasury Minister, Peter Costello, 6 March 2007.

The enforceable undertaking, while presented as the most detailed secured from a corporation in Australian history, contains a number of loopholes.[57] Macquarie Bank is banned from voting on the board on issues relating to Sydney airport to curtail a potential conflict of interest; it is not curtailed from engaging in the decision-making process. The requirement to retain jobs, regional services and maintenance facilities are all subject to market conditions. The restrictions only apply to the current consortium and there is no mechanism to extend the political control to new owners. Finally, the undertaking endorses, in effect, radical restructuring through the exponential expansion of Jetstar, a low cost subsidiary, which is not legally bound by the Qantas Sales Act.[58]

The Qantas takeover is not just a legal issue. Who controls the corporation and how it is controlled matters and matter profoundly. The tussle has captured public sentiment like no other. The decision by the government not to intervene sends an unambiguous signal of governmental unease to interfere directly in market issues. While this represents a logical extension of long-standing policy, it also opens the space for political contestation. The opposition Labour Party has been careful to keep its options open. It has not object to the bid on principle. Rather, it has suggested that it will subject the undertakings to extensive legal analysis. Given that the consortium complied fully with the pre-existing legal framework, the Federal Government had little choice but to allow it to proceed. The critical political question is whether the extractions received in return are of any demonstrable value.

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[57] See David Crowe, ‘Promises Aplenty, But Hard To Enforce,’ *Australian Financial Review* (Sydney), 7 March 2007, 11

[58] See Laura Tingle, ‘Political Nightmare in the Baggage Hold,’ *Australian Financial Review* (Sydney) 7 March 2007, 9.

The ideational battle for control centres on which side can now generate the traction to determine whether the satisfaction of narrow corporate objectives is in the longer interests of the corporation or, indeed, the wider the national interest. The battle for control of Qantas - by no means in itself not the most controversial in the recent wave of leveraged buy-outs – crystallizes the confluence of conflating and conflicting interests and its impact on the corporate governance and wider regulatory framework.

IV ALIGNING AND CONFLICTING INTERESTS

Market exit reduces public oversight. It allows the de-listed corporation to bypass the elaborate corporate governance, financial reporting and disclosure obligations imposed after the collapse of Enron and other corporations in both the United States and here in Australia. Paradoxically, the global private equity boom has been driven by the injection of capital from the very source that the reinvigorated corporate governance paradigm posits as exercising the necessary control over managerial excess. Across the capital markets, institutional shareholders, such as public pension funds have made a strategic decision to invest heavily in private equity. A case in point is the Qantas superannuation fund, which declined to mandate the three investment managers with delegated authority over its stake in the airline.[59]

[59] 'Qantas Staff Fund Won't OK Takeover', *The Australian* (Sydney), 8 February 2007, 23; see also Alan Murray, 'How Labor's Pension Funds Are Playing Private Equity Two Ways', *Wall Street Journal* (New York), 28 February 2007, A10 (quoting research by Private Equity analyst that 22% of all new money raised for private equity funding in the United States in 2005 derived from labour superannuation schemes). Sometimes the dialectic between disclosure and privacy can pertain within the one investor. Contrast, for example, the shareholder activism displayed by CALPERS within the corporate governance arena generally with its resistance to the release of information relating to its own private equity investments, see Hurdle, above n 26, 255-57.

The transformative potential (and risk) occurs at a number of levels. These include, but are not limited to: the impact of entreaties on the governance of target corporations; the efficacy of fiduciary duty, conflicts of interest management systems and codes of conduct as restraining forces on financial intermediary self-dealing; and the danger of market manipulation and wider macroeconomic instability.[60] As noted above, these risks pertain irrespective of whether the regulatory regime adopted is primarily mandatory (US), enabling (UK) or combined (Australia). As the debate over private equity intensifies, so to does the contestation over the efficacy of control mechanisms at each node in the overarching matrix.[61] The discussion below centres primarily on the Australian legal and regulatory framework.

A *The Limits of Directorial Discretion*

For the senior management of the corporation and its professional advisors the pre-contract stage of a Management Buy Out (MBO) is the most problematic. How each node manages the potential conflict with existing shareholders or their delegated authority, the board of directors, over what constitutes the long-term interests of the corporation determines the integrity of the wider corporate governance architecture. Insofar as the strategic decisions are taken in good faith and with reasonable diligence, the business judgement default applies.[62] Directors have a statutory obligation to disclose

[60] FSA, above n 7, 3; Reserve Bank of Australia, above n 8, 46.

[61] For a measured summation of the contours of this battle, see Editorial, ‘Barbarians Back in the Dock, *Economist* (London) 1 March 2007, 10 (arguing that while many of the claims made against private equity, particularly asset stripping are easily refuted the fees charged for asset management are largely unwarranted).

[62] *Corporations Act 2006* ss 201, 180(0), 180(2) respectively.

any potential conflict of interest.[63] They also have a common law obligation to 'identify clearly the perceived conflict and to suggest a course of action to limit the possible damage.'[64] This allows significant discretion. Draft guidance provided by the Takeover Panel is instructive in this regard. Participating insiders should disclose the interest to the board prior to the provision of non-public information.[65] In addition this information should only be disclosed with board consent.[66] On immediate notification of a potential bid, the board should establish protocols to distance the corporation from the conflicted managers.[67]

The draft guidance ostensibly rejects a prescriptive approach. It does, however, resolve potential incommensurability problems by requiring alternative systems of control to address directly the issues raised in the draft protocols.[68] In addition, while noting the absence of a legal requirement to launch a full auction, the Takeover Panel argues that financial information should be made freely available to trigger (at the very least) a rival bid. Failure by a target company board to do so would, it is suggested, be viewed with suspicion. [69] The provisions address the most glaring loopholes seen in the

[63] *Corporations Act 2006* s 191.

[64] *Fitzsimons v R* (1997) 15 ACLC 666, 668.

[65] Takeover Panel, *Insider Participation in Control Transactions*, Draft Guidance Note No 19 (2007) [12].

[66] Ibid [13].

[67] Ibid [13].

[68] Ibid [18]. The protocols include determination that control over the bid rests with non-executive directors through an Independent Board Committee. IBC representatives should attend all meetings between participating management and bidder, ensure all communication between the bidder and participating management goes through IBS, require participating management to (temporarily) resign from executive or board positions and secure confirmation from participating management that no non-public information has been disclosed.

[69] Takeover Panel, above n 5, [21] ("Due to the competitive advantage such information gives a bidder with insider participants, the panel is likely to scrutinise very carefully, if is receives an application, the

current MBO expansion. It remains to be seen, however, whether the discussion documents change corporate practice. Significantly, while the chairman and chief executive of the utility company Alinta resigned because of the potential conflict, his counterpart in Qantas remains in place, oblivious (or dismissive) of the Takeover Panel deliberations.

B *Investing in Conflict*

As with other areas of governance, the regulation of financial services balances conflicting imperatives. Regulators strive to facilitate liquidity, depth and innovation while minimising the transaction costs associated with an incomplete or uncertain legal framework. A critical component for longer-term growth is the projection and maintenance of probity. The complexity of contemporary markets creates enormous oversight problems. These can only be addressed through the formal enrolment of financial intermediaries into the surveillance apparatus. This is far from unproblematic. By facilitating access to both products and markets, they act as 'gatekeepers' to an inherently conflicted space.

The capacity of these communities of professionals to engage in self-dealing detrimental to the interests of individual clients or, by extension, the integrity of the wider market system, is central to the articulation of fiduciary obligation.[70] In common with

circumstances and reasons given by target directors).' In contrast, the UK demands full disclosure, see City Code on Takeovers and Mergers, Rule 20.2. The Takeover Panel blames the variance on Australian case law, which precludes forced disclosure, see *Goodman Fileder No 2* (2003) ATP 5.

[70] The fiduciary obligation originates in trust, see *Meinhard v Salmon* (1928) 164 N.E. 545, 546 ('A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctillo of an honour the most sensitive is the standard of behaviour'). In its most absolutist form, the fiduciary must render her own interests subservient to those of her client unless provided for by informed consent, see *Bristol & West Building Society v Mothew* [1998] Ch. 1, 18 (Millet LJ).

compliance, fiduciary obligation is a remarkably elastic proposition. As Finn makes clear, ‘it is meaningless to talk of [generic] fiduciary relationships as such.’[71] The relationship requires three interlocking determinants: the binding (or perceived binding) obligation to act in the interests of another, without intermediating contractual provisions limiting the fiduciary’s independence to act.[72] These overrides make it exceptionally difficult to differentiate a breach from manifestation of standard (if sharp) industry practice.[73] The reliance of fiduciary obligations to prevent *institutional* self-dealing is weakened by the interaction between policy acceptance of conflicts of interest and the dominance of the integrated investment banking model.

The archetypal integrated investment bank provides a suite of services. These can encompass securities underwriting, due diligence investigations associated with Initial Public Offerings (IPOs), the provision of analytical reports for affiliated retail brokerage facilities or wider market dissemination, private client money management, private equity financing and proprietary trading – i.e. specific banking units trading on their own account. Risks correlate to wider market activity. Cyclical increases in mergers and acquisitions enhance both opportunity and capacity for investment houses to exploit inside information. The situation is exacerbated by confusion over at what precise stage investment banks owe fiduciary duties to their clients and whether these restrictions can

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[71] Paul Finn, *Fiduciary Obligations* (1977), 1.

[72] Ibid 9-13.

[73] See Kenneth Davis, ‘Judicial Review of Fiduciary Decision-making – Some Theoretical Perspectives (1985) 80 *Northwestern Law Review* 1.

or should be contracted out by sidebar arrangements.[74] While regulators in Australia have been careful not to become embroiled in deal specific controversies, there can be no mistaking the Takeover Panel's unease:

> The Panel does not intend to impede normal business transaction or relationships which are not relevant in the context of a control transaction. However, the Panel will be concerned if professional and other advisors who, by reason of their previous association with a target company have come into possession on non-public information seek to become part of an actual or potential bidding vehicle or bidding consortium.[75]

Recent market practice calls into question the limits of internally policed and validated codes of conduct in dealing with this problem.[76] Here in Australia, Macquarie Bank, for example, found itself in an overt conflict. The utility company, Alinta, to examine a range of strategic options, retained Macquarie, which then surfaced as a key advisor to the management-led buyout team. When the potential conflict was initially reported, both Macquarie and Alinta proclaimed that their actions were within legal boundaries. The bank sought to clarify its position but not before it had been very

[74] See Andrew Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interests' (2005) 29 *Melbourne University Law Review* 478.

[75] Takeover Panel, above n 4 [11].

[76] This remains a bulwark of regulatory policy. For the UK, see FSA above n 7, 85 (Even if a provider remains outside formal regulatory authority in the UK, it must comply with the FSA Code of Market Conduct. The FSA has formally warned the industry that it should 'pay particular attention to their dealing activities and the dissemination of information to ensure compliance. Participants should note that the Code not only applies in respect of instruments trading on particular markets but also to products that are closely related to such instruments': at 85). Whether compliance is an adequate framework is highly questionable, see Edelman, McBarnet and Miller, these proceedings; for a spectacular case involving its failure, see Randall Smith, Kara Scannell and Paul Davies, 'A Brazen Insider Scheme Revealed', *Wall Street Journal* (New York), 2 March 2007, C1 (reporting an insider trading case involving a lawyer working for the compliance department of Morgan Stanley relaying information to an analyst at UBS who, in turn forwarded it to a hedge fund manager at Bear Stearns).

publicly sacked and the chief executive officer resigned.[77] The actions of both the senior management and Macquarie in the Alinta case would appear to trigger regulatory concern and be outside the parameters of reconstituted acceptable practice.

C *Insider Trading and Market Manipulation*

A critical part of the regulatory infrastructure to curtail insider trading and market manipulation among financial intermediaries has been to foster the creation and maintenance of 'Chinese walls'. These impose a structural separation between corporate 'insiders' (e.g. those advising external corporations on mergers and acquisitions or running private equity funds) and 'outsiders' (e.g. those trading on behalf of clients or the bank's own account on the basis of publicly available information).[78] As a largely enabling system of corporate oversight, their origin, like many such innovations in corporate governance design can be traced to industry fear of formal regulation. The first corporate Chinese wall was created in the United States, for example, as part of settlement talks between the Securities and Exchange Commission and Merrill Lynch as early as 1968.[79] The resulting settlement was instrumental in the creation of the compliance industry if not necessarily the solution to the problem.

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[77] 'Alinta Boss Quits Over Management Buy-out Row', *Australian Financial Review* (Sydney), 12 January 2007, 1. This is a problem that crosses jurisdictions. In the United Kingdom, for example, Goldman Sachs was involved in the buyout of British Airports Authority just months after providing its board with strategic advice on how to rebuff such an approach

[78] The leading authority in the United Kingdom accepts that Chinese Walls can have a place, unless it can be demonstrated that controls work, there is an assumption that information will travel within the firm, see *Prince Jefri Bolkiah v KPMG* [1999] 2 WLR 215, 235 (Millet LJ).

[79] *Re Merrill Lynch, Pierce, Fenner & Smith Inc* (1968) 43 SEC 933. The voluntary system was made mandatory, see (US) *Insider Trading and Securities Fraud Enforcement Act 1988*.

The existence of Chinese Walls provided a corporate defence when insider-trading provisions were added to the Australian regulatory framework. The import was met with derision in the courts. The symbolic nature of the nomenclature was itself deemed part of the problem. One prominent jurist dismissed the defence as ‘an attempt to clad with antique respectability and impenetrability something that is relatively novel and potentially porous’.[80] Despite these concerns a parliamentary committee endorsed the mechanism. The report based its evaluation on industry assurances that ‘Chinese Walls can and do work. Insufficient evidence has been provided to suggest otherwise’.[81] A caveat was introduced, however: ‘It is evident though that if Chinese Walls are to be effective, rigorous compliance programs need to be in place and should be subject to the scrutiny of the regulatory agencies’.[82]

It is for this reason that a test case taken by the ASIC against the local division of Citigroup crystallizes fundamental issues of national and global significance. These impact directly on the issue of proprietary trading. The management of the case also vividly demonstrates the changing dynamics of regulatory policy. The case, which is scheduled for hearing in March 2007 has been brought to comprehensively test whether (and, if so, at what stage) the advisory role performed by an investment bank is fiduciary in nature.[83]

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[80] Roman Tomasic, *Casino Capitalism, Insider Trading in Australia* (1989), 89-90.

[81] Griffith Report, *Fair Shares for All, Insider Trading in Australia* (1989), 34.

[82] Ibid.

[83] See Michael Evans, ‘ASIC Chief Rejects Citigroup Defence’, *The Age* (Melbourne), 10 April 2006 (Online Edition). For a generic statement of regulatory enforcement principles, see ASIC, *A Guide to How We Work*, 7 <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/asic_guide_how_we_work.pdf/$file/asic_guide_how_we_work.pdf>.

Citigroup is alleged to have engaged in ‘unconscionable behaviour’ by trading in the shares of a corporation its client was planning to acquire.[84] Citigroup's Mergers and Acquisitions team had been advising Toll Holdings on an AU$ $4.6 billion bid for Patrick, a rival logistics and transport conglomerate. ASIC alleges proprietary trading in Patrick shares breached a fiduciary duty to act in its client’s best interest.[85] Citigroup has denied any wrongdoing. In a statement the global bank commented: ‘Citigroup doesn't believe ASIC has any basis of a claim and that this is an attempt to regulate the proprietary trading desks, which are a feature of all major investment banks.’[86] The anger within Citigroup about the charges is intensified because no individual trader has been charged with a predicate insider trading offence. ASIC protocols require the agency to prosecute insider trading to the fullest possible extent. This can include transferring prosecutorial authority to the criminal law realm through the enlistment of the Director of Public Prosecutions. This was not done in this case.

It is certainly arguable that the insider trading allegations did provide ASIC with leverage to force concessions from Citigroup. My understanding is that Citigroup was prepared to accept regulatory concern regarding the governance of proprietary trading. It

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[84] *Trade Practices Act 1977* ss 51AA, 51AC, 52; *Australian Securities and Investments Commission Act 2004* ss 12CA, 12CC. For review of development of ‘unconscionability’ in the Australian context, see B Horrigan, ‘Unconscionability Breaks New Ground – Avoiding and Litigating Unfair Client Conduct After the ACCC Test Cases and Financial Services Reforms’ (2002) 7 *Deakin Law Review* 73; P Finn, ‘Unconscionable Conduct’ (1994) 8 *Journal of Contract Law* 37.

[85] Citigroup’s own code of conduct states: employees should ‘determine when fiduciary duties arise and keep in mind that a fiduciary has a legal duty to act in the best interests of its clients – putting its clients ‘interests ahead of its own interests of the interests of its affiliates or employees’: at 8 <http://www.citigroup.com>; see also *ASIC v Citigroup Capital Markets Pty Ltd* (2006) NSD 651/2006, 20 December. . The statement of claim alleges Citigroup: ‘preferred its own self-interest in maintaining its relationship with Toll free from a perception by Toll that Citigroup’s Chinese walls had failed to its duty to inform Toll of Citigroup’s involvement in the trading of Patrick shares’: at 24.

[86] Justin O’Brien, ‘Insider Trading Case to Test Chinese Walls’, *Irish Times* (Dublin), 1 May 2006, 16.

would also have been willing to accept the equivalent of a 'cease and desist order' as long as it did not have to admit liability.[87] Furthermore, it was prepared to accept an enforceable undertaking. Its attempts to reach a compromise with ASIC, however, were spurned. Only two discussions were held in advance of the formal launch of the civil proceedings in March 2006. According to a highly placed source, "Toll has not complained and in one sense this is a victimless crime. On the other hand, if there is a victim it is Citigroup which has been treated egregiously in a public relations battle based on misinformation."[88]

In large part, the case will turn on whether the conflicts management systems in place worked. ASIC claims that because senior management failed to contact Toll about trading after internal discussions in which opposing positions were expressed demonstrates that Citigroup put its own interests in front of the client. This exchange is at the heart of the fiduciary duty claims. The bank counters that the very fact that the discussion took place demonstrates the credibility of its system of oversight. It acknowledged a potential conflict, discussed the detail and ramifications and then resolved no conflict in fact existed.[89]

There is no doubt that lodging a claim against Citigroup gives the Australian regulator enormous potential capacity to force changes to industry practice. By

[87] One source involved in negotiations with ASIC suggested that the agency could not understand the bank's refusal to accept an undertaking. After all, the bank had "admitted to far worse things overseas." This account tallies with the assertion by a senior ASIC representative to the author last October that it was unlikely that the case would come to trial. If that really was the dynamic governing ASIC's calculation, however, it was misguided. In none of the global cases in which Citigroup has found itself under investigation has it ever admitted liability.

[88] Interview, Sydney 5 March 2007.

[89] Ibid. Sources in Sydney suggest that the bank will argue that not only did the system work but also that the predicate insider trading case can be defended by reference to demonstrable trading patterns.

replicating the more aggressive model of enforcement seen recently in the United States, ASIC is also narrowing the gap in national regulatory priorities. The muscular approach also dovetails with attempts to synchronize the enforcement agenda of the International Organization of Securities Commissions (IOSCO). To be effective, however, requires common operating framework. One of those closely involved in the management of the Citigroup case suggests that 'this is a case of the empire striking back. If ASIC thought that it could take on the biggest bank in the world on a flawed prospectus it was startling naïve.'[90] The source continued that in investment banking terms, 'being accused of insider trading is similar to being accused of a paedophile.'[91]

This raises a crucial question that has dominated these proceedings: Where does the optimal enforcement balance lie? If ASIC was concerned primarily with generating new protocols, does the transfer to the court arena enhance or stymie that objective? Is a test case the appropriate way to reconstitute the relationship between pivotal actors in policy rationale, design and subsequent surveillance? Or does it represent regulatory overreach?

V THE DYNAMICS OF REGULATORY REFORM

The management of conflicts of interest has become one of the controversial issues in financial markets regulation. Significant contestation persists over the necessity or wisdom of introducing more restrictive controls. The increasingly prescriptive approach to control mechanisms undermines many of the core theoretical assumptions

[90] Interview, Sydney 5 March 2007.

[91] Ibid.

underpinning the entire governance agenda. It suggests the imposition of externally imposed rules is preferable to and more effective than internally devised responsive solutions. The displacement of consultation by litigation may improve industry practice by enhancing the base formal criteria of a compliance program. The use (or threat) of coercion also partially undermines the inculcation of norms necessary for ethical management by causing key institutional players to retreat into ideational silos. From a policy dynamic perspective, this is the most troubling aspect. As a consequence the opportunity to debate the more fundamental problem of how to secure better ethical performance is lost. Changed ideational discourse, particularly in the United States, demonstrates the contingent nature of regulatory authority. It also highlights the difficulties posed in designing an integrated regulatory approach capable of counteracting the power of well-organised interest groups with the capacity to set the wider political or media agenda.

The creation of a Private Equity Council in Washington on 26 December by the premier funds - including Blackstone, KKR and Carlyle – is an indication of just how important it has become to pro-actively manage the policy process.[92] Private equity funds have also sought to influence the wider debate through a series of funded research initiatives and the establishment of extensive lobbying networks.[93] In this they are following a well-worn path. Redefining the essential problem as enforcement proclivity reconfigures policy outputs into more acceptable outcomes. This is made much easier if

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[92] Carlyle Group, 'Private Equity Council is Formed to Provide Research and Information' (Press Release, 26 December 2006) <http://www.carlyle.com/eng/news/l5-news3673.html>

[93] Private equity funds announced a two million dollar research project at the World Economic Forum in Davos. It will be coordinated by the Dean of Columbia Business School, Glenn Hubbard. Here in Australia, the Australian Private Equity and Venture Capital Association has retained professional consultants to provide research demonstrating the added value provided by private equity.

the normative as well as evidential basis for recalibration has tacit support at the highest political levels.[94]

Here the involvement of the US Treasury Secretary in the thematically linked collection of reports alluded to by Professor Coffee and Professor Hill in these proceedings is instructive. This support was overtly signalled in a pivotal speech delivered last November. Mr Paulson warned that three critical dysfunctions threatened the competitiveness of US capital markets: 'a complex and confusing regulatory structure and enforcement environment'; the costs associated with the implementation of governance reform, particular internal controls mandated by Sarbanes-Oxley; and continued litigation risk.[95]

Paulson, who took up the Treasury portfolio after a long and distinguished career at Goldman Sachs, was careful to endorse the need for criminal and civil law enforcement. He raised, however, serious concerns that competition between state and federal agencies to demonstrate muscularity in enforcement against corporate entities had become counter-productive. The pursuit of wrongdoing was 'worthy, necessary and acceptable,' Mr Pauslon intoned.[96] A vital caveat was introduced, however. 'When multiple jurisdictions and entities are involved, each with their own objectives and approaches, the enforcement environment can become inefficient, and, to the regulated, can appear threatening and confusing.' It is perhaps not surprising that Committee on Capital Markets Regulation mirrors the Paulson format. Paulson himself followed a

[94] See Cox, above n 14.

[95] Paulson, above n 12.

[96] Ibid.

template set by the prime drivers of the Committee when they pre-announced the research agenda and its conclusions three weeks before the Paulson speech in New York.[97]

Mapping how ideational discourse is framed within the realm of private equity requires detailed analysis. How are different constituencies organising and mobilising themselves. How is change in one jurisdiction experienced elsewhere? How are pressures to reform regulatory practice transmitted from one jurisdiction to another, and by which methods? What is the mediating impact of intervening variables, such as national structures, institutions, political preferences and societal interests? Such an exercise is, however, beyond the limited scope of this paper (and indeed this conference) in large part because we are at such an early stage in the private equity cycle.

VI CONCLUSION

As this paper has demonstrated, the expansion of private equity poses a series of inter-connected risks to both the corporate governance paradigm and to the regulation of the markets. Whether individual corporations undertake novel financing arrangements or acquiesce to excessive debt levels are, of course risk appetite decisions best left to the business itself. In that regard, for example, the Federal Government's decision to allow the Qantas sale to proceed, given that it did not breach legal restraints, was both rational and, in the circumstances, justified. What the takeover boom has also demonstrated, however, is the paucity of guidance to ensure that appropriate checks and balances are in place to limit managerial incentives to de-list.

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[97] See generally, Justin O'Brien, 'Testing the Limits of Authority', *Australian Financial Review* (Sydney), 19 January 2007, R3-4.

The policy advice provided by the Takeover Panel here in Australia represents a credible attempt to close down some of the loopholes. It also highlights the critical importance of linking abstract principles to granular articulations of what these principles mean in practice. This goes some way to ensuring that potential directorial abuses are minimised and that shareholder interests will be protected. This does not solve, however, the wider question of the impact of private equity on the wider corporate governance paradigm. Public listing provides a mechanism to reinforce the softer conceptions of governance associated with stakeholder rights, if only because there are opportunities to hold the company to account. An expansion of private equity may also lead to an erosion of conceptions of corporate social responsibility not least because success is measured on strictly financial terms.

A more difficult regulatory challenge is how to link acceptance of market risk with the development of more sophisticated mechanisms to ensure it is carried out within acceptable levels of probity. The transaction fees involved certainly raise at least the prospect that internal restraining mechanisms may not be powerful enough to ensure effective due diligence. This problem pertains throughout the investment cycle, from provision of strategic advice to rebuff or acquiesce in a leverage buyout, through to the IPO allocation when private equity seeks to dispose of the asset. The increasing involvement of investment banking in the management of private equity funds reinforces the potential problems.

The difficulties are magnified precisely because regulators have been placed increasingly on the defensive over the limits of regulatory authority. Just as private equity providers have only themselves to blame for poor media management of their personal

lives, strategic miscalculations on the part of the regulator can lead to seepage of media and political support. Private equity doers offer many benefits, not least the possibility of energising tired corporate models. It also poses substantial risks. How it should be regulated is a matter of profound public concern. What is required is sustained engagement between regulators, the professions and market participants. This debate is a vital component of the due diligence necessary to moderate the forces of creative destruction unleashed across global financial markets.