Scott Rogers
Competition and Consumer Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

10th October 2008

Dear Mr. Rogers,

Below I respond to issues raised by The Treasury's recent discussion paper *Creeping Acquisitions* (hereafter *CA*), specifically on conceptual frameworks for mergers & acquisitions (M&A), the importance of competition dynamics, market and industry models, the role of notification requirements for M&A, and the Australian Competition & Consumer Commission's (ACCC) 'With or Without' test. This submission is made on a personal basis as an interested party.

1. Mergers & Acquisitions

1. The Treasury proposes three broad rationales in *CA* clause 3 for M&A activity: firm efficiencies within markets, risk diversification driven by corporate strategy and portfolio management, and asset utilisation. The Treasury also identifies execution strategies in *CA* clause 4 for new management in post-M&A integration: low cost and differentiated competition, innovation and technological drivers, operational transformation through process management, and more efficient managerial decision-making.

2. Policymakers need to distinguish mergers from acquisitions as decision-makers may undertake each for different reasons. Merger triggers can include macroeconomic business cycles, exchange rate volatility, industry structure, inter-firm competition that affects a firm's capital structure, global offshoring/outsourcing and regulatory decisions such as industry deregulation or intermediation. Acquisitions in contrast are driven by "make-or-buy" decisions; valuation of intangible assets, intellectual rights and technology transfer; and opportunity scoping for industry white-spaces. Mergers may signify industry consolidation and cross-border integration; acquisitions may signify new market growth and foreign direct investment. M&A booms in the United States and Europe over the past decade also illustrate the role of the global financial architecture and the international political economy.

3. A significant reason for these differences is that the core disciplines involved in M&A opportunity evaluation—notably economics, finance, taxation and risk management—each have a different view and weighting of the risk spectrum (risk-averse, risk-neutral, risk-seeking, blind-spots, wild cards).[1] The subtle effects of these differences range from decision rules and go/no-go criteria in due diligence to staff selection for M&A teams and strategic repertoires when a firm is 'in play' for an M&A. 'Thought leadership' in M&A policy and regulatory development is thus informed by a holistic and transdisciplinary approach, in which the rich insights and innovations from each discipline will drive knowledge creation in an integrative, reflective manner.[2]

2. Competition Dynamics, Market & Industry Models

4. The above factors and trends highlight the importance of competition dynamics, market and industry models in modelling M&A outcomes. These function at micro, meso and macro levels respectively. In this modelling framework, the *Trade Practices Act 1974 (Cwlth)* (hereafter *TPA*) Section 50 operates at the micro and macro levels. *CA* clause 22 supports this interpretation through the Dawson Review's structural separation of competition and industry policies.

5. The holistic and transdisciplinary approach above might suggest that the structural separation of competition and industry policies is artificial. A second-order effect is that this may lead to regulatory gaps and inadequate institutional responses where regulators are constrained compared to M&A teams, and market failure later occurs.[3] Incentive problems, "anticompetitive" effects and "significant consumer detriment" outcomes mentioned in *CA* clause 7 are all relevant at the micro level of competition dynamics and the meso level of markets. However they cannot deal necessarily with the macro level of industries nor the broader issues mentioned below.

6. Thus, whilst I agree with *CA* clause 14 that "market definition" is crucial, the definition of markets in *TPA* subsection 50(6) no longer captures the complexity of markets, notably for cross-border M&A and for market creation in new industries. Whilst *CA* clause 13 acknowledges that *TPA* subsection 50(3) "prescribes a non-exhaustive list of factors" the range, strategic repertoire and weighting of these factors underpins the decision-making process for M&A teams and regulators. Notably *TPA* subsection 50(3)(g) defines "market dynamics" which are important for the ACCC's 'With or Without' test in *CA* clause 12.

7. The Treasury summarises two possible models to supervise and intervene in creeping acquisitions: the "aggregation model" and the "substantial market power model".

   The "aggregation model" in *CA* clauses 27 & 28 relies on the scenario mentioned in *CA* clauses 18, 23& 33 of supplier-driven acquisition of smaller firms who have a small market share. *TPA* subsection 50(3) supports this through specific factors to prevent monopsonies: "market concentration" (c), "countervailing power" (d), "price and profit margins" (e), minimal "substitutes" (f), "removal from the market of a vigorous and effective competitor" (h), and "vertical integration" (i).

   The "substantial market power model" in *CA* clauses 29, 30, 31 & 32 focuses primarily on the prevention of price-fixing, collusion, and oligopolies with Bertrand price equilibrium. This model reflects traditional explanations in corporate finance and managerial economics, and not contemporary strategies in risk management and taxation law to structure deals and competitive dynamics in markets.

   The holistic and transdisciplinary approach above suggests that there are other models of creeping acquisitions, notably M&A transactions with cross-border, unusual deal structure and special purpose vehicle elements.

8. *CA* clause 20 cites the Baird Committee's concern in 1999 about the survival of independent grocery firms, and clauses 24 & 25 outline the ACCC's Grocery Inquiry. The ABC *Four Corners* report "The Price We Pay" (28th August 2008) confirms the ACCC's concerns about small firm acquisitions.[4] However, *Four Corners* raises further concerns: Woolworths' use of operations strategies from the US retailer Wal-Mart which create supply chain efficiencies yet affect local competition, Coles' price-taking effects in wholesale markets, upstream control of farmers and growers, downstream effects on farmers markets as substitutes, and policy differences between the ACCC's Graeme Samuels and Allan Fels on when regulatory intervention is necessary. The *Four Corners* report echoes Robert Greenwald's earlier documentary *Wal-Mart: The High Cost of Low Price* (2005).[5] Whilst the debate about Wal-Mart's practices continues, it also illustrates the influence of cross-border and international factors in M&A strategies.

9. Both of the Treasury's proposed models may be circumvented through the exploitation of differences in market definitions, policy scope and application, and factor analysis for go-to-market execution. M&A firms can achieve this via deal structure, asset plays and new market definitions, informed by complexity models of economic and market dynamics.[6] Incumbent firms can achieve this via alternatives to acquisitions, notably incentive and performance-based contracts, selective complementors and strategic alliances in value chain networks, and private knowledge.

   As the Dawson Review foresaw in 2003, noted in *CA* clause 21, the second strategy avoids the asset, share and contract elements of *TPA* subsections 50(1), 50(2), 50(4) and 50(6). Private knowledge in M&A negotiations, together with the lack of notification requirements, could mean that M&A firms structure a deal to avoid *TPA* subsections 50(1) and 50(2) through special purpose vehicles (SPVs). *TPA* subsection 50(4) may also be limited if the M&A firm negotiates and structures a deal prior to clearance, or if the acquisition is a private entity (a significant motivation for private equity as an asset class and deal outcome).

   A first interpretation of the *Four Corners* report is that industry players factor the decision-making models and worldviews of regulatory staff into their corporate and implementation strategies. This enables M&A firms and incumbents to escalate strategies within legal boundaries which do not trigger regulatory intervention.

   A second interpretation is that despite the ACCC's powers in *CA* clause 11 and its awareness of "sufficient competitive tension" in *CA* clause6, the ACCC may be cautious about "taking enforcement action", which the M&A firms understand and use to structure deals. Independent research and review of the ACCC's reasons for its decisions cited in *CA* clause 6 might clarify this further, and isolate the specific circumstances under which the ACCC has demonstrable "willingness to act" in regulatory intervention.

   A third interpretation is that M&A firms have more experience with M&A's core disciplines and staff expertise, and are thus able to outpace the ACCC and other regulatory bodies.

10. *CA* clause 35 cites a need "to limit the impact of these additional or amended merger tests on the resources of the ACCC and the merger parties." One alternative way to achieve market disclosure and to minimise the resources impact on the ACCC is through the involvement of other interested parties in the M&A ecosystem that provide an information revelation function, notably the financial media outlets (*Australian Financial Review*, Bloomberg, CNBC, Sky News Business) and media monitor firms (LexisNexis Australia, Media Monitors). This is despite the fact that financial media outlets can also create distortions in micro level competition dynamics and meso level markets.[7]

3. M&A Notification Requirements & 'With or Without' Test

11. The lack of a notification requirement with the Australian Competition & Consumer Commission poses a significant challenge for regulatory supervision of creeping acquisitions. On the one hand, it reflects a monetarist stance of minimal intervention in markets, and a reduction in the administrative and regulatory burden that could halt deal flow. However, it also potentially introduces distortions into markets that signify broader issues for regulatory supervision and intervention:

    - Delays and gaps in information revelation and market pricing
    - Information asymmetries in underwriting, securitisation and offerings
    - The possibility of principal-agent, insider trading and governance problems
    - 'Noise' in media coverage and rumour markets in the financial services sector[8]
    - 'Winner's Curse' outcomes in M&A auctions[9]
    - Barriers to regulatory supervision of short-selling and 'over the counter' transactions compared to exchange markets
    - Offshore special purpose vehicles (SPVs) or off-balance sheet special investment vehicles (SIVs) that are part of an M&A capital restructure may not be disclosed

    Collectively, these factors suggest far more complex dynamics in the Australian economy rather than the weak-form Efficient Market Hypothesis view alluded to in *CA* clause 4 on the importance and role of M&A. In the US and European M&A booms of the past decade, these factors have fuelled risk-seeking behaviour and speculation opportunities for event-driven hedge funds, tactical asset allocation strategists, arbitrageurs, and financial media outlets.[10] In turn, this has led to speculative bubbles, firm collapses, market failures and systemic problems that go far beyond the single issue of creeping acquisitions.[11]

12. This context plausibly confirms why, as *CA* clauses 9 and 10 observe, the Australian Competition Tribunal has not been contacted since January 2007 to assess or clear potential M&A. Teams largely prefer to conduct their negotiations in private, and to minimise regulatory supervision that might detrimentally affect deal structuring and underwriting.

13. Notification requirements might be considered for M&A in specific scenarios, such as critical infrastructure and national security, sustainability, critical technology transfer, and employee superannuation benefits. Where relevant, this should be harmonised with other regulatory agencies, and with other relevant legislation such as anti-trust and corporations law. In particular, this could strengthen the links between competition, industry and innovation policies on a context-driven basis, and deter the information asymmetries that may cause adverse selection and market failure.

14. This submission has suggested several strategies to strengthen the analytical foundations of the ACCC's 'With or Without' test and evidence-based policy decisions without imposing a regulatory burden on financial markets nor stifling M&A and other financial innovation.

    In summary, the forward-looking capability of the 'With or Without' test must be anticipatory and *prospective* in nature. I have referred to speculative bubbles, firm collapses, market failures and systemic problems, in part, because they demonstrate the broader significance of regulatory decisions in this *prospective* view. In terms of creeping acquisitions, the Treasury's two models must be augmented by other scenarios and escalation frameworks of creeping acquisitions that more sophisticated M&A deals might trigger. The ACCC might also want to clarify the specific circumstances in which it would intervene, and how it evaluates the impacts in a complex multi-stakeholder system.

    To achieve this outcome, the ACCC, the Australian Competition Tribunal and other regulatory bodies could draw on the transdisciplinary and holistic understanding of the M&A body of knowledge to inform their regulatory approaches. Recent innovations in anticipatory management, foresight in financial institutions, and dynamics (competition, market and industry level) could also be integrated. These dynamics have important effects for legislation, efficient markets, and the scale and scope of regulatory supervision and intervention.[12] The Australia & New Zealand School of Government might provide one appropriate venue for this dialogue to occur between M&A specialists, industry representatives, consumer groups, policymakers and regulators.

I thank the Treasury for having an opportunity to offer input on this intriguing issue.

Sincerely,

Alex Burns
alex@alexburns.net

---

[1] Damodaran, Aswath. *Strategic Risk Taking: A Framework for Risk Management*. Upper Saddle River, NJ: Pearson Education Inc., 2008, p. xviii.

[2] Bernstein, Peter L. *Against The Gods: The Remarkable Story of Risk*. New York: John Wiley & Sons, New York, 1998.

[3] Akerlof, George. 'The Market for 'Lemons': Quality Uncertainty and the Market Mechanism.' *Quarterly Journal of Economics*, vol. 84, no. 3 (1970), pp. 488—500. Heller, Michael. *The Gridlock*

Economy: How Too Much Ownership Wrecks Markets, Stops Innovation, and Costs Lives. New York: Basic Books, 2008.

[4] Long, Stephen. "The Price We Pay", *Four Corners* (28th August 2008). Sydney, Australia: Australian Broadcasting Corporation. Accessed 10th October 2008, http://www.abc.net.au/4corners/content/2008/s2348906.htm

[5] Greenwald, Robert. *Wal-Mart: The High Cost of Low Price*. Culver City, CA: Brave New Films, 2005. Accessed 10th October 2008, Accessed 10th October 2008, http://www.walmartmovie.com/ . Greenwald, Robert. *Supermarket Swindle*. Culver City, CA: Brave New Films, 2005. Accessed 10th October 2008, http://supermarketswindle.com/ .

[6] Beinhocker, Eric D. *The Origin of Wealth: Evolution, Complexity and the Radical Remaking of Economics*. Random House, New York, 2006.

[7] Schuster, Thomas. *The Market and the Media: Business News and Stock Price Movements*. Lanham MD: Lexington Books, 2006. Blodget, Henry. *The Wall Street Self Defence Manual*. New York: Atlas Books, 2007. Frank, Thomas. *One Market Under God*. London: Vintage Books, 2002.

[8] Black, Fischer. 'Noise.' *Journal of Finance*, vol. 41 (1986), pp. 529—543.

[9] Burrough, Bryan & John Helyar. *Barbarians At The Gate: The Fall of RJR Nabisco*. London: Penguin Books, 1990. Thaler, Richard. *The Winner's Curse: Paradoxes and Anomalies of Economic Life*. New York: The Free Press, 1992.

[10] Drobny, Stephen. *Inside the House of Money: Top Hedge Fund Traders on Profiting in the Global Market* (2nd ed). New York: John Wiley & Sons, 2009.

[11] Bookstaber, Richard. *A Demon of Our Own Creation: Markets, Hedge Funds and the Perils of Financial Innovation*. New York: John Wiley & Sons, 2007. Lowenstein, Roger. *When Genius Failed*: *The Rise and Fall of Long-Term Capital Management*. New York: Random House, 2001. Taleb, Nassim Nicholas. *The Black Swan: The Impact of the Highly Improbable*. London: Allen Lane, 2007. Taleb, Nassim Nicholas. *Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets*. London: Penguin Books, 2005. Morris, Charles R. *The Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash*. New York: PublicAffairs, 2008. Soros, George. *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What It Means*. New York: PublicAffairs, 2008. Einhorn, David. *Fooling Some of the People All of the Time*. New York: John Wiley & Sons, 2008. Muolo, Paul & Matthew Padilla. *Chain of Blame: How Wall Street Caused The Mortgage and Credit Crisis*. New York: John Wiley & Sons, 2008. Shiller, Robert J. *The Subprime Solution: How Today's Global Financial Crisis Happened and What to Do About It*. Princeton, NJ: Princeton University Press, 2008.

[12] Vaidhyanathan, Siva. *The Anarchist in the Library: How the Clash Between Freedom and Control Is Hacking the Real World and Crashing the System*, New York: Basic Books, 2004.