SNOWBALL EFFECT
Back a Kiwi Business

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Takeovers Panel
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Small Code Companies and the Code

1. Introduction

1.1. Thank you for the opportunity to provide submissions on the matters raised in your consultation paper. We believe there is a demonstrable problem, and that a policy change would:

a) Achieve the Panel's objectives; and

b) Deliver benefits for both small Code companies and their shareholders.

1.2. We consider that each of:

a) the independent advisor report; and

b) the additional costs of Code compliance,

cause a demonstrable problem for small Code companies that requires policy change.

1.3. We suggest that the problem should be approached in the same way as the law has successfully approached the probity and fairness assurance provided by audit for more than a century. That is, shareholders have a right to the assurance provided by mandatory audit. But they can save their company the expense and trouble by putting that right into suspense until there are circumstances that seem to them to demand it. Moreover, the right can be brought out of suspense if only a small minority of shareholders want it.

1.4. Accordingly, we recommend that small Code companies should be able to choose whether to incur the cost of Code compliance on a transaction by transaction basis. The board should decide whether or not to apply the normal Code compliance process (there would be circumstances where the board might prefer the reassurance of the Code compliance process, including an independent review and report, and they could elect to get it). But if holders of 10% or more of voting shares elect to opt in, that would override a board preference to opt out.

1.5. We provide further comments and observations below.

2. Background

2.1. Our perspective on these matters has been informed by discussions with over 500 companies looking to raise funds through equity crowdfunding. Based on New Zealand and offshore experience, we believe that most companies raising funds through equity crowdfunding will become small Code companies after the capital raise is completed. We believe that Code compliance is likely to be a widespread and significantly discouraging issue for small companies raising funds through equity crowdfunding.

2.2. We have consulted with various lawyers and other equity crowdfunding participants.

2.3. Our submissions have been prepared with input from Snowball Effect's two non-executive directors, Stephen Franks and Alastair Lawrence. Stephen is a securities and company law expert, and Alastair is a career merchant banker and former Takeovers Panel member, with extensive experience in investing in small companies.

3. Current solutions for small companies

3.1. We consider there to be 2 current options to avoid becoming a Code company by raising funds though equity crowdfunding - corporate structuring to avoid the Code, and issuing non-voting shares.

3.2. We have discussed the use of corporate structuring (by using a nominee company as a single new shareholder) to avoid becoming a Code company with many companies, however they have generally been unwilling to progress that option for the following reasons:

a) It would add complexity to the capital raise process for investors.

b) The nominee company would become a Code company, potentially causing problems for future capital raises, private share sales, and director / employee / contractor remuneration.

c) It would reduce the "intimacy" between a company and its shareholders, diminishing the shareholder support that many companies want to harness from equity crowdfunding.

d) Additional cost and complexity with listing on a secondary market or capital raising in the future.

3.3. We think that corporate structuring to avoid the Code is not a suitable long term solution for small companies.

3.4. We have discussed the option of issuing non-voting shares to avoid becoming a Code company with many companies, however they have generally been unwilling to progress that option for the following reasons:

a) Non-voting shares are likely to be perceived less favourably by investors, reducing the chance of a successful capital raise.

b) Small companies generally prefer to have only one class of shares on issue.

c) It would reduce the "intimacy" between a company and its shareholders, diminishing the shareholder support that many companies want to harness from equity crowdfunding.

d) Additional cost and complexity with listing on a secondary market or capital raising in the future if there is more than one class of shares on issue.

3.5. We think that issuing non-voting shares to avoid the Code is not a suitable long term solution for small companies.

3.6. We do not believe that the current options for avoiding becoming a Code company are suitable long term solutions for small companies. Further, we think that companies should not make important (and potentially detrimental in the longer term) decisions about corporate and capital structure simply to avoid becoming a Code company.

4. Benefits of Code compliance for shareholders of small companies

4.1. In our experience, small Code companies are often involved in the following types of transactions:

a) Large shareholders buying small parcels of shares in response to small shareholder requests for a variety of reasons, including the need to create liquidity or in rescue circumstances.

b) Large shareholders receiving employee / director / contractor remuneration through shares.

c) Equity capital raises such as rights issues which result in large shareholders increasing their relative shareholdings, or where large shareholders underwrite a share issue.

d) Capital raising through private placements to existing shareholders, or private placements in excess of 20% to third parties.

4.2. For small companies, a number of problems arise from Code compliance in these circumstances, such as:

a) Disproportionate cost: As described below, we consider that normal Code compliance can cost upwards of $50,000, not including management time that is diverted from other activities. Of the more 500 companies we've spoken to in the context of equity crowdfunding, the vast majority are loss-making or have profitability of less than $200,000. For small Code companies, compliance would typically result in significant erosion of shareholder value.

b) Erosion of shareholder value through delay: Small companies are generally higher risk ventures by virtue of their scale and stage of development. Major shareholders are often the ones who are asked, and who are in the best position in terms of knowledge, to provide financial support in times of urgent need. Under the normal Code compliance process, the company would seek legal advice, talk to independent advisors, agree terms of reference, seek Panel approval to appoint an advisor, get the independent report completed, hold a shareholder meeting, and execute the decision. In our experience, this process can take around 8 weeks, not including the time taken to find an independent advisor, agree terms of reference, and seek approval from the Panel. Where capital is required urgently, as commonly occurs with small companies, the transaction needs to progress quickly if the company is to be saved. Small companies could easily collapse as a Code compliance process runs its course, destroying shareholder value. Erosion of shareholder value is a cost that we consider the Panel should take into account alongside the cash costs.

c) Challenges for independent advisors: Valuing certain small companies can be inherently difficult as a result of a number of factors, including the level of uncertainty relating to its position and prognosis, and the quality and reliability of financial information. For instance, accounts will not necessarily be GAAP compliant, and may not be audited. And the informality of vital information sources and dependence on very few people (for example in appraising the value of a client list, or the forward work flow) is likely to make valuation more difficult. Some independent advisors will not want take on this type of job, leading to delay in agreeing terms of reference with an independent advisor.

   Those who take on such a job will tend to price in the risk through increased cost and heavier qualification of the report and valuation, which could necessarily be covered in a very wide range. We would question the benefit or value of an opinion to shareholders in those circumstances versus the costs of procuring that report.

   The problem can be exacerbated if independent advisors are uncertain about the company's ability to pay, which could necessitate some form of surety from the company, which it may struggle to provide. If the company cannot provide such surety, the independent advisor may require surety from large shareholders, which may appear to taint the independence of the report.

   Further, a company may be unable to comply with the code because it cannot locate an independent advisor prepared to take on the mandate.

4.3. For the majority of transactions, we consider the costs of Code compliance to be prohibitive for small Code companies. As a result, we think that imposing the regime on small companies is a significant deterrent for companies looking to raise capital through equity crowdfunding. For the remaining transactions, given the size of companies we are dealing with, we consider the costs of Code compliance to be disproportionate to the value of the transaction and the benefits for shareholders.

4.4. It is worth considering a further problem in actual takeover situations. Shareholders of small, high growth companies often agree terms regarding drag and tag rights. Smaller shareholders contractually agree to be obligated to exit on the same terms if a certain percentage of shareholders wish to sell. These arrangements are highly suitable for small, high growth companies, and these contractual arrangements conflict with Code provisions in actual takeover situations. To that end, we believe that the proposed solution should also apply to takeover situations. We consider that while the board and shareholders have an option to comply with the normal code process, shareholders in small Code companies are appropriately protected. Further, the possibility of opt in should be prophylactic, diminishing incentives for unsavoury or exploitative offers, without forcing the cost of the procedure on small companies.

5. Costs of Code compliance for small companies

5.1. We consider your definition of "small Code company" to be appropriate.

5.2. We agree with your view that size of company is the relevant consideration (rather than method of capital raising).

5.3. We consider the costs of an independent advisor report to be underestimated. While $20,000 to $30,000 may be the Panel's usual experience, we expect that figure to be significantly higher for small Code companies. We are certain that there will be significantly more work and judgment required from an independent advisor for some small Code companies. That is an inevitable result of the inability to apply common templates for valuation without substantial preparation. There are inherent uncertainties with small companies, lower quality of financial information, and more diligence required in an attempt to verify that information or convert it to a suitable form. The increased risk to an independent advisor will be priced in the fees, heavier qualification of the report and valuation, or simply by refusing to provide the service.

5.4. We consider that the costs of Code compliance additional to the independent advisor report will typically range from around $15,000 to $30,000. These costs include legal advice, administration costs, Panel costs, and shareholder meeting costs. A further opportunity cost is incurred through senior management time being diverted from other activities. In small and thinly-resourced companies, this cost can be material.

5.5. In relation to the potential benefits for shareholders of small Code companies, we consider that each of the independent advisor report and additional costs of Code compliance cause a demonstrable problem that requires policy change.

6. Proposed solutions in the consultation paper

6.1. We don't think that the preferred solutions in the consultation paper would achieve the Panel's objectives:

a) Option 1 would not be effective given the demonstrable problem.

b) Option 5 would still cause significant cost and delay, and would not provide shareholders with any significant benefit.

7. Recommendation

7.1. We think that small Code companies should comply with the Code. However the board should have the ability to opt out on a transaction by transaction basis, and shareholders should have the ability to override a board decision to opt out. We suggest the following process:

a) If a transaction triggers a Code compliance process, the board must determine whether it's in the best interests of the company to opt out of normal Code compliance for that transaction.

b) If the board decides to opt out, it must complete a prescribed form which sets out the details of the proposed transaction and includes details of any associated interests in the transaction. The form is circulated to all shareholders, who have 10 days to opt in to normal Code compliance for the proposed transaction.

c) If 10% or more of voting rights opt for normal Code compliance for the proposed transaction, the transaction must proceed with normal Code compliance (or be abandoned).

7.2. We think that this option would best achieve the Panel's objectives:

a) It would clearly reduce compliance costs for small Code companies.

b) It would clearly maintain a proper relationship between the costs of compliance with the Code and benefits resulting from it, because the board and shareholders have the opportunity to decide whether the benefits of normal Code compliance are worth the cost on a transaction by transaction basis.

c) It would ensure that shareholders are treated fairly and are provided with sufficient information so that they can decide for themselves whether the circumstances put them on enquiry about the merits of a transaction on matters that would be addressed by Code compliance. If shareholders do not feel they are being treated fairly or have sufficient information, they can opt to receive further information on the merits of the transaction. The board discipline in summarizing salient features would be incentivized by the risk that 10% decide to get the extra assurance.

7.3. We think that the proposed solution provides sufficient checks and balances for all small Code company transactions, including takeover transactions.

7.4. We think that this solution has clear precedent in other regulation:

a) NXT market rules contain similar opting provisions for shareholders in relation to transaction announcements.

b) Company law contains similar opting provisions for shareholders, such as for audit requirements, annual meeting requirements, and electronic communication options.

7.5. We welcome your comments on our recommendation, and would appreciate the opportunity to discuss subsequent details such as the prescribed form.

Yours sincerely

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Snowball Effect