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Small Code companies – further consultation paper

1. Introduction

- 1.1. Thank you for the opportunity to provide submissions on the matters raised in your consultation paper “The Preferred Option”.
- 1.2. The Panel’s proposed exemption relates to capital raising transactions. We are equally concerned about the disproportionate or prohibitive costs involved with other change of control transactions. We believe the proposed exemption only solves a small subset of the problems that have been demonstrated.
- 1.3. To provide effective relief for small Code companies, we recommend that the proposed exemption is extended to cover all transactions, unless either the board or 10% or more of voting rights opt for normal Code compliance for a particular transaction.
- 1.4. This extended exemption would rightly place control within the hands of the shareholders the Code is designed to protect. The board and shareholders can then make commercial decisions about whether normal Code compliance is preferable for each applicable transaction.
- 1.5. This extended exemption is similar to the historic Code exemption for small companies, where small companies were excluded from the definition of a Code company and therefore all transactions were exempt. The differences are:
 - a) We understand the key reason for removing the historic exemption was concern about companies abusing the “small” threshold. This concern is removed by the introduction of a bright line valuation test for “small Code company” as the Panel has suggested.
 - b) Our suggestion goes much further than that original exemption by providing two layers of protection. First, the board must resolve that opting out of the normal Code process is in the best interests of the company. Second, shareholders can force the normal Code process by 10% or more of voting rights opting for normal Code process for a particular transaction. All that is being exempted is the mandatory requirement to go down the Code process path.
 - c) And the Panel could consider a further condition. An exemption could be made subject to any contrary provision in a constitution. If investors think the Code protections warrant the costs, they could require the constitution to negate the exemption. The extent to which companies opted for such prior opt in as an assurance to investors would be valuable information for the Panel over time.
- 1.6. We provide further comments and observations below.

2. Definition of small Code company

- 2.1. We are comfortable with the Panel's recommended definition of a small Code company.
- 2.2. We note that the Panel "does not propose to extend relief to small Code companies that have financial products that confer voting rights quoted on a licensed market." The definition of a licensed market should explicitly exclude facilities described in section 309(2)(c) of the Financial Markets Conduct Act 2013.

3. Reasons to extend the exemption

- 3.1. Our perspective has been informed by discussions with nearly 600 companies looking to raise funds through equity crowdfunding. We have consulted with various lawyers and other equity crowdfunding participants.
- 3.2. The Panel's proposed exemption relates to capital raising transactions. We are equally concerned about the disproportionate or prohibitive costs involved with other change of control transactions. Small Code companies are often involved in non-capital raising transactions that trigger Code problems, such as:

Small transfers

- a) Large shareholders often buy 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. Sometimes they are prepared to invest rescue funds by way of debt, but only if a shareholder deadlock is eliminated, or other shareholder problems are solved. Time and cost mean that Code compliance is out of the question. Delay can mean company failure in these circumstances. The shareholder opt in would deal with residual "rort" risks.

Remuneration

- b) Large shareholders often receive employee / director / contractor remuneration through shares. These may be newly issued shares, but for tax and other reasons they can use existing shares, sometimes held in trusts for that purpose.

Consideration

- c) Large shareholders are sometimes remunerated through shares as consideration for the provision of goods or services.

Buy-backs

- d) Companies often buy back issued shares to resolve company tensions or to allow those willing to continue on without those who have lost confidence.

Changes of control of existing share parcels

- e) Large shareholders sometimes restructure holdings of personal assets, especially when fresh capital is needed, but sometimes to resolve family or other disputes. Structures used to avoid application of the Code sometimes have unwind provisions that result in creation of Code triggering parcels. Opportunities to have direct holdings can be a useful safeguard for investors through such structures. They may not want to have the Code apply, but seek direct investment for other reasons. The opt in provisions are an adequate safeguard in the case of subsequent transfers.

Other

- f) There are a myriad of other non-capital raising transaction scenarios that emerge where Code application may not be wanted by shareholders. Sometimes it can be the difference between survival of a company and shareholder value, and abandonment.

3.3. We consider the following to be an educated estimate of the costs involved with Code compliance for all types of transactions:

- a) \$20,000 - \$50,000 (excluding GST) for an independent advisor report. The risks and costs of such work can be greater than for larger companies, simply because small companies cannot afford the level of record keeping and financial information that is available from larger companies. The advisors must make more assumptions, the personnel and other risks have greater relative importance, and opinions must be given with less inherent reliability. In summary, more difficulty, greater risk of being held to be wrong in hindsight, and less capacity to pay. Some small companies will struggle or be unable to find appropriately qualified advisors to provide the reports. Delay can mean company failure in these circumstances.
- b) \$10,000 - \$30,000 (excluding GST) for legal advice, administration costs, Panel costs, and shareholder meeting costs.
- c) Opportunity cost is incurred through senior management time being diverted from other activities.

3.4. Companies will still incur certain costs, such as legal and administration costs, when complying with our proposed extended exemption. We estimate those costs to be around \$5,000. Accordingly, we consider \$45,000 - \$75,000 to be a reasonable estimate of cash savings for each exempt transaction.

3.5. For these non-capital raising transactions, the costs of Code compliance are disproportionate and often prohibitive for small Code companies.

4. Recommendation for extending the exemption

4.1. There are 2 ways in which to extend the proposed exemption:

- a) Defining exempt transactions; or
- b) Exempting all transactions and allowing the board and shareholders to make commercial decisions about whether normal Code compliance is preferable on a transaction by transaction basis.

4.2. Given the difficulty in predicting the myriad of transactions that could occur in advance (and therefore the high risk of unintended consequences), we believe that exempting all transactions is the most appropriate way to extend the exemption. A cover-all definition would rightly place control within the hands of the shareholders the regulation is designed to protect.

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

- a) It would clearly reduce compliance costs for small Code companies, because many of the transactions that would trigger Code compliance processes are not related to capital raising.

- 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.
- 4.4. Additionally, we recommend that shareholders can, in advance, permanently opt out of normal Code compliance processes in relation to employee / contractor / director remuneration via the issue of shares. For example, if shareholders unanimously agree to an equity earn-in type of arrangement for a large shareholder, there should not be a requirement to go back to shareholders for approval when a Code process is triggered when shares are due to vest. Without this carve-out, contractual remuneration arrangements could be frustrated.

5. Prescribed form

5.1. We believe the Panel should consider the following amendments to the prescribed form:

- a) Amendments to reflect the different types of transactions that would be relevant if the exemption is extended as recommended.
- b) If there are no disinterested members of the board to comply with your paragraph 45 (h), then a statement to that effect.
- c) We consider the suggested time period of 10 business days to be appropriate.
- d) A shareholder opt-in threshold of 10%. This threshold is consistent with the long history of company law, as well as the Code compulsory acquisition threshold. 1 in 20 may be appropriate for widely held public companies where shareholder passivity makes it hard to reach objection thresholds (though we are not convinced of that), but 1 in 10 is a more appropriate ratio for smaller companies where it's easier for shareholders to communicate among themselves to reach the threshold. We think the thresholds should also be considered taking account of the advent of email and social media. It is much cheaper and quicker to communicate concerns to others than it was when snail mail was the only feasible option. The threshold should balance the interests of the majority with the interests of the minority. 1 in 10 is more likely to mean that the tail doesn't end up wagging the dog.

6. Summary

6.1. The Panel's proposed exemption relates to capital raising transactions. We are equally concerned about the disproportionate or prohibitive costs involved with other change of control transactions. We believe the proposed exemption only solves a small subset of the problems that have been demonstrated.

- 6.2. To provide effective relief for small Code companies, we recommend that the proposed exemption is extended to cover all transactions, unless either the board or 10% or more of voting rights opt for normal Code compliance for a particular transaction.
- 6.3. The extended exemption would make commercial sense, and would rightly place control within the hands of the shareholders the regulation is designed to protect.

We welcome discussion on our submissions and recommendations.

Yours sincerely



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Snowball Effect