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Small code companies and the Code – further consultation – the preferred option

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Takeovers Panel's further consultation paper dated 25 February 2015. The consultation paper outlines the Panel's preferred option for small Code companies, which is an opt-out / opt-in class exemption for small capital raisings.

2. The Law Society responds below to the questions in the consultation paper.

Q1: Do you agree with the Panel's new threshold and methodology for calculation of the test for "small Code company"? If not, how would you set the threshold for eligibility to rely on the class exemption, or what changes would you propose to the methodology?

3. As stated in its submission on the Panel's initial consultation paper,[1] the Law Society accepts there should be a demarcation (a bright line test), and that the demarcation for "small" should be pitched at Code companies with an enterprise value of $20 million or less after the transaction.

4. The Law Society also considers there is merit in using a methodology based on that used under the Financial Reporting Act 2013 to determine if an entity is "large" for the purposes of that Act. That methodology would enable the body of practice and knowledge developed under the Financial Reporting Act to be applied.

5. It is noted that there are likely to be some issues at the margins affecting start-ups (particularly those in the technology arena), although it is difficult to believe there will be many start-ups reaching the bright line in their first accounting period.

6. There may also be problems in some sectors of the economy, particularly the rural economy, where companies have been established to provide a governance structure for relatively low-value arrangements and valuations are not often tested for assets that are immovable, relatively illiquid and/or which have a very limited audience. Rural water schemes are a common example mentioned by rural advisers.

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1 Submission dated 12.12.14, available at http://www.lawsociety.org.nz/__data/assets/pdf_file/0010/85528/l-Takeovers-Panel-Small-Code-Companies-12-12-14.pdf.

Q2 Do you agree with the Panel's new preferred option? In particular, do you agree with:

(a) The information proposed to be required in the prescribed form?

(b) The proposed number of days shareholders would have to consider the prescribed form and vote on whether to opt back into the Code?

(c) The percentage of shareholders that would need to have voted to opt back in to force Code compliance or abandonment of a transaction?

(d) Takeover transactions being excluded from such an exemption?

(e) Acquisitions of an existing parcel of shares being excluded from such an exemption?

7. In relation to the Panel's new preferred option, the Law Society makes the following observations:

a. The information proposed to be required in the prescribed form:

Information about the intentions of all allottees may not be within the knowledge of the directors at the time of the decision to make the proposed allotment. This is likely to impact on the following information, namely:

i. (paragraph (b)) – the identity of any allottee proposing to rely on the exemption and, as a result, the identity of any person proposing to rely on the exemption whose control percentage would increase as a result of the proposed allotment; and

ii. (paragraphs (c) and (d)) – although they allow a maximum control percentage to be specified.

For example, the Law Society's earlier submission (at [24]) noted the prevalence of 'down rounds' among SMEs and their diluting effect: many small shareholders are unable or unwilling to contribute further capital and the value equation often means that a few shareholders may be left funding the issue at a high discount (using any common valuation methodology).

b. In the absence of concrete information about the intentions of the allottee, the Board should be able to make the assumption that the allottee will rely on the exemption and take up their full entitlement, and note their maximum control percentage accordingly.

c. A 5% threshold for shareholders that would need to have voted to opt back in to full Code compliance (or trigger abandonment of a transaction) seems very low. In many cases, this has the potential for a small rump of shareholders, with a very small stake in the company, to frustrate the company undertaking routine capital-raising at reasonable cost. The Law Society suggests 10% would be a more appropriate threshold. In this regard, it is not clear that the threshold used in the NXT market rules for transaction announcements or the opt-out procedure in the Companies Act for financial reporting matters is the appropriate benchmark. A benchmark from the Code context (such as the threshold for achieving dominant ownership under Part 7 of the Code) would be more appropriate.

d. The limited coverage proposed – excluding takeover transactions – is likely to be a cause of concern. Creating carve-outs and exemptions for SMEs is generally not a desirable approach. However, in the present case it is understandable for reasons of efficiency, cost and ease of understanding that the Panel wishes to test the waters and consider at a later date expanding the coverage of any exemption relief for small Code companies.

e. The exclusion of acquisitions of an existing parcel of shares from the coverage of the proposed exemption is consistent with the Panel's distinction between:

   i. transactions which (primarily) benefit the Code company, and

   ii. those which benefit the acquirer.

   However, the Law Society is concerned that narrowing the focus of the exemption will have a greater impact than the Panel anticipates. The Law Society is interested in whether there has been feedback from market participants that there is a strong case to be made for the inclusion of other non-allotment transactions (other than full or partial takeovers).

Q3 If the Panel grants a class exemption to solve the problem, do you think that there is any risk of inappropriate reliance? If so, can you suggest ways that this might be mitigated? For example, should the extent of permitted increase be capped?

8. In the absence of examples of the sort of "inappropriate reliance" the Panel might be concerned about, the Law Society is unable to suggest caps on permitted increases in capital or other similar controls. Such measures would add complexity and cost and would need to be analysed to ensure they address the problem and provide benefits that outweigh the likely compliance burden.

9. The Panel is urged to treat simplicity and uniformity of treatment as key objectives in developing the appropriate reach of the compliance regime for small Code companies.

Q4 What are the likely cost savings for a small Code company relying on the proposed class exemption process, in comparison to the costs of a full Code allotment process? Please provide quantitative information to the extent possible (for example, do you think for a capital raising of $500,000 there would be a saving in the order of $100,000?) and an explanation of how you came to those figures.

10. It is notoriously difficult to obtain authoritative data on the costs of capital-raising that allows for company-specific or context-specific issues. However, in its published material over the last decade NZX has noted the impact on SMEs of the costs of capital-raising and has given examples of costs of:

    a. 7% for an IPO; and

    b. 4.5% of funds raised for a subsequent capital raising.

11. These examples are a little dated and probably somewhat low (although they include a fixed cost element in the form of offer documents and document preparation). A figure in the range of 3 – 5% would not be unusual for many small-scale capital raisings by unlisted SMEs that do not break new ground or require detailed input from advisers. These figures can escalate quickly if the Code becomes a factor and specialist inputs are required. However, experience indicates that it would be a rare combination of factors that are specific to the company and/or its shareholders that caused the costs to reach 20% of the amount the company was seeking to raise.

12. However, for many SMEs, the costs of capital raising also include the costs associated with dealing with a broad spectrum of shareholder arrangements – which may approximate some (but possibly not all) of the complexities of process that affect an NZX issuer.

13. Therefore, the proposed class exemption, despite its limitations, could easily halve the costs of capital raisings for smaller SMEs that are Code companies by doing away with the need for an independent adviser's report and associated advice.

14. The Panel (at [54]) also seeks views on "whether the costs associated with other Code-regulated transactions (other than partial or full takeovers) are similar to those that apply to capital raisings and why those costs are disproportionate to the benefit of the company's shareholders in having the Code complied with for acquisitions of existing share parcels, changes of control or buybacks". In the Law Society's view, there is likely to be a combination of factors at play, including:

    a. the relative infrequency with which these issues arise for SMEs;

    b. the consequent need to explain unfamiliar scenarios to both the Board and shareholders;

    c. the preponderance of shareholder arrangements affecting many SMEs (particularly those affecting founder and/or cornerstone shareholders); and

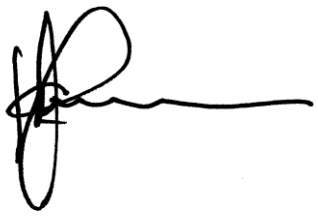
    d. stakeholders' understandable caution (particularly in the case of growth businesses), based on a desire to "get it right" and not risk creating a compliance issue that might hamper the growth of the business including the scope for a later IPO or trade sale (takeover).

15. For these reasons, it may be preferable for the proposed class relief to be targeted at all Code transactions affecting "small" Code companies rather than only at a subset of Code transactions.

Conclusion

This submission was prepared by the Law Society's Commercial and Business Law Committee. The committee convenor, Stephen Layburn, can be contacted through the committee secretary, Vicky Stanbridge (ph (04 463 2912 / vicky.stanbridge@lawsociety.org.nz).

Yours sincerely



Chris Moore
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