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SMALL CODE COMPANIES AND THE CODE

A CONSULTATION PAPER ISSUED BY THE TAKEOVERS PANEL

30 October 2014

TAKEOVERS PANEL

Introduction

1. The Panel has received feedback from a number of practitioners and directors of small Code companies that compliance with the Code is too expensive for small Code companies.

2. The Panel is inclined to think that the current policy settings are correct. However, it is open to exploring the issue and considering possible change. Accordingly, this consultation paper asks whether there is a demonstrable problem with the cost of Code compliance for small Code companies. The paper then presents a number of options for consideration, and identifies a possible preferred option that may, if adopted, serve to lessen the financial burden on these companies.

Request for comments on this paper

3. The Panel invites submissions on the issues raised in this paper and the options identified for addressing the issues.

4. The closing date for submissions is **5.00 p.m., Friday, 12 December 2014**.

5. Submissions should be sent for the attention of Lauren Donnellan to:

By email	lauren.donnellan@takeovers.govt.nz
By post	Takeovers Panel Level 3, Solnet House 70 The Terrace P O Box 1171 WELLINGTON 6011

Official Information Act

6. Any submissions received are subject to the Official Information Act 1982. The Panel may make submissions available upon request under that Act. If any submitter wishes any information in a submission to be withheld, the submission should contain an appropriate request (together with a clear identification of the relevant information and the reasons for the request). Any such request will be considered in accordance with the Official Information Act 1982.

Identification of the problem - description of the status quo

7. This paper considers whether there are potentially disproportionate costs of Code compliance for small Code companies.

8. Some practitioners and some directors of small Code companies have indicated to the Panel that there are compliance cost problems when raising relatively small amounts of capital from shareholders. In addition, shares in small companies can be illiquid, with few new investors wanting to come into the company, and perhaps only the company's founders willing to buy out shareholders who wish to exit their investment.

9. Also, even though offerors may be required to reimburse the target company's costs at the conclusion of a takeover, under rule 49 of the Code, the Panel understands that often not all of a target company's costs are reimbursed. Sometimes these costs are litigated through the Courts.

10. This paper assumes that high-value companies do not need to raise small amounts of capital through equity funding and that illiquidity is not a significant problem. This paper does not propose any change to the threshold for being a Code company.

"Code company"

11. The Code applies only to "Code companies". A company is a Code company if it is a New Zealand registered company that:[1]

    (a) is a party to a listing agreement with a registered exchange and has securities that confer voting rights quoted on the registered exchange's securities market; or

    (b) was within paragraph (a) at any time during the period of 12 months before a date or the occurrence of an event referred to in the Code; or

    (c) has 50 or more shareholders (with voting rights) and 50 or more share parcels.

"Small" Code companies

12. Previously, when the Panel has provided guidance on "small" Code companies, it has focussed on companies that are close to the threshold in (c) above. The Panel has advised that it is not averse to Code companies close to the threshold of "Code company" restructuring themselves so that they do not fall under the ambit of the Code.

13. However, this paper focusses on Code companies that are "small" by value.

14. For this purpose, the Panel proposes that a small Code company is a Code company with an enterprise value of $20 million or less *after* the completion of the Code-transaction at issue (also known as "enterprise value post-money"). This value is equal to the sum of the pre-transaction enterprise valuation of the company and the

[1] Some of the terminology (but not the meaning) of the definition will be amended by the consequential amendments under the Financial Markets Conduct Act 2013.

value of the new equity. All references to small Code companies in this paper have this meaning (unless otherwise stated).

Small Code companies and the Code

Fundamental rule of the Code

15. Small Code companies, and their shareholders, are subject to rule 6 of the Code, the fundamental rule. Rule 6 prohibits a person from becoming the holder or controller of an increased percentage of the voting rights in a Code company, unless, after that event, that person and that person's associates hold or control in total not more than 20% of the voting rights in the Code company.[2]

Exceptions to the fundamental rule

16. Rule 7 of the Code provides the mechanisms by which a person may increase their holding or control of Code company voting rights without breaching the rule 6 prohibition. That is, a person can increase their shareholding position in a Code company above the 20% threshold by making a full or partial takeover offer, obtaining shareholder approval for an acquisition or allotment, "creeping" by a maximum of 5% over a 12-month period (if the person holds or controls more than 50%, but less than 90% of the voting rights in the Code company), or by any means if the person already holds or controls 90% or more of the voting rights in the Code company.[3] All these mechanisms, other than "creeping", require full Code compliance, including the provision of an independent adviser's report on the merits of the transaction.

17. Another common mechanism under which a person's shareholding position can increase is where the Code company buys back its own shares. If a person's shareholding position would increase above the 20% threshold as a result of the buyback, shareholder approval can be obtained for the buyback under clause 4 of the Takeovers Code (Class Exemptions) Notice (No 2) 2001 ("Buyback Exemption") (the conditions of which include that an independent adviser's report accompany the notice of meeting).

18. Any time a person makes a Code-compliant increase in their shareholding under rule 7 or the Buyback Exemption, the person increasing, the directors of the Code company, and the company itself, have obligations under the Code that they must comply with (unless the transaction is a "creep" under rule 7(e) (discussed below)). These obligations include preparing a notice of meeting, holding a shareholders' meeting and obtaining an independent adviser's report on the merits of the transaction.

The creep rule and the "no-fly zone"

19. A shareholder who owns between 20% and 50% of the voting rights in a Code company is in, what may be called, the "no-fly zone". Every transaction within the no-fly zone that results in an increase in share ownership must comply with the Code.

[2] See rule 4 of the Code for the definition of "associate".
[3] See rule 7 of the Code for a full description of the Code-compliant mechanisms for increasing share-ownership in a Code company.

20. However, the Code has some built in flexibility for shareholders who own more than 50% of the Code company's voting rights. The Code allows these shareholders (but not their associates) to creep by up to 5% of the company's voting rights each year. In other words, a shareholder with more than 50% can buy more shares without having to comply with the Code's rules, but they must not buy more than 5% of the company's shares over any 12-month period.

Independent adviser's reports

21. Every takeover, capital raising or share trade transaction undertaken under the Code (i.e., where a shareholder would trigger the Code's fundamental rule) requires an independent adviser's report to be prepared on the merits of the transaction for the other shareholders. The cost of obtaining the independent adviser's report, coupled with the costs of legal advisers and the cost of holding a shareholders' meeting, has been the subject of comments made to the Panel that the cost of full compliance with the Code may be out of proportion to the value of some transactions for small Code companies. The main source of concern seems to be the cost of obtaining an independent adviser's report.

22. The Panel has obtained anecdotal evidence on the cost of independent adviser's reports from two advisers who provide reports for Code-regulated transactions. For example, a straightforward report for a share placement or buyback might cost in the vicinity of $20,000 – $30,000.[4] Although there is a relatively small number of advisers in the New Zealand market that advise on Code-regulated transactions (approximately 10 - 12), competition is said to be strong and prices to have fallen over the last decade.

23. Prices may have been almost double the above in the first several years of the Code's operation. However, although prices have fallen, the costs for small Code companies may be prohibitive, especially when seeking relatively small amounts of capital or when a small number of shares are being traded.

Rule 64 and the Panel

24. The Panel monitors Code-regulated transactions and ensures that the rules of the Code are being complied with.

25. Rule 64 of the Code is a particularly broad rule that helps to ensure honest behaviour in Code-regulated transactions. Rule 64 is a prohibition against misleading or deceptive conduct and enables the Panel to exercise its enforcement powers for any misleading or deceptive conduct relating to Code-regulated transactions or events. Misleading or deceptive conduct that is incidental or preliminary to transactions or events that are, or are likely to be, regulated by the Code, will also be subject to the Panel's enforcement powers.

26. Rule 64 applies to any person; not just to offerors, target companies and major shareholders. Any person who engages in misleading or deceptive conduct relating to a Code-regulated transaction or event is caught by the prohibition.

[4] These prices exclude GST and disbursements. When practitioners talk to the Panel about the cost to their Code company clients of these reports the figures stated are larger, but may include GST and disbursements.

27. Accordingly, if a transaction is regulated by the Code, rule 64 will apply to that transaction. Care needs to be taken by all persons involved that they don't engage in misleading or deceptive conduct.

Policy settings and crowd-funding

28. Following on from the 2009 Report of the Capital Markets Taskforce, policy settings for the capital markets have been amended to improve the regulatory environment. The Financial Markets Conduct Act 2013 ("FMC Act") introduced a number of new exclusions from the required disclosure obligations for offers of financial products. Some exclusions, such as for crowd-funding through licensed intermediaries, were aimed at making it easier for small and medium sized companies to raise capital.

29. Prior to phase 1 of the FMC Act coming into effect on 1 April 2014, there was some concern as to how the Code would impact newly-formed crowd-funded companies. In April 2014, the Panel advised that companies taking advantage of the exclusions from disclosure under the FMC Act to raise capital need to be aware that they could become, or may already be, subject to the Code. The Panel reiterated earlier advice that it is not averse to companies deciding to structure their holdings so that they do not fall under the definition of "Code company", provided that the structuring is undertaken in a manner that complies with the Code. Alternatively, it may be that becoming a Code company is inevitable, but group structures or other arrangements may reduce the likelihood of the Code's 20% threshold being crossed.

30. The first company to take advantage of the crowd-funding exclusion, Renaissance Brewing Limited, received legal advice on the effect of the Code and chose to become a Code company. According to publicly available information, Renaissance received NZD$700,000 from 287 people, who all became shareholders through the crowd-funding process.

31. The capital raising method by which a company becomes a Code company should not impact on whether consumer protection/market integrity regulation such as the Takeovers Code is available to the company's shareholders. The purpose of the Code is to ensure that all shareholders in relatively widely-owned companies can participate on a level playing field when control of the company's voting rights changes. This is the "fairness" objective that sits behind the Code. The Code also ensures that shareholders have an appropriate level of information, and adequate time, for making decisions that affect their shareholding investment in the company.

32. What is important is whether a company has a large enough shareholding base to be a Code company or not. Crowd-funding platforms should be aware of the Panel's position and should advise their clients accordingly. Other widely-owned, low-capitalised companies have the same issues to deal with in terms of Code compliance as crowd-funded Code companies. Accordingly, while earlier in 2014 there had been some suggestions that crowd-funded companies should be exempted from Code compliance, the Panel's focus for considering law reform is on all small Code companies.

Problem identification – conclusion

33. The Panel has previously provided guidance that it is not averse to small Code companies (by number of shareholders and share parcels) structuring themselves outside of the Code. The Panel itself is inclined to believe that the current policy settings are correct and that it is the responsibility of companies to consider the effect of the Code and structure themselves accordingly.

34. However, the cost of compliance with the Code, especially the commissioning of independent advisers' reports, may be, according to anecdotal evidence, prohibitive for small (by value) Code companies undertaking small transactions (e.g., raising a small amount of money, paying a major shareholder by allotting shares as consideration for the provision of goods or services, buying small parcels of shares from investors who want to exit the company, etc.). If not "prohibitive", the cost of compliance may be, at least, disproportionate to the value of a transaction and the benefit of Code compliance.

35. Anecdotal evidence also suggests that the cost of compliance with the Code may potentially stifle growth and development for small to medium sized enterprises.

36. The Panel is unsure whether the problem, if there is one, is isolated to the particular incidents that it has been advised about, or is widespread over a large number of small (by value) Code companies. The Panel seeks your feedback on the problem, as much as on the potential solutions.

Policy objectives

37. The Panel's policy objectives are to:

    (a) reduce compliance costs for small Code companies;

    (b) maintain a proper relationship between the costs of compliance with the Code and the benefits resulting from it; and

    (c) ensure shareholders are treated fairly and are provided with sufficient information so that they can decide for themselves the merits of a transaction.

Options

38. Although the Panel is inclined to think that its current policy settings are correct, that there is not a large scale problem, and that the status quo should be maintained, it has identified a preferred option in case submissions demonstrate there to be a legitimate problem. The Panel asks for your feedback on these options at the end of this paper.

39. The options considered by the Panel are:

    (a) maintain the status quo – preferred option 1 (if there is no problem);

    (b) a class exemption so that an independent adviser's report is not required for non-takeover transactions involving small Code companies;

(c) a class exemption to extend the Code's "creep" provisions for small Code companies;

(d) a class exemption so that an independent adviser's report is not required for any transaction that involves a small Code company's voting rights; and

(e) a class exemption so that an independent adviser's report is not required for any transaction that involves 10% or less of a small Code company's voting rights – preferred option 5 (if there is a widespread problem).

Option 1 – Maintain the status quo – preferred option 1 (if there is no problem)

Key features of option 1

40. Under this option, all Code companies, large and small, and their shareholders, would need to continue to comply with, and would retain the benefits of, the provisions of the Code, including:

(a) the requirement for shareholder approval to be obtained for Code-regulated acquisitions, allotments and buybacks;

(b) the disclosure of required information in notices of meeting and related documents, including directors' recommendations;

(c) an independent adviser's report on the merits of the transaction; and

(d) the protection of rule 64 of the Code and the Panel as regulator.

41. A person may increase their holding or control of Code company voting rights by "creeping" by up to 5% in a 12-month period if the person holds or controls more than 50% of the voting rights in the Code company.

Analysis of option 1

42. Option 1 ensures consistency with the objectives of the Code and ensures that shareholders are fairly treated and provided with an appropriate level of advice.

43. When companies that fall within the threshold of being a Code company comply with the Code, shareholders are furnished with sufficient information to make decisions about their shareholding investments and they enjoy the full protections of the Code.

44. Under option 1, companies and their shareholders can structure the shareholdings to fall within the ambit of the Code or not, depending on the perceived benefits of being a Code company.

45. Option 1 is the Panel's preferred option if it is found that there is not a problem with the cost of Code compliance for small Code companies.

46. However, anecdotal evidence suggests that the status quo results in a too-heavy compliance burden for low-capitalised companies and does not meet the objective of maintaining a proper relationship between the costs and benefits of compliance with

the Code. If this is the case in fact, and it is widespread, option 1 is not the Panel's preferred option.

Option 2 – A class exemption so that an independent adviser's report is not required for non-takeover transactions involving small Code companies

Key features of option 2

47. Under this option, small Code companies would not need an independent adviser's report for Code transactions that are not takeovers. However, all other features of the status quo would need to be complied with (e.g., the obligation to obtain shareholder approval, disclosure of information required by the Code, etc.).

48. For the purposes of this proposal, a takeover transaction is a transaction that is undertaken under:

    (a) rule 7(a) or 7(b) of the Code (i.e., a full or partial takeover); or

    (b) rule 7(c) or 7(d), where a person (together with their associates) would acquire or be allotted 50% or more of a Code company's total voting rights (on an undiluted basis for allotments).

Analysis of option 2

49. Option 2 would clearly meet the objective of reducing one of the most significant compliance costs of Code transactions.

50. Option 2 would partially meet the objective of ensuring shareholders are treated fairly and are provided with sufficient information so that they can decide for themselves the merits of a transaction. Shareholders would receive the information and disclosures required by the Code (other than an independent adviser's report), including a directors' recommendation on a transaction.

51. Transactions would still incur legal costs and the costs of holding a shareholders' meeting. However, companies would save the costs of obtaining an independent adviser's report. Shareholders would also retain all of the protections of the Code, including the rule 64 prohibition against misleading or deceptive conduct, and the Panel would retain its jurisdiction as regulator of Code compliance for every transaction covered by the Code.

52. Option 2 may partially meet the objective of maintaining a proper relationship between the costs and benefits of compliance with the Code. Shareholders would not receive independent advice on transactions, even relatively large transactions; however, small Code companies would be less inhibited from undertaking small capital raisings which may be of benefit to the company's operations.

53. Although option 2 meets some of the policy objectives to some extent, it is not the Panel's preferred option.

Option 3 – A class exemption to extend the Code's "creep" provisions for small Code companies

Key features of option 3

54. This option involves extending the Code's "creep" provisions under rule 7(e) to effectively remove the "no-fly zone" between 20 – 50% for small increases up to 5% of the company's total voting rights over any rolling 12-month period in small Code companies.

Analysis of option 3

55. Option 3 would clearly meet the policy objective of reducing compliance costs. However, the Panel does not believe a proper relationship between the costs and benefits of compliance with the Code would be maintained by allowing creeping, unregulated increases in the no-fly zone for small Code companies. Shareholders would have none of the Code protections for these creeping acquisitions. Moreover, a person could creep over a period of several years to a majority position of ownership of the company's voting rights without shareholders knowing that person's intentions for the company.

56. Option 3 does not meet the objective of ensuring shareholders are treated fairly or are provided with sufficient information in respect of any transaction involving 5% or less of the company's voting rights. Shareholders would not receive any Code disclosures or independent advice for these unregulated transactions.

57. Option 3 is not the Panel's preferred option.

Option 4 - A class exemption so that an independent adviser's report is not required for any transaction that involves a small Code company's voting rights

Key features of option 4

58. Under this option, small Code companies would not need an independent adviser's report for any Code transaction. However, all other features of the status quo must be complied with (e.g., the obligation to obtain shareholder approval, disclosure of information required by the Code, etc.).[5]

59. The target company statement for a takeover offer would still be required to include all of the required disclosures by directors of the target company, including all information that could reasonably be required to be material to the making of a decision by the offerees to accept or reject the offer, under clause 24 of Schedule 2 of the Code.

Analysis of option 4

60. Option 4 would clearly resolve the conflict between the expense of a transaction relative to the extent of the increase in ownership of voting rights for small Code companies. Small Code companies would not have to commission an independent

[5] An offeror would still be required to obtain a report under rule 22 of the Code if a takeover offer was made for more than one class of target company securities.

adviser's report for any transaction, whether a takeover, acquisition, allotment or buyback.

61. Option 4 would partially meet the objective of ensuring shareholders are treated fairly and are provided with sufficient information so that they can decide for themselves the merits of a transaction. Although shareholders would not receive an independent adviser's report, they would receive the other information and disclosures required by the Code, including a directors' recommendation on the transaction.

62. Transactions would still incur legal costs and the costs of holding a shareholders' meeting for allotments and acquisitions. However, companies would save the cost of obtaining an independent adviser's report. Shareholders would also retain all of the protections of the Code, including the rule 64 prohibition against misleading or deceptive conduct, and the Panel would retain its jurisdiction as regulator of Code compliance for every transaction covered by the Code.

63. Option 4 would partially meet the objective of maintaining a proper relationship between the costs and benefits of compliance with the Code because all of the Code's protections (apart from independent advice) would still be in place.

64. However, large transactions, such as takeovers and significant acquisitions and allotments, including those that would have a significant impact on shareholders, would not require an independent adviser's report. For takeovers, the target company directors would need to turn their minds to some of the issues normally addressed in an independent adviser's report, due to their obligations under clause 24 of Schedule 2 of the Code. For example, the directors may give advice on the likelihood of another offer being made, the impacts of various control positions depending on how many acceptances are received (including about compulsory acquisition), information about the company's forecast earnings, etc. In addition, rule 64 requires, effectively, that no material information is omitted from directors' disclosures to shareholders.

65. In view of this obligation on target company directors, the Panel believes that this option may prove difficult, especially in takeovers and other significant transactions. Although shareholders in small Code companies would still be given fulsome advice to help them to decide whether to accept or reject a takeover offer, this would not be independent advice. Although the policy objectives of reducing compliance costs and ensuring shareholders are provided with sufficient information for their decision-making would be partially met by option 4, having independent advice for shareholders considering significant transactions is important.

66. Option 4 is not the Panel's preferred option.

Option 5 – A class exemption so that an independent adviser's report is not required for any Code transaction that involves 10% or less of a small Code company's voting rights– preferred option 5 (if there is a widespread problem)

Key features of option 5

67. Under this option, small Code companies would not need an independent adviser's report for Code transactions that involve individual increases of control of 10% or less of the Code company's voting rights over any 12-month period. However, all other features of the status quo must be complied with (e.g., the obligation to obtain shareholder approval, disclosure of information required by the Code, etc.).

68. The terms of the exemption would reflect rule 7(e), so that the person could only increase their control percentage by a maximum of 10% or less over any rolling 12-month period ending on, and inclusive of, the date of the increase.

Analysis of option 5

69. Option 5 would resolve the conflict between the expense of a transaction relative to the extent of the increase in ownership of voting rights for small Code companies.

70. Option 5 would partially meet the objective of ensuring shareholders are treated fairly and are provided with sufficient information so that they can decide for themselves the merits of a transaction. Shareholders would receive the other information and disclosures required by the Code, including a directors' recommendation on the transaction.

71. Transactions would still incur legal costs and the costs of holding a shareholders' meeting. However, companies would save the cost of obtaining an independent adviser's report. Shareholders would also retain all of the protections of the Code, including the rule 64 prohibition against misleading or deceptive conduct, and the Panel would retain its jurisdiction as regulator of Code compliance for every transaction covered by the Code.

72. Option 5 meets the objective of maintaining a proper relationship between the costs and benefits of compliance with the Code because all of the Code's protections (apart from independent advice) would still be in place. At the same time, option 4 would give small Code companies flexibility to affordably resolve needs for small amounts of capital or to assist exiting shareholders when there are few willing buyers. Large transactions, such as takeovers, that would have a significant impact on shareholders would still require full compliance with the Code.

73. Option 5 is the Panel's preferred option if there is, in fact, a widespread problem with the costs of Code compliance for small Code companies.

Questions

74. The Panel is seeking your feedback specifically on the questions below. The Panel also appreciates any other feedback you may have on this paper.

1. In your view:

(a) Is there a problem with the cost of Code compliance for small Code companies?

(b) Do you think the Panel has correctly identified the problem?

(c) If not, how would you describe the problem?

2. Do you agree with the Panel's definition of "small Code company"? If not, how would you define "small Code company"?

3. Do you agree with the Panel's policy objectives? If not, what policy objectives would you suggest instead?

4. Which of the Panel's preferred options do you agree with – preferred option 1 or preferred option 5? If you think there is a better alternative, please describe it, along with your reasons for suggesting that option.

5. 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?