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SMALL CODE COMPANIES AND THE CODE

A FURTHER CONSULTATION PAPER ISSUED BY THE TAKEOVERS PANEL

THE PREFERRED OPTION

25 February 2015

TAKEOVERS PANEL

Introduction

1. On 30 October 2014, the Panel issued a consultation paper asking whether the cost of compliance with the Takeovers Code was disproportionate with the benefits resulting from the Code for "small" Code companies.

2. The paper focussed on Code companies that are "small" by value. For this purpose, the Panel proposed that a small Code company would be a Code company with an enterprise value of $20 million or less after the completion of the relevant Code transaction.

3. The Panel's position at that time was that it was inclined to think that the current policy settings in relation to small Code companies were correct (because companies can choose to structure themselves outside of the Code) and, accordingly, that the status quo was its preferred option. However, the Panel also presented four other options, including a preferred option if consultation convinced the Panel that there was a problem with the cost of Code compliance for small Code companies.

4. The consultation period closed on Friday, 12 December 2014. The Panel received submissions from 15 parties in total (including nine law firms and four crowd funding platforms). In summary, there was neither general agreement with the Panel's proposed definition of "small" Code company nor with either of the Panel's preferred options (nor with any other option presented in the initial consultation paper).

5. The Panel has analysed and considered the feedback received in response to the initial consultation paper and has now identified a preferred option - an opt out / opt in class exemption for capital raisings. This preferred option is different from the options identified in the initial consultation paper. Accordingly, the Panel's current priority is to seek submissions on its new preferred option in order to assist the Panel in finalising its view.

6. Whilst the Panel's priority is the class exemption for capital raisings, it also intends to undertake an analysis of the merits of relief for small Code companies in relation to additional transactions that require Code compliance. With this in mind, the Panel also seeks further information and comment to assist it in considering whether additional transactions should be included in a later class exemption.

Request for comments on this paper

7. The Panel invites submissions on the preferred option outlined in this paper and the additional information sought.

8. The closing date for submissions is **5.00 p.m., Wednesday, 25 March 2015**.

9. 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

10. Any submissions received are subject to the Official Information Act 1982. The Panel will 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.

Background and description of the status quo

11. To see the Panel's full analysis of the problem and its original proposed options for a solution, please see the initial consultation paper. A summary of the problem and the status quo is set out below.

Status quo - small Code companies and the Code

Fundamental rule of the Code

12. 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.[1]

Exceptions to the fundamental rule

13. 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 a change of control of a shareholder or an 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.[2] All these mechanisms, other than the last two, require full Code compliance, including the provision of an independent adviser's report on the merits of the transaction.

14. 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 does not participate in a buyback and that 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).

Independent advisers' reports

15. 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)). For acquisitions and allotments, 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.

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

16. The Panel considered that the main source of concern at the time of writing the initial consultation paper was on the cost of obtaining an independent adviser's report. However, feedback to the Panel has indicated that that it is not just the cost of obtaining the independent adviser's report, but also other costs, such as the costs of legal advisers and the cost of holding a shareholders' meeting, that make Code compliance out of proportion to the value of some transactions for small Code companies.

Initial consultation paper and submissions in response

Summary of initial consultation paper

17. For the purposes of the initial consultation paper, the Panel proposed that a small Code company was a Code company with an enterprise value of $20 million or less after the completion of the relevant Code transaction (also known as "enterprise value post-money").

18. The Panel stated in the initial consultation paper that it was inclined to believe that the current policy settings of the Code are correct and that it is the responsibility of companies to consider the effect of the Code and structure themselves accordingly. [3] Although the Panel was inclined to think that there is not a large scale problem, and that the status quo should be maintained, it identified a preferred option in the event that submissions on the initial consultation paper demonstrated there to be a legitimate problem.

19. From anecdotal evidence, the Panel formed the view that, if there was a problem with the cost of Code compliance for small Code companies, the independent adviser's report was likely the most significant and prohibitive cost of Code compliance. This was reflected in the options the Panel presented as potential solutions if there was found to be a legitimate problem.

20. The options considered by the Panel were:

    (a) maintain the status quo – preferred option (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

[3] Previously, when the Panel has provided guidance on "small" Code companies it has focussed on companies that are close to the threshold in the definition of Code company in rule 3A of the Code (50 or more shareholders and 50 or more share parcels). The Panel has previously 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.

(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 (if there is a widespread problem).

Summary of submissions on initial consultation paper

Is there a problem? Did the Panel correctly identify the problem?

21. The Panel stated in the consultation paper that the cost of compliance with the Code, especially the commissioning of independent advisers' reports, may be prohibitive for small 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.), and accordingly, may potentially stifle growth and development for these companies.

22. All of the submitters gave the same answer to this question, stating that the cost of compliance with the Code is prohibitive for small Code companies. However, more than one submitter questioned whether the Panel's estimate of $20,000 to $30,000 for the cost of an independent adviser was too low.

23. Whether or not the costs of an independent adviser's report are higher than the Panel estimated, more than half of the submitters stated that the other costs of Code compliance (including, but not limited to, the costs of legal advice, accounting advice, preparing and sending information to shareholders, holding shareholder meetings and the time of staff and directors spent on ensuring Code compliance) were equally, if not more, prohibitive for small Code companies.

The definition of "small Code company"

24. The Panel's initial consultation paper proposed that a small Code company would be a Code company with an enterprise value of $20 million or less after the completion of the relevant Code transaction.

25. Submitters disagreed with the Panel's threshold for "small Code company".

26. Submitters argued that where a Code company is unlisted the concept of enterprise value is not directly applicable (as there is no market capitalisation), and that the determination of enterprise value for small companies (especially young companies) can be difficult outside a formal capital raising round. Accordingly, it may be difficult for directors of a Code company to determine with certainty whether the company would be within the bounds of an exemption or not. Also, it was submitted that a company could structure a particular corporate action or event in a way that would allow it to fly under the $20 million enterprise value threshold, leaving such a threshold open to manipulation.

27. Many submitters suggested some form of asset test (gross assets, net assets, net tangible assets, net operating assets) or revenue test. All submitters suggested that express guidance on the calculation of the threshold chosen should be given. The Panel notes that a $20 million asset test was removed from the definition of Code

company in 2006 but, before its removal, determining whether and when a company fell within the threshold could be difficult and was never "black and white".

28. Another suggestion from one submitter was that a bright line test be implemented that is consistent with the Financial Markets Conduct Act 2013 ("FMC Act"). On this basis, only companies that had raised equity capital under an FMC Act disclosure statement (and had made a "regulated offer") should be regulated under the Code. It was submitted that this would allow companies to treat the private offer exclusions in Schedule 1 to the FMC Act as the definitive way to raise private equity capital without being subject to financial markets regulation (including the Code).

The Panel's policy objectives

29. At the time it issued the consultation paper, the Panel's policy objectives were 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.

30. All submitters agreed with the Panel's stated policy objectives. The Panel therefore does not propose to change or expand the scope of its policy analysis.

The proposed options

31. No one option proposed by the Panel was met with a majority of support from submitters.

32. The most agreement amongst submitters was in relation to a different option for reducing the costs of Code compliance. Seven submitters proposed a variant of an "opt out" regime for small Code companies, whereby the directors would determine whether it was in the best interests of the company to opt out of the Code process for certain transactions. Shareholders could require the company to opt back in if a certain percentage of shareholders voted that a transaction should be subject to full Code compliance in the circumstances.

Problem identification

33. The submissions received on the initial consultation paper have convinced the Panel that the costs of Code compliance can be disproportionate to the benefits of Code compliance for small Code companies. The Panel acknowledges that these costs go beyond just the cost of an independent adviser's report.

34. The Panel has considered the feedback it received on its initial consultation paper, discussions with market participants, and the policy settings for the exclusions from "regulated offers" in the FMC Act. Taking these issues together, the biggest aspect of concern within this policy setting is the cost of compliance with the Code for capital

raisings for small companies. The Panel has focussed on this aspect of concern in formulating its definition of small Code company and new preferred option in relation to raising further capital.

35. Accordingly, the new preferred option does not relate to full or partial takeovers. Neither does the preferred option cover acquisitions (including buybacks) or changes of control of existing share parcels. The Panel believes that this focus does not disturb too greatly the Code's purpose of regulating increases in control of Code company voting rights and may assist with the growth and development of small to medium sized enterprises. Allotments by companies are not usually made in order to directly impact the control of Code company voting rights, and any increase in control of voting rights is usually secondary to another purpose. In contrast, takeovers directly impact the control of Code company voting rights, and are intended to do so.

36. However, the Panel does acknowledge that other transactions subject to shareholder approval (acquisitions, changes in control of shareholders, or buybacks) in small Code companies can also involve high compliance costs. For this reason, and in order to assist the Panel with its on-going policy work programme, the Panel seeks feedback on the questions set out at the end of this paper on whether a class exemption should be extended to such transactions. The Panel is not persuaded that an exemption should be extended to full or partial takeovers, and does not propose to further consider that.

"Small Code company"

37. The Panel is in favour of having a "bright line" test for "small Code company" and, therefore, for determining precisely where the line would be drawn for falling within or outside of any proposed relief from full compliance with the Code. 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.

38. The Panel accepts the submitters' concerns with an enterprise value post-money threshold and acknowledges the support for a more certain asset-based threshold test than that which was removed from the Takeovers Act 1993 in 2006.

39. The Panel has therefore looked to the methodology underpinning the bright line test in section 45 of the Financial Reporting Act 2013 ("FRA") and the way in which it defines the meaning of "large" entity for the purposes of that Act.[4] That methodology appears to resolve the calculation issues that affected the previous asset-based threshold.

40. Accordingly, the Panel considers that the threshold for eligibility for relief should be for companies that have total assets of $20 million or less at the balance date of the company's most recent accounting period, as reflected in the Company's accounting records. As with section 45 of the FRA, financial reporting standards could assist calculation of "assets".[5] If the company has not completed its first accounting period,

[4] With some differences. For example, a total asset threshold of $20 million, no separate revenue threshold, and measurement at the most recent balance date (rather than the previous two balance dates).

[5] External Reporting Board Standard A2 (XRB A2) *Meaning of Statutory Size Thresholds*, issued February 2014, specifies, amongst other things, how the amount of total assets is to be determined (see paragraphs 8 and 11-12).

reference would be made to accounting records available for the most recently completed calendar month end before the board seeks to rely on the exemption.

41. It follows that a company will still be a "small Code company", and the proposed exemption will be able to be relied upon (discussed below), even if a company's total assets have significantly changed between the balance date of the company's most recent accounting period and the date the exemption is relied upon. The Panel accepts this as a consequence of the types of companies expected to rely on the proposed class exemption for capital raisings – small and medium, high-growth companies – and considers that the benefits of a clear bright line test outweigh concerns that a company may in fact no longer be "small" at the time the exemption is relied on. (In any case, as discussed below, the disinterested members of the board must still be satisfied an opt out is appropriate, and shareholders may trigger an opt in if the requisite percentage of shares are voted to object to opting out).

42. The Panel considers that adopting the above methodology and threshold, in conjunction with the proposed new class exemption, should closely align its policy for relief with the new policy settings in the capital markets for capital raisings. The FMC Act introduced a number of exclusions from the required disclosure obligations for offers of financial products, and some exclusions, such as for crowd-funding through licensed intermediaries and the small offers exclusion, were aimed at making it easier for small and medium sized companies to raise capital. In this respect, the Panel considers that its new proposed definition for eligibility for relief, and the Panel's new preferred option for relief (discussed below), will bring the objectives of the proposed class exemption in to line with the objectives of the FMC Act.

A new preferred option: opt out / opt in

Key features of the new opt out / opt in proposal

43. The Panel proposes granting a class exemption for any person who increases their holding or control of voting rights in a "small Code company" (described at paragraphs 40 - 41 above) as a result of an allotment of voting securities by the Code company. The Panel proposes the conditions of exemption would require adhering to the following process:

    (a) If a proposed allotment would trigger rule 6 of the Code, the members of the board of the small Code company that are not proposed allottees, or associates of allottees (unless the offer that will result in the allotment is made on a pro rata basis to all shareholders in New Zealand (disregarding, for this purpose holders outside New Zealand excluded from the offer due to offshore securities law requirements)), must determine whether it is 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. The form must be sent to all shareholders, who then have 10 business days to complete a prescribed voting form to vote for opting back in to normal Code compliance for the proposed transaction. The form must be distributed electronically to any shareholders that have made elections for electronic distribution of company notices under

section 391(3A-3C) Companies Act 1993, and in hard copy to those who have not made that election.

(c) If 5% or more of the Code company's voting rights are voted by shareholders to opt back in to Code compliance for the proposed transaction, the transaction must proceed with full Code compliance (or be abandoned), subject to any other applicable exemptions.

44. The opt out / opt in solution would apply only to allotments by the Code company, and not to takeover transactions. The exemption would also not apply to acquisitions of existing share parcels, changes of control of such parcels, or buybacks (but note that the Panel will give consideration to granting such an exemption at a later date).

45. The Panel proposes that the prescribed form sent to shareholders should be very brief, no longer than one page or two. The board must set out the following particulars, which are a simplified version of the particulars required by rule 16 of the Code:

(a) a description of the proposed allotment and the reasons for making the allotment;

(b) the identity of any allottee proposing to rely on the exemption and, if different from the allottee, the identity of any person proposing to rely on the exemption whose control percentage of voting securities in the small Code company would increase as a result of the proposed allotment (referred to from now on also as "the allottee");

(c) the control percentage of the allottee after the proposed allotment or, if the exact control percentage is not known, the maximum control percentage;

(d) the aggregate total control percentage of the allottee and the allottee's associates after the proposed allotment or, if the exact control percentage is not known, the maximum control percentage;

(e) the issue price;

(f) the reasons the board of directors believes it is in the best interests of the company to opt out of the Takeovers Code;

(g) a statement that by opting out of the Code, shareholders will not receive:

(i) the information usually required by the Code, in particular an independent adviser's report on the implications for shareholders of any change of control of the company as a result of the allotment and the merits of the allotment;

(ii) the opportunity to vote for or against the proposed allotment under the Code;

(h) a statement by the board of directors that it believes that it is in the best interests of the company to opt out of Code compliance for the proposed allotment (together with the reasons for that belief) and that only disinterested

members of the board voted on the decision (being those members that are not proposed allottees, or associates of allottees (unless the offer that will result in the allotment is made on a pro rata basis to all shareholders in New Zealand (disregarding, for this purpose, holders outside New Zealand excluded from the offer due to offshore securities law requirements)). If any of the directors dissent to or abstain from making the statement their names and their reasons for dissenting or abstaining must be stated.

46. A prescribed voting form would be included with the prescribed board form for shareholders to vote for opting back in to the Code. Every shareholder eligible to vote under the Companies Act 1993 and the company's constitution would be eligible to vote on whether to opt back in to the Code (including the allottee and any associates of the allottee).

Analysis of the preferred option

47. There are similar opt out / opt in regimes in New Zealand. For example NZX Limited's NXT market rules contain similar opting provisions for shareholders in relation to transaction announcements. The Companies Act 1993 also contains similar opting provisions for shareholders for audit requirements, annual meeting requirements, and electronic communication options.

48. Shareholders would still be protected by the Code in that communications and documentation regarding a transaction would still be subject to the rule 64 prohibition against misleading or deceptive conduct. Directors are also always subject to their fiduciary duties under company law. The fair dealing provisions of Part 2 of the FMC Act would also apply to the offer (even if it is not a regulated offer under that Act). Shareholders in listed companies who would expect the higher regulatory thresholds implied by listing on a licensed market would have the protection of the Code, because the exemption would not be available for listed companies even if they would otherwise be "small".

49. The Panel considers that takeover transactions should be excluded from the proposed class exemption because the main beneficiary of these transactions is the acquirer, and the Code company may be reimbursed for the costs of Code compliance. However, allotments provide new capital for the company, or recompense goods or services provided to the company. All shareholders benefit from this. The Panel considers that differentiating between share issue transactions (which usually relate to company growth, through additional capital raising) and non-allotment transactions (which benefit the acquiring shareholder) dovetails well with the objectives of the FMC Act to make it easier for small and medium sized companies to raise capital. As noted below, at this time the Panel does not intend to extend the preferred option to non-allotment transactions and seeks further information on whether such transactions (other than full or partial takeovers), should also be granted exemption relief.

50. The new preferred option would achieve the Panel's objectives set out in its initial consultation paper: The option would:

(a) reduce compliance costs for small Code companies where the board of the company decides that it is in the company's best interests to opt out of Code compliance (and shareholders do not opt back in to Code compliance);

(b) 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; and

(c) ensure that shareholders are treated fairly and are provided with sufficient information to decide for themselves on the merits of a transaction and whether the board of the company is correct that it is in the best interests of the company to opt out of Code compliance. The new preferred option allows shareholders to opt back in to Code compliance if they feel they are not being treated fairly, or do not have sufficient information to make a decision on the merits of a transaction. The low 5% threshold for opting back in to the Code means that, effectively, any one of the company's substantial shareholders can swing the vote for opting back in so that full Code-required disclosures would be made before a transaction can proceed.

Further considerations

51. The prescribed form and its disclosure requirements are obviously very significant in making such an option work, and it would be important for the Panel to ensure that the prescribed form would provide shareholders with the appropriate information to make a decision on whether to accept a board's decision to opt out of the Code. The Panel is interested in the market's views therefore, not only on the appropriateness of the preferred option, but also on whether its proposal for the content of the prescribed form looks appropriate.

Questions

52. 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. 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?

2. 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 in to 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?

3. 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 ?

4. 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.

Possibility of further relief for small Code companies

53. This consultation paper has focussed only on what the Panel can do to make it less costly for small Code companies to issue shares. This objective meets the Panel's stated policy objectives and also the policy settings for the capital markets in general. However, the Panel is open to considering further relief for small Code companies as part of its ongoing policy work programme.

54. In order to assist with further policy development in this area, the Panel seeks the market's 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. The Panel asks consultees to be as specific as possible regarding the types of transactions that should be offered relief and also the possible parameters of what should be exempted to avoid inappropriate reliance on any exemption the Panel should grant in the future.