

**A PROPOSAL TO CHANGE THE SMALL CODE COMPANIES CLASS
EXEMPTION**

A TAKEOVERS PANEL CONSULTATION PAPER

26 August 2016



TAKEOVERS PANEL

Introduction

1. The Panel is considering whether to extend the coverage of the [Takeovers Code \(Small Code Companies\) Exemption Notice](#) that was granted in July 2015 (the “Class Exemption”). The purpose of the Class Exemption is to reduce costs associated with complying with the [Takeovers Code](#) (the “Code”) by allowing small, unlisted Code companies to opt out of the Code when raising capital by share allotments.
2. There are two reasons why the Panel is considering extending the Class Exemption:
 - (a) practitioners (particularly lawyers) and some crowdfunding platforms have told the Panel that by only covering allotments the Class Exemption is too narrow to be of any great use; and
 - (b) the Panel is currently preparing a consultation paper that will propose a number of amendments to the Code. While most of the proposed amendments are minor technical changes, the Panel is also considering whether to recommend a change to the statutory threshold for being a Code company. The proposed change to the Code company threshold would result in small, unlisted Code companies no longer being Code companies. As the process for changing legislation (the [Takeovers Act 1993](#) and the Code) is complex, requires government approval, and may take several years before enactment, the Panel is considering extending the Class Exemption as an interim measure to reduce the costs of Code compliance for small Code companies.

Request for comments on this paper

3. The Panel invites submissions on the preferred option and the questions set out in this paper. The Panel would particularly like to hear the views of shareholders and their advisers (including financial advisers and planners), and the advisers to and directors of small, unlisted Code companies.
4. The questions asked throughout this consultation paper are attached as a separate document. It would be useful if respondents used this document for their submission.
5. The closing date for submissions is **5.00 p.m., 23 September 2016**.

6. Submissions should be sent to the attention of Joanna Lambert to:

By email communications@takeovers.govt.nz

By post Takeovers Panel
Level 3, Solnet House
70 The Terrace
P O Box 1171
WELLINGTON 6011

7. While the Panel prefers to receive written submissions (including any email comments), verbal feedback is also acceptable, especially from shareholders or directors of small Code companies. Please contact Joanna Lambert on 04 815 8451 if you would like to discuss the options and questions in this paper.

Official Information Act

8. 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.

Problem definition and description of the status quo

Background

1. The Code applies to “Code companies”. A Code company is a New Zealand incorporated company that:
 - (a) is listed with financial products that confer voting rights (e.g., ordinary shares quoted on a licensed market, like the NZX); or
 - (b) was within paragraph (a) at any time during a 12 month period before a transaction or event covered by the Code; or
 - (c) has 50 or more shareholders (with voting rights) and 50 or more share parcels.
2. Prior to the Takeovers Act and the Code being amended in 2006 so that small-by-value unlisted companies were no longer subject to the Code, a company was also required to meet the value threshold of “\$20 million or more of assets” to be a Code company.
3. Within the broader capital markets context, the Code regulates a range of takeover and share acquisition transactions in relation to New Zealand Code companies. The Panel’s role is to administer the Code. The number of Code companies is unknown, given the lack of available data, but is estimated to be somewhere in the order of 1000 to 1500 companies (less than 1% of New Zealand’s c.500,000 companies). Approximately 130 of these Code companies are listed on the NZX Main Board, NZAX or NXT markets.
4. As an independent Crown entity, the Panel is not subject to Government directions about how to exercise its powers. However, the Panel is part of the State Services and is accountable to its Minister. In recent years, the [Minister’s annual letter of expectations](#) has asked the Panel to consider ways it can contribute to the Government’s [Business Growth Agenda](#) goals. The most relevant section of the Business Growth Agenda for the Panel is that on Building Investment, which focuses on encouraging direct foreign investment into New Zealand and reducing compliance costs for New Zealand businesses to raise capital.
5. It is this policy environment in which the Panel has sought, and received, feedback on the compliance costs the Code imposes on small companies. The Panel consulted on the issue in [October 2014](#) and [February 2015](#), and granted the [Class Exemption](#) in response to submissions received. The Class Exemption allows “small Code companies” (unlisted companies with total assets of \$20 million or less) to opt out of Code compliance where a person increases their holding or control of voting rights (i.e., their share ownership) as a result of an allotment of shares by the Code company.

6. Since the Class Exemption came into force in July 2015, it has been relied on to exempt a person's increase in voting control as a result of an allotment of voting securities in a small Code company only one time.

Q1: *Why do you think the Class Exemption has been relied on only once since its introduction in July 2015?*

7. Some of the feedback received by the Panel during the 2014 and 2015 consultations on small Code companies indicated that the Class Exemption does not go far enough in reducing the costs of Code compliance for small-by-value Code companies. The Panel has continued to receive similar feedback since the Class Exemption was granted.
8. As noted in the Introduction, the Panel is working on a longer-term legislative solution to the disproportionate cost burden associated with Code compliance for small Code companies. The Panel is seeking feedback on whether to extend the Class Exemption as an interim solution.

How the Code regulates increases of shareholdings in Code companies

9. Shareholders, and prospective shareholders, are subject to rule 6 of the Code. Rule 6 prohibits a person from increasing their ownership of the voting rights in a Code company unless, after the increase, that person and that person's associates would hold or control in total not more than 20% of voting rights in the Code company (the "Fundamental Rule").¹ Accordingly, any associates' ownership of the company's shares has to be included in the calculation to work out whether an increase by a person would trigger the Fundamental Rule.
10. Rule 7 of the Code provides the mechanisms by which a person can increase their ownership of Code company voting rights without breaching the Fundamental Rule. Rule 7 permits a person to increase their shareholding position in a Code company above the 20% threshold by:
 - (a) making a full or partial takeover offer;
 - (b) obtaining the approval of the company's shareholders for an acquisition or an allotment or other increase;
 - (c) making "creeping" increases by a maximum of 5% over a 12-month period (if the person already owns more than 50% of the voting rights in the Code company); or
 - (d) any means if the person already owns 90% or more of the voting rights in the Code company.

¹ Rule 4 of the [Code](#) defines the important term "associate". "Associate" covers related companies, persons who act jointly or concert together or who follow one another's wishes, as well as persons with business or even personal relationships. See rule 4 for the complete definition.

11. The above mechanisms, except for the last two, usually require full Code compliance, including the provision of an independent adviser's report for the company's shareholders on the merits of the transaction.
12. Another common mechanism by which a person can increase their ownership is when the Code company buys back some of its own shares. The company cancels the shares it buys back, meaning that the shareholding percentage of people not participating in the buyback increases. If a person's shareholding position would increase above the 20% threshold, or if already above 20% would increase at all (unless the Code's "creeping" provisions can be used), approval from the company's other shareholders can be obtained under clause 4 of the [Takeovers Code \(Class Exemptions\) Notice \(No 2\) 2001](#) (the conditions of which include that an independent adviser's report be provided to the company's shareholders) (the "Buyback Class Exemption").
13. There can be significant costs to the Code company to facilitate any of these mechanisms for a person increasing ownership in the company. For takeovers of small Code companies, the costs are unlikely to be less than \$100,000 and can be several times this figure. For other Code-regulated transactions in small Code companies that require shareholder approval (e.g., allotments, acquisitions and buybacks), the costs may be similar to those of a takeover if the transaction is complex, or between \$50,000 and \$80,000 for smaller transactions. These costs are associated with legal advice, an independent adviser's report and holding a shareholders' meeting. For small Code companies, these costs may outweigh the benefits of Code compliance.

Q2: Do you have a different experience of the costs of Code-regulated transactions for small Code companies? If yes, please provide quantitative information on your estimate and an explanation of how you came to this figure.

Status quo - small Code companies and the Code

14. Following the Panel's [2014](#) and [2015](#) consultation on reducing the cost burden for small-by-value Code companies of complying with the Code, the Panel granted the [Class Exemption](#) for persons who increase their holding or control of voting rights in a small, unlisted Code company as a result of an allotment of shares by the Code company.
15. The purpose of the Class Exemption is to lower the disproportionate cost barriers to capital-raising for small Code companies, by potentially enabling the company to avoid the costs of holding a shareholders' meeting, obtaining an independent adviser's report, and obtaining legal advice on the process.
16. The Class Exemption permits a small, unlisted Code company to opt out of Code compliance when raising capital through an allotment of shares (or series of allotments). For the purposes of the Class Exemption, a company is "small" if, at its most recent balance date, it has total assets that do not exceed \$20 million.

17. The Class Exemption applies only if:²
- (a) the company's board has resolved that, in its opinion, opting out of Code compliance is in the best interests of the company;
 - (b) the company has given shareholders a brief disclosure document and an opportunity to object to the opt out (and thereby to require full Code compliance); and
 - (c) objections to the opt out represent less than 5% of the "free float" shares.
18. "Free float" in this context means the shares belonging to shareholders who are not using, and are not associates of any person using, the Class Exemption.
19. As set out in the Panel's 2014 and 2015 small Code companies consultation papers, there are other 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 certain transactions, and the Companies Act 1993 also contains similar opting provisions for shareholders for preparation of financial statements and audit requirements.
20. At the time of writing, the Class Exemption has only been relied on once. The purpose of this consultation paper is to obtain feedback to inform the Panel's review of the Class Exemption. If the Panel is satisfied that it would be appropriate to do so, and if an extension is consistent with the objectives of the Code, the Panel may extend the Class Exemption's application.
21. Small-by-value companies are offered different relief in different jurisdictions from their respective takeovers legislation ("Code"). In Hong Kong, the Code only applies to listed companies so the issue of small Code companies and the cost of compliance does not arise as frequently as it does in New Zealand. The Hong Kong Panel may exercise its discretion to allow some relief for small-by-value companies with a secondary listing in Hong Kong where the cost of Code compliance outweighs the benefits.
22. There are no formal exemptions from Code compliance for small companies in the United Kingdom, although the United Kingdom Panel has the ability to grant derogations and waivers from the Code. In Australia, there is no specific relief from the Code for small-by-value companies.

Policy objectives

23. The Panel's policy objectives for this review are to:
- (a) reduce compliance costs for small Code companies;

² A full description of the terms of the Class Exemption is set out on pages 10 to 12 of this paper. The current terms only relate to allotments.

- (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.
24. The Panel used these policy objectives for the 2014 and 2015 small Code companies consultation papers. All submitters on those papers agreed with the above policy objectives. The Panel continues to believe these policy objectives are appropriate for considering whether to extend the coverage of the Class Exemption.

Options

25. The options considered by the Panel are:
- (a) maintain the status quo; or
 - (b) extend the Class Exemption to include all other transactions and events (but not takeovers) that are subject to shareholder approval (such as acquisitions and buybacks) – preferred option.

Option 1: maintain the status quo

Key features of option 1

26. Under this option, unlisted Code companies whose total assets do not exceed \$20 million at the most recent balance date, and their shareholders, may choose to opt out of Code compliance under the Class Exemption, if the company is raising capital through an allotment and a person increases their ownership in the company above the Code's 20% threshold as a result of the allotment.
27. In all other cases, 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) regulated takeovers that require the same offer terms to be made to every shareholder, and adequate time to consider the takeover offer before deciding whether to accept it or not;
 - (b) the requirement for shareholder approval to be obtained for Code-regulated acquisitions, allotments and buybacks;
 - (c) the disclosure of required information in notices of meeting and related documents, and in takeover documents, including directors' recommendations;
 - (d) an independent adviser's report on the merits of the transaction; and

- (e) the protection of rule 64 of the Code (which prohibits misleading or deceptive conduct) and the Panel as regulator.
28. A person may increase their ownership of Code company voting rights without any Code-compliance obligations:
- (a) if the person does not increase their share ownership (together with that of any associates) above the Code's 20% threshold;
 - (b) by making "creeping" acquisitions of up to 5% in any 12-month period, if the person holds or controls more than 50% of the voting rights in the Code company; or
 - (c) by any means if the person holds or controls 90% or more of the voting rights.

Analysis of option 1

29. Option 1 meets the Panel's policy objectives to some extent, as identified in the table below:

Policy objectives	Analysis of Option 1 against Policy Objectives
Reduce compliance costs for small Code companies	Small Code companies may choose to use the Class Exemption to decrease costs associated with Code compliance when undertaking a capital raising via allotment, providing some relief. Costs would remain for other Code-regulated transactions undertaken by small Code companies.
Maintain a proper relationship between the costs of compliance with the Code and the benefits resulting from it	The costs of complying with the Code may outweigh the benefits of Code protection for small, unlisted Code companies. The Code's current application is more appropriate for larger and listed companies.
Ensure shareholders are treated fairly and are provided with sufficient information so that they can decide for themselves the merits of a transaction	<p>Providing all information required by the Code for a transaction ensures shareholders receive comprehensive information. The Class Exemption requires the board to provide some information, but an independent adviser's report on the merits of the transaction is not required (unless the company's shareholders opt back in to Code compliance for the transaction).</p> <p>It is arguable that some transactions do not occur because of the relative compliance costs that would be incurred, so arguably shareholders may have no opportunity to decide in those cases.</p>

30. Option 1 offers strong protections for Code company shareholders when changes of ownership of voting rights result in a person's holding or control of voting rights increasing above the Code's 20% threshold. It could be argued that shareholders in small, unlisted Code companies bear the greatest benefit from the Code, as they lack the ongoing disclosures that listed companies must make to their shareholders. However, the Code originally did not cover small, unlisted companies, until the \$20 million asset threshold was removed in 2006. For many small Code companies, the cost of Code compliance may outweigh the benefit of the Code's protections. Accordingly, Option 1 is not the Panel's preferred option.

Q3: Do you agree with the Panel's analysis of the status quo? If not, please provide the reasons for your view.

Option 2: extend the small Code companies Class Exemption to include other transactions that are subject to shareholder approval (such as acquisitions and buybacks) – preferred option

Key features of option 2

31. Under this option, all Code companies, large and small, would remain subject to the Code and to the regulation and oversight of the Panel.
32. However, small Code companies (defined in paragraph 16) would only be fully subject to the Code for full or partial takeover offers made under rule 7(a) or 7(b) of the Code, but the board could opt out of the Code for acquisitions, allotments and buybacks (unless shareholders choose to opt back into the Code).
33. The Panel proposes extending the Class Exemption to include all transactions and events that are not takeovers. Under this proposal, any transaction or event that currently requires shareholder approval under rule 7(c) (acquisitions), 7(d) (allotments) or the Buyback Class Exemption would be covered by the Class Exemption.
34. The Panel proposes the extension would require adhering to the process which is currently in place for the Class Exemption. If:
- (a) a proposed acquisition, allotment or other transaction or event (other than a full or partial takeover offer) would trigger the Fundamental Rule of the Code, the board of the small Code company must complete a prescribed form which sets out the key details of the proposed transaction (the "Disclosure Document"). The Disclosure Document must be sent to all shareholders, who then have 21 days to return a notice of objection (the "Objection Form") to the company to vote for opting back in to normal Code compliance for the proposed transaction.
 - (b) the company receives objections from shareholders representing 5% or more of the free float of the company's voting rights 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.

35. “Free float” in this context means the shares belonging to shareholders who are not using, and are not associates of any person using, the Class Exemption.
36. The Panel proposes information equivalent to what is currently required under the Class Exemption be provided to shareholders. Accordingly, the board must send to shareholders the Disclosure Document containing:
 - (a) a brief description of the transaction;
 - (b) a statement that, in the board’s opinion, it is in the best interest of the company to opt out of compliance with the Code for the transaction, and the names of directors who do not agree with that statement and their reasons;
 - (c) information along the following lines:
 - (i) a statement that the company falls within the definition of “small Code company” and therefore is not subject to full Code compliance for the transaction;
 - (ii) a statement that shareholders will not receive an independent adviser’s report on the merits of the transaction or other information required by the Code, and shareholders will not have the opportunity to vote for or against the transaction;
 - (iii) a description of the opt out/opt in process, including how to object to opting out of Code compliance, and stating the threshold required for the company to again be obliged to fully comply with the Code for this transaction.
 - (d) if applicable, the price for the shares being acquired or allotted;
 - (e) the reasons for the transaction;
 - (f) the identity of any director who is or may be increasing their holding or control of voting rights in the Code company due to the transaction;
 - (g) the following information in respect of each person who is using the exemption:
 - (i) identity of the person;
 - (ii) control percentage of the person immediately before the transaction;
 - (iii) control percentage of the person as a result of the transaction or, if the control percentage is not known, the maximum control percentage under the transaction;

- (iv) aggregate control percentage of the person and the person’s associates as a result of the transaction or, if the aggregate control percentage is not known, the maximum aggregate control percentage; and
 - (h) the Objection Form for shareholders to give a notice of objection about opting out of the Code for the transaction, clear instructions for submitting the Objection Form, and reasonable means to facilitate submission of the Objection Form (including a pre-paid reply envelope if sent by post).
37. The Disclosure Document must not be longer than two A4 pages in a minimum of 10pt font when printed (excluding the Objection Form).

Q4: Do you think there is a risk of inappropriate reliance on the Class Exemption if it is extended to cover acquisitions and buybacks? If yes, do you have any suggestions on how this risk can be mitigated?

Analysis of option 2

38. Option 2 meets the Panel’s policy objectives, as described in the table below:

Policy objectives	Analysis of Option 2 against Policy Objectives
Reduce compliance costs for small Code companies	<p>Extending the Class Exemption should reduce compliance costs for small, unlisted Code companies in relation to allotments, acquisitions and buy backs.</p> <p>Anecdotal advice received by the Panel suggests that the cost of complying with the Class Exemption may be approximately \$5,000 (including legal advice), representing a saving of at least \$45,000 to \$75,000 for each transaction where the board opts out of the Code. Assuming these savings would be similar for acquisitions and buybacks, the cost of Code compliance for small Code companies would be reduced.</p> <p>However, if shareholders were to require the company to opt back in to complying with the Code, delays would be caused for the transaction and total costs increased (due to now having to comply with the Code) or the transaction may be abandoned.</p>
Maintain a proper relationship between the costs of	The disproportionate compliance costs for small, unlisted Code companies would be potentially

<p>compliance with the Code and the benefits resulting from it</p>	<p>removed for allotments, acquisitions and buy backs. Larger and listed companies would continue to have to comply with the Code.</p> <p>Shareholders in small, unlisted Code companies would still be protected by the Code even for opt out transactions, as communications and documentation regarding a transaction would still be subject to rule 64 of the Code, which prohibits misleading or deceptive conduct. The Panel would retain its jurisdiction to monitor opt out transactions and respond to any complaints.</p>
<p>Ensure shareholders are treated fairly and are provided with sufficient information so that they can decide for themselves the merits of a transaction</p>	<p>For transactions occurring under the Class Exemption, shareholders in small, unlisted Code companies would not have the same access to information required by full compliance with the Code. However, the company's board is required to provide some information on the proposed transaction, and the low 5% threshold (of the shares belonging to shareholders (and their associates) who are not relying on the Class Exemption) for opting back into the Code means that, effectively, any one of the company's substantial shareholders could swing the vote for opting back in so that full Code-required disclosures would be made before a transaction can proceed.</p> <p>Arguably, more transactions will occur because of the reduced compliance costs.</p> <p>Takeovers (full and partial) are excluded from Option 2 because takeovers have a potentially greater impact on the company, and a more personal effect on shareholders than acquisitions by, or allotments to, other shareholders. In a full or partial takeover an offer is made to every shareholder. Shareholders are given information by the offeror and the Code company to help them make a decision on their own shareholding (i.e., whether to accept or reject the offer for their shares).</p> <p>However, in allotments, acquisitions and buy backs, shareholders are invited to participate in the transaction by voting in relation to another person increasing their shareholding.</p> <p>In some transactions, for example a reverse takeover, where a large allotment of shares to a</p>

	<p>person dilutes the other shareholders' percentage to a very small proportion of the total voting rights, the Panel anticipates that a board might not believe that it was in the best interests of the company to opt out of the protections of the Code.</p>
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Q5: *Do you agree with the Panel's analysis of the preferred option? If not, please provide the reasons for your view.*

Q6: *Do you agree with the Panel's preferred option? If not, please provide your reasons.*

39. The Panel is aiming to get the balance right between protecting investors and the integrity of New Zealand's capital markets, and not unduly inhibiting business growth. Allowing small Code companies the flexibility to opt out of Code requirements would allow the board and shareholders to determine what protections should apply to the company for a particular transaction.

Q7: *Is there anything else you would like the Panel to be aware of as part of this review of the Class Exemption?*

Submissions

40. The Panel would particularly like to hear the views of advisers to, and directors and shareholders of, small, unlisted Code companies as to whether they agree with the preferred option. Whether respondents agree or disagree, the Panel would like to have the benefit of understanding the reasons for this view.
41. The Panel recognises that there will most likely be views expressed on both sides, so the goal is to achieve the most balanced and appropriate outcome that contributes to the integrity of New Zealand's capital markets, while not unduly inhibiting business growth and risk-taking.
42. The Panel is seeking your feedback specifically on the questions in this paper. All of the questions are set out in the attached word document, which can be used by respondents for their submission.