NEW ZEALAND LAW SOCIETY
NZLS EST 1869

Law Society Building, 26 Waring Taylor Street, Wellington,
DX SP20202, Wellington or PO Box 5041, Lambton Quay,
Wellington 6145, New Zealand

TEL +64 4 472 7837 • FAX +64 4 473 7909
E inquiries@lawsociety.org.nz
www.lawsociety.org.nz • my.lawsociety.org.nz

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Lauren Donnellan
Takeovers Panel
PO Box 1171
Wellington 6011

By email: lauren.donnellan@takeovers.govt.nz

Small code companies and the Code – consultation paper

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the consultation paper published by the Takeovers Panel on 30 October 2014 asking whether there is a demonstrable problem with the cost of Code compliance for small Code companies.

2. In response to the questions raised for consultation, the Law Society responds as set out below.

Summary of response

3. We summarise the Law Society's responses to the questions posed by the Panel as follows:

Q1: Is there a problem with the cost of Code compliance for small Code companies?
Our experience matches feedback cited by the Panel about the problem of the compliance costs faced by smaller Code companies. These problems are often exacerbated 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. In addition, the Law Society is also concerned that New Zealand businesses not be at a relative disadvantage when compared with those in our trading partners, particularly Australia. However, we are concerned that the Panel's focus is narrow and limited to just the costs associated with an independent adviser's report. Small Code companies face a range of compliance obligations (and costs), often for relatively low value transactions. Also, whilst the Panel's April 2014 reminder about compliance with the Code and the (pragmatic) solution of structuring holdings so as not to become a Code company was timely, it masks the issue – and ignores those who have little practical scope to manage the prospect of falling within the Code.

Q2: Do you agree with the Panel's definition of "small Code company"?
The Law Society accepts the Panel's proposed demarcation that "small" equates to a Code company with "enterprise value post-money" of $20 million or less.
Q3: Do you agree with the Panel's policy objectives?
The Law Society shares the Panel's concerns that the compliance obligations be right-sized for small Code companies and their stakeholders. However, the Law Society is also concerned that New Zealand businesses not be at a relative disadvantage when compared with those in our trading partners, particularly Australia.
Q4: Which of the Panel's preferred options (option 1 or option 5) do you agree with – or is there a better alternative (if so, please provide details)?
The Law Society suggests that a hybrid version of Option 5 should be considered, that looks at one or both of: a. a proportion of the Code company's voting rights – using the 10% threshold suggested by the Panel; and b. a measure of enterprise value – we suggest that the threshold for a 'major transaction' under the Companies Act provides a useful benchmark. Any such exemption should address a wider range of compliance obligations than just the independent advisers' report. (And it should be in addition to, and not instead of, Option 3).
Q5: If the Panel grants a class exemption to solve the problem, do you think there is any risk of inappropriate reliance? (If so, please suggest possible mitigations.)
In the absence of more detailed commentary on question 5 in the consultation paper, the Law Society suggests that the risk of the proposed concessions being used inappropriately is likely to be low but not negligible. Whilst the Panel must not lose sight of the main objectives of seeking to ensure that shareholders are treated fairly and are provided with sufficient information so that they can decide for themselves the merits of a transaction, we believe the proposed concessions (if implemented) will largely be used in the context of legitimate transactions and not in an attempt to game any softening of the compliance burden on small Code companies. Also, in many if not most instances, the Code company and its stakeholders will also have the protections in the Code itself (including those provided by the 'truth in takeovers' regime provide by Rule 64) as well as the overlay provided by the Companies Act, including: a. the protections for minority shareholders; and b. the role of directors – in order to satisfy their duties under the Companies Act.

Problem identification

4. We commend the Panel on taking a proactive approach to the concerns expressed by those involved in or advising small Code companies about the compliance costs associated with relatively small-scale

activities. The experience of the Law Society tends to validate the feedback cited by the Panel about the compliance costs faced by smaller Code companies, often in relatively straightforward transactions such as raising small amounts of capital from existing shareholders. These problems are often exacerbated 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 (e.g. various rural water schemes). In such instances, a small (often low-value) administrative rearrangement can trigger compliance burdens and costs out of all proportion to the values involved.

5. As a result, the Law Society shares the Panel's concerns that the compliance obligations be right-sized for the target audience (i.e. small Code companies and their stakeholders). And, to repeat a point that the Law Society has made in other submissions in relation to commercial and business law matters, the Law Society is also concerned that New Zealand businesses not be at a relative disadvantage when compared with those in our trading partners, particularly Australia.

6. In these comments the Law Society has accepted the Panel's proposed demarcation that "small" equates to a Code company with "enterprise value post-money" of $20 million or less. Whilst experience indicates that this seems appropriate, we assume the Panel has some data (based on the SME sector) that indicates this is an appropriate threshold in terms of such measures as economic activity, employment, etc.

7. However, we are concerned that the Panel's focus appears to be confined to just the costs associated with commissioning an independent adviser's report, and not the wider range of compliance obligations (and their associated cost) for small Code companies. This is particularly the case in relatively low value transactions such as shareholder rearrangements and raising small amounts of capital.

8. Also, while the Panel's April 2014 reminder about the need to be aware of the need to comply with the Code was timely, we suggest that the (pragmatic) solution of structuring holdings so as not to become a Code company risks masking an issue that needs to be addressed on the sort of wider policy basis that underpins the consultation paper. And as noted in paragraph 12 below, in many cases there is little practical scope to manage the prospect of falling within the Code.

The creep rule and the "no-fly zone"

9. As is noted below, there is an important point of distinction between the application of the scoping for 'creeping' acquisitions between New Zealand and Australia. As the Panel will be aware, in Australia shareholders who own more than 19% can make creeping acquisitions of 3% in any 6-month period. By contrast, the "no-fly zone" creates practical difficulties which are likely to be felt most keenly in the case of small Code companies.

New developments – the FMC Act

10. The Law Society has welcomed the introduction of the Financial Markets Conduct Act 2013, particularly its implementation of recommendations of the Capital Markets Development Taskforce to provide measures to make it easier for SMEs to raise capital. Consequently, the Law Society is interested to watch the impact of new avenues such as crowd-funding, and to see whether they have a material impact on the costs and compliance burdens associated with raising capital. However, we share the Panel's views that the means by which an SME trips the 50-shareholder threshold should be irrelevant from a policy perspective – and that an economic threshold (such as enterprise value) is a better gauge of its ability to meet the compliance burden associated with being a Code company.

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

11. The Law Society understands the Panel's reasons – consistency and fairness as well as equal treatment of shareholders – for identifying the status quo as its preferred option, if there is found to be no problem with the cost of Code compliance for small Code companies. We also note the Panel's suggestion that smaller Code companies and their shareholders can choose to structure the shareholdings to fall within the ambit of the Code or not.

12. However, the Law Society is concerned that there is often little practical scope to manage the prospect of falling within the Code, and thereby the exposure to a heavy compliance burden. As a result, if this problem is relatively common (and in this regard we only have anecdotal evidence as a guide), then we believe the Panel is rightly concerned that the objective of maintaining a proper relationship between the costs and benefits of compliance with the Code is not being met.

Option 2 – a class exemption for non-takeover transactions (so independent adviser's report is not required)

13. For option 2, a 'takeover transaction' is characterised as:

    a. a full or partial takeover; or

    b. a transaction which results in a person (together with their associates) acquiring (or being allotted) 50% or more of a Code company's total voting rights.

14. We agree that Option 2 meets some, but not all, of the Panel's policy objectives. For this reason, we agree that this should not be the Panel's preferred option.

Option 3 – a class exemption to extend the "creep" provisions

15. For option 3, the proposal is to extend the scope for "creeping" in the case of small Code companies – by allowing small increases up to 5% of the Code company's total voting rights in any rolling 12-month period.

16. We note the Panel's policy objections to allowing creeping increases in the 'no-fly zone' for small Code companies. However, in Australia the creep exception allows a shareholder to increase its shareholding above the 20% threshold by 3% every 6 months. Some years ago, ASIC stated that it believed this exception was contrary to the spirit of the takeover laws because it allows a shareholder to acquire a controlling stake without making a formal takeover bid, avoiding having to pay a full control premium, without all shareholders having an equal opportunity to participate in the transaction and without the target having the opportunity to respond.

17. However, we understand there is an absence of any real evidence that this exception has in the past been used to allow surreptitious acquisition of control in circumstances where the market remains in the dark as to the ability of the shareholder to creep. It is noted that acquiring control using the creep exception is a very slow process – it would take more than 6 years to move from 20% to 50% relying only on the creep exception. Possibly there is a problem in the case of unlisted small Code companies where a substantial security holder notice is not required to be given for every 1% movement by the shareholder (so that there is an absence of a market signal about what is happening) that would enable the Code company to advise its shareholders. However, in the case of small Code companies, some of this information can be provided for example through the annual reporting process.

18. As a result, in the absence of compelling evidence that the creep exception is being used to avoid the general intent of the Code, the Law Society is not entirely convinced that a relaxation of the creep provisions as they apply to small Code companies is unwarranted.

Option 4 – a class exemption for an independent adviser's report in any transaction involving a small Code company's voting rights

19. Under this option, small Code companies would not need an independent adviser's report for any Code transaction, but the balance of the Code would apply to such transactions (e.g. target company statement, etc.).

20. We note the Panel's concerns that 'large transactions' (e.g. the acquisition of a significant stake or even a takeover) that have a significant impact on shareholders would not require an independent adviser's report. As a result, the Panel is concerned that the target company directors would be put in the position of having to address some of the issues typically addressed in an independent adviser's report, due to their obligations under clause 24 of Schedule 2 of the Code to ensure that the target company statement included:

> *Any other information not required to be disclosed by this schedule that could reasonably be expected to be material to the making of a decision by the offerees to accept or reject the offer.*

21. The Law Society is not entirely convinced that the burden would fall entirely on the directors of the target company. In practice, many target company boards would likely be advised that the provision of such information is outside the expertise of a target company director – and they would have little option but to commission an independent expert to provide it. Even if such a report was not specifically a Code report, the Code company would still be likely to incur compliance costs that are significant especially when compared with the value of the transaction. As a result, we believe that Option 4 would only go part-way to achieving the Panel's objectives.

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 (if there is a widespread problem)

22. 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 voting rights over any 12-month period – but the balance of the Code would apply to such transactions.

23. We note the Panel's assessment that Option 5 meets its cost/benefit objective of compliance whilst maintaining the Code's protections, and effectively gives small Code companies the flexibility they often need to affordably resolve issues affecting small amounts of capital or to assist exiting shareholders when there are few willing buyers. At the same time, the balance of the Code would apply to large transactions (e.g. takeovers) that would have a significant impact on shareholders.

24. Regrettably, we believe that this assessment still misses the point that (in many small Code companies) such 'large' transactions still involve relatively modest values. Again, to focus on the rural economy, a transaction involving a capital raising by a small-scale SME with more than 50 shareholders to raise new capital for a new development often amounts to a 'down round' in terms of both value and its diluting effect. This is often because 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).

25. Consequently, we believe that a hybrid solution may be required that looks at one or both of:

    a. a proportion of the Code company's voting rights – in this regard we have no specific objection to the 10% threshold suggested by the Panel; and

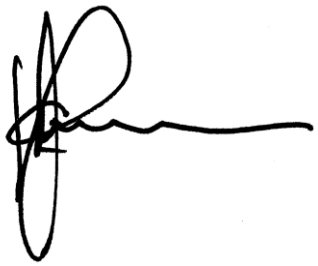
    b. a measure of enterprise value – and in the absence of a better model, we suggest that the threshold for a 'major transaction' under the Companies Act provides a useful benchmark.

    Any such exemption should also address a wider range of compliance obligations than just the independent advisers' report.

    (It should also be mentioned that we favour this approach in addition to, and not instead of, Option 3).

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
President