ANGEL ASSOCIATION NEW ZEALAND

NZVCA NEW ZEALAND PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION INC

Submission from the

New Zealand Private Equity & Venture Capital Association and The Angel Association

Financial Markets Conduct Bill Exemptions

April 2012

About the NZVCA and Angel Association

1. This submission is presented jointly by the NZVCA and Angel Association.

2. The NZVCA and the Angel Association have been active participants in the development of the Financial Markets Conduct Bill (**FMCB**) through engagement with The Capital Markets Development Task Force, MED and relevant ministers.

3. Our focus is on the application of certain key exemptions provided for in schedule 1 of the FMCB in the context of early stage (including Angel), private equity and venture capital investment in New Zealand.

4. The FMCB marks a significant step forward in the clarity of the legislation and the certainty afforded to issuers and investors alike. In particular, the development of new brightline tests, additional flexibility for small offers and the increased use of self certification constitute significant improvements.

5. A key concern is for us to maintain an active voice in the ongoing development of the FMCB and to highlight our support for the changes made to the law as encapsulated in schedule 1 of the FMCB. It is important to the private capital markets that there is no backward steps with respect to the changes proposed to be made to the law. In addition, there remain some areas where we feel that the regime could be further tailored to ensure the FMCB reflects commercial imperatives within the current policy framework.

6. The purpose of our submission is to highlight issues and propose some relatively accessible solutions with the aim of providing a suitable balance between regulatory protection and fostering investment and economic growth.

NZVCA

7. The NZVCA is a not-for-profit industry body committed to developing a world-best venture capital and private equity environment for the benefit of investors and entrepreneurs in New Zealand. Its core objectives include the promotion of the industry and the asset class on both a domestic and international basis. NZVCA members cover the whole spectrum of investment in New Zealand private enterprise, including angel investment, seed and early-stage venture capital through to development capital and private equity (including management buy-outs and buy-ins).

Angel Association

8. The Angel Association was established in 2008 to bring together the business angel networks and early stage funds to work towards an agreed national vision and to deliver the activities required to achieve that vision. It aims to increase the number, quality and success of angel investments in New Zealand and, in doing so, create a greater pool of capital for innovative start-up companies.

9. The primary objectives of the Angel Association are to:

    (a) promote the growth of angel investment in New Zealand, including encouraging and educating entrepreneurs, new angel investors and angel groups; and

(b) ensure the ongoing success of the industry through developing industry strategy, encouraging collaboration between members and providing education for those involved.

Contact details

10. The NZVCA and Angel Association would be happy to discuss the issues raised in this paper further. To engage further, please contact:

(a) Colin McKinnon (Executive Director NZVCA and Angel Association) on 09 302 5218 or colin.mckinnon@nzvca.co.nz; or

(b) Michael Pollard (Partner, Simpson Grierson) on 09 977 5432 or michael.pollard@simpsongrierson.com.

Current Law and the FMCB

11. The New Zealand private capital markets rely heavily on the core exemptions comprised in sections 3(2), 5(2CB) and 5(2CBA) of the Securities Act. These exemptions play an integral part in:

    (a) companies accessing capital for growth purposes;

    (b) facilitating the participation by key employees in a company's growth; and

    (c) enabling venture capital and private equity funds to raise investment capital.

12. The FMCB seeks to recast these exemptions with the aim of providing greater clarity as to which persons may be approached by issuers without falling foul of the FMCB's disclosure requirements. For ease of reference we set out below certain of the key exemptions found in schedule 1 of the bill.

    (a) **Wholesale Investor Exclusion (*clause* 3)**

    This category exempts offers to the following groups of people from the disclosure requirements of Part 3 of the FMCB:

    (i) Investment businesses (i.e. (i) enterprises the principal business of which is investment or providing certain classes of investment advice, (ii) banks, (iii) insurers or (iv) certain other financial services entities). (*clause 35*)

    (ii) Those who meet 2 or more of certain defined investment activity criteria, namely:

    (A) holding a portfolio of at least $1 million (or having done so in the previous 2 years);

    (B) having undertaken at least 10 transactions in financial products of over $20,000 over the last two years;

    (C) having undertaken at least five transactions in financial products of over $100,000 over the last two years;

    (D) holding net assets of at least $2m or having had an annual income of $200,000 or more for each of the previous 2 financial years; or

    (E) having had, during the last 10 years, employment with an investment business.

    (collectively, the **Investment Activity Criteria**). (*Clause 36*)

    (iii) Large businesses (i.e. businesses with assets exceeding $10 million or turnover exceeding $20 million). (*Clause 37*)

(iv) Eligible investors (i.e. those who provide written certification of their financial literacy (including the grounds upon which such certification is given) countersigned by a lawyer, financial adviser or chartered accountant (each an **Authorised Signatory**)). (*Clause 39*)

(v) Those making subscriptions of over $500,000 or subscriptions which, when aggregated with amounts previously subscribed in the same class of securities, amount to more than $500,000 (**Substantial Subscribers**).

(b) **Exclusion for offers to relatives of the Offeror or of a director of the Offeror. (*Clause 5*)**

This exclusion provides an exemption for offers to relatives of the Offeror or of a director of the Offeror (the **Family Exclusion**). Relatives for these purposes include extended family as well as the trustee of a trust under which a member of the Offeror's (or director's) extended family is a beneficiary who is (A) currently entitled to a share of the trust assets or (B) is in a position to control the trustee.

(c) **Exclusion for persons controlled by any of the persons exempt under clauses 3 to 8 of Schedule 1 (the Controlled Persons Exclusion). (*Clause 9*)**

(d) **The Exclusion for Small Offers. (*Clause 12*)**

An exclusion has been introduced relating to small offers (the **20/12 Exclusion**) which enables offers to be made without compliance with the disclosure provisions of the FMCB so long as the offer:

(i) is an offer of securities;

(ii) to no more than 20 investors;

(iii) in any 12 month period; and

(iv) is subject to a cap of $2 million.

In addition, the offer must be a “specified offer”, that is to say, made to persons:

(i) with whom the offeror has personal contact or professional or other connection; or

(ii) who have made statements or actions indicating they may be interested in offers of that kind; or

(iii) with income of more than $200,000 pa.,

(together, the **Exemptions**)

13. The Exemptions mark a significant improvement in the clarity of the legislation allowing investors and issuers alike to proceed with greater confidence. However, there remain aspects of the Exemptions which could be improved to strike the right balance between investor protection and the promotion of economic growth. Our recommendations (set out in the final

section below) seek to create the necessary link between the Exemptions and this growth imperative while preserving a sufficient degree of investor protection to satisfy the FMCB's policy objectives.

Industry Background

The Corporate Lifecycle and the Role of Investors

14. Before detailing our issues and associated recommendations, we have set out below some introductory comments on:

    (a) angel investment;

    (b) the structure and operation of private equity and venture capital funds; and

    (c) the lifecycle of a growth company and its funding requirements.

15. The reason for this commentary is to highlight:

    (a) the use of the current exemptions;

    (b) the interface between the growth companies and angel investment and subsequently venture capital and private equity investors; and

    (c) the need for an appropriate set of exemptions.

16. Our submission is clearly not only relevant to growth companies. However, the example of a growth company illustrates the need for an appropriate set of exemptions for early stage investment in particular.

Introduction to Angel Investment

17. An angel investor is an investor who invests directly, either as an individual or as part of an informal group or syndicate, in a privately owned business with which they have no prior connections. Angel investors typically bridge the gap between capital provided by founders, families and friends and structured capital provided by venture capitalists.

18. Many angels are part of established groups such as the Angel Association. Such groups are designed to facilitate the dissemination of expertise, opportunities, and the provision of some limited support infrastructure. To enable both the consideration of investment proposals by angels as well as any ultimate investment, angels are typically required to be certified as wealthy investors for the purposes of section 5(2CC) of the Securities Act. Clear and flexible exemptions are therefore essential for the efficient operation of the angel groups and the growth of the companies they fund.

Introduction to Private Equity and Venture Capital Funds

19. Private equity and venture capital funds are pooled investment vehicles used for making investments, typically in the private capital markets. These funds are often limited partnerships with defined lives which attract investment capital from institutional investors such as pension funds, from high net worth or experienced individuals, and from other persons exempt from the core requirements of public offer legislation in the jurisdictions in which they raise capital. Some funds have also raised capital using registered prospectuses.

20. Funds are raised and managed by the investment professionals of a specific private equity or venture capital fund (sponsor). At inception, investors make unfunded capital commitments to the sponsor, which are then drawn over the term of the fund as committed capital is invested.

21. The distinction between private equity and venture capital is largely irrelevant for the purposes of this submission, but by way of background, venture capital funds tend to focus on investments which are at an earlier stage in their life cycle than the more mature businesses which private equity focuses on.

22. There are two ways in which sponsors rely on the Exemptions.

(a) First, they are relevant in the process adopted by sponsors in fundraising.

(b) Second, sponsors typically rely on existing management to drive growth. During the lifecycle of most investee companies, sponsors seek to align their own interests with those of management by bringing management into the equity structure. The application of the Exemptions is critical here.

Lifecycle of a Growth Company

23. A typical lifecycle of a growth company involved in all phases of the private capital cycle is as follows:

Lifecycle Phase	Seed	Start-Up	Expansion	Leveraged/ Management Buy-Out	Exit
Description	Capital will enable the development, testing and preparation of a product or service to the point where it is feasible to start business operations.	Capital will enable business operations to commence. This includes further development of product(s) and initial production and marketing.	Capital is provided for growth and expansion whether to get it to break even or to achieve critical mass to position it for commercial success and possible exit.	Capital is provided to enable operating management to acquire an established business or product line.	Disposal to trade / IPO.
Sources of Capital	Founder(s) Friends and family Close business associate(s) Possibly angel	Founder(s) Friends and family Close business associate(s) Angel Possibly VC	Founder(s) Friends and family Management and close business associate(s) Angel VC	Capital widely available but in context provided by private equity. Management Banks and other debt financiers.	Not relevant in context of submission.

Lifecycle Phase	Seed	Start-Up	Expansion	Leveraged/ Management Buy-Out	Exit
Exemptions	Exemptions required to enable company to gain access to capital.	Refer column to immediate left. Exemptions required to facilitate operation of Angel groups.	Refer column to immediate left. Exemptions required in context of capital raising by VC fund.	Exemptions required in context of capital raising by private equity fund and for management incentivisation schemes.	Not relevant in context of submission.

24. Available sources of capital tend to increase as a company moves through the investment cycle. Key observations are:

(a) Companies closer to the seed end of the spectrum tend to rely on exemptions applicable to relatives and close business associates (currently provided by s3(2)(a)(i)), and perhaps section s3(2)(a)(iii)). Sweat equity is a common source of compensation. Relevant investors are familiar with the risk profile of the business the subject of their investment and are either sophisticated investors or connected with the business and would not regard themselves as needing the protections of the Securities Act.

(b) Angel investment tends to be available for relevant companies further down the life-cycle, followed by venture capital and subsequently private equity.

(c) Unduly complex or uncompromising securities laws hinder access to capital and the bringing of ideas to market. It also means there is likely to be a greater likelihood of non-compliance with law.

(d) Companies in the earlier phases of their life cycle seldom have the financial resources to pay for detailed legal advice on the complexity of securities laws and need access to a definitive, objectively assessable exemptions regime.

25. Access to third party funding of growth companies (and in particular angel and venture capital funding) is fundamental to facilitating economic growth and bringing new technologies to market.

Issues and Recommendations

The Exemptions aim to distinguish between public and private offers and to reflect a balance between facilitating economic growth and investor protection. In our view, however, there are certain relatively simple amendments which could be made to the Exemptions which are consistent with policy imperitives but which would assist to foster economic growth flowing from this part of the market. Our observations and recommendations are as follows:

Wholesale Investor Exclusion

1. As regards the requirement to meet two or more of the Investment Activity Criteria, we would submit that:

   (a) If an investor meets Investment Activity Criteria (A), (B) or (C), then there should no need for such person to satisfy one of the other thresholds in order to fall within the Wholesale Investor Exemption. Such a person is demonstrably of sufficient economic means to absorb any potential losses and has sufficient investment experience to protect themselves;

   (b) If an investor meets Investment Activity Criteria (D) or (E) then, then such person should not need to satisfy any of the other thresholds in order to fall within the Wholesale Investor Exemption as long as they certify that:

      (i) they have sufficient experience in acquiring or disposing of financial products to allow them to assess:

         (A) the merits of the transaction or class of transactions (including assessing the value of the financial products involved); and

         (B) their own information needs in relation to the transaction or transactions; and

         (C) the adequacy of the information provided by any person involved in the transaction or the transactions; and

      (ii) they understand the consequences of making such certification.

   (c) If the Committee does not agree with the argument set out in paragraph (a) above, we would submit that the satisfaction of any one of the five Investment Activity Criteria should be sufficient to bring the relevant person within the Wholesale Investor Exemption <u>so long as such person provides the certification outlined in (b) above</u>.

   We believe that the changes suggested in this paragraph 1. are important as preserving the requirement to meet 2 of the Investment Activity Criteria will perpetuate unnecessary barriers to entry at the small cap end of the investment spectrum. In particular, we would ask the Committee to consider the recommendations relating to the income/net asset criterion (i.e. Investment Activity Criterion (D)). Establishing this as a standalone requirement (supported, as necessary, by certification) is particularly important since, while a significant number of potential investors can satisfy this requirement there are few who can meet the other criteria without first having been permitted to participate in the investment process. Absent this proposed change, therefore, the problem is self-reinforcing.

2. The test as to whether or not an investor amounts to a Substantial Subscriber (and therefore as to whether or not the Wholesale Investor Exemption is available to that person) depends upon the meaning of the words "of the same class" in clause 3(3)(b)(ii) of Schedule 1. It is common for investors to invest in successive tranches of an issuer's securities. Each tranche is likely to attach slightly different rights (to reflect the seniority of the later money) and therefore, without clarification of the wording, it is possible that persons investing more than $500,000 across the different tranches would not be considered a Wholesale Investor. The concern of the legislation is to see that investors have sufficient investment experience and capacity to incur loss. From a policy perspective, the legislation should not interest itself with the rights received by investors in return for their investment. We would recommend that the wording "of the same class that are held by the person" in clause 3(3)(b)(ii) of Schedule 1 is deleted so that any prior investment in the financial products of the issuer will count toward the threshold.

3. The requirements relating to the certification to be provided by Authorised Signatories in clause 41 of Schedule 1 are, we would submit, potentially unclear and, as a result, could discourage Authorised Signatories from supporting Eligible Investors. In particular, there is a risk that Authorised Signatories will be uncertain as to the extent of enquiry which is required of them before they confidently assert that they have "no reason to believe that the certification is incorrect". In order to remedy this, we would suggest that the words "on the face of the certification" are inserted after the words "have no reason to believe" at the beginning of clause 41(1)(b).

The Family Exclusion

4. The Family Exclusion does not cover discretionary trusts because the beneficiaries under those trusts are normally not "presently entitled to a share of the trust estate or of the income of the trust estate" (see clause 5(2)(d)(i) of Schedule 1). Given how commonplace discretionary trust arrangements are in New Zealand and the apparent lack of policy reason for excluding them, we would suggest that clause 5(2)(d)(i) is extended to include those "presently <u>or contingently</u> entitled to a share of the trust estate".

Controlled Persons Exclusion

5. The Controlled Persons Exclusion only applies to the exemptions set out in clauses 3 to 8 of Schedule 1. For each of the exclusions not within clauses 3 to 8, the exempt individual or entity will need to invest personally in order to fall within the exemption . There seems no reason for this from a policy perspective and there may be significant disadvantages for investors. Notably, persons who fall within the 20/12 Exclusion will need to invest personally and not via trusts or other vehicles. We would recommend extending the Controlled Persons Exclusion to cover anyone exempt under the other relevant exemptions set out in Schedule 1 (including those in clauses 10, 12 and 15).

20/12 Exclusion

6. The 20/12 Exclusion appears to have been derived from the equivalent exemption provided under Australian securities law. It forms a useful (and necessary) addition to New Zealand

regulation but warrants amendment in order to properly address the particular issues arising in the New Zealand investment market. In particular:

(a) The restriction on relevant offers to no more than 20 Investors in any 12-month period is low in some contexts in the New Zealand marketplace. Given the typically low denominations of angel investments, club deals can, from time to time include up to 30 individual investors. We would submit that leaving the threshold at 20 reduces the impact of the exclusion in the New Zealand market while increasing it to 30 would allow the necessary flexibility for angel associations in particular. The effect of this change would be useful in improving the access of small businesses to capital while making no sacrifice in terms of investor protection (all persons in receipt of the offer being people to whom a "specified offer" can be made).

(b) Similarly, the limitation to $2 million in any 12 month period is relatively restrictive given the value of the New Zealand dollar in the context of growth companies often looking to compete with offshore parties. It could result in legitimate capital requirements not being met. We would argue for a higher cap and would note, in this context, that:

(i) the $2 million is obviously denominated in Australian dollars in the Australian context and that the New Zealand legislation should reflect the typical exchange rate disparities between the Australian and New Zealand dollar; and

(ii) the Australian legislation was put in place sometime ago and, during the intervening period, the effects of inflation as well as market expectations have caused the $2 million cap to become more and more restrictive.

(c) In addition to the restrictions relating to the number of persons and the amount of the offer, the 20/12 Exclusion is also limited to the extent that it must be a "specified offer", that is to say, made either to a person who has a connection with the Offeror, persons who have stated that they are likely to be interested in the offer or persons who have an annual gross income of at least $200,000. We have two recommendations to make in respect of these additional restrictions:

(i) As noted in 1 above, we believe that the exclusion relating to an annual income of $200,000 (or net assets of at least $2m) should be a standalone exemption (supported, as necessary, by a certification requirement). Persons who satisfy this test alone should be exempt and should not need to come within any other exemption. As a result, we believe that any person to whom an offer is made who has an annual income of more than $200,000 or net assets in excess of $2 million should not count toward the 20 person limit set under the 20/12 Exclusion.

(ii) If the threshold relating to an annual gross income of $200,000 per year is to remain as an element of the 20/12 Exclusion then we would submit that:

(A) there is no policy reason to restrict this to income and that an investor should, in the alternative, be entitled to satisfy a net asset threshold of $2 million. To maintain the current formulation will significantly inhibit the angel networks whose high net worth members are often retired or no longer commanding substantial salaries; and

(B) if the other Investment Activity Criteria are not accepted as standalone exemptions (in accordance with our suggestions in paragraph 1 above) then we would submit that they should also be included within the test for a specified offer such that any person who meets **one only** of the Investment Activity Criteria can be eligible to receive an offer which meets the 20/12 Exclusion.

Crowd Funding

7. As the Committee will be aware, there are moves in other jurisdictions to allow for small amounts of capital to be raised through online intermediaries. Such offers will be subject to limited disclosure requirements with the aim of providing cheap and efficient access to capital for those early stage companies which cannot fund a full offer process. In particular, legislation facilitating such a regime has now passed through both the House of Representatives and the Senate in the United States. The key elements of the new "JOBS Act" are:

(a) Companies are permitted to raise up to $1 million a year through crowdfunding.

(b) Investors with incomes or net worth of less than $100,000 can invest up to $2,000 or 5% of annual income or net worth (whichever is greater) while those with incomes or net worth greater than $100,000 can invest 10% of either net worth or income, up to $100,000.

(c) The transaction must be conducted through a registered broker or "funding portal".

(d) Certain key information relating to the issuer and its financial condition must be provided to investors and filed with the SEC.

While the US legislation is yet to be finalised, this certainly appears to be a substantial development and will be of significant value to the early stage companies which apply the regime. We can see "crowd funding" being very useful to early stage companies in New Zealand and would welcome any move to include such a regime within the FMCB. We are, of course, available should the Committee wish to discuss the details of any New Zealand crowd funding regime.