Submission from

New Zealand Private Equity & Venture Capital Association

Angel Association New Zealand

REVIEW OF SECURITIES LAW

AUGUST 2010

About the Submitters

1. This submission has been prepared jointly by the New Zealand Private Equity & Venture Capital Association (**NZVCA**) and Angel Association New Zealand.

2. This summary highlights our principal areas of interest and refers to expanded recommendations in the attached draft submission to the Ministry of Economic Development (**MED**) from NZVCA and Angel Association New Zealand dated March 2010.

3. The NZVCA is a not-for-profit industry body committed to develop 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).

4. The Angel Association New Zealand 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 creating a greater pool of capital for innovative start-up companies.

Contact details

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

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REVIEW OF NEW ZEALAND'S SECURITIES LAWS

Introduction

1. Too often the focus of securities law is solely on listed entities. However, for the health of a vibrant economy, small to medium sized businesses (the majority of business in this country) need effective and efficient access to equity capital.

2. The NZVCA and the Angel Association have been, and remain, actively involved with submissions to MED on securities reform. As you will be aware, in early 2010, the NZVCA and the Angel Association presented a draft paper to MED on changes that we sought to New Zealand's securities laws (**Draft Paper**). The focus of the Draft Paper was our concerns regarding the application of certain key exemptions and exceptions provided for in the Securities Act 1978 (**Securities Act**) in the context of the potential source of much of New Zealand's growth potential - early stage (including Angel), private equity and venture capital investment in New Zealand. A copy of our draft paper is **attached**.

3. In summary, our Draft Paper recommended the following changes to New Zealand's securities laws:

   (a) clarify and/or extend the application of section 3(2) of the Securities Act by:

      (i) extending or clarifying the close business associates exemption so that it expressly applies to key employees;

      (ii) removing the existing "habitual investor" exemption, and replacing it with express exemptions for institutional investors (defined by reference to appropriate monetary thresholds) and professional investors (being persons who invest money as a principal business activity);

      (iii) clarifying the "selected other than as members of the public" limb of the test to reflect our understanding of how it has been interpreted to date; and

      (iv) extending the minimum subscription exemption in section 3(2)(iia) of the Securities Act to include situations where the potential investor has committed to pay at least $500,000 (as opposed to having actually paid that amount);

   (b) allow "experienced investors" to self-certify and clarify that issuers may rely on these certifications;

   (c) for small scale offers, introduce both a value based exemption such as the Australian 20/12 rule, and consider a limited exemption for small one-off raisings;

   (d) soften the consequences of a single investor not falling within the section 3(2) exemption so that only the infringing allotment (and not the entire offer), is void;

   (e) revisit the way the Securities Act applies to offers made under section 3(2) (which are entirely exempt from the Securities Act) relative to those made under sections 5(2CBA) or 5(2CC) of the Securities Act (where criminal sanctions still apply under section 58 of the Securities Act for untrue statements);

(f) allow the Securities Commission to:

(i) publish regulatory guidelines on the interpretation of the law; and

(ii) have the power to make binding rulings on the interpretation of the law.

4. We stand behind these recommendations and are pleased to see that the majority of the recommendations have been included in MED's discussion document.[1] Thank you.

Securities Law Review Discussion Document

5. Two aspects of the discussion document that we have focussed on are:

(a) the treatment of limited partnerships – often used as the fund establishment vehicle for sponsors – although because of current securities restrictions, not yet used for public offers (and certainly not for large retail offers); and

(b) the proposed exemptions (which were the focus of our Draft Paper).

6. We have set out below some brief comments on these aspects of the MED discussion document.

Treatment of Limited Partnerships

7. The discussion document proposes to include limited partnerships within the definition of equity securities rather than treat them as collective investment schemes; although the discussion document does not consider the point in any detail.

8. Whilst recognising that the limited partnership structure is perhaps not likely to be widely used as a vehicle for large retail offers, it is important to ensure that the vehicle is appropriately treated under the new securities laws, since an offer to even a single investor can be captured by our securities legislation.

9. Some obvious issues arising out of the discussion document are the following:

(a) Further consideration needs to be given to the distinction between open and closed-end funds. Looking at the currently proposed definitions, a closed-end limited partnership may not fall within the definition of equity security, since there is an obligation to wind up the fund at the end of its life; and may not be a collective investment scheme, since investors are not normally able to withdraw their investment on demand. Clearly debt security is not the correct classification.

(b) The discussion document proposes prescribing homogenised functions and powers, requirements around returns, and pricing for collective

[1] Given that MED's discussion document contains a number of changes to the categories of offers that will be exempted from the new securities laws, we are not currently concerned with clarification of the exemption for persons "otherwise selected than as members of the public".

investment schemes. Limited partnerships (if they were used for retail offerings) appear to show some of the features of collective investment schemes (control for instance over investments sits with the manager and not the investor), but they are very different in many respects to what would normally be regarded as a collective investment scheme. Obvious examples include the liquidity of underlying investments, difficulties with valuation and the private nature of the businesses they invest into (and the need to maintain this).

(c) Collective investment schemes would require the appointment of a trustee or statutory supervisor and associated trust type documentation encapsulating matters such as manager's duties, redemption, winding up, meetings and surpluses, and the appointment of a statutory supervisor. Much of this is already captured by the Limited Partnerships Act.

(d) Finally, some careful work with the definitions and disclosure regimes will be required to reflect the separate legal personality of a general partner and limited partnership, perhaps similar to the way that unit trusts have been dealt with.

Exemptions

10. The discussion document proposes that offers to the following persons will be exempt (to some degree) from the new securities laws:

(a) investment businesses, being those whose primary business is investment or related activities;

(b) sophisticated investors, as determined by minimum quantified levels of investment activity and experience;

(c) large entities, as determined by minimum assets, income and employees;

(d) investors who make investments of $500,000 or more;

(e) relatives within four degrees of blood relationship to the issuer, and directors and their spouses;

(f) personal friends and close business associates, including directors, senior management, major shareholders of the company or related companies, and close relatives of these persons; and

(g) employees, with offers up to 15% of assets / gross value of securities.

11. The discussion document also seeks feedback on the following exemptions:

(a) investors who have obtained a recommendation to subscribe to a securities offering from an independent financial adviser;

(b) small investments of up to $2 million from up to 20 persons over 12 months (the 20/12 rule); and

(c) other potential exemptions, for example, retaining the wealthy investors exemption, or allowing an opt-out for those who have sought independent legal advice and signed a prescribed statement declaring that the Securities Act will not apply to the investment.

12. Our Draft Paper discussed our views on these topics in some detail. Our view in relation to the exemption regime proposed is that the suggestions are a marked move in the right direction, but work needs to be undertaken to ensure that:

    (a) there is adequate flexibility in capital raising (or involving interested parties in the relevant investment); and

    (b) relevant statutory tests can be measured objectively, and preferably, by reference to bright line tests.

13. Particular sensitivities seem to remain around offers to employees, ensuring that the $500,000 exemption captures committed capital, self certification, and retaining the wealthy investors category (widely used in angel groups in particular). There is a great deal of enthusiasm for something akin to the 20/12 rule for the reasons expressed in paragraph 12(a).

Offers to employees

14. We stated in our Draft Paper that we consider it important that key employees are able to participate in the growth companies at an equity level. This reflects the fact that for many growth companies, equity is the only available source of compensation. Also, issues to employees assist to incentivise management, especially where the investee company is a start up or in a growth/acquisition phase and requiring rapid growth. 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.

15. The discussion document proposes the exemptions for:

    (a) personal friends and close business associates, including directors, senior management, major shareholders of the company or related companies, and close relatives of these persons; and

    (b) employees, with offers up to 15% of assets / gross value of securities.

16. We have a number of points here:

    (a) We need to make sure that the senior management limb is not overly restrictive. Capturing merely the CEO and CFO for instance, undermines the usefulness of the exemption.

    (b) Some care is required with respect to usefulness of the second limb:

        (i) We understand that consideration is still being given to imposing disclosure requirements with respect to it, which makes it distinguishable from an offer to senior management under that exemption. Again, the goal is efficiency and cost effectiveness in capital raising.

        (ii) We are concerned that securities issued under the senior manager exemption should not reduce the availability of securities for other investors. Exemptions should be able to be combined. Staff often hold more than an aggregate of 15%.

Committed Capital of $500,000

17. We recommended in our Draft Paper that the "minimum subscription" exclusion should be expanded to include situations where the potential investor has committed to pay at least $500,000. The reasons for this recommendation are set out below.

18. Almost invariably, a participant investing in a private equity or venture capital fund is required to commit their investment amount from the outset, although calls for payment on the investment are typically made subsequently and in stages once the fund has identified viable investment opportunities.

19. In such scenarios, the investor cannot be said to have paid their $500,000 (or more) before the allotment of the securities and so does not fall within the current exclusion in section 3(2)(iia). This obviously reduces the availability of the exclusion and excludes persons who would ordinarily satisfy the financial requirements of the exclusion, but do not technically comply due to the timing of investment payments.

20. At a policy level, there does not seem to be any basis for drawing this distinction. It is our proposal that the exclusion is amended to allow for a person to fall within the exemption where they are required to commit to pay the subscription price of at least $500,000.

21. We acknowledge that some controls may be required around this exemption to ensure it is not abused. The distinguishing factor (relative, for instance to the situation of an investor paying by automatic instalments over a long period of time) is that the investor is exposed to a capital call of an amount of $500,000 immediately following allotment. We would welcome discussion on this.

Self Certification

22. As set out in our Draft Paper, we see merit in MED considering investor self-certification.

23. It seems that self-certification should be considered on an exception-by-exemption basis. No doubt it would only be of any value in relation to the exemptions which require subjective assessment by the issuer. We had previously recommended self-certification for the experienced investor exemption.

24. We believe a self-certification regime does require some safeguards. Three possible safeguards are the following:

    (a) Self-certification could be against criteria such as those already contained in the exemption.

    (b) Certification could be coupled with an appropriate "health warning" issued in connection with applicable offer terms, so that investors are aware of the consequences of their certification[2].

    (c) Offers to persons who self-certify should be subject to restrictions on misleading and deceptive conduct and the attaching liability provisions.

[2] As stated, in the CMD Taskforce December 2009 Report, this approach has been adopted in the UK.

25. There is also a question of whether the issuer has to have reasonable grounds to rely on the certification, or perhaps the converse, that the certification is ineffective if the issuer has grounds to believe that certification is incorrect.

Small Offers

26. We believe a small offers exemption is appropriate and extremely useful for private equity and venture capital.

27. While there might be a concern that such offers might be open to abuse, the Australian exclusion contains protections in that only $2 million can be raised by such offers in any 12 month period and from 20 investors. Further, the offers are limited to persons who had previous contact with the issuer, some professional or other connection with the issuer, or to persons who have stated or indicated that they are interested in such offers. We also consider that offers of this nature could be subject to the restrictions around misleading and deceptive conduct and the attaching liability provisions.

28. This type of value-based test is attractive in that it provides an objectively assessable exemption with clear criteria, facilitating a cost effective method of raising small amounts of capital.

29. In addition to the implementation of a value-based exclusion (as discussed above), we also consider that it would be useful to allow issuers to raise a limited amount of capital from the public using a terms sheet. We consider that a rule to this effect would create a good compromise between the protections in the Securities Act and raising small amounts of capital in a cost effective manner.

30. The Australian legislation contains a similar exclusion which allows an issuer to raise capital from the public using a "offer information statement" instead of the normal offer documentation (in the case of Australia this is a prospectus). This exclusion is subject to the condition that the amount of money previously raised by the issuer and any related body or entity controlled by the issuer using a terms sheet is $10 million or less.

Wealthy Investors Category

31. We see the retention of an exemption based on investor wealth as important, since, as you are aware, the exemption provides a bright line test which the issuer is able to rely on. This is particularly important in angel groups as qualification typically relies on proof of income at levels falling within the exemption.