Armillary Private Capital – Commerce Select Committee meeting re Financial Markets Conduct Bill

Thursday 21 June

Wellington

Mr Chairman and Members of the Committee

Thank you for allowing me time to come and speak to the submission made by Armillary Private Capital. I am the executive chairman of Armillary which is a specialist investment banking, funds management, financial training and advisory firm dedicated to the advancement of the NZ private capital markets. We are largely focused on working with private businesses.

Our team has many years of experience in the capital markets and we work with businesses over all stages of the business life cycle. We have been active in providing submissions to the Cameron Task Force and the MED in respect of the shaping of the new legislation and are passionate about working with small to medium sized businesses where we can be hands on and bring our collective experience to bear.

We also manage the Unlisted unregistered securities trading platform and I will be presenting on behalf of that business in about half an hour.

Before I focus on the specifics of our submission I would like to take a moment to paint you a picture from the pallet of our collective experience.

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Much of the work that we do to assist businesses to raise capital or drive a turnaround is grooming. Much of this grooming is in respect of tidying up processes, budgets and projections, clarifying strategy and establishing the right governance model. These are the things that make a business attractive and robust for investment; not just the product, service and earnings potential of the company, but its sustainability.

We have long held a view that if we can as a nation focus on creating 10 new jobs in each of the thousands of small to medium companies we will create more prosperity for all stakeholders and the economy as a whole. This can be done through the application of new capital and will create more wealth than we can ever hope to create by trying to grow our existing largest businesses which by nature cyclically downsize headcount to drive profitability. Sustained job creation is often a function of having an efficient capital market enhanced by having a tailored solution for small to medium enterprises.

We note that merely importing legislative structures and ideas from much larger economies often does not suit a large portion of our economy. Even in those larger economies there is now a recognition that the one-size fits all is not working for their small to medium enterprises.

This is particularly the case that we are now seeing in the US. We note the findings in a 2011 by Grant Thornton in the US in a paper titled "Hearing on legislative proposals to promote job creation, capital formation and market certainty". The paper states: "today's one-size-fits-all stock market model – the unintended consequence of well-intended regulatory change – has deprived issuers in this country of any real alternative as to how their stocks are supported.

Further if we look at the Jobs Act, recently passed in the US, it is focused on small growth companies. Their definition of a small growth company is one with revenues less than US$1b. Off the cuff I estimate that this definition would apply to something like 99.7% of New Zealand companies. Whilst we do not advocate that the Jobs Act be applied carte blanche in New

Zealand, we do advocate that the underlying issues that the Jobs Act is trying to address be given further thought and consideration.

We also advocate the opportunity for independent thought leadership in respect of securities legislation. While the draft of the Financial Markets Conduct Bill has some of this, our inclination is that it does not go far enough. It is stuck in the one-size-fits-all mentality which will ultimately be detrimental to the future prosperity of our economy and limit what we can achieve as a nation.

By way of example, raising capital in the private capital markets entails preparing an information memorandum including unaudited financial information, both historic and projected, often a legal review and marketing to a select group of individuals. In general this process would cost the company raising the capital about 5-6% of the amount raised. It is completed in a largely unseen process and carries all of the usual director liabilities etc.

In comparison the public offer last year by Energy Mad for $5m cost the company about 12% of the amount raised – that's $600,000. That is an incredible impost for any company and for the investors themselves. The economics of the Energy Mad offer hardly justify the effort for the company.

It is also worth considering that public offer documents contain audited historical and projected financial information and yet there is no subsequent measurement against these.

We believe that our legislation needs to go further than that which is currently drafted. Let's take the opportunity to tailor offers for the realities of the NZ market and move as much as possible into the public arena and remove the arbitrary distinctions between public and private offers. This will bring more offerings under the oversight of the FMA.

How can this be done?

In our submission to this committee and to the Cameron Task Force and MED we have continually focused on removing several key barriers to gain efficiency in the capital raising process:

Firstly the Product Disclosure Statement model can provide a low-cost environment for all capital raisings. We like this model however we are still concerned that the benefits could be lost to over-zealous legal disclosure and director fear. We advocate full disclosure but it needs to be sensible relevant disclosure, not just a long list of everything everyone can think of for risk mitigation purposes.

Secondly certification by a third party for an investor in the private markets has always proved problematic and is an impediment to the process. An entity raising capital must be able to rely on the investor being who the investor says he or she is. More often than not, investment bank and corporate finance advisers know who have the wealth to invest in private capital raisings, and they target those investors, not just any person in the street.

Thirdly that the definitions around business associates should be broadened to include parties that have an association with the investment bank or corporate finance adviser to the offerer.

All of the above said I continue to come back to the question of why? Why do we distinguish between private and public offers with all of the additional rules, exemptions, carve outs and additional certifications that go with this structure. Is it because we want to implement a one-size-fits-all model which we now know is flawed. Importing regulation developed for large businesses in large markets is just not economic or sensible in the NZ small to medium enterprise context.

A feature of the private markets is the ability for the investor to undertake their own direct due diligence on the entity they are looking to invest in without the extra reliance on the

documents. This, at the end of the day, is a key difference between the public and private markets. Having said that we note that many investors do not have the resources to undertake their own due diligence and we often see a small number of key investors being followed.

If transparency is the cornerstone of market integrity then we need to make all offers transparent and able to be marketed widely to ensure transparency and capital creation.

In our written submission to this committee we included that there also needs to be a capital raising middle ground between the Product Disclosure Statement model for large companies and the exclusions provided for private capital raisings.

We advocate allowing the use of a limited Product Disclosure Statement and document lodgement requirement for companies: which have revenues of less than $20m and equity of less than $10m; undertaking a capital raising of not more than $10m in any 12 month period; and with a minimum of two independent directors with experience.

In terms of the Product Disclosure Statement itself we recommend that it is largely templated to remove significant levels of cost. The company should be required to provide, if available, the last two years of historic financials and one year of projections although these would not need to be audited. Such document would be signed and certified by the directors and include appropriate prescriptive health warnings. We suggest that under this model audit would be required once the capital is raised and possibly compulsory listing to continue to support transparency.

We also recommended in our written submission that a company being allowed to utilise this form of capital raising must have some operating history of, say, not less than 2 years. On further consideration we withdraw that operating history recommendation as it will impact on new start-up entities utilising such a capital raising path.

Entities raising capital under this model must utilise a licenced investment bank or corporate finance adviser, a similar concept to that adopted by the NZX for NZAX sponsors. These licenced investment bank or corporate finance advisers, or sponsors, would need to show that they and their directors have appropriate market experience with partners/directors that are of good public standing and have an appropriate level of Public Indemnity Insurance.

Our rationale for the above is threefold:

Firstly, an Information Memorandum based private capital raising largely has a similar preparation cost to a standard public offer excluding the audit and full legal cost overlay;

Secondly, large broking firms are generally not interested in undertaking capital raisings of the size required by the private market as the arrangement fees generally do not meet their internal hurdles; and

Thirdly this model will provide more cost-effective transparency for investors and the capital markets as a whole whilst still being under oversight of the FMA.

I implore you to be bold and take the opportunity for a rethink. New Zealand needs to create capital for businesses to create jobs and prosperity. Importing legislation tailored to fit other jurisdictions does not show thought leadership or skill. Moreover it ultimately does not support our economy. We believe that we can do better.

Thank you Mr Chairman. I would be happy to respond to any questions that the committee has.