

6 May 2010

Submission To:

FAA Select Committee
New Zealand Parliament
WELLINGTON



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Dear Committee

This is a follow up submission to that made by INFINZ of which the writer was a participant in preparing.

In this submission we are providing comment in respect of the Financial Advisors Act 2008 ("FAA") and subsequent discussion documents, specifically in respect of current consideration of the definition of "wholesale clients".

By way of background, Armillary Private Capital and a number of other similar investment banking firms are largely focused on working with businesses in the private capital markets particularly in the SME and Venture Capital sectors.

A key issue which we believe needs to be clarified is in respect of the provision of investment banking services to businesses that comprise the SME and Venture Capital sectors in NZ and the extent to which this appears to be captured by the FAA.

These investment banking services largely comprise, but are not limited to providing assistance with:

- Equity raising;
- Debt raising;
- Advising on business acquisitions, mergers and divestments;
- Undertaking valuations;
- Assisting with due diligence; and
- Providing capital and balance sheet structuring advice.

Additionally we offer corporate advisory services which include:

- Business turn-arounds; and
- Business improvement advice.

As a matter of protocol an individual engagement is entered into with each of the business specific to the services that are being provided which clearly sets out the terms and conditions of engagement and fees to be charged.

Many of the businesses to which we provide such services have multiple shareholders and some are listed on either of the NZX boards or the Unlisted exchange. This number of shareholders raises certain difficulties in respect of undertaking individual needs analysis for each.

It is our understanding that the provision of investment banking services are currently captured by the FAA.

About Us

Armillary Private Capital traces its history in the New Zealand private capital markets back to 1992, where we began as part of a multidisciplinary financial intelligence services firm which grew to become part of a larger Australasian firm over time. In 2005, we were formally established as a standalone entity under common ownership with our parent, and in 2008 we secured our independence through the acquisition of the remaining interest in the firm. In 2009, we re-branded our firm as Armillary Private Capital, home to one of the most active independent corporate financial services teams in New Zealand focused primarily on the private capital markets. We have and continue to work with a range public and private businesses across the full spectrum of the business life cycle ranging from start-up to failure. Additionally, we work with a number of financial and educational institutions, corporations, and government agencies in the arena of financial training.

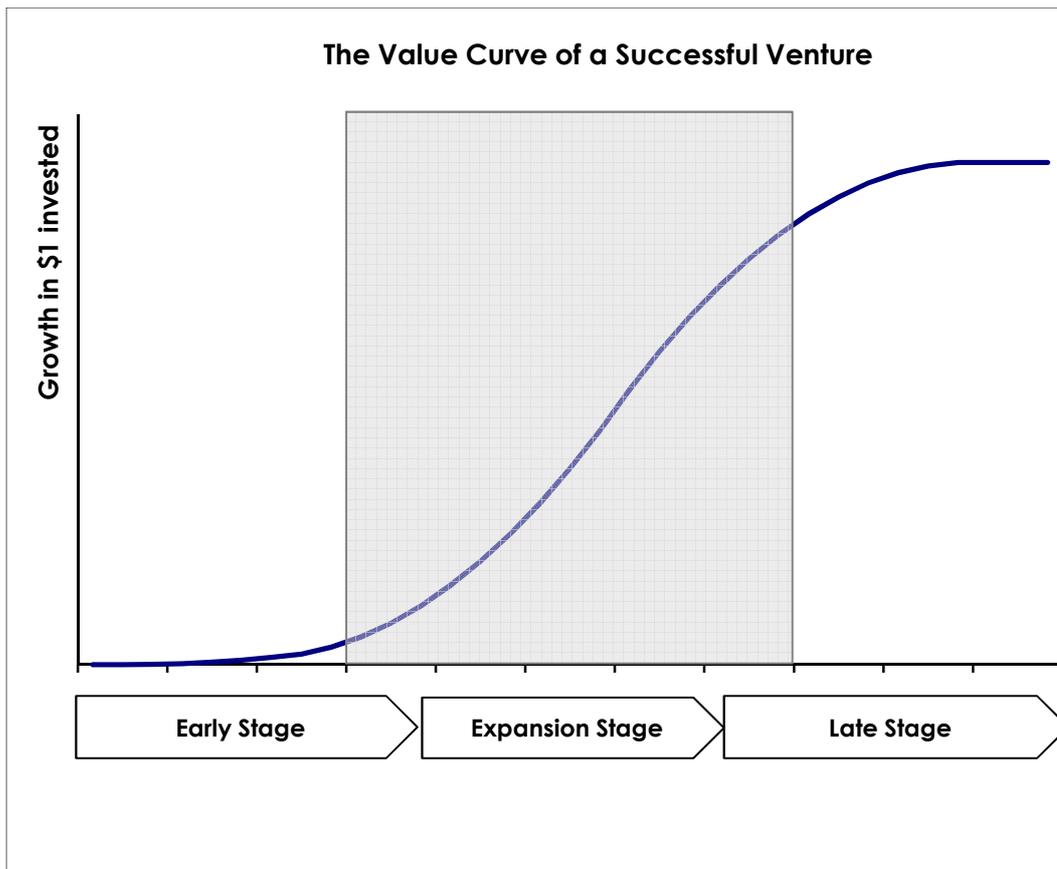
Capital Markets Task Force

After lengthy discussions with Rob Cameron, the Chair of the Capital Markets Task Force, in 2009, Armillary Private Capital provided a submission to that group. The following is an extract from that submission and we attach the full submission for your information.

Small Medium Businesses (SMEs)

The majority of work undertaken in the private capital markets is focussed on small-medium businesses, a major group of employers for whom capital constraints create a real and continual barrier to growth. We largely categorise SMEs as having revenues of up to \$20m and, in New Zealand, these firms are represented by those 50,000 registered businesses employing between 5 and 99 employees.

SME businesses not only provide significant employment within the NZ economy, but, if appropriately funded, are able to create significant value for all stake holders over time – this is shown within the shaded area in the chart below. For completeness, we note that distress is an additional overlay upon this graph and may occur at any stage.



Common Funding of SMEs

SMEs are largely funded by the business owner(s) providing a small amount of personal capital as equity overlaid with debt provided by their bank or other lender. This debt is secured over the business by a general security agreement supported by personal guarantees and mortgages over the owners(s) personal home(s) and possibly the land and buildings from which the business operates, if owned by the business or by an associated entity, often a family trust.

Common Funding Issues for SMEs

This funding structure generally causes a number of issues. These include:

- the business is ultimately controlled by the bank or other lender as security holder;
- limited liability is effectively unavailable for investors and the true cost of capital for the business is not recognised (as the cost of the guarantees are not recognised as a funding cost) and therefore these business often under-perform on a return on capital employed measure; and

- reinforcement of the constricting effects of the equity gap (as discussed below), as these businesses are unable to raise additional capital to continue to grow and/or survive.

New Zealand is not alone in facing these issues-- there is a structural inefficiency in most developed countries for small firms raising capital. As described by Parker O'Connor Trust Co. Ltd, this inefficiency is sometimes called the "equity gap". It arises when the capital requirements of a business outgrow the ability of its initial shareholder(s) to fund that requirement but the capital need is below the threshold necessary to attract institutional investment (excerpted from the Parker O'Connor Trust Co. Ltd profile of its register for syndicated investment). The equity gap, coupled with the common funding structures used by New Zealand banks and lenders, ultimately provides a cap on the amount of funding a business has access to and therefore limits its ability to grow.

For completeness, we note that the start of the equity gap is also dependent on the industry base, with availability of debt funding highly variable between industries and the nature of the asset base (asset funding and/or chattel finance vs. cash flow funding).

The balance of our submission to the Capital Markets Taskforce discussed the pertinent question for the New Zealand regime which is how can we make changes to help minimise the equity gap?

Our concern is that an overly restrictive FAA regime increases the effective size of the equity gap by introducing constraints on the intermediaries that play a critical role supporting those businesses that require quality advice and support in their efforts to raise capital.

The FAA Regime

We note that The Minister of Commerce has this week released a further document titled "Financial Service Providers (Pre-Implementation Adjustments) Bill – Additional Policy Issues" and that within this document is a section "Definition of Wholesale Client" which sets out the current thinking and includes:

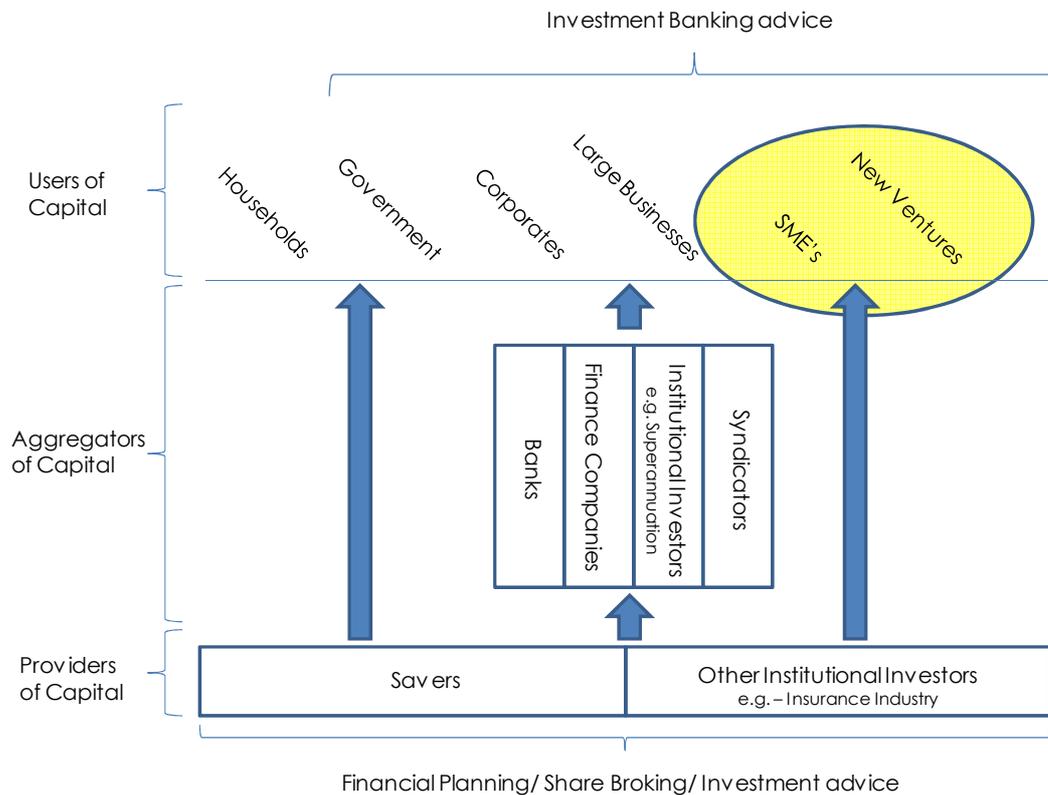
- Institutional Investors;
- Large Entities;
- Investors receiving advice in relation to a security that is valued at more than \$500k; and
- Eligible Investors.

As the Capital Markets Task Force noted in its report that there is a need to efficiently provide these small businesses with access to capital such that they are able to grow and develop within the context of the New Zealand economic environment. The Capital Markets Task Force presented recommendations to

assist with this, however the FAA now appears to be creating a new barrier to the provision of services to this market.

Capital Markets Context

In the context of the capital markets there are providers, aggregators and users of capital as shown in the diagram below.



Armillary Private Capital recognises and agrees with the need for Savers to be provided with quality advice which the FAA is looking to address.

However from a Private Capital Markets perspective where Armillary Private Capital and other investment banks operate and provide services to the many private businesses (SME's & New Ventures"), as highlighted in yellow above, which are not "wholesale clients" as currently defined, we believe that a barrier is being created for the channelling of capital in this area.

An example in point is that Armillary Private Capital is a registered broker under the NZ Trade and Enterprise Escalator Program regime which has been designed to assist small businesses to access quality advice and raise additional capital to support their growth needs. Many of these businesses have less than \$1m in revenue and often few assets or employees. The entrepreneur(s)/business owner(s) is purely focused on his drive to succeed and has most likely already mortgaged all of his/her assets to fund the business thus far.

Under the current legislation Armillary Private Capital as adviser would be required to undertake a personal needs analysis for the entrepreneur(s) which would realistically require advice saying that the entrepreneur(s) shouldn't have all his/her investment in one investment – the business the entrepreneur(s) is looking to fund. This is not a constructive starting point for someone who's passion is about their idea and business and raising enough capital to make it a success and one which is creating a barrier to arranging such capital.

A second example is where an SME business is looking to borrow additional capital from its bank and the bank requires personal guarantees and a mortgage over personal assets as additional security. In our opinion, the request for a mortgage in such cases has been carved out of the FAA through the QFE provisions is a sale of the lenders product. This appears to contradict the issue raised above.

We also note that not all of our engagements for businesses in the Private Capital Markets are capital raising focused. Armillary Private Capital also assists business to make acquisitions to grow and expand. Again because of their size such engagements are also captured under the FAA. We question whether these services to SME's were intended to be captured by the regime.

Therefore clarification in respect of the provision of such investment banking services is required and whether these are indeed captured under the FAA. If these services are intended to be captured consideration also needs to be given to how quality services can continue to be provided to those many businesses which are not "large entities".

Eligible Investors

We note that "Eligible Investors" has also been introduced to the definition of wholesale client. We consider this appropriate and believe that the definition of Eligible Investor should be directly linked to the Securities Act 1978 and any amendments to such arising from the Capital Markets Task Force recommendations.

Such investors are largely the focus of capital raisings in the Private Capital Markets and are especially active in the angel networks that operate regionally.

Importantly, Armillary Private Capital actively builds strong relationships and networks of such investors and is regularly courted by the same looking for investment opportunities, notwithstanding the fact that we are engaged by the entity looking to raise capital and therefore are not providing advice to such investors.

We strongly believe that self-certification by such investors is critical as third party certification, as is required by current securities legislation, creates an additional barrier for investment and further inefficiencies in the market place.

Recommendations

Taking all of the above into consideration, while recognising the need for appropriate investor protections to be retained, we believe that there needs to be balance between possible changes to the capital markets as a whole and the FAA regime.

Effectively closing quality advisory services to SME's and making the appropriate capital markets services less efficient and therefore less cost effective will not aide SME companies.

Accordingly, we propose consideration of the following recommendations.

1. *Clarification is required under the legislation in respect of the provision of corporate advisory and investment banking services to a business regardless of size (which is not a good proxy for the sophistication of the business or its shareholders) that these services are not captured under the FAA.*

We believe that this will provide better clarity for service providers in the market and allow for industry specialists to clearly understand and delineate which parts of the market that they operating in. Any other regime will de facto discriminate against the SME and Venture Capital sectors which are not only the growth engines of the economy but also those very sectors where capital is most difficult to access.

2. *Provide for corporate advisory/investment banking services to SME's and new venture businesses to ensure ongoing market efficiency.*

We believe that there are two options to achieve this. Firstly recognising those businesses within the "Wholesale Client" frame work, or secondly by registration of service providers taking into account track record and experience, appropriate tertiary qualifications, PI insurance similar benchmarks used by the NZTE Escalator program.

3. *Definition of "Eligible Investors" aligned with Securities Act legislation definitions and any changes to such arising from the current review are automatically incorporated.*

We believe that this will appropriately align the legislative framework.

We trust that the above provide insight into the workings of the Private Capital Markets and appropriate recommendations for the FAA regime.

We would be happy to discuss any or all of the above with yourselves should you so require.

Yours sincerely



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