27 October 2009

ARMILLARY
PRIVATE CAPITAL

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Dear Rob

Following on from our meeting in June we are pleased to submit for consideration by the Capital Markets Development Taskforce (the "Taskforce") our recommendations in respect of possible improvements that could be undertaken regarding the efficiency of capital raisings for private companies.

Since our preliminary discussion, we have given this question further thought, discussed the issue with other firms similar to ours, and selectively surveyed the international regulatory landscape. Accordingly, we have set out our thoughts and opinions as follows.

Defining the Need

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.

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.

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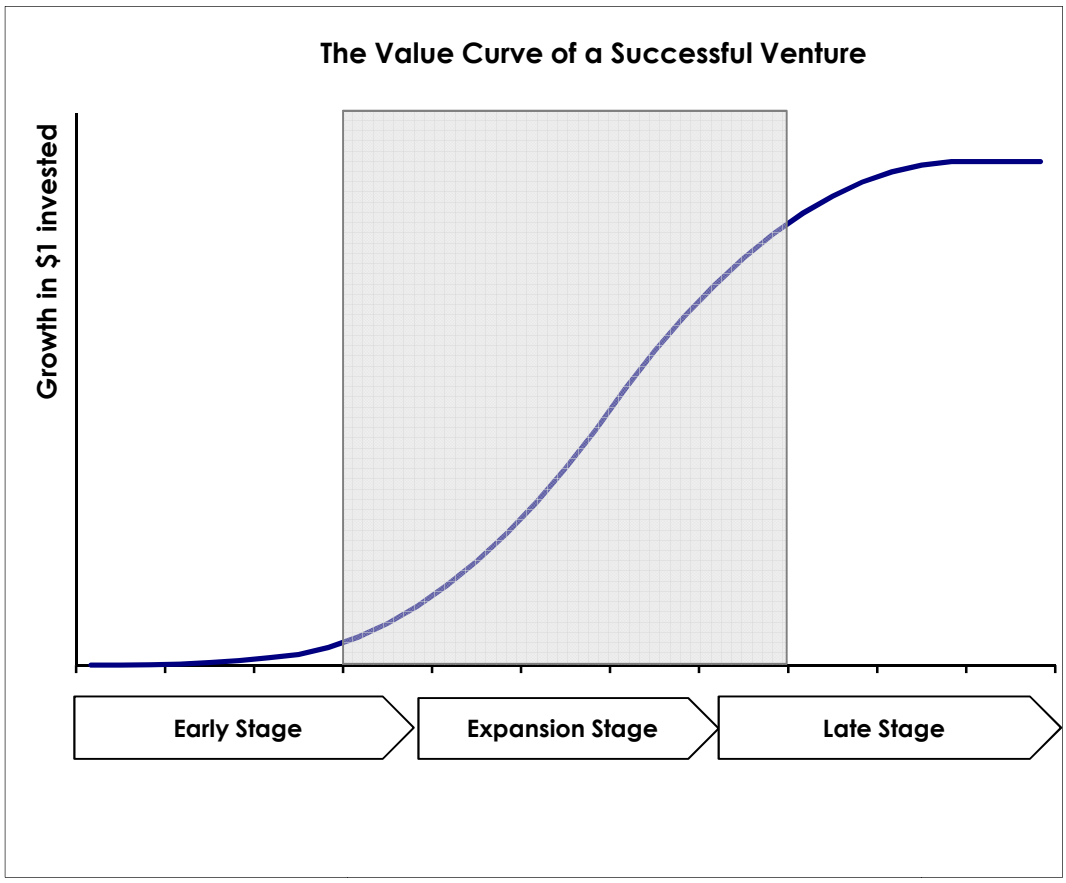
Small Medium Businesses (SMEs)

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 overlayed 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;

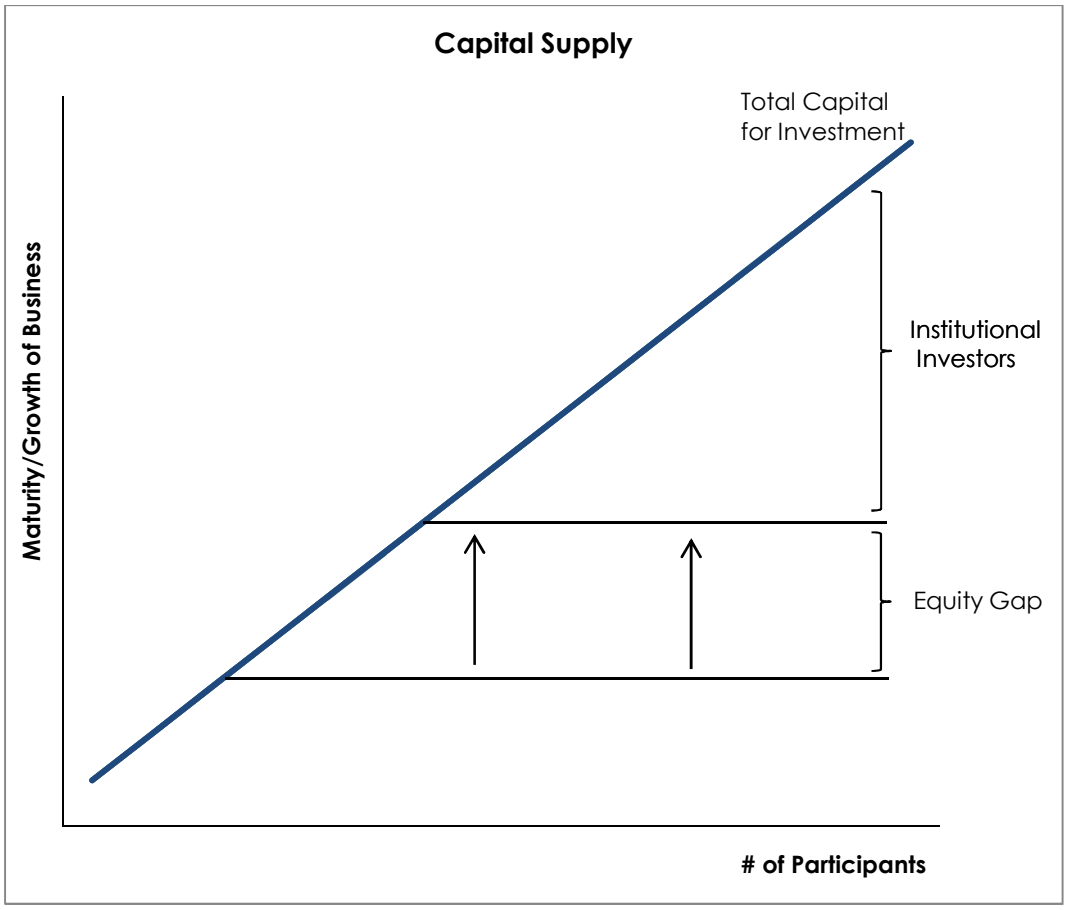
- limited liability is effectively unavailable for investors and the true cost of capital for the business is not recognised (as the cost of the guarantees are not recognised as a funding cost) and therefore these business often under-perform on a return on capital employed measure; and

- 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).

If follows that the pertinent question for the New Zealand regime is: how can we make changes to help minimise the equity gap?



Capital Raising Environment in NZ for SMEs - The Current Issues

For SMEs that require additional funding to achieve or accelerate growth, or even to provide capital for survival (e.g. in a liquidity crisis) a number of issues arise under the current regime.

Generally these businesses require funding of $1m-$10m; however, their current options are influenced by both the regime (documentation) and counterparty availability (distribution) as illustrated in the following table.

Documentation	**Comment**
Prospectus and Investment Statement	Cost makes this inefficient with the underlying drafting, Audit and legal fees costing between $60 and $100k plus distribution/brokerage averaging 4%. All up a capital raise could conceivably cost in the range of 7 - 12% of the amount raised

Information memorandum	Cost of an information memorandum is significantly cheaper. Interestingly the information is largely the same as a Prospectus and Investment statement without the legal and audit overlay. Therefore the cost is often much lower in the range of 4-8% of the total amount raised.
Distribution (Public Offer)	**Comment**
Engage an NZX broker to undertake the capital raising with an aim to list	Generally this level of transaction is too small for brokers to undertake
Distribution (Non-public)	**Comment**
Focus on Institutional Investors	This market is very limited with only one real player as most institutions do not have unlisted investments included in their mandates.
Focus on Private Equity Investors	Generally these transactions are too small for PE players with only a couple interested in the "small end".
Focus on exempt investors per the Securities Act [1978]	Access to private investors is fragmented and limited to the networks of each boutique investment bank
Focus on angel investor groups	Generally these businesses have outgrown the capacity of angel groups which by nature are very slow at providing capital. Angel groups by nature are limited to early stage opportunities.
Focus on friends and family	Have often supported the business thus far and are often unwittingly risking more than they understand (and face large concentration risk), ultimately run foul of current regulations by investing.

The result of these constraints is that private capital raisings in the New Zealand market are generally undertaken by way of information memorandum with investors providing confirmation that they are eligible investors. Interestingly, the eligible investor regime tends to provide an additional barrier for investors due to the additional documents that need to be executed by a party other than that making the investment. With many investors having their capital in one or more trusts, another technical barrier is erected regarding qualification, however, we note that the Taskforce has already dealt with this issue of being able to group personal and trust assets to pass the eligible investor test.

The current rules governing private capital raisings are often not understood by investors, are time consuming and those that can certify eligibility are often reluctant to do so due to potential professional liability.

Current New Zealand Regime

Most capital raisings for SMEs in NZ are normally undertaken by way of an information memorandum utilising the relevant exceptions to the Securities Act [1978]. The relevant exceptions provide for offers of securities that are not made to members of the public or offers to "eligible persons".

An offer is not made to the public if it is made to any or all of the following persons only:

- relatives or close business associates;
- habitual investors;
- investors subscribing for a minimum subscription of $500k; and/or
- persons selected "otherwise than as a member of the public".

The eligible person exception is applicable where the only persons who are able, under the terms of the offer to subscribe for the security are eligible persons, and each subscriber is an eligible person.

An eligible person falls into one or more of the following three categories:

- wealthy (has net assets of at least $2m or $200k of income for the each of the last two years as attested by a chartered accountant);
- experienced in investing money (as attested by a financial adviser); or
- experienced in the industry or business (as attested by a financial adviser).

Interestingly there is still significant debate as to what defines an investor selected as otherwise not a member of the public.

We note the recent recommendations by the Taskforce, specifically the recommendation, which we understand has been accepted, that will allow all investors in a private offering to fall into any of the above categories as opposed to the current position that all investors must be from one of the categories. This amendment will be helpful however we believe this only goes partway towards creating a less restrictive environment.

International Regime

As part of our consideration of this issue, we have looked at the current regimes in the UK, US and Australia. We discuss each of these below.

UK

In 2004 the UK government recognised after consultation on "informal capital raisings" that existing regulations were standing in the way of small firms being able to promote investment opportunities to individual investors.

The pre-existing environment was similar to New Zealand's current environment.

The overcome these problems, the UK Government decided to make two main changes to the then current regulatory regime:

- firstly, to allow investors to self-certify themselves as high net worth individuals or sophisticated investors, without having to go through an authorised intermediary; and

- secondly, to allow firms to promote to individuals that they "reasonably believe" are self-certified as high net worth individuals.

The aim of the changes was to simplify the regulatory regime for financial promotions and remove barriers that had previously inhibited business investment into small and growing firms. The changes were to make it easier for small, innovative, potentially high-growth firms to attract the funding they need to invest and succeed and ultimately contribute to the UK's economic prosperity.

A key was to make it easier for unlisted firms to raise finance from investors while retaining appropriate consumer protections.

The UK, similar to New Zealand, have exemptions based on income (GBP100k of income per annum) or assets (GBP250k of exclusive of the investors primary residence) as certified by an accountant or an employer. They introduced self certification based on four tests:

- member of a network or syndicate of business angels for at least six months;

- made more than one investment in unlisted companies in the previous two years;

- working or have worked in the previous two years in a professional capacity in the private sector, or in the provision of finance for small and medium enterprises; or

- is currently or has been in the previous two years a director of a company with annual turnover of at least GBP1m.

To minimise the risk of incorrect self-certification and maintain appropriate investor protection, a requirement was introduced necessitating promotional material sent to investors to carry appropriate "health warnings". These warnings consist of a short statement warning the investment opportunity described carries significant levels of risk of losing all assets invested. The appearance of the warning is prescribed so it appears prominently at the beginning of all promotions and must:

- precede any other written or pictorial matter;
- be indelible;
- be legible;
- be in a font size consistent with text forming the remainder of the communication;
- be printed in black bold type;
- be surrounded by a black border not less than 3 millimetres in width, which does not interfere with the text of the warning; and
- not be hidden, obscured or interrupted by any other written material.

The self certification statements also highlight the risks associated with unlisted equity and the loss of financial protection and redress under the Financial Services and Markets Act 2000 (FMSA).

In adopting these changes, it was recognised that, in addition to the health warnings, there are remedies outside the financial promotions regime that continue to afford protection to investors. These include common laws of fraud and negligence and section 397 of the FMSA which protects investors from misleading statements.

Australia

Offers in Australia fall under the Corporations Act 2001 which outlines when offers of securities require disclosure to investors and what types of disclosure documents can be utilised.

Offers that do not need full disclosure (and therefore do not require a Prospectus/Investment Statement) include:

- small scale offerings when no more than 20 investors acquire securities and no more than AU$2m is raised by the issue of securities in any 12 month period – know as the 20:12 rule;

- offers to sophisticated investors who pay a minimum of AU$500k upon acceptance of an offer or to investors who have net assets of at least AU$2.5m or gross income in the last two years of AU$250k per annum and are certified by a third party;

- offers to professional investors who have net assets in excess of AU$10m or to persons who control net assets of at least AU$10m;

- offers to certain people associated with the business (such as senior managers); and

- certain offers to present holders of securities in the business.

For the above, an information memorandum is utilised and conduct is subject to provisions of the Corporations Act 2001 as well as common law. The Corporations Act 2001 includes prohibitions on certain types of conduct relating to financial products such as making false or misleading statements or engaging in deceptive or misleading conduct.

It is worth noting that the Australian legislation includes a provision for sophisticated investors (investing more than AU$500k) that certain offers of securities do not need full disclosure (and therefore do not require a prospectus/investment statement) if made through a financial services licensee and the licensee believes on reasonable grounds that the person to whom the offer is made has previous experience in investing in securities that allows them to assess:

- the merits of the offer;

- the value of the securities;

- the risks involved in accepting the offer;

- their own information needs; and

- the adequacy of the information given by the person making the offer.

Under this provision, the licensee must give the person, before or at the time when the offer is made, a written statement of the licensee's reasons for being satisfied as to these matters and the person to whom the offer is made must sign a written acknowledgement before or at the time when the offer is made that the licensee has not given the person a disclosure document in relation to the offer.

US

Offers in the US fall under a number of legislative regimes at both the state and federal levels. Private offerings generally fall under Regulation D of the Securities Act 1933 which include various exemptions.

Rule 504 provides an exemption for an offer and sale of up to US$1m of securities in a 12-month period as long as the offering is prepared exclusively according to state law exemptions that permit general solicitation and advertising to accredited investors.

Rule 505 provides an exemption for offers and sales of up to US$5m of securities in any 12-month period. Under this exemption securities may be sold to an unlimited number of accredited investors and up to 35 "unaccredited" investors who do not need to satisfy the sophistication or wealth standards associated with other exemptions. Purchasers must buy for investment only and not resale.

The following table outlines the general US regime.

	Rule 504	**Rule 505**	**Rule 506**
Offering Amount Limitation	US$1m (in any 12 month period)	US$5m (in any 12 month period)	Unlimited
Number of Investors	Unlimited	Unlimited accredited investors, up to 35 non-accredited investors	Unlimited accredited investors, up to 35 non-accredited investors
Limitations on types of investors	None	None	Investors who are not accredited must be "sophisticated"
Limitations on issuers	Must not be a reporting company	None	None
Information requirements	Private placement memorandum	Non-accredited investors must be furnished with specific information	Non-accredited investors must be furnished with specific information
Filing Requirements	Form D must be filed with the SEC within 15 days of the first sale	Form D must be filed with the SEC within 15 days of the first sale	Form D must be filed with the SEC within 15 days of the first sale
Solicitation Requirements	General solicitation permitted only in limited circumstances	No general solicitation permitted	No general solicitation permitted

By definition, an "accredited" investor must have at least US$1m of assets or an annual income of at least US$200k in the last 2 years. Directors and executive officers of a company are also accredited investors for the purposes of acquiring securities from the company.

In conjunction with the Federal regulations each state has its own variations regarding securities offerings. Interesting examples representative of such variations can be found in California and Minnesota.

In California, state exemptions allow businesses to raise up to US$5m from an unlimited number of qualified investors (high net worth individuals).

In contrast, in Minnesota securities offers by a company to no more than 25 persons are exempt if the following conditions are met:

- the company reasonably believes all investors are in Minnesota other than institutional investors;

- no commission or remuneration is paid or given directly or indirectly for soliciting any prospective investor except reasonable and customary commissions paid by the company to a licensed broker-dealer; and

- ten days prior to the sale under the exemption, the company has filed with Minnesota a statement of the issuer on the form prescribed.

These Minnesota exemptions are not available to investment companies or a development stage company that either has no business plan or purpose or has indicated that its business plan is to merge with an unidentified company.

Summary

The following table provides a summary of each of the above countries regulations aligned to the NZ model:

	NZ	UK	Australia	US (Rules aggregated)
Offer Amount Limitation	Nil	Nil	See profile	$1-5m in any 12 months however may vary by state
Information Requirement	Information memorandum	Information memorandum with specific health warnings	Information memorandum	Private Placement Memorandum or defined information disclosure
Registration	No	No	No	Post issue
Number of investors	Unlimited	Unlimited	See profile	Unlimited or up to 35 in some cases
Investor Profile (any or combination of)	Relatives & business associates Habitual Minimum of $500k Otherwise as a member of the public Eligible Investors	Eligible investor	Small scale (20 investors) or less than $2m in any 12 month period Minimum of $500k to eligible investor Professional Investors - $10m assets Business associates	Accredited (Eligible Investors) May also be "unaccredited"

	NZ	UK	Australia	US (Rules aggregated)
Definition of Eligible Investor	$200k income or $2m assets or Experienced in investing or Experienced in industry	GBP100k income or GBP250k assets	A$250k income or A$2.5m assets	US$200k income or US$1m assets Director or officer of the issuer
Certification	Third party professional	Self based on 4 tests: Member of investment syndicate or angel network Eligible Investor Made more than one investment in last 2 years Working or worked in a professional capacity in the private sector Director of a company with annual turnover of more than GBP1m	Third party professional	

Recommendations

Taking all of the above into consideration, while recognising the need for appropriate investor protections to be retained, we believe that there is an opportunity to move in tandem with global capital markets to free up capital for small businesses and therefore reduce the equity gap. Making capital raising more efficient and therefore more cost effective while providing a platform for broader distribution to possible investors will not only aide SME companies in the short term, but will help put some of those businesses on a path which will see them moving towards listing on either Unlisted or NZAX as an interim step, or straight towards the NZX.

Accordingly, we propose consideration of the following recommendations, which largely stem from the concept of using an unregistered offer document that is able to be marketed more broadly. While we have set out a series of recommendations, we note these are all interlinked and are unlikely to be of significant value individually, whereas the cumulative value of such changes would be, in our opinion, significant.

1. Company and Governance

Recommendation

We believe it appropriate that there should be a limitation on the amount of capital that any one company is able to raise without being required to prepare a registered prospectus and investment statement – in our opinion this limit should defined in three ways:

a) in respect of the company itself – say revenues of less than $20m and equity of less than $10m;

b) a capital raising of not more than $10m in any 12 month period; and

c) any such company has a minimum of two independent directors with experience.

We also recommend that company's being allowed to utilise this form of capital raising must not be black box or investment company type entities – it is important that they have some operating history of, say, not less than 2 years.

Rationale

The additional costs of registering a prospectus and investment statement by a company of a certain size undertaking a capital-raising of significance should not be a barrier to the process and therefore exemptions aren't appropriate.

We believe that it is important that there is some form of quality control in respect of entities raising capital and a series of parameters provide for this.

Additionally it is important that the company can show good governance for investor protection. As all directors will be required to sign an offering document, the personal liabilities of being a director arise and therefore this should incentivise self policing – good directors will be incentivised only to stand for good quality companies.

It is also important to ensure that companies utilising this form of capital-raising are not entities with an unproven scope and or early stage concepts.

2. Offer Document

Recommendation

We recommend allowing the use of a Limited Prospectus or Information Memorandum that is provided to the Companies Office for acceptance and public posting against the entity's file. We recommend that the Companies Office acceptance of such document is purely administrative under a "tick-the-box" for completeness regime.

In terms of the document itself we recommend that it has similar format to a prospectus with headings provided for guidance to the drafter. Such document should including the last two years historic financials and one year projections although these would be unaudited. Such document would be signed and certified by the directors and include appropriate prescriptive health warnings.

Rationale

It is important that the offer document has defined form and substance.

3. Advisers

Recommendation

In terms of assistance for an entity raising capital we envisage a series of approved promoting investment banks, a similar concept to that adopted by the NZX for NZAX promoters. These approved promoters 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.

Rationale

As the above offer document is not necessarily reviewed by lawyers (providing a legal opinion) or the accounts and projections not audited, it would be expected that the approved promoting investment banks have a capability to review financial statements and projections and undertake sufficient review work to provide comfort to the investing public. Accordingly the approved investment banks must be able to show quality and experience.

4. Investor Requirements

Recommendation

In terms of investors we recommend three initiatives:

Firstly, self accreditation, as the current third party accreditation is a barrier to activity.

Secondly, a reduction in the eligible investor definition from net assets or income of $2m or $200k to $1m or $100k. This could also be overlayed with a minimum investment amount of say $50k.

Thirdly, we would see a broadening of the rules for eligible investors to include company directors or managers of an entity with more than $2.5m of turnover, an investor that has made an investment in private company previously, or management of an offering company.

Additionally, we would recommend definition of a professional investor being a party or company that has more than $2.5m assets under management.

Rationale

The key with investors is to create efficiency in the process and provide more definition to remove the grey areas. The third party accreditation regime is a barrier to capital raising and removing this barrier is important for efficiency of the process. Given there is little definition around business associates and professional investors it is important to clarify this for all.

5. Advertising & Promotion

Recommendation

As a final recommendation we would consider allowing restricted advertising in the media and on the internet with appropriate disclaimers and warnings.

Rationale

Distribution is often one of the most difficult parts of the process and therefore opening up the way private capital raisings may be marketed will assist.

Overall the above recommendations are aimed at creating efficiency of recycling capital within NZ to support the ongoing capital requirements of private businesses.

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

Yours sincerely

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