

# Financial Service Providers (Pre-Implementation Adjustments) Bill 2009

## **SUBMISSIONS**

**ANGEL ASSOCIATION NEW ZEALAND**  
Submitter: Colin McKinnon, Executive Director

**25 March 2010**



## 1. INTRODUCTION

- 1.1 The following are submissions on the Financial Service Providers (Pre-Implementation Adjustments) Bill 2009 (**Bill**) on behalf of Angel Association New Zealand (the **Angel Association**).
- 1.2 The Bill contains amendments to the Financial Advisers Act 2008 (**Financial Advisers Act**) and the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (**FSP Act**).
- 1.3 We would like the opportunity to appear before the Committee and speak on these submissions. Please contact Colin McKinnon, Executive Director, to coordinate this. Colin's contact details are:

Colin McKinnon (Angel Association, Executive Director)  
Level 6 Affco House, 12-26 Swanson Street, Auckland  
09 302 5218 or [colin.mckinnon@angelassociation.co.nz](mailto:colin.mckinnon@angelassociation.co.nz)

- 1.4 The Angel Association would also be happy to engage further outside the Committee process on the issues raised in this paper further. To do so, please contact:

Colin McKinnon (Angel Association, Executive Director)

or

Jeremy Muir (Senior Associate, Minter Ellison Rudd Watts)  
09 353 9819 or [jeremy.muir@minterellison.co.nz](mailto:jeremy.muir@minterellison.co.nz)

## 2. EXECUTIVE SUMMARY

- 2.1 The angel investment community covers non-professional angel industry participants (angel networks), seed funds (companies and partnerships which invest at the seed capital end of the growth spectrum) and broker service providers (such as the Escalator service offered by New Zealand Trade & Enterprise).
- 2.2 The issues for seed funds under the FAA and FSP Act are addressed in the separate submission on the Bill by the New Zealand Private Equity & Venture Capital Association Inc (**NZVCA**) and we acknowledge and support the issues and suggestions raised in that submission. New Zealand Trade & Enterprise, as a Crown entity, already benefits from statutory exemptions from each of the Acts. The thrust of this submission is in respect of non-professional angel industry participants.
- 2.3 We believe that requiring full compliance with the Financial Advisers Act and the FSP Act for non-professional angel industry participants would mean that emerging entrepreneurs could not present their ideas or businesses to angel groups and experienced investors would choose not to participate in angel groups. This would have a profound "chilling effect" on a source of capital which the Government, the New Zealand Venture Investment Fund (**NZVIF**), the Angel Association and all other groups interested in growing great New Zealand companies from early stage to the world stage, have been working hard to develop and nurture.
- 2.4 We propose the Bill exclude non-professional angel industry participants from compliance with:

- (a) all of the requirements (including the registration requirement) of the FSP Act; and
  - (b) all of the requirements of the Financial Advisers Act.
- 2.5 This may be done as part of a general carve-out/exemption for advice or services provided to the “wholesale” rather than the “retail” market. We recognise that it may be appropriate for any “wholesale” carve-out/exemption to treat non-professional angel industry participants differently from, say, professional advisers such as investment bankers providing advice to big corporate entities.
- 2.6 We include suggestions on an appropriate definition for “wholesale” clients.
- 2.7 It would be helpful for a growing industry if the Securities Commission were given the power to grant exemptions from *all* requirements of the FSP Act and Financial Advisers Act, rather than just certain disclosure obligations.

### 3. **BACKGROUND TO ANGEL INVESTMENT**

#### ***What is an angel investor?***

- 3.1 An angel investor is an individual who provides capital and, often, expertise to early stage businesses which can't find traditional sources of business funding. Angels typically invest their own capital, although a small but increasing number of angel investors are forming angel networks in order to share research and pool their investment capital.
- 3.2 More details on the angel market in New Zealand may be found in *The Business of Angel Investing in New Zealand: A Guide* written by NZVIF as a definitive guide to angel investing in New Zealand. This is available online at:
- [http://www.anglassociation.co.nz/template/documents/investors/angel\\_guide.pdf](http://www.anglassociation.co.nz/template/documents/investors/angel_guide.pdf)
- 3.3 Angel investment is a subset of the portion of the non-public (private) equity markets in New Zealand that targets young companies at the start of their lives and is a key source of capital for the 60 percent of companies not represented in the public markets. [Source: *The Business of Angel Investing in New Zealand: A Guide*]
- 3.4 According to NZVIF:

*To summarise, angel investing is a crucial part of any vibrant and growing economy. It provides the life-blood of capital and wisdom to businesses early in their growth phases, and while it is often unstructured and low profile, it is in dollar terms a very significant segment of potential business financing.*

[Source: *The Business of Angel Investing in New Zealand: A Guide*]

#### ***Who are we?***

- 3.5 The Angel Association was established in 2008 to bring together the business angel networks and early stage funds currently operating in New Zealand to work towards an agreed national vision and to deliver the activities required to achieve this.

- 3.6 The Angel Association aims to increase the quantity, quality and success of angel investments in New Zealand and in doing so create a greater pool of capital for innovative start-up companies.

***Benefits to New Zealand of angel investment***

- 3.7 Angel investors helped 63 New Zealand companies with more than \$50 million of new capital in the twelve months to 31 December 2009. Cumulatively, \$127 million has now been invested into young companies by angels since data has been collected in 2006.
- 3.8 Angel investors are playing an increasingly significant role in the financing of high-growth, innovative start-ups. These companies represent part of the ‘pipeline’ of companies referred to by the Capital Markets Development Taskforce. Some will be the next generation of top New Zealand companies on publicly listed markets—providing our capital markets can provide the investment to allow them to grow and develop through the growth pipeline.
- 3.9 Since 2006, by region, 54 percent has been invested in Auckland, 12 percent in Christchurch, 11 percent in Dunedin, 9 percent in Wellington and 5 percent in Palmerston North. Software and services have received 28 percent of the amount invested, followed by pharmaceuticals (23%), technology, hardware and equipment (13%), and food and beverage (12%).

***How do angel groups operate?***

- 3.10 At present angel groups operate under a variety of structures. For all structures, however, it is fair to say that they generally require a degree of public good and concern for “New Zealand Inc”, over and above a simple desire to make returns for their members.
- 3.11 The angel investment community covers, for example, non-professional angel industry participants (angel networks), seed funds (companies and partnerships which invest at the seed capital end of the growth spectrum) and broker service providers (such as the Escalator service offered by New Zealand Trade & Enterprise).
- 3.12 The issues for seed funds under the FAA and FSP Act are addressed in the separate submission on the Bill by the NZVCA and we acknowledge and support the issues and suggestions raised in that submission. New Zealand Trade & Enterprise, as a Crown entity, already benefits from statutory exemptions from each of the Acts. The thrust of this submission is in respect of non-professional angel industry participants.
- 3.13 One common feature of most angel networks is the need to co-ordinate a number of interested, experienced and motivated individuals in a cost-efficient and straightforward manner. For this reason, it is not practical to require full compliance with the full prospectus and investment statement regime under the Securities Act 1978 (**Securities Act**) for start up companies or entrepreneurs seeking capital from angel investors.
- 3.14 Accordingly, many angel groups operate under the various carve-outs and/or exemptions in the Securities Act. For example, an angel group may require a prospective angel to provide an appropriate certificate that he or she is an “eligible person” for the purposes of section 5(2CB) of the Securities Act.

- 3.15 Generally, it is more common for an angel group to rely on the “wealthy” category of eligible person as this provides a more straightforward form of certification (as a *bright line* test for qualification). This is despite that fact that they would also be “experienced”. However, in practice, it has proven more difficult to get third parties to certify experience than wealth.
- 3.16 If all members of the angel group qualify as eligible persons, a start up company or entrepreneur can seek capital (ie make an offer of securities) to the members of the angel group without the need for a prospectus or investment statement.
- 3.17 An angel deal may typically happen in the following way:
- (a) An entrepreneur (**Entrepreneur**) pitches an idea, product or existing business, “*Dragon’s Den*” style, to a group of angels.
  - (b) If all or some of the angels like the idea, they may decide to do further due diligence.
  - (c) The angels may appoint a single lead investor to co-ordinate due diligence and reporting back to the group on the investment (**Lead Investor**), including recommendations as to terms of investment.
  - (d) The angels may also select several individuals to carry out the due diligence and report back to the group (**Due Diligence Team**), including any recommendations.
  - (e) The angel group may also employ one or more staff members who assist in co-ordinating and documenting the investment (**Angel Staff**).
- 3.18 This is not intended to be a comprehensive explanation of all permutations of an angel deal.

***Intersection of angel investment with the Financial Advisers Act and the FSP Act***

- 3.19 On the current wording of the Financial Advisers Act and Financial Service Providers Act it would appear that:
- (a) the Entrepreneur;
  - (b) the Lead Investor;
  - (c) each member of the Due Diligence Team; and
  - (d) certain Angel Staff,

will be performing a financial adviser service by, in the course of business, making recommendations or giving opinions or guidance in relation to acquiring or disposing of (or refraining from acquiring or disposing of a financial product (generally shares in the start-up company)).

- 3.20 This would require each of them to be both authorised and registered under the Act.

- 3.21 We note that under the Bill there will be an exception for financial advice provided by an employee or representative of a qualifying financial entity (**QFE**) which is an issuer or promoter of securities. This obviously will not apply to the Entrepreneur here, who will not have any of the qualities of a QFE.
- 3.22 We do not believe that in any of these cases it is appropriate or reasonable to require entrepreneurs, angels and angel staff to shoulder the expense of registration and authorisation given the nature of the investment circumstances and the experience of the angels who are receiving the advice.
- 3.23 Further, we believe that requiring full compliance in each of the cases listed above, would simply mean emerging entrepreneurs could not present their ideas or businesses to angel groups and experienced investors would choose not to participate in angel groups, as applicable.
- 3.24 In other words, this would have a profound “chilling effect” on a source of capital which the Government, NZVIF, the Angel Association and all other groups interested in growing great New Zealand companies from early stage to the world stage, have been working hard to develop and nurture.

#### 4. **SUBMISSIONS**

##### ***NZVCA submission***

- 4.1 We acknowledge and support the issues and suggestions raised in the NZVCA’s submission on the Bill, to the extent that they also relevant for funds and companies which invest at the seed capital stage for growing businesses.

##### ***Wholesale carve-out/exemption***

- 4.2 We propose the Bill exclude non-professional angel industry participants (eg the Entrepreneur, the Lead Investors, angel members of a Due Diligence Team and Angel Staff) from compliance with:
- (a) all of the requirements (including the registration requirement) of the FSP Act; and
  - (b) all of the requirements of the Financial Advisers Act.
- 4.3 This may be done as part of a general carve-out/exemption for advice or services provided to the “wholesale” rather than the “retail” market.
- 4.4 We do not, however, consider that these non-professional angel industry participants are in exactly the same category as professional advisers to the “wholesale” market. For this reason, it may be appropriate for any “wholesale” carve-out/exemption to treat non-professional angel industry participants differently from, say, professional advisers such as investment bankers providing advice to big corporate entities. While it may, for example, be reasonable under a wider wholesale carve-out/exemption to require such professional advisers still to *register* under the FSP Act and comply with *conduct obligations* under the Financial Advisers Act, we do not think this would be appropriate for non-professional angel industry participants.
- 4.5 We submit that requiring non-professional angel industry participants to register will have a chilling effect on the industry as set out above, for no regulatory or other gain.

- 4.6 We submit that the conduct requirements in the Financial Advisers Act are more suitable for professional industry participants.

***Definition of “wholesale” client***

- 4.7 For the purposes of a definition of “wholesale” clients, we note:
- (a) Any definition should be broadly consistent with the existing carve-outs and exemptions under the Securities Act, which are currently relied on by angel groups.
  - (b) For this reason, the “wealthy person” category of eligible persons under the Securities Act (section 5(2CD)) should be included in the definition.
  - (c) If there is resistance to the inclusion of the “wealthy person” category, we consider the “experienced in investing money or in the industry or business to which the security relates” category under the Securities Act (section 5(2CE)) could also work, but we note that it has been found difficult to get independent financial service providers to provide the certification required for this category. This is because experience is more difficult for a third party to assess than wealth. For that reason, we would prefer that an angel investor could self-certify that they belong to this category. Any investor protection issues with self-certification could, we submit, be mitigated by either a requirement for angels to give such certification to a regulator (such as the Securities Commission) and/or for the “adviser” to consider on reasonable grounds that the angel does in fact appear to have the necessary qualification.

***Exemptions***

- 4.8 Given that, as noted above, the description of a typical angel investment transaction provided is not intended to be a complete description of all possible angel arrangements, we submit that it would be helpful if the Securities Commission were given the power to grant exemptions from *all* requirements of the FSP Act and Financial Advisers Act, rather than just certain disclosure obligations.
- 4.9 We submit that in a growing industry as new models of investment are tried and adopted, there will be a need for a fast and pragmatic approach to ensuring that non-professional angel industry participants are willing and able to participate in this important market function.