NZ | CORPORATE GOVERNANCE | FORUM

24 February 2023
Kristin Brandon
Head of Policy and Regulatory Affairs
Email: kristin.brandon@nzx.com

NZX Major and Related Party Transactions Guidance Note

Dear Kristin,

We welcome the opportunity to provide feedback on the exposure draft of the Major and Related Party Transactions Guidance Note (**Guidance Note**).

The New Zealand Corporate Governance Forum (**NZCGF**) is committed to promoting good corporate governance of New Zealand companies for the long-term health of the capital market. We believe that good governance improves company performance and increases shareholder value, which is a core focus for NZCGF members as custodians of capital.

We acknowledge NZX's efforts in updating the Guidance Note and NZX's constructive engagement with the NZCGF in response to our advocacy on this issue.

Overall, while we consider there are some material improvements in the Guidance Note, we believe that further substantive changes are required to appropriately reflect shareholder rights related to approval of major and material transactions.

We set out our answers to the selected consultation questions in *Appendix A – Answers to Selected Consultation Questions*. Our key observations follow in the remainder of this letter, and we raise certain matters not specifically covered by a consultation question.

The core major and material transactions tests in the Listing Rules should be updated

While we appreciate that this is outside the scope of the current consultation, we repeat our recommendation of the 2017/8 Listing Rule review, that NZX reviews the major/related-party transactions tests, which in our view don't adequately protect shareholder rights and are out of step with comparable markets.

As part of that review, NZX initially proposed a reduction of the threshold for major transaction approvals from 50% to 25%. This was ultimately not implemented, in part because of complexities in developing a revised approval threshold that was workable across a range of different issuers within the timeframes available at the time.

However, the result is that the current major transaction threshold leaves shareholders with little control over potentially very significant changes to their company. Further consideration should be given to a reduced threshold.

We also recommend that NZX considers a more sophisticated formulation of the test, as applies in other markets. As presently drafted, the major transaction test focuses on the Gross Value of the assets being acquired/disposed of as a percentage of Average Market Capitalisation. However, in our view, both the marginal risk of the transaction and the change to the Issuers risk profile need to be accounted for when assessing major transactions.

The current approach can result in substantive differences in approval requirements depending on the structure of a particular acquisition and balance sheet of the target[1].

Please refer to our 2017/18 submission for further details of examples of other percentage thresholds and more sophisticated tests for materiality that can 'look through' the legal form of the transaction[2].

Analogously the related-party threshold of 10% for related party transactions also merits review in our opinion.

The Guidance Note should more explicitly identify and reflect fundamental principles

We consider the proposed changes in the Guidance Note to be incremental adjustments to existing principles and processes. The initial impetus for the NZCGF advocating for this reform was we believe the Guidance Note required a holistic, first principles overview to better recognise shareholder rights.

In our view, the fundamental conceptual starting point, which should frame up the nature and content of the Guidance Note and the approach to any waivers, is the recognition that Listing Rule 5.1.1 and 5.2.1 define *a critical shareholder right to approve major and material transactions.* Granting a waiver in respect of these rights is a serious matter, as *NZX is in effect transferring to itself a fundamental shareholder right*.

As such, the Guidance Note should:

- More emphatically acknowledge this position at the outset, including by specifically cross-referencing NZX Corporate Governance Code Recommendation 8.3;
- Contain clear overarching principles that any waiver of these shareholder rights should only be sought, and will only be granted, in circumstances where it is clear that **both** 1) the underlying transaction is in the best interests of shareholders and 2) granting the waiver is in the best interests of shareholders (i.e., the costs of the approval process materially exceed the opportunity cost arising from not granting the waiver), and;
- Ensure that there are more specific principles, criteria and commentary contained within the Guidance Note, and the conditions of any waiver, are consistent with the above.

We consider that the broader principles are fundamental and suggest any departure from those principles in the Guidance Note should be carefully considered, as in practice the commentary in the Guidance Note informs how NZ RegCo determines when to grant waivers. If the Guidance Note refers to specific criteria, waivers may be granted notwithstanding that they are inconsistent with fundamental first principles of shareholder rights.

[1] For instance, using the first of the proposed examples in the Guidance Note:

- If this transaction was structured as a purchase of shares and the target company had $50m of debt within it, the Gross Value would be the $100m purchase price for the assets (i.e., shares/equity).
- If the same transaction was structured as an asset purchase and the Issuer acquired the business assets along with the debt, the Gross Value would be $150m (i.e., the market value of the assets acquired and disregarding the impact of the accompanying debt).

The current treatment results in different values despite the same business impact on the acquirer. Further, the treatment may encourage structures which circumvent shareholder approval rights.

[2] For example, by measuring impact of the transaction on total consolidated assets or EBITDA of the Issuer.

While the Guidance Note contains some significant improvement in this regard, we still consider that:

- It is overly reliant on specific criteria creating a risk that certain transactions will receive waivers which should not (and vice versa); and

- Particularly in the case of Material Transactions, it does not strike balance as to when waivers will be granted. The general thrust is that NZX may grant a waiver where it is satisfied that the Related Party conflict is immaterial or has not influenced the decision to transact. We do not consider that is the right test, as these are matters that shareholders can and should consider for themselves. Before granting any waiver, NZ RegCo should also be satisfied in respect of the fundamental principles previously outlined, i.e., the underlying transaction is in the best interests of shareholders and granting the waiver is in the best interests of shareholders.

Conversely, the commentary around waivers no longer being provided in respect of competitive M&A opportunities is overly definitive and restrictive. In our view legitimate cases may arise where acquisition opportunities are both value creating and obstructed by the waiver process. In such a case both conditions must be presented in the application, judged to be reasonable by NZX and reasonable support disclosed to shareholders.

Amendments and Variations

We fundamentally disagree with the proposed guidance in this area (for both LR 5.1.1 and 5.2.1), which we consider would seriously undermine shareholder rights.

By way of explanation, in assessing whether to approve a transaction, shareholders will typically evaluate whether the proposed transaction would contribute to sustainable shareholder value. As such, even a comparatively small change to the originally proposed transaction (especially the price) could change the value assessment and therefore impact on the decision to support the proposal.

The proposed guidance which suggests that a variation/amendment will only require a fresh approval if it constitutes a major transaction (on a stand-alone basis) is out of step with how shareholders exercise their approval right and is therefore inappropriate.

We have no objection to amendments or variations of a minor or administrative nature being made without a further shareholder approval requirement.

* * *

Please see *Appendix B – Other Matters*, for more detailed comments on drafting of the Guidance Note.

Once again, we welcome and thank the NZX for the opportunity to provide feedback on the exposure draft of the Major and Related Party Transactions Guidance Note (Guidance Note), and the constructive engagement of the NZX with the NZCGF in responding to its advocacy on this issue.

Please note that individual Forum members may make their own submissions directly to NZX, and this submission will be published on our website (www.nzcgf.org.nz) and LinkedIn page.

Yours sincerely,

Sam Porath
Chair
NZ Corporate Governance Forum

Appendix A – Answers to Selected Consultation Questions

#	Question	Response
1	Do you agree with the proposal to confirm that Rule 5.1.1 does not apply to the granting of a charge, and also the exercise of the charge?	We agree conceptually that granting a charge does not in and of itself constitute a major transaction. However, we recommend that the Guidance Note clarifies that the underlying transaction giving rise to the charge may constitute a major transaction – e.g.: *"However, a charge necessarily arises in the context of a commitment or obligation which may itself qualify as a major transaction. For instance, an indemnity or guarantee that was secured by a charge could nonetheless create a contingent liability that is an agreement to dispose of assets (i.e., cash) in an amount equal to that liability."*
2	Do you consider that a summary of the independent advice received by the Board when considering a transaction is useful information for shareholders to consider when assessing a major transaction?	Issuers typically receive a wide range of reports in respect of a material transaction (with different purposes and confidentiality issues), and it is important to be precise about what information is expected to be disclosed to shareholders. The Guidance Note refers to the disclosure of "a third-party report … prepared to support the transaction (for example third party share valuations or property valuations"), whereas the consultation question refers more broadly to "independent advice" – a much more expansive term. Disclosure of the key third party reports relied upon in evaluating the value added by the transaction, or a summary of them, is essential for shareholders to make an informed decision in respect of a major transaction. As noted in our covering letter, in considering whether to approve any transaction, institutional shareholders will assess whether the transaction contributes to sustainable shareholder value. In general terms, reports provided to support price or valuation are of strong interest to shareholders and generally meaningful support should be able to be provided to shareholders. Other more specific due diligence reports are likely to be subject to confidentiality restrictions around disclosure that will prevent them being disclosed to shareholders. However, if that is the case, to the extent possible, Issuers should include a summary of key findings to enable shareholders to meaningfully evaluate the transaction.
3	If the Board cannot share any independent advice received (for example, due to confidentiality), do you consider that a summary of why this is the case is useful for shareholders?	Yes. In addition, a summary of the advice should be provided to the extent possible (as the Guidance Note is currently drafted).

4	Do you consider that there is utility in Issuers providing information in relation to the break fees or sunk costs that apply to a major transaction?	Yes. These costs may be relevant to the shareholders evaluation of the transaction. Shareholders will also consider board performance in respect of the management and execution of major transactions, including incurring break fees for deals subject to shareholder approval.
5	Do you agree with the proposed guidance provided on waivers from Rule 5.1.1, and the standard conditions that NZ RegCo is likely to apply when granting a waiver?	We agree with the broad changes in raising the thresholds for granting waivers and expanding the disclosure requirements. The key areas where we would like to see further improvements are outlined in our cover letter. While we agree with NZX that the conditions of any consent are likely to vary greatly, based on the particular facts, we would like the default director certification to include: • The granting of the waiver is in the best interests of the Issuer's shareholders as a whole; • The core grounds on which the non-interested directors determined that the transaction, and grant of the waiver, are in the best interests of shareholders. It is not clear to us why the non-interested directors would certify that the major transaction is in the ordinary course of the Issuer's business. By nature, major transactions will often be outside the ordinary course of business, and we note that the non-independent directors separately certify that the transaction does not significantly change the nature of the issuer's business.
6	Do you agree with the proposed changes to the Guidance Note in relation to transactions with multiple Related Parties, or which have multiple components, as described above?	In general, we are supportive of the drafting, other than as it relates to a transaction with multiple components. While a related party may only be involved in one discrete element of a series of transactions, that component may still be material to the related party. Therefore, the risk of related party influence still exists in respect of the various components of the transaction.
7	Do you agree with the standard conditions that NZ RegCo propose for waivers from Rule 5.2. as set out in the Exposure Draft, or are there additional conditions (such as the publication of an independent assessment of the value of the transaction) that NZ RegCo should consider?	Refer to our comments in the cover letter with respect to our concerns in respect of the approach to waivers more generally. We would like the default director certification to include: • The granting of the waiver is in the best interests of the Issuer's shareholders as a whole; • The core grounds on which the non-interested directors determined that the transaction, and grant of the waiver, are in the best interests of shareholders.

Appendix B – Other Matters

- Section 2.1: the reference to "that NZX considers to be so significant" should be changed to "that are so significant" to make it clear this is an objective matter

- Section 2.5.1: The commentary on how the Issuer should determine gross asset value in situations where the figure is not specified in the Issuer's financial statements is inconsistent with the Listing Rules. The Listing Rules provide that Gross Value is the greater of (a) the gross asset value specified in the issuer's financial statements "if applicable" or (b) the market value of the assets. So, if there isn't a gross asset value specified in the financial statements, the Issuer must use market value of those assets. There is currently no basis in the Listing Rules for using an alternative method to derive a gross asset value.

- Section 2.5.1 worked examples: The worked examples could be improved by:

    - Being specific about whether the Issuer is acquiring shares or assets (rather than referring to "acquires a similar business") as the structure can make a difference.

    - Including an example where debt/liabilities are being assumed alongside the assets, to make it clear that the price is still the market value of the assets (i.e., not reduced to reflect the liabilities being acquired).

    - Adding commentary that these examples show the methodology for calculating the value of specific transactions. However, in each example there are several different transactions that may need to be considered. For instance, the repayment of debt and payment of a break fee are separate transactions that could trigger approval requirements (they simply are not aggregated together with the disposal for the purposes of quantifying the value of the sale transaction).

- Section 2.8: in the paragraph outlining the information NZX expects to be included in the notice of meeting, we suggest that the existing "in the case of an acquisition, details of how the Issuer intends to pay for the acquisition" is now superseded by the new paragraph on "how the Issuer will fund the transaction".

- Section 3.2.5:

    - Should the reference in parentheses be to paragraph 3.2.8 (rather than 3.2.9)?

    - We have a concern that the treatment of sub-underwriter relationships may be overly simplistic and focused on the technical contractual relationships. We would welcome further engagement with NZX on this topic. While we can certainly see situations where a sub-underwriter is structurally and substantively segregated from the offer structuring and terms, there are other situations where the related person might have a very high level of influence on the transaction terms via its relationship with the Issuer.

- Section 3.5: NZX should make it clear in its "no objection" notice in respect of the notice of meeting that the notice is not a basis for Issuers to decline requests from shareholders for further information to assess the merits of the transaction.

- Appendix 1: We suggest including the definition of Gross Value.