FOURTH
PUBLIC
CONSULTATION
PAPER

4. COMPANY LAW AND ONLINE REGISTRY REFORM: CAPITAL RAISING

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MINISTRY OF COMMERCE, INDUSTRY AND TRADE,
GOVERNMENT OF THE KINGDOM OF ESWATINI.

NEW ZEALAND COMPANIES OFFICE

The Government of New Zealand, through the New Zealand Companies Office, is assisting with these reforms.

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Executive Summary

This consultation paper is the fourth in a series prepared by the Ministry of Commerce, Industry and Trade (Ministry) to reform the Eswatini Companies Act 2009 and subsequently implement an electronic, online company registry. The first consultation paper provided a roadmap on how the reform would move forward, the second focused on issues around the initial incorporation of a company, and the third discussed issues that affect the ongoing maintenance of a company, such as director duties and instituting a solvency test.

This fourth paper examines financial matters, specifically how companies can be empowered to raise capital to operate and expand their business. Many of the policy points raised in this consultation paper may require an independent and more detailed diagnostic and could be subject to a separate and additional reform effort. However, it is prudent to raise these issues now so they can be considered when finalizing the structure and content of the new Companies Bill. If further reform work is undertaken, it will be easier to amend the new company law framework. This paper will look at the following specific issues:

1. What frameworks can be instituted that will make it easier for companies to obtain equity financing?
    a. Is the traditional formulation that only allows public companies to sell shares via a prospectus the best approach?
    b. Does the current Act make it impossible for companies to take advantage of the new Fintech revolution?
2. The current Act contains the traditional approach to borrowing, under which companies pledge their non-land assets via the company charge provisions. Is there a modern framework that would open up new opportunities for companies to obtain credit?

The Ministry welcomes all stakeholder feedback. Comments should be directed to the following email address: ________________________.

1.0 Raising capital and obtaining credit

1.1. Raising capital

Modern economic analysis clearly shows that difficulty accessing capital is one of the most significant constraints on small- and medium-sized enterprises (SMEs). The current Companies Act contains restrictions on the ability of a private company to raise additional funds. Section 16 currently provides:

> (1) In this Act "private company" means a company having a share capital and which by its articles—
>
> a. restricts the right to transfer its shares; and
>
> b. prohibits any offer to the public for the subscription of any shares or debentures of

the company.

This is the traditional approach and is intended to protect the public from fraud. For a private company to raise capital through the sale of shares, it must convert to a public company and issue a formal prospectus—a very expensive proposition. This approach is not a good fit for many small, private companies and thus severely restricts the ability of SMEs to grow.

The key policy consideration in the regulation of fundraising is the trade-off between investor protection and economic imperatives for domestic capital formation, sometimes called domestic resource mobilization or "DRM."

Investor protection is traditionally achieved by prospectus disclosure. However, disclosure comes at a cost to the issuer and the economy. For the issuer, these are transaction costs: the compliance costs or the net regulatory burden. The costs of preparing a prospectus are high, which has a chilling effect on capital raising—whence the cost to the economy. As a result, the modern approach is to relax the investor protection goal in limited instances to enable SMEs to access capital to encourage domestic capital formation and economic growth. The exemption for small offers in New Zealand and Australian legislation is an example of such a trade-off between investor protection and the economic imperative to support SMEs.

Recent trends in international capital markets have recognized that a non-traditional approach to raising capital may be appropriate for non-public companies, including direct issuance of shares or unsecured debt, to investors. Importantly, this would open up new sources of capital, such as crowdfunding, and the use of internet-based platforms. For this reason, many jurisdictions no longer rigidly prohibit raising funds from the public, either through the sale of shares or otherwise. Instead, the modern approach authorizes these transactions but imposes a strict duty on the company and its promotors to refrain from making false claims or otherwise engaging in deceptive advertising. Any such fraudulent actions are criminalized. This approach strikes a balance between allowing companies to tap financial markets but still protect investors.

The basic text required to relax the current prospectus requirement is simple and straightforward and could be modeled on the following:

1. **Misleading or deceptive conduct in relation to offer of securities to public**
    a. A person must not engage in conduct that is—
        i. reckless conduct in relation to—
            (1). any advertisement; or
            (2). the offer of debt or equity securities generally; or
            (3). any dealing (including trading) in debt or equity securities; and
        ii. misleading or deceptive or likely to mislead or deceive.

b. A person who contravenes this section commits an offence and is liable on conviction to a fine not exceeding $XXXXXX or to imprisonment for a term not exceeding 5 years, or both.

c. A person who suffers loss as a result of contravention of this section may claim damages or other relief or both against¾

   i. the issuer of the debt or equity security; and

   ii. if the issuer is a company, the directors of the company at the time of contravention.

d. A director of an issuer who is liable under subsection (3)(b) is jointly and severally liable with the issuer and the other liable directors.

2. **Definitions for purposes of prior section**

For the purposes of the prior section,—

advertisement means a form of communication—

a. that—

   i. contains or refers to an offer of debt or equity securities to the public; or

   ii. is reasonably likely to induce persons to subscribe for the debt or equity securities of an issuer, being securities to which the communication relates and that have been, or are to be, offered to the public; and

b. that is authorised or instigated by or on behalf of the issuer of the debt or equity securities or prepared with the co-operation of, or by arrangement with, the issuer of the securities; and

c. that has been, or is to be, distributed to a person

debt security—

a. means any interest in or right to be paid money that is, or is to be deposited with, lent to, or otherwise owing by, any person (whether or not the interest or right is secured by a security interest in any property); and

b. includes—

   i. a debenture, debenture stock, bond, note, certificate of deposit, and convertible note; and

   ii. an interest or right that is declared by regulations made under this Act to be a debt security for the purposes of this Act; and

   iii. a renewal or variation of the terms or conditions of any interest or right of a security referred to in subparagraph (i) or (ii); but

c. does not include any interest or right or a security referred to in paragraph (b)(i) or (iii) that is declared by regulations made under this Act not to be a debt security for the purposes of this Act

distribute includes—

a. make available, publish, and circulate; and

b. communicate by letter, email, newspaper, broadcasting, sound recording, television, cinematographic film, video, Internet site, or any form of electronic or other means of communication

equity security—

a. means any interest in, or a right to share in, the share capital of a company; and

b. includes—

   i. a preference share, and company stock; and

   ii. a security that is declared by regulations made under this Act to be an equity security for the purposes of this Act; and

   iii. a renewal or variation of the terms or conditions of any interest or right or a security referred to in subparagraph (i) or (ii); but

c. does not include any interest or right or a security referred to in paragraph (b)(i) or (iii) that is declared by regulations made under this Act not to be an equity security for the purposes of this Act

offer includes an invitation, and any proposal or invitation to make an offer, and to offer has a corresponding meaning

The Ministry seeks input on whether it is in the best interests of Eswatini to engage in a further review of the reform options available to assist companies in raising finance. This could lead to a change to the current approach, which only allows public companies to raise capital through offers to the public and requires public companies to first issue a prospectus before seeking to raise funds.

1.2 Existing prospectus regime

A full reform of capital raising may follow the enactment of a new Companies Act, so it is important that the new regime continues to support the regime outlined in Chapter VI of the current Act. Although there may be some drafting adjustments needed, any further reforms should be able to be accommodated within the structure of the new Companies Act.

1.3. Company charges: enactment of a Personal Property Securities Act

The current Companies Act includes the old (and outdated) company charges regime. A Personal Property Securities Act (PPSA) can significantly increase access to credit for SMEs and individuals operating their businesses as sole proprietors or in partnerships.

A PPSA provides a means by which movable property (not land or buildings) can easily serve as collateral for a loan. It accomplishes this by providing for the creation of "security interests" in movable property. These security interests are recorded—in real time—in a centralized, online electronic registry that is searchable via the internet. This allows lenders to secure their interests in collateral concurrent with the disbursement of loan funds, and to determine immediately whether a proposed debtor has already pledged particular collateral to secure an existing loan. The ability to perform this search against a would-be borrower generates greater confidence in lenders to extend credit, knowing that the collateral for their loan has not been previously pledged. Due to the efficiency of this regime, most asset-based lending in developed economies uses movable property as collateral, not land. Given that many SMEs do not own land, a PPSA significantly increases access to credit for small businesses.

The following is a detailed analysis of how a PPSA works.

A. What type of movable property is subject to the reform?

"Movable property" includes tangible property, such as inventory and equipment, and also intangible property, such as accounts receivable, other rights to payment, and even property to be acquired in the future. A lender may, for example, take a security interest in "all inventory and its proceeds," without needing to describe in detail all a store's wares. It also allows payment obligations to be used as collateral. For example, a construction company may be owed for the completion of a roads project. The approved invoice has real value that can be pledged for an interim loan to make payroll until the invoice is paid. The "receivables" lender would receive their loan amount first and then the company would take the rest.

The intent of the Act is to be applied as broadly as possible, covering a variety of types of property and transactions. However, it is crucial to note that the Act does not apply to land (immovable property).

Usually, there are some narrow exceptions drawn as to what sits outside the scope of a PPSA. For example, most countries do not call for large ships or airplanes to be subject to their PPSA, as there are already specialized legal registries in place to address these highly movable items. Further, most countries do not allow for a pledge of payments from a superannuation fund under their PPSA, lest retirees are deprived of income in their vulnerable years. A PPSA is flexible enough to allow for customization to carve out any specific type of movable property deemed inappropriate for inclusion in the Eswatini PPSA framework.

B. Who may pledge movable property as collateral?

There is no limitation under a PPSA on who may use movable property as collateral. So long as someone has

rights in the property and the ability to enter into a contract, that person or entity may pledge the property as collateral. This is important because the PPSA makes clear that individual persons, not just corporate entities, may use the PPSA. This means that sole proprietors and partnerships can use the PPSA to unlock the value of their movable property to stand as collateral for loans.

C. What transactions are covered by the PPSA?

While it is obvious that the PPSA applies to a traditional borrower-lender transaction, it also applies to other commercial transactions because of the broad language in which it is written. The text of the Act does not refer to "lenders" or "borrowers," but rather to "secured parties" and "debtors." Thus, an equipment dealer selling a bulldozer on credit is a "secured party," and the buyer is a "debtor." In this case, the debtor would have given a "security interest" in the bulldozer in favor of the secured party, the seller. This feature of the PPSA facilitates a significant increase in trade-creditor financing.

A PPSA should apply to all transactions that have traditionally been used to create security in personal property. Without this rule there would be no way for potential future lenders to know that a particular asset offered by a prospective borrower was subject to a claim by a prior party. Including these transactions in the PPSA registry creates greater transparency of the creditworthiness of a prospective borrower. These transactions include such things as: hire-purchase agreements, retention of title financing, chattel mortgage, mortgage debenture, and company charges. Note that the terminology used no longer matters: if movable property is used to secure payment or performance, the PPSA should apply.

In other jurisdictions, imaginative business people have created financing products for specific situations. For example, seed suppliers have financed the sale of their product, in return for a security interest in the crops to be harvested. Various trade creditors may use the Act in ways that foster supply-chain financing. Contractors with large accounts receivables from trustworthy payers may be able to pledge these receivables to obtain short-term financing so as to meet payroll. A PPSA is flexible enough to cover a variety of situations.

D. What are security interests? How are security interests created?

Under the PPSA, a "security interest" is the term used for the charge or mortgage over the movable property that secures the underlying obligation to pay. The granting of the security interest creates a property right in the movable property, in favor of the secured party (the lender), that can be acted upon in the event of default.

A security interest is granted by a debtor under a "security agreement." In the typical borrower-lender transaction, the standard loan documents are the security agreement. The security agreement need not contain any particular terminology or follow any prescribed format—it needs only be signed by the debtor and describe the collateral. All other formal terms and conditions are left to the parties to decide.

Once the security interest is granted by the debtor, the secured party records a "Notice of security interest" into a centralized, online electronic registry. This registry can be publicly searched, so that others can determine whether property has already been pledged to secure a previous loan. Potential future lenders will access this registry as part of their due diligence when assessing whether to make a loan or not. The ability to perform a real-time, online search against a would-be borrower increases lenders' confidence in extending credit.

E. What is "priority" in collateral? How does a lender establish their priority?

A key component of a PPSA pertains to establishing "priority" in collateral. Priority refers to determining which person has the best claim over collateral. Simply put, a person with priority has first rights in the collateral. Priority is most important where more than one creditor has a claim on the debtor's property. The secured party with priority can seize the property and obtain its full value before any other creditor can obtain any value from it.

A PPSA sets out clear rules for determining priority in the collateral among competing creditor claims on that collateral. In practice, by far the most common method of establishing priority in collateral is by filing a "Notice" of a security interest in the online, electronic registry implemented under the Act. However, filing a Notice is not the only means of establishing priority, and the PPSA will spell out the conditions for securing priority by other means, such as by taking possession of the collateral.

Priority is extremely important as creditors that can establish their superior rights in the collateral will feel secure that no other creditors can jump ahead of them in the event of a default. It is also a very important concept with regard to buyers of movable property. The general rule is that if a person buys property that a previous creditor has priority over, then the buyer takes the property subject to that prior interest. In other words, if there is a prior security interest, the secured party (the lender) may still later seize the purchased property to pay off the seller's debt.

F. How does the PPSA encourage a secondary lending market? What are "purchase money security interests?"

One of the most important economic features of a PPSA is that it encourages the growth and use of secondary lenders. It does so through a special lending tool called "purchase money security interests." These are a type of lending product that allow secondary lenders to extend credit even where a primary lender has taken a charge over all assets of a borrower. Where a secondary lender gives new money for a new asset, that secondary lender has priority over that asset. This may be best explained through an example. Assume Lender 1 has a security interest over "all assets" of Borrower. Borrower needs a new bulldozer, but Lender 1 offers terms that include an extremely high interest rate. Under a PPSA, Borrower can obtain a loan from Lender 2 to buy the bulldozer, and Lender 2 takes priority in the bulldozer. This gives borrowers much greater bargaining power with lenders and, over time, results in a lowering of borrowing costs to all businesses.

G. The online, electronic registry and its contents: what must be filed?

In practice, by far the most common method of establishing priority in collateral is through filing a "Notice" of security interest in the online, electronic registry implemented under the PPSA. By publicizing its security interest, the secured party establishes its priority as of the date and time of filing. In practical terms, the "filing office" consists of a web-enabled, electronic registry into which Notices are entered by the secured party. There are no paper filings involved. Instead, all PPSA Notices that are filed in the online filing office are simple, one-page forms. They are also public records and may be searched via the internet in real time.

Compare this process to the burdens imposed by the company charge process wherein all the loan documents must be recorded. A PPSA does not require that the full loan documents be filed. Instead, the basic concept is that the registry should collect only enough information to notify a searcher that a particular debtor and particular property are subject to a security interest.

In most cases, a general description of the collateral is sufficient. For example, a Notice stating that "all inventory and equipment now or hereafter held by Company ABC is subject to this security interest" would be sufficient. There are limited cases where a more specific description is required. For example, to facilitate easy searching of motor vehicles, most jurisdictions require the serial number (the VIN) to be entered into the filing office database to ensure priority over subsequent buyers and/or lessees. This allows searchers to type in the serial number to see if there is a charge over the car. Future consultations will discuss these exceptions and their potential applicability to Eswatini.

H. Enforcement

A PPSA establishes the process for enforcement against the collateral in the event of default by the debtor. Since the value of personal property often declines rapidly over time, the enforcement process should be streamlined to optimize the value realized from the collateral. There is even a provision in most versions of the PPSA that allows taking possession of collateral without judicial action in certain instances, so long as there is no "breach of the public peace." If this is not possible, the PPSA should provide a simplified and expedited judicial action for pre-judgment possession of the collateral. However, while the PPSA provides for rapid sale of the collateral, it often also seeks to protect debtors against loss by requiring retention of the sale proceeds until final judgment of the case in front of a judge. This means that the debtor will still get their day in court to assert whatever arguments they deem appropriate.

The secured party should be able to dispose of the collateral in any commercially reasonable manner. Most versions of the PPSA allow a secured party to conduct a public or private sale and also allow the secured party to buy the collateral if it is the highest bidder. To protect the debtor and other creditors, a PPSA should require a secured party to give notice of proposed sale to the debtor, other secured parties of record, and other persons who have an interest in the collateral. A PPSA should also protect debtors by granting them the right to redeem the collateral at any time before its sale, by paying the costs of enforcement and fulfilling

the remaining obligation on the underlying transaction. Once there is no remaining dispute about rights in the collateral, the secured party may distribute the proceeds of disposition in order of priority established by the law. A PPSA will set out the distribution scheme according to the relative priorities of parties in the collateral.

These matters will be discussed during consultations around the PPSA to make sure that enforcement provisions fit within the existing legal framework in Eswatini and address practical considerations.

Conclusion

The Ministry strongly believes that it is in the long-term interest of Eswatini to consider a PPSA reform. The question is one of timing. It is possible to undertake both a PPSA and Companies Act reform at the same time. Conversely, it is also possible to complete the company reform project and then undertake the PPSA project. The PPSA registry can then either be added on to the company registry platform or can operate as standalone system. If the registry is integrated, company or other entity searches would highlight any secured interests which are registered against the entity. Further discussions around this issue will help reveal the proper path forward.

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