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Informal Capital Raising Consultation Responses
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Dear Sirs

Informal Capital Raising and High Net worth and Sophisticated Investors

I am a solicitor specialising in corporate law with more than 20 years experience of advising start-up and early stage companies particularly (but not exclusively) in the technology sector. This experience extends to assisting such companies with the legal aspects of raising private equity finance. I have also acted for private individuals who have invested in early stage companies as well as advising an informal grouping of business angels on the implications of the financial promotions restriction contained in the Financial Services and Market Act 2000 and the current high net worth and sophisticated investor exemptions referred to in your consultation paper of January 2004.

My response to the questions in your consultation paper are set out below. I have confined my response to those questions related to the three alternative models proposed.

Question 1

Are the current exemptions allowing appropriate numbers of high net worth and sophisticated investors to become certificated?

No. From the outset I was concerned that the current exemptions were unduly restrictive, too bureaucratic and unlikely to be effective. In my experience where business angels are concerned the rules are being ignored. In a place like Cambridge there are very good business networks; investors and investee companies can usually find the opportunities if they want to. In my experience many small firms do not worry about the financial promotion restriction on the basis that many of their investors are known locally to be serial entrepreneurs. They are therefore assumed to know what they are doing and to be able to afford to lose their investment.

Question 2

If no to question 1, is this posing a problem for smaller firms seeking to raise capital via unlisted equity and for investors?

In practice no. See answer to question 1 above. However, it is clearly undesirable for companies seeking equity investment to be committing technical breaches of the law and for that reason I support reform.

Question 3

Do you agree that promotion should be allowed on the basis of a reasonable belief that an individual is either a certified high net worth individual or a certified sophisticated investor?

Yes.

Question 4a

Should potential investors be able to self certify that they qualify as high net worth individuals?

Yes.

Question 4b

Do the majority of sophisticated investors already meet the high net worth criteria?

In my experience yes.

Question 4c

If yes to question 4a, should the sole certification exemption replace or be introduced alongside the current high net worth exemption?

It should replace the current high net worth exemption. The only argument for retention put forward in the paper is that "some investors may be more comfortable with the current regime and not wish to move wholly to a self-certify regime for the high net worth individual exemption". Why should this be the case? People who are sophisticated enough to make judgements about investing in (usually) early stage private unlisted companies are unlikely to need the "comfort" of a certificate given by their employer or accountant.

Question 5

Should the net assets test for self certification by high net worth investors be increased to £500,000, remain at £250,000 or be set at another level?

The existing minimum threshold of £250,000 already excludes the investor's principal residence, life insurance policies and pension provisions. The current threshold is reasonable. Paragraph 4.12 of the paper says that changing the net asset test to £500,000 would exclude 52% of current EIS investors. It then refers to many of these being "family or friends". However, there is no exemption from the financial promotion restriction where the communication is made to family or friends. In this region acquaintances will often invest in more than one company although the sums involved are relatively small. I see no good reason for raising the threshold which may have the effect of reducing the pool of potential investors (assuming that investee companies observe the rules).

Question 6

Do you think that a test for self-certifying as a sophisticated investor should be introduced alongside the current regime?

No: it should replace the current regime.

Question 7

Do you agree with the proposed criteria for sophistication? What changes do you suggest and why?

I do not think the criteria are workable. One of the suggested criteria is being a member of certain named professional bodies. One of these is The Law Society. Why should it be assumed that a solicitor is a "sophisticated investor"? A personal injury lawyer may know nothing about the operations of private companies. On the other hand The Institute of Chartered Surveyors is excluded. I know of at least one Chartered Surveyor who operates as a business angel.

The criteria that the investor has carried out transactions on securities markets at an average frequency of 10 per quarter over the previous four quarters and the size of the investor's securities portfolio exceeds £100,000 does not in my view demonstrate that the investor necessarily understands about investing in illiquid shares in early stage high risk businesses. Investing in such businesses is very much dependent on judgements about the management team, the nature of the technology and the market for the goods or services. People in investing in listed securities are not normally looking at these issues in any depth.

In paragraph 4.17 it is stated that "the main concern with allowing individuals to self-certify is that it could allow some individuals who are not sufficiently knowledgeable or experienced to invest in higher risk unlisted and illiquid securities". My response to that is that each draft of the model statutory instruments makes it clear that the financial promotion communication has to state that reliance on the communication for the purpose of engaging in any investment activity may expose the individual investor to a significant risk of losing all of the property invested. That statement should be required in bold and placed in a prominent position on the communication. Beyond that I believe that individuals should be capable of looking after themselves.

The more complicated the procedure is made to self-certify the less likely it is that busy people will bother with it.

Question 8

Do you think that self-certifying as a sophisticated investor without detailed criteria to test against should be introduced?

Yes. See the answer to question 7. In paragraph 4.22 it is suggested that there is potential for abuse "if investors are led to sign away their rights by unscrupulous advisers". Presumably you mean advisers assisting companies to raise finance. Personally I am sceptical about this but if it is thought to be a risk then it can be dealt with by making the "health warning" more prominent (see reply to previous question). If the investor still proceeds to invest then I would regard that as their decision. People who can read should be capable of understanding a statement that says that they run the risk of losing the whole of their investment.

Question 9

Out of models 1, 2 and 3, which do you think provides the most appropriate balance between investor protection and facilitating investment in SMEs, and why?

For the reasons given above I would support model 3.

Yours faithfully

JOHN SHORT