
Business Angel-Led Enterprise Capital Funds

A consultation on proposed changes to
the Regulated Activities Order

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INTRODUCTION

The equity gap **1.1** Access to finance is essential for growing businesses to invest, to implement new technologies and strategies and to contribute to a more productive economy. External sources of finance are particularly important for start-up and small businesses, which often lack retained profits to re-invest to support their own growth. The UK has well-developed capital markets by international standards, and the majority of UK firms report few problems in accessing finance to operate their business. Nevertheless, a small but economically important minority of innovative, growth-oriented businesses continue to face difficulties attracting funding. For this small subset of businesses, equity finance is often needed alongside or instead of debt.

1.2 *Bridging the finance gap: next steps*¹ set out the results of the Government's consultation on access to growth capital for SMEs, and presented evidence of an equity gap facing businesses seeking to raise relatively modest sums of risk capital. The gap arises when businesses with viable investment propositions are unable to attract investment from informal investors or venture capitalists. Whilst the severity of the equity gap varies according to factors such as business sector, stage of development, region and round of funding, the available evidence suggests that the equity gap remains a constraint for some businesses seeking up to £2 million of growth capital, and can be particularly severe for those seeking less than £1 million.

Enterprise Capital Funds **1.3** SMEs make an important contribution to the output, employment and productivity of the UK. The Government's strategy to raise levels of enterprise is centred on building a supportive business environment which encourages people to start and grow businesses and addressing market imperfections that act as barriers to business growth. The Government is already taking targeted action to help markets overcome the specific barriers that lead to the equity gap through measures such as Regional Venture Capital Funds, the Enterprise Investment Scheme and Venture Capital Trusts.

1.4 However, notwithstanding the contribution of these measures, a small but important number of SMEs continue to be constrained the availability of private-sector investment. *Bridging the finance gap* therefore announced the Government's intention to launch a 'pathfinder' round of Enterprise Capital Funds (ECFs), to explore the scope to develop a long term ECF programme. The objectives of such a programme would be to stimulate an increased flow of private capital into the equity gap, and to lower the barriers to entry for potential new participants in this part of the risk capital market. ECFs will be commercially-managed funds, established to invest a mix of public and private sector capital in SMEs with growth potential that are affected by the equity gap. The Government is currently awaiting a decision from the European state aids approval process before launching the competitive bidding process for the pathfinder round of ECFs.

¹ *Bridging the finance gap: next steps in improving access to growth capital for small businesses*, HM Treasury and Small Business Service, December 2003: www.sbs.gov.uk/financegap.

1.5 The ECF programme is based on a variant of the US Small Business Investment Company (SBIC) model, which has backed the growth of successful companies such as Apple, Intel, FedEx and AOL. The design and structure of ECFs is the result of extensive consultation² with interested parties across the UK, and incorporates significant changes to the SBIC model to suit the UK market.

Business angels **1.6** Business angels are an important source of equity finance for SMEs and as such, play an important role in addressing the equity gap. Broad estimates suggest they provide between £500 million and £1 billion of investment per annum in around 3,000 to 6,000 businesses³. The overwhelming majority of these investments are concentrated at the lower end of the equity market, with fewer than 10 per cent of angels investing more than £250,000⁴. The informal nature of business angel investments means that the transaction and due diligence costs of equity investing are typically lower, increasing the viability of making small-scale equity investments. Business angels often provide important further benefits in terms of offering expertise, management support and contacts to entrepreneurs.

1.7 Whereas structured business angel syndicates have been a significant feature of the US enterprise economy, there are currently relatively few groups operating in the UK. Similarly, whilst informal business angel networks have developed in the UK over the past few years, this is not nearly to the same extent as in the US. The Government believes that structured syndicates have a potentially important role to play in the UK, enabling greater total sums of investment into individual firms. Business angel syndicates would also help to increase the impact of the overall business angel sector in equity investments by allowing individual investors to reduce their risk exposure (by spreading investments across a more diverse portfolio of companies), allowing members to share expertise, information and contacts, and providing an entry route and learning opportunities for new or less experienced business angels.

1.8 Enterprise Capital Funds offer a potential mechanism for groups of high net worth and sophisticated investors to take the first steps towards formalising existing loose networks and benefit from government support to leverage their impact in the private equity market. However, the Government is aware that the costs of regulatory compliance may present a barrier for groups of angels who are contemplating formalising their investment activities via an ECF.

Regulatory issues **1.9** The costs of complying with regulation have been highlighted in feedback to the Government's recent consultation on changes to the financial promotions regime⁵. That consultation document proposed changes to the Financial Promotion Order to facilitate informal capital raising by unlisted firms from high net worth and sophisticated investors. Responses have indicated that, for investors who possess the necessary information and expertise to make informed investment choices, the benefits of regulatory protections are perceived to be small relative to the financial and time-related compliance costs. The Government's response and the proposed changes in legislation will be published in Autumn 2004.

² *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*, HM Treasury and Small Business Service, April 2003: www.sbs.gov.uk/financegap.

³ *The size of the informal venture capital market in the UK*, Mason, C. and Harrison, R., Small Business Economics, 2000.

⁴ InvestorPulse 2003 business angel survey.

⁵ *Informal capital raising and high net worth and sophisticated investors*, HM Treasury, January 2004.

1.10 One of the objectives of the ECF pathfinder round is to test the appetite for ECFs amongst business angel groups (who would actively invest their own funds, but not the funds of other passive private-sector investors), as well as amongst fund management professionals. However, regulatory compliance costs may discourage groups of business angels from submitting bids for pathfinder ECFs. This consultation therefore considers the issue of the costs associated with regulation by proposing to allow the operator of a business angel-led ECF (“BA-led ECF”), under certain circumstances, to operate that fund without the need for authorisation by the Financial Services Authority (“FSA”) under the Financial Services and Markets Act 2000 (“FSMA”).

1.11 The proposals in this consultation are in addition to the proposed changes to the financial promotions regime. They would create exclusions from regulation for the operator of a BA-led ECF when carrying out of certain activities specified in Financial Services and Markets Act 2000 (Regulated Activities) Order 2001⁶ (“the Regulated Activities Order”). In designing these proposals, the Government has taken account of the need to preserve full consumer protections for those who need them, while avoiding disproportionate compliance costs for those who do not. Chapter 4 of this consultation document therefore sets out the measures that the Government proposes to put in place to minimise the potential risks associated with the proposals. In particular, the intention is that the exclusion will apply only to operators of BA-led ECFs where the investors are suitably qualified to make informed investment decisions, and fully appreciate (and have signed a statement to that effect) that they are forgoing the usual protections available under FSMA.

⁶ S.I. 2001/544.

2

ECF OVERVIEW

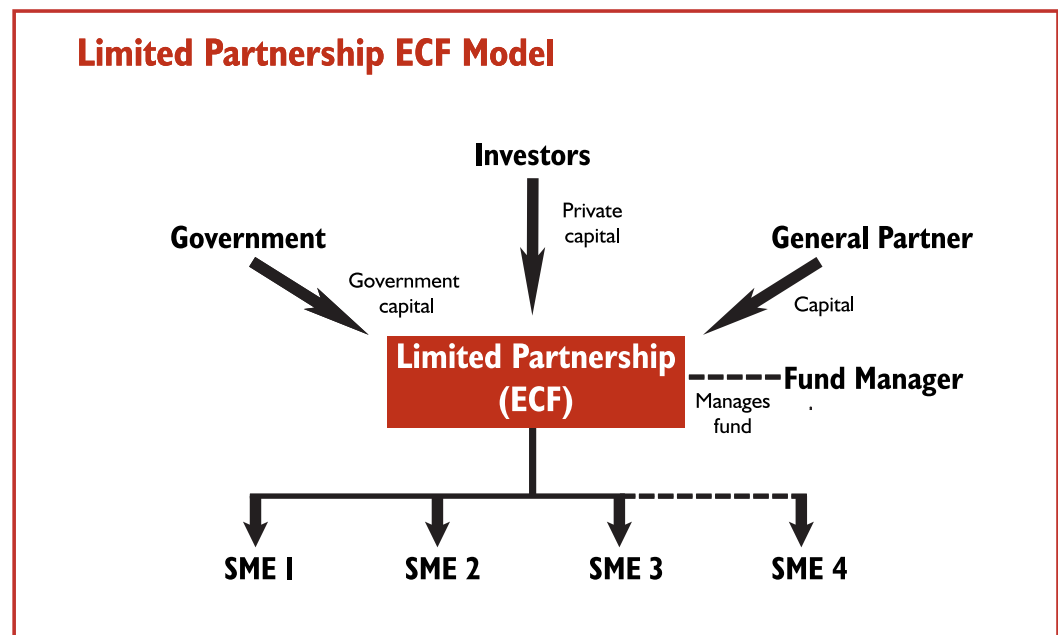
2.1 The Government set out a broad overview of envisaged fund structures in the pathfinder ECF draft bidding guidance¹. This set out two variants in which the limited partnership (LP) structure under English law could be suitable for:

- (i) ECFs managed by professional fund managers on behalf of ‘passive’ third-party investors, and
- (ii) BA-led ECFs.

(i) Standard ECF model

2.2 It is expected that most ECF operators will wish to use the standard limited partnership structure that is widely used in the venture capital industry (see figure 1). In this structure, the government and other investors in the fund would be limited partners, and the general partner would appoint a professional FSA-authorized fund manager to manage the fund on behalf of the partnership. To maintain their limited liability, the limited partners cannot become involved in the management of the fund. This model is therefore appropriate for ‘passive’ investors whose money is managed by a third party (the general partner, or fund manager appointed by the general partner).

Figure 1



2.3 The Government believes that it is entirely appropriate that the operator of an ECF should fall within the regulatory system when an ECF is structured in this way. To do otherwise would create unacceptable risks for consumers of financial services. Indeed, feedback to the *Bridging the finance gap* consultation indicated that many potential investors would invest in an ECF only if the protections of the regulatory system were available.

¹ Pathfinder ECFs – Draft Guidance for Applicants, Small Business Service, May 2004: www.sbs.gov.uk/financegap.

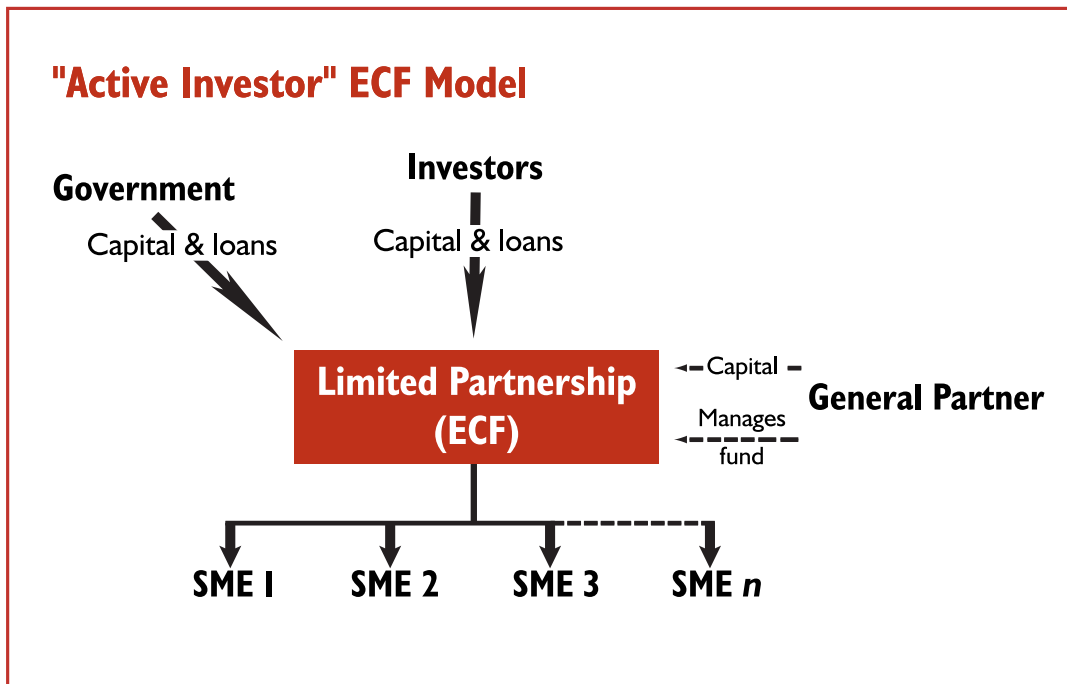
(ii) Business angel-led ECF

2.4 While the above model is suitable for ‘passive’ investors, it is not appropriate for investors who have the expertise and the inclination to manage their own portfolio of investments in unquoted SMEs. The Government has therefore proposed a variant of the standard venture capital LP model that could be suitable for groups of business angels seeking to invest their own funds in a BA-led ECF that they collectively manage themselves (see figure 2).

2.5 As in the standard LP model, it is envisaged that the government and private investors would all be limited partners in the fund. The private investors would form a body corporate to act as the operator, and this vehicle would manage the activities of the fund. This structure should allow the private investors to manage their own portfolio of investments through a BA-led ECF without compromising their limited liability status as partners within the ECF.

2.6 While there is no guarantee that bids will either be received (or accepted) for an BA-led ECF, as set out in the draft bidding guidance, one of the objectives of the pathfinder round is to test the level of private investor appetite for the ECF product. This will help inform the Government’s decision on whether and how to develop a long-term ECF programme.

Figure 2



Interaction with regulatory system

2.7 Under the current regulatory framework, the limited partnership of both the standard and the BA-led ECF model would be a collective investment scheme within the meaning of the FSMA section 235. Although the limited partnership itself would not need to be regulated, the general partner or fund manager (as operator of the collective investment scheme) would, under the current financial services regulatory regime need to be FSA-authorized.

2.8 However, where a BA-led ECF is investing only the funds of the government and of the business angels themselves (but not the funds of third parties), the Government believes that it would, under certain circumstances, be appropriate for the operator of the ECF to act without having to be authorised under the Financial Services and Markets Act 2000. Chapter 3 sets out in detail the circumstances under which the Government proposes to exclude the operator of a BA-led ECF from having to be authorised under FSMA, and the measures that will be taken to ensure that full consumer protections are maintained for those who need them.

Question 1: Should suitably qualified individuals be permitted to manage their own funds and those of the government through a BA-led ECF without having to be authorised to do so under the Financial Services and Markets Act 2000?

Question 2: If no to Q1, what are the reasons why BA-led ECFs should be required to be authorised?

Wider regulatory issues

2.9 The Government acknowledges that there is scope for greater angel investment and involvement in SMEs through syndication beyond ECFs. However the Government is also aware that the costs of compliance with FSMA regulation and the perceived uncertainties surrounding such regulation, in particular authorisation requirements, are regarded by some as a barrier to syndication and the establishment of angel networks. The Regulated Activities Order may in particular discourage ‘archangels’ or ‘gatekeepers’ who organise or assist other business angels. The Government welcomes views on whether further changes to the regulatory regime are necessary or desirable to encourage syndication outside the mechanism of ECFs.

Question 3: Do respondents believe that the exemptions for BA-led ECFs could be appropriately extended to other forms of collective business angel activity?

Question 4: If yes to Q3, what other forms?

Question 5: If yes to Q3, what arrangements should the government make to ensure adequate consumer protections?

3

PROPOSED REGULATORY CHANGES

3.1 Under current legislation, the LP itself would be a Collective Investment Scheme within the meaning of FSMA, because at least one of the investors (namely the government) would have no involvement in the day-to-day management of the fund. The partnership itself would be unregulated but the operator of the BA-led ECF would be carrying out various regulated activities and so would need to be authorised in respect of those activities.

3.2 To enable a BA-led ECF to operate without having to be authorised under the financial services regulatory system, the Government proposes to amend the Regulated Activities Order to exclude certain activities from regulation when they are undertaken by the operator of a BA-led ECF. The draft Statutory Instrument, which, if made, would introduce such exclusions is set out in Annex A, and this chapter summarises the activities to be excluded from regulation, and the tightly-defined circumstances under which they would be excluded.

3.3 The Government does not believe there will be a need for any specific transitional provisions or for any consequential changes to other regulatory provisions under FSMA, including those relating to collective investment schemes and the FSA's Handbook of rules and guidance. However, the Government would welcome views on any changes that might be needed.

Activities to be excluded

3.4 Under the current financial services regulatory regime the operator of the BA-led ECF (i.e. the angel-owned general partner) would be likely to be carrying on, by way of business, the following activities specified in the Regulated Activities Order at some point in its lifetime:

- Establishing, operating and winding up a collective investment scheme (i.e. a BA-led ECF)
- Managing the assets belonging to the participants of the BA-led ECF
- Making transactions or making arrangements for transactions for the participants of the BA-led ECF
- Safeguarding and administering the assets belonging to the participants of the BA-led ECF
- Dealing as agent on behalf of the investors in a BA-led ECF

3.5 The Government therefore proposes to exclude these activities from regulation under the circumstances set out below¹. The exclusions would only apply to activities carried on by the operator of the BA-led ECF that relate directly to the management of that ECF, and not in relation to any other activities it might also undertake.

¹ See article 2 of the draft SI Annex A and in particular the proposed new article 72E of the RAO.

3.6 The Government notes that the operator of a BA-led ECF may want to carry on other activities, for example arranging deals for third party investors, or advising prospective third party investors on investments. In addition, the participants will often act through or on the advice of professional third party advisers and intermediaries. The Government's intention is that these activities should continue to be regulated (requiring authorisation and providing the consumer protections that go with it). It is envisaged that any problems with third party advice will be referable to the Financial Ombudsman. However, the Government believes that business angels should not be required to be authorised under the Financial Services and Markets Act 2000 when, for example, they are arranging the establishment of a BA-led ECF.

Question 6: Are there any other activities specified in the Regulated Activities Order that a BA-led ECF might need to carry out by way of business?

Question 7: Are there any activities listed in paragraph 3.4 above, that a BA-led ECF would not, in practice, need to carry on?

Circumstances in which the exclusions would apply

3.7 The proposed exclusions from activities specified in the Regulated Activities Order in respect of BA-led ECFs are designed to apply only to a particular type of body corporate, where that body corporate is operating a BA-led ECF².

3.8 Thus the proposed exclusions would only apply where a BA-led ECF was being operated by a body corporate the members of which were participants (i.e. investors) in the BA-led ECF and between them have invested at least 50% of the total investment in that BA-led ECF, excluding any investment made by the government.

3.9 A BA-led ECF for this purpose is defined in the Statutory Instrument³ as being a collective investment scheme:-

(a) which is established for the purpose of enabling collective investment in shares, instruments creating or acknowledging indebtedness and warrants in unlisted companies;

(b) in which the government has invested and the other investors are all certified high net worth or sophisticated investors, high net worth companies, high net worth unincorporated associations or trustees of high value trusts, and who fully appreciate (and have signed a statement to that effect) the implications of the ECF operator being unauthorised; and

(c) which is prevented by the arrangements by which it is established from acquiring investments that are not investments in unlisted companies and in respect of which the aggregated costs exceeds £2 million unless that acquisition is necessary to prevent or reduce the dilution of an existing equity stake in that unlisted company.⁴

² See article 2 of the draft SI Annex A and in particular the proposed new Article 72E(6) of the RAO.

³ See article 2 of the draft SI Annex A and in particular the proposed new Article 72F(1) of the RAO.

⁴ The £2 million restriction on investments that an ECF may make is separate from the constraints regarding coinvestment with other investors that will be written into legal documentation (the limited partnership agreement or shareholder agreement).

Question 8: Do you agree that the proposed exclusions to the Regulated Activities Order will have the effect of removing the requirement to be authorised from an operator of a BA-led ECF?

Question 9: Are there any further comments on the design of the exclusions, and on the draft Statutory Instrument (Annex A)?

4

ASSESSMENT OF RISKS

4.1 In excluding BA-led ECFs from requiring FSA authorisation the Government is aware that there are potential risks as well as benefits. This Chapter sets out the risks that have been identified and how they could be minimised.

Misselling

4.2 The most significant risk is that investments in ECFs are sold to consumers for whom they are unsuitable. This is a potential problem given the limited recourse available to investors in a BA-led ECF in the event of problems occurring.

4.3 To mitigate against this risk the Government proposes to exclude BA-led ECFs from having to be authorised under the Financial Services and Markets Act 2000 regulation only where investors are high net worth or sophisticated, in line with the definitions set out under the Financial Promotions Order (“FPO”). Even where an ECF is being founded by a mix of experienced and inexperienced angels who are looking to develop their expertise, the requirement that all individuals are high net worth or sophisticated will still stand.

4.4 It should be noted that any changes to the certification requirements following the Government’s consultation on the FPO will be carried forward for the purpose of the exclusion to the Regulated Activities Order relating to BA-led ECFs.

4.5 Further, the government will require all investors in a BA-led ECF to have signed a statement that they are aware they are investing in an unregulated ECF; they fully understand the risks associated with investing in unquoted SMEs via an ECF; they are aware it is open to them to seek professional investment advice; and they understand that the consequences of the operator of the ECF being unregulated include that it is not subject to regulation by the FSA (and so will not, for example, have had to undergo a fit and proper test and will not be subject to FSA rules such as those on holding client money) and that redress through the FSA, the Financial Ombudsman Scheme or the Financial Services Compensation Scheme will not be available. Please refer to the draft Statutory Instrument in Annex A.

4.6 In addition to these protections, the government will undertake due diligence in respect of the proposed ECF management team before committing any capital to the fund. For BA-led ECFs this will cover all investors in the fund. In order to secure maximum value for taxpayers’ money, the government will invest in a BA-led ECF only where it is satisfied that all the private investors have the expertise needed to manage public funds responsibly. To demonstrate this, investors will need to show that they have previous experience of making equity-based investments in unquoted SMEs, or that they have otherwise acquired the necessary skills, experience and understanding to make informed investment decisions. If the government is not satisfied that an investor has the necessary skills and knowledge to understand the risks of investing in a BA-led ECF, they will not pass due diligence hurdles and the ECF will not be formed.

Limited recourse for investors

4.7 One consequence of excluding BA-led ECFs from the regulatory regime is that investors would not have recourse to the protections and remedies generally available under FSMA. Although investors (including the government) would have recourse to the common laws of fraud and negligence, it is a more complex means by which to seek redress and therefore unlikely to afford the same degree of protection as that available under FSMA regulations. Investors would continue to be protected from misleading statements under section 397 FSMA. There will also be clear contractual obligations set out in the Partnership Agreement that constrain the actions of the partners and provide for remedies in cases of breach of contract, but again, these controls will be less robust than those that flow from FSMA regulation.

4.8 The Government believes that its due diligence process will offer an appropriate check that proposed investors are sufficiently experienced to understand that the risks of investing in a BA-led ECF include giving up recourse to FSMA.

4.9 The Government also recognises the need to ensure that potential investors recognise that its due diligence checks are not a substitute for FSA authorisation, and that they do not provide the same protections. The checks will be narrower in scope and purpose than those carried out by the FSA in the authorisation process and will not imply threshold competence. The government may not have access to the same information used by the FSA in its checks (although it may have access to alternative sources of information). The Government considers that the statement that investors will be required to sign, confirming that they understand the consequences of a BA-led ECF being unregulated, offers an appropriate degree of protection against this risk.

Market misconduct

4.10 FSA-authorized firms are subject to FSA rules on market and inter-professional conduct, which are designed to protect, for example, other counter-parties. BA-led ECFs will not be investing in quoted securities, but the entities in which they invest may deal in quoted securities, so their activities are capable of having a significant market impact.

4.11 If operators do not require FSA authorisation they will not be subject to FSA rules. However, they will still be subject to the misleading statements offence under section 397 of FSMA, and the market abuse regime. Furthermore, the other safeguards such as the £2 million limit on the cost of investments and government vetting should also limit the scope for abuse.

Question 10: Do respondents agree with this assessment of the potential risks?

Question 11: Can and should the government do anything further to mitigate the risks?

5

TIMETABLE FOR RESPONSES

The Government welcomes responses to the issues and questions raised in this paper by 11 October 2004. Copies of this consultation document can be found at <http://www.hm-treasury.gov.uk/ba-ledecfs>

When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation please make it clear who the organisation represents, and where applicable, how the views of members were assembled.

All responses received may be made public unless specifically requested otherwise. In the case of electronic responses, general confidentiality disclaimers that often appear at the end of the emails will be disregarded for the purposes of publishing responses unless an explicit request otherwise is made in the body of the response.

Responses should be sent to:

Business Angel-led Enterprise Capital Funds consultation responses
Enterprise Team (4/N2)
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Email: ba-ledecfs@hm-treasury.gsi.gov.uk

NEXT STEPS

After the consultation deadline has closed the Government will assess responses and decide whether it is appropriate to proceed with the proposed changes as set out in this document. Assuming the Government decides to proceed, a Statutory Instrument amending FSMA 2000 will be made and then laid before Parliament. The intention is that the Statutory Instrument will then come into force 21 days after it has been laid.

The Government is committed to ensuring that legislative changes are finalised prior to the launch of the ECF bidding process.

6

CONSULTATION QUESTIONS SUMMARY

Question 1: Should suitably qualified individuals be permitted to manage their own funds and those of the government through a BA-led ECF without having to be authorised to do so under the Financial Services and Markets Act 2000?

Question 2: If no to Q1, what are the reasons why BA-led ECFs should be required to be authorised?

Question 3: Do respondents believe that the exemptions for BA-led ECFs could be appropriately extended to other forms of collective business angel activity?

Question 4: If yes to Q3, what other forms?

Question 5: If yes to Q3, what arrangements should the government make to ensure adequate consumer protections?

Question 6: Are there any other activities specified in the Regulated Activities Order that a BA-led ECF might need to carry out by way of business?

Question 7: Are there any activities listed in paragraph 3.4 that a BA-led ECF would not, in practice, need to carry on?

Question 8: Do you agree that the proposed exclusions to the Regulated Activities Order will have the effect of removing the requirement to be authorised from an operator of a BA-led ECF?

Question 9: Are there any further comments on the design of the exclusions, and on the draft Statutory Instrument (Annex A)?

Question 10: Do respondents agree with this assessment of the potential risks?

Question 11: Can and should the government do anything further to mitigate the risks?

7

REGULATORY IMPACT ANALYSIS

PURPOSE AND INTENDED EFFECT OF MEASURE

Objective 7.1 The objective of the proposed changes is to enable suitably informed and experienced groups of individual investors (“business angels”) to collectively manage their own and the Government’s capital through an Enterprise Capital Fund (“ECF”) and, under certain circumstances, for that activity to not require authorisation under the financial services regulatory system. It is intended that this will reduce the costs, and so increase the commercial viability, of investing in a portfolio of equity gap businesses.

7.2 The Government wishes to achieve this objective in a way that ensures the full protections of the regulatory system are preserved for consumers who need them.

7.3 The objective will be achieved by excluding the operators of business angel-led ECFs (“BA-led ECF”) from requiring authorisation by the Financial Services Authority (“FSA”) when engaging in certain activities in tightly defined circumstances.

7.4 The deregulatory changes will directly affect those individuals looking to operate a BA-led ECF, and will indirectly benefit unquoted SMEs seeking equity finance.

Background 7.5 Access to finance is essential to enable successful businesses to grow. However, many small businesses with high-growth potential face difficulties in raising external finance, particularly equity finance. This has led to an ‘equity gap’ for small firms seeking relatively modest amounts of risk capital. Proposals to introduce a variant of the US Small Business Investment Company (“SBIC”) model were set out in the *Bridging the finance gap* consultation¹ as a potential new approach to increase the availability of growth capital to small and medium sized enterprises (“SMEs”) affected by the equity gap. *Bridging the finance gap: next steps*² subsequently announced the Government’s intention to launch a pathfinder round of ECFs, further adapting the US SBIC model to suit the UK market. The pathfinder round will gather evidence and market intelligence that will inform the Government’s decision on whether and, if appropriate how, to develop a long term ECF programme. The Government will launch the competitive bidding process for pathfinder ECFs as soon as possible after European state aids approval is received.

7.6 The Government believes that ECFs also offer a potential mechanism to provide government support to groups of angels in formalising existing networks. Business angels are an important source of equity finance for SMEs, and play an important role in addressing the equity gap. Structured business angel syndicates have been a significant feature of the US enterprise economy, and potentially have a similar role to play in the UK, where there are currently few such groups operating.

¹ *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*, HM Treasury and Small Business Service, April 2003: www.sbs.gov.uk/financegap.

² *Bridging the finance gap: next steps in improving access to growth capital for small businesses*, HM Treasury and Small Business Service, December 2003: www.sbs.gov.uk/financegap.

7.7 One of the objectives of the pathfinder round is to test the level of appetite amongst private investors for the ECF product. However, the Government is aware that the time and cash costs of compliance with regulation under the Financial Services and Markets Act 2000 (“FSMA”) may be a barrier to groups of angels considering bidding for a pathfinder ECF. To maximise the attractiveness of ECFs to groups of high net worth and sophisticated investors seeking to manage their own funds, the Government therefore proposes to allow the operator of a BA-led ECF not to be FSA authorised in order to carry out activities specified in the Regulated Activities Order (“RAO”).

Risk Assessment

7.8 Responses to the Government’s recent consultation on changes to the financial promotions regime³ have highlighted that experienced private investors often regard the costs of complying with regulation as disproportionate to the value of the protections afforded by FSMA. This is particularly the case where regulatory protections are designed to safeguard investors who may actually possess the necessary information and expertise to make informed investment choices. The fixed costs associated with venture capital investing are a key cause of the market failure ECFs are designed to address.

7.9 The fees for FSA authorisation and on-going supervision combined with professional and compliance costs for funds that are similar to ECFs have been reported to be between £50,000 and £100,000 a year (please refer to the ‘Costs and benefits’ section for further detail). It is likely that these costs are likely to be regarded as disproportionate to the benefits of authorisation by business angels. This may deter groups of business angels from bidding to run an ECF that is managed collectively by the investors themselves. This risks undermining the Government’s objective of encouraging groups of angels to formalise existing informal networks.

OPTIONS

1) Not to legislate

7.10 Without deregulation, the operators of a BA-led ECF would need to be authorised by the FSA under FSMA. The Government believes that, where an ECF is established and operated by a group of experienced investors wishing actively to manage their own funds, the costs of FSA authorisation and compliance are likely to be disproportionate to the benefits of regulatory protection. Responses to the *Bridging the finance gap* and *Informal capital raising* consultations indicate that experienced business angel investors consider the benefits of regulatory protection to be small, relative to the costs.

7.11 Maintaining the *status quo* is therefore likely to stifle demand for the ECF product amongst business angel groups. It is also therefore likely to compromise the effectiveness of the pathfinder round, and to reduce the value for money of government investments in pathfinder ECFs.

³ *Informal capital raising and high net worth and sophisticated investors* HM Treasury January 2004.

2) Exclude all operators of ECFs from the regulatory system

7.12 The Government could exclude all operators of ECFs from having to be authorised under the financial services regulatory system. This would reduce the costs to ECFs of making equity gap investments but, in the Government's view, would create unacceptable risks for those consumers of financial services who do not fully understand the risks of making equity-based investments in unquoted companies. Moreover, many prospective investors will specifically require the protections afforded by the financial services regulatory system, so excluding all operators of ECFs from having to be authorised would severely restrict the attractiveness of ECFs and reduce the programme's impact in addressing the equity gap.

3) A targeted exclusion for BA-led ECFs

7.13 A carefully targeted exclusion could enable BA-led ECFs to avoid the costs of regulation where the angel investors have stated that they do not require the normal regulatory protections, and are sufficiently knowledgeable to understand the risks of making equity-based investments in unquoted SMEs.

7.14 The benefit of this option is that it would remove the need for authorisation for groups of suitably experienced individuals who are collectively managing only their own funds (and the government's), while preserving full regulatory protections where it is appropriate to do so.

7.15 However, there are risks inherent in creating such an exclusion, primarily that 'unsuitable' investors are mis-sold ECFs. This risk is heightened given that the proposed exclusion would mean that investors would not have recourse to the protections under FSMA. Although investors in a BA-led ECF would not have recourse to the FSA, redress may be sought via the common laws of fraud and negligence. Investors would also be protected from misleading statements⁴ and in addition there will also be clear contractual obligations set out in the Partnership Agreement for each BA-led ECF that constrain the actions of the partners and provide for certain remedies in cases of breach of contract. It should be noted however that these controls would be less robust than those that flow from FSMA regulation.

7.16 The government will conduct due diligence on all proposed investors in BA-led ECF, and this process will help to mitigate against these risks. The government would be able to turn down applications for BA-led ECFs where there were any concerns that the investors did not appear to be sufficiently aware of the risks involved. Such investors would be able to apply to invest in a regulated ECF if they so chose. Furthermore, the Government proposes to exclude BA-led ECFs from regulation only in circumstances where all investors are certified high net worth or sophisticated. Finally, the government will require investors to sign a statement confirming they understand the consequences of investing in an unregulated fund.

7.17 The Government believes that its due diligence checks will offer an appropriate check that proposed investors are sufficiently experienced to understand that the risks of investing in a BA-led ECF include giving up recourse to FSMA, and will help to ensure that public funds are managed responsibly.

⁴ Section 397, FSMA 2000.

COSTS AND BENEFITS

7.18 The costs and benefits described below compare the legislative option a targeted exclusion for BA-led ECFs (option 3), with the option of not legislating (option 1). Option 2 has been dismissed as creating unacceptable risks for consumers of financial services products, and being incompatible with the needs of investors who will actually want the protections of FSMA. This is because ECFs not constituted by private investors seeking to collectively manage their own funds, are expected to use the traditional limited partnership model favoured by most venture capital funds. As such, private investors would be 'passive', leaving the management of their money and all investment decisions to professional fund managers. In these circumstances it is right that the fund managers should be FSA-authorized and investors have access to the protections afforded by FSMA.

7.19 The sectors most likely to be affected by the proposed changes will be:

- private investors who meet the criteria for certification as high net worth individuals or sophisticated investors; and
- unquoted SMEs that will be eligible to receive equity-based investment from ECFs.

Benefits

7.20 The immediate benefit is that each BA-led ECF will save initial authorisation costs and ongoing FSMA compliance costs. The wider implications of this are:

- a greater likelihood of bids for BA-led ECFs for the pathfinder round;
- more business angles likely to formalise existing 'loose' networks; and
- ultimately more private capital available to small businesses currently affected by the equity gap.

7.21 It is estimated that the total costs of securing FSA authorisation for funds that are similar to ECFs can easily reach between £50,000 and £100,000 per year. The majority of these costs consist of the necessary professional fees, for example to legal and audit firms, and cash set aside for regulatory capital. In addition to these start-up costs, further costs will be incurred in ensuring ongoing compliance.

7.22 The number of BA-led ECFs that would benefit from these deregulatory measures is unknown at this stage; the purpose of the pathfinder round of ECFs is to enable the Government to test the possible level of appetite that might arise in a longer-term programme.

Costs

7.23 This proposal is a deregulatory measure designed to save BA-led ECFs the costs of complying with regulation in circumstances where these costs would otherwise have been disproportionate. It is therefore intended that the impact on their costs will be to reduce them. The Government does not believe the proposal will impose costs on others.

EQUITY AND FAIRNESS

7.24 Government funding to pathfinder ECFs will be allocated by a competitive bidding process. Applications will be judged on the basis of overall value for money, against a set of criteria that will be published in advance, and independent experts in the SME finance arena will be involved in the assessment process. All these steps will help to ensure a fair and open application process for ECFs.

SMALL FIRMS' IMPACT TEST

7.25 In developing its plans for ECFs, the Government has consulted extensively with interested parties, including business and SME representative bodies and the wider SME finance community.

7.26 The deregulatory measure proposed in this consultation will not directly affect small businesses, but will reduce the costs incurred by BA-led ECFs when making equity-based investments in small firms. In turn, this should increase the effectiveness of the ECF proposals, and so benefit innovative, growth-oriented small businesses by boosting the supply of risk capital.

7.27 The Small Business Service has been consulted on the impact on small firms of excluding BA-led ECFs from authorisation.

COMPETITION ASSESSMENT

7.28 One of the objectives of the ECF programme is to stimulate the entry of new risk capital suppliers into the 'equity gap' segment of the market. It is therefore intended that the proposed deregulation for BA-led ECFs will help to stimulate competition in the market for risk capital.

7.29 The Government recognises that the deregulatory measure could place similar business angel-led funds which are not Enterprise Capital Funds, and which would therefore still need to be authorised, at a slight competitive disadvantage. The Government has committed to exploring the regulatory burden on private investors, in particular the impact of the Regulated Activities Order on business angel activities. It is intended that the responses to this consultation as well as the financial promotions consultation will help inform any further changes to the regulatory regime. Question 3 of this consultation seeks views on whether there are other, non-ECF, arrangements for which the proposed exemption might be appropriate.

ENFORCEMENT AND SANCTIONS

7.30 The Financial Services and Markets Act 2000, and subordinate legislation, is enforced by the Financial Services Authority, which has a large range of sanctions at its disposal, including the criminal law and powers to levy fines. Even if operators of BA-led ECFs are not required to be FSA-authorized, various FSMA provisions such as the misleading statements offences in section 397, will remain available. In addition, the Partnership Agreement will remain enforceable in the courts in the usual way.

MONITORING AND REVIEW

7.31 The Government will assess the early progress of the pathfinder round of ECFs before deciding whether to proceed with a longer-term ECF programme. The impact of the proposed deregulatory measure, if introduced, would be considered as part of that assessment.

CONSULTATION

7.32 Over 150 interested parties commented on the original *Bridging the finance gap* consultation.

7.33 The Small Business Service and the Financial Services Authority have been consulted in detail on this deregulatory proposal, prior to this public consultation.

SUMMARY AND RECOMMENDATION

7.34 To increase the attractiveness of ECFs to groups of suitably knowledgeable business angels seeking to manage their own funds it is desirable that the costs of complying with regulation are proportional to the benefits conferred by regulatory protections.

7.35 It is therefore proposed that BA-led ECFs are excluded from having to be FSA-authorised in order to carry out activities specified under the Regulated Activities Order.

7.36 It is recommended that these changes be implemented via secondary legislation under the Financial Services and Markets Act 2000.

8

THE CONSULTATION CRITERIA

This consultation is being conducted in line with the Code of Practice on Consultation. The Criteria are listed below. The full version can be accessed at <http://www.cabinet-office.gov.uk/regulation/Consultation/Code.htm>

The Six Consultation Criteria

1. Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
2. Be clear about who may be affected, what questions are being asked, and the timescale for responses.
3. Ensure that your consultation is clear, concise and widely accessible.
4. Give feedback regarding the responses received and how the consultation process influenced the policy.
5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
6. Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

If you feel that the consultation does not satisfy these criteria please contact:

Ros Eales
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

2004 No.

FINANCIAL SERVICES AND MARKETS

The Financial Services and Markets Act 2000 (Regulated Activities)
(Amendment) (No.***) Order 2004

<i>Made</i> - - - -	2004
<i>Laid before Parliament</i>	2004
<i>Coming into force</i> - -	2004

The Treasury, in exercise of the powers conferred on them by sections 22(1) and (5) and 428(3) of, and paragraph 25 of Schedule 2 to the Financial Services and Markets Act 2000⁽¹⁾, hereby make the following Order:

Citation and commencement

1. This Order may be cited as the Financial Services and Markets Act 2000 (Regulated Activities)(No.***) (Amendment) Order 2004 and comes into force on [enter date].

Amendment to the Regulated Activities Order

2. After article 72D of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001⁽²⁾ (large risks contracts where risk situated outside the EEA) there is inserted—

“Business Angel-led Enterprise Capital Funds

72E.—(1) A body corporate of a type specified in paragraph (6) does not carry on the activity of the kind specified by article 21 by entering as agent into a transaction on behalf of the participants of a Business Angel-led Enterprise Capital Fund.

(2) There are excluded from article 25(1) and (2) arrangements, made by a body corporate, of a type specified in paragraph (6), for or with a view to a transaction which is or is to be entered into by or on behalf of the participants in a Business Angel-led Enterprise Capital Fund.

(3) There is excluded from article 37 any activity, carried on by a body corporate of a type specified in paragraph (6), which consists in the managing of assets belonging to the participants in a Business Angel-led Enterprise Capital Fund.

(4) There is excluded from article 40 any activity, carried on by a body corporate of a type specified in paragraph (6), in respect of assets belonging to the participants in a Business Angel-led Enterprise Capital Fund.

(1) 2000 c.8.

(2) S.I. 2001/544; article 72D was inserted by S.I. 2003/1476, articles 2 and 11.

(5) A body corporate of a type specified in paragraph (6), does not carry on the activity of the kind specified in article 51(1)(a) where it carries on the activity of establishing, operating or winding up a Business Angel-led Enterprise Capital Fund.

(6) The types of bodies corporate specified are—

(a) a limited liability partnership—

(i) which operates a Business Angel-led Enterprise Capital Fund; and

(ii) the members of which are participants in the Business Angel-led Enterprise Capital Fund operated by that limited liability partnership and between them have invested at least 50 per cent. of the total investment in that Business Angel-led Enterprise Capital Fund excluding any investment made by the Secretary of State; and

(b) a limited company (within the meaning of section 1(2)(a) or (b) of the Companies Act 1985⁽³⁾)—

(i) which operates a Business Angel-led Enterprise Capital Fund;

(ii) the members of which are participants in the Business Angel-led Enterprise Capital Fund operated by that limited company and between them have invested at least 50 per cent. of the total investment in that Business Angel-led Enterprise Capital Fund excluding any investment made by the Secretary of State.

(7) Nothing in this article has the effect of excluding a body corporate from the application of the Money Laundering Regulations 2003⁽⁴⁾, in so far as those Regulations would have applied to it but for this article.

(8) Nothing in this article has the effect of excluding a body corporate from the application of section 397 of the Act (misleading statements and practices), in so far as that section would have applied to it but for this article.

Interpretation for purpose of article 72E etc.

72F.—(1) For the purposes of this article and of article 72E—

“Business Angel-led Enterprise Capital Fund” means a collective investment scheme which—

(a) is established for the purpose of enabling participants to participate in or receive profits or income arising from the acquisition, holding, management or disposal of investments falling within one or more of—

(i) article 76, being shares in an unlisted company;

(ii) article 77, being instruments creating or acknowledging indebtedness in respect of an unlisted company; and

(iii) article 79, being warrants or other instruments entitling the holder to subscribe for shares in an unlisted company;

(b) has only the following, as its participants—

(i) the Secretary of State;

(ii) a body corporate of the type specified in article 72E(6); and

(iii) one or more persons each of whom at the time they became participants was—

(aa) a sophisticated investor;

(bb) a high net worth individual;

(cc) a high net worth company;

(dd) a high net worth unincorporated association;

(ee) a trustee of a high value trust;

(c) is prevented, by the arrangements by which it is established, from—

(i) acquiring investments, other than those falling within paragraphs (i) to (iii) of sub-paragraph (a); and

⁽³⁾ 1985 c.6.

⁽⁴⁾ S.I. 2003/3075.

- (ii) acquiring investments falling within paragraphs (i) to (iii) of sub-paragraph (a) in an unlisted company, where the aggregated cost of those investments exceeds £2 million, unless that acquisition is necessary to prevent or reduce the dilution of an existing share-holding in that unlisted company;

“high net worth company” means a body corporate which—

- (a) falls within article 49(2)(a) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001⁽⁵⁾ (high net worth companies, unincorporated associations etc.); and
- (b) has executed a document (by the affixing of its common seal or by a director and the secretary of the company, or by two directors of the company, signing it) in the following terms:

“This company is a high net worth company and falls within article 49(2)(a) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001. I understand that any Business Angel-led Enterprise Capital Fund (within the meaning of article 72F of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001), in which this company participates, or any person who operates that Business Angel-led Enterprise Capital Fund, in which this company participates, will not be authorised under the Financial Services and Markets Act 2000 (and so will not have to satisfy the threshold conditions set out in Part I of Schedule 6 to that Act and will not be subject to Financial Services Authority rules such as those on holding client money). I understand that this means that redress through the Financial Services Authority, the Financial Ombudsman Scheme or the Financial Services Compensation Scheme will not be available. I also understand the risks associated in investing in a Business Angel-led Enterprise Capital Fund and am aware that it is open to me to seek advice from someone who is authorised under the Financial Services and Markets Act 2000 and who specialises in advising on this kind of investment.”;

“high net worth individual” means an individual who—

- (a) is a “certified high net worth individual” within the meaning of article 48 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (certified high net worth individuals); and
- (b) has signed a statement in the following terms:

“I declare that I am a certified high net worth individual within the meaning of article 48 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and that I understand that any Business Angel-led Enterprise Capital Fund (within the meaning of article 72F of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001), in which I participate, or any person who operates that Business Angel-led Enterprise Capital Fund, in which I participate, will not be authorised under the Financial Services and Markets Act 2000 (and so will not have to satisfy the threshold conditions set out in Part I of Schedule 6 to that Act and will not be subject to Financial Services Authority rules such as those on holding client money). I understand that this means that redress through the Financial Services Authority, the Financial Ombudsman Scheme or the Financial Services Compensation Scheme will not be available. I also understand the risks associated in investing in a Business Angel-led Enterprise Capital Fund and am aware that it is open to me to seek advice from someone who is authorised under the Financial Services and Markets Act 2000 and who specialises in advising on this kind of investment.”;

“high net worth unincorporated association” means an unincorporated association—

- (a) which falls within article 49(2)(b) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001; and
- (b) on behalf of which an officer of that association or a member of its governing body has signed a statement in the following terms:

“This unincorporated association is a high net worth unincorporated association and falls within article 49(2)(b) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001. I understand that any Business Angel-led Enterprise Capital Fund (within the meaning of article 72F of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001), in which this association participates, or any person who operates that Business

⁽⁵⁾ S.I. 2001/1335.

Angel-led Enterprise Capital Fund, in which this association participates, will not be authorised under the Financial Services and Markets Act 2000 (and so will not have to satisfy the threshold conditions set out in Part I of Schedule 6 to that Act and will not be subject to Financial Services Authority rules such as those on holding client money). I understand that this means that redress through the Financial Services Authority, the Financial Ombudsman Scheme or the Financial Services Compensation Scheme will not be available. I also understand the risks associated in investing in a Business Angel-led Enterprise Capital Fund and am aware that it is open to me to seek advice from someone who is authorised under the Financial Services and Markets Act 2000 and who specialises in advising on this kind of investment.”;

“high value trust” means a trust—

- (a) where the aggregate value of the cash and investments which form a part of the trust’s assets (before the deducting the amount of its liabilities) is £10 million or more;
- (b) on behalf of which a trustee has signed a statement in the following terms:

“This trust is a high value trust. I understand that any Business Angel-led Enterprise Capital Fund (within the meaning of article 72F of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001), in which this trust participates, or any person who operates that Business Angel-led Enterprise Capital Fund, in which this trust participates, will not be authorised under the Financial Services and Markets Act 2000 (and so will not have to satisfy the threshold conditions set out in Part I of Schedule 6 to that Act and will not be subject to Financial Services Authority rules such as those on holding client money). I understand that this means that redress through the Financial Services Authority, the Financial Ombudsman Scheme or the Financial Services Compensation Scheme will not be available. I also understand the risks associated in investing in a Business Angel-led Enterprise Capital Fund and am aware that it is open to me to seek advice from someone who is authorised under the Financial Services and Markets Act 2000 and who specialises in advising on this kind of investment.”;

“participant” means a person who participates in a Business Angel-led Enterprise Capital Fund; and references to such a participant, doing things on behalf of such a participant and property belonging to such a participant are, respectively, references to that participant in that capacity, to doing things on behalf of that participant in that capacity or to the property of that participant held in that capacity;

“sophisticated investor” means an individual who—

- (a) is a “certified sophisticated investor” within the meaning of article 50 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001; and
- (b) has signed a statement in the following terms:

“I declare that I am a certified sophisticated investor within the meaning of article 50 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and that I understand that any Business Angel-led Enterprise Capital Fund (within the meaning of article 72F of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001), in which I participate, or any person who operates that Business Angel-led Enterprise Capital Fund, in which I participate, will not be authorised under the Financial Services and Markets Act 2000 (and so will not have to satisfy the threshold conditions set out in Part I of Schedule 6 to that Act and will not be subject to Financial Services Authority rules such as those on holding client money). I understand that this means that redress through the Financial Services Authority, the Financial Ombudsman Scheme or the Financial Services Compensation Scheme will not be available. I also understand the risks associated in investing in a Business Angel-led Enterprise Capital Fund and am aware that it is open to me to seek advice from someone who is authorised under the Financial Services and Markets Act 2000 and who specialises in advising on this kind of investment.”;

“unlisted company” has the meaning given by article 3 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.”.

Signatory text

Address
Date

Name
Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Order)