

LONDON BUSINESS ANGELS LIMITED IN ASSOCIATION WITH THE LONDON DEVELOPMENT AGENCY

INFORMAL CAPITAL-RAISING CONSULTATION RESPONSES

“Informal capital raising and high net worth and sophisticated investors: A Consultation document on proposed changes to the Financial Promotions Order” January 2004 – HM Treasury

April 2004

The following responses have been collated following consultation with the investor members of the London Business Angels Network and the London Development Agency.

Q1 Are the current exemptions allowing appropriate numbers of high net worth and sophisticated investors to become certified?

No, we are unaware of many, if any, certified HNW/Sophisticated investors in our network of over 200 private investors. The supply of informal investment is more closely related to the ‘marketing of the marketplace’ to both investors and companies seeking finance rather than any specific exemptions.

Q2 If no to question 1, is this posing a problem for smaller firms seeking to raise capital via unlisted equity and for investors? Please give examples where appropriate.

We suspect that most early stage companies do not understand the risks they run, particularly in the light of the answer to Q1. This risk is greater still amongst ‘friends and family’ who may not always be caught by the ‘one off promotion’ exemption and are even less likely to fulfill the HNWI or Sophistication requirements.

The above has resulted in uncertainty with companies seeking finance which ultimately leads to a less efficient market place. Should there

actually be adverse publicity in the future about companies being sued for breach of the Act, then the appetite for raising informal venture capital is likely to significantly diminish stunting early growth.

Q3 Do you agree that promotions should be allowed on the basis of a reasonable belief that an individual is either a certified high net worth investor or a certified sophisticated investor?

Reasonable belief in itself could potentially create too large a loophole for unscrupulous promoters, as well as the genuine, however, this could be avoided where the belief is based on some objective criteria.

Q4a Should potential investors be able to self-certify that they qualify as high-net worth individuals

We believe that this should be possible.

Q4b Do the majority of sophisticated investors already meet the high-net worth criteria?

Based on our own network we believe that there are a fair number who, while likely to classify as Sophisticated, would not also classify as HNW. Unsophisticated high net worth investors may not appreciate the very high risks involved in investing in early stage companies

Q4c If yes to Q4a, should the self-certification exemption replace or be introduced alongside the current high net worth exemption?

Alongside

Q5 Should the net asset test for self-certification by high net worth investors be increased to £500,000, remain at £250,000, or be set at another level? Please give reasons and evidence for your choice.

We believe the parameters for self certification as HNW could be set as a percentage of Net Worth / Annual Income as follows:

- 10% of Net Assets (ex pension, house and previous business angel investments)

- 20% of Gross Salary (p/a), ex previous business angel investments.

We believe that this will provide investors with sufficient latitude to make up their own mind on whether they wish to invest up to these levels. It is very difficult to legislate for each individual's personal circumstances, which will depend on factors such as: percentage of wealth invested; stage in life and family commitments; a combination of income and capital, as well as the security of that income. A £10,000 investment from a single man earning £50,000 a year, with £20,000 capital is very different to a married man with young children earning £100,000 a year nearing retirement age without a pension and a large outstanding mortgage. The family income and commitments is more important than the individual circumstances. Ultimately these are matters which an individual will need to determine for themselves.

Q6 Do you think a test for self-certifying as a sophisticated investor should be introduced alongside the current regime?

Alongside

Q7 Do you agree with the proposed criteria for sophistication? What changes do you suggest and why?

In addition to the current classifications of Sophistication we believe there is a case for investors from broader business and entrepreneurial backgrounds to classify as Sophisticated. However, such persons often lack an understanding of the risks of holding minority stakes in unquoted companies. We believe that an investor's membership of an 'industry regulated' business angel networks complying with certain quality standards could provide for this.

Industry regulation' means being subject to policing by NBAN, which will set out an appraisal process which each 'regulated' network should undertake before accepting membership of a new investor. This appraisal process could include training for the new investor in how to evaluate and make a business angel investment. London Business Angels Network is already implementing such a scheme through its ready2invest programme supported by London Development Agency.

Q8 Do you think self-certifying as a sophisticated investor without detailed criteria to test against should be introduced?

We believe that the above classifications of Sophistication are a necessary minimum to protect investors from claiming they are Sophisticated without necessarily understanding the risks of the investment they are making.

Q9 Out of Model 1, 2 and 3, which do you think provides the most appropriate balance between investor protection and facilitating investment in SMEs, and why? Please provide examples or supply evidence where appropriate.

Model 3, with the criteria set out in Q7.

Q10 Should amendments equivalent to those made to the Financial Promotions Order be made to the CIS Order?

Yes

Q11 What other regulatory issues are proving a constraint on business angel investment?

- The complexity of the current EIS rules provides confusion and resulting uncertainty amongst investors interested in making qualifying investments. The EIS income tax relief of 20% could be much higher (say 40%) for investment in micro start up/early stage companies where the investment risks are much higher.*
- The current restriction on the investment period for EIS Approved funds to 6 months makes fund management under this scheme practically impossible. Reforming this rule and allowing a longer period for investment of funds raised would encourage more 'informal' venture capital funds for syndicated business angel investments.*

Q12 Are there particular regulatory barriers preventing angel syndication?

The FSA puts great onus on giving advice. However, syndicate members may wish to share due diligence with each other, but fear to do so in the uncertainty of what the regulations permit.

Q13 What regulatory constraints or costs impact on access to equity finance for growing firms?

- *We understand it is very difficult to get an opinion from the FSA. A help line, along the lines of the Inland Revenue, which could answer specific questions, would be helpful. These answers could be recorded by FSA and used as a defense against breaches of the Act, provided all the relevant facts were declared at the time.*
- *We have identified a general lack of affordable Investment Readiness Programs for early stage companies seeking equity finance. These programmes with public sector subsidy need to be readily available to suitable SMEs and could be delivered by Business Angel Networks who understand the requirements of early stage investors. An example of best practice here is ready4growth www.ready4growth.com which is an investment readiness programme for 450 early stage Technology SMEs across Europe being delivered by Greater London Enterprise/ London Business Angels to 200 SMEs without charge in the UK.*

Q14 Is there an under-provision of private sector intermediation in this area and if so, what is the cause?

Due to the relatively small sums of money being raised, private sector intermediaries are typically unable to afford to provide a proper fund raising service.

The market is currently fragmented with a number of small organizations offering fund raising services and access to business angels, charging disproportionately high front end fees but failing to deliver the promised funds. This creates a lack of trust in the industry and increases the need for appropriate intermediation services to navigate clients through to the genuine sources of finance.

We propose that this problem could be overcome with the further promotion of regional, 'industry regulated', business angel networks. Policed by NBAN these networks would meet certain threshold

conditions, including complying with set procedures and guidelines. With the support of the regional development agencies these regional BANs could provide Investment Readiness training as well as the Investor Readiness training necessary to meet the sophisticated investor test (alluded to in Q7, above). Compliance with the industry regulation could also include the publication of all fund raising activity to provide additional transparency on success figures.

As the profile and professionalism of such regional BANs increases the need for more costly intermediaries would diminish and companies could directly source early stage, business angel funding.

Finally, thought also needs to be given to how the profile of sophisticated investors can be diversified. Attracting successful women business owners and professionals or those from an ethnic minority background is particularly important in the London context.. Potentially there is a very significant resource, both financial and in terms of expertise that could be utilized more effectively. A more diverse range of investors would be an effective means of identifying promising investment propositions from amongst a broader range of entrepreneurs

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