

## **Consultation on Business Angel / Private Equity Investor Certification**

### **Response from Innovateur**

#### **About Innovateur and our perspective**

Innovateur is a voluntary initiative by experienced venture entrepreneurs with the objective of supporting emerging high-growth ventures.

Over the course of the past year over 2,000 users have register with Innovateur and many thousands more use the resources provided.

Our aim is to contribute towards improving the environment for venture entrepreneurship by providing practical information, resources and access to high quality events for ventures - without charge. Our efforts are guided by our experiences of the venture development process and specifically what information / resources / interaction would have helped us.

Part of the process of improving the environment for venture entrepreneurship is improving the efficiency of early stage equity finance. Improving market efficiency in the allocation of such capital is vitally important to both investors and high quality ventures, hence our comments. We feel the government ought to be congratulated on the serious approach they have taken so far.

#### **Improving the Environment for High-Growth Ventures**

Emerging ventures have the challenge of delivering greater value growth than established ventures, and yet have to do so from scant resource base.

The environment in the UK is now generally supportive and a great deal of positive initiatives are effecting a practical improvement to high-growth ventures, despite the collapse of the equity markets in 2000 / 2001. However, it is critically important that complacency does not creep in and with it rising bureaucratisation as its effect on emerging ventures is disproportionately large.

The single greatest threat to high-growth ventures in the UK are rising barriers to participation in early stage investment in unlisted securities.

The FSA regulation as it stands is showing signs of causing harm. There are some serious problems with the definitions and certification process which rather than increase protection simply increases the costs of participation and reduce the potential for risk diversification, and a more efficient selection of opportunities to investigate in detail.

There is general agreement that these types of investments should only be marketed to wealthy or sophisticated investors - in terms of seeing detailed information on the offer and information enabling them to make investment decisions. General introductory information should not be so strictly dealt with as it makes the market less efficient for investors who then find it impractical to select the most appropriate investment.

The onus on commercial providers to be authorised by the FSA should remain, but should not be extended to the voluntary sector as that would hurt lower investment amounts.

An appropriate sharing of responsibilities would be for the potential investor to certify that they fit the suitability test, and for the intermediary and prospective venture to re-present the qualification criteria to the investor and seek a specific affirmation that they understand the rules and have self-certified under the HNWI or SI exemptions.

Further to this, all the standard warnings should be readily be made available to entrepreneurs and networks so they can copy and paste them onto any sensitive documents - rather than have to rely on paying for what should be uniform and simply expressed statements.

Consideration should also be given to including a strong and simple introductory phrase to the effect of :

"Do not invest in unlisted securities unless you can afford to loose the full value of your investment".

This is far clearer and we should suggest more effective than having to pay someone to effectively confirm you have self-certified (as the process does not carry any general education on managing the risks of these types of investment - the investor still relies on the warnings given and information provided on risks by the investment network!)

Risk reduction is better served by access to knowledge and by facilitating diversification through syndication for smaller investors. Effective diversification requires access to lower deal sizes which the current framework is working against.

### **Competition and opportunity for selection**

Investors should have more access not less to competing projects.

Rising participation costs and other barriers will simply force deal sizes to rise and we will end up with the 'venture capitalisation' of the informal risk capital market, giving rise to higher investment costs, larger portions of investment going to intermediaries, and weaker selection of opportunities to be presented to investors – as these will be made by and increasingly smaller number of parties with limited competition.

The objective of this act should be encourage the bridging of the current equity gap - not create a second gap at the bottom end of the scale.

The efficient and effective allocation of risk capital is best achieved by improving the imperfections in the market, not adding to them . The focus has to be on increasing the flow of knowledge, expertise and information to the UK 's private angel investment community.

### **Practical initiatives – investor education and consistent warnings**

All material with specific deal details should be presented with cogent and terse standard warnings (which the FSA should make readily available and accessible for authorised persons, non-profit networks and entrepreneurs).

More effort should be placed on improving business angel education as knowledge is the best form of protection. We are facilitating some events and workshops for business angels to meet others in collaboration with angel networks. We need government to encourage more investor education.

### **Specific Responses to Consultation Questions**

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

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**NO**

***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.*

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**YES** – there is a clear impact on high quality early stage ventures. Specifically there are often not enough angel investors at investment events. Three presentations by networks we attended recently had less than 6 investors, and one just three. Despite the high quality of the ventures there was no prospect of them being funded.

We have set up a service to publish angel deals being completed in order to inform entrepreneurs and investors about the networks that are active. **We have found that a number of the networks have not completed a deal in 2004 despite growing confidence!**

***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 individual or a certified sophisticated investor?*

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**YES** – But this must also apply to self-certification.

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

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**YES** – doing so on the basis of acknowledging a clear and concise statement and having to do so again in a specific affirmation prior to having the investment details of an opportunity presented – by details, we mean specific offer and contact details, not introductory descriptions stating the type of venture and amount sought which must be allowed.

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

YES, but a substantial number do not.

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

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They should both exist on a self-certification basis.

***Q5:** 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? Please give reasons and evidence for your choice.*

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It should remain at £250,000 if the sophisticated investor criteria is widened.

If the test is not widened then it should be reduced to £100,000.

It should certainly not rise to 500,000 as that would offer no more protection, harm investment and unreasonably restrict the freedom of wealthy investors.

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

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

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**NO**

The test needs to be broadened as at present it artificially prescriptive.

Specifically we would like to have two other classes of sophisticate investor included:

- a.) those with senior experience of a specific market sector in question (at senior management level)
- b.) entrepreneurs who have had experience of developing ventures that have successfully raised equity finance and in which process the entrepreneur was closely involved

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

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YES, though we would also agree with a far less artificially prescriptive test.

*Q9: 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? Please provide examples or supply evidence where appropriate.*

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**Model 3** is the most appropriate as the other models do not offer greater protection, they simply require increased administration.

Advisors must be required to confirm that the investor is clear about self certification.

Simple and clear warnings – produced by government - should accompany materials for investment appraisal.

This would shift the focus back upon appraising the quality and appropriateness of investments rather than artificial hurdles which offer NO greater protection from unscrupulous advisors.

Practical initiatives like workshops for existing and prospective Business Angels would provide far more benefit and protection for investors than asking an intermediary to produce a certificate.

If any hurdle should be placed it should be on education – such as requiring the angels to attend a seminar on investment. That would offer real protection.

If model 2 is adopted, the sophisticated investor test needs to be expanded as it is artificially prescriptive – see earlier comments on exempting individuals with experience of business sectors or venture development.

**Q10:** *Should amendments equivalent to those made to the Financial Promotion Order be made to the CIS Order?*

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

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The requirement of the need to hold a share for three years to gain EIS relief in all circumstances should be reviewed with a view to being relaxed – such as on a flotation – otherwise the interests of investors and the venture can conflict.

Not being able to offset financing costs against VAT is an anomaly that disproportionately affects emerging ventures and we would urge the government to review.

The share incentive schemes should be streamlined to enable emerging ventures to attract quality management and take on the high risk.

**Q12:** *Are there particular regulatory barriers preventing angel syndication?*

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Syndication is a more effective way of diversifying away systematic business risk (though such investment must never be regarded as anything but high-risk). The current system is highly inhibitive as it raised participation costs

The major limiting factor affecting both participation in the market, and to a greater degree syndication, are the requirements for certification. These potentially place an additional legal onus on the lead investor within a syndicate.

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

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The limitations on specific advertising to the general public should remain.

The current system of certification should be abolished.

The principal restrictions in the market are structural – to do with the VC industry and a lack of efficiency in the market. Initiatives underway by government will help, but the primary focus must be on measures to improve, not reduce, market efficiency.

**Q14:** *Is there an under-provision of private sector intermediation in this area and if so, what are the causes?*

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Facilitating angel investment is difficult to undertake commercially because of the small amounts involved. Most successful networks have other sources of income.

Access to new non-traditional VC sources of finance will help private networks to address the equity gap and achieve deals that are more commercially attractive to profit motivated intermediaries.

However, we must not be tempted to regulate-out the non-profit making intermediaries as

that will lead to further market failure.

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