

**Nicholson Graham & Jones response to HM Treasury Consultation Document on  
proposed changes to the Financial Promotion Order (January 2004)**

Nicholson Graham & Jones is a medium sized City law firm. We are well known for acting for entrepreneurs and SMEs. A core area of our business is the legal aspects of company fund raisings, and we regularly encounter situations where the financial promotion rules are relevant. Our clients are commonly small companies looking for pre-venture capital funding which will typically be raised from a combination of friends/relatives of the promoters and business angels. These clients are often in a financially difficult situation and we do not find it easy to tell them that there are statutory provisions which may effectively prevent certain willing potential investors from investing in their business. Typically, the clients are not willing to contemplate the expense of involving an authorised firm in their fund raising activities.

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

No. Whilst we regularly advise clients on both exemptions we generally find ourselves trying to structure transactions in such a way that other financial promotion exemptions apply - for example, the "one-off promotion" exemption, in relation to which FSA guidance has been helpful. There is no enthusiasm on the part of fund raising companies to force proposed investors to obtain either high net worth (HNW) or sophisticated investor certification. Often there are a good number of potential investors who would need to obtain the certification and the amount of bureaucracy and inconvenience involved generally causes the client to instruct us to seek another route. In addition, we understand that there may be reluctance on the part of authorised firms to sign off sophisticated investor certificates because of liability considerations. We very rarely see HNW investor certificates. Overall, it is our experience that the HNW and sophisticated investor exemptions are very rarely used and are commonly regarded by clients, and the persons who would have to obtain them, as being impractical.

**2. 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.**

Yes. These are companies which often may not be able to afford our fees. Legal costs associated with tracking a suitable course through the financial promotion rules can be substantial for a small company. We suspect that inadvertent breaches of the financial promotion rules by small companies may be fairly commonplace (although we do not have any specific information on this). We think that this problem might recede if the financial promotion exemptions were to offer a practical, easy to implement solution which can become standardised - so that specialist financial services legal advice is not needed on every occasion. Even in a firm of our size there are only a handful of lawyers competent to advise on the intricacies of the financial promotion exemptions.

3. **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?**

This would be an improvement because it may allow some additional flexibility. We do, however, believe that there remain significant shortcomings with this formulation.

The Government proposal requires the promoter to have a "reasonable belief" (inter alia) that the proposed investor has a current signed certificate. A reasonable belief could exist where the potential investor is dealing with the fund raising company through an intermediary who keeps a list of its duly certified clients - and can report on a potential investor's status to the company concerned. We do however see a problem where the fundraising company deals with the potential investor direct - as is very common in our experience. In this case we would advise our clients that it would be hard to establish a "reasonable belief" of due certification without actually seeing the HNW or sophisticated investor certificate, certainly in the initial stages of a new regime, because so few people are likely to be properly certified (although they may meet the criteria). This would necessitate a due diligence exercise on the part of the company seeking funding in relation to all persons it intends to approach directly for funds, including those who do not subsequently contribute any funds. This creates a significant administrative and practical burden very similar to the burden under the current rules.

In the alternative it could be made clear in the legislation that for the purposes of forming a "reasonable belief" a fund raising company is able to rely upon oral confirmation from a potential investor to the effect that that person meets the HNW or sophisticated investor tests and has the relevant certificate, without a need for further enquiry. In practice, however, we would expect that some prospective investors might state that they have certification when they do not, in particular once they understand that this is the way to allow them to participate in the funding. In addition, it will be difficult to persuade potential investors to sign a prescribed form of certificate if that certificate is not required to be shown to anyone.

It would be more practical still if a small unlisted company were free to offer a funding opportunity in writing to any person who it believed (acting reasonably) may pass the test for "high net worth" or "sophisticated" status (whether they have the correct certification or not). The relevant business plan or information memoranda could be required to make it clear that any subsequent investment could only be made by persons who do actually meet the HNW individual or sophisticated investor tests (and have the necessary certification) and the application form for securities could contain the self-certification language. The fund raising company could then be required to have the necessary "reasonable belief" of due certification (as proposed by the Government) at the moment of investment rather than earlier in the process. The

problem this seeks to address is the difficulty of persuading an early stage company to devote resources and time to performing due diligence on all potential sources of funding at the start of the fund raising process. Clearly, though, this would require a more radical re-think of the financial promotion regime than is currently proposed by the Government.

4. **(a) Should potential investors be able to self-certify that they qualify as high-net worth individuals?**

Yes, we are in favour of this approach. We think it may be even better to have a combined self certification of BOTH HNW and sophisticated investor status, with both elements required. We think that the addition of a test as to sophistication might dissuade certain rich but impressionable and unsophisticated people from signing these certificates. We also believe that a combined test would capture most of the regular "business angel" investors if the limits of HNW status are set at the current levels. We envisage that the self-certification of sophistication could be along the lines of the wording in paragraph 50(b) of the Financial Promotion Order - not the more objective self-certification of sophistication proposed in paragraph 4.14 of the consultation paper.

**(b) Do the majority of sophisticated investors already meet the high net worth criteria?**

We do not know but we suspect the answer is yes.

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

We cannot see any good reasons for keeping the existing exemption. There are however good reasons for having only one HNW exemption because this would reduce the complexity of the law, make it easier for us to explain the options to clients, and consequently lead to greater clarity as to the law amongst business people and potentially greater "buy-in".

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

We do not see any good reasons for changing the HNW net assets test from £250,000 (excluding main residence etc).

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

As mentioned above, we think that the best approach might be a combined HNW and sophistication test with investors having to self-certify as to both limbs of the test to qualify. We do not think many people have made use of the current sophisticated investor regime so we do not have any strong views as to whether it should be removed or retained. Since the proposed self-certification regime relating to sophistication could reduce the burden on some of our clients we do not object to it in principle, although we do recognise that it carries with it a measure of risk to investors which is probably more acute than the similar risk in relation to self-certification of net assets/income.

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

We have not considered this in detail.

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

There is no doubt that this would be very popular with many of our clients.

We suspect, however, that the Government will regard this (we think correctly) as a step too far. If this is the case, we put forward our combined test described above as a possible alternative with an objective element. The self-certification for sophistication in our combined test could be along the lines proposed in Model 3 in the consultation paper.

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

We have suggested a further alternative which is a modification of model 1. Of the three models suggested, we favour model 1. We do not think that model 2 is likely to add much to model 1 and the objective tests of sophistication seem rather arbitrary. Our clients would almost certainly favour the flexibility offered by model 3, but the risks to investors may outweigh the benefits.

In fact, we think that the main issue to address is not so much the decision between the three models proposed. We consider that the main difficulty arising from the Government's proposed alternatives is the need for the fund raising company to do due diligence on potential sources of funding to establish "reasonable belief". This must take place before it sends an initial business plan or information memorandum (which will almost certainly be a "financial promotion") to potential investors. This creates a real blockage in practice and could be avoided by requiring self-certification in the

application form for shares (and not at an earlier stage in the process). Our thoughts are explained further in the answer to question 3 above.

10. **Should amendments equivalent to those made to the Financial Promotion Order be made to the CIS Order?**

Yes. Incidentally, we are unsure why the HNW individual exemption in both the CIS Order and Financial Promotion Order does not cover investment in CISs which invest wholly or predominantly in real property. A change to introduce this flexibility would be most welcome.

11.-14. We have no comment to make on these issues.

Nicholson Graham & Jones (Philip Morgan)

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