

## **INFORMAL CAPITAL RAISING AND HIGH NET WORTH AND SOPHISTICATED INVESTORS**

### **UKBI RESPONSE**

#### **Introduction**

Incubation is a unique and highly flexible combination of business development processes, infrastructure and people, designed to nurture and grow new and small businesses by supporting them through the early stages of development and growth. Successful incubation is about creating a supportive environment in which new ventures can develop and fulfil their growth potential as well as giving them access to a wide range of business development resources and tailored services. Improving access to growth capital on behalf of their clients is therefore of prime importance to incubation managers, and to regional/national economic development.

UK Business Incubation (UKBI) is recognised by Government as the lead body for business incubation. Our key aim is to ensure the continued development of quality incubation in the UK. We have an extensive and growing network of incubation managers, industry experts, regional and national policy makers, united by the belief that incubation plays a significant role in 'seeding' and developing sustainable ventures that will contribute to the health and wealth of local, regional and national economies.

In responding to this consultation, we have gathered opinion and input from a cross section of our membership base, which includes incubation practitioners, 'stakeholders', and the wider business support community.

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

It is the experience of UKBI members that few of the investors they regularly deal with seek certification. They find the certification process expensive, intrusive and inconvenient to pursue. Furthermore, some accountants are reluctant to produce the necessary certification for fear of being held liable in the future.

For angel networks, compliance with FSA regulations can be extremely onerous and prohibitively costly. Those networks that choose not to be FSA-registered often find that HNWLs are put off joining the network because of the need for certification. Many networks are therefore simply ignoring the requirement altogether and it is recognised by UKBI members that this is not an adequate solution.

#### **Q2: If no to question 1, is this posing a problem for smaller firms seeking to raise capital via unlisted equity and for investors?**

Undoubtedly it is because there are fewer HNWLs entering the market as a result. It is definitely a problem for many investors for the reasons given above. It is also problematic for angel networks or clubs. However, the downward trend in investment activity in smaller firms must be set in the context of an overall economic downturn.

#### **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?**

Members of UKBI believe that 'reasonable belief' does not solve the fundamental problems associated with the current certification process.

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

Members of UKBI agree that self-certification appears to be a good alternative to the current system of certification. A level of 'quality checking' is absolutely necessary to encourage more quality investors and exclude 'rogue' investors. However, this should be a 'light touch' form of regulation. Most angel investments are based on personal chemistry (i.e. a blend of trust, belief, respect, commitment, communication and a shared agenda). Personal chemistry cannot be over-regulated. Most angels are well aware of the 'risks' associated with such investments and therefore should be allowed to take personal responsibility for taking them. The wording of any self-certification would need to reflect this.

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

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

Replace

**Q5: Should the net assets test for self-certification by high net worth investors be increased to £500k, remain at £250k or be set at another level?**

The level should not be increased. Increasing the net assets level would exclude a large number of potential investors, particularly family and friends (an important source of early-stage equity for start-up companies). It should be left at £250k.

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

UKBI members believe it would be useful for them to have the choice.

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

The current definition of sophistication needs to be broadened to include:

Measures should be based around knowledge/understanding of business and possibly business sector (although not compulsory).

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

No

**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?**

Model 3

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

No view given.

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

Uncertainty over existing FSA regulations is causing problems. Many investors are not sure about what is or is not allowed and even when they seek external advice are often unable to get clear answers.

Members of UKBI know of examples of regulations which have been applied very rigidly to the detriment of the small firm seeking angel finance. At one recent 'Elevator Pitch', the entrepreneur was not able to tell investors how much money he/she needed. Some investment networking meetings have been known to turn away investors 'at the door' if they cannot produce the necessary certificate. This is stifling the supply of early-stage finance.

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

Many angels prefer to work in syndicates, investing in a larger number of companies and spreading the 'risks'. The problem is that syndicates are currently faced with excessively high costs associated with regulatory compliance. The FSA or other representative bodies (e.g. NBAN) should undertake research to discover the true cost of running syndicates.

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

Apart from the regulatory burdens already highlighted:

- Due diligence – it is very difficult and costly for small start-ups to provide the information necessary to satisfy the FSA
- Seats of boards of investee companies

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

The experience of UKBI members is that there is a shortage of high calibre intermediaries.

**Additional points**

At present, there is no requirement for angels investors to demonstrate any level of expertise or competence. This is of particular concern when the angel is an 'active' investor, supporting the investee through mentoring and the provision of advice and support. UKBI supports the idea that there should be some attempt to 'professionalise' the sector with a voluntary 'kitemark' of competence. Great care would need to be taken, however, to ensure that this did not become an exercise in the 'standardisation' of business angel activity.