

13 April 2004

Informal capital-raising consultation responses  
Enterprise Team (4/N2)  
H M Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Dear Sir

### **Consultation on proposed changes to the Financial Promotions Order**

This response is submitted on behalf of the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland.

We welcome that the Government has decided to review the Financial Promotion Order (FPO) and to provide this opportunity for consultation.

We would observe, at the outset, that in our view the FPO is overly complicated and needs a complete review. While the current review is welcomed, in some respects it adds to the complexity rather than detracts.

We would also observe that the current and draft revised Investment Services Directive do not treat unlisted company shares as a regulated investment. There is a grave danger that investment opportunities in unlisted company shares will move overseas to the detriment of the UK economy. While the treatment of advice about unlisted companies is a much wider issue than the current consultation, in our view consideration should be given, as part of the review of the Financial Services and Markets Act, to the need for unlisted company shares to be treated as a regulated investment.

One change that could be made without any adverse consumer implications is to allow advice given to companies (of any size) and arranging deals for companies to be excluded from the definition of 'regulated activities' under clauses 25 and 53 of the Regulated Activities Order. This would extend the scope of the current exemption for the sale of a body corporate (clause 70 of that Order) and for intra-group transactions (clause 69) to cover all purchases or sales of investments by companies, regardless of whether they are majority or minority shareholdings. As a result, most corporate finance activity would become exempt, except in so far as it related to making promotions to individuals.

We would observe that the title of the consultation paper does almost answer the consultation itself. Informal capital raising is just that. Adding regulatory controls will increase costs, inhibit investment or, because of the informal nature of the activity, be ignored. While we would agree that ignorance of the law is not an excuse, the law should take a proportionate approach and only seek to operate in areas where it will protect those that need protection or to correct an 'unruly' market. But in trying to do that, the law should have regard to how best to achieve its aim without unintended side effects.

We are of the view that the side effect of the current arrangements is to stifle investment opportunities.

The object of a financial promotion is to communicate an inducement or an offer to enter into a financial promotion. There is thus a simple ‘chicken and egg’ situation. To rely on any exemption that needs information about the status of the recipient, how can that information be obtained? Sending a letter with the request – ‘please self certify yourself on the attached form and return’, without giving any reason for the request, (because to do so would make it an inducement) is bound to fail.

The consultation paper (at paragraph 3.7) notes the difficulty in obtaining data. We share that view, and in the time available it has not been possible to survey our members to any degree. Anecdotal discussion with firms suggests that they are issuing very few certificates for high net worth individuals or sophisticated investors simply because there is no demand. There is also a further problem with clause 48 and 50 of the FPO. The person providing either type of certificate cannot then ‘use’ it to make promotions to that client. There is thus a natural reluctance to give such a certificate if it then prevents the firm from further advising the client which is the service the client really wants. This is a further barrier which is not addressed in the consultation paper.

As an aside, it would seem a relatively simple matter for the FSA to add a further question to its annual returns. This could ask how many sophisticated investors certificates the firm had issued. This would at least build up a picture of the usage of this provision.

The consultation paper notes (at paragraph 3.2) that the financial promotion regime aims to address the asymmetry of information between investor and investee. The nature of investments in private limited companies is such that this asymmetry is always likely to exist. To reduce this risk, by for example requiring a prospectus, would run counter to the Government’s aim of encouraging such informal investment. Thus that there is a risk must be accepted and other ways sought to reduce it. Equally, as the consultation paper suggests, much capital raising happens informally, between family and friends. Almost certainly this happens in total ignorance of the FPO and any other requirements. We do not believe the proposals in the consultation paper will or can address this situation. (There is already a risk of mis-guided investment, but there does not seem to be any evidence that this is happening.) In our view, there needs to be a balance struck between the desire to encourage investment and being overly protective.

Our responses to the individual questions of the consultation are in the appendix to this letter. However, our overall view is that these proposals only offer a marginal improvement on the current situation and do not go far enough.

Our preference is that an individual merely seeks to indicate that he or she is willing to consider potential investment opportunities. Any criteria are necessarily arbitrary. Regardless of the net worth of an individual, or the previous number of transactions entered into, they may or may not be willing to consider a new investment. It is a personal decision and individuals should be allowed to make it. There is also a natural reluctance to declare the information needed to make the certification and to pay a fee simply to receive information that, for other reasons, may be of no interest.

In our view there is an equally important issue which the consultation paper only touches on, in paragraph 4.1. This is how the high net worth individual etc is initially identified. This particular paragraph implies that promoters will not send out the information unless the relevant certificate is seen. Indeed, in our experience the business angel networks that have websites will only allow investors to register if the individual can produce a certificate. The paragraph then implies that under the proposed arrangements there is an initial invitation, made to those that the promoter reasonably believes are high net worth individuals or sophisticated investors. Then, on receipt of a self-certified statement, further information is disclosed.

If the concern is about investor protection, a clear statement, as part of the investment information can deal this with. The use of such a statement would be the basis of an exemption in the FPO. The statement would deal with the following:

- The communication has not been approved.
- There is a risk that the entire investment could be lost.
- Indicate how further information can be obtained.
- That opportunities to use the ombudsman or compensation schemes are restricted or non-existent as the case may be.
- That if the individual is in any doubt about making the investment, professional advice should be obtained.

On this last point we would observe that firms in the Designated Professional Body (DPB) arrangements are allowed to advise on the sale and purchase of unlisted company shares. Indeed, in many cases they are better placed to advise on such investments than a FSA authorised person. Therefore, any notice that advice should be sought should also make reference to firms licensed in DPB arrangements. Barriers to advice about these investments is equally stifling to investment opportunities. This is currently relevant in the light of the formation by the Treasury's Small Business service of the accountants' working group which is looking at the access to finance and advice about finance for SMEs.

On a related issue, clause 49 of the FPO deals with promotions to high net worth companies etc and clause 51 with promotions to associations of high net worth individuals. These exemptions should also be reviewed with a view to their amendment so that promotions can be made to these entities on the same basis as for individuals.

### Conclusion

The type of capital raising under discussion here is, by its very nature, informal. Regulations in respect of it will not necessarily be complied with simply because of this informal nature. Any regulations that do apply should be proportionate, and not unnecessarily impede the capital raising process.

Our view is that investment will only occur if there is the widest promotion of the opportunities. Potential investors should be allowed to register their willingness to invest without further requirements. They would then receive information about potential investments according to any criteria they may have specified (e.g. industry sector, size of investment etc). Companies seeking potential investors could then access that site and send details to those investors whose criteria the investment fits. The register could be

operated by the FSA with only a nominal (or preferably nil) charge for registration. This would allow for the inclusion of appropriate warnings.

In addition promoters should be allowed to mailshot anyone they believe is a potential investor (with no preset criteria) offering to supply further information about an investment. This initial letter and all subsequent communication would carry appropriate warnings as described above and any further communication would only be allowed with the potential investor's express permission. We believe that this will provide the necessary consumer protection. Thus the exemption is based on the nature of the communication, not the nature of the potential recipients.

In our view it is only by taking such steps that access to and availability of finance will be increased.

We have commented in this response on the position of companies as investors, although not part of this consultation, as we consider that this is an area where regulation can be removed without any consequent consumer detriment.

If you have any queries on the response please contact Peter Burton, Head of Regulatory Policy, on 01908 546273 or email, [Peter.Burton@icaew.co.uk](mailto:Peter.Burton@icaew.co.uk). We would also be happy to meet with you to discuss our response.

Yours faithfully

Peter F Green  
Chairman  
Joint Investment Business Committee

## Responses to the consultation questions

The following responses are numbered to follow the numbering of the list of questions in Part 8 of the consultation paper.

1. We are of the view that the current arrangements are a barrier to potential investors. They effectively have to pay a charge to receive information that they want to receive and the sender wishes them to see.
2. Without further time to survey our members we can only provide anecdotes. When the requirements are described to clients who wish to send out details of investment opportunities, they are usually dismayed by what is required and the potential cost. They do see this as a barrier and it will inevitably put some off. Thus, in our view the certification process is a barrier, and is reducing the scope for companies to raise funds.
3. Our view is that the only requirement is a reasonable belief that the individual is likely to want to invest. There should be no reason to consider further the 'capacity' of the potential investor for particular investments. The ability for an individual to invest is a personal matter and not really capable of discernment by a third party and it will vary over time.
4. (a) We believe that individuals only need to self-certify their willingness to invest. There is no need for further criteria, which in any event are arbitrary.
4. (b) We have no information on this. Anecdotally, possession of a certain amount of net assets does not mean that an individual is a better investor than one who has fewer but has more experience. Again the key issues is whether an individual wishes to invest in unlisted company shares, that they are made aware of the risks and that seeking professional advice could be appropriate.
4. (c) There is no need for alternative methods of certification. As we do not see the need for self-certification of meeting pre-defined criteria, we can see no reason to retain the current high net worth exemption. In any event the key is the willingness of the individual to invest. Consumer protection can be provided in other ways, by making clear disclosures of the risks involved and the need for professional advice, including from a firm licensed in the Designated Professional Body arrangements.
5. Again, we believe any limit is arbitrary and should be removed entirely. Increasing the limit will merely reduce the pool of potential investors. In any event, the measure is the capacity of the investor to invest and how this amount relates to the total wealth. Any pre-set limit is necessarily arbitrary.
6. As stated before, we believe the current regime should be removed. It presents a barrier to those who wish to start investing and so do not have the track record envisaged here.
7. See our answer to question 6. The criteria will, of necessary, be arbitrary and we do not think that any particular criteria would be better than any other. Such criteria will always have an in built element of prudence and it is, in our view, better for the individual to make their own choices.

8. Detailed criteria are not required. It may be useful, on the FSA's website, to indicate to investors the issues that they should consider when making investments, including the availability of advice.
9. By definition there cannot be evidence in respect of the three models as these are not in use. In our view, investor protection is best served by making clear to the individual the risks involved, the potential protection forgone and the advisability of seeking professional advice.
10. Whichever amendments are finally made should also be made to the CIS order. The aim should be to reduce the regulatory barriers wherever possible. The regulations governing financial promotions have developed over a period of time. Their complexity is such that a professional cannot always be sure that he is aware of all the relevant legislation – which is further compounded by the issue of changes and amendments without publishing consolidated documents. The regulations are further compounded by similar complexity in determining exactly what an investment is and whether a joint venture or a partnership falls to be regarded as a regulated investment by reason of falling within the equally complex Collective Investment Scheme Regulations. If the professional is faced with such difficulty, a director of a company looking for finance is faced with a near impossible task. This task may be made impossible if the director wishes to give an indication to the prospective investor of the potential options as to an exit route for his/her investment. The use of the incorrect wording could find the investment falling within the Open-Ended Investment Companies Regulations 2001 (as amended).
11. There are a number of issues that we would draw to your attention as causing concern:
  - 'Lead' investors who are seeking other investors are concerned that they are making a promotion and this restricts their ability to form a 'group' to make an investment.
  - The Enterprise Investment Scheme regulations restrict the amount of qualifying capital and shareholding percentage. If the relief attached to the company shares and not the individual investor it would possibly be easier to regulate but crucially it would leave the decision to invest to the individual, on the basis of desire and capacity to invest, rather than an artificial taxation limit.
  - Section 22 of the Finance Act 2003 effectively discourages academics from receiving equity shares in university 'seed funded' companies. This in turn reduces the opportunities for investment by business angels.
  - As already discussed, it is difficult to send out information to potential investors without first dealing with the high net worth/sophisticated investor certificate. If there are insufficient potential investors of this type and a wider population has to be addressed, then there may be a need to have the advertisement approved under section 21 of the Act or the production of a prospectus. Both are costly exercises.
12. The most obvious problem is that a syndicate is likely to be seen as a collective investment scheme. This would then bring about another range of regulation that would be counter-productive. Without appropriate change, there could also be a problem with promotions to these groups, caused by section 51 of the Financial Promotions Order, about associations of high net worth individuals or sophisticated investors.

Our interpretation of the FPO is that an organiser of a business angel network is arranging deals in investments or managing investments, both regulated activities, and needs to have the appropriate level of authorisation from the FSA. Unless and until the status of an organiser of a business angel network is reviewed, to allow such an organiser to fall outside the regulations by, perhaps, redrafting Article 47 of the FPO, many professionals will be excluded from acting. If the intention of the Treasury is to assist and promote private investment, this needs to be addressed.

13. As mentioned in question 11, if an exemption does not apply, then a document has to be issued which is approved under s 21 of the FSMA or else a prospectus compliant with the Public Offer of Securities Regulations. Even if another exemption applies, the cost of issuing a document that complies with an exemption can be high, as some exemptions require an onerous level of information to be included, eg in relation to the provision of historic financial information. If a document is issued, on whatever basis, it usually has to be fully verified to a standard of a public document. This, in itself, is costly. Even if all the factors noted above are resolved, there remains the hurdle of Public Offer of Securities Regulations. These operate independently of the FPO and do not share the same exemptions. It is possible for all the potential investors to be certified as high net worth or sophisticated investors and to fall outside the exemptions - unless Clause 7 (2) (d) is clarified to include those persons holding such certificates or is otherwise amended if our suggestion is taken that certificates are not needed.
14. We believe that there is an under-provision of intermediaries in this area. The natural intermediaries are professional firms. Firms have clients who are looking to invest and for investors. However, for professional firms there are a number of barriers if they are not FSA authorised (which some would see as a barrier in itself). A firm within the Designated Professional Body arrangements of Part XX of the Act can only provide regulated services if they are incidental to the provision of professional services (section 327 (4)) and which arise out of or are complementary to another professional service provided to the client (section 332(4)). Thus it is difficult for a firm that is not FSA authorised to offer these services on a stand-alone basis. They may already have as clients potential investors or those looking for investment, but because of the Part XX restriction cannot make contact with others.

There is in any event a concern that a firm of accountants, issuing either a high net worth investor or a sophisticated investor certificate will be precluded from marketing investment opportunities to those individuals. While this may not be the case if the firm is acting in an agency capacity for the target enterprise, there is clearly concern and clarification should be provided on this point.