

## RESPONSE BY FISMA LIMITED TO HM TREASURY ON

### INFORMAL CAPITAL RAISING AND HIGH NET WORTH AND SOPHISTICATED INVESTORS: A CONSULTATION ON PROPOSED CHANGES TO THE FINANCIAL PROMOTION ORDER

#### 1. FiSMA's view of the Equity Gap

The equity gap in the UK over the last few years has got worse not better. This is largely because venture capital organisations focus more and more on the larger transaction (£20m+). 3i PLC (which was set up by the Bank of England to address the equity gap) has shrunk from 28 area offices to about 5 offices in the UK dealing with new business.

The UK is the most creative society in the world: but entrepreneurs have huge difficulty raising funds to take their ideas forward.

The funding gap does not just affect start ups and early stage companies. Many companies with a proven business model are unable to expand because they cannot raise the necessary equity.

VCT's and other similar vehicles are not going to solve the equity gap problem as they all congregate in the least risky investments that meet the minimum regulatory criteria.

#### 2. Solution

So how do you solve the funding gap? To us it is obvious. Over the last 20 years there has been a huge growth in the number of wealthy private individuals who know how business works. The solution is simply to create an environment where these hidden experts can communicate with companies seeking capital.

Gordon Brown's statements about creating the Enterprise Economy and Patricia Hewitt's statements about access to capital cannot be implemented without creating an environment where these hidden experts can communicate with entrepreneurs.

Historically there has not been an easy mechanism to access business angels. There are meetings where companies seeking cash can present to 10 or 20 potential investors. But no one has harnessed the power of the web to create a communication facility on a mass scale until the recent launch of [www.fisma.org](http://www.fisma.org)

The Financial Services and Markets Act (often called FiSMA) created rigid barriers about financial promotions but then created numerous exemptions. But the exemptions for the hidden experts and entrepreneurs do not really work except one. The exemption that works is where the company operates on a not for profit basis and complies with certain other requirements. FiSMA Limited was set up to utilise this exemption to help solve the equity gap.

FiSMA Limited has had help from the FSA and the Bank of England and people whom we have met representing the DTI and Treasury have been very encouraging.

#### 3. FiSMA's focus

FiSMA has focus on the company raising up to about £2m as this is where the funding gap is worst. But the truth is there is a funding gap up to say £20m. Therefore what FiSMA does is simply be a communication facility for companies seeking capital. It is really like Exchange and Mart or AutoTrader. Or it could be said to be a giant billboard with a useful navigation system.

FiSMA allows start ups and early stage companies to post business plans but we imagine the most popular with FiSMA investors will be existing businesses seeking expansion capital.

FiSMA targets the hidden expert: this is the wealthy individual who has not only money but business experience and who can contribute not only money but also ideas on marketing or production etc. In order to view a business plan investors are required to answer questions to see if they understand the risks of investing in unquoted investments. This is not required under the not for profit exemption but it just seems sensible.

#### 4. FiSMA's view of the current law

The Government created an environment in financial regulation where everything is forbidden unless exempted. We think that approach is wrong. The Government ought to think through what evil they wish to stop and the principle ought to be everything is permitted unless forbidden. Such an approach ought to give greater certainty, reduce cost and bureaucracy and generate a better entrepreneurial culture.

We doubt whether tinkering with the law in the way proposed can achieve Government objectives. We would prefer the law remain the way it is until a more fundamental review. However, on the assumption that such a view will not prevail we give our answers below to the specific questions.

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

A1: No. Even when an investor is certificated the exemption requires a notice which is often overlooked.

**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.**

A2: See opening remarks.

**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?**

A3: Given the current law, a change to "reasonable belief" would not work on the basis that everyone knows almost nobody is going for certification. Therefore, how could you have reasonable belief that they have done so?

Reasonable belief is a concept that can be applied subject to other appropriate changes in the legislation.

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

A4a: Yes. However, we still question whether there ought to be an exemption based solely on a high net worth test. Is it logical?

[www.fisma.org](http://www.fisma.org) uses the not for profit exemption but thinks it sensible to vet investors before they can see business plans. A copy of our test is attached. We do not argue that this is perfect. However, it is our view of the sort of questions that ought to be asked before allowing an investor to see a business plan. The way the test works is that points are awarded depending on the answers and if they get over a certain number of points then they are allowed through to see business plans. Separately, if a solicitor, accountant or corporate adviser claims to be experienced in advising companies in raising capital and also claims to be knowledgeable about the risks in investing in unquoted companies, then again they are allowed to see business plans

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

A4b: There are so few certificated sophisticated investors that an answer to the question is not meaningful.

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

A4c: The existing self-certification exemption does not work and needs to be replaced.

**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.**

A5: If the current rules remain we believe it should stay at £250,000. If it is increased a problem emerges with the net asset test. Take two individuals each with net assets of £1m. First has a house valued at £760,000 and cash £240,000 and is thus not a HNWI. The second has a house valued again at £760,000 but this time has a mortgage of £200,000 and has cash of over £250,000 and is thus a HNWI.

We wholly accept that whether the house is or is not included is a political decision. We are simply making the point that the higher the figure the more illogical it becomes to exclude the house.

We note that in Jersey one class of “expert investors” is where the investor invests at least US\$100,000. Why not consider a similar category in the UK at say £50,000? It is a simple test that removes bureaucracy.

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

A6: We agree with the introduction of self-certifying as a sophisticated investor. However, we believe all evidence points to the existing regime not working and we believe it should be scrapped to avoid confusion.

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

A7: See detailed comments on draft legislation.

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

A8: We have a conceptual problem in seeing how you can establish reasonable belief that someone is a sophisticated investor unless specific questions are asked. Can reasonable belief be established if an investor is merely asked to sign a sophisticated investor statement?

On the other hand we have seen it argued that the sophisticated investor has to provide evidential proof, such as evidence of his past dealings in unquoted stocks. We think this is a nonsense. Common sense needs to be applied. If someone is asked how many unquoted stocks he has invested in and he responds, 3 or whatever, then it is unnecessary bureaucracy to ask that person to verify the information.

There are some who argue the sophisticated investor should be dealt with like a driving licence and that, once licensed, those people ought to appear on a public register so that they can be contacted by those people seeking capital. We believe this is absurd. Experienced investors (who might be sophisticated and rich but time poor) want to be invisible. They want to choose whom to approach and when. The thought of being on a public register appals most wealthy private investors.

The system that most investors want is one where they can choose whether to make an approach.

**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.**

A9: Model 3. We attach legislation showing suggested amendments. Additional comments are:

1. It needs to be made simpler to operate. For instance there is a requirement for a statement and also a notice. Under the current legislation we are aware of people knowing about the statement but being completely unaware of the need for a notice. We think that if the notice is required then most of the notice should be built into the statement as per the attached (one for HNWI and the other for SI).

2. Communications today are mainly through the internet. These statements have to be capable of being dealt with on the internet. It would be wrong to create regulations which required statements to be delivered through the post. Such a system would not work.
3. We do not agree that the statement has to be revalidated every 12 months.
4. A huge amount of confusion has been caused by the definition of “unlisted” company. We see no reason why the exemption should be limited to “unlisted” companies. If there are policy reasons for this limitation then they ought to be clearly articulated. At the very least the definition of “unlisted” company ought to be reviewed. It should have a common sense definition and not be a trap for the unwary.
5. As indicated above we see no reason to maintain the certified sophisticated investor. We think there should simply be a self-certified sophisticated investor.

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

A10: Yes. There ought to be harmony between the provisions.

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

A11: Normally there needs to be a lead investor. It is possible for that lead investor to use exemptions under the financial promotion regime, such as the “one-off” exemption. However, the lead investor can fall foul of the Regulated Activities Order and in particular the provisions relating to arranging deals in investments. Many lead investors, who are often highly regarded members of the business community, are not aware of the law relating to arranging deals in investments and do not appreciate when they cross the boundary and commit a criminal offence and take on civil liabilities.

For a business angel group to work effectively there needs to be a lead investor (who can change from deal to deal). However, lead investors who are made aware of the Regulated Activities Order stop acting as a lead investor. Thus, many well qualified lead investors stop acting as such and this prevents deals from being done.

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

A12: See A11.

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

A13: The concept of having an authorised person act as an intermediary between an entrepreneur and sophisticated investors, in all sizes of deals, does not work because of the costs. Points relating to this include:

- i. To get qualified as an authorised person the costs commonly quoted is £40,000. Any firm which spends £40,000 cannot afford to provide services to companies seeking capital much below say £2m.
- ii. The FSA does not have a customer focus approach. They do not see themselves as a supplier of services to companies and investors. There has grown up around the FSA a whole plethora of gatekeepers (often ex FSA employees). Some of these are very good and can help applicants phrase applications in a fashion that is more acceptable to the FSA. But with a different attitude at the FSA this cost could be dramatically reduced.

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

A14: We all see a need to protect investors but protection must not kill communications or stifle innovation or stop appropriate investment. When setting regulations what one has to bear in mind includes:

- i. that investment goes in cycles. What is an appropriate curb on over exuberance at a point in the cycle is inappropriate prevention at another point in the cycle;
- ii. Government ought to remember that in the small companies sector it is often the company (entrepreneur) that needs protection rather than the wily, experienced investor.

In setting up [www.fisma.org](http://www.fisma.org) we have come into contact with a number of people in the Business Link organisation. Comments arising from those contacts are:

1. There are a few committed energetic creative people in the Business Link organisations that make things happen. Some of them are actively helping us with [www.fisma.org](http://www.fisma.org)
2. At a fairly senior level there seems to be a “not invented here” syndrome which makes it difficult for the Business Link organisations to work well with the private sector.
3. We hear a lot of criticism about wasted expenditure (e.g. fancy offices and entertaining) and lack of focus of getting cash into companies.
4. Much effort within Business Link organisations seems to go towards obtaining SMART awards or other government funding for companies. It cannot be good for an enterprise culture to be using tax payers money for grants and then be creating a large bureaucracy around those grant applications also funded by the tax payer. To make a business sustainable and a net contributor to the coffers of HM Treasury there ought to be more of a focus by Business Link organisations on attracting in private investor funds.

**Attachments:**

1. Knowledgeable investor test used by FiSMA;
2. Self certificated high net worth statement (incorporating part of the notice);
3. Self certificated sophisticated statement (incorporating part of the notice); and
4. Model 3 draft legislation showing suggested amendments.

**FiSMA – can you be classified as a knowledgeable investor?**

1 Are you a director, officer or employee of an Authorised Person and if so do your responsibilities when acting in that capacity involve you in the carrying on of dealing in securities, arranging deals in investments, managing investments or advising on investments? [This question uses statutory wording and if you are in any doubt about the meaning your answer must be No.]

Yes No

Go to Q1(a) Go to Q2

1(a) Are you using this site in your capacity as a director, officer or employee of the Authorised Person?

Yes No

Go to Q1(b) Go to Q2

1(b) Name of Authorised Person.....and FSA registration number.....

2 What is your net worth (excluding your primary residence, any insurance policy relating to that residence and pension)?

Less than £50,000 More than £50,000 More than £100,000 More than £250,000

3 What is your annual income?

Less than £25,000 More than £25,000 More than £50,000 More than £75,000 More than £100,000

4 Are you qualified as solicitor or accountant and do you regularly advise investors in unquoted companies?

Yes No

5 How many unquoted companies have you owned shares in?

0 1-3 3-5 More than 5

6 How many unquoted companies have you been a director in?



### **High net worth individual statement**

I make this statement so that I am able to receive promotions which are exempt from the restriction on financial promotion in section 21 of the Financial Services and Markets Act 2000. I declare that I qualify for exemption as a certified high net worth individual. I accept that the content of promotions and other material that I receive may not have been approved by a person who is authorised under that Act and that their content may not therefore be subject to controls which would apply if the promotion were made or approved by an authorised person. I am aware that it is open to me to seek advice from someone who is authorised under that Act and who specialises in advising in this kind of investment. I am also aware that engaging in any investment activity as a result of a promotion made to me may expose me to significant risk of losing all of the property I have invested.

I confirm I had:

- a) during the financial year immediately preceding the date on which this statement was signed or accepted, an annual income to the value of £100,000 or more; or
- b) throughout the financial year immediately preceding the date on which this statement was signed or accepted, net assets to the value of £250,000 or more.

In calculating my net assets no account has been taken of

- a) the property which is my primary residence or any loan secured on that residence;
- b) any rights under a qualifying contract of insurance; or
- c) any benefits (in the form of pensions or otherwise) which are payable on the termination of my service or on my death or retirement and to which I (or my dependants), or may be entitled.

### **Self-Certified sophisticated investor**

I make this statement so that I am able to receive promotions which are exempt from the restriction on financial promotion in the Financial Services and Markets Act 2000. The exemption relates to self-certified sophisticated investors and I declare that I am such an investor. I accept that the contents of promotions and other material that I receive may not have been approved by an authorised person and that their content may not therefore be subject to controls which would apply if the promotion were made or approved by an authorised person. I have the requisite knowledge and experience to know that engaging in investment activities of this kind may expose me to a significant risk of losing all the property invested. I am aware that it is open to me to seek advice from someone who specialises in advising on this kind of investment.

[Note: We think the solution to the equity gap is to open up communications between what we call “hidden experts” and entrepreneurs. However, we do not see how the person making the communication can believe on reasonable grounds that someone is a self-certified sophisticated investor unless there has been some sort of test as well as acceptance of the statement.]