

Informal capital-raising consultation responses
Enterprise Team (4/N2)
HM Treasury
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19 April 2004

Dear Sir/Madam,

Informal capital raising and high net worth and sophisticated investors: A consultation on proposed changes to the Financial Promotion Order

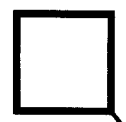
This response is submitted on behalf of the British Venture Capital Association ("BVCA").

The BVCA represents the overwhelming number of UK based private equity and venture capital firms. The BVCA has around 165 members who are invested in over 11,000 companies. Those 11,000 companies employ around 3 million people – equivalent to approximately 18 per cent of the private sector workforce.

The BVCA believes that the current financial promotion regime is not working effectively in relation to the exemptions for high net worth and sophisticated investors. The existing requirement for an individual to be certified by a third party before receiving a financial promotion is too cumbersome to be used in a widespread way, with the result that small businesses are having difficulties in making promotions to individuals, even to individuals who are capable of assessing the relevant risks.

The alternative approach of having their promotions "approved" by an authorised person is also seldom used in practice because authorised firms are unwilling to approve documents unless they receive a large fee for doing so - their only way of off-setting the costs of undertaking the associated verification process and the increased regulatory exposure which they incur as a consequence. We suspect that in practice a lot of SMEs ignore or are ignorant of the current requirements.

The consultation paper concentrates on the impact of the exemptions for High Net Worth and Sophisticated Investors in the context of raising equity for small businesses at the "business angels" stage - but much of the content applies equally to other stages of the fund raising process. It is clearly necessary to have a regime which enables small businesses to raise finance when they need it, in a legitimate manner, without placing undue restrictions on them.



This response provides answers to those questions in the consultation paper about which the BVCA feels qualified to give an opinion. It follows on from the meeting between representatives of the BVCA and Sue Connaughton of HMT on 24 February 2004 to discuss these issues.

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

The BVCA believes that very few investors are currently certified as "high net worth" or "sophisticated". Those that are so certified only become certified when a particular entity wishes to promote a particular investment to them, and there is no other way of making the promotion. Alternative approaches, such as promoting the investment to the individual's independent financial adviser are often deemed to be simpler in practice. The BVCA also believes that many small firms do not appreciate the breadth of the financial promotion regime and therefore may breach the restriction inadvertently.

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.

Yes - the BVCA believes that this is posing a problem for both capital raisers and for investors where firms are aware of the breadth of the regime. It is proving a serious hindrance to enterprise by being a cumbersome and expensive process.

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?

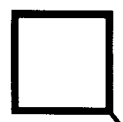
Yes. The BVCA believes that this approach should be adopted because it would maintain investor protection while allowing promotions to be made to people qualified to assess the relevant risks. If an individual has certified that he is "high net worth" or "sophisticated" in order to receive financial promotions the entity making the promotion ought to be able to rely on that certification.

In many cases the entity trying to raise capital approaches only people it already has contact with and therefore is capable of assessing their level of expertise.

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

Yes - the BVCA believes that self certification for high net worth investors would be an improvement on the current situation, particularly in view of the fact that many people who have sufficient income or assets to pass the test are either not employed or are self-employed and therefore are not able to apply to an employer for the certificate.

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



The BVCA believes that a regime for self-certifying as a high net worth investor should be introduced in substitution for the current regime - the BVCA does not see any merit in a regime which adopts two approaches to such certification.

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

The BVCA believes that a regime for self-certifying as a sophisticated investor should be introduced in substitution for the current regime, provided that the self-certification regime applies to all types of investment and not just to the shares in unlisted companies - the BVCA does not see any merit in a regime which adopts two approaches to such certification.

However, the BVCA does not believe that the regime for self-certifying as a sophisticated investor requires a "test" that is more than illustrative - potential investors may acquire "sophistication" by a number of routes.

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

As noted above, the BVCA strongly believes that the proposed criteria for self-certifying as a sophisticated investor should not have more weight than is required to provide an illustration of criteria which might be taken into account in assessing sophistication.

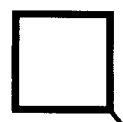
The BVCA believes that the criteria suggested do not necessarily denote "sophistication" in the context of SMEs. They do not have the objectivity provided by the criteria for the "high net worth" test. In particular, the third element of the draft criteria for assessing sophistication is seriously flawed. The second limb of this test (in draft article 50A of the FPO) requires a person to have, in the preceding financial year, "entered into ten or more transactions every three months" involving shares (or other investments) in an unlisted company. Since transactions in unlisted companies can take a long time to put in place there are very few individuals who would pass this test - maybe ten in the UK.

For example, even private equity funds (whose sole purpose is to enter into transactions in unlisted companies) generally make between two and four such investments a year.

This argument applies equally to the equivalent exemption in the CIS Order: the second limb of the third test requires a person to have during the preceding year "entered into 10 transactions involving unregulated schemes". The BVCA doubts that this test will be passed by more than a very few people.

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

Yes - the BVCA believes that since potential investors may acquire and demonstrate "sophistication" in a number of ways it would be too restrictive to have to measure sophistication against certain prescribed objective criteria.



The BVCA suggests that it would be appropriate for the self-certification wording to state expressly that the investor understands and will consider carefully the risks involved before making the investment.

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.

The BVCA favours model 3 because it considers that this is the simplest approach for SMEs and that investor protection is maintained by requiring the potential investor to self-certify. This is subject of course to the SME not putting pressure on an individual to self-certify where it would not be appropriate for him to do so. In addition, the process of investing in an SME is usually fairly drawn out, enabling a potential investor to have ample opportunity to assess the risks of the investment.

In addition, since most SMEs tend to promote investments to their existing contacts, the SME will already have a reasonable idea of the individual's ability to assess the risks of the investment.

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

The BVCA believes very strongly that amendments equivalent to those in the Financial Promotion Order should be made to the CIS Order so that authorised firms are not placed at a disadvantage when making promotions relating to unregulated collective schemes compared with firms and individuals which are not authorised.

If you have any questions about this response please contact Sheila Palmer at the BVCA in the first instance.

Yours faithfully



**MARGARET CHAMBERLAIN
CHAIRMAN, REGULATORY COMMITTEE**

