

**Informal Capital Raising and High Net Worth and
Sophisticated Investors**

**Comments on the Treasury's Consultation Document
of January 2004**

1 Article 48(1) (the initial approach to certified high net worth individuals)

- 1.1 The exemption for marketing to high net worth investors applies only if the individual to whom the communication is made is a “certified high net worth individual”. For this purpose, knowing merely that the individual concerned is very wealthy is not enough. The communicator must in addition know that the individual has made within the previous twelve months the required statement set out in paragraph (2)(b) and (under the present article 48(2)) has in place a current certificate of high net worth. Accordingly, the communicator must be able to check that the individual is indeed a “certified high net worth individual” before it makes the financial promotion to him.
- 1.2 It is therefore important that the communicator must be able to ask the individual whether he qualifies before it makes the proposed communication to him. The Treasury had originally suggested that there would presumably be a register of qualifying certified high net worth individuals which a proposing communicator could inspect. Unfortunately, however, no such public register seems to have been established, although I understand that there is one subscription-only register which is currently being used. Indeed, the FSA has recently informed us that the FSA has not established a register itself.
- 1.3 In addition, our private equity clients have often found, when trying to ascertain whether an individual qualifies as an “expert” investor for the purposes of IMRO’s marketing rules, that the wealthy individuals whom they have approached will not divulge their status until they know details of the investment which is to be marketed to them. These are the same individuals who would be approached by the non-authorised communicator in the hope that they are certified high net worth individuals.
- 1.4 Accordingly, the exemption provided by the present article 48(1) normally cannot be used in practice. I am therefore grateful for the Treasury’s proposal (at paragraph 4.1 of their consultation document) to introduce a “reasonable belief” requirement in relation to the recipient’s status.
- 1.5 However, I am unable to envisage how the communicator can reasonably believe that the recipient (or his employer or accountant) has actually issued a certificate. There are not really any reasonable grounds on which the communicator can rely for his belief that the recipient is indeed “certified”. Accordingly, the proposed relaxation of the exemption provided by article 48 is, unfortunately, not as helpful as it may look.

- 1.6 Given the Treasury's intention to facilitate communications to business angels, and indeed, its intention to allow for self-certification, I would hope that the Treasury will therefore agree to drop the requirement for the communicator to believe that the recipient (or his employer or accountant) has signed a certificate. Instead, it should be acceptable to the Treasury that the initial communication can be made if the communicator believes on reasonable grounds (merely) that the recipient (or his employer or accountant) is a "high net worth individual", because that will normally be all that the communicator will be able to know.
- 1.7 Accordingly, please would the Treasury therefore **amend** the "reasonable belief" requirement in article 48(1)(b) so that it reads:
- "is made to a person whom the communicator believes on reasonable grounds to be a high net worth individual"
- 1.8 I was pleased to see that the FSA has given general guidance that a mere enquiry about a person's status for this purpose does not contravene the financial promotion restriction (AUTH App 1.4.27G). It must be right that an enquiry as to status does not constitute an "inducement" within section 21. Similarly, although the FSA did not refer to it, asking the recipient of the communication to sign a "status" statement in the form set out in paragraph (2)(b) also does not constitute an inducement.
- 1.9 However, the FSA's guidance does not allow anything more than a "reference" to the type of investment concerned. I am sure that a communicator will want to say a bit more about the business it is asking the recipient to invest in. In order to make the exemption useable, if the "status" letter constitutes a financial promotion "inducement" within section 21 (because it describes the proposed investment to the recipient), it would accordingly be necessary **to provide expressly** that the exemption also covers an initial "status" letter which contains this description.
- 1.10 This would allow the proposed communicator to be comfortable, before it markets the investment(s) or financial services to him, that the proposed recipient is indeed a certified high net worth individual. It also allows the proposed communicator to tell the proposed recipient the details of the proposed investment(s) and to provide for him to sign a statement in the terms set out in paragraph (2)(b).

- 1.11 The exemption for an “initial” status letter should include paragraphs (3) and (4) of the existing article 48 or paragraphs (3) to (6) of the substitute article 48. However, as the recipient is being written to on the basis only that he is a “high net worth individual”, rather than a “certified high net worth individual”, the word “certified” should not appear in paragraph (4)(a) or (b) or, in the substitute article 48, paragraph (6)(a) or (b).
- 1.12 However, it should perhaps be made clear that the “initial” communication can be made, and its response relied on, only if the letter expressly states that it does not itself constitute an offer or invitation to treat but that the offer or invitation can be made only if the individual makes the required statement. It also must not contain or be accompanied by a form of application (or similar).
- 1.13 In order to limit further what can be said by the communicator in this initial “status” letter, it would be important also to impose one or more of the restrictions contained in article 69 (or in article 72, if substituted), albeit that restrictions relating to the market will be irrelevant. In addition, because the communicator may well not establish an investee company until he knows that he is likely to find investors, the exemption should perhaps apply even if the communication is to be made by an individual who is or will be a director or chairman of the investee company, and the investments concerned are to be issued by that company (or a body corporate in the same group).
- 1.14 The “status” letter will, importantly, set out a certificate in the form contained in paragraph (2)(b). The exemption should provide that the communicator cannot make a further substantive communication to the proposed investor unless it receives back a signed statement from the proposed investor in the form set out in paragraph (2)(b). I set out in the Appendix a few amendments that I suggest should be made to that statement.
- 1.15 The existing or substitute article 48 will apply as now to the follow-up offer letter in the sense that the investor will have confirmed that he is a certified high net worth individual, provided of course, that the follow-up letter is sent within the required 12- month period.
- 1.16 My proposed “initial” status letter will not be necessary if the communicator is satisfied for other reasons that the proposed recipient has indeed made the statement required by paragraph (2)(b). However, if, as I suspect, the communicator does not have reasonable grounds to assume that the proposed recipient is a “certified high net worth individual”, he will need to go through the 2

communication procedure that I have suggested. It certainly seems to me to be a price that proposed communicators will think is well worth paying.

1.17 The Treasury is well aware of the risk that a recipient of the initial “status” letter may sign the certificate required by paragraph (2)(b), even though he does not in fact qualify as a high net worth individual. I am afraid that I cannot see how to avoid that risk and what I am trying to do by the proposed initial “status” letter is to protect the officers or proposed officers of the investee company from committing a criminal offence by failing the “reasonable grounds” test.

1.18 It would be helpful to try to reduce the risk of the recipient pretending to be what he is not by making it clear that he will get no compensation for the loss of any of his investment and that “the property invested” means his money.

1.19 Accordingly, in paragraph (4)(d), or (6)(d), line 2, after “of the” **insert** “money or other” and after “invested” **insert** “without compensation”.

2 Question 3

2.1 Promotions should be allowed on the basis of reasonable belief in the case of a certified high net worth individual, although in my view it would be dangerous to do so in the case of certified sophisticated investors.

2.2 I would stress that the “sophisticated investor” category would seem not to include the “friends and family” who constitute a large number of investors (see paragraph 4.7 of the Consultation Document). Given that they may invest only to help the communicator, there should perhaps be a specific exemption for them.

3 Question 4

3.1 Potential investors must be able to self-certify that they qualify as high net worth individuals. The self-certification

exemption should, in my view, replace the third party certificate.

4

Question 6

4.1

I think that it would be dangerous to provide a test for self-certifying as a sophisticated investor. That is perhaps why the SEC does not allow a “sophisticated investor” exemption without the “high net worth” test.

4.2

The reason that there are so few certificates for sophisticated investors is probably that the FISMA-authorized firm would not want to provide a certificate (with its attendant liabilities) for the benefit of their competitors. However, perhaps this problem can be solved by allowing certificates to be signed by members of the bodies referred to in the “designated professional bodies” order.

5

Question 7

5.1

I think that it is inappropriate to regard members of “designated professional bodies” as being sophisticated in relation to unlisted investments.

5.2

The requirement for a person who works in the financial services and markets sector should include the fact that the knowledge of that person must relate to one or more of the financial instruments in paragraph (7) rather than those in paragraph (8).

5.3

In my view the carrying out of transactions on securities markets is irrelevant to the question of whether the investor is sophisticated in relation to unlisted investments.

5.4

I think that it is wrong for discretionary investment activity to be used to test sophistication. Surely when an investor gives his investments over to a discretionary investment

manager he is actually attesting that he does not feel sophisticated enough to select investments himself. I seem to remember that the SFA, and perhaps IMRO, did not want an investor who gave his investments to a discretionary investment manager to be treated as “expert” in order to avoid the normal “private investor” protections.

6

Question 10

6.1

Amendments equivalent to those made to the Financial Promotion Order should indeed also be made to the CIS Order. Exactly the same issues arise.

6.2

Indeed it is probably safer for high net worth individuals (and, if required, sophisticated investors) to invest in unlisted companies through the medium of private equity investment funds. This would allow for diversification and leaves the manager of those funds to decide which investee companies it is appropriate to invest in.

Charles Abrams

19 April 2004

APPENDIX

Amendments to the paragraph (2)(b) statement

1. In line 1, **delete** “promotions” and **substitute**:
“an offer or information relating to an investment (a “financial promotion”)”
2. In line 3, after “relates to” **insert** “making a financial promotion to”
3. In line 4, after “the content of” **insert** “financial”
4. In line 10, after “all of the” **insert** “money or other”
5. In line 10, after “invested” **insert** “without compensation”