



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

NESTA Consultation Response: April 2004

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Background

NESTA – the National Endowment for Science, Technology and the Arts – was established by the 1998 National Lottery Act to pioneer ways of supporting and promoting talent, innovation and creativity in science, technology and the arts. We do this through a number of programmes – Learning (formerly Education), Fellowship, and Invention and Innovation. To date we have made 424 awards through these programmes and invested over £26million in supporting creativity and talent across the UK.

Through the Invention and Innovation Programme we have invested almost £9million in innovative start-ups and ground-breaking ideas, helping individuals and businesses develop their ideas and access further funding. As an organisation involved in supporting small businesses we are well placed to recognise the regulatory barriers that they face.

Most of the businesses that we fund are at a very early stage of development, and our investment ranges from £50,000 to £150,000, with occasional additional funding of up to £250,000. We invest at a slightly earlier stage than business angels, and many of our investments go on to attract angel investment following the end of NESTA's involvement. It is therefore very much in our interest to ensure a healthy supply of business angels – the people who are most likely to be affected by the proposed changes to the Financial Promotions Order.

Our position as one of the UK's largest single sources of early-stage seed funding also means that we have considerable experience in helping small businesses reach the stage where they can access informal capital, facilitating further investment opportunities.

As a supporter of businesses that are served by the type of investor that the government seeks to encourage, we welcome the opportunity to respond to this consultation.

Overview

In our response to *Bridging the Finance Gap: A consultation on improving access to growth capital for small business* (2003) NESTA identified that a key barrier to the development of groupings of Business Angels is the Financial Services and Markets Act (FSMA), which we felt imposed considerable administrative burdens. This has been acknowledged by the Government in its 2003 White Paper.

We fully support the stated aim of this consultation; "to strike an appropriate balance between consumer protection for those investors who are likely to be well-informed, experienced and in a position to obtain appropriate advice, and access to finance for smaller high-growth businesses, seeking relatively modest injections of capital."

While supporting the aim, we have a number of concerns as to whether some of the proposals will be successful in achieving it. In particular, we feel that a number of considerations need to be addressed:

- The proposed criteria used to define a sophisticated investor;
- Whether it is feasible or desirable to attempt to develop an objective definition for sophisticated investors; and
- Whether a different model might better achieve the consultation's objective, while at the same time strongly encouraging business angel networks.

Sophisticated Investors

We do not believe that the criteria that the consultation sets out as pre-requisites for a sophisticated investor, found in section 4.14, will achieve their stated aim. Both the first and second criteria select those eligible for self certification on the basis of professional credentials which, while seemingly relevant, in reality do not necessarily qualify the holder to make sophisticated investments in SMEs. These are:

- Membership of one of the bodies in the FSMA Designated Professional Bodies Order.
- To work or have worked, for at least 12 months in the financial services and markets sector in a position which requires knowledge of one or more financial instruments.

Taking these together, we do not believe that, for example, membership of The Law Society will necessarily equip individuals with the skills needed to act as a sophisticated investor. While in certain corporate law issues they may have qualifications that are relevant to small businesses, this is unlikely to represent an understanding of the investment requirements of these businesses. The inclusion of actuaries in this list we presume is a direct response to the government's desire to see the risks involved in investing in small businesses minimized. However, while actuaries help businesses assess the risk of certain events occurring, they only do this on the basis of quality data¹ that is not of specific relevance to small business investments.

While at first glance both accountants and those involved in the financial services and markets sector may seem qualified to make sophisticated investments, their qualifications will not necessarily equip them with the experience required to successfully invest in small *high-growth* businesses. Accountancy provides

¹ They assemble and analyse data on the costs and impact to future revenue growth of events such as injury, loss of property, pension contributions etc.

understanding of the balance sheets of potential investments but does not provide the individual with expertise on the management issues underlying these, or on the process of getting the business to market.

The skill set required to perform these investments is relatively rare and, while the above professions may well be suited to many traditional investments, they are not necessarily suited to investing in small, high-growth businesses, which are essentially entrepreneurial activities where the emphasis should be more on managerial skills.

We also believe that third proposed criteria for self certification is also unlikely to identify sophisticated investors:

- The investor has carried out transactions on securities markets at an average frequency of 10 per quarter over the previous four quarters **and** the size of the investor's securities portfolio exceeds £100,000.

This merely sets a criterion that qualifies investors by their experience of trading in liquid investments. This may lead to the qualification of individuals whose preference is to support proposals from liquid businesses with clear and quick exit strategies. This approach is not appropriate for investment in small businesses seeking early-stage funding. Often they are not yet at a stage where they have a product to sell, which often makes the relationship between the market and product difficult to gauge. It also means that many small high-growth businesses have longer lag times between the idea and its realisation as a commercial asset.² This could be problematic for a lender with a propensity for liquid investments, who will be used to seeing returns over a shorter timescale than these businesses require.

Clearly the consultation paper is correct in asserting that a need exists to protect the investor. All investments in SMEs have a certain risk connected with them as it is in the nature of the market that many of the investments lose money and lead to business failures. However, as currently described, we do not believe that self certification as set out in this document will increase the protection for the investor and more importantly will fail to secure the desired types of investments.

Alternative models

Instead of allowing investors to self certify on the basis of the criteria specified in the consultation document the government could replace it with the following model:

- The investor has at least X³ years board level experience in a small high-growth business with a trading record or has spent at least Y⁴ years a position requiring experience of the type of financial package they are seeking to provide.

This would ensure that the investor is aware of the dangers of investing in small businesses and is also in possession of the specialized knowledge best suited to achieving profitability, for the lender and the borrower.

² For business angel investments the median holding period is 4 years for a profitable exit, 2 years for a failure, and 6 years from a "living dead" investment. Data from *Is It Worth It? The Rates of Return from Informal Venture*, Mason C and Harrison R (2002)

³ We believe 3 to 4 years experience would be an adequate requirement.

⁴ Ibid

This investor would have first hand knowledge not only of the nature of small businesses, how they bring their products to market and what makes them a success, but also would have the skills required best to protect his investment. The ability to recognise a good idea is often different from recognising whether and how this idea can be realized as a product or a service. This might require a more hands-on approach than the consultation currently implies.

However, behind this there is a broader question of whether it is ever possible or desirable to set objective criteria for a sophisticated investor. Using relevant experience as a criterion is no guarantee for sophistication, though we believe it will provide a higher correlation than the criteria laid down in section 4.14. Therefore one could argue that discussing the exact criteria to be used is neither fully useful nor fully relevant.

Government could, instead, consider replacing self certification with a requirement on new investors to limit the number of investments that they make until they gain a level of sophistication. In addition, "virgin" business angels should be encouraged to limit their investments as part of developing the skills to become a sophisticated investors. This could be done by entitling a new business angel to the same exemptions laid out for sophisticated and high net worth investors if:

- The investor limits his investments to no more than X%⁵ of his total net worth for Y⁶ years. After this period they will qualify as sophisticated investors.

This should be done in conjunction with an increased focus on the promotion and encouragement of more business angel groups. These groups are of paramount importance to the delivery of a number of government initiatives, such as Enterprise Capital Funds, Regional Venture Capital Funds and others. As pointed out in the SBS *Bridging the Finance Gap consultation* (2003), more widespread angel collaboration would allow business angels to make larger investments and increase overall investments by:

- Allowing investors to reduce risk exposure by spreading their investments over a more diverse portfolio of companies;
- Allowing syndicated members to share expertise, information and contacts. When investing alone, many business angels prefer to invest in activities that they have prior experience of. This allows them to mitigate some of the risks involved in spreading the scope and scale of their investments; and
- Providing an entry route for new business angels, allowing them to overcome what is a significant learning curve associated with becoming an investor in "smaller high-growth businesses, seeking relatively modest injections of capital". Thus improving the quality as well as the quantity of the investments.
- Providing a more easily accessible "gateway" for small companies seeking investors.

While it would be important to look at the regulatory issues, which business angels cite as one of the major barriers to improved collaboration, there is also the broader question of increasing the capacity of the National Business Angel Network (NBAN) in order to meet many of the government's aims associated with increasing the amount of enterprise within the UK economy.

⁵ Say no more that 10 to 15% of his total assets are committed.

⁶ We believe 3 to 4 years experience of this type of investment would be an adequate requirement.

Within the scope of this consultation document the Government may, therefore, wish to consider replacing self certification with group certification. Instead of focusing on the individual's criteria for sophistication, which is difficult to define, consideration should be given to allowing the business angel networks to identify and certify sophisticated investors, within an agreed framework. Within many of these networks there are already the skills required to make these investments and by looking at best practice within this field the Government could identify the networks best placed to judge sophistication. New investors could be encouraged to undertake an induction programme, delivered by the network and approved by the FSMA, in order to be granted sophisticated investor status. Furthermore, as business angels are experienced entrepreneurs, they can provide the crucial hands-on managerial experience, which reduces the risk of failure for the investor and the business.

This needs to be achieved in conjunction with the establishment of a more formal code of conduct within the business angel networks. By doing this the Government would encourage a higher standard of investor. We would also like encouragement to be given for business angel networks that group inexperienced angels with more experienced lead investors who take a leading role. By encouraging more support for "virgin" angels within this community, better investor protection and access to finance for small businesses might be achieved.

We suggest that the government look at a number of networks that already display good practice in investing in small high-growth businesses – such as Braveheart Ventures and Archangel in Scotland, the Oxford Investment Opportunity Network, the GEIF Ventures in Cambridge and OneLondon (formally the London Enterprise Agency).

Conclusion

We recognise that many of the recommendations above cannot be implemented merely through regulatory changes. However, there is an important role for the government in encouraging the NBAN to adopt many of these recommendations. We would welcome the opportunity to discuss in more detail how NESTA might be able to play an active role in reforming the investment framework, both formal and informal, within the wider task of supporting investment in innovation and creativity across the UK.