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HM TREASURY

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

Response to consultation from the Quoted Companies Alliance

April 2004

A company limited by
guarantee registered in
England
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CONTENTS

1. Background
2. Response to Questions

Appendix

The Quoted Companies Alliance

1. BACKGROUND

This submission is being made by the Marketing & Regulations Committee of the Quoted Companies Alliance. Our interest and concern relates to the raising of equity finance for smaller companies, particularly where those companies could subsequently aspire to be traded on quoted or listed markets. In addition we consider that the consultation is relevant to the raising of equity for quoted, rather than listed companies.

We recognise the importance of investor protection in this area but also that where investors wish to participate and can demonstrate some experience and knowledge they should be allowed to do so.

2. RESPONSE TO QUESTIONS

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

A1: No.

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: In our view the low take-up indicates that the current regime is not working with exemptions as defined.

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: Yes, if the concept of high-net worth investor is to be continued. In our view high-net worth by itself is not a sufficient criterion to forego the protection for such investors. There are a sufficient number of claims being made by “high-net worth investors” against authorised firms for monies lost during the period 1999-2001. Many of these arise from investments in multiple rather than single stocks.

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

A4a: Yes, subject to the answer A3 above.

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

A4b: No. We understand that there are few certificated sophisticated investors. However we consider that there is potentially a significant pool of sophisticated investors not being tapped. In this group we would include, amongst others, all authorised persons, directors of listed companies and established/experienced investors.

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

A4c: The current self-certification exemption should be replaced and the existing regime discontinued.

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 consider that the test should be changed to be based on criteria relating to the investor's [non-discretionary] portfolio, such as at least 10 holdings in listed companies with a total cost in excess of £100,000. In our view this would demonstrate that the investor had adequate assets, a spread in their portfolio and some knowledge of the equity market.

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

A6: In our opinion the current regime should be replaced by a new self-certification regime.

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

A7: Markets are cyclical and therefore any test based on number of transactions in a period is in our view inappropriate. Similarly we consider that investments in unquoted companies are likely to be only a part of an investor's overall portfolio of equity holdings. Additionally investors with discretionary portfolios are not responsible for the investment decisions and cannot demonstrate readily appropriate knowledge or experience. Hence we consider that, if quantitative tests are demanded, these should be based on numbers of holdings and total cost in listed companies which are easily demonstrable. By basing the criteria on number of holdings and total cost the criteria would be less volatile. Similarly the suggestion that the holdings in "listed" companies are used is based on the ease of obtaining/confirming such details and because it demonstrates relevant experience of an investor wishing to get involved in early stage equity funding.

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

A8: See A7 above.

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. See Answer A7 above

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

A10: There ought to be no inconsistency.

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

A11: Our primary interest is in companies who are or will be looking to raise finance in the quoted and listed markets.

Q12: Are there particular regulatory barriers preventing angel syndication?

A12: Our primary interest is in companies who are or will be looking to raise finance in the quoted and listed markets.

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

A13: We have two main areas of concern:

- the impact of regulations limiting the initial distribution for quoted [and listed] companies which militates against broader distribution and hence undermines secondary market liquidity. A wider pool of sophisticated investors would be attractive both to issuers and investors. Experience in a number of new issues indicates that such sophisticated investors recognise the value to themselves of distribution to such groups;
- the lack of tax relief on the incidental costs of raising equity. Such relief would lower the cost of raising capital and give it equal tax treatment with raising a loan.

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

A14: The mechanics, using the Internet, are available to manage the distribution appropriately and have been used on a number of issues involving “closed user groups”.

THE QUOTED COMPANIES ALLIANCE (QCA)

A not-for-profit association funded by its membership, the QCA represents the interests of SQCs, their advisers and investors. It was founded in 1992 and originally known as CISCO.

The QCA has over 200 members. 60% of these are smaller companies quoted on the stock market, or companies with aspirations to join. 40% are drawn from the full range of professional advisory firms whose business is either wholly or significantly derived from servicing smaller companies.

The QCA is governed by an elected Executive Committee, and undertakes its work through a number of highly focussed, multi-disciplinary committees and working groups of members who concentrate on specific areas of concern, in particular:

- taxation
- introduction of, or changes to, legislation affecting SQCs
- corporate governance
- share schemes for employees
- trading, settlement and custody of shares
- structure and regulation of stock markets for SQCs; Financial Services Authority (FSA) consultation
- political liaison – briefing and influencing Westminster and Whitehall, the City and Brussels
- accounting standards proposals from the Accounting Standards Board
- company law reform

QCA's Aims

As the only organisation dedicated solely to the particular interests of the SQC sector, the QCA has three primary goals:

Identification

To create a distinct identify for the SQC sector, and demonstrate its value to the stock markets and the UK economy.

Representation

To pro-actively pursue and represent the interests and requirements of the SQC sector to enable it to increase its contribution and ensure that its specific needs are addressed.

Affiliation

To build a strong and vocal collective body of support from within the SQC sector, among corporate directors and securities industry leaders. Through a coalition with quoted company representative groups in the European Union, the QCA participates in the formulation of changes at a European level.

DEFINITION

The Quoted Companies Alliance definition of Smaller Quoted Companies (SQC) is:

- all fully listed companies – excluding the top 350 ie with market cap of €500m+
- plus companies quoted on AIM
- plus companies quoted on OFEX

The QCA also represents companies planning to float.

SQCs contribute to the economy:

- there are approximately 2,000 SQCs
- they represent around 85% of the total of quoted companies by number
- they employ 2 million people
- this figure represents around 10% of total private sector employment
- every 5% growth in the SQC sector could reduce UK unemployment by a further 100,000
- They generate:
 - corporation tax paid of £2.0 billion pa
 - income tax paid of £5.0 billion pa
 - social security paid of £2.0 billion pa

The tax figures exclude business rates, VAT and other indirect taxes.

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