



## ***Informal capital raising and high net worth and sophisticated investors***

### **A response from the Community Development Finance Association (cdfa)**

Our comments are made from the perspective of creating wealth in disadvantaged communities and underserved markets.

#### **Question 1: Are the current exemptions allowing appropriate numbers of high net worth and sophisticated investors to become certified?**

We believe that the exemptions are appropriate but the system for implementing them needs to be reviewed. These exemptions should have a much higher profile among their target market and this will have the effect of increasing the number of certifications which, as the paper acknowledges, is low.

#### **Question 2: Is the lack of certifications posing a problem for smaller firms seeking to raise capital via unlisted equity and for investors?**

It is our experience that this is the case. In particular, there does appear to be an ongoing lack of venture capital available for investments of less than £2 million. This gap could at least partially be filled by high net worth and sophisticated investors if certification were more readily available. The cdfa is particularly concerned about this gap in deprived communities, where there tend to be a large number of micro-businesses and small family-owned companies. Community development finance institutions have emerged to fill some finance gaps in these markets but have tended to focus on their needs so most are offering just debt finance. This can leave a gap in terms of dynamic, fast-growing businesses that would require a venture capital investment to allow them to achieve their ambitious goals. In the first year of the experience of Bridges Community Ventures (one of the cdfa's initial members), for example, the team has rarely encountered a situation in which there was any competition for the investments that Bridges Community Ventures was looking at, which does seem to provide at least anecdotal evidence that there is little finance in the investment size of Bridges Community Ventures (up to £2 million) in deprived areas at least.

#### **Question 3: Do you believe 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?**

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We believe that the implementation of a reasonable belief test should be allowed. However, in order to be effective - particularly for smaller firms – guidance on establishing “reasonable belief” should be made available.

**Question 9: Out of models 1, 2 and 3, which do you think provides the most appropriate balance between investor protection and facilitating investment in SMEs?**

Model 3 seems to provide the most appropriate balance as it proposes the simplest solution to the sophisticated investors issue. However both processes for self-certification need more active marketing and promotion if they are to be successful.

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

Community development finance institutions (CDFIs) specialise in providing access to finance for businesses currently undeserved by commercial banks and traditional equity providers. While many provide debt finance, increasingly CDFIs are providing equity investments for businesses that are high growth but may not offer the same yield and/or have a different risk profile than more traditional equity propositions.

CDFIs in turn raise finance to onward invest and lend from a range of (often socially as well as financially) motivated investors. Currently, many CDFIs use an Industrial and Provident Society structure to raise such investments. There is increasing pressure on this company form by the regulatory authorities and these pressures mean that CDFIs are finding it increasingly difficult to find an appropriate legal form through which they can raise investment which can then be used to onward invest. In effect the lack of access to suitable investment structures and the current costs (both direct and opportunity costs) incurred while the appropriateness of the Industrial and Provident Society structure remains uncertain means CDFIs are unable to reach their full potential in improving access to equity finance for growing firms – particularly those in disadvantaged areas.

The cdfa is the UK national trade association for community development finance institutions (CDFIs). Its members provide loans and equity investment to businesses and individuals that find it difficult to access finance from commercial banks. The creation of a trade association for CDFIs was one of the recommendations made by the Social Investment Task Force in its report, *Enterprising Communities – Wealth Beyond Welfare*, which was presented to the Chancellor of the Exchequer in October 2000.

The **cdfa**'s mission is to promote and strengthen the CDFI sector by supporting its growth and influence, enhancing its capacity to deliver and advocating on its behalf. Our goals include:

- Growth in the size and diversity of the sector
- Improved and sustained performance levels of CDFIs
- Enhanced reputation for CDFIs
- To influence the policies of key stakeholders.
- Excellent services to members