

Accountants and business advisors

**PKF Response to Government Consultation
Document**

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

January 2004

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1 Introduction

This document sets out the responses of PKF to the various questions set out in the Government's recent consultation paper on "Informal Capital Raising and High Net Worth and Sophisticated Investors", issued in January 2004.

2 Question 1

- 2.1 PKF believes that very few certifications are being carried out for either high net worth individuals or sophisticated investors. There are a number of reasons why authorised persons such as PKF are very reluctant to provide these certificates :-
- 2.1.1 In terms of verifying an individual's net assets, the level of due diligence required is unrealistic. Not only does title to every asset (including chattels) have to be satisfactorily confirmed, the bigger issue is the verification of, and indeed existence of, liabilities. Whilst a mortgage on a property can easily be confirmed, it is more difficult to identify liabilities which the individual being certified fails to inform PKF of their existence, for example. It is not possible to contact every bank or other potential lender on the off-chance that the individual has borrowed money from that lender.
- 2.1.2 Matters get worse when the existence of other forms of liabilities are taken into account – eg. are gambling debts to be included?
- 2.1.3 Furthermore, the question of other unspecified liabilities, eg. commitments made to family and friends, is a difficult one. Are these really liabilities and, if so, do they have to be quantified and deducted from the value of the individual's assets? Furthermore, does the individual need to include assets and liabilities of his / her spouse as these are often inter-dependent?
- 2.2 Turning now to the definition of sophisticated investors, whilst in general, it is easy to conclude that a particular individual has the necessary skills in a hypothetical situation, the concern is that, having given such a certificate, the individual starts to appraise an investment opportunity where he is lacking in the relevant skills and experience. In other words, a sophisticated investor may be good in one area but not so good in others. Should this preclude him or her from being able to receive informal capital raising opportunities in those areas in which he / she has the relevant experience?

- 2.3 Finally, the high net worth certification is a transient one. A particular date is taken and an individual's assets and liabilities assessed at that date. It is useless as soon as it is produced as a person's circumstances may well have changed significantly from the date at which it is drawn up. In our view therefore, it would be misleading or indeed dangerous to rely in the future on that certification. So far as the sophisticated investor certificate is concerned, whilst this is purely a judgmental matter, again individuals' experience and skill sets change over time and, in PKF's view, it would be setting a dangerous precedent to rely even on this certification for any reasonable length of time.

3 Question 2

- 3.1 The inability to access high net worth individuals due to their lack of certification under either the high net worth or the sophisticated investor exemptions is undoubtedly causing a problem to smaller firms seeking to raise unlisted equity capital. In the main, the current legislation is, PKF suspects, being ignored rather than complied with. Hence, the hoped for investor protections are, in reality, illusory. PKF believes that business angel networks in particular are handicapped significantly by the current legislation as, for most fund raising activities in the equity gap arena, the costs for producing a fully verified document (to the standard of the POS Regulations 1985, as amended) is unrealistic.
- 3.2 A further question arises as to when an individual is considered "family" or is a "business angel". Whilst there is no specific exemption for members of families supporting other members of their family, it is very rare indeed for such persons to be certified as high net worth individuals or sophisticated investors. Nor does PKF believe they should be so certified, since a family investor is backing an individual he or she knows well, and often the investment is not made entirely for financial gain.

4 Question 3

- 4.1 PKF does not believe that promotions should be allowed on the basis of a "reasonable belief" as an individual is either a certified high net worth individual or a certified sophisticated investor or is not. Unless the potential investor is an out and out liar, this apparent concession will not deliver any increase in the quantity of individuals able to receive informal investment proposals. PKF also does not believe that such investors need to be protected from a plethora of unwanted promotions. It is within the investor's remit to either return such promotions unopened or merely to destroy them and hence, protection from this problem is not, in PKF's view, a big issue.

5 Question 4a

5.1 PKF believes that potential investors should be able to self-certify that they qualify as high net worth individuals. Whilst there is a slight risk of unscrupulous intermediaries pressurising individuals into self-certification which is either false or misleading, PKF believes that the benefits outweigh the disadvantages. Such activities by the aforementioned unscrupulous intermediaries would be best dealt with by the FSA rules on intermediaries being more rigorously enforced, in PKF's view.

6 Question 4b

6.1 PKF believes that the majority of sophisticated investors already meet the high net worth criteria and accordingly, believes that there should only be one set of rules, based on an objective test rather than the current two test models. Whilst there are dangers in this (eg. individuals who are wealthy but do not have the necessary investment skills such as professional footballers), again the advantages seem to us to outweigh the disadvantages.

7 Question 4c

7.1 In PKF's view, if self-certification is to be allowed, then there is no need for the current high net worth exemption, requiring third party verification, to continue because, in our view, it will never be used.

8 Question 5

8.1 PKF believes that the net asset test level for self-certification for high net worth investors should remain at £250,000. This figure, in effect, relates to "free assets" and since the intention is to enable such monies to be recycled into SMEs, an investment of say 20% of this figure would still generate an investment of £50,000.

8.2 PKF believes that by raising the hurdle to £500,000, a considerable number of potential investors will be frightened off, in the firm belief that their free assets, less liabilities, are unlikely to exceed this figure. Whilst EIS statistics suggest that currently 74% of total investment is made by individuals who would meet a £500,000 high net worth test, it is PKF's belief that the rules should be designed to increase the number of potential investors and to set the level of free assets less liabilities this high, would not be in keeping with this policy.

9 Question 6

- 9.1 As mentioned in previous answers, PKF does not believe that there is much merit in the “sophisticated investor” test compared with the high net worth test. Accordingly, PKF does not believe a self-certifying test for this category should be introduced alongside the current regime, as we consider this regime should be scrapped.

10 Question 7

- 10.1 PKF does not agree, as a result of the comments above, with the proposed criteria for sophistication. If necessary, the high net worth individual self-certification could be restricted purely to allow investment in SMEs, thereby not allowing the individual’s to make other forms of high risk investment without having the relevant knowledge or protection. It is noted that the current rules have failed to prevent abuses within the financial sector, such as “split-level” investment opportunities.

11 Question 8

- 11.1 Again, as mentioned earlier, self-certification of a sophisticated investor without detailed criteria against which to test the sophistication of the investor is, in our view, not required. The restriction mentioned in Question 7 above to restrict investment activity to an area which the investor has the requisite knowledge and experience would, PKF believes, be a better safeguard.

12 Question 9

- 12.1 Asked to choose between the three models set out in the Consultation Document, PKF believes that model one, focussing on the net asset test, would be the most appropriate, in order to ensure that investors at least understand the quantum of the risk they are about to take by making such an investment. As to the probability of success or failure, PKF believes it is not sensible to try and regulate for the investor’s judgement on this matter as even the most sophisticated investor (ie. venture capitalists) do not get it right all the time.

13 Question 10

- 13.1 PKF believes that the equivalent amendments to the financial promotion order ought also to be made to the CIS order.

14 Question 11

- 14.1 The other regulatory issue providing a constraint on business angel investment is a requirement to have a financial promotions “authorised” by a regulated body. Removing this constraint would, however, result in a “free for all” with potentially a larger exposure to risk by the investor than might otherwise be acceptable. Nevertheless, PKF believes that Government should review the way in which the financial promotions orders currently work to see if there is room for simplification. For example, at the moment, most business angel investors are concerned at the lack of due diligence and, where it is carried out, the cost of it. There might be a case for ensuring that the party issuing the financial promotion order carries out the due diligence on behalf of the investor and would be liable to the investor for the consequences. This, at least, would ensure that a modicum of due diligence is undertaken in a relatively cost-effective manner, although it is accepted that there will be limited division of duties between the act of raising the capital and the need for investor protection.

15 Question 12

- 15.1 In PKF's view, there are very few regulatory barriers preventing angel syndication. The main concern is a commercial one, namely that business angels like to make their own decisions and hence, syndication can be a frustrating process. It is quite common for five and six investors to agree to make a joint investment under syndication and for one or more to pull out at a late stage. This then leaves the remaining partners in the syndication either to increase the amount of their investment or to search for new investors. All this can slow the process down considerably.

16 Question 13

- 16.1 Again, there are few regulatory constraints on access to equity finance for growing firms and indeed the Government's latest initiatives have increased the supply of such monies, especially in the “equity gap”. However, the cost of making such investment, including the cost of due diligence, still remain high in relation to the amount of money invested. This is a commercial reality and, short of subsidising due diligence, it is not easy to see a satisfactory resolution of this matter. Nevertheless, the need for due diligence, especially in the equity gap area, remains a high priority to provide investor protection.

17 Question 14

- 17.1 PKF recently undertook a report for the SBIT in connection with the availability of private sector intermediation in the equity gap arena. Whilst this document is confidential to the DTI and the SBIT, members of the SBIT have had sight of this report which deals in some detail with this issue.

18 Conclusion

- 18.1 PKF strongly believes that modifications need to be made to the current certification regimes if the level of business angel activity in the UK is to start to grow and mirror more appropriately the level achieved in the United States.
- 18.2 PKF would welcome further discussions on any of the points raised above.

[Email after to Nick and Henry Fairpo for urgent comments]