

Informal capital-raising consultation responses
Enterprise Team (4/N2)
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

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By post and e-mail to: informalcapital@hm-treasury.gov.uk

Dear Sirs

This response is made on behalf of the City of London Law Society Regulatory Committee. We apologise that our response to your consultation: "Informal capital raising and high net worth and sophisticated investors" is past the deadline, due to illness on the part of the writer.

We welcome the fact that HM Treasury proposes to recast the exemptions in the Financial Promotion Order applicable to high net worth and sophisticated investors for two reasons. First, we hope that the current proposals form only one part of a comprehensive effort to reduce regulation which affects small and medium-sized enterprises. Second, we hope that the proposals might represent a first step in a wider review of the financial promotion regime, in which a blanket prohibition, subject to narrow exemptions, might be replaced by regulation targeted at identified consumer protection issues.

In this response, we first respond to the specific questions posed by HM Treasury, and then make some additional observations on the proposals.

Response to questions

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

The current exemptions are not allowing appropriate numbers of such investors to become certificated.

Q2: Is this posing a problem for smaller firms seeking to raise capital via unlisted equity and for investors?

We consider the current exemptions to be of no practical benefit to businesses seeking to raise capital. The firms represented on the Committee act for a variety of private equity and venture capital investors and investee companies. We can think of no occasion on which our

clients have ever relied on the current exemptions. We contrast this with the breadth of the equivalent exemption in the United States, where it is the driver for venture capital and business angel investment. Subject to our comments below on matters of detail, we believe that the changes will be of particular benefit to smaller private equity investors and target businesses and to smaller private equity funds.

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?

We agree that financial promotions should be permitted on the basis of a reasonable belief that an individual is either a sophisticated investor or is a high net worth individual. However, we doubt that there is any purpose in permitting a promotion in circumstances where the person making the communication has a reasonable belief not that an individual has high net worth, but that the individual is in possession of a certificate which evidences that he has high net worth. How should the person making the communication form a reasonable belief that the recipient possesses a certificate, without sight of the certificate? If one has seen the certificate, what is the purpose in providing for communications based on reasonable belief?

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

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

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?

However, we have reservations about private customers self-certifying that they are sophisticated investors. There is potential for abuse of this system by unscrupulous advisers. By contrast, it would be reasonable for a private customer to certify his own high net worth, which can be determined objectively. Nevertheless, as we have pointed out above, the current exemption for sophisticated investors does not work. On balance, we therefore prefer HM Treasury's Model 2, including a test for sophisticated investors.

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

The self-certifying scheme in respect of sophisticated investors in Model 2 only applies to investments in unlisted companies. The certified sophisticated investor can apply to a wide range of investments. While it may not be used much in practice, we do not think that it should be removed because the alternative, the self-certified sophisticated investor, is so much narrower.

Q7: Do you agree with the proposed criteria for sophistication?

The third limb of the proposed test should be deleted: we consider it extremely unlikely that any professional private equity firm makes ten unlisted investments per quarter; for any individual to do so would be practically impossible given the due diligence and documentation necessary for even relatively small transactions. In any event, the number of transactions which a person has recently undertaken is not a meaningful test of his sophistication.

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

We believe that amendments equivalent to those proposed for the FPO should be made to the CIS Order.

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

Other regulatory issues which could prove a constraint relate to the mis-match between FSA rules on customer classification and the proposals. It would be helpful to capital raising by smaller businesses, and logical, if FSA rules on regulatory classification (for example rules on reclassifying a private customer as an intermediate customer) and those built into the financial promotion exemptions were aligned.

The complexity of the financial promotion regime generally is an issue, and we suspect that it is ignored in business to business transactions and trade sales as well as in many cases where small investments are made. It is presently the case that, where a person relies successfully on an exemption in order to make the first in a series of promotions, subsequent promotions by the same person, relating to the same investment opportunity, do not fall foul of the restriction. However, problems are frequently encountered in practice when another person involved in the arrangement seeks to make a subsequent communication, to the same investor, about the same investment opportunity. In these circumstances, it should not be necessary to repeat the rubrics which were necessary in order for the initial communication to satisfy the exemption. This problem applies equally to other exemptions in the FPO as to the proposed exemptions for high net worth and sophisticated investors.

The cost of authorisation (in management time and procedures rather than capital) in the case of business intermediaries dissuades many such firms from getting involved in the marketing to potential investors. Provided they only advise the company raising the funds and do not get involved in negotiations with potential investors, they can usually avoid the need to become authorised. This does not mean, though, that unauthorised firms are of relatively little help in actually obtaining investors for their clients. Some rely on the exemption for non-profit organisations, but this is of limited practical use.

One alternative might be to introduce a genuine “lightweight” authorised regime for private sector intermediaries similar to that which applies to energy and oil market participants (although practical experience has shown that that regime is not as lightweight as had been expected).

In addition, we suspect that a large number of previous such intermediaries were firms of solicitors and accountants which, since they ceased to be authorised firms after N2, have stopped such activity. Although a limited amount of such activity is permissible under the DPB regimes, it is hedged about by the requirement, for example, that the activity be complementary to another professional service supplied to the relevant client and the prohibition on discretionary management. The biggest problem is the prohibition on their issuing financial promotions to their clients unless an exemption in the Financial Promotion Order applies. The experience of this Committee is that, since FSMA came into force, most City firms have prohibited their employees from, for example, informing clients of possible investment opportunities, in order to avoid unintentionally breaching either the financial promotion restriction or the controls on regulated activity.

Availability of exemptions by type of investment

Whilst we welcome efforts to enable private companies to access capital more easily, we believe that there is a need for internal consistency within the financial promotion regime as a piece of investor protection legislation.

It is clearly HM Treasury's policy to relate the exemptions only to unlisted securities. Implicit in the consultation is the assumption that it is easier for a high net worth or sophisticated investor to understand an investment in an unlisted company than in a listed company. We do not believe that this assumption is valid. On the contrary, listed shares, by their nature, present lower risks to investors than do unlisted shares, in the sense that they are issued in a regulated environment in which there are higher levels of transparency and information.

Both proposed new exemptions should be available to allow the promotion of a broader range of securities, and at least listed shares. Both new exemptions should also permit the promotion of collective investment schemes which invest other than in unlisted securities. Both exemptions should permit the promotion of funds of funds (whether the underlying securities are listed or unlisted) because such funds present lower risk to investors.

As far as the drafting is concerned, we have the following comments:

Model 2 - Article 48(6)(c) - the words, "and such approval is, unless this exemption or any other applies, required by section 21 of the Act" should be deleted as it requires a judgement by the issuer whether or not there might be some other exemption available or not. The same point arises in Article 50(4)(c).

In Article 50(1)(e) - this statement should only be required if relevant. Not all investments which may be promoted under Article 50 may involve any additional liability at all, in fact it would be surprising if there were many that did.

Implications of the FSAP

In considering next steps in relation to the proposed exemptions, we hope that HM Treasury will consider the implications of the Financial Instruments Markets Directive and the Prospectus Directive. We assume that the exemptions will be drafted so that they apply to overseas individuals (given the possibility of electronic promotions).

We would, of course, be happy to meet to discuss any of these points.

Yours faithfully

MARGARET CHAMBERLAIN
Chair, CLLS Regulatory Committee