

**HM TREASURY CONSULTATION**

**Informal capital raising and high net worth and sophisticated investors:  
A consultation document on proposed changes to the Financial Promotion  
Order – January 2004**

**Response by**

**Development Capital Exchange (DCX)**

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## 1. INTRODUCTION

Development Capital Exchange (DCX) thanks the Secretary of State for seeking our views.

DCX is a financial newswire for entrepreneurs. Against this simple description the philosophy, since launching as a newsletter (*Capital Exchange*) in 1992, has always been to publish entrepreneurial investment and collaboration information to the widest possible audience of serious potential investors and collaboration partners, so that the flow of capital and resources can follow naturally. This has been achieved through concentrating on effective publishing techniques, as opposed to offering a brokerage type service. The reader is invited to compare this simple approach to an apparently complex issue to the failed 'business angel' initiative promoted firstly by NatWest in 1995 and adopted by the DTI from 1998 onwards.

The reader will note that nowhere in this submission do we refer to 'business angels' unless quoting from other sources. It is our contention that the business angel concept, supported by DTI subsidy and sponsorship from financial institutions has served only to obstruct and impede the flow of informal investment capital into growing enterprises.

We describe it as 'entrepreneurial investment' – a term which DCX would want to be credited with as we seek to distance ourselves from the 'Business Angel' concept as far as possible.

## 2. THE ENTREPRENEURIAL CULTURE

Britain's entrepreneurs, through risking their own money and assets in 2.6m independent enterprises, generate half our national GDP and more than half of all jobs. However, it is not generally realised that unlike the 1800 major corporations capitalised through the stock exchange with £1.5 trillion, these 2.6m enterprises are not just overwhelmingly debt funded (usually secured on the owners family home), they have also always been disadvantaged by not having access to the kind of financial and market information that the plc's enjoy through newswires like Reuters and Bloomburys. This lack of an entrepreneurial market and financial information source has left our entire private enterprise economy fragmented, inefficient and unable to fully exploit its own resources.

A great deal has been written over the past 10 years about Business Angels. The origins of the term can be traced back to William Wetzel Jr of the University of New Hampshire. His research in 1993 showed that 'Business Angels' had invested \$20bn in the US Informal Investment economy, four times that invested by the US venture capital industry.

This culture began in the mid-1950's in Silicon Valley and, since then, has been a significant driving force for the grass roots of the US economy. Chancellor Gordon Brown on returning from Silicon Valley in 1998, after seeing for himself its importance, declared that this entrepreneurial investment and collaboration culture needed to be introduced into the UK. Capital Exchange has been attempting to develop such a culture since 1992, despite being overwhelmed by widely publicised and misleading material promoting the 'business angel' concept through the DTI supported National Business Angel Network (NBAN), which has now admitted its failures.

At the very beginning of the 'Business Angel' myth there was a fundamental flaw, which has carried over into the UK and continues even to this day among those involved in 'Business Angel' market development. The flaw is this: William Wetzel Jr and others failed to realise that informal investment is a natural part of the entrepreneurial culture. It is as natural as setting up joint ventures, strategic alliances and giving consideration to mergers, licensing and other forms of collaboration on an almost daily basis. Attempts to separate this natural entrepreneurial activity into a distinct 'business angel' so-called 'market', have resulted in confusion and widely held misconceptions among entrepreneurs at all stages of growth.

There are not many so-called business angel networks in the USA because entrepreneurial investment is an integral part of the USA business culture promoted through extensive networking, as well as ongoing participation by professional advisors such as business consultants, accountants and others who act as intermediaries as a natural part of their advisory processes.

### 3. RISKS OF INTERVENTION

It is understood that it is the declared intention of the Chancellor to intervene wherever he feels it necessary to promote and encourage private investment and other issues surrounding the enterprise economy. However, it is important to distinguish clearly between intervention and interference.

In the real entrepreneurial world, what starts out as a passing comment about a **market opportunity** might become a discussion about a **joint venture** which, in turn, may progress to negotiations about a **strategic alliance** which could progress to an actual **merger** with additional **funding** for the new enterprise from a third party who could benefit as a supplier to it. The whole process may take weeks, months or, maybe, years and the permutations that might emerge in a specific scenario are infinite. Flexibility, opportunism and the willingness to risk personal capital or assets are the driving forces behind this culture.

The upshot of this culture is that, on occasions that are rarely pre-planned, an entrepreneur will find himself in a position where he has capital available which he can use as he pleases. He can pay off his mortgage, buy a holiday home or, if he can identify a suitable opportunity without too much fuss, bother or expense, invest and become involved in a start-up or growing enterprise. If an entrepreneur comes across a prospective investment opportunity, be it £20,000 or £2m that interests him what, seriously, are the chances of him finding out how to register as a 'high net worth' or 'sophisticated' investor before making his move? An indication of the answer is given by the known number of those already registered, against the known market size in the UK, Australia and the USA.

To illustrate, research is consistent in highlighting that the overwhelming majority of so-called 'business angels' are directors, CEO's or Chairmen of their own enterprises. This theme, constant throughout the endless research that has been undertaken over the past thirty years, from the Bolton Committee report in 1973 and onwards by the ESRC, European Commission, Rural Development Agency, Barclays Bank and others in 1992 and the DTI, NatWest and ESRC in 1995, some of which is highlighted in Appendix I, seems to have passed those who interpret it by. To anyone who understands the culture, however, it is obvious that this is because they are primarily interested in furthering their business interests, be it through investment or collaboration, and they do not feel beholden to register with any authority to do so.

They see no reason to register with anyone in order to risk their own money, which is part and parcel of the career they have chosen to pursue. Indeed, to be obliged to do so would be a sure way of directing their available capital into a holiday home rather than a cash-starved growing enterprise. Middle market estimates would suggest that there are as many as 200,000 entrepreneurs at any one time in a position to invest between £20,000 and £500,000 each in 20,000 – 50,000 start-up or growing businesses. They've been doing it for hundreds of years without having to be certificated to do it.

**Consequently, DCX would suggest that if there is any further attempt at regulating the free flow of entrepreneurial investment and collaboration information or trying to identify and certify those qualified to make entrepreneurial investments, there is a genuine risk of causing severe and lasting trauma to the private enterprise economy, which currently accounts for half of GDP and more than half of all jobs.**

#### 4. RESPONSE TO QUESTIONS:

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

**Q12: Are there particular regulatory barriers preventing angel syndication?**

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

The answer to all these questions centres on the way in which the investment opportunity is promoted. In the 27<sup>th</sup> January 2004 edition of the *Financial Times* Jonathan Guthrie, a respected commentator writing about informal investment, made the assertion that ...'investments are generally sold rather than bought...' Where an investment is presented in the form of a *prospectus*, this is true.

The prospectus is a document, produced within the regulatory environment, which expects the investor to write a cheque on the strength of what he reads in it, in the safe and secure knowledge that it's production is governed by stringent financial regulation. And so it should be, in order to protect the investor.

However in the entrepreneurial investment market, predominantly in the £20,000 - £2m range, the core document is the **business plan**. This is produced by the business itself, very often with the assistance of it's professional advisors which is simply a statement of where the business has come from, where it's at, where it wants to get to and how much it's going to cost to get there. Nowhere in it does there appear an offer of shares (or there *shouldn't!*).

Very often the funding requirement to achieve these objectives is too much for the bank to lend against, because there is no collateral left and too little for the venture capital companies to bother with, because the cost of due diligence cannot be justified. This is the cause of the 'equity gap', which can only be filled by entrepreneurial investment.

In these cases, and leaving aside how the two sides of the equation are brought together, the investor meets with the company and it's directors. He injects his own business and market experience into the business plan, sees if there is room for him to contribute his own particular business skills and experience to the board and conducts his own due diligence, with the support of his professional advisors before making an investment decision. If he decides to move ahead everything becomes negotiable. Equity participation, exit route, bank mandates, shareholders agreements, directors service contracts and all other documents and agreements are produced within existing company law, with the support of legal and accountancy advisors before any money is handed over. Every single agreement is unique.

Entrepreneurial investment, potentially 20,000 – 50,000 deals each year, is bought - not sold. This is far removed from the regulated environment.

#### **OUR PROPOSED ANSWER:**

Proposed changes to the Financial Promotion Order should:

- a) Clearly separate the *prospectus* from the *business plan*.
- b) Introduce a fixed form of words that should be carried as the very first page of any business plan produced with a view to securing entrepreneurial investment. Warning of the risks and keeping at bay those who are not experienced in conducting their own business affairs.
- c) Allow business advisors, including non-authorized consultants and others, to promote business plan-based entrepreneurial investment opportunities on behalf of clients, who will not reveal the name of the client on the newswire. However, in order to exclude inexperienced investors which might be attracted to the opportunity through the wider media, they should be advertised ONLY on DCX, a specialist newswire open only to experienced entrepreneurs, corporate venturers and enterprise funds.

- d) Promote DCX as the specialist information medium through which such opportunities can be reported and/or advertised and to which only people declaring themselves to be confident in their business abilities (as already promoted in our warning in the DCX registration zone) should subscribe. In this way, the proposals above can be promoted through DCX Associates and the DCX newswire itself can introduce systems to ensure that such standards are being maintained and, perhaps, developed through the professional standards association we want to encourage our associates (currently 300 but potentially 5,000) to establish.

All the above suggestions are made with a view to keeping regulatory, promotion and other costs for those seeking as well as offering entrepreneurial funding under control, at the same time introducing a degree of quality control over entrepreneurial investment opportunities that are actually promoted on the newswire.

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

Yes, but the more intermediaries there are the more fragmented the 'market' becomes if it does not have a common information medium. How would the City's stockbrokers, merchant banks, corporate finance, merger and acquisition houses, the stock exchange and the UK's 1800 publicly listed corporations operate without newswires like Reuters or Bloomburys?

In the USA, information flows freely through informal networks of entrepreneurs, their advisors and a few structured networks operated by the major consultancy and business advisor operations. It is a combination of the formal and informal US structure that DCX is setting out to introduce into the UK. The newswire approach, given sufficient support from HM Treasury and others would actually encourage new intermediaries into the market through consultancy and accountancy operations becoming involved.

Whilst research shows that most entrepreneurs (inaccurately identified solely as 'business angels') identify opportunities through their own networks of contacts and advisors, they are limited in their range and scope because these networks are necessarily parochial. DCX, operating simply as the financial newswire for entrepreneurs, overcomes this parochialism.

However, participation by these networks in DCX is minimal as, for some reason, they regard us as some kind of competing 'bulletin board' when, in fact, ours is a highly structured news and information service which complements, not competes with, the intermediaries. The overwhelming majority of our subscribers are individual entrepreneurs who want to keep their 'ear to the ground' for opportunities, be they investment or collaboration, that might interest them.

The issue is not so much of a 'finance' or 'equity' gap – it is an 'information gap' which DCX is uniquely positioned to fill.

The need is so obvious that, perhaps, it has been overlooked by all concerned. DCX takes this opportunity to bring our philosophy to the attention of those who influence these issues, at the same time pointing out that D.C.X. Ltd retains copyright and intellectual property rights to our philosophy, *modus operandi*, all material and submissions produced by us. We would vigorously resist any moves by government to 'intervene' by setting up its own informal investment information, publishing or news service which could be perceived as competition to D.C.X. Ltd in the same way that the DTI-subsidised NBAN has severely impacted our operations from 1998 onwards.

## **5. OTHER ISSUES FOR CONSIDERATION**

### **a) Start-up bank lending**

It is well known, supported by DTI and VAT registration figures, that forty percent of businesses fail within the first three years of start-up.

In a recent advertising campaign, Barclays Bank announced that they help 1,000 businesses a week to start-up. A subsequent campaign by NatWest announced that they help even more. Would these campaigns encourage so many people to start their own businesses if they also carried a 'wealth warning' announcing: "Forty percent of start-up businesses fail within three years. Your business loan must be repaid whether or not your business succeeds'?"

There is a very simple procedure that could be introduced to dramatically reduce this failure rate at the loan approval stage. This would reduce the number of borrowers suffering the trauma of failure and, also, the banks' bad debt provisions.

### **b) Involvement of entrepreneurs**

How many individuals in the intervention and regulation decision-making process have actually risked their own money or assets (usually the family home) on starting or growing their own business be they at the FSA, HM Treasury, DTI, Venture Capital funds or anywhere else? The decisions and interpretations on research that have been made over the past decade would suggest that it is not many, if any at all.

Entrepreneurs should be involved in this process. Not the high-profile ones like Richard Branson who have access to finance and all the other advantages of success, but representatives from among the millions of 'Joe Battlers' who are constantly struggling against under-capitalisation and market domination by the major corporates.

Only then will valid decisions be made that can be accepted and responded to by the estimated three million British entrepreneurs they affect.

## ANNEX I

**RESEARCH AND DATA REVIEW SUBSTANTIATING THE CASE FOR  
DEVELOPMENT CAPITAL EXCHANGE (DCX)**

**The following are extracts from relevant research with, where appropriate, DCX interpretations and comments:**

**ESRC Research, 1992, funded by Barclays Bank, DTI, European Commission and Rural Development Commission**

“...vast majority of investors were male, aged 35-65 and either business owners, managers or chief executives”

*DCX – meaning that these individuals are entrepreneurs who, by their very nature, are as much interested in expanding their existing interests through further exploiting their business assets such as production, marketing and distribution (collaboration) as they are in direct cash investment.*

“Over 60 per cent had experience of setting up their own business...”

“93 per cent were looking for high capital appreciation with expected annual rates of return between 30 per cent and 40 per cent for investments in pre-start-up and start-up companies to 20 per cent for...more established firms.”

*DCX – meaning that it is unlikely that a sufficient number of suitable opportunities to provide quality of choice are going to become available through parochial networks operating without a common news/information medium.*

“Few investors were members of organised business referral organisations and most learned of new openings through friends, business associates and the press.”

*DCX – questioning the validity of the ‘more business angel networks’ argument and reinforcing our proposition to release the flow of information so that the flow of capital and resources can naturally follow.*

“70 per cent of those questioned would have invested in more businesses if they had known about them...in most cases they had invested only 30 per cent of their available capital.”

*DCX – “...if they had known about them...” yet again reinforcing the argument to release the flow of information so that the flow of capital and resources can naturally follow.*

“A separate survey of non-investors highlighted their reasons for never investing in small businesses. The main reason was lack of information about firms needing extra finance: 48 per cent fell into this category.”

*DCX – do we really need to articulate it again?*

**Dr Colin Mason and Prof Richard Harrison, 1995, research for Venture Net, a project resulting from the network of 3,000 consultants, which had developed through the DTI’s Enterprise Initiative (1992-1995).**

“Estimates of the number of business angels in the UK range from 30,000 - 50,000. In terms of the amount invested, SMEs are estimated to have raised about £2bn from the informal venture capital market (although recent research suggests this may be a significant underestimate).”

“The potential scale of the informal venture capital market is considerably greater than these figures suggest. First, most business angels cannot find sufficient investment opportunities that meet their criteria and so have substantial amounts of finance available for informal investments. Research is consistent in finding that between two-thirds and three-quarters of business angels would have invested more if they had come across a greater number of suitable investment opportunities. Moreover, the sums that these investors say they have

available for investment are significant, frequently exceeding the amounts that they have already invested. This reflects the fact that the search for, and appraisal of, investment opportunities is a time-consuming activity.”

“Research amongst potential Angels suggest that their inability to identify firms, which require finance, is the main reason why they have never invested in entrepreneurial companies.”

“As a result of these inefficiencies the potential of the informal venture capital market remains under-utilised. Business angels want to make more investments but cannot find sufficient investment opportunities that meet their investment criteria. Others are discouraged from becoming business angels by their inability to find investment opportunities. Meanwhile, the invisibility of business angels, which is associated with their desire for anonymity and the lack of public records of their transactions, renders them very difficult to identify by entrepreneurs seeking equity finance.”

*DCX – VentureNet disappeared without trace, because it tried to deliver a macro-economic solution with micro-economic (fee-based brokerage and deal matching) tools. The DCX Newswire argument is constantly reinforced throughout this research: release the flow of information so that the flow of capital and resources can naturally follow.*

#### **NatWest/DTI/ESRC, 1994, in preparation for launch of NatWest Angels Service.**

“...there are 200,000 – 400,000 potential investors with £20,000 to £500,000 each to invest in unquoted companies.”

*DCX – In truth, estimates vary between 20,000 and 400,000 but these numbers more than support a newswire/information dissemination product for the market. We believe there is a constant middle market fluctuating around 200,000.*

#### **Cruickshank, 2000, Report into Competition in UK Banking**

“...it is suggested that between 20,000 and 50,000 businesses are seeking equity funding (£20,000 - £5m) at any one time...”

*DCX – Again, these numbers support the need for the DCX Newswire.*

#### **Booz Allen & Hamilton, 2001**

“...more than 20,000 alliances have been formed worldwide (1998 through 2000), approximately 70% contained equity.”

*DCX – while this survey was essentially based on the middle-market, the principle of a permutation of alliance (through introducing additional resources) and capital is clearly illustrated in 70% of transactions. The principle applies as much to smaller businesses and ‘business angel’ investment. This vital collaboration element has not been supported in any respect by the DTI.*

#### **Association of Strategic Alliance Professionals**

“A January 2000 survey of 1300 US and European firms revealed that strategic alliances are very much preferred over VC, IPOs and mezzanine financing.”

*DCX – Again, the survey was taken on middle-market companies, but the principle applies even moreso to smaller enterprises, as strategic alliances offer them the opportunity to retain a larger equity holding in the businesses they have built. Ie: their ‘sweat equity’ has the opportunity to build value.*

**APPENDIX II**  
**PRESS RELEASE**

## MEDIA INFORMATION

### **FINANCIAL NEWSWIRE FOR ENTREPRENEURS**

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#### **Fills Information Gap in Entrepreneurial Investment Market**

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A newswire bridging the information gap between as many as 50,000 capital-starved growing businesses and the 200,000 successful entrepreneurs who want to invest in them is now available at [www.dcxworld.com](http://www.dcxworld.com). Launched originally as a newsletter in 1992, Development Capital Exchange (DCX) has spent three years establishing its service on-line and has now completed a year of testing in order to ensure that a robust and reliable service can be delivered. On 30<sup>th</sup> Dec, BBC News 24 compared the DCX newswire for entrepreneurs to that of Reuters and Bloomburys providing investment, joint venture, strategic alliance, merger and acquisition news to major corporates.

DCX CEO David Rose said: "It's not generally appreciated that Britain's entrepreneurs, through risking their own money and assets in 2.6m independent enterprises, generate half our national GDP and more than half of all jobs. However, unlike the 1800 major corporations capitalised through the stock exchange with £1.5 trillion, these 2.6m enterprises are not just overwhelmingly debt funded (usually secured on the owners family home), they have also always been disadvantaged by not having access to the kind of financial and market information that the plc's enjoy through newswires like Reuters and Bloomburys. This lack of information, focused on the needs of entrepreneurs, has left our entire private enterprise economy fragmented, inefficient and unable to fully exploit it's own resources. By releasing the flow of information from the growth company sector, DCX provides entrepreneurial investors and corporate venturers with the opportunity to make much better informed decisions about how and where to target their capital, resources and valuable business experience."

It is estimated that there are as many as 200,000 entrepreneurs at any one time with capital available of between £20,000 and £500,000 each to invest in growing enterprises. DCX subscribers set their preferences in the DCX Newswire zone at [www.dcxworld.com](http://www.dcxworld.com) and then

receive e-mail news alerts announcing innovations, new products and processes in those markets that interest them and in which they can participate through direct investment, joint venture or other forms of collaboration if they wish. Those they are not directly interested in are treated as background market intelligence.

The DTI Finance Gap report in December 2003 showed that more than 18,000 growing businesses each year are seeking early-stage funding, yet as few as 135 actually find it. Other estimates quote between 20,000 and 50,000 businesses at any one time unable to find equity funding for expansion. DCX fills the information gap, also mentioned in the DTI report where, until now, there has been no way of conveying the funding needs of capital-starved growing enterprises to the capital-rich successful entrepreneurs who want to invest in them. Only entrepreneurial investors, along with a few enterprise funds can fill this equity funding gap, usually regarded to be the point above which the banks run out of collateral to lend against (c£20,000), and the threshold below which venture capital funds cannot justify the cost of due diligence (c£5m).

DCX subscribers themselves provide joint venture, strategic alliance, merger and business-for-sale news items. Forty percent of start-up businesses fail within the first three years, something of which investing entrepreneurs are well aware, but DCX is doing all it can as a publisher to ensure that only those which have at least produced a quality business plan achieve exposure on the newswire.

The core document for this type of unregulated investment is the business plan, which is a basis for negotiation as opposed to the prospectus, which is an actual offer of shares. All deals are negotiated directly between the investor and the directors and shareholders of the investee company, with shareholders and other agreements produced with the support of their respective professional advisors.

**Rose added: "Until now, entrepreneurs have never had access to the kind of financial and market information that major corporates find so indispensable, which is the real reason why the entrepreneurial investment and collaboration market has never been able to flourish and why so many enterprises never achieve their full potential. Now, by releasing this information DCX can facilitate as many entrepreneurial investment, joint venture, strategic alliance and merger deals as the market can stand."**

Further information at [www.dcxworld.com](http://www.dcxworld.com).

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