

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

Date 19 April 2004  
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Dear Sirs,

### **Consultation document on proposed changes to the Financial Promotion Order**

Set out below are responses of Eversheds LLP to questions raised by HM Treasury paper on Informal capital raising and high net worth and sophisticated investors: A consultation document on proposed changes to the Financial Promotion Order - January 2004:

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

**Answer to Q1:** No, it is very rare for an investor to be certified as a high net worth investor or a sophisticated investor.

**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.

**Answer to Q2:** We agree with the statement in paragraph 2.2 of the Treasury paper that an important minority of innovative, growth-orientated businesses continue to face difficulties attracting funding. Since the current exemptions are only allowing insignificant numbers of high net worth and sophisticated investors to become certificated this prevents many of such businesses raising capital from such investors.

**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?

**Answer to Q3:** Yes. (We do not see why this should be limited to investments in unlisted companies - we understand that a broader self-certification exemption applies in the US).



**Q4A:** Should potential investors be able to self-certify that they qualify as high-net worth individuals?

**Answer to Q4a:** Yes. (We do not see why this should be limited to investments in unlisted companies - we understand that a broader self-certification exemption applies in the US).

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

**Answer to Q4b:** We do not have any information on this.

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

**Answer to Q4c:** The self-certification exemption should replace the current high net worth exemption. (We do not see why this should be limited to investments in unlisted companies - we understand that a broader self-certification exemption applies in the US).

**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.

**Answer to Q5:** The test should remain at £250,000.

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

**Answer to Q6:** A test for self-certifying as a sophisticated investor should replace the existing regime for certification as a sophisticated investor.

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

**Answer to Q7:** We agree with the proposed criteria for sophistication.

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

**Answer to Q8:** No.

**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.

**Answer to Q9:** We consider that there should be self-certification for both high net worth and sophisticated investors and an objective test for self-certification and therefore recommend Model 2 as providing the most appropriate model from amongst those offered in the consultation document.

**Q10:** Should amendments equivalent to those made to the Financial Promotion Order (“FPO”) be made to the CIS Order?

**Answer to Q10:** We agree that the changes to the FPO and the CIS Order should be harmonised. We note that the definition of self-certified sophisticated investor proposed for the CIS Order is not limited, as the definition proposed for the FPO is, to investments relating to unlisted companies. We suggest that that limitation should be removed from the proposed amendments to the FPO.

**Q11:** What other regulatory issues are providing a constraint on business angel investments?

**Answer to Q11:** See answer to question 12. In addition the ability to form an investment company investing in SMEs is seriously inhibited by the current form of Articles 14 and 15 of the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 S1 2001/1544 (“the RAO”). Article 14 provides that dealing in investments as principal by buying, selling, subscribing for or underwriting shares or other securities as principal is a specified kind of activity requiring authorisation under the Financial Services and Markets Act 2000 (“FSMA”). Under Article 15 (Absence of holding out etc) of that Order a person (“A”) does not carry on an activity requiring regulation by entering into a transaction which relates to a share or other security unless -

- (a) A holds himself out as willing, as principal, to buy, sell or subscribe for investments of the kind to which the transaction relates at prices determined by him generally and continuously rather than in respect of each particular transaction;
- (b) A holds himself out as engaging in the business of buying investments of the kind to which the transaction relates, with a view to selling them;
- (c) A holds himself out as engaging in the business of underwriting investments of the kind to which the transaction relates; or
- (d) A regularly solicits members of the public with the purpose of inducing them, as principals or agents, to enter into transactions constituting activities of the kind specified by article 14, and the transaction is entered into as a result of his having solicited members of the public in that manner.

The difficulty relates to (d). In paragraph (d) above, “members of the public” means any persons other than -

- (a) authorised persons or persons who are exempt persons under FSMA in relation to activities of the kind specified by article 14;
- (b) members of the same group as A;
- (c) persons who are or who propose to become participators with A in a joint enterprise;

- (d) any person who is solicited by A with a view to the acquisition by A of 20 per cent or more of the voting shares in a body corporate;
- (e) if A (either alone or with members of the same group as himself) holds more than 20 per cent of the voting shares in a body corporate, any person who is solicited by A with a view to -
  - (i) the acquisition by A of further shares in the body corporate; or
  - (ii) the disposal by A of shares in the body corporate to the person solicited or to a member of the same group as the person solicited;
- (f) any person who -
  - (i) is solicited by A with a view to the disposal by A of shares in a body corporate to the person solicited or to a member of the same group as that person; and
  - (ii) either alone or with members of the same group holds 20 per cent or more of the voting shares in the body corporate;
- (g) any person whose head office is outside the United Kingdom, who is solicited by an approach made or directed to him at a place outside the United Kingdom and whose ordinary business involves him in carrying on certain activities specified by the RAO.

This is an unusual definition of members of the public. It does not match other definitions of the public and it does not exclude, for example, sophisticated investors or high net worth investors or high net worth companies or trusts. The effect of these provisions is that, for example, a company which regularly contacts small and medium sized companies with a view to investing in them may be conducting a regulated activity requiring authorisation under FSMA unless that individual or company is always seeking to acquire more than 20% of the voting shares in the companies, which may not be commercially acceptable or sensible.

We recommend that Article 15 of the RAO should be redrafted so that it clearly does not apply to business angel activity or to the making of investments in stocks, shares and/or investments acknowledging indebtedness of an unlisted company.

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

**Answer to Q12:** Business angel syndication activity may constitute the regulated activity of arranging deals in investments under Article 25 of the RAO and hence require authorisation under FSMA. Currently there is an exemption under Article 28 of the RAO in respect of arranging transactions to which the arranger is a party. Enterprise schemes, as defined in paragraph 4 of the Schedule to the Financial Services and Markets Act 2000 (Exemption) Order 2001, are exempt from the requirement for authorisation under FSMA in respect of the activity of arranging deals in investments under Article 25 of the RAO so long as they do not carry on that activity for, or with the

prospect of, direct or indirect pecuniary gain (as defined in that paragraph). Thus Article 25 of the RAO is a regulatory barrier to business angel syndication by any person who is unable to take advantage of one of those 2 exemptions.

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

**Answer to Q13:** See the answers to questions 11 and 12. In “Launch Pad - a Model for a First Stage Equity and Loan Fund” prepared by Kevin Caley and Ian Cruddas as a Phoenix Fund Project initiated by Sheffield Enterprise Agency it was calculated that obtaining authorisation from the Financial Services Authority under FSMA for small venture capital operations would cost £45,000 in professional fees and staff time and then the annual additional costs of regulation would be in the region of £30,000. These costs of FMSA regulation are particularly a barrier to the formation of limited partnerships investing in growing firms. However, limited partnerships (which are unregulated collective investment schemes) are the accepted form for private equity and venture capital investment.

Consideration therefore should be given to exempting from Article 51 of the RAO the activities of establishing, operating or winding up an unregulated collective scheme which invests wholly or predominantly in investments falling within paragraphs 14 and/or 15 of Schedule 1 to the Financial Promotion Order being stocks, shares and/or investments acknowledging the indebtedness of an unlisted company and which is promoted only in reliance on exemptions provided in the Financial Promotion Order and CIS Order (as amended pursuant to the Consultation Document).

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

**Answer to Q14:** Our experience of advising regional development agencies on setting up schemes and funds for venture capital investment is that there is a severely limited supply of suitably qualified intermediaries who are prepared to offer their services in this area.

We would be pleased to expand on any of the answers given above if this would be helpful.

Yours faithfully,

**Ronald Paterson**  
**Partner**  
**Eversheds LLP**