

## RESPONSE FROM JON MOULTON

Dear Sirs,

### **Informal Capital Raising**

I am writing in response to the Treasury paper of 24<sup>th</sup> January 2004.

By way of credentials my day job is running Alchemy Partners, the private equity firm and my hobby is investing in private companies – I have invested in over 150 over the past 23 years. I currently hold investments with a cost of about £13.5m in some 95 positions.

I will not debate the point that the equity gap might actually be largely generated by the general lack of return existing to those filling the gap. It may well be that “hole” is a better word than “gap” though.

There is no question that personal equity investing in small unquoted companies is very risky. A very substantial majority of such investments end in failure.

My daily experience is that the current restrictions are very widely ignored and not policed at all. Out of 10 proposals put to me it is unusual for 1 to follow the FSMA rules.

Before I start the “authorized” questions list, might I point out the following:-

Out of 20 people approached on a typical fundraising it may be that 1 proceeds to invest. The application of regulation to the other 19 is a waste of time and expense. A BIG POINT!

Regulation should be a condition precedent to investment not to solicitation. This is more material than the proposed changes.

Questions:

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

A1: No. Certification is hardly used and difficult to obtain. There is no satisfactory means for a 3<sup>rd</sup> party to confirm anyone’s net assets as they cannot guarantee full disclosure of liabilities. Earnings are also not always easy to verify and they change.

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?

A2: A little. Generally they ignore it and the only victims are those that gesture at compliance.

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?

A3: The issue is still silly. Solicitations are a nuisance but not worse. Solicitation should be allowed on the basis that there is a reasonable belief that someone might qualify as a sensible investor. Investment should require a stronger basis.

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

A4a: Yes. Particularly as 3<sup>rd</sup> parties cannot reliably do so without powers of discovery normally reserved for bankruptcy investigation!

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

A4b: Probably. Frankly how could I know?

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

A4c: Replace. There is no need for a second process.

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.

A5: This is where the foolishness of the current regime – and the proposals – becomes most obvious. If I am asked to invest £1m and my net worth is £250k, then the investment is imprudent – but if I am asked to invest £20k it probably is not so personally risky.

Any level should be set at something proportionate. Investors who could certify that the investment does not exceed (say) 25% of their net worth before investment could be allowed to complete an investment.

It is not the presumed intent of policy to stop someone investing £10k into (say) a new shop out of £100k net worth – proportionality is the issue not absolute magnitude. And small investment should be encouraged.

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

A6: Yes – and no! The test should be introduced but not “alongside”. It is fictional to imagine that authorized persons are generally equipped to give the required judgement.

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

A7: No. The proposals are absolutely ludicrous in the detailed drafting proposed and largely do not reflect the very varying requirements (possibly uncatchable) to review and evaluate diverse unquoted investment risks. Such risks range from technological to legal to financial to managerial and are not obviously caught in actuarial training!

A major problem in financial regulation generally is the complexity thereof. In this area of smaller companies the likelihood of the entrepreneur, or his adviser, following “proposed Article 50A(4)(b) in Schedule 1 to the Model 2 draft S1 at Annex B” (doubtless as amended) is insignificant.

In 4.15 of the text there is a request for evidence. This is not easy as presumably the concern is to demonstrate that some lack of sophistication demonstrably generates a level of loss. I do not believe any meaningful study exists, or could be constructed in the practical world.

I would suggest that the “sophisticated investor” test be reduced to a requirement that the investee reasonably believes the investor capable of understanding the nature of the material risks inherent in the investment and that they have been brought to his attention. Otherwise, to be effective, particularly for a wider range of investments (hedge funds etc) the requirements need to be onerous or inadequate.

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

A8: Obviously as the question is constructed the answer is no. However, the lack of appropriate and relevant “detailed criteria” is a serious issue for any form of certification.

Q9: Out of the 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?

A9: Again I find the question unduly restrictive. 2 is the best of a bad lot. Haemorrhoids are better than tumours but it does not make them necessary. Given the lack of compelling evidence for the scale of damage arising without regulation it is impossible to give evidence to support one inappropriate regime or another. Cost-effectiveness should feature more in this consideration.

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

A10: CIS are usually quite different from one-off angel investing with appropriately different risks and costs. The desire for consistency is misplaced.

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

A11: The biggest threats to angel investing are excessive regulation either in Financial Services or in taxation. Complexity exists at levels not justifiable and not followable by smaller enterprises and investors.

Q12: Are there particular regulatory barriers preventing angel syndication?

A12: No significant barriers outside Financial Services regulation.

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

A13: Excessive complexity of Financial Services regulation and taxation. Perhaps not in the intended field of this paper but the new Schedule 22 effects on taxation of management equity are likely to be severe and adverse – indeed they are already restricting transactions.

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

A14: There is no visible shortage. Quality is an issue and likely to remain so given the small investment sizes with corresponding small rewards for intermediaries.

I can confirm I have no issue with the non-confidentiality of response and would be happy to respond to any queries.

Yours faithfully,

**Jon Moulton**