

CONSULTATION PAPER ON PROPOSED CHANGES TO THE FPO

RESPONSE FROM BEER & PARTNERS LTD

BACKGROUND

Beer & Partners is the largest, indeed just about the only, authorised private sector participant in the “business angel” market. We see around 3,000 proposals each year seeking capital in the £100,000 to £2,000,000 range, accepting about 150 of these each year as clients. In 2003 we achieved a “success” rate of 46%. We have around 900, mainly private, investors registered with us and 10 offices around the country. We are FSA authorised.

Furthermore we have the only known publicly available certification process for sophisticated investors, www.sophicert.com. In the 14 months that this has been available, I have signed 2 certificates. I have never seen an HNW certificate.

I believe therefore we are very well positioned, perhaps uniquely so, to give a useful response to the Consultation Paper.

OVERVIEW

I will deal with each of the questions posed in the order given, but believe very strongly that the issues are wider and deeper than the paper implies, and will include these matters in the responses at the appropriate place. I have touched on these in a separate e:mail to Phil Wynn Owen of FRI Directorate following our very welcome meeting of 11 March at Treasury (Minister present).

It may seem paradoxical that an authorised firm such as mine, one of very few in the angel market, is seeking relaxation of the regime, since this relaxation would lose us market advantage (at least it would if the law were to be observed). It is however more important that the market is opened out sensibly, and to the private sector.

Having said that, I very much welcome the opportunity to broaden our discussion not merely to the finer points of the FPO, but to SME funding generally and am particularly gratified at the interest that Ruth Kelly is taking in these matters. Any criticism should please be read in that context.

I am also grateful to Daniel Tunkel of S J Berwin for advice on some of the more complex technical points: any opinions given are however mine alone.

You will also see throughout this response that I have a number of queries, mainly concerning the apparent irrationalities of the current and horrendously complex legislation. These are not rhetorical, and if Treasury really do wish to engage with a market whose importance is way out of proportion to its size in money terms, then could you please do so. Useful though discussions with Treasury and DTI have been, I have been disappointed with the feedback, particularly where the end result of these discussions have been at variance with practitioners’ recommendations, for example on the Enterprise Funds. It would be very helpful, to our understanding and to perhaps the Government’s, if I could appreciate the rationale behind the decisions taken; we all want to help in any way we can after all. I don’t mind being wrong!

In endeavouring to cover each of the 16 questions fully, I appreciate that my overall recommendations for a completely new structure of regulation are hard to pick out; I have therefore added a synopsis at the end.

Q1. Are the current exemptions allowing sufficient numbers to become certified?

No. There are a number of reasons for this, each of which will need to be dealt with under any new proposals else the problems will not be resolved. I am incidentally assuming that there is now no question that the current regime is actually working – as I said I have signed 2 certificates in two years and never seen others. The reasons are:

- Investors do not want them. This is because they lose rights if they are certified. Not having a certificate means that the promoter has broken the law, which means that an investor can void the investment contract and get his money back – at least try to. He will not of course attempt to do so if the investment has done well. In other words refusing to be certified gives an investor a two way bet. It is perhaps not too strong to suggest that it is a crooks charter. The argument that only by being certified can an investor be allowed to see unapproved investment opportunities is facile and misreads human nature.
- Authorised persons, employers, accountants etc who are asked to sign certificates risk their livelihood for scant reward. If they get it wrong, FSA would quite probably (at least in the signatory's eyes) put them out of business. An investor is highly unlikely to want to pay for a certificate, given the point above. Frankly my firm has taken something of a calculated risk in Sophicert in order to play our part in opening up the market as best we can.
- The very person who is in the best position to gauge either wealth or sophistication – the investor's financial advisor – is in effect barred by law from doing so, since he may not then carry out investment business with that investor. This shows particularly bizarre thought processes on the part of the draughtsman and assumes that financial advisors would recklessly hazard their reputation, and FSA authorisation by certifying recklessly.

If we do stay with third party certification, the above mistakes should no be repeated.

Q2 If no, is this a problem for smaller firms seeking to raise capital through unlisted equity?

No. This is simply because the law is being ignored. It might be more accurate to say that it is only a problem if a promoter seeks appropriate advice; not that many lawyers appear to fully understand the Regulations, but that is a separate issue that I will deal with later. I think Caroline Williams (a lawyer) at the 11 March meeting put it very neatly when she said that seeking advice put promoters at a disadvantage; that is very true. Most of the 2/3,000 businesses we see have already been through the friends and family route, usually illicitly, and almost universally in ignorance of that fact. We have stopped asking them whether they took appropriate advice to ensure that their "F&F" round fell within the exemptions, since we know what their answer will be (a puzzled look!).

So we are left with the interesting situation that the law is being ignored almost without exception, yet no one seems to have been damaged as a result. In the 8 years that my firm has been going, during which time we must have seen 10/15,000 companies, I have yet to come across a single instance of this causing a problem to investors. That is not to say that investors do not lose money in our markets; of course this happens, but that is not the issue. Actual cheating must be a very very rare occurrence in my experience. In any event there are sufficient weapons at our disposal, such as the Theft Act, to take appropriate action against miscreants and misleaders. So I think we should question the very fundament of the certification process. Put simply, if we do not need it, why have it. After all in our markets the promoter needs protection more than the investor – who please is protecting the promoter from wealthy, experienced and evil-minded investors? Beer & Partners does its best through public domain checks, but we do recognise that these are not always adequate.

Q3 Do you agree that promotions should be allowed on the basis of a reasonable belief that an individual is certified?

As stated above, I do think that the premise is flawed, in that formal certification is unnecessary (see also Q9). I am however willing to accept that a complete free-for-all may be, for the time being at least, politically charged, and will answer this point too. Yes “reasonable belief” should be permitted. It would be absurdly bureaucratic if a promoter should be required to actually see a certificate (since that is the effect of the FPO). At the moment conversations with potential investors can only begin along the lines of “I must ask you whether you are a certified investor, but I must not tell you why I am asking you that question”. A quite absurd situation of course and hardly conducive to a free flow of information, but the only one permitted by the existing FPO.

Incidentally none of the formulations of the Amendment Order included in the Consultation Document deals adequately, at least in my view, with the “reasonable belief” test and the language found in the existing Article 50 is retained unamended; this drafting point should be addressed.

It would be wrong to limit the exemption to the communicator of the promotion. The increasing use of internet is very likely to lead to second/third hand promotions to potentially certified HNWs. Whilst the original source of the promotion may have actual knowledge of the investor’s status, the person who actually makes the promotion will not, and will need to rely on other people’s knowledge and belief; that makes them very vulnerable.

We need care in “reasonable belief”. Where is the burden of proof? It must rest with prosecuting authorities, but would it in reality? FSA, who are fortunately silent on Business Angel matters – quite rightly they must look at this market as being at the very lowest point of their risk spectrum – should give guidance on a “reasonable belief” test. I accept though that such guidance would not have the force of law, and might not protect the promoter in a borderline case from possible prosecution. Perhaps prosecuting authorities, in the event that prosecution ever occurs, should be given a clear message that they need to be satisfied that a promoter acted “recklessly”. That is a well established term in law I understand.

Q4a. Should a potential investor be able to self-certify that they qualify as high net worth?

Yes. There are two reasons for this:

- a. Who else will be willing to certify? There are real risks here for, say, an accountant should he issue a certificate ill-advisedly. They are no doubt aware that the very wealthy will not necessarily disclose all of their financial affairs to a single firm, and if there are doubts as to whether they have full information before them, no accountant who values his ability to maintain his PI cover will certify. The seriously HNW have money all over the place. Certainly the fees he would have to charge to make the risk worthwhile would make it uneconomic for the investor. This is particularly so in the light of my first point to Q1.
- b. Who else is able to certify? Not the employer, given that the investor has one in the first place (only a small minority of our own investors for example are employed other than by their own investment vehicle). Further, I would imagine (we have too few employed investors to be certain) that investors would be unwilling to disclose their worth to employers. Perhaps too a request to certify would lead an employer to suspect that his employee is devoting energies outside his employment, possibly in breach of his service contract.

In summary only the investor himself can possibly certify. I see no problem with that. If for example an investor self-certifies that he passes the HNW test, when he does not, then he himself is the only potential sufferer is he not? In other words investors should be trusted to exercise their own judgement in this matter, after all they must be trusted with the investment decision itself.

Q4b Do most sophisticated investors already meet the HNW test?

There is bound to be some linkage, though there have been so few tests of the sophistication process that it is hard to tell. Put somewhat simplistically, our own investors for example tend to be sufficiently wealthy for a reason – they are good businessmen. The reality in the market – and I suspect there is unanimity among the players here – is that an understanding of the risks coupled with an ability to add value to their investment through imported skills is more important than “mere” wealth. We value the sophisticated test, however derived, as much more useful than the HNW test.

Q4c Should the self-certification exemption replace or be introduced alongside the current HNW exemptions?

I am not sure that it matters greatly, but on balance I would prefer replacement. This on the grounds of simplicity – the rules are complex enough as it is. 4.10 of the Consultation Document posits that “some investors may be more comfortable with the current regime and may not wish to move to a self-certify regime for the HNW exemption”. I would like to see evidence for this, and suggest that the very low take up of the existing regime implies quite the opposite.

Incidentally there is a flaw in the present HNW exemption in that it covers those who invest “wholly or predominantly” in private company shares or debt, but this excludes the increasingly popular “funds of funds”, and even those types of fund which invest in buy-outs and take-privates.

Q5. Should the net assets test for self-certifying by HNW investors be increased to £500,000, remain at £250,000 or be set at another level?

In a sense this is the “wrong” question. Surely this depends on the individual investment that is proposed. Let the investor decide whether his wealth is sufficient to sustain a particular investment. See comments later (Q9) and above (Q4a) regarding the timing of the testing process, which will explain this view.

If the HNW test has a role at all, which frankly I doubt, it is with the first time investor, who has insufficient experience to pass a sophistication test. For this reason alone I would not favour reducing the limit. I do not think it appropriate that we encourage the unsophisticated, and (relatively) poor into a potentially high risk market. This too should be read in conjunction with my comments on Q4a.

There are some “loopholes” in the current HNW test. It can be passed simply by re-mortgaging one’s house and putting the cash in the bank – yet there is no net change to underlying wealth.

The earnings test is fraught with danger too. What is the use of a certificate that someone was earning £100,000 in the preceding financial year if that person is now redundant, earning nothing, and perhaps wants to invest in order to “buy a job”? That is far from uncommon. Indeed the current Order (Articles 48 and 50), and which is retained in the revised draft Article 48 requires, in effect, that the test be satisfied at some point within the preceding 12 months. I have a solution to the complexities of the rather long winded Article 48(2)(b) – make sure the test is satisfied at commitment rather than at point of promotion. More of this later.

There has been talk, by the way, of establishing a publicly available register of certified investors. This is quite absurd and yet further discourages investors from certifying. No private investor wants the public – even if access were to be restricted – to know his wealth. Once the information is in the public domain, investors are open to mail-shot by anyone, or indeed become vulnerable to the criminal fraternity.

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

No, in place of. This largely for the reasons set out in my response to Q4c. However the sophistication test is in my view far more relevant to the business angel market than HNW. It is essential that any investor fully understands the risks upon which he is embarking. There are rewards too, and we do not want to protect someone from making a profit! I would not like to see anyone, however wealthy, perhaps through inheritance, the National Lottery or whatever, going into a market that they do not understand, and that surely must be a central aim of protective legislation such as this.

I have no problem whatsoever with self-certifying as a concept (indeed I would welcome it), provided that there is sufficient evidence that an investor has been made sufficiently aware of the risks before committing himself to those risks. For that reason we as a firm include a strong “wealth warning” rubric in all our own financial promotions. Though this is not a legislative requirement of an authorised person, it should be. I suggest that this becomes a core plank of future promotion legislation, whether or not that promotion has been approved by an authorised person. For information our own rubric reads:

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

No. It is frankly absurd to suggest that a solicitor is sophisticated but a barrister not. One wonders also why, say, actuaries are deemed to be sophisticated in these markets but chartered secretaries, surveyors or doctors are not. No, the Consultation Document is looking at this in completely the wrong way; experience in for example running a company is far more important than merely being a member of the sort of profession that happens to be caught within a (some would say irrational) regulatory perimeter. Why too should proposed Article 50A(8) exclude someone who has significant experience in foreign exchange hedging or swaps and who is not therefore to be regarded as sophisticated. The requirement to demonstrate 10 share transactions, regardless of purpose, value etc is a “churners charter”.

Incidentally there is a problem with the word “sophisticated”, which has dictionary connotations far beyond what is in practise needed. I would prefer “sufficiently knowledgeable”. This would also deal with the problem of those who are knowledgeable about one sector but not another (a software expert does not necessarily understand property for example). If we are to be serious about reform, let’s look at irrelevant sophistry as well.

There is also some confusion in the definition of an “unlisted” company, and I wonder why the present exemption is limited to these at all.

We must not be critical without offering an alternative. One of our related websites is www.fisma.org. This is not for profit and is therefore not authorised (more of which later), but nevertheless contains a useful, and in my view perfectly adequate test of “sufficient knowledge”. Tom MacKay, who also attended the Treasury meeting, will be able to explain the thought processes that went into this. For a sterner test, look up www.sophicert.com, directly or through our own website, www.beerandpartners.com. These alternative, though both relevant, criteria calculate a mark based on weightings given to each question. I have a duty of confidentiality to our partners in both these sites, but experience in managing or investing in unquoted businesses carries far more weight than, say, the number of times someone has day traded shares in Vodaphone. I am happy to devote time, in conjunction with Treasury or FSA in defining the rules, based on the work my colleagues have already done in this arena.

Incidentally my colleagues in Sophicert asked FSA for guidance on the planned test, to be told that this was entirely a matter of market practise. As Beer & Partners is de facto the market it is a comfort to know that my own firm’s processes have the rule of law!

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

This is a difficult one, but on balance – no. I believe FSA was wrong not to have given us better guidance – not “detailed criteria”. There has to be some common standard which will allow investors to judge themselves fairly. This brings us to a need for better education among investors (see the Q11 response). I am unconcerned that such guidance would not have the force of law since, as with the self-certified HNW test. After all if he gets it wrong the only sufferer is the self-certifier himself.

I certainly do not believe that it would be helpful to ask a self-certifier to provide evidence of appropriate past experience; this would be unduly bureaucratic, discourage the certifier and indeed serve no useful purpose that I can see.

Q9. Of the three models, which provides the appropriate balance between investor protection and facilitating SME investment and why?

Model three - permitting self-certifying for either the HNW or sophisticated (or rather “sufficiently knowledgeable”) test. We have already seen that take up of the current third party certification process has been miniscule; so that clearly does not work, for the reasons I have already explained. It seems to me to be clear that if the process does not work it offers no protection to the investor. Since the rules are almost universally ignored, de facto they do not exist and therefore do not impact on SME funding either. So rationally any system that requires third party certification will continue to be wholly ineffective.

Frankly I cannot see that either models 1 or 2 have any future place whatsoever and my firm would absolutely oppose them. A self-certifying regimen seems to work in the US, or at least I have seen no evidence that it does not.

This is a convenient point to note that there is one important difference that we in the UK would do well to copy – the timing of the bite of regulation. Under the US accredited investor scheme a declaration (or certificate in UK parlance) is made as part of the investment subscription process. This is, in my view, the most logical time for an investor to state for the record that he has sufficient financial means to absorb a loss, should that arise, understands the risks, knows that it is open to him to take independent advice etc. After all, the investor is at risk in making a financial commitment, not merely in receiving a financial promotion; this is completely different from the retail market – the investor is not being asked to risk funds “off the page”. Furthermore this timing would negate all the difficult issues relating to income and worth referred to in Q5 above. I have raised this very issue before with Treasury, without success or an explanation that made much sense to me.

The balance of protection issue is always a difficult one I agree. The reality of our market is that the promoter is more in need of protection than the investor, and perhaps the whole regulatory mindset needs to recognise this. My own firm does receive complaints from client companies from time to time (happily rare) regarding the behaviour of investors. Our investors are experienced businessmen, reasonably wealthy and have the time, resources and contacts to make life difficult for our client companies. Small growing businesses, perhaps with young and inexperienced management do not. Companies are more vulnerable to predatory investors than investors to crooked companies.

There is a further protection for investors that should be examined critically – the protections they lose if they are certified. The Consultation Document is silent on this, one of the prime causes of failure of the present system. If investors are to lose the protections (which seem fairly widely misunderstood by the way), then even self-certifying might be a problem. I recommend that the normal protections be reinstated, or at least the reasons for their continued withdrawal clearly justified. Personally I would take a fair amount of convincing.

I would be very interested in seeing any evidence that there is wide-spread fraud, in the private unquoted investor arena. Indeed I am not aware of a successful prosecution of a company in that market under the 2000 Act. I'd like to know of one if it exists.

So who are we really trying to protect, and from what?

I have already argued that, should an investor self-certify incorrectly he is only harming himself. Provided that he has been given sufficient warning of the dangers of investing in unquoted companies, I would allow him to exercise his own judgement, perhaps unwisely, perhaps not; it's his money after all.

This would protect SMEs simply by decriminalising much of the investment promotion that currently takes place.

Currently, all (broadly and with limited exceptions) promotions need to be approved by an authorised person, who – one hopes – follows FSA’s Rule Book in giving that approval. This means that approved promotions are “fair, not misleading and verifiable” – not “verified”, an important distinction that must be preserved. In the case of unapproved promotions, or those issued by exempt persons such as the growing band of alleged “not for profit” businesses, we do not have that assurance. I recommend that all promotions carry a warranty, signed by the directors of the company seeking funds (not agents or advisors), that the promotion is fair, not misleading and verifiable. I appreciate that “warranty” has a strong legal connotations – this is an important point. It is important that directors take and are seen to take responsibility for the validity of the information upon which an investment decision is likely to be based.

In a nutshell I recommend that we deal with almost all of the problems mentioned above by the following simple process:

- Permit investors to self-certify that they are sufficiently knowledgeable to understand the risks and have the financial resources, immediately before an investment is made. Issue clear and straightforward guidelines (after all these are designed for laymen not lawyers) as to the criteria that investors are expected to meet.
- Ensure that an appropriate wealth warning, perhaps along similar lines to our own, is attached to every promotion.
- All promotions in addition should contain statement from the Directors (not their agents (or advisors) that the information given is fair, not misleading and verifiable.

Should Treasury feel that this does not give honest investors an adequate protection, could you please justify this view?

Q10 Should equivalent amendments be made to the Collective Investment Scheme Order?

I feel insufficiently experienced in this market to comment, though intuitively disharmony between different Orders leads to confusion, error and lawyers fees. I am happy to discuss this further with Treasury in order that I can better understand the implications of the proposals and advise accordingly if you wish.

Q11 What other regulatory issues are proving a constraint on Business Angel investment?

Many of the current problems would disappear if my recommendations in Q9 are brought into effect. For the record other relevant matters include:

- Lack of understanding of the current law and its probable interpretation.

Not a regulatory issue in itself of course, but there is widespread lack of understanding concerning how a company can and cannot raise capital. I have to say that FSA have not served the market well in this. Authorised persons are perhaps even more poorly served since they have the horrendous complexity of the FSA Rules, with almost daily changes thereto, to contend with, not to mention the POS Regs, Companies Act etc. My firm is the leader in its market and I have Compliance responsibilities within it, yet I am often uncertain. Pity help the owner manager trying valiantly to wade through it all without the benefit of expensive and specialist lawyers. FSA have a clear duty to improve consumer education, which they have signally failed to undertake in respect of our market and this needs to be rectified as soon as possible. Remember that companies, business angels and indeed authorised persons are consumers too. What we need is a simple, authoritative guide through the minefield. If that cannot be achieved (I have tried and failed) then there is a deeper problem; surely if the law cannot be understood it cannot rationally be enforced. I am happy to work with FSA on this - it is so important in opening out our markets, and so little attention has been paid to this issue.

- The “one-off promotion” exemption (why “one off”?).

Presumably though this ill-understood exemption would disappear if my recommendations in Q9 are adopted. If they are not then this exemption needs to be broadened and clarified. Here is a real example. My firm wants to set up a number of investor clubs through which companies can meet investors, which seems simple enough, indeed highly commendable. We do not want the risk of approving any promotions these companies might make, since I will not know them well enough – they will not necessarily be retained clients of the firm since they cannot afford the cost of the processes that we as a firm would have to go through to satisfy ourselves that any promotion meets FSA criteria. We could certify that club members are sophisticated, but this too would cost money (my own house is at risk if we get it wrong after all!), and I want to encourage new investors, suitably educated, into the market in a social environment. But how can a club such as this work possibly work whilst keeping within the letter of the law?; I do not know. The “one-off” exemption is no use, since I would want to encourage companies to present to more than one club, or the same club several times.

- The “rule of 50”, the maximum allowed before a hideously expensive POS document is required.

Unauthorised persons need to keep careful control of business plans issued and returned so that no more than 50 are in potential investors' hands at any one time. Why? – this is nonsensical. Companies often have more than 50 friends and family, directly or through their advisors. Can we please look too at the rationale behind this arbitrary and, in my view, unnecessary restraint?

- The “€40,000 rule” – the minimum single subscription before a POS is required.

I appreciate that this is an EC regulation, but again the rationale escapes me. Possibly it was felt that someone investing £30,000 (the approximate sterling equivalent) could afford to lose it, but someone investing £25,000 could not. Bizarre. Again the logic behind that restriction, which is a real problem in our Private Placings, escapes me. My firm has made valiant attempts to find a loophole, so far without success and we do not want to have to keep trying. Again, if we adopt my Q9 suggestions, this issue disappears.

- The cost of honesty.

Despite the existing ill understood exemptions, very broadly only authorised persons may issue an investment promotion. I know the FPO states otherwise, but that is the unwanted effect. The Authorisation process is expensive and time consuming – I am told that £40,000 (including lawyers) and 6 month is about “par”. This is quite absurd and considerably restricts the market. These and the significant on-going compliance costs to authorised persons have to be paid for by investee companies. Again the Q9 suggestions remove this as an issue.

- The perimeter of regulation.

It is too wide. My firm has met literally hundreds of finance consultants, early retired bankers and the like who are helping smaller companies to raise funds. They will help with the strategy, then the business, then they will talk to banking contacts. Then they have a real problem in that they cannot deal at all with that same company’s residual equity requirements. For that they need to become authorised. Why so? What protection does that really afford? We need a fresh and realistic look at the Regulated Activities Order.

Q12 Are there particular regulatory barriers preventing angel syndication.

Yes, two.

Firstly it’s a criminal activity and perhaps a possible jail sentence for trying to bring companies and suitable investors together is a little on the harsh side. I know this is a somewhat facetious remark but it is, sadly, true in most cases. Syndicates are almost always informal. One lead “investor” will trawl for business plans, reject most and look carefully at a few; this is quite an arduous, and certainly highly skilled, task. He will then prepare a briefing note on the company and talk to friends (the syndicate members) who have the money but not the time to look for their own opportunities. The lead investor may or may not invest himself alongside his friends. The lead investor is carrying out investment business quite clearly; he is very very unlikely to be FSA authorised, and that is a criminal offence is it not? We have around 30 known – and perhaps many more unknown – syndicates on our own investor list; only one of these is authorised and this is a highly structured business with over 100 fee paying members. As soon as the lead investor realises that he has fallen foul of the RAO, he stops, and everyone suffers accordingly.

Secondly, and this is not directly a regulation issue, the oncoming Enterprise Funds are a disappointment. The consultation process was comprehensive, for which Treasury and DTI are to be complimented. However it does appear that the offer from Anthony Clarke and myself to work with you to make these relevant and helpful to business angels has not been taken up. You may recall that we, and other practitioners, were in favour of a model whereby syndicates, under the supervision of an authorised person, could invest as an Enterprise Fund itself. Angels prefer to invest directly, might well invest through syndicates (certainly that is the case for around 400 of our investors), but do not want fund managers to take their investment decisions for them. I cannot speak for Anthony of course, but I repeat the offer I have already made.

Many of the issues that hold back syndicates will be dealt with if the recommendations in this response are adopted.

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

Much of this has been covered already and solutions offered, but to summarise:

- Lack of awareness and understanding of the law.
- The perimeter. An investment promotion is very widely defined in the FPO, and the “link in the chain” approach is deeply flawed. A promotion should for example not include mere invitations to events. Again I suggest that FSA define with more clarity precisely what is, and what is not, regarded as an investment promotion. Indeed one highly respected lawyer has even suggested to me that Treasury and SBS’s consultation paper *Bridging the finance gap: a consultation on improving access to growth capital for small businesses* could itself be construed, albeit tortuously, as an investment promotion that should have been approved by an authorised person. That may or may not be so, but it is alarming that point has even been considered.
- Overburden of the law – promoters cannot approach potential investor direct, except under exceptional, unduly strict circumstances.
- Misapplication and patchy take up by the banks of the excellent SFLGS scheme.
- The bite of the POS regulations – we need to widen the circumstances under which a POS document, with the significant attendant costs, is not needed.
- Lack of training for businesses in what is involved in the investment process and what investors are really looking for; I can see little evidence that the numerous “investment readiness” programmes are hitting the spot.
- Poor performance of the RVCs, presaged in Mason and Harrison’s paper of November 2003 “*Closing the Regional Equity Gap? A Critique of the DTI’s RVC Initiative*”. This coupled with their failure to engage with the private sector.
- Inadequate attention to the need to improve awareness and understanding on the part of potential investors. It is nothing short of scandalous that neither NBAN nor FSA have paid any apparent attention to that essential commodity – the investor. I have written to DTI on this point. I very much welcome the pilot investor training initiative by OneLondon, and would like to see this extended around the country; again my firm is happy to help in this.
- Poor performance, in general, of the plethora of publicly funded “Angel Networks”.
- Potential inappropriateness of the Enterprise Funds.
- Business Links’ general unhelpfulness, at least in our experience, in terms of working with the private sector to prepare growing companies for investment.

- Too much stress on the perils of investment, not enough on the potential rewards, leading to undue caution on the part of the regulator, leeching through to the investor.
- EIS relief tends not to be useful to Angel investors. I have dealt with this matter more fully in my response to last year's *Bridging the finance gap* consultation. Could someone please explain why it was not implemented?

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

No. There are possibly hundreds of private sector players; sadly though the vast majority are operating outside the regulatory framework and understandably prefer to continue that way. "Private sector intermediation" does, strictly speaking, include uncounted numbers of golf clubs, Rotaries, pubs, where most informal investment discussion actually takes place, but I presume these are not to be included in the implied assumption to the question.

But the real issue here is how to encourage more overt, rather than covert, private sector activity. I believe that my own firm is almost alone in this known market for several reasons:

1. There's little money in it, and a business such as ours needs to have volume in order to be profitable. Investors do not want to pay (why should they, when they can network with friends, their bank, accountant etc gratis?). Smaller companies are sometimes unable to pay the fees that are necessary if compliance and reputational risks to the intermediary are to be minimised, and obligations to the regulatory authorities met.
2. The cost of regulation. I have dealt with the initial costs. The ongoing cost is harder to determine, but I would not be surprised if, within my firm, compliance costs amount to at least 20% of fixed overhead (including PI cover).
3. The grant culture. I know this is only tangentially relevant to the point, but we do see too many situations where public money has been given to poor business propositions, when a private investor would have benefited the management to a much greater extent. Let's cut down the hand-outs please.
4. Perhaps most importantly though and this matter absolutely must be dealt with, there is strong, direct and indeed unfair competition from the plethora of public sector networks. I know this beggars belief, but we have even had instances where a Business Link has refused to work in partnership with us in funding proposals; worse (if that is possible) this in cases where we know they do not have the contacts or expertise themselves to help the investee company. This is scandalous. I strongly object to subsidising, as a tax payer, those public sector networks who are in our space, and:

- a. Do not have to be authorised. The “not for profit “ exemption – I think “loophole”, or perhaps even “scam”, is more accurate - should be withdrawn immediately; it has no justification now, and will have less if my recommendations are implemented. This additional hidden subsidy means that they neither have to bear the costs of regulation nor do they even have to meet the very high standards expected of authorised persons. Nor indeed do they have any obligation to quality control investors – a vital part of an intermediary’s responsibilities. One large publicly funded network refused to co-operate with us when we offered to show their investment proposals to our investors, on the apparent grounds that they were unwilling to confirm that their promotions, which we would pass on verbatim, satisfied the FSA’s “fair, not misleading and verifiable” test; that must be a real worry.
- b. Are heavily subsidised to extent that businesses are misled into believing that they can raise capital for a few pounds. This is mismanagement of the expectations.
- c. Are by and large – there are one or two honourable exceptions – ineffective. I would like to see independent evidence of their real achievements. I am not entirely without an interest to declare in this, but few that I meet are staffed by committed, experienced and determined managers.
- d. Pay no attention whatsoever to what I had understood to be their remit to work only where there is market failure (perhaps at the sub £50,000 level), and to signpost to appropriate private sector practitioners in areas where there is not market failure (perhaps over £50,000). If however DTI accept that they are entitled to receive public money in order that they can undercut and thereby skew the market, then that must be a serious issue. If there is no EC legislation about unfair subsidies, there should be.

I appreciate that this final point is a matter that I should address to DTI, and I will do so, through Rory Earley.

SYNOPSIS OF RECOMMENDATIONS

1. Define “promotions” more tightly, to include only those that are specific invitations to invest.
2. Promotions to include a clear wealth warning and (and this is important) a statement that each of the directors warrants that the promotion is fair not misleading and verifiable. If a director is not prepared to so warrant, either the promotion must not be issued, or the director resigns. Provided such promotions meet these requirements, they need not be approved by an authorised person.

3. Investors must not be allowed to invest unless they have signed a confirmation, no earlier than 30 days prior to the commitment actually taking place, that they have sufficient resources to meet the commitment and understand the risks involved, and confirm that they have taken whatever independent advice that they consider necessary.
4. Where it is possible to invest “off the page”, e.g. with an application form attached,

An authorised person should confirm the declarations in 2 above,

The minimum investment amount to be reduced to £5,000, from €40,000.

The distribution limit of 50 is abolished
5. FSA and practitioners (not NBAN, please) to establish a training and awareness programme for investors, and provide proper guidance on the regulations (less needed if my simplified process is adopted).
6. Remind the Business Links of their responsibilities and probe their effectiveness as a Business Angel Network.
7. Look again at the proposed structure for EFs.

David C H Beer,
Chairman.