

Informal Capital Raising Consultation Responses
Enterprise Team (4/N2)
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Dear Sirs,

Informal capital raising and high net worth and sophisticated Investors

We are writing in response to the Consultation Paper published by HM Treasury in January 2004 on improving access to growth capital for small businesses. Sandy Finlayson is the Partner in charge of this firm's corporate and commercial business which specialises in high growth young companies and his principal area of interest lies in the financing of such companies. Stuart Hendry is an Associate in our Corporate Department and he is very heavily involved in Business Angel investment, carrying out the bulk of the legal work for Scotland's largest and most active Business Angel Syndicate. This has included all the compliance work for the current certification regime. The views expressed in this letter are our own views and not the views of my firm. By way of background we should explain that over the past 10 years our firm has been involved in the following:-

- the establishment of the first Business Angel Syndicate in Scotland. It is now the largest and most active syndicate and is one of the principal providers of equity finance to start up and early stage high growth young companies with a current portfolio of some 25 investee companies;
- the establishment of Northern Venture Trust, the second VCT to be established in the UK;

- the establishment of The Eastern Scotland Investment Fund and The Strathclyde Investment Fund, two public/private funds, each of approximately £7M, with financing from business angels, the UK public sector, a grant from the European Regional Development Fund and a loan from a UK Clearing Bank;
- membership of LINC since it was first established in Scotland and which has enjoyed considerable success in promoting a very active Business Angel community in Scotland;
- about twenty-five spin-outs from ten of Scotland's thirteen Universities with a number of our clients having appeared in the Deloitte & Touche Fast 50 Awards for high growth technology companies in Scotland including a winner and runner up; and
- through our professional work we have become heavily involved in the operation of the Enterprise Investment Scheme and over the years have submitted a number of papers to different Government Departments about the financing of small businesses.

We respond to the detailed questions raised in the Consultation Document as follows:-

Question 1

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

Answer

This question must be answered against the background that large numbers (possibly the vast majority) of Business Angels are unaware of the "certification" regime. For those who are aware of it there is certainly a perception amongst some that the Financial Services & Markets Act ("FSMA") has created an additional layer of bureaucracy which did not exist under the Financial Services Act ("FSA"). However, professional advisers who are experienced in working in this area have cautiously welcomed the certification regime. While imperfect in some respects it has at least introduced a degree of clarity into what was previously a very confused area of law and regulation.

It would appear from the commentary in the Consultation Paper that the take up of the certification regime has been very low and there will be two reasons for this, namely:-

- Firstly, a large number of Business Angels will simply be unaware of the existence of the certification regime. This is a fairly esoteric area of law and regulation which is known only to a relatively small number of experienced

Business Angels and professional advisers who specialise in this area; and

- A number of experienced Business Angels will undoubtedly have taken the view that they do not require to submit themselves to a process of certification by a third party.

This question could perhaps have been framed differently in the sense that it refers to the “current exemptions” rather than “current regulations”. In considering this issue it is important to understand that there probably exists a very low level of awareness of the “certification regime” and individuals cannot seek certification unless they are aware of the requirement to do so.

Question 2

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

Many small companies do have a problem in raising unlisted equity and it is perhaps important to draw attention to the first sentence of paragraph 1.2 of the introduction to the Consultation Paper which states that:

“While the UK’s well developed and sophisticated financial markets successfully meet the demands for capital of the vast majority of firms, a small proportion of businesses find it difficult to raise funds”.

The financial markets cater exclusively for the requirements of those companies which are listed on a recognised investment exchange which represent a very small proportion of the UK’s stock of limited liability companies. The vast majority of the UK’s limited liability companies have a turnover of less than £1,000,000 per annum and these are the ones which have difficulty. It is therefore incorrect to suggest that: “A small proportion of businesses find it difficult to raise funds”.

However, the shortage of certified investors is not in itself a particular barrier for the following reasons:-

- The owners of the vast majority of small businesses know very little about the FSMA and the certification regime and they therefore are unaware that they should only approach certified investors; and
- Even if they were aware that they could only approach certified investors there is no form of register available to identify such individuals.

Question 3

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

The “reasonable belief” test is difficult to satisfy, at least within the context of certification. What happens in practice is that prospective investors may be approached by businesses looking for finance if:-

- The Company thinks that the prospective investor might be interested in investing in the business; and
- The business thinks that prospective investors might have the necessary financial resources to invest.

This is the test of “reasonable belief” which happens in practice and to impose a “reasonable belief” test in relation to certification would require an enormous effort to educate a very large and disparate group of small businesses about the detailed regulatory issues involved which we suspect that this would not be practical.

Question 4a

Should potential investors be able to self-certify that they qualify as high-net worth individuals (“HNWIs”)?

Answer

Yes in principle. This is a simple objective test and anyone from a business background ought to be able to work out for themselves whether or not they meet this requirement.

An issue could arise however in relation to an individual who either has inherited wealth or has received a substantial capital sum either by way of compensation for an accident claim or significant lottery winnings and the regulations should address the position of such individuals who may not be able to make an informed judgement about this type of investment.

Question 4b

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

Answer

The answer to this question depends on the criteria used to define a “sophisticated investor”. The suggested criteria refer generally to lawyers and accountants and “authorised persons” within the meaning of the FSMA. However, many such individuals, particularly those at an early stage in their careers, would not qualify as HNWIs. On the other hand many successful businessmen who have no previous connection either with the professions or the Financial Services Industry and who have become HNWIs as a result of their own efforts in business should undoubtedly be classified as sophisticated investors.

Question 4c

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

Answer

As a general rule HNWIs should be able to self-certify as the test is an objective one. The requirement to obtain a certificate from a third party which presumably has to be paid for does create an unnecessary barrier to investment. It is however recognized that special circumstances exist in relation to HNWIs who for whatever reason may not also be sophisticated investors.

Question 5

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

This is a difficult question to answer in absolute terms but you may wish to consider the following issues:-

- Firstly, and in common with all other types of investment, it is wise for a Business Angel to adopt a portfolio approach. One Business Angel with £250,000 to invest might be able to build a successful and well balanced portfolio of investments whereas another with £500,000 to invest could lose it all in one badly judged investment – it has happened!;
- While it is accepted that there must be an arbitrary limit it may mean less in the South East where there is a greater concentration of wealth than in remote rural areas. Rather than impose an arbitrary limit the interests of individual investors would be better protected if they invested through syndicates and adopted a

portfolio approach. However, this is probably primarily a matter of education rather than regulation.

Question 6

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

Answer

A self-certification regime for sophisticated investors could sit comfortably alongside the proposed self-certification regime for HNWIs. However, in considering the detailed regulatory framework it is important that consideration should be given to the following points:-

- While those HNWIs who have acquired their own wealth should be able to self-certify care must be taken to consider the position HNWIs such as accident victims or lottery winners who are manifestly not sophisticated investors; and
- The definition of sophisticated investors should be extended to include those who come from a successful background in business and who are perhaps more likely to be Business Angels than young professionals.

Question 7

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

Answer

The proposed criteria for sophistication are inappropriate for the reasons outlined above and require amendment to take account of market realities. Business Angels are much more likely to be successful businessmen than lawyers, accountants or other authorised persons. The regulations should take account of the large number of individuals who have been made redundant or taken retirement from their first career and who might typically have between £50,000 and £100,000 to invest. Such individuals are not HNWIs and are typically looking to invest in a business which will also be able to offer them full or part-time employment.

Many successful businesses have been created on the back of redundancy settlements and it is important that this type of entrepreneurial activity should not be stifled by unnecessary regulation.

Question 8

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

Answer

There are perhaps as many as a million trading companies in the UK all of whom have shareholders. The commercial reality is that those who are involved in very small companies will continue to go about their business and raise money from small shareholders in blissful ignorance of the certification regime.

The investment risk lies not in receiving information (which is the barrier raised by the certification regime) but in the making of an investment.

Rather than deny individuals access to information it may be more appropriate to require them to sign a declaration prior to investment to the effect that they understand the risks. Every time a share subscription is completed a return of allotments (Form 88(2)) must be filed with the Registrar of Companies and it would be a simple matter to redesign this form so that it contains an appropriate declaration by the investor.

This declaration could contain an appropriate "Health Warning" and a statement to the effect that the investor understands the risks. To avoid unnecessary bureaucracy such a requirement should not extend to HNWIs and sophisticated investors.

Question 9

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

The essential problems with the current certification regime and the amendments which are proposed are that:-

- The whole thrust of the regime is to deny individuals access to information unless they are duly certified. If it is accepted that the vast majority of the investments made in private companies are made without the parties concerned having any knowledge of the certification regime it offers very little real protection other than to give advisers comfort that they are not breaking the law by sending unapproved documents to certified investors; and
- No mechanism exists to enable those who wish to provide information to establish whether or not the intended recipient is duly registered with some authority as an appropriately certified individual.

The net result of the certification regime as existing and proposed is that it fails to achieve the primary policy objective which we understand is to increase the flow of private capital to private companies in an appropriate way.

This issue could be addressed by channelling investment queries through one of the established Angel Investment Syndicates or through LINC (Local Investment Networking Companies) or NBAN (National Business Angel Network). The advantage of these networks (both formal and informal) is that they bring together groups of people with a common interest and the best way of offering real (as distinct from illusory) protection to inexperienced investors would be to:-

- Put them in touch with other investors who are experienced in this type of investment;
- Encourage them to learn about the issues involved in this type of investment before they commit themselves;
- Promote the concept of investing through syndicates and on a portfolio basis; and
- Ensure that investments are made with appropriate legal documentation. It should be noted that private investors who invest with properly structured agreements have much greater protection than investors in listed companies in the sense that they will generally:-
 - Have access to detailed management information;
 - The right to appoint a Director and often the Chairman;
 - The right to approve Executive remuneration;
 - The right to approve annual budgets; and
 - In certain circumstances the right to force the sale of the company.

Question 10

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

Answer

The question of whether it is necessary to amend the CIS Order depends on the wider issue of whether the Government wishes to encourage syndicated investment by Business Angels on a collective basis and if so this will require a wider regulatory and taxation review.

Question 11

What other regulatory issues are proving a constraint on business angel

investments?

Answer

The principal regulatory barriers are as follows:-

- Restriction on financial promotion - This issue is being addressed with the development of the certification regime;
- Arranging, Managing & Dealing in Investments – Established Business Angel Syndicates tend to take advantage of the “not for profit” exemption and operate with a “gatekeeper” who is employed by a not for profit company. However, if a group of investors choose to invest together and one of them takes the lead in undertaking the due diligence and negotiating the deal it might be argued that the individual concerned is “arranging a deal” in contravention of the FSMA.
- Once the deal has been arranged the investment has to be managed which may also involve a member of the syndicate and when the investment has run its course it must be sold which may involve dealing in an investment. During the life of the investment the Company may ask one of the investors to help to negotiate a credit line with the Bank and this could also fall foul of current FSMA restrictions. There are a whole series of detailed issues in here which require to be considered in detail;
- Within the context of the Scottish market, Scottish Enterprise National operates a network of local enterprise companies which employ consultants who work with their client companies. The work of such consultants will regularly involve financing issues and it does seem anomalous that one state funded organisation employs consultants in the pursuit of economic policy which may be in contravention of some of the finer points of financial regulation imposed by another arm of Government;
- Syndication - There is a clear trend towards increasing syndication by sophisticated Business Angels who understand the benefits of investing alongside a group of likeminded individuals. However, it is not possible for syndicates to invest on a collective basis as this would fall foul of a raft of other FSMA regulations and syndicates must therefore depend on individual investors making their own decision in respect of each individual investment;
- Taxation – EIS tax relief is very important for Business Angels and if they pool their funds together in any form of collective investment scheme the tax breaks are lost. The one exception to this general rule is the “Approved Investment Fund” which is a hangover from the old BES legislation. However, we are not aware of any AIFs which are currently active as they must invest all of their funds within 6 months which makes them impractical.

Question 12

Are there particular regulatory barriers preventing angel syndication?

Answer

It is not possible for syndicates to invest on a collective basis without falling foul of the CIS regulation. Even if it was possible for Business Angels to invest on a collective basis for regulatory purposes they would lose the benefit of EIS style tax breaks.

We understand that this issue is being addressed within the context of the new Enterprise Capital Funds ("ECF"). We understand that it may be possible for Business Angels to structure an ECF as a limited company so that they invest their own funds and fall outwith the scope of FSMA regulation. We understand that such a structure will offer maximum taper relief but will not offer the initial EIS relief which is very important to the majority of Business Angels. For this reason ECFs may be unattractive to Business Angels. We think this would be unfortunate as they will miss the intended target (startup/early stage companies) if they become another niche product for professional fund managers who will inevitably look for mature investments and take a more risk averse approach.

One of the requirements of a Venture Capital Trust ("VCT") is that the VCT should be listed on a recognised investment exchange to obtain the relevant tax breaks. In addition to the generous tax breaks a VCT can invest a significant part of its money in listed investments and by way of loans rather than ordinary shares. We have always felt that an unlisted VCT should be an attractive structure for genuine Business Angels, possibly with the restriction that the funds raised could only be invested in qualifying ordinary shares.

Question 13

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

Answer

The principal regulatory constraints are those imposed by the FSMA. While the EIS legislation has generally been a very welcome initiative which is fundamental to the financing of high growth young companies there are a number of anomalies relating to its operation which we feel are worthwhile drawing to your attention, namely:-

Nil/Partly paid Shares

A company is disqualified if it issues nil or partly paid shares during the period of one year before or three years after the EIS investment.

It seems unduly restrictive that a company can be tainted by a share issue which happens prior to the EIS investment.

Redemption/Buy-back of Shares

Relief is again denied where a company redeems or buys back shares within the period of one year before or three years after investment. This makes it impossible to “marry” an EIS investment with an investment in Redeemable Preference Shares with redemption dates starting within the three year period. As there are a number of small funds which commonly use Redeemable Preference Shares, the EIS restriction makes it difficult to put together an investment involving EIS investors and a fund which prefers to invest through preference shares.

Cash and non-Cash Allotments

We do not understand why there should be a prohibition against making cash and noncash allotments on the same day. There does not appear to be any logical reason for this restriction and it can easily be avoided by allotting shares at 11.59pm on one day and issuing other shares at 00.01am on the next day. This is a significant practical problem in the sense that many investments in the current economic climate are of a “rescue” nature involving the conversion of debt into equity before the new investment is made. We cannot see any logical reason for imposing an artificial barrier on this type of transaction particularly where a rescue financing often needs to be accomplished very quickly in order to save a business.

Cash Allotments

The problem here arises also as a result of the current economic climate. If a company gets into difficulty it will often turn to its investors for urgent assistance and the investors may typically be asked to write a cheque to cover the end of the month payroll to stabilise the financial position while the company endeavours to put a financing package together. It seems iniquitous that an investor who responds to the “clarion call” is then denied EIS relief either because the conversion of the loan into shares is not treated as a cash allotment or because of the “return of value” provisions.

Application of Funds

It is necessary for the company to spend 80% of the investment in the first year. The conservation of cash should be well up the agenda of every small company

which is interested in survival and a direction to spend money in order to preserve tax relief is not helpful. If it is applied literally it means that a pre-revenue start up must undergo another round of financing within the first year if it is not to become insolvent and if the company is trading the rule does not make any sense as a trading company should generally be aiming to generate cash from its operations.

Licensing

The licensing rules are now unduly restrictive, as many small technology companies must rely on licensing as one of their principal routes to market. In many cases it is simply not possible for a small technology company to finance the investment required to create a direct sales or distribution network, particularly if it is selling into a global market. While the rules accommodate intangible products such as computer software or a new pharmaceutical formulation they appear to discriminate unfairly against patented hardware such as a new medical device.

While it is accepted that the government wishes to exclude financial leasing businesses from the EIS rules the distinction between hardware and software does create an unfortunate anomaly. As a matter of policy the Government is keen to encourage the formation and development of knowledge based businesses and if a company is successful in developing a new technology it would seem logical that such a business should be supported under the EIS rules irrespective of whether the technology involved is hardware or software.

Subsidiary Rule

The current rules prohibit the qualifying company from having a shareholding of greater than 50% but less than 75% in a subsidiary. We were recently involved in one case which involved the target company having to give up 0.2% of its interest in a subsidiary company in order to qualify under the EIS rules. It seems anomalous that a company should have to give up what could be a significant commercial advantage in order to secure investment.

Question 14

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

Answer

Yes. Private firms are extremely wary about involvement in this area both because of concern over the regulatory issues involved and the difficulty of making a reasonable return from this type of work.

Over the past ten years LINC has played a hugely influential role in creating, developing and educating the Business Angel market in Scotland and in supporting the active Business Angel syndicates which have now become active in Scotland. However, it operates on a very small budget and it could do much more both to stimulate this type of investment activity and ensure that it takes place within the current regulatory framework if it was more securely funded.

We hope that the foregoing is helpful and would be happy to elaborate on any of the issues which we have raised in this letter.

Yours faithfully,

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