

**EXPLANATORY MEMORANDUM TO THE
FINANCIAL SERVICES AND MARKETS ACT 2000 (FINANCIAL PROMOTION
AND PROMOTION OF COLLECTIVE INVESTMENT SCHEMES)
(MISCELLANEOUS AMENDMENTS) ORDER 2005**

2005 No. 270

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 The Order makes changes to the financial promotions regime to make it easier for small firms to raise equity finance. Investors will be allowed to self-certify themselves as high net worth individuals or sophisticated investors and therefore receive promotions from firms that have not been approved by a person authorised by the Financial Services Authority. Small firms will be allowed to make such unapproved promotions to individuals that they reasonably believe are self-certified as high net worth or sophisticated.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Background

4.1 The Order, which is made under the Financial Services and Markets Act 2000, amends the Financial Services and Markets 2000 (Financial Promotion) Order 2001 (S.I. 2001/1335) (“the FPO”) and the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (S.I.2001/1060) (“the CIS Order”). It is being made in order to improve the operation of the existing provisions in the FPO and CIS which exempt high net worth and sophisticated investors from certain requirements relating to promotions.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

Not applicable.

7. Policy background

7.1 Section 21 of the Financial Services and Markets Act 2000 contains a restriction on making financial promotions. One of the effects of this restriction is that

firms wishing to raise relatively small amounts of equity capital usually have to get their financial promotion approved by a person authorised by the Financial Services Authority (FSA).

7.2 The FPO includes exemptions from this restriction designed to facilitate investment in small firms from wealthy individuals and groups, a class of investor commonly known as ‘business angels’. Business angel investment provides a vital source of early-stage finance for many innovative, growth-orientated firms. Such firms often don’t have the track record or the cash flow to obtain substantial bank or other debt financing, and find themselves too small for traditional venture capital financing, which is generally understood to start at investment sums of around £2 million or above. There is a range of estimates of how much this business angel investment activity is worth, from broadly £500 million to £1 billion per year in around 3,000 to 6,000 businesses. Many business angels also provide advice as well as funds, sometimes joining the board or bringing expertise in, for example, management, marketing or finance.

7.3 The FPO exemptions allow promotions that have not been approved by a person authorised by the FSA to be made to individuals who are certified as either ‘high net worth’ (HNW) individuals or ‘sophisticated investors’. These exemptions were originally made in order to facilitate investment by experienced, wealthy individuals and groups, including business angels. The Government consulted on changes to these exemptions in January of this year in light of consistent feedback that the exemptions were failing to work as intended. Responses to the consultation and further feedback from stakeholders confirmed that the operation of the current exemptions inhibits business angel investment. This is because of the time, cost and inconvenience of certifying by an employer or accountant (as HNW), and the high costs associated with being certified by an authorised third party (as a sophisticated investor) who may wish to undertake expensive due diligence. Although there are no records kept of the numbers who have certified, feedback suggests that the current take up of the exemptions is low.

7.4 The changes in this Order make it easier for investors to become certified and therefore receive financial promotions that have not been approved by persons authorised by the FSA by:

- introducing a new self-certification regime for HNW and sophistication; and
- allowing firms seeking finance to make promotions (that have not been approved by a person authorised by the FSA) on the basis of a reasonable belief that the recipient of the promotion is a HNW individual or a sophisticated investor.

7.5 The Order also makes equivalent amendments to the Financial Services and Markets Act (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the ‘CIS Order’) to maintain consistency with the FPO. Section 238 of the Financial Services and Markets Act 2000 precludes a person authorised by the FSA from inviting or inducing someone to participate in a collective investment scheme unless that scheme is an authorised unit trust scheme, a scheme constituted by an open ended investment company authorised pursuant to regulations made under section 262 of the Financial Services and Markets Act 2000 or an overseas scheme recognised pursuant to section 264, 270 or 272 of the Financial Services and Markets Act 2000. The CIS Order provides exemptions from this prohibition, including exemptions equivalent to the HNW individual and sophisticated investor exemptions contained in the FPO.

7.6 Allowing self-certification potentially carries an increased risk to consumer protection because of the possibility of individuals certifying themselves incorrectly. In this context it is important to note that in receiving a promotion that has not been approved by a person authorised by the FSA, investors may not be able to seek redress through some of the usual avenues (e.g. the Financial Ombudsman Service or the FSA) if things do go wrong.

7.7 Following consultation and discussion with stakeholders the Government considers that the additional risks to consumers in introducing self-certification for HNW are minimal. The criteria defining HNW set out in the self-certificate statement are objective and easy to understand. To minimise the risk of unsuitable individuals signing themselves off as sophisticated investors, the Government has worked closely with interested stakeholders to ensure that the criteria are also objective and are in terms that people would unmistakably recognise as applying or not applying to them. The Government was careful to ensure that both statements are in 'plain English', that they spell out the potential loss of consumer protections and warn of the risks of investing.

7.8 The Government has discussed the sophisticated investor criteria with a number of interested stakeholders, including members of the Small Business Investment Taskforce and directors of business angel networks. They have helped to ensure that the criteria are appropriate. The Government has also undertaken consumer testing of the self-certificate statement. This showed that members of the public do not perceive the sophisticated criteria as applying to them, and it suggested that they would not sign the statement. The feedback from the consumer testing was that the form conveyed a significant risk effectively, and that the warnings about the loss of rights and risk of losing property and other assets from investing are sufficiently clear.

7.9 To further mitigate the risks to consumers the Order requires that all financial promotions that have not been approved by a person authorised by the FSA, that are made to high net worth individuals and self-certified sophisticated investors have to be accompanied by a prominent new 'health warning'. The new self-certification statements include clear warnings about the loss of regulatory protection and the risks of losing all money invested.

7.10 The Government believes that the changes in the Order will make it easier for small, innovative and potentially high-growth firms to obtain investment. This is an important part of the Government's overall efforts to build a more enterprising culture, create the best possible environment in which to start and grow a business, and tackle specific barriers to successful small firm formation and growth.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 The impact on the public sector is nil.

9. Contact

Ros Eales at HM Treasury (Tel: 020 7270 5925 or e-mail: ros.eales@hm-treasury.gov.uk) can answer any queries regarding the instrument.

HM Treasury

10th February 2005

REGULATORY IMPACT ASSESSMENT – Informal capital raising and high net worth and sophisticated investors

PURPOSE

Objective

1 The objective of the changes is to:

- facilitate relatively small levels of capital raising by unlisted companies; and
- make it easier for investors to receive unapproved financial promotions relating to unlisted companies.

2 These objectives will be achieved by:

- making it easier for small firms or intermediaries to promote to high net worth individuals or sophisticated investors; and
- allowing investors to self-certify as high net worth individuals or sophisticated investors.

3 Those mainly affected by the changes will be:

- unlisted firms seeking to raise equity finance;
- private investors seeking to invest in unlisted firms;
- unauthorised intermediaries arranging investments in unlisted firms;
- individuals or firms authorised by the Financial Services Authority (FSA) able to certify an individual as a sophisticated investor; and
- accountants and employers able to certify an individual as high net worth.

Background

4 Access to finance is essential for growing businesses to invest, to implement new technologies and strategies and to contribute to a more productive economy. A small but important minority of innovative, growth-oriented businesses continue to face difficulties attracting funding. Government analysis has pointed to a shortfall of equity finance that is most acute for businesses seeking between £250,000 and £1 million, but which can also be severe for many seeking up to £2 million¹. This gap in equity finance is a barrier to productivity growth, as it can stifle the development of innovative start-up and early-stage businesses, and can constrain the supply of capital for some established businesses that are seeking to modernise or diversify their activities.

5 Private individuals are an important source of finance for many early-stage firms. Although quantification of the typical size of such investments is difficult because of its informal nature, one recent estimate suggested as much as £12.8 billion was invested in UK small businesses between 1999 and 2000 by friends and family of the business owners, or by individual investors previously unconnected with the entrepreneur, i.e. business angels.²

6 The Financial Services and Markets Act 2000 (FSMA) prohibits unauthorised persons (in general terms, those not authorised by the FSA to carry on regulated activities) from “promoting” financial products and services unless:

- the content of the communication has been approved by an authorised person; or
- the communication falls within one of the exemptions specified in the

¹ HM Treasury and the Small Business Service, *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*, April 2003

² Cowling, Murray and Harding, *The virtuous circle of informal investment activity: Evidence from the UK*, 2003

Financial Promotion Order (FPO).³

7 The general effect of this legislation is that firms wishing to raise informal equity capital have to get their financial promotion approved by an authorised person in order to send it to potential investors. The costs associated with approval are likely to be disproportionately high for firms seeking relatively modest sums of equity finance. To address this, the Financial Promotion Order (FPO), as it is currently, allows unlisted firms to raise equity capital without the substantial costs of getting their financial promotion approved if the promotion is made to potential investors whom the promoter knows are certified as high net worth individuals or sophisticated investors.

8 The current certified high net worth individual exemption requires investors to obtain a certificate signed by either their employer or their accountant, stating that they either earn at least £100,000, or have net assets worth at least £250,000 (excluding their primary residence, rights under certain contracts of insurance and certain benefits in the form of pensions or otherwise). The current sophisticated investor exemption requires an authorised person to certify that the investor is sufficiently knowledgeable to understand the risks associated with the relevant description of investment.

9 The present Promotion of Collective Investment Schemes Exemption Order⁴ also uses the high net worth individual and sophisticated investor provisions as an exemption against the prohibition on authorised persons promoting unregulated or unauthorised collective investment schemes.

Risk Assessment

10 The present FPO exemptions described above were designed to facilitate informal capital raising by unlisted small firms from investors who are likely to be well informed, experienced and in a position to obtain appropriate investment advice. Although there are no records of the numbers of investors that have certified as a high net worth individual or sophisticated investor, responses to the consultation document and feedback from stakeholders have confirmed previous suggestions that under this current regime take-up has in fact been extremely low.

11 Responses to the consultation document identified a number of problems with the current certification regime:

- time consuming;
- complex – requirements are not understood by investors;
- authorised persons are reluctant to certify individuals as sophisticated investors because of potential professional liability;
- authorised persons are reluctant to certify because of the restriction on promoting to individuals, having certified them as sophisticated or high net worth; and
- the financial promotions regime itself is not widely known about (both amongst informal investors and unlisted firms/promoters).

³ The Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 – S.I. 2001/1335

⁴ The Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemption) Order 2001 – S.I. 2001/1060

12 Respondents to the consultation document confirmed that the current high net worth individual and sophisticated investor exemptions stand in the way of smaller firms seeking to raise capital via unlisted equity for investors. This is in the context of the equity gap for companies seeking smaller amounts of finance; informal investors are crucial to addressing this gap, however, the current regulatory regime creates a barrier to investment.

Options

13 There are two options:

- not to legislate, in which case the situation would remain as it is; or
- legislative change.

14 Legislation will mean a number of changes to the existing regime:

1) Promotions will be allowed on the basis of a reasonable belief that an individual is a self-certified high net worth or a self-certified sophisticated investor. (The practical effect of the current exemptions in the FPO is that an unlisted firm must actually see a certificate before it can send promotional material to a potential investor).

2) A self-certification exemption for high net worth individuals will replace the current high net worth exemption. The current exemption requires an accountant or employer to sign a statement.

3) A self-certification exemption for sophisticated investors will operate alongside the current exemption. Self-certification as a sophisticated investor will be on the basis of an individual signing a statement to the effect that they meet one or more of the following criteria:

- member of a network or syndicate of business angels for at least six months;
- made more than one investment in unlisted companies in the previous two years;
- working, or have worked in the previous two years, in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises;
- are currently, or have been in the previous two years, a director of a company with an annual turnover of at least £1 million.

4) A requirement for promotional material to carry a statement, the wording and appearance of which will be prescribed, warning of the risks in investing in unlisted equity (see further below).

15 The changes to the FPO are set out in further detail in the response document. These changes are intended to facilitate investment in small firms, by making it easier for investors to become certificated and therefore receive unapproved financial promotions. However, it is important to note that introducing self-certification potentially lessens investor protection.

16 There are risks to consumer protection inherent in the existing regime by allowing investors to receive unapproved promotions. This is because an investor who has received an unapproved promotion may be unable to seek redress if things go wrong

through some of the usual avenues, for example, the Financial Ombudsman Service or the FSA.

17 Allowing self-certification potentially carries an increased risk to consumer protection because of the possibility of individuals signing a statement incorrectly. To minimise the risk of incorrect self-certification and maintain appropriate investor protection, there is a requirement for promotional material sent to certified high net worth individuals or self-certified sophisticated investors to carry 'health warnings'. The health warning consists of a short statement warning that the investment opportunity described carries a significant risk of losing all property invested. The wording and appearance of the health warning is prescribed by legislation so it appears prominently at the beginning of financial promotions. Further, the self-certification statements that high net worth individuals and sophisticated investors will be required to sign also highlight the risk of losing property and other assets when relying on financial promotions and highlight the loss of regulatory protection and redress under FSMA.

18 Promotions to self-certified high net worth or sophisticated investors are to be limited only to investments in unlisted equity, or in the case of collective investment schemes certain types of scheme. There are provisions ensuring that investments made as a self-certified high net worth or sophisticated investor cannot lead to the investor losing more money than he or she invested.

19 Investors will continue to have recourse to protections that lie outside the financial promotions regime, such as civil claims based on fraud and negligence and the offence of misleading statements and practices contained in section 397 of FSMA.

Promotion of Collective Investment Schemes Exemption Order

20 Section 238 of FSMA precludes an authorised person from inviting or inducing someone to participate in a collective investment scheme unless that scheme is an authorised unit trust scheme, a scheme constituted by an open ended investment company authorised pursuant to regulations made under section 262 of FSMA or an overseas scheme recognised pursuant to section 264, 270 or 272 of FSMA. The Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 ('the CIS Order') provides exemptions from this prohibition, including the high net worth individual and sophisticated investor exemptions. For reasons of consistency between the FPO and CIS Order, the consultation document suggested that equivalent amendments be made to the exemptions.

Costs and benefits

21 The costs and benefits described below are of the changes to legislation compared with the option of not legislating.

22 The sectors affected will be:

- unlisted firms;
- private investors ('business angels');
- unauthorised intermediaries;
- firms or individuals who are FSA-authorised to certify an individual as a

- sophisticated investor; and
- accountants and employers able to certify an individual as high net worth.

Benefits

23 The immediate benefit is that high net worth and sophisticated investors will save the costs of certification by a third party. Further, the change allowing promotion on the basis of a reasonable belief that an individual is certified high net worth or sophisticated will mean that small firms are able to promote to a greater number of potential investors. The wider implications of this are:

- more investors are likely to sign a statement that they are high net worth or sophisticated;
- more investors are likely to receive promotions from unlisted companies; and
- ultimately more private capital will be available to unlisted companies currently affected by the equity gap.

Costs

24 The changes to the FPO and the CIS Order are deregulatory measures designed to decrease the costs of compliance with both Orders. They are intended to reduce the total costs associated with promoting and investing in unlisted equity for small firms. Investors will save the costs of third party certification by being able to self-certificate.

Equity and fairness

25 It is not expected that any particular group or business sector will be disproportionately affected by the legislative changes.

Small firms' impact test

26 The proposed changes in legislation to the FPO and the CIS Order are expressly designed to impact positively on small firms by facilitating greater investment in them.

27 The Small Business Service (SBS) has been consulted on the impact on small firms of the proposed changes and are happy that they will not adversely affect small firms, but rather see them being of benefit in the longer term.

Competition assessment

28 The impact on competition is believed to be relatively small; the changes to the FPO and the CIS Order will continue to apply to the same groups of individuals or firms under the current legislation.

29 It could be argued that the changes will have a positive impact on competition as they are designed to boost the start up and growth of new businesses, any other impact on competition will be on the position of those authorised firms or individuals that currently offer a service of certification as high net worth or sophisticated. The replacement of certification for high net worth individuals with self-certification will remove this market for authorised third parties. The introduction of self-certification for sophisticated investors is also likely to decrease the demand for certification services. As feedback from stakeholders and responses to the consultation document suggests that current levels of certification are very low and that

authorised third parties are often reluctant to offer certification services, the impact of the changes is expected to be low.

Enforcement and sanctions

30 Responsibility for enforcement of the FPO will remain with the FSA. The FSA has a large range of sanctions at its disposal, including the criminal law and powers to levy fines.

Consultation

31 There were 62 responses from interested parties on the 'Informal capital raising'⁵ consultation. The consultation period closed on 19 April 2004. The Government took due account of consultation responses in developing the legislation set out in this document. Overall, the response provided a sound basis to proceed with the changes.

32 The FSA and the SBS have also been consulted.

Monitoring and review

33 The proposals for changes to the FPO and the CIS Order are part of the two-year review of FSMA.

34 The Treasury updates FSMA secondary legislation when it is appropriate to do so.

Summary and recommendation

35 To ensure small businesses have access to the finance they need to invest and grow, it is important that the regulatory regime under which these firms can raise relatively small levels of capital strikes an appropriate balance between consumer protection for those investors who are likely to be well-informed, experienced and in a position to obtain appropriate advice, and access to finance for small and growing firms. The current exemptions from the restrictions on financial promotions are not working as intended.

36 To facilitate investment in small firms, the introduction of self-certification for high net worth individuals and sophisticated investors will make it easier for investors to self-certify and therefore receive unapproved financial promotions. The changes would also make it easier for small firms to promote to high net worth individuals and sophisticated investors by allowing promotions on the basis of a reasonable belief that an investor is certified as such.

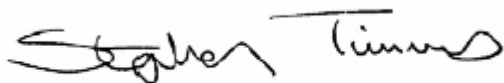
37 The changes will be implemented via secondary legislation under FSMA.

⁵ http://www.hm-treasury.gov.uk/media//195F1/changes_FPO_condoc_240103.pdf

MINISTERIAL DECLARATION

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister, Stephen Timms MP, Financial Secretary to the Treasury.

A handwritten signature in black ink that reads "Stephen Timms". The signature is written in a cursive style with a horizontal line above the name.

Date: 25 November 2004

CONTACT POINT

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