BUSINESS ANGEL INVESTING & THE FINANCIAL SERVICES & MARKETS ACT 2000

INTRODUCTION

The main provisions of the Financial Services & Markets Act 2000 (the "FSMA") and its derivative regulations are a vast body of legislation whose primary aim is the regulation of the financial services industry. The definition of investments includes the shares in any company (public or private) and investors in private companies therefore need to be aware of the extent to which the FSMA applies to them.

The principal regulatory objectives are:-

- Maintaining confidence in the financial system;
- Promoting public understanding of the financial system;
- Securing the appropriate degree of protection for consumers; and
- Reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

While the main thrust of the legislation is directed at financial institutions listed companies, the public markets, listed securities, Collective Investment Schemes and the banking, insurance and pensions industries, the legislation extends to investments in private companies, and the purpose of this note is to highlight some of the principal issues affecting investment in such companies by private individuals (often referred to as 'business angels').

GENERAL PROHIBITION

It is an offence to carry on a "regulated activity" in the United Kingdom unless you are an "authorised person" or an "exempt person". Under the FSMA, authorised persons must be authorised by the FSA and exempt persons are as defined in Exemption Orders published by the Treasury.

Regulated activities include:-

- Dealing in investments;
- Arranging deals in investments;
- Managing investments; and
- Giving investment advice.

Investments include shares or stock in the share capital of a company which includes any body corporate wherever incorporated. Investments also include debentures, debenture stock, loan stock and any other instruments creating or acknowledging a present or future indebtedness, share warrants, options and loans secured over land. These definitions are widely drafted to include investments (and loans) in all private

companies.

BUSINESS ANGEL SYNDICATES

The Government now recognises the important role played by business angels both individually and in syndicates in the creation and development of small companies, and it is widely recognised that the advice and assistance which they are able to offer is often as important as the cash investment.

While the vast majority of business angels are not authorised persons, it is now quite common for syndicates of business angels to appoint a "gate- keeper" who is responsible for co-ordinating their activities and who is frequently the first point of contact for prospective investors.

Business angel syndicates may be organised in a number of ways but typically:-

- The investors may subscribe for shares in a company of which the gate-keeper is a Director and the company makes its own investments. While such an arrangement is likely to resolve many of the regulatory issues as the company is investing its own money, it is not tax efficient and therefore unattractive to the vast majority of business angels (who will want to secure 'EIS' tax relief on their investment);
- The angels may become members of a company limited by guarantee which is run by the gate-keeper. The gate-keeper may be paid by the company to co-ordinate the activities of the syndicate but the company itself must be run on a not for profit basis with the control of investment decisions left in the hands of individual business angels; or
- There may be no formal structure in place at all with a syndicate operating on a completely ad hoc basis. While it is up to the gate- keeper to co-ordinate the activities of the syndicate, he must be careful not to carry out a "regulated" activity on behalf of the syndicate or of any of its members.

This means that:-

- The gate-keeper must not "deal in investments". However, as long as individual members of the syndicate make their own investment decisions this should not be a problem.
- The gate-keeper should not "arrange deals in investments". This issue is resolved by the key members of the syndicate "arranging the deal" themselves. While the gatekeeper has an important role to play in carrying out the due diligence and the discussions leading up to a deal, the deal itself is arranged by the key investors who distribute the "financial promotion" to other members of the syndicate.
- While the gate-keeper may accept some responsibility for gathering information about investee companies and passing relevant information on to investors, he will not undertake any form of discretionary investment management activity and the investors would typically appoint one of their number or some third party to act as a non-executive director with responsibility for monitoring the investment.
- While the gate-keeper may become involved in discussions about the purchase or sale of investments, he will not be involved in the giving of investment advice. The gatekeeper

would also consult with the investors before agreeing to any matter which requires the consent of the investors and the investors would always be closely involved in the ultimate realisation of their investment and make their own decision.

POWERS OF ATTORNEY

It is common practice for the gate- keeper or a "lead" business angel to act as attorney for a group of investors. If the gate-keeper accepts a Power of Attorney from an investor either he or the person drawing up the Power of Attorney should make it clear to the investor that he should take advice from the authorised person in relation to the matters which are covered by the Power of Attorney. This is often dealt with in the membership form for a business angel syndicate that the granter of the Power of Attorney would need to sign. The Power of Attorney should be used for administrative and procedural matters only (eg the completion of an investment) and never to make discretionary investment decisions.

FINANCIAL PROMOTION

In terms of the FSMA unauthorised financial promotion is a criminal offence which carries a custodial sentence of up to seven years. The simple act of giving a Business Plan to somebody who is not entitled to receive it could constitute unauthorised financial promotion. There are however detailed regulations which enable the distribution of unauthorised Business Plans to certain categories of investor.

The financial promotion restriction does **not** apply to any 'non-real time communication' or 'solicited real time communication' (ie Business Plan or Business Plan presentation) which:

(i) is made to an association, or to a member of an association, the membership of which the person making such communication believes on reasonable grounds comprises wholly or predominantly persons who are:

- certified high net worth individuals;
- high net worth companies, unincorporated associations or trustees of a high value trust;
- certified or self-certified sophisticated investors; and

(ii) relates only to an investment under the terms of which a person cannot incur a liability or obligation to pay or contribute more than he commits by way of investment.

The above exemption makes the job of a "gate-keeper" much easier than under previous legislation.

CERTIFIED HIGH NET WORTH INDIVIDUAL

A "Certified High Net Worth Individual" is an individual who has signed a declaration stating that he understands the risks involved in accepting promotions which are not authorised by the FSA and that, during the financial year immediately preceding the date in which the certificate is signed, the individual had either (i) an income of not less than

£100,000 or (ii) net assets to the value of not less than £250,000 (excluding principal residence and pension provision). This self-certified declaration must be renewed on an annual basis and must be in the prescribed statutory form (see separate Briefing Note).

CERTIFIED SOPHISTICATED INVESTORS

A "sophisticated investor" may be either self-certified or certified by an authorised person.

For self-certification, the individual must sign an annual declaration stating that he understands the risks involved in accepting promotions which are not authorised by the FSA and that the individual:-

- is a member of a network or syndicate of business angels for at least six months prior to the date of signing; or
- has made more than one investment in an unlisted company in the two years prior to the date of signing; or
- is working (or has worked in the two years prior to the date of signing) in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises; or
- is (or has been in the two years prior to the date of signing) a director of a company with an annual turnover of more than £1m.
- This self-certified declaration must also be in the prescribed statutory form (see separate Briefing Note).
- If an individual is unable or unwilling to be self-certified, he may nevertheless be certified by an authorised person to the effect that he is "sufficiently knowledgeable to understand the risks associated with that description of investment". This certificate is valid for three years and must be accompanied by a further annual declaration signed by the investor stating that he understands the risks involved in non- FSA authorised investments. The wording of this declaration should follow the prescribed form (see separate Briefing Note).
- Associations of High Net Worth Individuals or Sophisticated Investors
- The financial promotion restriction does not apply to associations of certified high net worth individuals or certified sophisticated investors (i.e. business angel syndicates) the members of which are duly certified.
- High Net Worth Companies, Unincorporated Associations etc
- The person making the financial promotion must reasonably believe that the relevant company, unincorporated association or other entity falls into one of the following categories:-
- Any body corporate which has, or which is a member of the same group as an undertaking which has, a called up share capital or net assets of:-
    - not less than £0.5m, in the case of a body corporate which has more than 20 members or which is a subsidiary undertaking of a parent undertaking which has more than 20 members; and
    - not less than £5m, in the case of any other body corporate; or
- Any unincorporated association or partnership which has net assets of not less than £5m; or
- A 'high value trust', which has gross assets of not less than £10m.

BUSINESS PLAN DISCLAIMERS

While some investors may find the certification scheme cumbersome, it is clear that Parliament has taken account of the many concerns which have been expressed over the distribution of Business Plans which may constitute unauthorised financial

promotion.

Since 3 March 2005 it has been a legal requirement that Business Plans must have a prominent warning as follows:

Warning: The content of this promotion has not been approved by an authorised person within the meaning of the Financial Services and Markets Act 2000. Reliance on this promotion for the purpose of engaging in any investment activity may expose an individual to a significant risk of losing all of the property or other assets invested.

There are various statutory requirements regarding this warning (see separate Briefing Note). The Business Plan must also be accompanied by an indication - (a) that it is exempt from the general restriction (in section 21 of the FSMA) on the communication of invitations or inducements to engage in investment activity on the grounds that it is made to either a certified high net worth individual or sophisticated investor; (b) of the requirements that must be met for an individual to qualify as a certified high net worth individual or sophisticated investor (see separate Briefing Note); and (c) that any individual who is in any doubt about the investment to which the Business Plan relates should consult an authorised person specialising in advising on investments of the kind in question.

MISLEADING STATEMENTS AND PRACTICES

In terms of section 397 of the FSMA any person who:-

- Makes a statement, promise or forecast which he knows to be misleading, false or deceptive in any material particular;
- Dishonestly conceals any material facts whether in connection with a statement, promise or forecast made by him or otherwise; or
- Recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular; is guilty of an offence with a maximum custodial sentence of 7 years.

In this context it is important for those preparing Business Plans to understand clearly the difference between financial projections and financial forecasts. In either case these should be reasonably based on appropriate assumptions which can be verified by prospective investors but projections are merely illustrative whereas forecasts represent the directors view of the likely outcome.

THE PROSPECTUS REGULATIONS 2005

In terms of the Prospectus Regulations it is an offence to distribute a financial promotion to 100 people or more unless it meets the requirements of the Regulations (ie it is a Prospectus) or:-

- The minimum investment is at least 50,000 euros;
- The investment is denominated in amounts of not less than 50,000 euros; or
- The total amount being raised is less than 100,000 euros.

It is important that this restriction should be borne in mind when distributing financial promotion material.

CONCLUSION

The FSMA and its subordinate legislation are even more complex and wide reaching than the legislation which they replace. However, the Government has attempted, through subordinate legislation (in particular with the Financial Services and Markets Act 2000 (Financial Promotion Order) 2005), to take on board the concerns of informal investors. It is

now much easier for business angel syndicates to comply with the FSMA but a further relaxation of the rules could help with the administrative burden that many business angel syndicates are currently faced with.

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