

**EXPLANATORY MEMORANDUM TO THE
FINANCIAL SERVICES AND MARKETS ACT 2000 (REGULATED ACTIVITIES)
(AMENDMENT) (No. 2) ORDER 2005**

2005 No. 1518

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

2. Description

2.1 This Order creates an exemption for operators of a business-angel led Enterprise Capital Fund (“BA-led ECF”) from the requirement to have Financial Services Authority (“FSA”) authorisation when carrying out certain activities under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(S.I. 2001/544), as amended (“the Regulated Activities Order”).

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

3.1 None

4. Legislative Background

4.1 The Regulated Activities Order specifies the activities that are “regulated activities” so as to require the FSA’s authorisation under the Financial Services and Markets Act 2000. The Regulated Activities Order includes some exceptions so that certain regulated activities are exempt from the requirements that usually attach to such activities.

4.2 This Order amends the Regulated Activities Order to add a further exception. The effect of this exception is that certain regulated activities, when carried out by operators of BA-led ECFs, are not “regulated activities” within the meaning of the Financial Services and Markets Act 2000 and the Regulated Activities Order.

4.3 The amendment is given effect by adding two articles to the Regulated Activities Order. Article 72E of the amended Order prescribes the limits of the exception, including a list of the activities that fall outside the definition of “regulated activities” when carried out by BA-led ECFs. Article 72F of the amended Order provides for the interpretation of terms in Article 72E.

5. Extent

5.1 This Order applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 Not applicable

7. Policy background

7.1 Small to medium enterprises (“SMEs”) make an important contribution to the output, employment and productivity of the UK. Access to finance is essential for growing businesses to invest, to implement new technologies and strategies and to contribute to a more productive economy. External sources of finance are particularly important for start-up and small businesses, which often lack retained profits to re-invest to support their own growth.

7.2 *Bridging the finance gap: next steps*¹ set out the results of the Government’s consultation on access to growth capital for SMEs, and presented evidence of an equity gap facing businesses seeking to raise relatively modest sums of risk capital. Despite the contribution of existing Government interventions to help markets overcome the barriers that lead to the equity gap, available evidence suggests that it remains a constraint for some businesses seeking up to £2 million of growth capital, and can be particularly severe for those seeking less than £1 million.

7.3 *Bridging the finance gap* therefore announced the Government’s intention to launch a ‘pathfinder’ round of ECFs. ECFs will be commercially-managed funds, established to invest a mix of public and private sector capital in SMEs with growth potential that are affected by the equity gap. The pathfinder round would test the scope for a long-term ECF program which would aim to stimulate an increased flow of private capital into the equity gap, and to lower the barriers to entry for potential new participants in this part of the risk capital market.

7.4 Business angels are an important source of equity finance for SMEs and as such, play an important role in addressing the equity gap. Broad estimates suggest they provide between £500 million and £1 billion of investment per annum in around 3,000 to 6,000 businesses. Whereas structured business angel syndicates have been a significant feature of the US enterprise economy, there are currently relatively few groups operating in the UK. The Government believes that structured syndicates have a potentially important role to play in the UK, enabling greater total sums of investment into individual firms.

7.5 ECFs offer a potential mechanism for groups of high net worth and sophisticated investors to take the first steps towards formalising existing loose networks and benefit from government support to leverage their impact in the private equity market. One of the objectives of the ECF pathfinder round is to test the appetite for ECFs amongst business angel groups (who would actively invest their own funds, but not the funds of other passive private-sector investors), as well as amongst fund management professionals.

7.6 However, the Government is aware that the costs of regulatory compliance may present a barrier for groups of angels who are contemplating submitting bids for pathfinder ECFs. The Government therefore consulted on proposals to allow the operator of a BA-led ECF, under certain circumstances, to operate that fund without

¹ *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*, HM Treasury and Small Business Service, April 2003: www.sbs.gov.uk/financegap.

the need for authorisation by the FSA under the Financial Services and Markets Act 2000 (FSMA) and the Regulated Activities Order².

7.7 The Government consulted on the amendments to the Regulated Activities Order in July 2004. 12 formal responses were received from a number of different sectors, including legal firms and companies providing financial services and advice. The majority of responses agreed that suitably qualified individuals should be permitted to manage their own funds and those of the government through a BA-led ECF without having to be authorised to do so.

7.8 This Order follows the consultation and further discussion with stakeholders. A small number of amendments were made to this Order as a result of the consultation. The significant amendments are:

- the addition of an exemption for advice on investments to be made by or on behalf of the participants in a BA-led ECF;
- an additional article to broaden the definition of “a limited company”;
- the inclusion of self-certified sophisticated investors in the list of participants of a BA-led ECF; and
- the amendment of the definition of “high net worth company”.

7.9 This Order creates exclusions from regulation for the operator of a BA-led ECF when carrying out of certain activities specified in the Regulated Activities Order.

7.10 In designing this Order, the Government has taken account of the need to preserve full consumer protections for those who need them, while avoiding disproportionate compliance costs for those who do not. The consultation document set out the measures that the Government will put in place to minimise the potential risks associated with the proposals. In particular, the exclusion contained in this Order will apply only to operators of BA-led ECFs where the investors are suitably qualified to make informed investment decisions, and fully appreciate (and have signed a statement to that effect) that they are forgoing the usual protections available under FSMA.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 The impact on the public sector is negligible.

9. Contact

Andrew Price at HM Treasury Tel: 020 7270 5925 or e-mail: andrew.price@hm-treasury.x.gsi.gov.uk can answer any queries regarding the instrument.

² “Business Angel-Led Enterprise Capital Funds: A consultation on proposed changes to the Regulated Activities Order” HM Treasury, July 2004.

REGULATORY IMPACT ASSESSMENT

PURPOSE AND INTENDED EFFECT OF MEASURE

- Objective**
- 1.1.** The objective of the changes to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (“the Regulated Activities Order”) is to enable suitably informed and experienced groups of individual investors (“business angels”) to collectively manage their own and the Government’s capital through an Enterprise Capital Fund (“ECF”) and, under certain circumstances, for that activity to not require authorisation under the financial services regulatory system. It is intended that this will reduce the costs, and so increase the commercial viability, of investing in a portfolio of equity gap businesses.
- 1.2.** The Government wishes to achieve this objective in a way that ensures the full protections of the regulatory system are preserved for consumers who need them.
- 1.3.** The objective is achieved by excluding the operators of business angel-led ECFs (“BA-led ECF”) from requiring authorisation by the Financial Services Authority (“FSA”) when engaging in certain activities in tightly defined circumstances.
- 1.4.** The deregulatory changes will directly affect those individuals looking to operate a BA-led ECF, and will indirectly benefit unquoted SMEs seeking equity finance.

- Background**
- 1.5.** Access to finance is essential to enable successful businesses to grow. However, many small businesses with high-growth potentially face difficulties in attracting finance, particularly equity finance. This has led to an ‘equity gap’ for small firms seeking relatively modest amounts of risk capital. ECFs were proposed in the Bridging the finance gap consultation³ as a potential new approach to increase the availability of growth capital to small and medium sized enterprises (SMEs) affected by the equity gap. Bridging the finance gap: next steps⁴ subsequently announced the Government’s intention to launch a pathfinder round of ECFs. The pathfinder round will gather evidence and market intelligence that will inform the Government’s decision on whether and, if appropriate how, to develop a long term ECF program. The Government will launch the competitive bidding process for pathfinder ECFs as soon as possible after a decision is taken on European state aids approval process.
- 1.6.** The Government believes that ECFs also offer a potential mechanism to provide Government support to groups of angels in formalising existing networks. Business angels are an important source of equity finance for SMEs, and play an important role in addressing the equity gap. Structured business angel syndicates have been a significant feature of the US enterprise economy, and potentially have a similar role to play in the UK, where there are currently few such groups operating.
- 1.7.** One of the objectives of the pathfinder round is to test the level of appetite amongst private investors for the ECF product. However, the Government is aware that the time and cash costs of compliance with regulation under the Financial Services and Markets Act 2000 (“FSMA”) may be a barrier to groups of angels considering bidding for a pathfinder

³ *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*, HM Treasury and Small Business Service, April 2003: www.sbs.gov.uk/financegap

⁴ *Bridging the finance gap: next steps in improving access to growth capital for small businesses*, HM Treasury and Small Business Service, December 2003: www.sbs.gov.uk/financegap

ECF. To maximise the attractiveness of ECFs to groups of high net worth and sophisticated investors seeking to manage their own funds, the Government therefore intends to allow the operator of a BA-led ECF not to be FSA authorised in order to carry out activities specified in the Regulated Activities Order (“RAO”).

Risk Assessment

1.8. Responses to the Government’s consultation on changes to the financial promotions regime⁵ have highlighted how private investors often regard the costs of complying with regulation as disproportionate to the protections afforded by FSMA. This is particularly the case where regulatory protections are designed to safeguard investors who may actually possess the necessary information and expertise to make informed investment choices. The fixed costs associated with venture capital investing are a key cause of the market failure ECFs are designed to address.

1.9. The fees for FSA authorisation and on-going supervision combined with professional and compliance costs for funds that are similar to ECFs have been reported to be between £50,000 and £100,000 a year (please refer to the ‘Costs and benefits’ section for further detail). It is likely that these costs are likely to be regarded as disproportionate to the benefits of authorisation by business angels. This may deter groups of business angels from bidding to run an ECF that is managed collectively by the investors themselves. This risks undermining the Government’s objective of encouraging groups of angels to formalise existing informal networks.

OPTIONS

1) Not to legislate

1.10. The operators of an BA-led ECF would therefore need to be authorised by the FSA under FSMA. The Government believes that, where an ECF is established and operated by a group of experienced investors wishing actively to manage their own funds, the benefits of regulatory protection are likely to be disproportionate to the costs of FSA authorisation and compliance. Responses to the *Bridging the finance gap* and *Informal capital raising* consultations indicate that experienced business angel investors consider the benefits of regulatory protection to be very small, relative to the costs.

1.11. Maintaining the *status quo* is therefore likely to stifle demand for the ECF product amongst business angel groups. It will therefore compromise the effectiveness of the pathfinder round, and will reduce value for money for the Government’s investments in pathfinder ECFs.

2) Exclude all operators of ECFs from the regulatory system

1.12. The Government could exclude all operators of ECFs from having to be authorised under the financial services regulatory system. This would reduce the costs to ECFs of making equity gap investments but, in the Government’s view, would create unacceptable risks for those consumers of financial services who do not fully understand the risks of making equity-based investments in unquoted companies. Moreover, many prospective investors will specifically require the protections afforded by the financial services regulatory system, so excluding all operators of ECFs from having to be authorised would

⁵ *Informal capital raising and high net worth and sophisticated investors* HM Treasury January 2004.

severely restrict the attractiveness of ECFs and reduce the programme's impact in addressing the equity gap.

3) A targeted exclusion for BA-led ECFs to the Regulated Activities Order

1.13. A carefully targeted exclusion from regulation for the operator of a BA-led ECF when carrying out certain activities specified in the Regulated Activities Order would enable BA-led ECFs to avoid the costs of regulation where the angel investors have stated that they do not require the normal regulatory protections, and are sufficiently knowledgeable to understand the risks of making equity-based investments in unquoted SMEs.

1.14. The benefit of this option is that it removes the need for authorisation for groups of suitably experienced individuals who are collectively managing only their own funds (and the Government's), while preserving full regulatory protections where it is appropriate to do so.

1.15. However, there are risks inherent in creating such an exclusion, primarily that unsuitable investors are misold ECFs. This risk is heightened given that the exclusion would mean that investors would not have recourse to the safeguards and protections in FSMA if things went wrong. Although investors in a BA-led ECF would not have recourse to the FSA, redress may be sought via the common laws of fraud and negligence. Investors would also be protected from misleading statements⁶ and in addition there will also be clear contractual obligations set out in the Partnership Agreement that constrain the actions of the partners and provide for remedies in cases of breach of contract. It should be noted however that these controls would be less robust than those that flow from FSMA regulation.

1.16. To mitigate against these risks the Government will conduct due diligence on all proposed investors in BA-led ECF. The Government would be able to turn down applications for BA-led ECFs where there were any concerns that the investors did not appear to be sufficiently aware of the risks involved. Such investors would be able to apply to invest in a regulated ECF if they so chose. Furthermore, the Government intends to exclude BA-led ECFs only in circumstances where investors are certified high net worth or sophisticated. Finally, the Government will require investors to sign a statement confirming they understand the consequences of investing in an unregulated fund.

1.17. The Government believes that its due diligence checks will offer an appropriate check that proposed investors understand the risks of investing in a BA-led ECF include giving up recourse to FSMA, and will ensure that public funds are managed responsibly.

COSTS AND BENEFITS

1.18. The costs and benefits described below compare the legislative option (targeted exclusion (option 3), with the option of not legislating (option 1). Option 2 has been dismissed as creating unacceptable risks for consumers of financial services products, and being incompatible with the needs of investors who will actually want the protections of FSMA. This is because ECFs not constituted by private investors seeking to collectively manage their own funds, are expected to use the traditional limited partnership model favoured by most venture capital funds. As such, private investors would be 'passive',

⁶ Section 397, FSMA 2000

leaving the management of their money and all investment decisions to professional fund managers. In these circumstances it is right that the fund managers should be FSA-authorized and investors enjoy the protections afforded by FSMA.

The sectors most likely to be affected by the proposed changes will be:

- private investors who meet the criteria for certification as high net worth individuals or sophisticated investors
- unquoted SMEs in sectors that will be eligible to receive equity-based investment from ECFs

Benefits

The immediate benefit is that each BA-led ECF will save initial authorisation costs and ongoing FSMA compliance costs. The wider implications of this are:

- a greater likelihood of bids for BA-led ECFs for the pathfinder round
- more business angles likely to formalise existing 'loose' networks
- ultimate result of more private capital available to small businesses currently affected by the equity gap

Costs saved 1.19. The costs that would be saved are described below. As the pathfinder round for ECFs has not yet been launched it should be noted that these are costs that would be avoided rather than reduced.

Costs of FSA authorisation include:

- an FSA application fee of £5,000;
- professional fees to a law firm or compliance expert to assist with the application, of £15,000 - £30,000;
- professional fees to an audit firm of not less than £10,000 for sign-off on the budget and regulatory capital statement (if a large audit firm is used, this could rise substantially)

1.20. It should also be noted that even once authorised, there are ongoing compliance costs. External estimates have put total costs of fees for FSA authorisation and on-going supervision combined with professional and compliance costs for funds that are similar to ECFs between £50,000 and £100,000 a year.

1.21. The number of BA-led ECFs that would benefit from these deregulatory measures is unknown at this stage; the purpose of the pathfinder round of ECFs is to enable the Government to test the possible level of appetite that might arise in a longer-term programme.

Costs

1.22. The changes to the Regulated Activities Order are deregulatory measures designed to save BA-led ECFs the costs of complying with regulation in circumstances where these costs would otherwise have been disproportionate. It is therefore intended that the impact on their costs will be to reduce them. The Government does not believe the proposal will impose costs on others.

EQUITY AND FAIRNESS

1.23. Government funding to pathfinder ECFs will be allocated by a competitive bidding process. Applications will be judged on the basis of overall venture fund management, against a set of criteria that will be published in advance, and independent experts in the SME finance arena will be involved in the assessment process. The Government will ensure a fair and open application process for ECFs.

SMALL FIRMS' IMPACT TEST

1.24. In developing its plans for ECFs, the Government has consulted extensively with interested parties, including business and SME representative bodies and the wider SME finance community.

The deregulatory measure contained in the Order will not directly affect small businesses, but will reduce the costs incurred by BA-led ECFs when making equity-based investments in small firms. In turn, this should increase the effectiveness of the ECF proposals, and so benefit innovative, growth-oriented small businesses by boosting the supply of risk capital.

1.25. The Small Business Service has been consulted on the impact of excluding BA-led ECFs from authorisation on small firms.

COMPETITION ASSESSMENT

1.26. One of the objectives of the ECF programme is to stimulate the entry of new risk capital suppliers into the 'equity gap' segment of the market. It is therefore intended that the proposed deregulation for BA-led ECFs will help to stimulate competition in the market for risk capital.

1.27. The Government recognises that the deregulatory measure could place similar business angel-led funds which are not Enterprise Capital Funds, and which would therefore still need to be authorised, at a slight competitive disadvantage. The Government has committed to exploring the regulatory burden on private investors, in particular the impact of the RAO on business angel activities. It is intended that the responses to this consultation as well as the financial promotions consultation will help inform any further changes to the regulatory regime. Question 3 of this consultation seeks views on whether there are other, non-ECF, arrangements for which the proposed exemption might be appropriate.

ENFORCEMENT AND SANCTIONS

1.28. The Financial Services and Markets Act 2000, and subordinate legislation, is enforced by the Financial Services Authority, which has a large range of sanctions at its disposal, including the criminal law and powers to levy fines.

MONITORING AND REVIEW

1.29. The Government will assess the early progress of the pathfinder round of ECFs before deciding whether to proceed with a longer-term ECF programme. The impact of the deregulatory measure would be considered as part of that assessment.

CONSULTATION

1.30. The Government consulted on the changes to the Regulated Activities Order in July 2004. Responses were received from a number of different sectors, including legal firms and companies providing financial services and advice. The majority of responses agreed that suitably qualified individuals should be permitted to manage their own funds and those of the government through a BA-led ECF without having to be authorised to do so.

The Small Business Service and the Financial Services Authority have been consulted in detail on this deregulatory proposal.

SUMMARY AND RECOMMENDATION

1.31. To increase the attractiveness of ECFs to groups of suitably knowledgeable business angels seeking to manage their own funds it is desirable that the costs of complying with regulation are proportional to the benefits conferred by regulatory protections.

IMPLEMENTATION

1.32. It is therefore proposed that BA-led ECFs are excluded from having to be FSA-authorized in order to carry out activities specified under the RAO.

1.33. It is recommended that these changes be implemented via secondary legislation under the Financial Services and Markets Act 2000.

MINISTERIAL DECLARATION

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

Signed by the responsible Minister, Ivan Lewis MP, Economic Secretary to the Treasury

Date:

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