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Bridging the finance gap

The Government is proposing to create a new investment vehicle for small companies. If the proposals go ahead, Enterprise Capital Funds could open the way for business angels to play a wider role in fund management with a lower regulatory threshold.

Despite the presence of investment vehicles such as venture capital trusts and the Enterprise Investment Scheme, the Government has become increasingly concerned that small companies are finding it difficult to raise money. Its proposals for Enterprise Capital Funds (ECF) set out two types of fund: the first, for passive investors, will have to comply with various regulatory requirements set out by the Financial Services Authority (FSA); the other will be available to business angels and will be outside the scope of the FSA's regime. The Government will be an investor in both types of fund and will commit up to two-thirds of the money in an ECF up to a cap of £25 million to any individual ECF.

Current regulatory hurdles

Most funds comprising syndicates of investors looking to invest in a portfolio of companies will be collective investment schemes (CIS). They will typically be established as limited partnerships where the limited partners (or investors) are entirely passive in order to maintain a limited liability for the debts of the partnership. The active partner, called the general partner, is liable for the debts of the partnership and is usually a special purpose company established by the promoter or proposed manager of the fund.

The general partner usually delegates its responsibilities of operating and managing the fund to another company. Both of these activities require FSA authorisation. Obtaining and then maintaining such authorisation are significant obstacles for a potential operator / investment manager. Applicants must show, on an ongoing basis, that they are fit and proper to carry on the business by reason of competence (as illustrated by exams and experience), integrity and financial standing. Even if the investment manager is already authorised it may not have the necessary FSA permission to operate the fund (and may not want to have to deal with the administration of running the fund).

The second regulatory hurdle comes from the strict limitations placed on the promotion of a CIS. A CIS looking to invest in SMEs and other private equity investments may only be promoted to people who fall within certain categories. These include certified high net-worth individuals, certified sophisticated investors or investors whose financial adviser has advised them that the CIS is a suitable investment.

The two certified categories were introduced in December 2001, but there has been relatively low take-up of certification. To become a certified high net-worth individual, an individual has to get his employer or accountant to certify that he has net assets of £250,000 or an annual income of £100,000. This is straightforward, but adds extra administration into an individual's life. To become a certified sophisticated investor, an FSA regulated person has to certify that the individual is a sophisticated investor in the relevant type of investment. However few authorised persons have been willing to grant a certificate which could expose them to a potential liability.

Even if the investors have these certificates, before sending out any fund promotion document, the promoter of the fund has to know that an individual is certified. This has led to preliminary letters being sent by promoters of funds, along the lines of "we have something really interesting to tell you, but cannot do so unless you complete and return the enclosed certificates and statements".

Overcoming the hurdles

The Government's view is that FSA authorisation is an unnecessary hurdle when dealing with groups of experienced investors such as business angels, and that business angels should be actively involved in managing the assets of ECFs.

It is proposed that a business angel led ECF should not require any of the parties to be FSA authorised, provided the ECF only invests in unlisted companies and its participants comprise the following:

- the Government
- a body corporate whose members are participants in the ECF and who between them have invested at least 50% of the total investment in that particular fund, excluding any investment made by the

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government (ie this is the general partner made up of business angels who are also investing personally)

· one or more of the following:

  · a sophisticated investor

  · a high net-worth individual

  · a high net-worth company, unincorporated association or trust.

This will allow groups of business angels to join together without the need for FSA authorisation and, through their interests in the general partner, to take an active role in managing investee companies. Non-business angel led ECFs will require authorisation for the operator and manager.

Consultation is also taking place on simplifying the certification process so that high net-worths and sophisticated investors will be able to self-certify. Promoters of funds will be able to contact such individuals on the reasonable belief that they will qualify, hence removing the need for those cryptic letters.

Next steps

During the consultation process, it has been queried whether a new vehicle is needed at all, so the Government is proposing that only a handful of ECFs will initially be allowed in order to test whether there is a need. Anyone who is interested in putting together an ECF (whether business angel led or otherwise) will need to take part in a tender process. Details can be found in the Pathfinder Enterprise Capital Funds Draft Guidance for Applicants published in May 2004. In summary, the applicants will need to provide information on:

· the fund structure, its proposed term and total commitment

· the investment strategy looking at sector, investment spread and proposed exits

· fund operation considering how deals will be sourced

· details of target investors

· details of the proposed ratio of private investment to government funding and explain why the proposals represent the least necessary public support

· fee structures and carried interest arrangements

· financial projections and budgets

· details of the key personnel and management.

Applications must be received within 8 weeks of notification being made in the Official Journal of the European Union and publication of final guidance. The Government will consider the applications and notify successful applications after 12 weeks. The successful applicants will then have 6 months to reach final closing.

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