

Venture Capital Schemes: Association of Investment Companies submission, part 1

The Association of Investment Companies (AIC) welcomes the opportunity to comment on HMRC's proposed amendments to change the VCT rules to conclude the State Aid approval process and refine the targeting of the relief.

The AIC represents 94 VCTs which account for some 90% of the assets of the sector. We are keen to help deliver the technical objectives of the proposed changes (in particular ensuring the scheme fits within European Commission requirements) while maintaining VCTs' ability to deliver their public policy objectives. That is, providing capital to small businesses which customarily struggle to raise finance from traditional institutions.

The targeting proposal raises particularly strong concerns for the VCT sector. Its current construction, which focuses on the concept of an 'enterprise' rather than a company, threatens to change the character of the VCT scheme. It creates a new way of assessing eligible investments which threatens to disrupt the sector and compromise the flow of VCT capital.

With this in mind, we warmly welcome the announcement that any new legislation based on the EC small enterprise definition would only be applied to money raised after the detail of the legislation is announced.

Also, as we have concerns about using the EC Small Enterprise definition, and are considering alternative options to address HMRC's concerns, we warmly welcome the extension of the consultation on this issue. This will provide an opportunity for the industry to engage with HMRC to establish the best way of addressing its concerns while causing minimum disruption to the sector.

The AIC will submit a separate response addressing the targeting in more detail in due course.

Changes required as a result of securing State Aid approval for VCTs

HMRC's efforts to make these changes sympathetic to the smooth operation of the VCT scheme are welcome. In particular, the AIC supports the proposed regulations designed to:

- Ensure VCT investment is not made into a company in difficulty;
- Replace the requirement for a company to carry on its qualifying trade wholly or mainly in the UK to one requiring a permanent establishment in the UK;
- Require VCTs to be traded on an EU regulated market, rather than be included in the UK's Official List.

These proposals deliver the technical objectives of HMRC and will not unnecessarily disrupt VCT investment activity.

Unfortunately, the changes that will require VCTs to hold 70% of their investment in equity are not so benign. In principle the AIC does not support requiring a higher level of equity investment. Our fear is that this will disrupt an investment model which has previously delivered appropriate commercial outcomes (including providing incentives for investee company managers) while delivering capital to smaller businesses facing a funding gap. That said, we recognise that this change results from State Aid negotiations with the Commission and is therefore unavoidable. Nevertheless, we are keen to limit the impact of these changes as far as possible within the constraints set by the State Aid approval process. The AIC therefore **recommends** a number of targeted changes should be made to these proposals to minimise this risk.

The following adjustments to the regulations will achieve this outcome:

- **Allowing preferential rights to a dividend:** The Commission is concerned that the substance of the return accrued by VCTs from eligible shares should arise from a profit and that it should result from exposure to risk. This objective does not preclude VCTs being allowed certain preferential rights to dividends. Any dividend, preferential or otherwise, would be paid out of the profits of the investee company, and therefore be profit-dependent (as required by the State Aid Risk Capital Guidelines).

The proposed amendments to Section 285, proposed (3A) (a) and (b) should allow certain preferential rights. For example, they will allow a class of share which is entitled to a proportion, say, 5% of distributable profits. The rule should also allow a VCT to receive a set amount to be paid from the profits available for distribution. (One caveat is that this right should be limited so that, in circumstances where a distribution is not made, the right to a payment applying to that period cannot be rolled over to the next distribution period. This will prevent the preferential rights from giving the equity the characteristics of a debt instrument. It is therefore a suitable restriction.)

Whether or not both these preferential rights would be secured by the proposed draft is not clear. The AIC **recommends** that the legislation be clarified to make clear these rights are allowed. One option would be to adjust Section 285, proposed (3A) (a) to say:

“carry no right to dividends of a fixed amount calculated by reference to the amount invested” [proposed amendment emphasised]

If such an adjustment is not possible, we **recommend** that HMRC should provide guidance which makes this interpretation clear i.e. that preferential rights as described above can be secured.

This approach will maximise the range of investment structures available for VCT investment without compromising the demands of the State Aid approval process.

- **Revising the control test:** The AIC **recommends** that the control test should be adjusted to allow VCTs to receive higher levels of dividend payments. This will compensate for a reduction in amount they can invest through debt securities and maximise VCTs' potential to agree commercially attractive deals.

All things being equal, the requirement for a higher level of equity holdings means VCTs will receive a higher proportion of the profits available for distribution. In this context, maintaining the ceiling on dividend payments is inappropriate as it threatens to make it difficult for a VCT to ensure a proper balance of risk and return.

If the restriction on receiving dividends were not removed one option would be for the debt component of the VCT's investment to attract a higher level of interest. This is not inherently attractive as it will involve agreeing interest rates which fall outside the range seen in more natural arrangements (i.e. those not constrained by the VCT rules). Such unconventional arrangements could encounter significant resistance from management or other shareholders. It might also create complications when considering future adjustments to the capital structure of the company. Allowing the VCT to receive a higher proportion of the profits available for distribution will give it more flexibility to negotiate mutually attractive arrangements incorporating a wide variety of possible approaches. This will make increasing the eligible shares requirement as palatable as possible and limit the detrimental impact of introducing this State Aid requirement. The AIC therefore **recommends** deleting the limit on receipt of dividends in circumstances where the requirement to hold 70% of a qualifying investment in eligible shares is applied.

Other aspects of the control test should remain in place. A VCT should be prevented from controlling more than 50% of the voting rights or a majority of shares in the investee company. They should also not be able to receive more than 50% of the assets of the company in the event of a wind-up.

The AIC would be keen to discuss these issues further and pleased to work with HMRC to deliver the recommendations set out in this paper.

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For more information on the issues raised in this response contact:

Guy Rainbird, Public Affairs Director, The Association of Investment Companies. guy.rainbird@theaic.co.uk