

Maximising the economic impact of VCTs:

Using 'treasury' shares to manage VCT scheme costs and support sustainable investment in small businesses

Policy submission from The Association of Investment Companies

Venture Capital Trusts (VCTs) are investment funds which channel development capital and management expertise to small businesses. They are supported by a number of tax incentives which mitigate the risks of this activity and increase VCTs' potential to secure a more attractive investment return. Smaller businesses are risky for a variety of reasons. They have low levels of resources to see them through economic turbulence or deal with competitive threats. They lack the funds required to build capital assets, branding or market share. They may have inexperienced management teams who do not have the skills to develop the company or deal with changing market conditions. All these factors are reflected in their high failure rate.

VCTs invest in business with the potential to become strong wealth and employment creators but which, because they are inherently risky, struggle to secure development capital through traditional routes. They have become an important source of funding and could be even more significant over the next few years as slowing economic growth and withdrawal of bank lending facilities restrict financing. The management expertise offered by VCTs may also be particularly valuable where smaller businesses find themselves facing harsher trading conditions for the first time.

With this in mind, the Association of Investment Companies (AIC) is concerned that the current interpretation of the VCT rules in relation to 'treasury' shares is restricting the ability of the sector to provide maximum benefit to small businesses and increasing the cost to the Exchequer of the VCT scheme. The AIC therefore **recommends** that the Government reviews its position on the use of treasury shares by VCTs and changes its interpretation of the rules to enable their use.

Share buy-backs by VCTs

'Treasury' shares (which are explained later in this paper) are important to VCTs because these companies are particularly active in buying-back their own shares.

VCTs are listed closed-ended companies. They have a set number of shares in issue, which are traded through a stock exchange. All listed companies (assuming they secure permission from their shareholders) are able to buy-back their shares. They may do this for any number of reasons but VCTs customarily undertake buy-backs to enable their shareholders to exit their investment when the secondary market for the shares is illiquid. This is often a problem for shareholders as potential investors customarily buy newly issued shares so they can take advantage of the attractive 'up-front' income tax relief.

Where VCTs do not act as a buyer 'of last resort' investors face the risk that the discount (the difference between the market price of the shares and the net asset value of the portfolio) would be substantial. The risk of having to sell at a wider discount than was prevailing at the date of purchase could be a significant disincentive for investors. As most VCT purchasers buy on launch when there is no discount it is invaluable if VCTs can seek to manage the level of discount at which shareholders can exit their investment.

Buy-backs by VCTs are therefore seen by investors and their advisers as highly desirable. An undertaking to buy-back shares is usually made in a VCT's prospectus and is commonplace across the sector.

Buy-backs are customarily offered to shareholders from launch. However, most investors do not seek to sell their shares during the early years of a VCT's life i.e. until the holding period (3 or 5 years depending on when the VCT was launched) has elapsed. Investors must hold their shares for a set duration to secure the up-front income tax relief. Consequently, most share buy-back activity is undertaken by VCTs when this holding period has elapsed. In these circumstances buy-backs can represent a significant proportion of a VCT's capital value.

For example, generalist VCTs launched before 5 April 2004 have now passed their holding period. As a whole, these companies repurchase, on average, between 2% and 4% of their own shares each year. AIM-focussed VCTs in the same situation are purchasing up to 6% of their own stock on average. Some companies exceed even these levels. A few generalist VCTs have bought back nearly 13% of their shares in the last 3 years. One VCT investing in AIM stocks bought back over 17% of its shares over the same period. Clearly, as time elapses after the end of the holding period, the likelihood that VCTs will buy-up an increasing proportion of their stock increases substantially. (We estimate that 47 VCTs have bought in shares with a total value of £10.7 million so far this year.)

So, while buy-backs provide an important exit route, they can also carry some disadvantages for the VCT and its remaining shareholders. Buy-backs at this volume reduce the amount of funds available for new or 'follow-on' investments as the manager has to maintain a pool of cash to pay for them. Also, money leaves the fund for good when it is paid out to investors.

Where buy-backs reduce the size of the VCT, they can also create structural problems. Most notably they can increase the operating cost/NAV ratio of a VCT, which disadvantages remaining shareholders. This happens because the costs of the fund are normally relatively fixed.

One option to counter-balance the impact of share buy-backs is for the VCT to make a new issue of shares, and this is a regular occurrence within the sector. However, the Government should also consider how it can encourage VCTs to use treasury share powers as an alternative mechanism to replace depleted funds as this could deliver a number of public policy benefits – not least reducing the overall cost of the VCT scheme.

Treasury share powers

Traditionally, when shares are bought back by a company they are then cancelled – and cease to exist. However, since December 2003, the law has allowed them to be held ‘in treasury’. Repurchased shares do not have to be cancelled but can be owned by the company itself. While in treasury these shares cannot be voted, have no other rights, and do not receive a dividend. However, they can be sold at a later date to meet new demand for the company’s stock and, in the case of a VCT, to raise funds for investment.

The decision to buy-back shares and hold them in treasury for subsequent re-sale is ultimately controlled by shareholders. For example, shares held in treasury continue to carry pre-emption rights and their re-sale has to be approved by shareholders via a special resolution.

When shares are re-sold from treasury the purchaser does not receive the 30% income tax relief that newly issued VCT shares provide. This is correct as they are the same shares which received that tax-relief on launch.

If the sale and purchase of the shares held in treasury had instead been carried out in the secondary market, without the involvement of the VCT, the transaction would not have attracted any income tax relief for the purchaser so there is no reason for it to do so in this case.

Restrictions on the use of capital raised through selling treasury shares

It is currently unattractive for a VCT to use treasury share powers to resell the same shares back into the market (without the income tax relief applying) to secure investment funds because of the way these funds are viewed by HMRC.

HMRC maintains that funds raised via a sale of treasury shares are ‘new’ money and therefore applies the most recent investment rules for eligible investments. Therefore, even if the shares were originally issued at a time when the capital raised could be invested in businesses with gross assets of up to £15m, when they are re-sold today the funds raised can only be invested in businesses with assets of £7m or less. (Other new investment restrictions, such as the limit on investing in companies with 50 employees or more and the bar on investing in a business which has received tax-advantaged funding of £2m in the previous 12 months would also apply.)

This means that the VCT has to maintain two investment pools (or potentially more, if the rules keep evolving) with different investment restrictions. This creates administrative complexity, increases the compliance burden and, as new pools have more restricted investment criteria than previous ones, this increasingly limits the investment freedom of the fund.

Of course, the same issues apply where new shares are issued to replace investment funds lost through share buy-backs. However, in this scenario, the negative implications for the VCT are offset by the advantages of securing

the income tax relief, which enhances the return for investors and makes it easier to secure buyers. This would mean the VCT has a committed cohort of shareholders who are unlikely to require buy-backs during the 'holding' period. Any administrative disadvantages with new share issues are outweighed by the overall benefits. As a result, while a number of VCTs have gained approval from shareholders to re-sell shares out of treasury, we believe that none have ever used these powers. Allowing VCTs to invest funds secured from re-sale of treasury shares under the original terms will change the commercial calculation and deliver public policy benefits.

Benefits of VCTs using treasury shares

Allowing VCTs to invest money received from the re-sale of treasury shares under the same qualifying conditions that applied when the shares were first issued will:

- **reduce the costs of the VCT scheme to the Government:** At the moment there is no benefit in VCTs using treasury share powers so they invariably replace lost funds by issuing new shares. This creates a cost for the Government in the form of the up-front income tax relief, which would not be incurred under the treasury shares route.
- **maximise the ability of VCTs to support a wide variety of small businesses:** The nature of the funding gap for small businesses changes over time. In recent years lending conditions have been relatively favourable and many small businesses had been able to borrow investment capital. However, less favourable economic conditions are likely to limit these funding sources in future. Normal restrictions caused by the economic cycle are likely to be exacerbated over the next few years by tighter restrictions on bank lending policies following the credit-crunch.

If HMRC's approach to treasury shares is not adjusted, the ability of VCTs to invest in companies with assets between £7m and £15m will be reduced. This is a real risk as it is VCTs with the ability to invest in these businesses which will increasingly have shareholders coming to the end of the 'holding' period over the next few years. VCTs are likely to be under increasing pressure to make buy-backs. As a consequence, diversity within the VCT sector's asset base could be reduced substantially. The public policy concern should be that a possible reduction in available capital will bite just when these businesses are facing harsher economic circumstances but they still have investment needs.

This problem is particularly pressing as the Government is now unlikely to be able to replenish the '£15m pool' by changing the rules on qualifying investments because of European State Aid rules.

The Government decided to focus the VCT scheme on businesses with gross assets of no more than £7m in 2006. However, we anticipate that this decision was informed by the fact that VCTs had already raised over a billion pounds which could be allocated to companies with assets up to

£15m. We envisage that the Government would not want this source of funding to fall away, particularly as it would then lose the ongoing benefit of its original investment in this part of the economy. Unfortunately, this is a risk where £15m qualifying funds are used for share buy-backs.

- **reduce the overall level of State Aid provided through the VCT scheme:** State Aid within the VCT sector potentially applies at three levels: aid for investors; aid to an investment fund vehicle or manager; and, aid to the enterprises in which an investment is made. If VCT shares are resold from treasury with the funds received used for investment under the rules which previously applied, then the amount of State Aid provided will be reduced at all three levels.

The proportion of aid provided through up-front income tax relief, in relationship to the total number of investors (and the amount invested) will be smaller than if the shares are cancelled and new shares are issued. By the same token, the investment vehicle will be able to maintain a growing level of investment (as it retains original funds and grows its asset base through successfully supporting businesses) in relation to the total amount of income-tax relief provided. Finally, the number of businesses which benefit from VCTs' investment activity will be greater and the impact of the aid will be spread more thinly between them.

If there were incentives for VCTs to replace investment capital through the resale of treasury shares rather than issuing new stock, then the amount of State Aid provided by the Government would fall as a proportion of the total investment activity of the sector. This should attract the Government from a fiscal perspective as well as the European Commission because it reduces the potential for the VCT scheme to distort the single market.

- **Reduce administrative and compliance burdens on VCTs:** Allowing VCTs to dedicate funds received via a resale of shares from treasury to a pre-existing pool should create administrative benefits. Potentially it could allow a VCT to manage its affairs so that only one set of criteria is applied to its investment approach.

Maintaining one investment pool should help reduce costs of monitoring and accounting for the investment activity of the fund and could help control costs. It may also make the search for investment opportunities (and the subsequent due-diligence processes) less complicated as VCT managers will only have one set of investment criteria to consider when assessing potential investment opportunities.

Indeed, where multiple pools already exist, VCTs could seek to reduce them over time by using more restricted capital to fund share buy-backs until that pool is exhausted. This would magnify the benefits to the company (but should not be a concern to the Government as this outcome would be achieved without cost or increasing the overall level of State Aid provided).

In addition, selling existing shares into the market over time as demand arises may also be more cost-effective than issuing new shares. This would particularly be the case where the VCT was able to manage the sale so that, for example, it did not breach thresholds which require it to produce a prospectus.

- **help VCTs attract new investors.** This would be most likely where a particular VCT could demonstrate a strong investment track record and held a mature portfolio of investments which would appeal to new investors seeking exposure to small businesses as an alternative asset class. These would most likely be discretionary wealth managers acting on behalf of private clients who might be attracted by the potential for tax free capital gains and dividends and the unique investment opportunities available. The absence of an up-front income tax relief might be compensated for by the fact that these VCTs would be able to offer different investment opportunities to those raising new capital. In particular, exposure to a broader range of new businesses, notably those with assets between £7m and £15m. The more diversified asset base of these VCTs may also give them a slightly different risk profile.

In these circumstances, there would be real incentives for VCTs to market blocks of repurchased stock to potential secondary market purchasers. The VCT would have to offer them in sufficient volume to attract discretionary wealth managers who may be seeking to make a relatively large investment, but if levels of buy-backs had been high this would not present a problem.

The sale of shares from treasury could be of particular benefit to a VCT and its existing shareholders where the purchasers were long-term holders who were unlikely to sell their stakes once a specific holding period had elapsed. This could create a virtuous cycle where the VCT have to intervene less frequently in the market, and therefore have to maintain a smaller cash pool for buy-backs. This would increase funds available for investment in small and growing businesses. Having a more stable, long-term investor base may also reduce the tendency of discounts to widen.

Creating this environment will require time and effort by individual VCTs, who will have a number of commercial challenges to address. In the first instance they have to develop their marketing message. Traditional appeals to investors will have to be supplemented with information exploring the level of capital growth and potential dividends which can be delivered without factoring in the income tax relief (which, to date, has been a key area of interest for many potential VCT purchasers).

Developing this market will also involve the VCT's shareholders agreeing the terms under which treasury shares can be sold. Secondary market purchasers will be more likely where shares are sold at a price which represents an attractive level of discount to the NAV (which will help compensate for the lack of the income tax relief). The terms on which any

treasury shares can be sold will have to be approved via a shareholder vote, and this may take some time to be agreed.

However, at the moment there is no incentive to even try and manage the challenges involved in using treasury shares, because the commercial incentives to do so are undermined by HMRC's view of how the funds received can be invested.

- **Enhance the ability of VCTs to become a self-sustainable asset class:** Over the long-term the widespread use of treasury shares could help support a stronger secondary market. This would be a lengthy process, and other factors (such as sustainable demand from institutions seeking to diversify their asset allocation) would also have to emerge, but treasury shares could help deliver this outcome.

This would be an important milestone and help move the VCT sector towards the Government's long-term objective of a truly sustainable asset class involving a universe of investment funds which can operate on an ongoing basis without reliance on raising new capital subsidised by up-front income tax reliefs.

Next steps

The AIC **recommends** that the Government should review its policy on the use of treasury shares by VCTs with a view to enabling funds received to be invested in accordance with the rules applying when the shares were originally issued.

The AIC would be pleased to discuss relevant issues or provide any more information to assist with this process. If a decision is taken to change the policy position the AIC would be delighted to discuss any technical or practical issues which flow from this.

The AIC hopes that the required change could be achievable through a change in interpretation of the current rules and will not require legislative reform. If this were the case the AIC hopes the change will not require prior approval from the European Commission. While the AIC believes that the Commission would eventually agree to the proposal (because it reduces the overall level of State Aid provided to the VCT sector) we envisage the process would be lengthy. The AIC is well aware that approval for the current VCT scheme has been outstanding for over 12 months. The sector would be very concerned if a sensible administrative change, which could have widespread and significant benefits, were to be delayed for a similar period.

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