Patient Capital Review

Initial comments

Investment companies are an ideal mechanism to channel long-term development capital directly to small and unquoted business as well as infrastructure projects.

Investment companies are closed-ended funds whose shares are traded on public stock markets. The sector is made up of 387 companies, with just over £160 billion of assets under management. It includes:

- 71 venture capital trusts (VCTs), with assets under management of £3.5 billion. VCT shares are overwhelmingly held by retail investors, who receive various tax incentives to compensate them for the increased risk of providing development capital to small businesses (that is those with gross assets under £15 million at the time of investment).

- 20 investment companies, with £15.6 billion of assets under management, that have mandates to invest specifically in private equity.

- 7 investment companies, with £8.4 billion of assets under management, that specialise in investment in infrastructure.

A number of other investment companies hold a mixture of assets that include direct investment in unquoted businesses. This includes, for example, Woodford Patient Capital, which has a portfolio consisting predominantly of UK companies, both quoted and unquoted.

Investment companies are excellent vehicles for patient capital because their structure allows them to invest directly in companies and seek long-term exposure, without the need for liquidity that affects other fund structures. They can raise funds from a wide range of sources, accommodate the risks of investing in smaller businesses, provide business expertise as well as capital and provide assistance to the management of companies in their portfolio.

The AIC **recommends** that the Patient Capital Review should support the supply of patient capital by:

- reconfirming the positive role VCTs play in providing development capital to small UK businesses and recommending that the government make a renewed public commitment to the long-term future of the scheme.

- exploring options to use new tax incentives to encourage retail investors to invest in long-term investments. This should include, for example, considering the creation of a “Patient Capital ISA”.

- removing regulatory barriers to advisers, particularly IFAs, recommending or purchasing investments in funds that provide patient capital.

Suitability of investment companies for providing patient capital

Pooling capital via funds offers the opportunity to mobilise long-term, direct investment in UK businesses. The UK has long-standing expertise in launching and operating investment companies. These vehicles have characteristics that make them an extremely attractive model for providing patient capital:

- **Structural advantages:** Investment companies are 'closed-ended'. This allows them to offer stable long-term financing. Their investment decisions are driven solely by their investment strategy. In contrast with open-ended funds, the portfolio manager does not need to also consider flows of cash in and out of the fund. Even when an investment company holds illiquid assets, investors benefit from liquidity in their own holdings because the investment company's shares are traded on a public stock market. These characteristics make them far more suitable for providing patient capital than 'open-ended' alternatives. See the Annex for a full discussion of the structural advantages of providing patient capital via investment companies.

- **An additional source of funds:** Investment companies offer the potential to mobilise capital from sources that have not tended to provide direct investment into companies. For example:

  - Many institutional investors, notably pension funds, have traditionally held quoted equities and other liquid assets. This reflects their requirement to retain sufficient liquidity in their holdings while still securing the desired investment returns. Some institutional funds have investment mandates that prevent them from holding anything but listed securities. The allocation of UK pension funds to 'alternative' assets has increased in recent years. Nonetheless, their exposure remains overwhelmingly in UK and overseas quoted equities, fixed income and gilts. Listed investment companies, particularly those with larger market capitalisations, allow pension funds to allocate capital to unquoted UK companies while maintaining the desired level of liquidity in their portfolios. Given the scale of pension fund investment, even a small shift in asset allocation could create significant additional resources for investment in patient capital.

  - Retail investors seeking to build a balanced portfolio can also provide an additional source of patient capital. Most of their portfolios are likely to be devoted to more mainstream assets, such as quoted equities, bonds and cash. However, they can diversify their exposure (and increase their capacity to meet their long-term investment goals) by allocating some of their capital to venture and private equity. The fact that the shares of investment companies are quoted on public stock markets means they retain the ability to sell assets at short notice should the need arise.

    Retail investment in patient capital via investment companies, be they VCTs, private equity or infrastructure funds, is likely to create an additional source of patient capital as few of these investors are likely to have the expertise or level of resources required to invest directly in unquoted companies.

  The greatest opportunity to mobilise an additional source of finance for investment in patient capital arguably lies in changing the perspective of IFAs. Many IFAs have overlooked

patient capital opportunities, even though they offer their clients the opportunity to diversify risk and secure stronger investment returns (see IFA portfolio composition, below). Addressing this issue offers a significant opportunity to deliver the ambitions of the Patient Capital Review.

- **Greater flexibility in defining risk appetite:** Smaller businesses seeking development and growth funding have struggled to secure finance from banks, particularly since the 2008/9 financial crisis. The government has sought to address this with initiatives designed to match SMEs with lenders and the 'funding for lending' scheme. While these initiatives may help, they may not substantially increase levels of lending provided to small companies by banks. Sensible prudential considerations, including their own capital requirements, limit the appetite of banks to provide unsecured loans or invest in companies without extensive track records.

  Investment companies do not have the same prudential restrictions and capital requirements as banks. This reflects their very different role in the financial system. They are not systemically relevant nor do they offer risk-free deposits or benefit from government guarantees. Their risk appetite is defined by the investment policy set by the company itself, which is approved by the shareholders and can only be changed with a shareholder vote.

  Investment companies have the capacity to identify investment objectives, and an appetite for risk, that is commensurate with providing patient capital.

- **Provision of business expertise:** Investment companies, whether providing private equity or venture capital, often provide more than finance to investee companies. Particularly where capital is being provided to support a small business's efforts to 'scale up', or otherwise transform its commercial model, an investment company is able to provide direct input into the business. This often involves working alongside management in the investee business to help them realise their commercial strategy (and deliver the investment objectives of the fund).

  The provision of additional management expertise is particularly useful for SMEs, which often lack the experience or internal resources to progress to their next stage of development. A recent AIC survey of investment by VCTs recently found that 80% of business within VCT portfolios had a representative of the VCT manager or the VCT itself join their board.

- **Follow-on funding:** Investment companies are well suited to providing further rounds of development capital to businesses as their needs evolve. Their ongoing engagement with the management of an unquoted business builds on the due-diligence undertaken at investment and provides the basis to respond to its future funding requirements. This capacity is particularly important for smaller businesses which remain less able to approach more traditional sources of finance, such as banks, or gain access to public stock markets.

The suitability of investment companies as sources of patient capital, particularly for the type of innovative businesses seeking scale-up capital which are the focus of the review, is exemplified by the VCT sector. The VCT scheme, launched in 1995, has been supported by

successive governments that have recognised the benefits of the structure. VCTs operate within rules which focus their investments on smaller companies that otherwise struggle to raise finance. In return, retail investors receive a number of tax reliefs to compensate for the risk of investing in smaller, unproven companies.

The VCT scheme has successfully delivered patient capital to thousands of UK SMEs for more than 20 years. Continuing support for VCTs should be a key part of the government's efforts in this area.

Additional information on the benefits of VCT investments are set out in the AIC report "Feeding the fledgling economy. VCT 2015 investment review".

The AIC is currently gathering information for its 2016 review of VCT investment and will be pleased to share its conclusions with the Patient Capital Review team in due course.

Reducing 'frictional' costs of operating investment companies

In the long-term there are a number of changes to the legal and regulatory environment that would make it easier and cheaper to use investment companies as a source of patient capital. For example:

- The current prospectus rules for investment companies are more onerous than for open-ended funds. The regimes should be 'equalised' to create a more competitive market and reduce costs of market entry.

- The VCT investment requirements have become unnecessarily complex because of EU State aid requirements. There is significant potential for them to be streamlined without compromising the government's goal of ensuring VCT investment is narrowly focussed on smaller businesses requiring direct investment.

- Other obligations, notably those imposed by the Alternative Investment Fund Managers Directive (AIFMD), could also be reformed to reduce compliance burdens.

The government's capacity to act unilaterally on these matters is constrained until the UK has left the EU. As the Patient Capital Review is seeking to make recommendations to the Chancellor for consideration ahead of the Autumn Budget 2017, this submission does not address these issues. However, they are important matters that should be addressed in due course.

Supplying capital to investment companies with patient capital mandates

There are significant opportunities to increase the supply of capital to investment companies that make patient capital investments, particularly those with private equity and infrastructure mandates.

For example, HMRC is currently working to adjust the range of eligible investments that can be made within insurance bonds without adverse tax consequences for the investor. These wrappers are widely used by wealth managers for financial planning purposes. At the moment the rules prevent investment in non-UK investment companies, many of which offer exposure to illiquid asset classes such as private equity, infrastructure and property. Following a consultation last summer, HM Treasury and HMRC have recognised that the current limits on the range of investments that can be made via insurance bonds is inappropriate. The list of eligible investments has not kept pace with market developments. The most recent Autumn Statement therefore announced the government's intention to update the rules and legislative adjustments are expected in the coming months.

This reform is significant for the provision of patient capital because it increases the flexibility that wealth managers, and other investors, will have to allocate capital, tax-efficiently, to investment companies holding assets such as private equity and infrastructure. What is at one level a technical change offers the potential to support a significant increase in demand for these companies. In turn this could increase the appetite of fund promoters to launch funds with 'patient capital' mandates.

There are other opportunities for the government to encourage demand for investment companies with mandates to provide patient capital to UK businesses.

Tax incentives for retail investors

Tax incentives are an extremely powerful mechanism to encourage retail shareholders to invest in a certain way. Increasing the retail market's exposure to patient capital offers the potential to help savers build more diversified portfolios that deliver superior investment returns. Properly targeted, tax incentives secure substantial amounts of additional capital for the type of long-term investments which are the subject of this review.

VCTs exemplify this potential. Between 1995 and up to the end of the 2015/16 tax year, the scheme has raised £6.3 billion for investment in smaller UK businesses. This achievement would not have been possible without the provision of tax incentives including an initial income tax relief and reliefs on capital gains and income. These measures have enabled the sector to create a new pool of capital that would otherwise have been unavailable for this important cohort of smaller businesses.

The Budget Statement announced that the Patient Capital Review will consider existing tax reliefs aimed at encouraging investment and entrepreneurship. The intention is to ensure that they are effective, well targeted, and provide value for money.

The AIC recognises that this process may identify refinements to the VCT scheme that will enhance its effectiveness. This will enable these funds to continue supporting small businesses, with broader benefits in terms of promoting economic growth and job creation. The AIC therefore **recommends** that the Patient Capital Review should reconfirm the benefits provided by VCTs and recommend that the government makes a renewed public commitment to the long-term future of the scheme.

The AIC is keen to engage with the review team on this agenda. In particular, we would be interested to understand the main lines of inquiry and what information and evidence the AIC might provide to assist with this process.

The Patient Capital Review also should consider what potential there might be to develop similar mechanisms to secure capital for other businesses that could benefit from a more reliable source of development capital. It should consider how larger companies, on higher rungs of the funding ladder, could be supported. Insofar as any initiative might be focussed on larger (and therefore inherently less risky) companies, the mix of tax incentives is likely to be different. For example, these incentives might be more narrowly focussed on allowing retail investors to secure tax-free dividends and capital growth. ISAs, which offer reliefs of this nature, have successfully encouraged long-term saving and investment. The introduction of the Innovative Finance ISA in April 2016 increased the choice and flexibility available to ISA investors. It was also intended to achieve a broader public policy objective of potentially increasing resources for peer-to-peer lending and enable this sector to better compete with banks.

There may be options to develop the ISA concept further to secure investment by funds in a targeted range of 'patient capital' investments.

The AIC **recommends** that the Patient Capital Review should consider options to use tax incentives to encourage the allocation of retail investor's capital to patient capital. This should include, for example, consideration of options to create a "Patient Capital ISA", whether as a stand-alone product or part of the current ISA framework. Were such a wrapper to become available it would provide a significant incentive to both direct investors and intermediaries to consider allocating part of their investment portfolio to patient capital.

Stakeholder views should be sought to identify what other options might be desirable and how a range of solutions might be developed to complement existing schemes (such as VCTs) and to target different parts of the market.

IFA portfolio composition

Exposure to patient capital investments can provide risk diversification and the opportunity for enhanced investment returns. This potential is recognised, for example, by the Wealth Manager Association (WMA) private investor indices. These set out proposed asset allocations for investors with differing appetites for risk and varying investment objectives. The four indexes identified are "conservative", "income", "growth" and "balance". The indexes currently recommend holdings of "hedge fund/alternatives" (which excludes commercial property) of 17.5%, 12.5%, 7.5% and 10%, respectively, in each of these indexes. Private

investors of all types could be well served by having at least some exposure to asset classes such as venture capital, private equity and/or infrastructure.

Given this, it is of concern that the IFA market does not tend to allocate client funds to alternative assets, including patient capital. Our estimate is that around 1% of client assets are dedicated by IFAs to investment companies in any one year. As this amount includes investment companies holding quoted equity, the proportion of assets dedicated to patient capital is even lower. This raises questions as to whether IFAs are securing the optimum asset exposure for their clients and, as a consequence, potentially constraining the supply of patient capital to the UK economy.

Prior to 2012 there were commercial incentives that limited the appetite of IFAs to recommend investment company shares (irrespective of the underlying assets). IFAs were usually paid via commission from product providers. Investment companies have legal requirements that limit their ability to pay commission. This financial incentive biased IFAs towards open-ended funds. Commission was banned in 2012 as a result of the Retail Distribution Review (RDR). This has led to some changes in the market, with some IFAs giving greater consideration to investment companies. However, given the capacity of investment companies to offer asset diversification and superior long-term returns, the amount of investment via this route remains low.

One concern is that the regulation of IFAs is overly focussed on how they make specific product recommendations rather than ensuring that they help their clients acquire a balanced a portfolio that is optimised to meet their long-term needs. This means that IFAs are potentially averse to recommending any individual investment that might provide exposure to alternative asset classes, including those providing patient capital. For many advisers this aversion has a major influence on their overall asset allocation, even where the risks of individual patient capital investment would be counterbalanced by other assets in the portfolio.

An inappropriate regulatory focus on specific investments, instead of emphasising the need to create a balanced portfolio, was exemplified by the Financial Services Authority's (FSA) decision to introduce rules on "non-mainstream pooled investments" (NMPIs). These rules prevent IFAs from recommending certain types of fund to ordinary retail investors, including certain investment companies most likely be offering exposure to 'patient capital' assets such as private equity or infrastructure.

The FSA's concerns about so-called NMPIs arose even though any client recommendation would be made after the IFA had undertaken a "suitability" assessment designed to identify a client's appetite for risk, existing portfolio and investment objectives. It is unclear why regulations should prevent recommendations of an individual holding, even a potentially risky one, if that risk is counterbalanced by other types of asset.

When the proposals were first brought forward by the FSA its intention was to prevent widespread distribution of any investment fund that offered exposure to illiquid assets (including venture capital, property, infrastructure etc.). The rules as originally proposed would have prevented IFAs recommending VCTs except to a very narrow range of 'sophisticated' clients. This is despite VCTs having been specifically designed with tax incentives that make them attractive to retail investors.

Some of the more extreme investment restrictions implied by the NMPI proposals have been avoided. Nonetheless, this debate seemed to indicate a general regulatory preference for retail holdings to be focussed on a narrow range of quoted assets, even if they are held in an investment vehicle that offers liquidity and those investments can help diversify risk. The Financial Conduct Authority (FCA), the successor to the FSA, seems to share this caution about the suitability of retail investment in funds other than open-ended vehicles holding liquid assets.

The current regulatory context creates disincentives for intermediaries to consider alternatives to open-ended funds, such as investment companies, which enable access to patient capital investments. Even where advisers consider a broader range of fund structures, their inclination to devote client money to those offering access to underlying illiquid assets is low. The least risky option, from an IFA's compliance perspective, is to recommend funds offering exposure to quoted shares and securities.

This is a significant barrier to increasing the availability of long-term finance for direct investment in UK business. IFAs are responsible for investments amounting to hundreds of billions of pounds. An estimate in September 2016 found that IFA platforms hold some £400 billion of client assets. The actual figure of investable capital is likely to be much higher as IFA platforms represent only a part of the assets IFAs advise on. This suggests that the lack of appetite for alternative investments by IFAs is a significant constraint on the amount of retail funds available for investment in patient capital.

The AIC **recommends** that the extent to which regulation acts as a barrier to advisers, particularly IFAs, considering investment options that could provide patient capital should be a priority for the Patient Capital Review. The review should also identify measures to remove any barriers which are identified.

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Annex: Structural advantages of providing patient capital via investment companies

Investment companies have a fixed number of shares in issue. The number of shares does not change, except when the company undertakes a secondary issue of shares or a specific capital reorganisation, such as a share buy-back or reconstruction.

In the normal course of business, investors buy and sell their shares on the stock market, with no involvement of the company or the asset manager. The level of secondary market trading in the company's own shares has no impact on the funds available for investment in the portfolio. The delinking of trading in the shares of the company and its underlying assets makes these funds ideal for long-term investment in unquoted companies.

In contrast, open-ended funds (such as OEICs and unit trusts, which make up most of the UK's fund sector) have a variable capital base. That is to say, the number of units or shares in issue increases and contracts according to the prevailing level of demand. When a greater number of investors purchase units/shares than are selling at that time, the fund manager issues new units/shares. The fund receives new money in return. This capital is used to acquire more assets for the fund's portfolio. Open-ended funds customarily invest in quoted shares or other financial instruments with high levels of liquidity (such as gilts).

When a greater number investors sell/redeem units/shares in an open-ended fund than are making purchases, the manager has to provide sufficient cash to pay investors. This may mean selling assets at short notice to fund redemptions. The requirement for open-ended funds to satisfy redemption at short notice makes them less suitable to invest in illiquid assets. If they were to be fully invested in illiquid assets (with no cash holdings or capacity to sell assets at short notice) they would be unable to manage redemptions at times when there are more sellers than purchasers.

Indeed, the structural issues arising from holding illiquid assets in open-ended funds has recently raised regulatory concerns. The FCA has invited views on ways in which the mismatch between illiquid underlying assets and obligations to provide liquidity at the fund level can be resolved (see "*Illiquid assets and open-ended investment funds*" DP17/1. February 2017.)

Trading and holding liquid securities provides important economic and investment benefits. However, the role that open-ended funds can play in providing direct investment to UK businesses is limited because of the fundamental characteristics of their structure.

Investment companies are inherently better suited to investing in venture capital, private equity and infrastructure as they do not have a structural requirement to be able to realise investments at short notice.