Venture Capital Trusts share buy-backs:

a technical consultation

July-Sept 2013

A Response from Amati Global Investors

Question 1: Does this description accurately reflect the range of VCTs' interventions in investors' share sales?

2.3 and 2.4 outline details of the mechanisms through which investors sell shares, mentioning three options i) private sale ii) selling via a stockbroker to a market maker iii) selling directly back to the VCT, and suggesting that ii) and iii) are "generally available". This is not strictly accurate. The only option which is generally available is selling via a stockbroker (or other agent) to a market maker. A shareholder can only sell directly back to a VCT if that VCT has put in place special arrangements for this to happen such as a tender offer, and that is not generally the case, and where it does happen it is normally a time-limited offer. Where a shareholder contacts a VCT to buy back shares directly, this will still take place via a stockbroker and a market maker. Nearly every VCT, therefore, will have dealings with the parties who make a market in their shares, and most will make an effort to manage the discount to NAV per share at which the shares are bought by a market maker (as outlined in 2.4). Acting in this way is crucial to protecting individual shareholders' interests in what would otherwise be a highly illiquid market where market makers will charge a very high price for taking risk.

The arrangements outlined in 2.5 are more accurately described as allowing investors who have held a VCT for longer than the minimum holding period, and who are happy to commit to investing in the same VCT (or another VCT from the same fund management group) for a minimum of five more years, to realise the value of their current investment, and obtain a fresh round of tax relief for re-investing the proceeds. The five year commitment is the key consideration here, but it has not been mentioned. An analogy can be drawn here with fixed term deposit accounts. If you put money in a five year term deposit, when this expires you can generally either switch to an instant access account on a much lower interest rate, or you could invest in a further five year term deposit, again at a higher rate. In other words, there is a clear value attached to the five year commitment. The bank offering the higher rate for a five year fixed term would not assume that investors who had previously held a five year deposit should not get a higher rate again because they were merely reclycing into a new five year deposit. Those VCT investors who chose to hold for longer than five years (which in our experience has been the majority) have effectively moved from a fixed term to instant access. They can sell any time without penalty. Those who sell, and then make a new investment are effectively entering into a new five year fixed term. The question is this: does this new five year term have a value in meeting the objectives of VCT legislation? We believe it does, but only if it brings with it a new obligation to make qualifying investments with 70% of the money raised.

Question 2: Do you believe that the approach described in paragraph 3.6 would meet the policy aims set out at paragraph 3.2?

The difficulty in answering this lies in working out what would constitute "further abuse" here. When does money which a shareholder receives from selling shares in a VCT cease to be "recycled" if the seller makes another investment in the same VCT in the future?

The likely outcome of the proposed rule changes is that the more active investors who are generally inclined to sell at the end of their qualifying period will sell and re-invest in a VCT from a different manager. However, what happens to active investors who already hold investments in VCTs from many different managers, having made these in several consecutive years? Their affairs will become highly complex to manage, and they will probably decide to sell but not make any further VCT investments.

Question 3: Would this approach impact adversely on VCTs' ability to raise new funds from investors, as well as preventing recycling of existing investments? If so, please explain why, if possible including quantitative evidence.

We believe that there will be some negative impact on VCTs' ability to raise new funds from investors. If investors feel that they don't understand what kind of time commitment they need to make when they invest in a VCT (i.e.: is it five years or longer than that?) then some will clearly be put off. However, whilst economic conditions are in recovery phase this may not make a significant impact on the market as a whole. In harder times it will be just another reason not to invest.

Question 4: Would this approach have any other unintended adverse consequences? If so, please describe.

Many retail investors in VCTs are not particularly sophisticated, and don't keep very good records. We believe that some are likely to be caught out unintentionally by this legislation, and suffer some significant costs as a result, and this risks damaging the reputation of the VCT market. We would prefer a solution which impacted managers only, albeit that it would involve us in extra work.

Question 5: Is six months an appropriate period for a time limit, or should a longer or shorter period of restriction apply?

This question points to a certain lack of underlying logic for the legislative change being proposed. There is no way of defining what an appropriate period is. It is not clear what benefit the tax payer gets from making investors wait between selling and re-investing, other than hoping that by making it much less convenient fewer people will do it. However, it is not clear that these changes will make any significant impact on how many shareholders choose to sell VCTs after five years, or how many choose to make a follow-on investment in a VCT. In other words, we don't believe that these changes will meet the objective of significantly slowing down the velocity of turnover in the shareholder bases of the VCT industry as a whole.

However, we recognise that this kind of approach may well be judged pragmatically to be the way forwards here. In this case we would suggest that combining a time limit of one month (both forwards and backwards looking) with the approach outlined in 3.11 would provide the best overall solution.

If the time period is set at 6 months we would suggest that consideration should be given to dividend re-investment schemes (DRIS). It looks like members of a DRIS would never be able to sell shares without adverse consequences, as they would be buying small numbers of shares every six months or so.

Question 6: Is there a simple way of defining a fund management group in this context?

We are not well placed to comment on this.

Question 7: How best could the behaviour described at paragraph 3.10 be prevented?

By implementing the proposed additional rule outlined in 3.11. This could be done in addition to the changes proposed in 3.6 if the priority is to stop enhanced share buybacks completely, rather than merely restricting their use to a fair level.

Question 8: Are there any other ways VCTs or investors could get around a rule of the type described at paragraph 3.6?

Not that we can think of specifically, but logically investors would avoid the issue by simply selling shares in one VCT and buying a near equivalent from a different manager. Given that this is a competitive industry most VCTs have a near equivalent in the market. We don't believe that enhanced share buybacks have increased the extent to which investors focus on the qualifying period. We believe rather that they came into being because the VCT legislation itself introduces the concept of a qualifying period and that a rational investor who is still a tax payer is likely to want to sell once the qualifying period has elapsed. Before enhanced share buybacks were a significant factor in the VCT industry there were a number of years when the market became heavily dominated by limited life VCTs. We believe the sharp increase in enhanced share buybacks over the last two years has arisen because it has been used as a roll-over mechanism for some of these limited life vehicles, where investors had been expecting a return of cash at the end of their qualifying period. In these cases it is clear that the focus on the qualifying period was part and parcel of the original VCT proposition.

Question 9: Do you believe that any of these other solutions described at 3.11 onwards would be effective in meeting the policy aims set out at paragraph 3.2? If so, would they be preferable to the changes proposed?

We strongly favour the approach briefly outlined in 3.11. Our reasoning is as follows.

i) This is an imposition on VCT managers rather than investors. We believe that VCT managers are much better placed to deal with additional complexity than retail investors and their advisors are. For retail investors the VCT market is already complex enough.

ii) This approach has a clear and consistent inner logic, which is in line with what most VCT investors believe happens anyway (i.e. that 70% of money invested goes into qualifying holdings).

iii) This approach does not cloud the issue for investors as to what is expected of them when they invest in a VCT, and what they receive from doing so. The imposition of restrictions on selling and re-investing clouds the issue as to whether investors are free to exit after the qualifying period or not. An analogy here could be made with a fund platform that believes it can keep more client money by making withdrawals difficult and inconvenient. Instead the effect is more likely to be that clients choose to invest on a different platform altogether where they are better served.

iv) This approach will also take care of the problem described in 3.10 about excessive dividend payments. It effectively addresses all forms for capital return.

v) Whilst it wouldn't eliminate enhanced share buybacks, it will eliminate the abuse of them, and will force all VCTs who wish to offer them to do so responsibly, and with the intention of making further qualifying investments. It would mean that the obligations imposed on a VCT are the same whether money is raised from new investors or from exiting shareholders who chose to re-invest.

vi) Under the current legislation there is no necessary link between the granting of tax relief to investors and new qualifying investments being made. That seems like a serious anomaly. This proposal will put such a clear link in place.

vii) This approach could be used to make sure that VCTs which have already used enhanced share buybacks previously are given some obligations to invest the proceeds in new qualifying holdings, depending on how the commencement provisions were applied. It would be very hard for a VCT manager to argue that this was unfair, and time could be given to make the new investments.

viii) Whilst this involves some extra work for VCT managers, it is not a difficult test to monitor because the data involved is static, and has no dependence on market conditions, or how well investments perform. It doesn't effect the highly complex protected money regime.

ix) This proposal is simple to legislate for.

x) It will prevent VCTs from raising money on which investors claim tax relief, simply to pay their own expenses and to cover dividends, without having made sufficient qualifying investments in the past, and without continuing a make new ones.

xi) It will prevent the abuse of dividend payments being made where this would create a situation that meant that funds were being raised and returned to shareholders without 70% going into qualifying investments. We believe that this would address the concerns being raised in 3.10.

Question 10: Can you suggest any other legislative solutions which might better deliver the desired policy aims?

If the principal objection to the proposal outlined in 3.11 was that it would only curtail enhanced share buybacks rather than preventing them altogether, then we would propose that in addition to this new test the VCT legislation is amended specifically to prevent VCTs from buying back shares where this is conditional on using the proceeds to subscribe for new shares. Alternatively, if the approach outlined in 3.6 is favoured, then we would suggest than in conjunction with the new test outlined in 3.11, a one month period would be enough, and would be in line with the provisions that already relate to realising capital gains from investments. To go longer than this would, in our view, place something of a red flag over VCTs in investors' minds. It would also be likely to result in inadvertent breaches by investors, which could damage the reputation of the sector.

As a final point for consideration we would like to add that VCT managers, in addition to the obligations they have towards the tax payer, also have obligations to their customers under the Treating Customers Fairly ("TCF") regulations. The issues and policy objectives raised in the consultation paper, which in essence all relate to how investors can realise their investment in a VCT, bring these two sets of obligations into a degree of conflict. Under the TCF regulations managers are obliged to ensure that investors understand the relevant terms and conditions of their investment and the risk that it carries, and that investments are sold only to suitable investors. Thus far, from 2004/5 onwards the terms have included a clearly defined minimum holding period, after which an investor is free to realise their investment without any penalties or

further obligations. Whatever conclusions are drawn from the consultation, maintaining clarity and straightforwardness in the legislation, such that it is easy for retail investors to understand what an investment in a VCT involves, should remain a high priority.

Note on Annex A

A.4 states that VCT shares disposed of at a gain are exempt from capital gains tax. This is understood by all VCT shareholders. However, as A.15 notes, this gets more complicated where share buybacks are concerned. It is possible that an investor may unwittingly become subject to income tax on any gain made from a sale, having believed that the disposal would be free of tax. We understand that this situation can arise only when a VCT repurchases shares directly (rather than in the normal course of business through the market). However, most VCT investors are unaware of this technicality, and its existence presents a risk to the clarity and simplicity of the overall scheme from a retail investor point of view. We would recommend that, in the spirit of TCF, at the same time as regulating the use of share buybacks by VCTs through the proposals made in this consultation document, the Government also consider tidying up this area of the legislation by giving distributions from share buybacks the same tax-free status as dividend distributions.