HM Treasury

Financing growth in innovative firms: consultation response

November 2017

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Executive summary

The UK continues to be a world-leading place to start a business, but some of the UK's highest potential, most innovative start-ups can struggle to scale up because of a lack of finance. To understand these barriers further, HM Treasury published the consultation 'Financing Growth in Innovative Firms' earlier this year and received many responses containing new analysis and views, including recommendations made by a panel of industry experts convened by Sir Damon Buffini as part of this 'Patient Capital Review'.

In response to the consultation and to help create an economy that is driven by innovation that will see the UK becoming a world leader in new technology, the Budget now announces an action plan to unlock over £20 billion to finance growth in innovative firms over 10 years by:

- Establishing a new £2.5 billion Investment Fund incubated in the British Business Bank with the intention to float or sell once it has established a sufficient track record. By co-investing with the private sector, a total of £7.5 billion of investment will be supported.
- Significantly expanding the support that innovative knowledge-intensive companies can receive through the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) while introducing a test to reduce the scope for and redirect low-risk investment, together unlocking over £7 billion of new investment in high-growth firms through EIS and VCTs.
- Investing in a series of private sector fund of funds of scale. The British Business Bank will seed the first wave of investment with up to £500m, unlocking double its investment in private capital. Up to three waves will be launched, attracting a total of up to a total of £4 billion of investment.
- Backing first-time and emerging fund managers through the British Business Bank's established Enterprise Capital Fund programme, supporting at least £1.5 billion of new investment.
- Backing overseas investment in UK venture capital through the Department for International Trade, expected to drive £1 billion of investment.
- Launching a National Security Strategic Investment Fund of up to £85m to invest in advanced technologies that contribute to our national security mission.

We will support long-term investment by:

- The Pensions Regulator will clarify guidance on how trustees can include investment in assets with long-term investment horizons, such as venture capital, infrastructure and other illiquid assets in a diverse portfolio. HM Treasury will establish a working group of institutional investors and fund managers to increase the supply of patient capital, including tackling continuing barriers holding back Defined Contribution pension savers from investing in illiquid assets.
- Changing the qualifying rules in Entrepreneurs' Relief to remove the disincentive to accept external investment and consulting on the detailed implementation of that change.
- Carrying out a feasibility study on a new guarantee programme modelled on the US 'Small Business Investment Company' programme.

And we will promote successful investment in all parts of the economy by:

- Launching a commercial investment programme run by the British Business Bank to support developing clusters of business angels outside London.
- Identifying ways to tackle barriers faced by female-led firms in accessing venture capital through new behavioural research commissioned by the British Business Bank.
- Working with businesses, lenders, insurers, the British Business Bank and the Intellectual Property Office to overcome the barriers to high growth, IP-rich firms, such as those in the creative and digital sector, using their intellectual property to access growth funding.

We will monitor implementation of these actions over time and redeploy resource across programmes as appropriate. These actions sit alongside continuing to explore the potential for a mutually beneficial relationship with the European Investment Fund once the UK has left the EU. Allocation of resources across programmes would be reconfigured if the UK does not retain a mutually beneficial relationship.

Finally, the government welcomes the high level of engagement over the course of the Patient Capital Review. Treasury Ministers will continue to engage with businesses on these issues by convening a series of roundtables to listen to the needs of high growth firms to help further understand the economic conditions for them to succeed, and how to create them.

This document provides further details of these measures and the responses received to the consultation 'Financing Growth in Innovative Firms'. It contains anonymised quotes where these were representative of specific broader views.

Chapter 1
Introduction

1.1 The Prime Minister announced in November 2016 that HM Treasury would lead a review to strengthen the UK as a place where high-growth innovative firms can obtain the long-term 'patient' finance that they need to scale up. The review forms part of the government's industrial strategy, supporting growing businesses and boosting productivity.

1.2 As part of the review, HM Treasury published the consultation 'Financing growth in innovative firms' in August 2017 to identify and tackle factors affecting the supply of patient capital. The consultation closed on 22 September 2017 having received over 200 written responses and over 70 responses to an online survey conducted as part of the consultation. The respondents can be categorised as follows: approximately a third were investors (mostly venture capital funds, angel investors and retail investors); a quarter were business owners and entrepreneurs; a sixth were from trade organisations; the remaining responses were from universities, think tanks, law and accountancy firms and other individuals.

1.3 The purpose of this document is to summarise the responses received to the consultation and to set out the government's response. This relatively short document summarises a wide range of views and opinions and, as a result, does not set out many of the individual proposals put forward by stakeholders. However, the government's overall response reflects a detailed analysis of individual responses.

1.4 Finally, when the review was announced, Sir Damon Buffini was asked to convene a panel of industry experts to support the review. The panel helped shape the themes of the consultation and has provided a cross-industry response to the consultation setting out its policy recommendations. The panel's response is being published alongside the government's response to the consultation.

Chapter 2

The patient capital gap

Box 2.A: Relevant consultation questions

- Do a material number of firms in the UK lack the long-term finance that they need to scale up successfully?
- Where is the gap most acute by type of firm, stage of firm development and amount invested?
- Have we correctly identified the UK's current strengths in patient capital?
- In what order would you prioritise the UK's weaknesses in patient capital?
- What are the main root causes holding back effective deployment of and demand for patient capital?
- What are the main barriers holding back effective supply of patient capital by major investors?

Summary of responses

2.1 There was broad agreement that the UK has made great strides over the past decade in increasing the supply of finance to high-growth innovative firms. Respondents described how, in some parts of the UK, the different elements needed to create and scale-up successful businesses have developed simultaneously. These elements include finance, entrepreneurial ambition, skills and networks. One respondent's comment exemplifies this:

> "There are some very well-developed ecosystems for investment in the UK which have the resources to support innovative firms and, crucially, the experience and knowledge to add value and select the best investment opportunities. These tend to be in the areas of the country that have a long legacy of technology and innovation and typically the investors have exited innovative companies and have the funds and expertise to reinvest into the next generation of start-ups. Examples are Oxford, Cambridge and London … Scotland [also punches] above its weight for equity investment."

2.2 The panel of industry experts supporting the review similarly set out that the UK is "already more successful than our European peers" as a "place for growing businesses to obtain the long-term patient finance they need to scale up". This is partly due to "successful government policy interventions such as the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs)".

2.3 Alongside this agreement on the UK's strengths, many respondents also agreed that the patient capital gap is most acute for "innovative, growth companies seeking to scale-up to become established, reputable companies with global clout". Several responses then identified the gap more precisely as applying to pre-revenue or pre-profit firms and for "companies that have delayed cash flows or significant product development time", whereas "capital is readily available for businesses with a proven business model".

2.4 Respondents identified two specific areas of weakness within the market. First, many respondents identified an overall gap in follow-on investment in firms that had already received initial investment. This was sometimes defined by stage of investment, focusing in on Series B to D investment. Other respondents referred to investment size, with £5 million to £50 million being quoted most often as the weakest range of investment.

2.5 Second, while early stage investment conditions have generally improved, respondents reinforced that some firms still struggle to attract early stage investment. For example, different respondents identified weaknesses in early stage investment outside of London in both the creative industries and digital technology sectors; another identified a continuing gap for early proof of concept investment in university spin-outs.

2.6 Many responses then argued that technology-rich and knowledge-intensive firms are affected most acutely by these funding issues. Several responses referred specifically to the life science sector, while others described a much broader mix of innovative sectors facing funding challenges.

2.7 There was also agreement that there is a more favourable funding environment in London compared to most of the rest of the UK. Some suggested that geographical clustering of investment around London, Oxford, Cambridge and in Scotland resulted from these regions' history of successful technology start-ups, supported by local universities.

2.8 The panel of industry experts also set out three areas of weakness in the market: "providing larger cheques to scale-ups already receiving funding; addressing some of the latent and unsatisfied demand for financing from the best high-growth businesses; and providing large-scale investment to highly ambitious capital-intensive businesses, such as university spin outs."

2.9 Respondents commented on other specific areas of weakness within the market. First, several emphasised the unique nature and strong contribution of the UK's public markets, while others noted a declining number of smaller companies seeking quoted status.

2.10 Second, some respondents identified crowdfunding as a prominent example of the increasing strength of the UK finance sector over the last decade, while others suggested that it was less successful in supporting effective long-term investment.

2.11 Third, several respondents suggested that the lower use of venture debt by UK firms was an example of wider weaknesses remaining in important parts of the UK financing ecosystem.

2.12 Finally, several respondents emphasised the need to look beyond access to finance, with many firms also held back by a lack of management skills or ambition.

2.13 When turning to the root causes of these issues, respondents highlighted that pension funds, insurers, banks and overseas investors preferred investment in asset classes making shorter-term returns and requiring less specialist expertise for successful investment.

2.14 The panel of industry experts set out three elements holding back wider growth in the market. The first element is that the UK venture capital market has historically delivered poor returns; this results in less capital being attracted to the asset class, which in turn results in less talent being attracted to the patient capital sector; this then depresses returns, completing the circle. It then advocated that improvement in any one element could "generate positive feedback within this loop and could bring the ecosystem into an improved equilibrium". It concludes that "the development of the UK's world-class private equity industry in the 1990s from similar circumstances provides a powerful example of how an increase in availability of capital had a profound impact on both the presence of top talent in the UK and returns."

Chapter 3

Current interventions: tax

Box 3.A: Relevant consultation questions

- Which programmes (investment programmes, tax reliefs and tax-incentivised investment schemes) have most effectively supported the investment of patient capital to date?
- Are there areas where the cost effectiveness of current tax reliefs could be improved, for example reducing lower risk 'capital preservation' investments in the venture capital schemes?
- Are there other ways the venture capital schemes could support investment in patient capital, in the context of State aid restrictions and evidence on cost effectiveness?
- When is it more appropriate for government to support patient capital through investment rather than through a tax relief?
- Is there an optimum minimum length of time of investment for entrepreneurs and investors to focus on the long-term growth of their company and, if so, what is it?
- What other steps could government take to make current tax reliefs more efficient and effective, to provide the best support in line with their policy objectives?

Summary of responses

3.1 There was broad support for the government's role in strengthening investment conditions. Many respondents described government support through the venture capital schemes as crucial to the growth of investment over recent years.

3.2 Many respondents noted the specific importance of the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS) for innovative companies. One called them "absolutely vital" for investment in innovative business, and many entrepreneurs reported using them to attract angel investment. Another respondent was specific about the benefits to their sector, commenting: "EIS and SEIS incentives have been particularly effective at stimulating investment and are extremely valuable to bioscience investors". Another noted the benefits conferred by EIS outside of London, saying that it "underpinned" the growth of the investment market in Scotland and had encouraged and strengthened the angel investment community. Others noted the importance of the tax reliefs across many industries.

3.3 Many respondents called for the extension of current limits on EIS and VCTs. This included the panel of industry experts, which set out that "the hard limits on investment size create inefficiencies as businesses transition away from tax incentivised investment, particularly due to the inability of angels and VCTs to provide follow-on funding. To minimise this impact, the limits could be extended or removed … Amongst a range of options available to government, these changes could focus on Knowledge-Intensive Companies, to target the types of business that have the greatest need for patient capital. To minimise the cost to government, a new "Growth EIS or VCT" with a reduced level of tax saving could be created."

3.4 Alongside this, some respondents noted concerns about the current use of the tax-advantaged venture capital schemes for tax-planning purposes by a minority of investors and fund managers. Some argued that these concerns reflected use of the schemes before rules changes in 2015, which narrowed the definitions of firms eligible for reliefs (EIS and VCTs) and introduced a new 'growth and development' test. Others however argued that there is still significant investment being channelled into investments targeting 'capital preservation'. One respondent noted that that 62% of £746 million raised by EIS funds in 2016/17 targeted capital preservation investment, while also noting that only 26% of funds raised by EIS funds this year listed this as an objective. A few respondents also supported in principle the redirection of tax reliefs towards higher risk companies, for example with one respondent proposing a lower rate of relief should be available for non-R&D intensive firms. Some respondents argued that the reliefs should continue to support lower risk investments. Many respondents from the Venture Capital Trust community also put forward a number of potential reforms to increase the incentive for investment in higher risk investment opportunities.

3.5 While a small number of respondents proposed exclusion of all film productions to reduce capital preservation investment, the film industry highlighted the important role that EIS has played in supporting independent film in Britain. Many responses argued film should not be excluded from EIS and instead suggested reforms to ensure that EIS supports the high-risk aspect of film and TV production. Specific proposals included excluding revenues from pre-sale of a film and income from film tax relief from EIS-eligible investments.

3.6 Several responses commented on the current administration of the tax-advantage schemes, calling for the EIS/SEIS tax processes to be more efficient and reduce waiting times for certificates. Respondents also suggested improvements be made to the advance assurance process.

3.7 On SEIS, we received mixed responses, with some highlighting its strengths in crowding in investment and others suggesting that it has had a smaller impact than the EIS and VCTs. One response presented detailed analysis suggesting that the introduction of SEIS had resulted in a reduction in the average amount invested at the seed stage of a company by creating an artificial ceiling on the amount invested in these rounds. Some responses expressed the view that the generosity of the SEIS rate of income tax relief (50%) was causing overvaluations in some sectors.

3.8 Fewer responses commented specifically on Entrepreneurs' Relief, but those that did regarded it as a successful relief. Some expressed concern that it did not provide sufficient incentives for entrepreneurs to become serial entrepreneurs. One respondent noted: "in some circumstances, [Entrepreneurs' Relief] can also be a perverse incentive for early sub-optimal exit to the detriment of the company". Reflecting a few other suggestions to extend the minimum holding period, another respondent commented: "there is a question around how far [Entrepreneurs' Relief] balances encouraging long-term growth and the benefits to the business owner upon disposal of the assets… an extended five year holding period for Entrepreneurs' Relief would encourage long-term capital investment". Several industry groups also proposed anti-dilution measures to be introduced for founders that have their ownership stakes diluted to less than 5% by multiple investment rounds.

3.9 There was also less comment on the role of Business Property Relief in supporting investment. Some retail investors emphasised its role in encouraging long-term holdings and getting retail investors to invest, particularly on growth markets such as the Alternative Investment Market, while other feedback suggested that a lot of investment currently being supported through the relief is very low-risk. One respondent suggested that up to £1 billion a year is currently being invested into funds targeting the relief, with only around one-third of this directed at companies on the Alternative Investment Market and other growth markets.

3.10 In general, most respondents agreed that government support for venture capital is needed through both investment and tax relief, though government investment should only be used when there is a market failure as it otherwise crowds out private investment. Respondents also noted investment and tax reliefs complemented each other, so a mixture of tax relief and publicly supported investment programmes is most suitable. Finally, many respondents did not believe there was an optimum holding period for a company to focus on long-term growth, as it varies from business to business.

Policy response

3.11 Commenting on **the tax-advantaged venture capital schemes (the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs)**, consultation respondents raised concerns that a funding gap remains for heavily capital-intensive and R&D intensive firms. To respond, the schemes will be extended significantly for these knowledge-intensive firms. As such, from April 2018 and in line with State aid rules:

- **The annual investment limit for EIS investors will be doubled** from £1 million to £2 million, provided that any amount above £1 million is invested in knowledge-intensive companies.

- **The annual investment limit for knowledge-intensive firms will be doubled** from £5 million to £10 million through the EIS and by VCTs.
- **Greater flexibility will be provided for knowledge-intensive companies over how the age limit is applied** for when a company must receive its first investment through the schemes. Knowledge-intensive companies will be able to choose whether to use the current test of the date of first commercial sale or the point at which turnover reached £200,000 to determine when the 10-year period has begun.
- **A new knowledge-intensive EIS approved fund structure** will be consulted upon, with further incentives provided to attract investment.

3.12 For SEIS, evidence from the consultation suggests that it works well at incentivising investment into the earliest stage companies (under two years old), but some respondents also suggested it is contributing to valuation bubbles in some sectors. The government will continue to monitor this.

3.13 The government is also responding to evidence gathered through the consultation of a significant subset of low-risk 'capital preservation' investments within EIS, SEIS, and VCTs. The government wants to ensure that the schemes are focused towards supporting investment in companies with high growth potential, in line with their original objectives.

3.14 From Royal Assent of Finance Bill 2017-18, **a principles-based test will be introduced into the tax-advantaged venture capital schemes.** The new test will ensure that the schemes are focused towards investment in companies seeking investment for their long-term growth and development.

3.15 The new test will not affect independent, entrepreneurial companies seeking to expand. Tax-motivated investments, where the tax relief provides all or most of the return for an investor with limited risk to the original investment (i.e. preserving an investors' capital) will no longer be eligible.

3.16 The new 'risk to capital' condition depends on taking a 'reasonable' view as to whether an investment has been structured to provide a low risk return for investors. The condition has two parts: whether the company has objectives to grow and develop over the long-term (which mirrors an existing test with the schemes); and whether there is a significant risk that there could be a loss of capital to the investor of an amount greater than the net return. HM Revenue and Customs (HMRC) will publish detailed guidance on this test alongside publication of the Finance Bill. **Annex A** provides further details of this test.

3.17 The exclusion of capital preservation arrangements from the schemes is also expected to reduce waiting times for genuine growth companies seeking HMRC's opinion on the eligibility of prospective investments under its Advance Assurance service for the venture capital schemes. The response to the Advance Assurance consultation will be published on 1 December and contains further detail on improvements to the service.

3.18 Some respondents expressed concerns about the complexity of the rules for these schemes. The government has chosen a principles-based test aimed at restricting the scope for lower-risk capital preservation investments with simplicity in mind, as well as to ensure that genuine entrepreneurial companies are not affected, and will monitor its effectiveness with a view to simplify aspects of the venture capital schemes legislation should the test prove effective.

3.19 Some respondents expressed concern about the activity of some EIS funds and VCTs, including the artificial inflation of share prices and use of structures involving liquidity preferences. The government will continue to monitor the market and take action against behaviours not in the spirit of the schemes if necessary.

3.20 In addition, evidence presented in response to the consultation showed that many VCTs have responded to recent VCT rule changes in 2015 by moving away from investing in established companies towards investment in riskier, early stage firms in greater need of support. To continue this transformation, **the government will further target VCTs towards investment in higher risk areas of the market while also responding to concerns that certain conditions currently placed on VCTs restrict their activities unnecessarily**. The changes are:

- from 6 April 2018 certain historic rules that provide more favourable conditions for some VCTs ("grandfathered" provisions) will be removed
- from 6 April 2018, VCTs will be required to invest at least 30% of funds raised in qualifying holdings within 12 months after the end of the accounting period
- from Royal Assent of the Finance Bill, a new-anti abuse rule will be introduced to prevent loans being used to preserve and return equity capital to investors. Loans will be have to be unsecured and will be assessed on a principled basis. Safe harbour rules will provide certainty to VCTs using debt investments that return no more than 10% on average over a five year period
- with effect on or after 6 April 2019 the percentage of funds VCTs must hold in qualifying holdings will increase to 80% from 70%
- with effect on or after 6 April 2019 the period VCTs have to reinvest gains will be doubled from 6 months to 12 months

3.21 These changes are intended to reduce investment in lower risk opportunities and therefore incentivise more investment in genuine high-growth companies. While some respondents felt that a lower rate of relief for less innovation-focussed companies would be more appropriate, the government's intention is that changes announced at this Budget will result in a significant shift away from low-risk investment. The government will monitor impacts to judge the effectiveness of these changes. The government will also review concerns that VCT status can be disproportionately threatened by unintentionally making a non-qualifying investment. In addition, as with all financial services firms, the government encourages EIS fund and VCT providers to sign up to the Women in Finance charter.

3.22 **Entrepreneurs' Relief** (ER) was introduced in 2008 and provides a 10% rate of Capital Gains Tax for qualifying disposals of business assets. The purpose of ER is to act as an incentive for entrepreneurs to start and grow their business by allowing them to keep more of the rewards when their investment is successful.

3.23 The government is concerned that the qualifying rules of Entrepreneurs' Relief should encourage long-term business growth. The rules will therefore be **changed to ensure that entrepreneurs are not discouraged from seeking external investment through the dilution of their shareholding**. This will take the form of allowing individuals to elect to be treated as disposing of and reacquiring their shares at the then market-value. The government will consult on the technical detail.

3.24 Finally, the consultation asked about **Business Property Relief** (BPR). BPR plays a valuable role in preventing the breakup of otherwise viable businesses purely in order to meet IHT liabilities. BPR was also extended in the 1990s to all levels of shareholdings and shares quoted on growth markets. These extensions have supported investment in growth markets such as the Alternative Investment Market. A number of respondents suggested that some of the investment supported by BPR is in low-risk companies and that it could play a greater role in supporting investment into innovative firms. The government will keep BPR under review, and is committed to protecting the important role that this tax relief plays in supporting family-owned businesses, and growth investment in the Alternative Investment Market and other growth markets.

Chapter 4
Patient capital investment funds

Box 4.A: Relevant consultation questions

- What scale of new investment should the government seek to unlock and over what timeframe?
- Should resources be focused on one intervention (e.g. a single fund of significant scale) or spread over a number of different programmes?
- When considering how to replicate EIF investment if the EIF were no longer an investor in the UK, to what extent should the government seek to replicate the EIF's current activities in (a) venture capital and (b) private equity?
- Beyond replicating existing EIF investment if required, what areas should government focus on to increase investment in patient capital?
- When considering how to support increased investment, should the government consider supporting one or more of the setup of a public-private partnership, a new incubated fund in the British Business Bank to be sold in part of full to private investors once it has established a successful track record and a series of private sector fund of funds to invest in patient capital?
- If desirable, what steps should government take to encourage investors to form a new public-private partnership to increase investment in patient capital?
- What steps should the government take to support greater retail investment in listed patient capital vehicles?
- Will focusing resources on increasing investment provide better value for money than changes to the tax environment?

Summary of responses

4.1 There was broad support for the concept of a new large-scale patient capital investment fund, building on the current role played by the British Business Bank. While there was no agreement on the precise quantum of investment, respondents agreed it would have to be a fund of scale and a majority said resources would be better spread over a number of different programmes. Several respondents said a single intervention could stifle innovation, while other respondents cautioned against government "picking winners".

4.2 Responses were mixed on the specific structure of any new fund. Several responses recommended that the government should consider replicating the Israeli Yozma programme (discussed in the consultation document). Other respondents favoured investment into a series of private sector fund of funds overseen by the British Business Bank. Where this approach was favoured, it was considered the most efficient option because it would combine expertise with the enthusiasm of new private investors.

4.3 Many respondents supported the concept of a new fund within the British Business Bank, while others proposed operating through existing British Business Bank programmes. Those advocating a private-public partnership proposed that the government should cornerstone the fund and appoint fund managers to invest. In order to implement this model successfully, respondents suggested that the government should model its approach on organisations that have successfully raised public and private capital.

4.4 Many respondents noted the important role that the European Investment Fund (EIF) has played in supporting investment. Some respondents noted particular features of the European Investment Fund contributing to its value to the UK as an investor. These included the EIF's "stringent due diligence" and "understanding of the technologies it invests in", and its ability to 'anchor' funds rather than top them up.

4.5 When discussing this role, some respondents called on the government to match EIF funding in full if a domestic replacement is required. Others disagreed, setting out that the private equity market is well-developed and it is unnecessary to match EIF funding for this market. For example: "we feel the emphasis should be on the venture sector rather than private equity which does not appear to suffer from the same market failure."

4.6 Beyond the EIF, some respondents asked for any new fund to invest into evergreen structures, rather than investing primarily in traditional 10-year term venture partnerships. Several respondents also raised concerns over the lack of transparency of the EIF and called for any new fund to be transparent and ensure its returns are published. Separately, respondents from the creative industries and digital sectors set out a need to strengthen business angel investment outside of London for these sectors.

4.7 In its response, the panel of industry experts proposed setting up a single "patient capital investment vehicle" to invest in venture capital funds and co-invest directly in scale-ups and science based start-ups. They propose that fundraising could reach £1 billion annually. Government would act as a cornerstone investor to signal "strategic intent" and help attract initial investment and the highest potential fund managers. The vehicle would contain individual funds to support both retail and institutional investment.

4.8 Alongside the "patient capital investment vehicle", the panel of industry experts encouraged the formation of a series of "Patient Capital Investment Companies". These are private funds that would also be in receipt of HMGguaranteed loans. The loans' objective would be to increase returns to private investors by leveraging their investments, based on the example of the "Small Business Investment Company" programme in the United States. In doing so, "this programme would … improve the returns profile of UK venture investments, incentivise greater deployment of capital for venture, and catalyse the development of the UK venture capital community." The panel proposes that the government should operate this programme on a commercial basis.

4.9 Turning to separate questions about listed patient capital funds, some respondents suggested that retail investors are not suitable sources of finance for growing, pre-revenue companies scaling up. One reason given was that listed vehicles can be vulnerable to low liquidity, particularly when the price trades below the net asset value. However, other respondents were strong advocates for existing listed investment vehicles such as Venture Capital Trusts.

4.10 Many responses discussed potential incentives for listed patient capital funds. Some agreed with the consultation document that the existing ISA regime should not be complicated further, but advocated the creation of new tax incentives, including extending Business Property Relief to listed patient capital funds.

4.11 Responses also proposed a wide variety of government backed investment structures to catalyse retail investment in patient capital. Some responses suggested that the government 'cornerstoning' listed patient capital funds would provide a sufficient signal to encourage retail investment. One recommendation was that the government should seed a series of listed investment trusts which would build towards £1 billion size, and that this would provide the liquidity necessary to bring in significant private investment and be of sufficient size to build investment expertise.

4.12 Responses on whether increasing investment or changes to the tax environment would be better value for money were mixed. On the one hand, many respondents viewed changes to the tax environment as more effective than increasing investment, citing the success of existing reliefs such as the Enterprise Investment Scheme in incentivising business angel activity. These respondents also expressed doubt that government investment would be effective because unrelated policy objectives could influence investment decisions and it might lack the professional, market approach to selecting investments of diverse, competing fund managers. On the other hand, other respondents viewed investment as more effective than changes to the tax environment because it can be better targeted.

Policy response

4.13 In response to feedback from the consultation, the government will:

- **Set up a new dedicated subsidiary of the British Business Bank to become a leading UK-based investor in patient capital across the UK.** It will be set up with the intention to float or sell in part or full once it has established a sufficient track record and in line with State aid rules. Its investment strategy will seek to provide capacity to the market that would not otherwise be there while achieving a commercial return on its investments. It will also provide transparency to other investors about its investment strategy and returns. The new subsidiary will be capitalized with £2.5 billion. By co-investing alongside private investors, a total of £7.5 billion of investment will be unlocked.

- **Invest in a series of private sector fund of funds**. The first wave will be seeded by up to £500m of investment by the British Business Bank. This will attract new investors into UK patient capital of sufficient scale to have a meaningful impact. We expect this investment to catalyse the formation of up to three fund of funds with the ratio of public to private capital in the first wave estimated at around 1:2. The launch of individual fund of funds will potentially be staggered over time. Up to two further waves of investment will be launched, unlocking up to £4 billion in total of new investment.

- **Back first-time and emerging venture capital fund managers through the British Business Bank's established Enterprise Capital Fund programme**, unlocking at least £1.5 billion new investment.

4.14 When responding to the consultation, many respondents also noted the important role that the European Investment Fund has played in supporting the development of the UK venture capital market in particular. While some respondents proposed that the government should set out plans to replace the EIF at the Budget, the UK's negotiating position remains to explore the potential for a mutually beneficial relationship with the EIF once the UK has left the European Union. Allocation of resources across programmes would be reconfigured if the UK does not retain a mutually beneficial relationship with the European Investment Fund.

4.15 To support listed funds that invest in patient capital, as part of its broader remit, the FCA's new Asset Manager Authorisation Hub will support firms to better understand regulatory requirements around holding illiquid investments, and will hold a dedicated event on long-term investment next year.

4.16 Respondents also highlighted how there continue to be difficulties in accessing earlier stage capital in parts of the market. In response, the government will:

- **Develop a new commercial investment programme through the British Business Bank to support developing clusters of business angels outside London**. This programme will supplement existing programmes to support access to finance outside of London that include the Northern Powerhouse Investment Fund and the Midlands Engine Investment Fund. It may for example support intellectual property-rich small businesses outside of London with low physical collateral.

- **Launch a National Security Strategic Investment Fund** to invest in early stage companies developing innovative technologies that have the potential to contribute to our national security mission in areas such as sensing, materials, cybersecurity and data analytics. This replicates the approach taken by many corporate investors to achieve specific strategic objectives.

4.17 Finally, the panel of industry experts proposed a series of "Patient Capital Investment Companies" to increase investors' returns from investing in patient capital. While the analogous US programme (the Small Business Investment Company programme) is currently more focused on mezzanine finance and buy-outs[1] and may not therefore be immediately transposable to the UK, it represents a potential additional tool for increase SME access to finance that should be considered in detail. As such, HM Treasury and the British Business Bank will carry out **a feasibility study to implement a 'Small Business Investment Company' programme in the UK through a new guarantee programme**.

4.18 Combined, these measures will support firms in a range of industries, including the creative industries, life sciences, digital technology and high-growth innovative firms across other sectors.

[1] SBA Annual review of Small Business Investment Companies 2014, available at: https://www.sba.gov/sites/default/files/files/SBICAnnualReport_FY2014_Final_508_1.pdf

Chapter 5

Removing barriers to investment

Box 5.A: Relevant consultation questions

- Beyond measures already being considered to support more effective asset allocation decisions by DB pension funds across their portfolio of investments, what further steps should be taken to support investment by DB pension funds in patient capital?
- How can individual DC pension savers be best supported to invest in illiquid assets such as patient capital?
- Are there barriers to investment in patient capital for other investors that the government should look to remove?

Summary of responses

5.1 The majority of respondents were supportive of increasing pension scheme investment in patient capital.

5.2 For example, one respondent noted that the current allocation of UK pension funds and insurers to unlisted equities is extremely low. Another noted that pension funds usually have long investment horizons and should be able to take long-term positions in companies, that this is particularly true of the large DC schemes serving predominantly younger members; these savers will generally need a sustained, lengthy period of growth for their pension pots generated by the scheme targeting higher returns. However, the respondent noted that it seems that many pension funds are generally taking a more short-term, risk-averse approach to investment.

5.3 A number of respondents recommended guidance be issued on how to meet the "prudent person" test while investing in illiquid assets such as patient capital. Others suggested amending pensions legislation to clarify trustees' duty to invest for the long term and clarifying the Law Commission's findings on fiduciary duties. Overall, targeted communication to investor and adviser groups was encouraged.

5.4 Several of the responses proposed more radical policies. Some proposed that the government should set mandatory targets for pension funds to allocate a portion of their assets under management to patient capital. Several supported the current consolidation of Local Authority pension funds which could improve governance, internal expertise and resources. It was suggested that if the current programme is successful, this approach could be extended to other small and medium sized funds.

5.5 But some respondents were not supportive of government intervention in this area. One expressed the view that government intervention to encourage risk taking could lead to losses for schemes. One other respondent felt that Defined Benefit pension schemes should not be used as an instrument of government policy, but also felt that a review of the rules was required as pension scheme portfolios currently take a sub-optimal level of risk.

5.6 The panel of industry experts recommended "introducing an "opt-in" requirement on new payments into DC pension schemes. The intent would be to emulate the successful implementation of the French LME Law in 2008 which mandated that Corporate Employee Savings Schemes must offer a Solidarity Investment Funds option. This resulted in significant growth in the amount of capital allocated to Solidarity Investment Funds from €200 million to €6 billion between 2002 and 2016".

5.7 Respondents also discussed the role of regulation. Some stated that there were no regulatory barriers as such to pension funds or individual savers investing in patient capital. Others cited Solvency II as an issue for the insurance sector and drew attention to equivalent provisions in Solvency II as the 'prudent person' rule in pension funds. However, there was no specific comment about the effectiveness of current provisions in Solvency II for European Venture Capital Funds. The management fee charge cap that places a ceiling on the management fees payable in a default scheme provided for Defined Contribution pension savers was discussed as a potential barrier to further investment in patient capital by some respondents from the insurance sector.

5.8 Several respondents thought that a lack of information prevented optimal capital allocation. For funds, the lack of quality independent third party research for investments under £100 million was said to make it difficult to satisfy the "prudent person" test. Lack of third party research was also cited as a limiting factor for individual pension savers. One respondent suggested that the US approach could be worth looking at, where start-ups must complete a Section 409A valuation (of the Internal Revenue Code) giving a pricing methodology that enables a secondary market to function.

5.9 Many respondents said that the requirement of investing platforms that investments be valued and tradeable on a daily basis acts as a barrier to investing in patient capital by Defined Contribution pension schemes.

5.10 DC pensions are frequently invested in unit-linked funds, and some respondents highlighted the FCA's permitted links rules as a barrier to investing in patient capital. One called for the scope of the permitted links rules to be restricted to pure personal pensions to allow managers of sophisticated large pension schemes to create the right fund structures to access alternative assets.

5.11 Additional incentives were recommended by a few responses: dividend tax relief for pension schemes and increasing the individual Lifetime Allowance for approved patient capital investments. Another respondent set out that the reduction in the Lifetime Allowance from £1.8 million high point in 2010/11 had resulted in investment being diverted into patient capital, such as through Venture Capital Trusts.

5.12 Finally, several respondents highlighted the important role that overseas investors already play in the UK venture capital in order to provide the expertise and capital for high-growth innovative firms to grow to scale.

Policy response

5.13 The consultation responses contained a number of insights into the barriers facing investors seeking to invest in patient capital. We will continue to analyse these responses and investigate these barriers over the coming months.

5.14 The consultation responses also highlighted a few immediate actions that can be taken:

- Some pension investors perceive the current interpretation of regulations to act as a barrier to investment. To respond, **the Pensions Regulator will clarify guidance on how trustees can invest in assets with long-term investment horizons**, such as venture capital, infrastructure, market-returning investments that have a social side benefit and other illiquid assets in a diverse portfolio. This will give pension funds confidence that they can invest in assets supporting innovative firms as part of a diverse portfolio. With over £2 trillion in UK pension funds, small changes in investment have the potential to transform the supply of capital to innovative firms.

- HM Treasury will establish **a working group of institutional investors and fund managers to unlock further supply of patient capital, including tackling continuing barriers holding back Defined Contribution pension savers from investing in illiquid assets** as highlighted for example in the panel of industry experts' recommendations.

- We have passed the comments on the Solvency II Prudent Person Principle to the Prudential Regulation Authority. **We understand that the PRA is presently considering the Prudent Person Rule and will take a decision on whether to consult on new guidance on implementation of this principle in the New Year**.

- Finally, recognising the important contribution of overseas investors to UK patient capital, **we will back overseas investment in UK venture capital through the Department for International Trade, expected to unlock £1 billion of investment** over the next 5 years.

Chapter 6
Other measures

Box 6.A: Relevant consultation questions

- What steps should government take to support the next generation of high potential fund managers to develop their knowledge and skills and to raise their first or next fund?
- What further steps, if any, should government take to increase investment into university spin-outs specifically?
- What further steps should be taken to increase investor capability in the public markets to invest effectively in firms requiring patient capital to grow to scale?

Summary of responses

6.1 Many respondents commented on other factors outside of the supply of finance to strengthen the UK patient capital ecosystem. For example, there was a general agreement that the UK's patient capital ecosystem could do more to attract and retain top talent. Common themes included views that government could stimulate a more innovative and entrepreneurial culture, though many thought the duty was on the private sector to support and encourage talent.

6.2 When commenting on ways to attract the best new fund managers to the sector, many highlighted the work of the British Business Bank's Enterprise Capital Fund programme in supporting emerging fund managers. Stakeholders have also highlighted the important role that increased diversity could play in the patient capital ecosystem. However, respondents had mixed views about the role of government in specifically supporting increased investment capability. Some endorsed broader measures to allow the most talented individuals to come to the UK, both as fund managers and to work in start-ups. Other respondents thought that the British Business Bank could be instrumental in highlighting best practice, and supporting investment managers with a proven track record.

6.3 When commenting on the university spin-out sector, many respondents argued that wider extensions to venture capital schemes could benefit spin-outs and called for business and universities to foster closer relationships. Some saw potential in further developing human capital by government funding MBAs for PhD holders. Others pointed out that there were already programmes in this area, such as the Kauffman Fellows Program, which should be promoted. Others highlighted the important role of other funding streams (e.g. the Higher Education Innovation Fund) in supporting university spin-outs.

Policy response

6.4 Consultation responses highlighted that university spin-outs sometimes continue to struggle to access finance at their earliest stages of development. These university spin-outs should benefit specifically from the new knowledge-intensive fund structure discussed previously in this response. Alongside this, the Budget commits a further £2.3 billion of additional R&D spending in 2021-22, taking total direct R&D spending to £12.5 billion.

6.5 Consultation responses also highlighted the importance of supporting a vibrant and diverse investment community, including by attracting the next generation of high potential fund managers. In response, **we will carry out a study assessing how to support the next generation of high potential fund managers to develop their knowledge and skills and to raise their first or next fund**.

6.6 Stakeholders have also drawn attention to the role of diversity within the venture capital community itself. The government welcomes existing initiatives like Level20 and Diversity VC in raising awareness of this issue, and is now **calling on venture capital and other financial services firms to join over 160 other financial services firms in signing the Treasury's Women in Finance charter** and committing to improve gender balance. The Charter pledges include: setting a target for gender diversity in senior management (which could mirror or exceed those suggested by other initiatives); committing to publish that target and progress made against it on an annual basis; and creating a link between pay and achievement of the target. In addition, **the British Business Bank will undertake behavioural research into how to overcome the specific barriers faced by female-led firms in accessing venture capital**.

6.7 Many consultation responses highlighted the importance of wider support for innovation and the growth of entrepreneurial ecosystems. Through this Budget, the government has set out specific measures to support innovation and entrepreneurial ecosystems, and to help strengthen commercialisation of our world-leading research base, including:

- increasing the rate of the R&D Expenditure Credit from 11% to 12% with effect from 1 January 2018;
- working with businesses, lenders, insurers, the British Business Bank and the Intellectual Property Office to overcome the barriers to high growth, IP-rich firms, such as those in the creative and digital sector, using their intellectual property to access growth funding;
- creating a new GovTech Fund to support innovators and entrepreneurs to develop new digital products to address public sector challenges, and a new GovTech Catalyst- a small central unit based in the Government

Digital Service that will give businesses and innovators a clear access point to government;

- expanding Tech City UK's reach to become Tech Nation; and
- doubling to 2,000 the number of Exceptional Talent visas available for top talent in the digital technology, science, arts and creative sectors seeking to work in the UK.

Chapter 7
Next steps

7.1 As a next step, HM Treasury and the British Business Bank will work with the patient capital sector and investors on detailed delivery arrangements, including the set-up of the 'incubated' fund and the private fund of funds investment programme.

7.2 This consultation response will then be followed up with a report to the Chancellor for Budget 2018 setting out how the different measures within the response are being implemented.

7.3 This will be followed by an evaluation of the impact of the policies set out in this response for Autumn 2020. This will measure the impact of these policies against the following objectives:

- progress towards unlocking over £20 billion new capital in 10 years through the action plan
- progress towards deepening the pool of potential investors in patient capital and thereby creating a more vibrant investment environment in the UK
- progress towards reducing government investment in the market by the end of the 10-year action plan
- progress towards targeting tax reliefs at the firms who will benefit from support over low-risk capital preservation investments

7.4 Allocation of resources across different programmes will then be confirmed dependent on the outcome of this evaluation. Allocation of resources across programmes will also be reconfigured if the UK does not retain a mutually beneficial relationship with the European Investment Fund over the longer term.

7.5 Finally, the government welcomes the high level of engagement from venture capital and high-growth businesses over the course of the Patient Capital Review. HM Treasury Ministers will continue to engage with businesses on these issues by convening a series of roundtables to listen to the needs of high growth firms to help further understand the economic conditions for them to succeed, and how to create them.

Annex A

The venture capital schemes: a principles-based test

What has been announced?

A.1 A new principles-based test will be introduced into the Enterprise Investment Scheme, the Seed Enterprise Investment Scheme and Venture Capital Trusts. It will apply from Royal Assent of Finance Bill 2017-18.

A.2 The new test will ensure that the schemes are focused towards investment in companies seeking investment for their long-term growth and development. It will not affect independent, entrepreneurial companies seeking to expand.

A.3 Tax-motivated investments, where the tax relief provides all or most of the return for an investor with limited risk to the original investment (i.e. preserving an investors' capital), will no longer be eligible.

What will the condition involve?

A.4 The new 'risk to capital' condition depends on taking a 'reasonable' view as to whether an investment has been structured to provide a low risk return for investors.

A.5 The condition has two parts: whether the company has objectives to grow and develop over the long-term (which mirrors an existing test with the schemes); and whether there is a significant risk that there could be a loss of capital to the investor of an amount greater than the net return.

A.6 The condition requires all relevant factors about the investment to be considered in the round. The legislation will suggest some factors that may be considered, for example the nature of the company's ownership structure (such as being controlled by fund managers as nominees for the investors), or whether income from an asset forms a substantial part of the trade.

A.7 A company may meet the condition and be eligible for investment under one or more of the schemes even if one or more factors that are features of capital preservation are present.

Who will be affected?

A.8 Companies seeking investment for their long-term growth and development, where the investment is at genuine risk, will not be impacted.

A.9 The condition will affect companies that are providing investors with a low-risk investment opportunity where the upfront tax relief provides most of the return. Currently, these companies are often created by or connected to advisers. For example, a fund manager may raise £20 million from investors and create four companies, each of which will deliver a project. The fund manager invests £5 million in each company and each company uses the money to create an asset which can be sold at the end of the holding period. The money is then distributed to the investors, with returns above the target often capped. These arrangements will not be eligible for relief.

A.10 The government recognises that different sectors have different operating models. For example, film and media production companies often use special purpose vehicles (SPVs) within a company group structure to produce individual projects, in line with normal commercial practice. The condition will allow the use of SPVs involving a production company seeking investment for its long-term growth and development with the intention of reinvesting profits for future activities.

A.11 The government also recognises that within film and media specifically, it is normal commercial practice to secure pre-agreed income (e.g. pre-sales or eligibility for other support). To meet the risk to capital condition investment must be genuinely at risk. Investment that is not covered or protected by pre-agreed income or support (referred to in the media industry as the "gap") will be eligible. The rule also does not preclude the investment being made to fund costs where a proportion is covered or protected by pre-agreed income or support, provided that the investor remains at significant risk.

Box A.1: Illustrations of how the risk-to-capital condition will be applied

Note: These examples are intended to provide an illustration of the risk to capital rule, and do not provide formal guidance. A company will need to meet all other qualifying conditions for the relevant scheme.

- An investment in a restaurant business that is independently run and has ambitions to grow its trade by setting up a new outlet **would qualify**. The fact that it has substantial assets (premises, kitchen equipment) does not mean that it loses eligibility because HMRC will look at the investment in the round, including the intention to engage employees. In this case, investors would be taking a risk that the restaurant can grow its business.
- An investment in a life sciences firm that wants to build its own research facility to enable it to expand its existing operations **would qualify**. The fact that it is using investment to create a substantial asset does not cause it to lose eligibility because the company already has employees who will be working in the new facility – and the company may engage new employees – and the asset is not being used to give investors a protected low risk return.
- An investment in an animation production company to develop, market and exploit a series of new characters **would qualify**, even if the company outsources the animation to freelance animators. The government recognises that many sectors use outsourcing as part

normal commercial practice. In this case, outsourcing is not an indicator of a capital preservation investment.

- An investment in an independent film production company, which is seeking investment to fund a production via a SPV as part of its plans to develop and grow its film making trade over the long-term, **would qualify,** provided that the investor remains at significant risk. The presence of a SPV would not itself preclude eligibility, as this is in line with normal commercial practice in the media sector.

- An investment in a company set up to construct and then operate, through sub-contractors, a crematorium, where the company is closely affiliated to the EIS fund manager marketing the investment, is **unlikely to qualify**. The control and influence of a fund manager, as nominee for the individual investors, along with substantial assets (land, equipment), suggest a capital preservation strategy. HMRC would nevertheless take account of all of the facts before reaching a decision.

- An investment in a company set up to acquire and operate a wedding venue, targeting low returns to be achieved by an early exit, with returns in excess of the target capped by the fund manager, would **be unlikely to qualify.** The low targeted returns and plans for an early exit indicate an absence of any intention to grow and develop the company's trade in the long term, whilst the capping of returns above the target suggests a low risk profile and is also an indicator capital preservation. HMRC would nevertheless take account of all of the facts before reaching a decision. By contrast, a genuine entrepreneurial company owning and operating a wedding venue, seeking investment for long-term growth, would qualify.

Why has the government taken this approach?

A.12 In response to the consultation, Financing Growth in Innovative Firms, evidence was provided suggesting that £467 million of investment by EIS funds in 2016-17 was focused on capital preservation. This was 62% of investment by EIS funds. The government wants the venture capital schemes to be focused on support for companies with high growth potential.

A.13 The government has previously excluded certain activities that are typically lower risk, such as energy generation. However, these exclusions have led to the growth of other lower risk, capital preservation arrangements.

A.14 The risk to capital condition is a principled approach which enables the government to avoid excluding further specific types of activity, which would risk excluding genuine entrepreneurial businesses, whilst reducing opportunity to use the schemes for tax motivated investment.

When will these changes take effect?

A.15 HM Revenue and Customs (HMRC) will publish draft technical guidance on the application of the condition alongside the publication of the Finance Bill. From the point that guidance is published, HMRC will not provide advance assurance for investments that would appear not to meet the terms of the upcoming risk to capital rule.

How will this help companies applying for the advance assurance service?

A.16 HMRC estimates that up to 80% of senior officers' time in its specialist unit is currently spent on advance assurance applications that may be in future deemed as 'capital preservation'. This new test should therefore free up significant resource to ensure that companies with genuine ambitions to grow and develop have a smoother experience of HMRC's advance assurance service.

A.17 This change, together with other measures announced in HMRC's response to the consultation on streamlining the advance assurance service, will help to ensure that, by spring 2018, the vast majority of applications will be dealt with within 15 working days.

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