The Quoted Companies Alliance
6 Kinghorn Street
London EC1A 7HW
Tel: +44 20 7600 3745
Fax: +44 20 7600 8288

Web: www.theqca.com
Email: mail@theqca.com

Business Finance Green Paper
Fourth Floor
Department of Business, Innovation and Skills
1 Victoria Street
London SW1H 0ET

business.finance@bis.gsi.gov.uk

22 September 2010

Dear Sirs,

HM Treasury and Department of Business, Innovation and Skills – Financing a private sector recovery

INTRODUCTION

The Quoted Companies Alliance (QCA) is a not-for-profit membership organisation working for small and mid-cap quoted sector, as well as companies aspiring to access public equity markets. Their individual market capitalisations tend to be below £500m.

The QCA is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

RESPONSE

We welcome the opportunity to set out how we think a private sector recovery can be financed. A successful return to economic health can only be brought about by encouraging and promoting investment in the areas where sustainable UK jobs can be created. We believe that the small and mid-cap quoted sector can be the engine for economic growth and jobs.

We think the economic case is clear that the largest companies, which we would define as being the constituents of the FTSE 350, over any sustained period, at best, have a neutral impact on UK jobs. We believe that a vibrant small and mid-cap sector will be the UK's best opportunity for creating an increase in sustainable employment.

Before we tackle the questions set out in the paper, we would like to set out four specific areas/proposals, which we believe will stimulate the sector and can be implemented without significant legal or regulatory changes:

- **Investor enablement:** Participation in primary market activity is currently restricted almost entirely to institutional investors. While this is a direct result of the regulatory landscape, we believe that far more could be done to facilitate participation by certain categories of private investors. In particular, we believe that web-based technology is sufficiently advanced to allow companies to approach such investors directly, thus utilizing all the regulatory exemptions available to them. We set out more about this proposal later in this response.

- **Improving access to non-bank finance:** It is clear from our members that there is significant interest in further exploring the idea of a corporate bond market for small and mid-cap issuers. In particular members have pointed out that a market for such instruments and

other forms of "quasi equity", such as preference shares, existed in the 1970s and early 1980s. We are also aware of the greater sophistication of the PIPES market (private investment in public equity) in the USA with debt and "quasi equity" in smaller listed companies being far more common there.

- **Greater transparency:** The effect of the current regulatory system is that those who need the most information get the least. In the absence of reliable information, many investors do not remain inert, but base investment decisions on supposition and conjecture. In particular the changes in the rules on the distribution of investment research following the implementation of MiFID in November 2007 have led to a dearth of independent research on small and mid-cap companies. We believe that a systematic approach to independent research - which is available to all - is needed.

- **Incentivising investors and stakeholders:** We would like to see a comprehensive review of the UK"s approach to encouraging entrepreneurial behaviour. In particular we would like to see the EIS and VCT schemes remodeled with a specific purpose in mind – the creation of jobs. We would like to see the schemes widened. We believe that discouraging investee companies from taking on employees because they would break an arbitrary limit on employee numbers is currently counterproductive. In addition we believe that the sectoral scope of the schemes should ensure that jobs in hospitality, leisure and service industries are every bit as valuable as jobs in hi-tech and bio-tech.

The above paragraphs are only intended as an outline. We have set out more detail on our ideas in the course of the specific responses to questions set out below.

We would like to emphasise our view that a holistic review of how small and mid-cap quoted companies can raise finance more efficiently is long overdue. Policymakers, lawmakers and regulators have concentrated too long on the secondary trading markets. They have forgotten that markets were and should be designed to enable companies to raise finance effectively in an environment which enables investors to find companies and vice versa. The secondary markets are just that: secondary.

We believe that our proposals should be looked at as a package which, if implemented comprehensively, will contribute significantly to the private sector recovery. There is a need for Government to have a stated policy which positively discriminates towards the small and mid-cap quoted sector, to promote the sector and to find a proportionate way to assist companies to raise the finance they need to grow and create jobs.

Turning to the specific questions in the Green Paper, we set out our answers below:

1. Do you agree with the evidence base as set out in this paper? Are there any additional issues that should be considered?

In preparation for our response to this Green Paper we have hosted four roundtable sessions which have been attended by Monica Ennis and Victoria Gibbs (Primary Markets Team – HM Treasury) and Thomas Hemmingway (HM Treasury). These roundtables have enabled direct feedback to HM Treasury from many of those involved in the small and mid-cap quoted sector, including stockbrokers, companies, lawyers, accountants and other professional advisers and institutional investors.

While it is clear that many of the participants would agree with much of the evidence set out in the Green Paper there are a few issues which arose which do not entirely accord with the paper. In particular there were specific examples of the poor behaviour of the high street banks towards companies in the sector, including few such banks engaging in new lending, the costs of facilities having increased to what would have been regarded, pre 2008, as being penal rates, banks setting significant deposits off against overdraft facilities without notice and the refusal to extend overdraft limits to previous operating levels.

In addition, we believe that the paper does not adequately recognise that the cost of raising capital is a major issue for many small and mid-cap quoted companies. For example, we have estimated the costs for joining AIM to be:

Costs of Floating on AIM		
Accounting	£90,000 - £150,000	
Legal	£100,000 - £200,000	
Corporate Finance	£100,000 - £200,000	
Broker's Commission	5 - 7% of funds raised	
Printing	£10,000	
Registrars	£5,000 - £10,000	
AIM Admission Fees	£5,870 - £66,250	*Varies depending on market cap
AIM Annual Fees	£4,750	
Public Relations	£10,000 - £20,000	

We have estimated that the ongoing costs of being on AIM could be in the range of £125,000 per annum, resulting from ongoing regulatory costs, PR and investor relations activities.

The costs of raising capital on markets, especially with regard to a public offer (e.g. rights issue or open offer), can be prohibitive for small and mid-cap quoted companies. We have estimated that a fundraising of £5 million where a prospectus is required could cost £500k - £600k, which represents well over 10 per cent of the amount raised. The result of this is that small and mid-cap quoted companies do not see public fundraisings, which involve retail investors, as a cost-effective or efficient way of raising money, and as such seek to do fundraisings, e.g. placings, that only involve institutional investors so as to avoid the need for a prospectus. This has the knock-on effect of cutting off retail investors from the small and mid-cap quoted sector. We recognise that this may change given the amendments to the Prospectus Directive that have passed through European Parliament. However, we still see the issue of the cost of capital raising as an important issue which should have been included in the evidence base in this paper.

In addition, we believe that the procedures, structure and culture of the UKLA can have a significant effect on the cost and timing of capital raising for quoted companies. We will provide further input on the future of the UKLA in HM Treasury"s consultation – „A new approach to financial regulation: judgement, focus and stability".

2. Do you think greater certainty over future tax and regulation would have a significant impact on current demand for or supply of business finance?

Yes. There can be no doubt that the significant uncertainty over certain tax policies towards the end of the last government caused damage to businesses. In particular the abolition of taper relief (which caused a localised spike in transactional activity in early 2008), the changes to the capital gains tax rules and the subsequent guessing game over what was going to happen in the March 2010 budget did not help business in any way.

3. Are there any regulatory obligations that may disproportionately deter SMEs from listing on exchange-regulated markets such as AIM and Plus Quoted? What can be done to address this?

There is general consensus amongst our quoted company members that the biggest deterrent to listing on exchange regulated markets is the cost. The costs are driven largely by the need to comply with the legal and market requirements (please see Question 1 for an outline for costs).

<u>Regulation affecting fundraisings and listings – Prospectuses</u>

We have lobbied the EU directly on the review of the Prospectus Directive and believe that we have

obtained some significant changes which will help companies in the longer term, including raising the threshold at which a prospectus is required from €2.5 to €5m, the number of persons to whom a document can be sent before a prospectus needs to be published from 100 to 150 and obtaining a "proportionate" prospectus for companies of less than €100m market cap and on secondary issues to existing shareholders.

While there is still much work still to be done on what these "proportionate" prospectuses will look like and while it is still likely to take up to 18 months for UK companies to feel the benefit of any of these changes, we believe that some impact on compliance costs could be made by greater development and use of standard form documentation, by enabling significant amounts of documentation to be incorporated by reference and by greater use of web technology. We urge the Government to effect the changes to the Prospectus Directive at the earliest opportunity so that the cost of raising up to €5m can be reduced as soon as possible.

A proportionate approach to accounting – IFRS for SMEs

We support the adoption of full IFRS for larger listed companies, but believe it is appropriate to recognise the difference in scale, and of resources available to smaller listed companies and those companies quoted on exchange regulated markets, which may have a capitalisation of just a few million pounds compared to their global listed counterparts capitalised at many tens of billions of pounds.

We therefore consider that both small companies listed on regulated markets and companies quoted on exchange regulated markets (such as AIM and PLUS-quoted in the UK) should have the choice to use IFRS for SMEs or full IFRS, rather than having to use full IFRS as at present. We recognise that implementing such a change would require a change in the relevant EU regulation in respect of companies listed on regulated markets, but consider that the „one size fits all" approach to financial reporting by EU listed companies is not appropriate for the reasons stated above.

IFRS for SMEs was produced to provide a simplified, self-contained set of accounting principles that are appropriate for smaller companies and are based on full International Financial Reporting Standards (IFRSs), developed primarily for listed companies. By removing choices for accounting treatment, eliminating topics that are not generally relevant to SMEs and simplifying methods for recognition and measurement, the resulting standard reduces the volume of accounting guidance applicable to SMEs by more than 85 per cent when compared with the full set of IFRSs. As a result, it potentially offers a workable, self-contained set of accounting standards to allow financial performance across international boundaries to be compared on a like for like basis.

The standard is available for any jurisdiction to adopt, whether or not it has adopted full IFRSs. Each jurisdiction must determine which entities should use the standard. Currently, the IASB"s only restriction is that listed companies and financial institutions should not use it. We believe that removing this restriction could provide a significant lessening of the financial reporting burden on smaller quoted entities without significantly affecting the usefulness of financial reports, and we have raised this issue directly with the IASB and the European Commission

Furthermore, it is important to note that while it is compulsory for companies on a regulated market to adopt full IFRS under the European Commission"s Fourth and Seventh Company Law Directives, there is no EU regulation which compels its use on AIM. We believe that converting to IFRS is a significant part of the process of coming to AIM and forms a further significant part of the ongoing costs of maintaining a quotation on AIM. It takes up significant amounts of management time and increases the length of corporate documentation.

We note that the use of IFRS and IFRS for SMEs is an issue that is being considered by the UK Accounting Standards Board (ASB) in its review of the Future of UK GAAP. We have made representations directly to the ASB, but we also urge Government to reconsider the timing of the current review and the proposed dates for implementation. This is necessary to ensure that there has been adequate time for consultation with all stakeholders, given the large group of companies that could be potentially affected by the proposed changes to the accounting framework in the UK.

4. Are there any additional barriers to corporates (of any size) accessing equity markets and how could these be addressed?

Lawmakers, policymakers and regulators have concentrated on investor protection. This has resulted in investors, who are not employed in institutional investment houses, largely being kept uninformed and being unable to invest other than on the basis of speculation and conjecture.

We believe that the attitude that investors, and in particular retail investors, have to be protected from the consequences of their own decisions in an investment environment, appear more motivated by regulator protection than investor protection.

We would like to see a change in attitude from investor protection to investor enablement. We call for an active policy which encourages and rewards a culture of investment (rather than speculation) in companies which contribute to the current and future economic prosperity of the UK.

Database of Qualified/Professional Investors

Rather than attempting to overturn existing investor protection rules or change financial firms" business models, the QCA seeks to use the current framework as far as possible. In particular, as we have outlined above, we recommend the creation of a database of individuals who would like to participate in primary market investment. We believe that it is currently simply too difficult for brokers to tap into that market but that significant interest in such participation exists.

We consider that web technology could be used to enable the creation of a database of individuals who are Qualified Investors (as defined in the Prospectus Directive) and/or Professional Investors (as defined in MiFID) in terms of European regulation, and/or High Net Worth Individuals or Sophisticated Investors (as both terms are defined in the Financial Promotions regulations) in terms of UK regulation. These investors could then pre-select from a menu the types of issues they would be interested in participating in, for example by industry, location and/or size of offering. The system could then be used to randomly generate lists of potential participants which brokers could use to ensure that all the available exemptions were used (i.e. where an issue has been marketed to, say, 40 persons, the system could be used to generate a further 60 individual names to ensure that the 100 persons exemption was being fully used). For such a system to be successful, its existence would have to be well publicised.

Allocation rules and model portfolio approach

The financial crisis has shown that equity finance has a key role to play in financing private sector recovery with small to medium sized companies acting as a key contributor to this recovery. However the consolidation in banks, fund managers and brokers has had the side effect of pushing the minimum (economic) investable amount of these consolidated entities to levels which make it unattractive for them to invest in many smaller companies. A fund manager or stockbroker with tens of clients will be looking to invest significant 6-figure sums in order for the allocation size for each client to be sensible at the same time as treating all their clients fairly.

Another issue which significantly restricts access to equity capital is the application by both private client and institutional investment managers of a „model portfolio" approach. This effectively means that investment managers cannot favour any single fund or group of funds under their management over any other funds they manage. As a result investment managers who have large numbers of funds cannot make small investments. The distribution of a small investment across their portfolio would result in large numbers of small holdings, which would ultimately carry disproportionate administration costs. We believe that equity investments sub £2m are particularly affected, but it may affect investments up to £10m.

Availability of research on small and mid-cap quoted companies

A further issue is the dearth of independent research on small and mid-cap companies. Prior to the implementation of MiFID in November 2007, the FSA"s rules on what constituted independent

research were commendably practical. However MiFID changed the rules completely with the result that it is now very difficult for research to qualify as independent. It is almost impossible for research funded by the corporate subject of the research to qualify. The problem is that no one other than the quoted company is interested in paying for independent research. The attempt by NASDAQ a few years ago to introduce a system, which would fit the MiFID model, under which issuers would subscribe annually to be covered by a certain number of reports but with no influence over who the researcher was or when the research would take place, did not succeed due to lack of take up. It currently appears that the London Stock Exchange"s more recently launched equivalent system is also not successful for the same reason.

That research funded by issuers is not "independent" may not be a significant issue for institutional investors. Such "research" is treated under the rules as a "financial promotion". Institutional investors are still entitled to receive such information. However retail investors are not and, accordingly, issuers cannot publish such research on their web-sites. Almost the only source of information for private investors is to rely on publications such as Investors Chronicle. Yet the participation of private investors in the secondary market is important to maintain liquidity and keep spreads down. We believe that the health of the quoted markets could be improved by better access to more research and analysis.

Tax treatment of equity versus debt finance

Another barrier to equity funding is the inability of issuers to obtain a tax deduction for the costs of raising such finance, which can be significant. It is the market norm for the company seeking the finance to pay for the costs of everyone involved in the transaction. Brokers and corporate advisory fees can be hefty but the issuer will also end up paying the broker/corporate adviser"s legal fees as well and will be unlikely to be able to recoup any VAT involved. These costs are not deductible against profits unlike the costs of raising debt capital.

Pension fund investment

A further issue raised by some of our broker members is the pressure that pension funds are currently under to invest in bonds rather than equity. We are informed that much of that pressure is put on those funds by the Government. We would like this issue to be explored further and see whether and to what extent the Government could recommend pensions funds to invest in small and mid-cap quoted companies as part of a balanced portfolio.

Indices

We also understand that the main indices used in the UK for benchmarking and investment, the FTSE All-Share and the FTSE 100 (which makes up the vast proportion of the All-Share index), are_not designed to be a representation of the UK economy. There are many examples of companies within the FTSE 100 which are global companies which happen to be headquartered in the UK rather than companies which are wholly or mainly UK related. Many pension funds and retail investment vehicles use the FTSE All-Share as a benchmark for the UK economy. As a result investors who think they are electing to invest in UK companies may be unaware that they are exposed to international volatility and economic changes through the weightings and constituents of the FTSE All-Share index.

The QCA calls for a real UK index made up of weightings and constituents which is a representation of the UK economy. This would enable investors to have a better choice and would encourage investment in companies which grow in the UK and produce UK jobs. This index could be sponsored by the Department of BIS or HM Treasury.

5. How can Government ensure that the best small businesses in all parts of the UK are visible to publicly backed venture capital funds? Should Government intervention to address the equity gap focus on the best firms regardless of geography, or seek explicitly to address regional economic disparities? The Government would be particularly interested in views on regional stock exchanges.

We do not comment on how to ensure that the best small businesses are visible to publicly backed venture capital funds, save to say that part of the success of AIM (and Plus Quoted) is the lack of any other organised way of accessing equity investment for small growing companies. While the BVCA figures quoted in the Green Paper may show investment levels in smaller companies as remaining relatively steady over the past few years, our experience is that the big players in private equity have had no real interest in growth companies for many years. The primary focus of that industry is on buy-outs and re-financings of existing large and successful businesses. The Business Angel market is highly fragmented and for many growth companies finding an Angel is more a matter of serendipity than planning.

Almost the only systematic way for a growth company to get itself in front of a range of equity investors is to go down the IPO path. As a result, many such companies come at a time when they might, in other economic circumstances, be better off waiting for a couple of years.

As for regional stock exchanges, while the QCA is stock exchange neutral and seeks to achieve the best overall environment for small and mid-cap quoted companies, we do not favour diverting limited resources into regional exchanges. The point of coming to a public market for most companies is to raise money. That is achieved by engaging a broker who will be able to provide the company with opportunities to present its story to suitable investors. To that extent, the forum on which the shares will eventually be traded is not relevant. It becomes relevant only because it is a requirement or preference of the investor. There is already significant choice of in equity markets already available in the UK with the London Stock Exchange"s premium listing or standard listing segments on the Main List, AIM, Plus-Listed, Plus-Quoted and NYSE Euronext.

If the theory behind regional stock exchanges is to harness local investors to invest in local businesses we believe that, as stock exchanges no longer have any physical trading floor, this is not likely to be a particularly fruitful way of proceeding. However, we would like to see more enquiry made as to the untapped potential of „local" investing. We recommend consideration of a retail investment product – which might be structured similarly to an ISA – under which retail investors could invest small amounts of cash, perhaps on an annual basis, but which would give them some influence on how the money was invested. They could perhaps specify the industry and/or locality in which they would like their money to be invested. The actual investment would be undertaken by the administrators of the fund and their reward would be related to fund performance rather than the individual company their money was invested in.

In tandem with this, we believe that regional or local indices, research and analysis would be better tools to create greater transparency and interest in local investing than regional exchanges.

6. How can publicly-backed equity schemes and the Growth Capital Fund make more use of private capital in future? How could the scale and reach of publicly backed funds be improved? Are there any gaps within the portfolio? Does the potential model for the Growth Capital Fund meet the objective of filling a gap in the availability of funding for growth companies? Are there ways in which the potential model could be developed to improve its appeal to investors or its ability to make a material contribution to the funding of growth companies?

The proposed Growth Capital Fund will definitely assist in filling the funding gap and the QCA supports the concept of the fund being established on a long term basis. Combined with other initiatives, which the Government can influence, such as reform to the Venture Capital Schemes (EIS and VCT schemes) so as to encourage investment within the funding gap (in part through tax incentives) into a much broader range of companies[1], we believe it could be of profound and long term benefit as indeed was the original 3i fund.

State Aid rules are well understood and should not pose any kind of significant obstacle to this proposal, and no doubt were considered in some detail prior to the announcement of the fund's establishment by the previous administration.

[1] We discuss this in more depth in our response to Question 9.

The provision of the Growth Capital Fund is one of a number of tools which needs to be utilised to address the funding gap. The Rowland"s Review concluded that the market gap in funding (typically between £2 million and £10 million to SMEs in the UK) is permanent, not just short term and cyclical and is clearly exacerbated by the recession.

The Review also concluded that neither bank lending nor equity investors are likely to fill this gap in the foreseeable future. Furthermore, a mezzanine product would be best suited to fill this gap. This product would address the aversion of many stakeholders (particularly owners) to pure equity (which they often feel is to dilutive up front) and provide a return above regular bank lending to reward investors.

The QCA contends that the Review is correct in stating that neither bank lending nor equity investors are likely to fill this gap on their own under our current traditional fund raising methods. However, a growth capital fund combined with other initiatives, for example reform to the Venture Capital Trust (VCT) regime could have a considerable positive impact.

It was in 1931 the then Macmillan Committee Report identified a "MacMillan Gap" being a chronic shortage of long term investment capital for small and medium sized businesses. The parallels with the current economic climate are obvious. As summarised in the Rowland Review, the ICFC and later 3i were designed to fill the equity gap. The unique business model which is contrived to satisfy the general demands of SMEs for permanent and long term capital without sacrificing the investee firm's ownership, as well as the need to reward its own shareholders' capital, still has far reaching implications today among the design of future public initiatives.

The returns on 3i's investment capital although modest, proved to be commercially acceptable over a much longer period than venture capital. Moreover, it enabled 3i to maintain its commitment to the provision of long term and permanent capital to SMEs and added significant value to the economy as a whole.

7. How could more high-net-worth individuals be encouraged to become Business Angels and participate in larger deals through syndicates? Are there specific issues impeding business angel activity that the Government should address, such as investor readiness or the structure of publicly-backed venture capital funds?

We believe that high-net-worth individuals could be better encouraged to provide equity funding for growth companies by providing appropriate taxation incentives. We believe that the abolition of taper relief and the tightening of the EIS scheme have both discouraged high-net-worth individuals to become involved in equity investment. We discuss this in more depth in our response to Question 9.

As outlined above we also believe that more could be done to facilitate the participation of high-net-worth individuals in direct investment into small and mid-cap companies on their IPO and subsequent fundraisings. See our answer to Question 4 above.

8. How can eligible businesses help themselves to become 'investment ready' for equity finance? Where should this be done by private sector, market-led solutions? What role is there for Government in supporting this, and should intensive Government support be focussed on businesses high growth potential?

The QCA has recently published a guide for companies aspiring to join a UK public market entitled *Are You Ready? A Brief Guide for a Company Aspiring to Go Public*, which outlines some of the key characteristics that companies looking to join a market should aim to have and also what small and mid-cap investors look for in a company when making an investment decision. A copy is enclosed with this letter. This guide has been developed by our Corporate Finance Advisors Committee. We believe that there should be a greater awareness in public sector business advisory bodies of the sorts of issues raised in our guide.

9. How effective are current tax incentives for equity investment in small businesses, such as the Enterprise Investment Scheme or Venture Capital Trusts?

Venture Capital Schemes – EIS and VCTs

The Enterprise Investment Scheme („EIS") and Venture Capital Trusts („VCTs") were introduced in the mid 1990s by the previous Conservative government, to provide assistance to small and medium sized companies who were facing the "equity gap". The „equity gap" (between £2m and £10m) has become more pronounced since 1995, as traditional institutions have moved away from providing finance to smaller companies.

The schemes are targeted at companies which might otherwise find it difficult to raise funds. Certain trades are excluded from benefiting from the schemes because of the nature of their operations or because they typically have significant property assets which could be used as collateral for raising money.

Companies which are designed to benefit from the schemes are inherently risky in nature, and not all have succeeded. However many companies have grown by virtue of receiving funds under the schemes, and it is believed that such companies have helped increase employment and exports in line with the original policy objectives. As a result the Exchequer has received further PAYE and social security contributions, and potential unemployment costs have been avoided. Such companies continue to provide corporation tax and VAT receipts.

As such, the QCA believes that the current tax incentives should be maintained.

Since 2006 the schemes have been restricted as a result of seeking EU State Aid approval and for example, now exclude companies which have 50 or more employees. The EIS and VCT schemes have the potential to assist in the financing of a private sector recovery, and the QCA recommends that the Government look again at the range of companies that can receive funds from EIS and VCT sources.

The QCA believes that, while the original policy objective of the schemes should be maintained, the schemes should be remodeled with a specific purpose in mind – the creation of jobs. As such the qualifying criteria should be refocused accordingly, including a revision of the limits upwards.

VCTs have assets of some £2.5 billion under management, and tax relief has already been given to investors. Many older VCTs have recycled the funds under management, having made successful realisations and invested the proceeds into other investments. It is thought that at any one time somewhere around one quarter of VCT funds is available for investment. This is a significant sum which has the potential to be harnessed in the near future to support small and medium sized businesses described in the Green Paper, particularly if some of the investment limits were raised. There would be no further tax cost to the Exchequer in making these funds available to more businesses.

The previous Government announced in the March Budget that they intended to consider the case for increasing the employee limit, the gross assets limit and the annual investment limit. The current State Aid Risk Capital Guidelines permit State Aid to companies with up to 250 employees, and with an annual balance sheet total of €43 million (or equivalent in local currency). We recommend that the limits in the EIS and VCT legislation are reviewed, to allow the schemes to provide finance to small and medium sized companies within the State Aid criteria and away from companies where it is not clear that value is being added to the economy. The employee limit has reduced the supply of funds to companies with 50 or more employees. The number of employees has no bearing on the ability of the employing company to raise finance, and it appears that the current limit of 50 employees is contrary to the original policy purpose of the schemes.

The State Aid Risk Capital Guidelines permit the Commission to agree an annual investment limit above the current level if evidence of market failure is given. The Rowlands Growth Capital Review, which identified the funding gap as being between £2m and £10m, could be used as part of that evidence to raise the threshold to at least £5m (or higher), in line with the views expressed in the Green Paper.

Aside from the employee, balance sheet total and annual investment limits, the Government can make changes to the schemes to make it easier for private individuals to provide much needed capital. The EIS permits „business angel investors" to receive EIS income tax relief, but the conditions are onerous. Such business angels provide expertise and may also be able to provide finance, but if they have had any connection with the company at any time prior to their investment, or received any payment, they may not be able to qualify for the tax relief. The QCA believes this is a disincentive to the provision of both expertise and finance, and that further funds and expertise from business angels might be forthcoming for small and medium sized companies if these restrictions are eased.

We believe that there may be a number of technical changes to EIS and VCT schemes, such as the „business angel investors" point above, that HM Treasury could make to the schemes without affecting the schemes State Aid approval status. Many smaller companies find it difficult to qualify for the schemes because of small and strict technicalities. For example, we have compiled these two case studies of a smaller company that had difficulty qualifying for EIS relief as a result of the qualifying trade requirement:

Case Study 1

A group of musicians produced a demonstration album and they were advised to seek funding via the EIS to develop it. The receipt of royalties and licence fees is not a qualifying activity unless they are attributable to the exploitation of 'relevant intangible assets' (s195 ITA 2007). In order for intellectual property (the album) to be a relevant intangible asset, it has to be created in circumstances in which the right to exploit it vests in the company (whether alone or jointly with others) - s195(5).

In this case, the adviser did manage to find evidence of the intention for the IP to belong to the company, such as production invoices for the album being paid on behalf of the company, and so HMRC agreed that the trade did qualify – but it was quite a battle.

There must be many entrepreneurs, who create IP which they subsequently wish to exploit, but fail to meet the qualifying trade requirements because they either did not know that the IP would be worth exploiting at the time they created it or were unaware that it had to be created in circumstances (with evidential support) where it belongs at least partially to the company, which the investors will acquire shares in (or a subsidiary). It would be helpful if the legislation could be amended so that IP is still a relevant intangible asset if it is created by a person who subsequently becomes a connected person with the EIS company or something along those lines.

Case Study 2

A company wished to establish a trade specific to the 2012 Olympics. Obviously this trade will not continue much beyond the Olympics and so they will not be able to satisfy the requirement that the trade is carried on for 3 years (s181(1)). After speaking to the SCEC on a no names basis recently, their view was that if the Company was wound up after the Olympics that would not be an exemption within s182 (companies ceasing to meet the trading requirements because of administration or receivership), and that in order for investors to qualify to EIS relief the company would have to start another trade after the Olympics with no more than a short break between the two.

It may be useful to explore widening the exemption in s182 so that it includes companies which cease trading for genuine commercial reasons within the 3 year period and where there has not been any tax avoidance motive behind their establishment.

HM Treasury should explore in depth more technical issues in the schemes that make it difficult for companies to qualify, in addition to the re-evaluating the limits. The schemes should not dictate business behaviour or business models, or restrain entrepreneurial behavior. We would be happy to find more case studies, such as the one above, and make further suggestions in due course.

Capital Gains Tax (CGT) reform

CGT reform and taxation of equity stakeholders in business is closely connected with the detailed discussion in the Green Paper on the availability of equity finance. We believe that, in addition to the VCT and EIS reliefs discussed above in this response, well targeted and cost effective capital gains tax reliefs to encourage equity investment in private and publicly held companies will demonstrate that the Coalition Government is prepared to act quickly and decisively to promote entrepreneurial activity (the key message in the CGT arena in the Coalition's paper "Our Programme for Government").

We also believe that now is the right time for the new Coalition Government to address, for the long term, this vitally important area of personal taxation, being an area where the previous Government's recent policy and legislation has been in various measures short-termist and poorly implemented.

As will be appreciated, the companies the QCA represents are dependent on their ability to attract talented individuals to contribute to the success of their businesses, whether as employees, officers or „business angels". Our members also need to attract investors who are willing to commit capital over a period of years to the small and medium sized businesses so essential to the UK economy.

It is our view that the Government can help small and medium sized businesses to attract the necessary talent and investment by adapting the existing Entrepreneurs' Relief, at least in so far as it relates to disposals of shares rather than other business assets, and perhaps even rebranding it as "Stakeholders' Relief". In doing so we are, necessarily, conscious that any potential additional costs for the Treasury involved in any extension of the current rules need to be carefully justified, and any rebranded tax relief needs to be well targeted and effective.

The introduction of Entrepreneurs' Relief was a reaction to the severe (and in our view justified) criticism accompanying the abolition of taper relief. The announcement that Entrepreneurs' Relief was to be introduced was made on 24 January 2008 (almost four months after the pre-budget report which prompted such an outcry). The Finance Bill which implemented this measure was published a scant two months later. In view of this timetable the parliamentary draftsmen evidently decided to use the old retirement relief as a basis for the new provisions.

Therefore the current definition of "personal company" is similar to, but not the same as, that for retirement relief. The key differences are the removal of the requirement for involvement in a "managerial or technical capacity" and the additional requirement to hold 5% of the ordinary share capital in the company as well as 5% of the voting rights.

The figure of 5% appears to have been lifted from retirement relief with little thought being put into whether or not this was appropriate. HMRC's representative to the House of Lords Select Committee on Economic Affairs, when asked to explain why this level was set, stated that "where to draw the line in determining the appropriate percentage was a matter for Ministers, but 5% had been in retirement relief". The relief was said to be directed at "those with a material stake in a company and those who play an active role in it"[2].

Our proposals are directed at more accurately targeting the relief by identifying those who make the most meaningful contribution to the success of a business.

We are proposing that such relief should be targeted at what we have termed „stakeholders" in companies, by virtue of the contribution (and risks) that such an individual makes in building up a successful business. We have identified the following types of stakeholder:

- employees and officers;
- business angels; and
- long-term investors.

[2] Jane Kennedy, Public Bill Committee, 8 May 2008 (PM), column 136.

Employees and Officers

The rationale for offering relief to employees and officers who own shares in the business is that this will make share-based employee incentivisation packages (a key weapon in a company"s recruitment and retention arsenal, as well as the most tried and tested way to align the performance of the individual with the performance of the business) more attractive to individuals and reward their contributions to the business for which they work. This will help businesses to attract the talented people they need to grow successfully – a company"s personnel are its key stakeholders.

We would, therefore, request the removal of the inappropriate personal company definition.

The personal company definition in Entrepreneurs" Relief means that an individual must hold 5% of the voting rights and 5% of the ordinary share capital in the company in which he holds shares to qualify for relief (the "5% Requirement"). This is in addition to the need to be an employee or officer of the relevant company.

The 5% Requirement penalises those shareholders working within high-capital-requirement, high-growth businesses as their need for significant outside investment is more likely to result in those shareholders actually involved in the running of the business having to accept dilution of their rights (often to below the qualifying 5%) or not being able to negotiate 5% packages due to the high value of such a holding. This is at odds with the overarching aim of promoting entrepreneurial business activity.

The 5% Requirement can also lead to an anomalous „cliff–edge" two-tier system amongst management with those unable to negotiate compliant packages now receiving even more unequal tax treatment in view of the fact that their colleagues will receive increased relief (following the welcome increase of the overall lifetime limit) whilst they will be subject to the newly increased 28% rate of capital gains tax.

We note that the 5% Requirement also can result in inequality between companies and LLPs. It is possible for a member of an LLP to qualify for relief on the sale of any part of his interest in the LLP regardless of his percentage interest in the LLP. This inequality demonstrates that the business world has moved on since retirement relief was phased out in 1999, and questions again the appropriateness of the 5% Requirement for companies.

Such tension could perhaps be tolerated if there was a well-reasoned argument behind the 5% Requirement. However, the limit appears to be an arbitrary way in which to define a „material stake" in a business which was simply lifted from the old retirement relief with no critical thought as to whether it was appropriate. For the reasons stated above we consider the 5% Requirement is inappropriate and should be abolished for employees/officers of the business.

Business Angels

We would ask the government to include within the restructured relief „business angels", who may not for very good commercial reasons wish to be officers or employees, but who are considering investing for a material stake in the equity capital of a company. At present, notwithstanding that such a potentially significant entrepreneurial investor may provide key financing for the company, no Entrepreneurs" Relief is available.

Here, we believe that it may be more appropriate to define the materiality of the equity investment in order to qualify for the relief, either in terms of a minimum equity stake or a minimum level of investment. In addition, in order to target this category of "Stakeholders" Relief" more precisely to address the increased difficulties of obtaining equity investment in the SME sector, it may also be appropriate to set a limit on the size of the business whose shares can qualify. Such a limit should be a straightforward and fair one to apply, perhaps based on market capitalisation for companies whose shares are publicly traded on any UK market (but with no such limit for private companies). We would see any market capitalisation limit to be in the region of at least £100 million.

Long-term Investors

We would argue that investors who choose to invest over a period of years in smaller companies, perceived as „riskier", make a valuable contribution by providing the stable financial base necessary to promote growth. These individuals are true stakeholders in the business, and such a relief would encourage longer-term rather than speculative investing. Taper relief recognised and rewarded this (although we have sympathy with the view that the reduction in the qualifying period to just two years was too generous), and the current Entrepreneurs" Relief includes a general condition that the shares have been held for 12 months. As with business angels, it does not seem to be relevant in this context whether the investor is an employee or officer of the business or not.

We would propose that those who invest in the business and hold their shares for at least 4 years should also be eligible for "Stakeholders" Relief", with no minimum equity stake required here. As with business angels, it may be appropriate to target this category of relief more precisely, and we would propose a similar straightforward and fair business size limit perhaps based on market capitalisation for publicly traded shares.

Stamp Duty

London is the only one of the world's three major financial centres with a tax on the transfer of shares and the UK has by far the highest rate among the G-8 economies, which makes the UK an unattractive market, particularly for European investors. A study by the ABI, City of London Corporation, IMA and London Stock Exchange entitled "Stamp Duty: its impact and the benefits of its abolition" (May 2007) confirmed this and showed that Stamp Duty increases the cost of equity for publicly listed companies by 7-8.5%. The same report indicates that Government"s tax-take could increase if Stamp Duty were abolished as a result of increased turnover. The study estimates that the annual tax-take could increase by as much as £4,000m, which would exceed the estimated cost of abolition by well over a £1bn. Also, the study indicates that its abolition would have a one-off increase in Capital Gains Tax intake of £281m.

Even a gradual reduction in Stamp Duty could yield significant up front benefits if there was a firm commitment from Government to abolish the duty over a period of three years. Such a commitment would have a beneficial impact on the markets as a result of increased investment.

Abolition of duty on shares will significantly enhance the UK"s attractiveness as an investment centre. Alongside the substantial shareholding exemption and the proposed exemption for foreign dividends, this measure could create a UK „participation exemption", "which is likely to lead to an increased level of direct foreign investment" (The Tax Reform Commission, Tax Matters: Reforming the Tax System, October 2006).

As such, Government should announce its commitment to eliminating Stamp Duty/SDRT over a three year period.

However, the Government should immediately remove Stamp Duty on shares in respect of small companies which are quoted on AIM or PLUS Markets, and on shares outside the FTSE 350 on the Main List, as we do not believe that this would significantly reduce the Government"s tax income.

Individual Savings Accounts (ISAs)

The tax status of AIM and PLUS quoted companies has changed radically following the abolition of Business Asset Taper Relief. Consequently, companies quoted on an exchange-regulated market do not qualify for certain reliefs that are available to listed companies.

Currently shares in AIM and PLUS quoted companies do not qualify to be included as ISA investments. Given that this sector has recently lost significant CGT advantages, this would be a reasonable step to assist this market sector. We also note that in March 2010 Budget of the previous Government there was mention that this measure would be explored in more depth.

We view this measure as redirecting investment into a much-needed area, and hence we believe it can be implemented without significant cost to the Treasury.

As such, we would propose that investments quoted on exchange-regulated markets (e.g. AIM and PLUS) should qualify for inclusion in ISAs.

10. Are there any steps that industry, financial institutions or government could take to promote access to debt capital markets for a greater number of UK businesses?

As noted in the introduction to this letter, it is clear from the roundtables with our broker and advisory members that there is significant interest in further exploring the idea of a corporate bond market for small and mid-cap issuers. In particular these members have pointed out that a market for such instruments and other forms of "quasi equity", such as preference shares, flourished in the 1970s and early 1980s.

For the sake of completeness, we should mention that a number of our corporate members had difficulty in envisaging such a market and felt they needed the practicalities to be made far more concrete before they would feel comfortable in commenting on the idea.

A number of our members participated in HM Treasury"s consultation on this subject earlier this year and would like to participate in the next steps.

We are also aware of the greater sophistication of the PIPES market (private investment in public equity) in the USA with debt and "quasi equity" in smaller listed companies being far more common there.

11. What more could be done to promote greater competition in the provision of business finance?

As mentioned in our response to Question 10 above, we believe that further exploring how to promote access to debt markets for small and mid-cap quoted companies could be a way to promote greater competition in the provision of business finance.

12. What other actions could be taken to help businesses (of all sizes) access a wider range of different finance options?

As mentioned in our response to Question 9, we believe that improving tax incentives to encourage investment into the small and mid-cap quoted company sector will help these companies to access a wider range of investors.

13. Looking ahead, what are your views on future risks to the provision of business finance, in particular bank lending? If you have concerns, do these reflect transitional factors in the wake of the financial crisis, or structural factors? Are there steps that the banking sector, regulators or policy makers should be taking to mitigate these risks?

We see the need to promote and foster a renewed equity culture in the UK, opposed to encouraging smaller companies only to seek debt finance, as essential. Doing so will help companies access business finance through various channels and to fill the growing finance gap, as well as helping to avoid another financial crisis similar to the one that we have experienced and are still feeling the effects of.

Bank lending has become far more sophisticated in its approach to funding commercial enterprises which have few physical assets. The value of intangible assets, particularly intellectual property, and the ability to utilise book debts, inventory, investments and other non-physical assets as collateral has greatly enabled banks to help finance hi-tech companies and service businesses.

In spite of these developments the Green Paper graphically illustrates the banking sector"s significant and continuing over exposure to traditional real estate lending.

Others are better placed than the QCA to comment on the effects of Basel III and CRD 2 and 3 on bank lending to corporate borrowers. We understand that the net effect of these new regulations is to directly decrease the availability of credit to the sector due to the requirements for the banks to have increased capital resources to back such loans.

Our concern is that new regulatory restrictions on bank lending at this stage in the economic cycle may lead banks to a return to more traditional lending practices including increased reliance on physical assets as collateral. Paradoxically far from solving the banking sector"s exposure to real estate, that exposure will increase.

We urge those involved in bank regulation to do what they can to avoid a structural impasse in which the pursuit of perceived "safety" in lending decisions does not result in an effective withdrawal of existing credit arrangements and a bunker mentality over future commercial lending.

14. **What steps can banks, industry or Government take to strengthen bank's relationships with their customers and ensure businesses are not discouraged from seeking finance? What steps can the banking sector and others take to improve the financial readiness of businesses?**

We surveyed our corporate members about their banks" behaviour in the last 12 months, asking them whether they needed to approach their banks to renew existing facilities or for additional funding and, if so, what response they received from their banks in this process. In addition, we asked them how they would like to be treated by their bank in the event that their existing facilities were not going to be renewed or were to be renewed under different terms.

24 companies responded to the survey; 80% are quoted on AIM and 40% with a market cap between £0 and £20m.

We found that out of 24 respondents, 45% stated that their banks" general attitude has been either very helpful/supportive or supportive in this economic climate. 25% also noted that they viewed their banks" attitude as neutral/no change.

30% stated that their banks" general attitude has been unhelpful/unsupportive or very unhelpful/unsupportive. As such, the results show that experience in the small and mid-cap quoted sector is mixed.

With regard to what would be best practice in the event that their bank decides not to advance a facility or will only do so with additional/different conditions, responses indicated that banks should consider the following:

1. Banks should give clear reasons – with reasonable notice - of their decision not to advance a facility.

2. Banks should give clear reasons – with reasonable notice of at least 6 months - of any anticipated variations to existing facilities.

3. Bank managers should be aware of their credit committee's likely response (and be prepared and able to communicate this to their customer at the earliest opportunity), so that companies do not waste time negotiating with managers only for the credit committee to turn the application down. Any professional costs or bank recharges in respect of any exercises initiated in connection with the renewal or maintenance of facilities should be reimbursed where this happens.

4. Banks should communicate changes to their lending criteria and/or publish their criteria. If criteria change during a loan period, then transfer to another bank should be free.

5. Banks should provide clear and consistent instructions on what needs to be done to secure a new facility, including what information they need.

6. Where the performance of a business is in line with bank expectations, banks should be clear in their reasons - and give sufficient notice – where different conditions are to be applied to the facilities.

Overall, it seems that banks must be open to communicating clearly and openly – and this behaviour needs to fostered.

15. What options might Government consider to support increased lending to business (including possible expansion of the EFG or of payments to part of the supply chain)?

How effective is the EFG in increasing access to debt finance for small businesses? What could be done to improve it and can more cost be borne by users?

We have no comments on this question.

16. What steps would be beneficial in making securitisation more attractive to investors and a stable form of funding for lenders? Are there particular sectors or products that this should be focused on?

We have no comments on this question.

17. Are there significant constraints on access to trade finance for UK exporters? What measures could banks, industry or the government take to increase the availability of trade finance?

We have no comments on this question.

If you would wish to discuss this response, we would be pleased to attend a meeting.

Yours faithfully,

Tim Ward
Chief Executive

Enc: *Are You Ready? A Brief Guide for a Company Aspiring to Go Public* (May 2010)

APPENDIX B

THE QUOTED COMPANIES ALLIANCE (QCA)

A not-for-profit organisation funded by its membership, the QCA represents the interests of small and mid-cap quoted companies, their advisors and investors. It was founded in 1992, originally known as CISCO.

The QCA is governed by an elected Executive Committee, and undertakes its work through a number of highly focussed, multi-disciplinary committees and working groups of members who concentrate on specific areas of concern, in particular:

- taxation
- legislation affecting small and mid-cap quoted companies
- corporate governance
- employee share schemes
- trading, settlement and custody of shares
- structure and regulation of stock markets for small and mid-cap quoted companies; Financial Services Authority (FSA) consultations
- political liaison – briefing and influencing Westminster and Whitehall, the City and Brussels
- accounting standards proposals from various standard-setters

The QCA is a founder member of European**Issuers**, which represents quoted companies in fourteen European countries.

QCA's Aims and Objectives

The QCA works for small and mid-cap quoted companies in the United Kingdom and Europe to promote and maintain vibrant, healthy and liquid capital markets. Its principal objectives are:

Lobbying the Government, Brussels and other regulators to reduce the costing and time consuming burden of regulation, which falls disproportionately on smaller quoted companies

Promoting the smaller quoted company sector and taking steps to increase investor interest and improve shareholder liquidity for companies in it.

Educating companies in the sector about best practice in areas such as corporate governance and investor relations.

Providing a forum for small and mid-cap quoted company directors to network and discuss solutions to topical issues with their peer group, sector professionals and influential City figures.

Small and mid-cap quoted companies" contribute considerably to the UK economy:

- There are approximately 2,000 small and mid-cap quoted companies
- They represent around 85% of all quoted companies in the UK
- They employ approximately 1 million people, representing around 4% of total private sector employment
- Every 5% growth in the small and mid-cap quoted company sector could reduce UK unemployment by a further 50,000
- They generate:

  - corporation tax payable of £560 million per annum
  - income tax paid of £3 billion per annum
  - social security paid (employers" NIC) of £3 billion per annum
  - employees" national insurance contribution paid of £2 billion per annum
  -

The tax figures <u>exclude</u> business rates, VAT and other indirect taxes.

For more information contact:

Tim Ward
The Quoted Companies Alliance
6 Kinghorn Street
London EC1A 7HW

www.theqca.com

-o0o-