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Sharesoc response to consultation on Venture Capital Trust share buy-backs

Dear Nalini,

Sharesoc is the UK Individual Shareholders society, a non-profit organisation representing over 2,500 individual investors. Our website can be found at www.sharesoc.org.
We are aware of a number of submissions from investors on this topic, and while we echo many of the comments made we also make some additional points below.

Preliminary comments:

The underlying goal of the VCT rules is to promote investment in UK SMEs, thus promoting jobs and economic growth. In order for the policy aims to be achieved, attention must be given to both ends of the investing timeline – purchase and sale. In principle we agree with the objective of restricting conditional buybacks with the caveats mentioned below. But as any purchaser must eventually become a seller, the often problematic secondary market in VCTs has often acted as a deterrent to investment. Any legislation which makes exit more difficult would further limit the effectiveness of the VCT sector, and the proposed legislation must be amended to avoid unintended consequences.

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

Yes, for the most part. The reason for VCTs' intervention in the market is to provide a means of exit for investors; the operation of a successful exit mechanism is critical to successfully encouraging investment in any sector. Nobody would invest in Country X if it were not possible – eventually – to repatriate profits and capital. Similarly, there must be an eventual exit mechanism for investors in VCTs. While the typical exit mechanism for an investor in a listed market is simply to sell on the Stock Exchange, for VCTs this market has often been illiquid and/or at very wide discounts, thus discouraging investors from future investment in the sector. There have been some efforts on the part of managers to promote the secondary market in VCTs, but there are several reasons why there are few buyers of secondary shares:

a. The relatively poor investment performance of the sector as a whole can be seen from industry performance tables, though there are some notable exceptions.
b. The relatively small size of any given VCT makes them illiquid, a problem sometimes compounded by multiple share classes.

c. The 5 year hold period significantly reduces supply and means that the universe available to potential secondary investors is limited.
d. A potential secondary market purchaser (rightly) does not receive 30% upfront tax relief, this makes his purchase more expensive when compared to a primary market purchase of the same or similar VCT.

The result is an illiquid secondary market which trades on very wide discounts, dissuading investors from entering the sector despite the initial tax reliefs. In order to address this problem, the VCTs themselves have adopted several mechanisms beyond those typically seen in listed companies to promote liquidity (or otherwise provide at least a partial exit) and thus to make primary VCT investment more attractive. These include:

a. Periodic secondary market purchases and small tender offers, sometimes combined with a discount management policy.
b. Significant tender offers.
c. Continuation votes.
d. Promotion of limited life / planned exit VCTs (with which HMRC has no issue).
e. EBBs ('exit' is only on the tax relief component).

Each of these items provide a measure of liquidity, but the distinguishing characteristics of the final item are that it is conditional on the investor reinvesting into the VCT, and it puts just 30% of the Net Asset Value into the investors pocket. In our view, an EBB is the least effective tool for investor liquidity and thereby promotion of the sector. The first four mechanisms provide cash to investors and reduce the asset and fee base of the VCT manager; an EBB provides only partial investor liquidity and maintains the asset and fee base of the manager at the expense of the taxpayer and HMRC policy goals.

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

We do not believe that the option described at 3.6 would meet the policy aims as formulated, and yet would also have significant unintended adverse consequences. The second part of the formulation is good, in that there should be a prohibition on a VCT making the purchase of shares conditional upon the same investor repurchasing shares as it does not really benefit investors, and imposes a cost on HMRC without achieving policy goals. There are many reasons, however, why an investor may wish to voluntarily reinvest sale proceeds into another VCT from the same (familiar) fund management group. He may have exited a limited life VCT, may wish to switch for example from an AIM based to a traditional VCT, have sold for personal liquidity reasons and then come into some cash, or have sold some pre 2004 Deferral Relief shares within his annual CGT allowance. Each of these types of transactions would be precluded by the proposed wording.

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

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

Yes and yes. The two main problems of the VCT market are investment performance and the difficulty of exiting. While neither is the responsibility of HMRC, and it cannot affect the first, HMRC can, at little or no cost, ensure that policy either promotes or at least does not harm the secondary market in VCTs.

Prohibiting investors from reinvesting sale proceeds into a new VCT by the same group would discourage future investment, create additional bookkeeping for investors, and restrict investment possibilities. For example, it would not be possible to reinvest (voluntarily) after a partial tender offer, or to reinvest funds from a matured VCT. There are also failing VCTs which have been rescued by reputable managers – any exit from these would preclude the investor from reinvesting in a more successful fund from the same manager. The changes proposed might also impede the consolidation of the industry into a smaller number of more successful managers.

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

See question 2 above. If HMRC insist on including the first part of the formulation in part 3.6, then the time limit should be much shorter than 6 months. A 30 day limit would be analogous to existing rules for matching ordinary listed company purchases and sales. Note that the imposition of a time limit may also impact DRIS schemes and will have other unintended consequences.

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

This would not be necessary if the proposal were to be restricted to prohibiting conditional repurchase offers.

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

Paying out dividends to investors has always been possible, permissible, and desirable. Dividends go to all investors, and so it would not be possible to 'link' it to the participation of some – but not all – shareholders. Making a large dividend conditional upon a further subscription by all shareholders would require a vote (and forcing subscriptions from all investors may prove practically unworkable), but at that point the formal link has made it conditional and therefore would violate the proposed (amended) rules. The voluntary reinvestment of dividends – in the same or other VCTs - has always been permissible and lies within policy goals. In extremis, the permissible structure approaches a limited life VCT, where a new share class or VCT is offered as a voluntary replacement investment.

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

The rule proposed at 3.6 is flawed. With a simple limitation on conditionality between the repurchase and sale, there will be an effective restriction on undesirable behaviour.

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

Our view is that the rules governing VCTs are already too complex, and introducing further rules and conditions will increase the cost of compliance along with increasing the likelihood of inadvertent breaches.

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

As we understand it, the overriding policy aim is to promote investment in SMEs, thus creating jobs and economic growth, at minimal cost to HMRC. A simple prohibition on a conditional linkage (of any time period) between the sale of new shares and the repurchase (directly or indirectly) by a VCT will promote this policy aim.

HMRC may wish to consider bringing VCTs in line with AIM shares (from 2014) and abolishing stamp duty on secondary transactions as a way of promoting investment in the sector by improving secondary market liquidity.

Another possibility could be allowing any losses on VCTs to be deductible from other Capital Gains or from Income, similar to EIS.

We agree that making the VCT alone responsible for compliance may have serious consequences for all investors of a breach by the VCT. However, shifting the compliance burden to the investor increases the administration required of investors, making the sector less attractive. In addition many investment advisors are leaving the industry as a result of RDR, meaning that more investors in VCTs will be faced with managing the existing complexities by themselves. Has consideration been given to shifting some of the burden of compliance by a VCT on to its Managers? Direct responsibility by Managers will help prevent some arbitrage of the legislation.

General Anti Avoidance rules will also give some protection to HMRC and the taxpayer against abusive behaviour.

In summary, we suggest that the goals of HMRC are best met by a simple prohibition on conditional linkages between the repurchase of shares (by whatever means) by a VCT and the sale of new shares to the same investors. This avoids unintended consequences and is easy to implement and control.

We hope that this response is helpful in refining the proposed legislation. The author can be contacted at mark.lauber@sharesoc.org for any further information.

Yours sincerely

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