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UNLOCKING GROWTH

PROPOSALS TO EXPAND VENTURE CAPITAL INVESTMENT AND ACTIVITY IN THE UK

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FOREWORD

Although the US seems to be due for some retrenchment, the growth which has taken place in a massive mature economy over the last decade has been an incredible achievement. Its fruits will almost certainly outlive any temporary decline. It has been underpinned by both the technical advances that have taken place and the generation of New Economy efficiencies in managing businesses. In turn the speedy exploitation of both has been substantially the result of the major growth in venture capital/private equity financing and activity, which have taken off in the US over the last 15 years.

Studies have shown that venture capital investment has created between three and five times the number of jobs as average business investment. Professor Lerner's studies have shown that investment in new technology has created output equal, on average, to five times the expenditure.

As a proportion of national income, total venture capital investment in the US is nearly four times that in the UK.

In the context of a broadly comparable, Anglo-Saxon market economy system to the US, the UK has done well in venture capital in comparison with Continental-Europe over the last decade, but nowhere near as well as the US. As a proportion of national income, total venture capital and relevant investment in the US is currently nearly four times the level of that in the UK. In the last three years our overall economic growth has been only some 60% of that in the US. I, therefore, asked Patrick Burgess together with leading members of the British venture capital community to examine how venture capital could be nurtured and increased in Britain, focusing in particular on the

contributory factors to US success. This pamphlet summarises the findings and recommendations of a far larger document which might be of particular interest to those practising in the Industry.[1] It also presents the background to the persuasive arguments which are deployed here.

Self evidently, the tax regimes not just for venture capital investors, but in particular, for venture capital entrepreneurs and employee option schemes are crucial, although by no means exclusive factors. The excellent paper, which Patrick Burgess and his colleagues have put together, goes beyond these territories, which have been covered by other major studies undertaken recently. The interaction between university communities and venture capital activity has been a key factor in US success. There is considerable scope in Britain to follow this model. In the US, the venture capital industry has also generated more stable institutional flows of venture capital investment. This reduces the cyclical dependency on private individuals. The role of the banking industry in venture capital also needs to be free of unnecessary restraints. Although in the context of a much larger economy, the US has also been more effective in nurturing regional venture capital activity and investment.

> *If taxes are to be reduced and public services improved, then our sustainable economic growth rate must be increased… To achieve this requires a higher and more reliable level of venture capital investment and activity.*

An organised venture capital industry brings the crucial business and market disciplines to new enterprise and new technology investment.

If the UK economy is to afford both the reduction in our levels of taxation which its citizens want and its economy needs, and higher, sustained investment in education and health, as in the US, we must increase our sustainable economic growth rate. The key to achieving this is a higher and more reliable level of venture capital investment and activity.

An enormous amount of research and work has gone into producing this paper. I am most grateful to Patrick Burgess and the members of the Advisory Committee for their input.[2]

Howard Flight MP
March 2001

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1 *Venture Capital: the key to economic growth* is available from the Centre for Policy Studies, 57 Tufton Street, London SW1P 3QL. Price £50.

2 The Members of the Advisory Committee are listed in the Acknowledgements at the end of this paper.

SUMMARY

> Money is none of the wheels of trade: it is the oil which renders the motion of the wheels more smooth and easy
>
> – David Hume, *Essays, Moral and Political*

There is no doubt that the venture capital industry has played a major role in Britain's recent prosperity. It could, however, do much more. Specific features of the tax and regulatory regimes are inhibiting what should be the primary lubricator of British economic success. If these were removed, the results could be startling.

Britain's venture capital industry is the largest and most developed in Europe. It now accounts for 49% of the total European venture capital investment. Between 1983 and 1999, the industry has invested almost £11 billion in close to 16,500 companies, with a record investment of £1.5 billion in 1999. In 2000, the British Venture Capital Association (BVCA) estimates that the level of start-up and business expansion capital grew even further to £2 billion.

However, it must be recognised that, in comparison to the US, this record leaves plenty of room for improvement. The following table shows that venture capital funding is about three and a half times more important in the US than in the UK.

	UK	US
GNP (2000, estimate)	£900 billion	£6,000 billion
Venture Capital Funding	£2 billion	£43 billion
Venture Capital Funding as a % of GNP	0.2%	0.7%

Note: The above data for Venture Capital Funding exclude MBOs and MBIs
Sources: BVCA; PwC MoneyTree Survey; World Bank.

Should the UK achieve a comparable level of venture capital funding to that prevailing in the US, the data above suggest that venture capital investment in the UK would rise from its 2000 record level of £2 billion p.a. to £7 billion p.a.

Should the UK achieve a comparable level of venture capital funding to that in the US, venture capital investment would rise from its current level of £2 billion p.a. to around £7 billion p.a.

But if the British venture capital industry is to catch up with that of the US, a series of obstacles must be overcome. This ambition should be welcome to parties of all persuasions, as it would significantly increase the prosperity of the country as a whole. The obstacles which need to be overcome fall into four main categories:

- A less than supportive taxation system, one which is often seen by practitioners to be suspicious and obstructive;
- The difficulties of attracting highly qualified and experienced management to small business start-ups;
- A cultural wariness of venture capital which can be found amongst, *inter alia*, the professions, the retail banking industry, the universities and the civil service;
- Over-regulation, particularly that which restricts the involvement in the venture capital industry of the pension funds, insurance companies, charities and other financial institutions.

British venture capital investment is running at about 30% of the US level per £ of GNP. It is in the interests of all parties and all the people of the UK to reduce this gap.

For all the Government's fine words, British venture capital investment is running at about 30% of the US level per £ of GNP. Whichever political party is in power should address the causes of this major British underperformance vis-à-vis our Anglo-Saxon cousins. Implementation of the recommendations on the following pages would do much to correct the shortfall.

RECOMMENDATIONS

The following proposals are deliberately modest, that they may receive the realistic consideration of policy makers. The data above, however, shows that, if implemented, their impact could be enormous.

1. **Abolish, or at least substantially reduce, Capital Gains Tax (see pages 6 to 8)**
   Capital Gains Tax (CGT) prevents young companies offering adequate rewards to attract experienced managers, inhibits investment by restricting exit routes, and damages liquidity in the markets by punishing those who realise their investment. If this were to be done, reliefs would still be needed for a transitional period to overcome "cultural drag".

2. **If the latter option is taken, shorten taper periods and make reliefs more commercially realistic (see pages 6 to 8)**
   Tapering gradually reduces the sum on which CGT is payable. In the UK, however, the periods are longer than in the US. Special measures should be put in place for serial investment.

3. **Reform regulation of share incentives (see pages 9 to 11)**
   Share incentive schemes allow small firms which cannot pay high salaries to attract experienced executives. The current schemes in place are, however, too complex and restrictive.

4. **Remove regulation from all small and medium size enterprises (see pages 12 to 16)**
   Red tape hobbles small business particularly tightly. A fledgling company backed by venture capital currently has to spend too much time and money on bureaucracy.

5. **Allow some tax relief for MBA students (see page 11)**
   This step would mitigate the difficulty of taking time out of work to study for an MBA, and would address the problem of the lack of high quality management.

6. **Ensure that the proposed regime permitting approaches directly to high net worth individuals is implemented without hindrance (see page 13)**
   This piece of red tape merely complicates the process of finding finance.

7. **Allow corporate bodies to market directly the availability of investment finance (see page 13)**
   At present corporate bodies wishing to invest must go through an approved third party when seeking to find suitable investment vehicles. While "dealings as principal" are exempt as an activity, advertising their availability is not. The draft regulations under the new Financial Services and Marketing regime do not appear to permit it.

8. **Protect business angels and mentors from being labelled as shadow directors and from other regulatory liability (see page 12)**
   Those who lend support to a young company as a mentor or business angel should be able to do so free of red tape. The provisions on shadow directors (those who act as de facto directors) may well catch angels and mentors, making it less likely that they will take on the responsibilities involved in the first place.

9. **Remove the unnecessary regulation surrounding the VCT, EIS and Corporate Venturing schemes (see pages 13 to 15)**
   These schemes are valuable vehicles to encourage the investment of venture capital by offering tax efficient ways of doing so. The restrictions which surround them, however, are extensive and limit their value.

10. **Alter the basis of Corporate Venturing, so that it is based on the investment of a percentage of actual corporation tax payable (see pages 15 to 16)**
    Corporate venturing (by which an existing company chooses to invest some of its profits in venture capital projects) is just taking off in the UK. However, the way it has been set up by the Government makes it likely that only a tiny minority of companies will take advantage of the opportunities offered. A simpler scheme, allowing the relief stemming from the investment to be based on a percentage of actual corporation tax payable, would make it much more attractive. Alternatively, the scheme should be linked more clearly to the new proposals for a form of roll-over of gains made from substantial participation in other countries.

11. **Reflecting its status as a global industry, work for the international relaxation of the current system of royalty taxation (see page 27)**
    The present system attaches a "withholding tax" to royalty payments. This is becoming increasingly unrealistic. While abolition of the UK system of taxing royalty payments is promised, other jurisdictions need to be won over. In a global market place, this is vital.

12. **Review the definition of research and development on a regular basis (see page 26)**
    The fast development of the technology sector (and others) means that the Inland Revenue rules (and accounting practice) on what constitutes research and development need to be kept under regular review, particularly at the universities.

13. **Abolish the Minimum Funding Requirement for pension funds (see pages 17 to 18)**
    The manner in which the Minimum Funding Requirement for pension funds operates effectively obliges pension funds to invest in gilts, and thereby inhibits investment in venture capital schemes. This piece of regulation is partly responsible for the relatively poor levels of investment by UK pension funds in venture capital.

14. **Ensure that regulation does not limit the easy availability of exits for venture capital providers (see page 5)**
    It is essential that venture capital providers are able to realise their investment easily when they judge that the company is "market ready". The UK is currently well placed in its provision of exits, but there is a danger that regulation could limit this. Venture capital needs to be viewed as part of the much wider fabric of the national economy. In this context, attention must be paid to the needs of smaller quoted companies as well.

15. **Simplify planning procedures for university science parks (see page 25)**
    The examples of Silicon Valley and Cambridge Science Park show how a university can be a magnet for small businesses. To encourage these clusters, planning laws relating to such sites should be made simpler.

16. **Review the workings of the Insolvency Act 1986 (see page 23)**
    In many ways, the workings of the Insolvency Act have now departed from the intentions of those on whose thinking it was based. A review must allow a more sympathetic approach to those taking the risk of starting a new business. Relabelling changes as a "rescue culture" does not go far enough.

17. **Reform the law on limited partnerships (see page 13)**
    Based on a 1907 statute, restricted to 20 partners, such partnerships were prevented from marketing themselves for most of the 20th century. However, they are a most flexible investment instrument (and thus widely used in the US).

18. **Encourage banks to adopt a more nuanced approach to the assessment of proposals from young and growing companies (see pages 21 to 22)**
    Banks tend nowadays to adopt an overly mechanistic approach to financing companies. This often works to the detriment of start-ups. A more subtle approach would help young and expanding companies to succeed. More encouragement needs to be given to the recently established pilot schemes.

CHAPTER ONE
THE BRITISH VENTURE CAPITAL INDUSTRY

The venture capital industry is one of the most important lubricants of Britain's economic prosperity. The injection of funds into young and expanding companies at crucial stages of their development, together with assistance in their most efficient operation, is a key part of the wealth creation process.

Britain's venture capital industry is the largest and most developed in Europe. It now accounts for 49% of the total European venture capital investment. Since 1983, the industry has invested around £11 billion in close to 16,500 companies, with a record investment of £1.5 billion in 1999.[3] If management buy ins (MBIs) and management buy outs (MBOs) are included in the data, the investment since 1983 totals over £35 billion, with £7.8 billion invested in 1999.

In 1998, UK venture capital companies contributed £22.3 billion in taxes and produced £178 billion in sales revenue in the UK.

In 1998, UK venture capital-backed companies contributed £22.3 billion in taxes and produced £178 billion in sales revenue in the UK.[4] Many well known names have been backed by venture capital at some stage of their development, several of which are now quoted on the Stock Exchange. Major unquoted companies include MORI; Books, etc; Golden Wonder; Dolland & Aitchison; and ABC Cinemas. Quoted companies backed by venture capital include National Express Group; Whittards of Chelsea; Hamleys; and Cantab Pharmaceuticals.[5]

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[3] Source: British Venture Capital Association.

[4] Source: BVCA/PcW survey.

[5] Source: BVCA.

Nowadays, venture capital providers in the UK are drawn from a wide constituency. Their number includes publicly listed investment companies (like 3i), offshoots of banks and US venture capital houses, Venture Capital Trusts (VCTs), participators in Enterprise Investment Schemes, and business angels. These different types will be explored in greater detail later in this paper.

Despite its pre-eminence in Europe, however, the British venture capital industry still lags behind that in the United States. The US economy has been a huge beneficiary of the success of venture capital and the entrepreneurial spirit which it empowers. The UK's industry, on the other hand, got off to a rather slower start and has been hindered by heavy taxation and cultural drag.

The Social Investment Task Force recently made a series of recommendations for realising the potential of the venture capital industry. However, its solutions were narrowly targeted. An intelligent liberation of the industry would provide far more benefit to Britain – and not least to our poorest communities.

The Government recently received a report from its Social Investment Task Force, entitled *Enterprising Communities: Wealth Beyond Welfare*, which made a series of recommendations for realising the potential of the venture capital industry to rejuvenate "under-invested" communities. Its solutions, though, are narrowly targeted. Nevertheless, at its root is the welcome acknowledgement (which this paper shares) that the venture capital industry has a huge potential to create wealth in which all can share. An intelligent liberation of the venture capital industry in the UK by the means suggested in this paper would provide even more benefit to Britain – and not least to our poorest communities.

CHAPTER TWO
THE ROLE OF THE VENTURE CAPITAL PROVIDER

The venture capital industry exists to channel funds to young or expanding companies which require investment and which represent a good prospect for future success.

START-UPS AND MENTORING

One of the key roles of the venture capitalist is supporting start-ups. The investor will look to put money into the company by taking shares in it, generally looking to participate in the company for a period of about five to ten years. Ultimately, of course, the venture capital provider will want to sell on its interest when the company is ready to qualify for more traditional means of support – when it is "market ready".

In a start-up, the capital provider will often want to have some degree of management participation, to ensure that the company is run in an effective manner, thus maximising his return. Usually, such participation will be welcomed. This management input is known as "mentoring". Many small firms are in need of the sort of guidance that mentors can provide. They can make a startling difference in the speed (and degree of success) of a business's development. Their involvement can also give confidence to banks and other investors, making the raising of additional funds much easier.

INCUBATORS

Fledgling businesses are also given assistance by incubators. These are a relatively new development in the UK, and provide a combination of financial, legal, management and other types of support to start-ups. Quite a number of venture capital houses now have incubator funds, supporting a wide range of young companies. By taking advantage of economies of scale and offering skills

and experience which might otherwise be lacking or out of reach in financial terms, support can be better targeted. The incubator recently set up by the Internet firm, Lycos, for example, offers finance, office space and technical support to all its sponsored start-ups. Those based in a business school or an academic environment may find the regime particularly favourable.

The efficacy of incubators can most clearly be seen through a comparison of the traditional start-up model with the new incubator-based model. While the old-style start-up might take four to seven years (or even more) to become "market ready", the incubator approach can produce the same effect in between two and five years.

Some experienced personalities in the venture capital field have now become involved in incubator activity, as have many major companies, perceiving an opportunity for profitable investment. The London Business School has set up its own incubator organisation and is working with others to set some best practice standards in this area; many universities have done the same. Similarly, big corporate names like IBM, the Royal Bank of Scotland and several management consultancies have all set up incubator funds. The technology boom in 2000 led to a significant upsurge in the number of incubator funds operating in the UK (and, of course, in the US): there are currently thought to be over 150 different internet-focused incubators operating in London alone.

BUSINESS ANGELS

Young companies also often find the support they need in the form of business angels. Private investors who are interested in taking a more hands-on role in guiding a fledgling firm perform an invaluable role in helping such companies reach their goals, with their offer of management advice, introductions and other practical experience. The statistics show that business angels generally invest around £50,000 (unlike traditional venture capital providers which tend to put up much larger sums), and their involvement is strongly weighted towards start-ups and early stage companies. It is estimated that each year 3500 young companies now secure support from about 18,000 business angels, usually brought together by "networks", effectively dating agencies for fledgling companies and angels. Local networks, such as Sussex Enterprises, and a number of private organisations, such as Pi Capital, have proved highly successful at matching business angels with small firms who value their investment and guidance.

VENTURE CAPITAL FOR EXPANSION

Moreover, the venture capital industry can also play a crucial role in the expansion of a business. It is in the expansion stage of a business that most jobs are usually created. It is also the time when the management team will probably need to expand and become "professional". The involvement of venture capital providers is essential to the success of this process. About a quarter of business angel activity takes place in the expansion stage, where the practical guidance angels can offer is again immensely valuable. Indeed, it has been argued that the UK's venture capital industry is much more effective at this stage than at the start-up stage.[6]

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[6] See R. Harding, *Venturing Forward*, IPPR, 2000.

MBOs AND MBIs

Between 70% and 80% of venture capital in the UK, however, goes into management buy outs (MBOs) and management buy ins (MBIs). MBOs and MBIs are often an effective method of reinvigorating a tired company, giving it new potential for job and wealth creation. The low inflation climate nowadays, however, makes taking on a substantial debt burden at this stage a more difficult proposition for those leading an MBO/MBI. The role of the venture capitalist can therefore be particularly important: because its returns are success-based, its financing structure can be less onerous than one which is heavily reliant on inflation to assist in the process of debt retirement.

It is crucial that the capital provider can take his money out of the business when it is judged ready to move into the marketplace… Government must not hamper this process by over-regulation.

EXITS FOR THE INVESTOR

Ultimately, whatever the method of investment, the venture capital provider will want to realise his stake and exit from the business. The UK and the US share one key feature which has contributed significantly to their success: the range of exits available. It is crucial that the capital provider is able to take his money out of the business when it is adjudged ready to move into the marketplace. The fact that the US and the UK both make available a number of forums for selling on the investor's equity (often through flotation on a suitable exchange, be it the Official List, TechMark, OFEX, AIM, NASDAQ or the like) has encouraged venture capital providers enormously. Government policy should pay attention to the needs of smaller-quoted companies (which are really a separate asset class but a vital stage to most business growth). Above all, it must not hamper the process of exit by over-regulation.

CHAPTER THREE
REFORMING CAPITAL GAINS TAX

A BARRIER TO EXIT AND A FETTER ON LIQUIDITY

Capital Gains Tax (CGT) represents the main barrier to exit for the venture capital provider.

Capital Gains Tax acts as a significant barrier to the development of the venture capital industry.

The importance of allowing the venture capital provider to realise his investment cannot be over-stressed. CGT operates as a significant barrier by landing the investor with a large tax bill when he sells on his shares. The effect of tapering (a gradual reduction in the percentage of the gain on which tax is payable) limits this liability, but only over a fairly long time period: this means that the investor may not be able to exit at the time he finds most appropriate. Barriers to exit when the company has reached the stage where the venture capitalist's involvement is no longer necessary provide a major disincentive to his investing his funds in the first place.

Moreover, the relatively high level of CGT limits the amount of money available for investment or reinvestment in the marketplace. The traditional source of capital for a small business has been the ordinary man with a sum of money to invest. This was the case long before the concept took on the more sophisticated form of the "business angel". These potential investors, however, are heavily taxed on their existing capital gains, which means that many are unwilling to liquidate their current (older, non-venture capital) investments to create a supply of new capital for future investment. Although there is plenty of paper wealth in the UK, few individuals are willing to sell and realise it, unless they are forced to do so for some reason.

THE LESSON OF THE US

A substantial cut in CGT in the United States 20 years ago was the stimulus which made the American venture capital industry the world leader. The results were remarkable: the US now invests some 7% of its investable funds in venture capital/private equity, compared to only 1% in the UK. Economists agree that the cuts in CGT were the crucial factor in stimulating this success. The Nobel Prize winner, Robert Mundell, for example, has written of how the US economy took off as a result of the imposition of tight budgetary control and tax cuts in this area,[7] while the 1985 US Treasury report stated that the earlier reductions in CGT had had little effect on revenue, but had positively affected both economic growth and productivity.

20 years ago, the US made a substantial cut in CGT. This was the stimulus which made the American venture capital industry the world leader.

The effect of high levels of capital taxation on realisation of existing investments can be seen clearly from the reaction of US investors to an ill-advised rise in CGT in the 1986 Tax Reform Act. This legislation raised the maximum CGT from 20% to 28%. Capital gains realisation fell sharply from $350 billion in 1986 to an annual $100-150 billion between 1987 and 1991. At present in the US, gains are taxed at the prevailing rate of income tax, but the tax on long-term capital gains (defined as assets held for over 12 months – a much shorter period than that on which tapering works in the UK) is limited to 20%.

CGT IN THE UK

In the UK, CGT is considerably higher than it is in the US. Venture capital providers will almost universally have to pay it at the 40% rate, subject to tapering and a number of reliefs. The system of reliefs, though, is impossibly complex, again inhibiting investment, and all are highly restrictive. Although the tapers are useful in limiting the tax liability of a venture capitalist, the long periods involved (compared to those prevailing in the US) make it more difficult for an investor to exit when he wishes. Even the new system introduced by the Finance Act 2000 involves taper periods, which inhibit serial investment.

In the UK, almost all venture capital providers could pay CGT at higher rates – compared to just 20% in the US.

A significant reduction in CGT in the UK plus an overhaul of the reliefs and tapers available – or, even better, the abolition of CGT entirely – would provide the stimulus which the venture capital industry needs to take it to the next level. Even so, because of the effect of "cultural drag", some reliefs and encouragement may need to be retained for a transitional period.

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[7] See BVCA *2000 Budget Paper*.

Moreover, if CGT in its present form were to be abolished, the concerns of many could be assuaged by the introduction of a short-term gains tax, which would, together with the case law developed over the last 20 years, provide the Inland Revenue with the tools to police the boundary between capital and income.

If the tax is not to be phased out altogether (which is strongly recommended), significant changes still need to be made. This was the view taken by Sir Peter Williams in his report on high-tech investment published three years ago.[8] He stated that changes to CGT had to be the "first line of attack" on the failings of the UK venture capital industry.

First, a significant reduction in the rates of taxation is essential, to make the investment an attractive proposition in the first place. This reform has been strongly backed by the BVCA in its recent submissions to the Chancellor.[9] Second, a reduction in the periods for the tapering of CGT would be highly effective to meet shortening time frames, while positive deferral of CGT for serial investors, better adjusted to meeting their timing needs, would be of particular value. Some extra targeting of reliefs (at least in the next few years) would also be welcome.

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[8] Sir Peter Williams, *Financing of High Technology Businesses – a report to the Paymaster General*, HM Treasury, March 1998.

[9] See BVCA, *Budget Bulletin 2001*, October 2000.

CHAPTER FOUR
IMPROVING MANAGEMENT

Industrial and commercial expertise needs to be encouraged as well as financial investment. Nearly every venture capitalist would agree that the determining factor in the success or failure of a venture is the quality of management. It is crucial that young or expanding businesses are able to attract the best managers. To do that, it is necessary to provide the right incentives to experienced and talented executives.

The determining factor in the success or failure of a venture is nearly always the quality of its management… It is crucial that young businesses attract the best managers. To do this, share options are of the utmost importance… Unfortunately, the current position is unsatisfactory.

THE CRUCIAL ROLE OF SHARE INCENTIVES

During the early stages of its life, a company may not be able to afford to pay top level salaries to attract management of the necessary calibre. However, there are other methods of providing remuneration for executives. Share options and incentives for executives are of crucial importance. Attractive equity packages are essential to recruit and retain managers of quality at the start-up and expansion stages of a business's life cycle.

The current position regarding share options, however, is unsatisfactory. While two new schemes have recently been introduced – the All Employee Share Ownership Plan (AESOP) and the Enterprise Management Incentive Scheme (EMIS) – they will do little to improve the existing problems.

Both schemes allow companies to offer share options with tax advantages attached, though the extremely low thresholds on the former scheme mean that it is of little use for attracting top quality managers. Both, however, complicate further an already tortuous picture, as they run in parallel to the old schemes. A simple, generous system allowing companies to offer incentives without attracting high tax bills would be a major boon.

PROBLEMS WITH THE CURRENT SCHEMES

The Parliamentary debates on the Finance Bill 2000 were characterised by a strong resistance on the part of the Government to changes which would simplify the new system and clear up some of its uncertainties. Some relaxations were announced in the November Pre-Budget Report, but serious impediments remain. The reforms introduced by the Government have gone some way towards adopting the recommendations of the Williams Report[10] on high-tech investment, but the real opportunity has not been grasped. The recommendations should have been carried through in full. Even now, the Government's proposals in this area remain too small in scale, too limited in scope and too complex in their safeguards.

> *The Government's proposals are too small in scale, too limited in their application and too complex in their safeguards.*

Crucially, the Williams Report suggested that there should be no limits on the value of awards under what is now the Enterprise Management Incentive Scheme. Nevertheless the overall amount of reward is still capped and the restricted amount of available activity inhibits the hiring of experienced and talented managers. The equity gap must not give way to a management chasm. Attractive equity packages to recruit and retain managers as a business grows are essential. As it is, managers will still be significantly more heavily taxed than their US counterparts – even though the UK needs to attract suitable managerial talent from abroad.

The other problem with the Enterprise Management Incentive Scheme is the confusing and complex rules which surround it. Most important of these is the limitation of its effect to those companies which comply with the "Gross Assets Test" of £15 million. These uncertainties and restrictions seem likely to militate against its widespread use.

> *Remarkably, these packages have become less attractive over recent years.*

The sort of reform of capital gains taxation advocated in the previous section would have a very positive effect on the value of the share incentives which can be made available to executives by young companies. Remarkably, the overall tax picture has actually made these packages less attractive over recent years. Prior to 1988, when the top rate of income tax was 60% and the top rate of

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[10] Sir Peter Williams, op. cit.

CGT was 30%, the tax differential made it attractive for top managers to take the risk of running a small or fast expanding business, with share incentives as a major part of their remuneration package. Since this differential has now disappeared, the Government needs to find an alternative way of facilitating the right incentives.

It is also suggested that non-executive directors of smaller companies backed by venture capital (or subject to Enterprise Investment Scheme disciplines), whose mentoring role is particularly important, should be permitted to be paid in shares rather than in cash. Given that they will be receiving non-cash remuneration, and therefore will lack the liquidity to pay tax immediately on receipt, they should then be taxed only on receipt of cash from the sale of the shares. (This would also alleviate serious valuation problems, particularly in unquoted companies). Given the experience and guidance that can be lent to a new company by a set of experience non-executive directors, a positive taxation regime which encourages their involvement is a must.

THE STRENGTH OF MANAGEMENT TALENT

There is also concern about the disappointingly low number of top quality managers in the UK today. We need to produce a greater number of new business managers to form the pool from which developing companies can find their executives. Government encouragement for those studying for an MBA (through tax relief) might well prove thoroughly worthwhile. An encouragement of a true understanding in more schools of business, and the role that venture capital plays, would also be a very positive move. A significant increase in the number of high quality managers would still represent only a small amount of the tax foregone in tax relief; the incremental benefit of this availability would be disproportionately large.

CHAPTER FIVE

OVER-REGULATION OF THE VENTURE CAPITAL INDUSTRY

Regulatory reform is also a necessity. It is well known that small business are hit particularly hard by the burden of red tape, and a general reduction in the levels of regulation for small and medium size enterprises would be welcome. The Government has stated on numerous occasions that it is committed to reducing the level of bureaucracy for small businesses, but the indicators suggest that the level has in fact risen.[11] Companies with up to 250 employees should be relieved of most regulatory controls. More specifically, the regulatory regime surrounding venture capital-supported firms also needs reform.

POTENTIAL LIABILITIES FOR MENTORS AND BUSINESS ANGELS

Involvement with a company as a business angel or as a mentor could give rise to a number of unfortunate liabilities arising from the manner in which legislation is framed. Investors taking on these roles need to be protected from the danger of being labelled as a shadow director, from the threat of disqualification due to their involvement with the firm, or from the possibility of finding that they have also incurred liabilities under the new Financial Services and Markets Act 2000, because they are not regarded as part of an authorised investment process.

THE COST OF A VENTURE CAPITAL OFFERING

The expense of getting venture capital offerings off the ground, moreover, is often out of proportion to what is to be raised. Some level of documentation is obviously helpful, but the level of detail required needs to be examined so as to remove any unnecessarily burdensome requirements which inhibit such offerings. By analogy, a scale of centimetres rather than millimetres on a map generally provides the same information.

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11 See the IoD survey, (*Reg Alert*, July 2000), which found that only 1% of respondents had experienced a drop in regulation over the last two years.

MATCHING INVESTORS AND BUSINESSES

There is also a large amount of red tape surrounding the process of matching a venture capital provider with a firm needing investment. This should be abolished. Start-ups should be allowed to market themselves directly to high-net worth individuals (from whom they wish to attract investment) without requiring them to do so through an authorised intermediary. Venture capital fund managers should also be allowed to market limited partnerships (or other unregulated collective investment schemes) to high-net worth investors; while under the newly proposed scheme such investors will attract exemptions, the draft new provisions relating to investment advertisements will not permit a corporate venturer to publicise his wares without an intermediary. Companies should be allowed to market the availability of investment finance without having to use an authorised firm to do so.

The red tape surrounding the process of matching a venture capital provider with a firm needing investment should be abolished.

LIMITED PARTNERSHIPS

The law surrounding limited partnerships also needs some re-examination. Current regulations state that the number of partners in such a partnership must be no more than 20. The limited partnership is an attractive and flexible form for those coming together to invest in small or expanding companies. This stipulation restricts its usefulness.[12] The Law Commission is undertaking a review of partnership law generally, but it has tackled “ordinary” partnerships first, leaving limited partnerships for a later date. The new law on limited liability partnerships is something completely different. Limited partnerships have proved extremely popular in the US, and the restrictions surrounding them in the UK need urgent review.

Of particular concern is the level of regulation surrounding the Enterprise Investment Scheme and Venture Capital Trusts.

ENTERPRISE INVESTMENT SCHEMES AND VENTURE CAPITAL TRUSTS

There is particular concern at the levels of regulation surrounding the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs). These schemes are designed to encourage investors to put their money into small companies which meet the relevant criteria by offering reliefs against income tax and CGT. Both have proved generally effective, and should be retained unless CGT is abolished altogether (which would largely remove their rationale, except possibly during a transitional period), but the major regulatory impediments to their success should be ironed out as soon as possible. Principal amongst these restrictions are:

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12 See BVCA, *Statement approved by the Inland Revenue and the Department of Trade and Industry on the use of limited partnerships as venture capital investment funds*, May 1987.

- The EIS restrictions on expanding the business of a group overseas;
- The restrictions on approved EIS funds requiring all investment to be made within six months, which is unrealistic and is ineffective in ensuring that the most appropriate targets are sought out and backed;
- EIS restrictions preventing mergers for paper consideration, particularly where the idea of the merger would be to create a strategic alliance. While VCTs have been given some leeway in this area by the Finance Act 2000 (although the regulations have not yet been published in final form), EIS companies themselves are still threatened with the loss of relief in this circumstance;
- Restrictions surrounding top-up funding. Businesses which could survive sometimes fail for want of a funding top-up at a critical moment in the company's life. Investors in such circumstances should be able to provide further funding without being regarded as having crossed thresholds leading to loss of reliefs. Small businesses which are expanding fast often find it difficult to obtain bank funding: investors should be permitted to "follow" a successful initial investment without penalty. The gross asset test (see further below) should be abolished or the limit increased considerably, and/or exemptions should be introduced to allow topping up in financial emergencies without breaching it;
- The gross assets test also hits manufacturing companies particularly hard. They have fixed plant and equipment, and stock and work in progress on a much greater scale than most "new economy" companies. If abolition is thought impracticable, an increase to around £30 million would be helpful. An alternative test could be introduced by reference to the number of employees in the business: relief could be limited to concerns with up to 250 employees;[13]
- Restrictions surrounding reinvestment relief;
- The list of those trades which qualify. This list is now out of date and is largely unnecessary;
- EIS restrictions on leasing. In particular, the leasing of assets by one EIS company to another should be a qualifying trade for EIS purposes. Manufacturers should be able to lease out their own products – a regular practice in "normal" industry, particularly amongst original equipment manufacturers;
- The 30% rule for connected parties. EIS relief is denied if an investor has more than 30% of the issued share capital at any time of a relevant company. On an initial subscription ahead of a venture capital house subscribing, an investor may find himself exceeding the ceiling even though his share may subsequently be diluted. The percentage holding test should be applied when the EIS company in question first seeks investments or commences a qualifying trade;

[13] Changes in this area are a particular concern of the BVCA. See BVCA, *Budget Bulletin 2001*, October 2000.

- It should be possible for EIS money and major (controlling) venture capital holders to co-exist in a company without loss of relief;
- A relaxation in the rules governing VCTs to enable them to finance businesses by loans in a more flexible way should be considered. In particular, the current maximum that can be invested in any one company in any one tax year (just £1 million) is much too restrictive. The Gross Assets Test, mentioned above, is also a major impediment here. The fact that VCTs cannot take control of a company means that syndicates for VCTs are necessary when there is any requirement above £1 million. Whereas the syndication of hi-tech deals is now the norm, this has not yet occurred in "old economy" companies.

The removal of these unnecessary restrictions would enhance the attractiveness of these business forms substantially.

CORPORATE VENTURING

Several of these problems also apply to the new corporate venturing regime, introduced by the Finance Act 2000. Corporate venturing has been a feature of the development of new industries in the US since the early 1980s, and involves a larger company investing capital in a smaller venture. Companies like Cray Computers, St Jude Medical and Medtronics were all initially financed by corporate venturing funds in the early 1980s, and in recent times major companies like Lycos, Motorola, Cisco, American Express and Random House have all devoted funds to corporate venturing. In the UK, however, there has until recently been little such activity. The Government's initiative to encourage it by offering a degree of relief on corporation tax is thus to be welcomed.

Only 15% of companies are considering corporate venturing. This disappointing level of interest is due to the restrictive regulatory regime which surrounds it.

Research shows, however, that only 15% of companies are considering this opportunity. This disappointing level of interest is due largely to the restrictive regulatory regime which surrounds it, much of which it shares in common with the EIS and VCT schemes.

There is also one intrinsic structural problem in the regime put in place by the Finance Act 2000. In order to obtain corporation tax relief on the value of their investment, corporate venturers have to put up cash. This does not appear to be a difficulty until one considers how it is going to work in practice. Due to the fact that no one in the corporate hierarchy is likely to have a clear-cut budget for corporate venturing, partly because of the way the scheme is framed, it seems likely that inertia will prevail. If, on the other hand, a corporate venturer's incentive were to be based on investing a percentage of its actual corporation tax payable, then finance directors would have a clear budget to work with, and the rest of the Board could examine whether it had been invested. As a result, the Board, and the finance director in particular, would actively seek proposals from operating departments to exploit the opportunities offered by the scheme.

THE FINANCIAL SERVICES AUTHORITY

Finally, and more generally, there is a fear growing that the new regulator for the financial services industry, the Financial Services Authority (FSA), may prove to be heavy handed in its relations with the venture capital industry.[14] It seems that those within the FSA who have responsibility for collating its new rules may well have less experience of early stage endeavours than those who were involved with IMRO (which previously covered the field of venture capital). Where a lighter and more informed regulatory regime is badly needed, it is feared that the FSA approach could prove less responsive and less imaginative.

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[14] See, generally, M. McElwee & A. Tyrie MP, *Leviathan at Large*, Centre for Policy Studies, 2000.

CHAPTER SIX
PENSION FUND INVESTMENT

Pension funds are huge players in the UK equity markets. A change both in their investment attitudes and in the regulatory climate, encouraging them to increase their venture capital investment levels, would have a massive effect on the venture capital industry and on the economy as a whole.

A LOW LEVEL OF INVESTMENT

Currently, only the largest in-house managed pension funds make venture capital investments. The low level of investment by pension funds in venture capital-backed firms is a major inhibitor of the success levels of young and expanding companies. While US funds devote some 5% to 10% of their resources to venture capital – some of it interestingly in the UK – UK funds devote only about 1%. Greater involvement would release significant sums of cash for investment by these firms.

While US pension funds invest between 5% and 10% of their resources in venture capital, UK funds invest only 1%… The main factor inhibiting greater UK pension fund investment is the Minimum Funding Requirement.

Principal amongst the factors inhibiting greater investment by pension funds is the Minimum Funding Requirement (MFR). This regulation was intended to secure the pension promise, by insisting that pension funds maintained a minimum level of funding. Its method of calculation, however, has meant that pension funds have felt obliged to invest a high percentage of their funds in gilts, often not the most appropriate investment vehicle to match particular

actuarially-led formulae. This sense of obligation has limited the amount of money available to be invested in other areas such as venture capital. The Government is currently considering reform of the MFR.

In addition to concerns about the MFR, the National Association of Pension Funds also recently stated that if its members were to invest more, the attractiveness of venture capital as an asset class would have to be improved. They also suggested that, given a pension fund's preference for liquidity, such investment would probably be targeted more at second stage investments (i.e. expansion finance or MBOs/MBIs).

ENCOURAGING GREATER INVESTMENT

A recent London Business School (LBS) study, however, was more upbeat. It even suggested that the MFR problem was perhaps not as troubling as many pension funds were suggesting. Smaller funds could involve themselves in the venture capital market through investment in venture capital funds rather than directly. Larger pension funds, however, were well suited to making venture capital investments directly into specific businesses, and should appoint a dedicated private equity fund manager to manage a diversified portfolio of such assets. Diversification was an important ingredient of successful performance. The study also suggested that venture capital liquidity has improved, with an active secondary market.

The suggestion that venture capital is a less than attractive vehicle for pension fund investment is also misplaced. Indeed, it seems likely that the need to obtain adequate returns will drive pension funds to look more closely at venture capital investment. The LBS study indicated that the outcome of venture capital investments, made on a portfolio basis, net of management fees and carried interest and taken to term, compared very favourably with other investments.

The Government's proposals for stakeholder pensions, however, may prove a retardant for greater venture capital investment by pension funds. The ceiling of 1% on management fees may well leave fund managers believing that venture capital investments are too demanding of time and effort (though, in fact, this need not be the case).

Increasing amounts of pension fund monies are going into Self Invested Pension Plans (SIPPs), a new form of pension structure that allows the future pensioner a direct say in constructing an individually-tailored investment portfolio for his retirement. But SIPPs are not permitted to invest in unquoted companies. They could be significant investors in future years, and reforms are needed permitting appropriate venture capital investment.

CHAPTER SEVEN
INSURANCE COMPANIES

Many of the points made above in relation to pension funds also apply to insurance companies. The venture capital record of insurance firms is better than that of pension funds, but is inconsistent: while British insurers provided some 9% of the funds raised by the members of the BVCA in 1999, in 1998 they provided only 3%.

Insurance funds could play a much bigger role in the provision of venture capital, were it not for a number of restrictions which circumscribe their investments. The market for long-term insurance is divided into two categories – non-linked with profits policies, and linked policies. The problems involved depend on the type of policy.

NON-LINKED POLICIES

Non-linked policies suffer from restrictions in the way the premium income can be invested. Exposure limits are established in the Admissibility Rules for different classes of asset: for instance, there is a maximum of 10% for collective investment schemes overall (including in limited partnerships invested in property), and of 1% for investment in any one entity.

This has a number of knock-on effects:

- venture capital investments can be crowded out by property investments;
- small insurers cannot offer a large enough amount for any single investment to be able to participate in the larger funds;
- the exposure limits may prevent diversification of investments, increasing the policyholder's risk;

- as free assets shrink – and regulatory rules do not take appropriate account of the growth of underlying assets – even less is allowed and insurers' investments in asset classes thought to be "low yielding" (like venture capital and private equity) therefore operate to diminish further their free asset ratio;
- smaller companies which (naturally) outsource their investment management tend to invest their pension and life funds together. This leads to complications in identifying and computing their tax liabilities.

We believe that larger insurers have, in practice, some freedom to invest. This could be aided, though, if the exposure limits set out in the Admissibility Rules were carefully relaxed for all insurers, and property investments and venture capital investments could be treated as separate from each other.

LINKED POLICIES

So far as linked policies are concerned, premium receipts can only be invested in quoted investment trusts. If insurers want to get into venture capital using funds from this source, they have to do so by that route. But if they, in turn, are interested in unquoted investments, and if they carry a wide spread between bid and offer prices, the shares in such investment trusts will not be regarded as readily realisable – and so, effectively, such investment is ruled out. Further study is needed here to see if adjustments to the current rules are feasible and appropriate.

CHAPTER EIGHT
BANKS

The role of banks in the life of a young or expanding company has proved particularly problematic. The internal practices of most banks are profoundly inimical to investment in such companies – those which often need the support of banks most.

The internal practices of most banks in the UK are profoundly inimical to investment in young and expanding companies.

A number of recent trends have led to a particular tightening of credit available to Small- and Medium-Sized Enterprises (SMEs):

- The criteria for obtaining an overdraft often demand that no one of the company's debtors should represent more than 10% of the total debtors book. This means that young companies, often dealing with a few major companies, find it hard to obtain working capital, regardless of the quality of their clients. Banks' computer profiles/models, which determine the availability and cost of a loan, need to be more nuanced;
- Banking regulation has become much tighter in the 1990s. This has involved any lending below a certain figure, say £500,000, not being graded at all, which increases interest pricing;
- Increasingly, banks will not finance companies which are loss-making. Companies developing technology, for example, thus have to rely almost entirely on equity funding in their early stages, as most banks do not consider intellectual property as security;

- The Government's Small Firms Loan Guarantee Scheme for small firms (SFLCS), under which SMEs can borrow up to £250,000 guaranteed up to 85% by the DTI, is available where a reasonable lending proposition is beyond the bank's internal criteria. Such criteria in most banks operate to exclude loss-making companies, however, so they shy away from the SFLCS option. The process, moreover, is time-consuming and complex.

In some parts of the UK, banks have begun to experiment with schemes for small businesses. In the US, they have been encouraged by the threat of publicity: there, banks are required to report annually on their involvement with small businesses. In the UK, banks need to be encouraged to expand their activities in this area.

CHAPTER NINE
INSOLVENCY

Steps need to be taken to pursue the current initiatives aimed at making the UK's culture in relation to insolvency closer to that of the US. In the US, lines appear to be drawn more easily under the past, and losses are accepted as a fact of commercial life. An easing of UK laws and attitudes in this area would allow a more sympathetic climate for those who have the energy and initiative to start new businesses – and those who support them. It would also banish that great inhibitor, "fear of failure". Current practice is far from the vision of Sir Kenneth Cork, whose report led to the Insolvency Act 1986. His original vision owed far more to the encouragement of the "rescue culture". The current consideration of reform in this area must be more far-reaching than it currently promises to be.

The increasingly draconian powers and attitude of the Inland Revenue and HM Customs and Excise in relation to any overdue amounts should also be reviewed.

CHAPTER TEN
CHARITIES

There is an abiding perception that it is difficult for charities to invest in venture capital. This is due to a number of factors.

The first among these may well be an over-caution on the part of many trustees (often lawyers) who judge that the degree of risk venture capital investment is thought to involve would not be compatible with the high standard of care required of the trustee. Here, the trouble lies with perception more than reality.

Currently, the Charity Commission is revisiting its approach to investments. The new Trustee Act 2000 will give all trustees general powers to invest in any kind of investment. However, it will then require them to exercise this wide power in accordance with a statutory standard of care and with an eye on standard investment criteria set out in the legislation. Among those criteria is the requirement to consider the "suitability to the trust of investments of the same kind as any particular investment to be made or retained and of that particular investment as an investment of that kind". Neither public opinion nor received wisdom have caught up with commercial reality sufficiently quickly for a trustee not to remain wary about investing in venture capital.

Until this investment approach is revised, it seems likely that charities will not be able to take advantage of the returns which venture capital investment could bring them. Properly diversified and over the correct timescale, however, charities and the venture capital industry could be mutual beneficiaries of investment.

CHAPTER ELEVEN
UNIVERSITIES

In the United States, the participation of universities has been a significant catalyst for the success of the venture capital industry. The research park created by Stamford University was the driving force behind the development of Silicon Valley. A similar effect can now be discerned in East Anglia where "Silicon Fen" is developing rapidly in the environs of Cambridge University. In different ways, Cambridge, Oxford, UMIST, Imperial College and the University of East London have all been active in creating a cluster of young businesses in their environs and with links to their work.

In the US, the universities have been an important catalyst in the success of the venture capital industry.

Universities can thus be important motors in aiding young companies. All of them should develop an expectation that their academics will work on commercial applications of their work – moving the "D" in their R&D activities to incubators that they themselves have established. Universities should provide more management training and skills development opportunities for their staff, and consider setting greater store by developing commercial and management skills in their students.

If more universities could act as anchors for science park activity, the venture capital-backed sector could receive a major boost. Planning procedures should be simplified for such projects as soon as possible.

CHAPTER TWELVE

RESEARCH AND DEVELOPMENT

There is perhaps now a greater desire to encourage innovation than for many years. The broad acknowledgement that the New Economy is knowledge-based and demands quick and inventive thinking has released a large amount of energy in a short time frame. In the past, however, too much of the inventiveness of UK research and development workers has ended up being exploited by overseas entrepreneurs. A flourishing and effective venture capital industry, correctly targeted, could return more of the benefits to the UK.

Some policy problems, however, surround the research and development sector.

RESEARCH AND DEVELOPMENT

The new, clearer definition as to what constitutes research and development is thoroughly welcome, but it needs to be kept under review in a fast moving sector. Recently, the Inland Revenue has moved to accepting as bona fide research and development any activity which would be treated as such in normal accounting practice. It is important to ensure that this approach remains wide enough to embrace any new developments which emerge in the next few years. Since one trend which is to be encouraged is a greater interface between universities and innovative business, it may be necessary, for example, to investigate the tax treatment of "pure research" in due course.

Another specific problem relates to the regulations surrounding the EIS and Corporate Venturing schemes. It is standard practice in manufacturing industry that a company's products are to some extent "assemblies", and make use of the licensed intellectual property rights of others. Rules about receipt and payment of royalties, if they affect qualification for relief, must avoid inhibiting both this and, for the same reasons, the development of new and better products – or indeed, overseas expansion.

ROYALTIES

The arrangements regarding payments of royalties (i.e. periodic fees paid by a user to an inventor/owner or similar intellectual property) also need re-examination. A relaxation of the present royalty regime has been promised in the UK – but this could prove difficult as most OECD countries attach a withholding tax to payments designated as "royalties". The process of globalisation and the use of the internet will make this much more difficult, and attempts to impose taxation of royalties across borders will act only to inhibit investment. The Government needs to press for an international change in attitude and a new set of mechanical arrangements to deal with this aspect.

CHAPTER THIRTEEN
PUBLIC SECTOR ACTIVITY

Government involvement in essentially commercial activities such as venture capital investment and business creation must be treated with caution. The taxpayer is right to be sceptical of any attempt by the public sector to "pick winners" in the business world, given its past record of failure. To the extent, then, that the public sector should have a role in this area, it must be an enabler; alternatively, its involvement must be done with no pretence that it is anything other than as a part of a social – not a commercial – agenda.

The taxpayer is right to be sceptical of any attempt by the public sector to "pick winners" in the business world.

LOCAL ACTIVITY

In general, attempts by local authorities to involve themselves in business creation have not been successful. Political imperatives, such as job creation, tend to trump commercial realities. The early experience of the Greater London Enterprise Fund is a case in point.

On the other hand, bodies such as Sussex Enterprises, which has grown out of local Chamber of Commerce activity, and is, in effect, a commercial "mutual", are developing geographically focused venture capital investment and are the natural collaborator for regional funds. The hard-headed business attitudes which the practising business people involved bring makes all the difference.

Sussex Enterprises is the first new style Chambers of Commerce in the UK. Business leaders in the area were concerned that after a powerful recovery in the early 1990s, led by SMEs, the mistakes of earlier boom and bust cycles should not be repeated. Sussex Enterprises is a company owned by its members

which facilitates initiative. In 1997, a study identified the weak availability of growth finance for small businesses in the area as one of the key barriers to sustained growth in the local economy. Where less than £500,000 was being sought, businesses often failed to find it – and thus failed themselves. Sussex Enterprises, in discussion with venture capital funds, found, however, that it was not the potential high risk of the investments which was the problem: the difficulties revolved around the cost to the funds of finding and filtering propositions; the monitoring costs after investment; and the difficulty which small businesses have in producing a business plan.

Sussex Enterprises thus pursues joint venture arrangements with various venture capital funds – with institutional and private investors. Its rate of success has been highly encouraging. Its experience suggests a number of propositions which are essential to success at the regional and local level:

- Venture Capital Funds of less than £25 million are unlikely to be viable: funds of that size need a business base with something like 30,000 registered VAT businesses and more than 3,000 VAT registered start-ups in the locality each year to generate a viable deal flow;
- Funds need a strong local partner or partners with an ability to use existing channels to find and filter possible businesses and ready them for investment: separate marketing channels are uneconomic on this scale;
- Funds need the flexibility to go for some large, as well as some small, propositions: funds limited to the bottom end of the market – less than £250,000 – cannot survive without public subsidy;
- Whatever the previous involvement of partners, an independent and commercial executive committee must make the investment decisions, acting on solely commercial grounds: indeed, private investors are wary of committing funds where there is a risk of political interference. That is therefore self-defeating.

CENTRAL GOVERNMENT ACTIVITY

Support from *central* government is rather more problematic. Announcements by the Labour Government have made much of the amounts of money to be made available. However, they have failed to make clear their purpose: is it commercial or is it social? While this remains unclear, they are likely to be able to achieve neither.

In 1999, the Government announced proposals for nine Regional Venture Capital Funds, with some expected soft finance backing from the Government, allied to a larger contribution of funds from private sources. So far, these proposals have not borne fruit, though it is said that bids are currently being considered, subject to an EU investigation on whether the programme breaches European law on state aids. The Government also announced at the same time the "Phoenix Fund", running to £30 million over three years to help local community initiatives. This too has thus far produced little of substance. Other programmes have involved taxpayers' cash rather than tax breaks. £20 million has been put aside to launch a hi-tech fund. £45 million is to be made available

in enterprise grants for SMEs. The Government has also set up a Knowledge Bank to help new knowledge-based businesses (i.e. those with no tangible assets) to obtain finance.

All of the central government initiatives pose the same problems. Who is going to identify the winners? To what extent will political considerations inform the choice of grantee? What restrictions will be proposed by central government? What will the criteria be? What sort of success rates will be expected?

It is not impossible that co-operation between bodies like Sussex Enterprises and central government could bear fruit, by bringing the required commercial nous to the project, but the Government needs to think much more carefully about how it targets any funds for young and growing companies.

THE "ENTERPRISING COMMUNITIES" REPORT

The most recent development in this area is the Report of the Social Investment Task Force, *Enterprising Communities: Wealth Beyond Welfare*, which was published in October 2000. One of the primary recommendations was the creation of a "Community Development Venture Fund", to apply the principles of venture capital to under-invested communities. This is a serious, important and intelligent goal. But there must be doubts as to whether the aspirations of the Report's authors will bear the fruit that they hoped for. The Report envisages the investment by the Government of £100 million, matching the postulated funding of £100 million from the private and charitable sectors. Private sector investors will benefit from tax reliefs as encouragement.

> *The Task Force's plans will have much less of an impact than a deregulation and a stimulation of the mainstream venture capital industry.*

This scheme, though, is going to find it difficult to find investors given that the report acknowledges that the investments will have both higher risk and lower returns than normal, even with the extra help it envisages. Once again, it is not yet clear to investors whether it is to be run on a strictly commercial basis, or whether social and political factors will determine its goals. It is hoped that it will succeed. It would need abundant good will. But even so, it will form only the tiniest part of the UK's venture capital market: the £200 million investment (over several years) envisaged in the Report is dwarfed by the UK's venture capital pool of £35 billion and the annual venture capital investment (including MBOs and MBIs) of £6.2 billion. Interestingly, it says nothing of the need for further reform of the Share Option schemes, although its target projects are likely to need the highest quality of management. The Task Force's plans will have much less of an impact than a deregulation and stimulation of the mainstream venture capital industry through the means outlined in this paper, in the sense of the benefit which would flow from a vibrant national economy. It seems quite possible that even deprived and under-invested areas could in practice benefit indirectly more from this approach than from that outlined by the Task Force.

ACKNOWLEDGEMENTS

I would first of all like to thank Howard Flight MP who first approached me with a view to establishing a Committee under my chairmanship to consider the development of venture capital activity in the UK. The following Committee members gave generously of their time and expertise over numerous meetings: Adrian de Ferranti; Stephen Hill; Andrew Holmes; Michael Jackson ; William Jackson; Nigel Luckett; Kit Maunsell; David Royds; Andrew Sells; Peter Smaill; Mark Storey; and Edmund Truell.

Many of the participants prepared detailed and original papers from which I have drawn freely. All made valuable contributions to the discussions from which this pamphlet emerged.

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helpful on a number of aspects relating to investment by charities. Responsibility for the views expressed in this paper are mine alone, however.

Readers will no doubt wish to refer back to other materials which contain original statistics and research. In particular we would mention the *Report on Investment Activity 1999* of the British Venture Capital Association in conjunction with the London Business School, *The Economic Impact of Venture Capital in the UK*, produced by PricewaterhouseCoopers and the BVCA; *Global Private Equity* produced by 3i plc and PricewaterhouseCoopers; the *Global Enterprise Monitor* published under the aegis of the London Business School and others; two important papers by Oliver Burgel, again published under the aegis of the London Business School: *UK Venture Capital and Private Equity as an Asset Class for Institutional Investors* (also supported by the National Association of Pension Funds) and *UK Venture Capital and Private Equity as an Asset Class for Insurance Companies*; two previous reports which touched on this field, Financing of *High Technology Businesses - a report to the Paymaster General, March 1998* ("the Williams Report"), published by H.M. Treasury and *"Tech-Stars" – Breaking the barriers for technology -based SMEs*, published by the CBI; two papers published by the Insolvency Service: *A Review of Company Rescue and Business Reconstruction Mechanisms* and *The Cycle of Corporate Distress, Rescue and Dissolution. A study of Small and Medium-Sized Companies* (the latter by Julian Franks and Colin Sussman), April 2000, and, finally, the Parliamentary Debates on the Finance Bill, 2000.

In a fast moving world, we have had to draw a line on our deliberations somewhere. Since we began our work, we have been delighted to observe an increasing interest in the subject from all the major political parties in the UK and, increasingly, across Europe. We have commented on the position as it stood at 31 January 2001.

Patrick Burgess

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The Government's recent Communications White Paper envisages the creation of a new all-powerful regulator, Ofcom, which will police the rapidly evolving telecoms, media and communications industries. While claiming that the regulator will have a light touch, the author shows that as currently formulated, it powers are draconian. This new quango will, for example, have the authority to: block take-overs and mergers; draw up "detailed rules" to enforce "acceptable community standards"; compel news providers to be "impartial"; enter premises and confiscate documents; fine companies up to 10% of their turnover and impose civil penalties on individuals; monitor training of broadcasters and possibly journalists, making sure media companies have approved schemes in place.

A report today by the Centre for Policy Studies says Ofcom would be an over-powerful regulator. Its chief executive would be one of the most powerful unelected figures, it would not be accountable to parliament, and its accounts would not be scrutinised by any official body – Brian Groom in *The Financial Times*

NICE AND BEYOND: The parting of the ways? **£7.50**

Christopher Booker

The Nice summit is a turning point for relations between Britain and the EU. France and Germany have now openly stated their wish for an "avant garde" of member states to proceed rapidly to much closer political integration. The German foreign minister has commented that: "We must put the last brick in the building of European integration, namely political integration", while the French Prime Minister spoke of a "hard core of a few more closely integrated countries". Will the British Government try to push a reluctant public into monetary union and political union, or will it accept Britain in a "second tier"?

In a proposal which had gone virtually unnoticed before the publication by the Centre for Policy Studies of Christopher Booker's pamphlet, Nice and Beyond, federalist-inclined countries are to be allowed to push ahead with deeper integration – Leading article in the *Daily Telegraph*

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