MILLS & REEVE

Financial Conduct Authority: Patient Capital
Consultation Paper CP18/40 and Discussion Paper DP18/10

Comments provided by Mills & Reeve LLP

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INTRODUCTION

This document is submitted in response to the Consultation Paper on proposed amendment of COBS 21.3 permitted links rules, CP18/40, (the "**Consultation Paper**") and the Discussion Paper on patient capital and authorised funds, DP18/10, (the "**Discussion Paper**") issued by the Financial Conduct Authority in December 2018.

Mills & Reeve is a national UK law firm with 116 partners and a total strength of over 1,000 staff operating from six offices including London, Manchester, Birmingham and Cambridge. Mills & Reeve is one of the top performing law firms in the UK when it comes to client satisfaction, according to the latest editions of legal directories Chambers UK and The Legal 500, and has been named for a record fifteenth year running as one of the 100 Best Companies to Work For in The Sunday Times annual survey. Mills & Reeve advises clients active in investing in and/or managing patient capital. We act for a range of clients from investment firms, government departments, universities, charities and others on the establishment and operation of specialist early stage investment funds and on issues relating to venture capital investment.

We begin with general comments, and then quote selected questions from the Consultation Paper and Discussion Paper followed by our responses.

GENERAL COMMENTS

In this response we focus on the availability of patient capital to early stage businesses, and the rules affecting those who invest in or manage investments in these kinds of companies. We welcome the overall objectives of the proposed rule changes and believe the proposed alterations are likely to be effective in improving the availability of patient capital to the businesses requiring it. However we question whether the deployment of that capital would be wholly efficacious in achieving its purpose -- ie in successfully supporting more early stage companies through growth stages -- without considering additional protections which might be put in place.

Addressing the incentive structures applicable to fund managers

Authorised funds typically invest in readily realisable assets with a focus on income and/or or short term capital returns. Therefore quite naturally management fees and carry arrangements in authorised funds often geared to incentivise investment firms to produce profits in the relatively short term. Management fees are typically much lower, reflecting less active involvement from the investment firm, and the manager might expect to profit from a

combination of management fees and carry or performance fees, paid on an ongoing basis from income and capital returns from a moving portfolio. In comparison, many early stage venture capital funds operate with a much tighter belt: management fees are borrowed from the investor at the outset, leaving less capital available for investment. Patient capital requires intensive fund manager interaction with its portfolio companies, and often the management fees are set at a much higher level, where the higher level reflects the manager's running costs. Accordingly the VC investment firm is expecting the substantial proportion if not all of its profits to come from carry or performance fees on exit. This fee gearing actively incentivises VC fund managers to take a patient view themselves.

Therefore, unless the investment firm adjusts its fee structure accordingly, one potential issue with an authorised fund increasing its portfolio to include a greater proportion of non-readily realisable assets is the affect this could have on the retail investor's income returns, as the income-producing half of the portfolio bears the full weight of the management fees.

In addition, a manager who is primarily incentivised to profit from immediate income and capital returns may be unlikely to manage its portfolio "patiently". Currently this less of an issue as there are relatively low limits to the amount of patient capital which an authorised fund can invest. However there could be dangers in relaxing the rules on authorised funds investing in illiquid assets, particularly where the investments are in early stage businesses, without taking into account the manager incentivisation arrangements that accompany that relaxation. A key objective of the government's Patient Capital Review is to promote **long term** investment in growing businesses, with benefits for employment and productivity, as well as the development of promising new technology. Quoting from HM Treasury's Paper, "Financing growth in innovative firms: consultation response":

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

While authorised funds may well increase investment in VC funds or directly into early stage businesses, their managers' desire to maintaining those investments over the long term may be challenging. In order to achieve the short term returns necessary to their own business, managers may find themselves incentivised to:

- focus on investing in income-producing businesses rather than true patient capital; for instance where a company will be dependent on funding for years and is unlikely to pay dividends; and/or
- push for early exits following first funding round rather than committing the tranched investments required over time; and/or
- 'spread-bet' by investing in a large number of growing businesses, then taking a 'crash and burn' approach, selecting a small number of those achieving the best performance over the first one or two years. Other businesses, the majority, may find that they are no longer supported or even forced into early exits or liquidation; and/or

- take a riskier approach to valuations which could lead to more frequent suspension events.

If any of the above approaches were taken, where the authorised fund was invested directly into companies, instead of building many small companies over the medium to long term, this could have the effect of forcing a large proportion of the smaller companies initially selected out of business, with a consequent loss of jobs, and sacrifice of promising technology and growth potential.

This may be contrasted with the approach taken by venture capital funds. These generally aim to grow a select number of portfolio companies over a longer period of time, and adopt measures consistent with this aim. Board level practical support if often provided alongside a medium to long term approach to funding.

Where the authorised fund invests into these venture capital funds, the authorised fund may be more likely to select those venture capital funds investing into less patient capital sectors (eg manufacturing rather than life sciences) or otherwise exerting pressure onto their venture capital fund investments to achieve short term returns or exits with the above results.

The manager of an authorised fund invested into venture capital may also be inclined to carry 'dead weight' (ie not exit companies which are income-producing but are not likely to achieve substantial growth). Although this is not in and of itself negative – supporting 'low flyers' is as important as supporting the potential unicorns – this could cause tension either where an authorised fund invested in a venture capital fund exerts pressure on the latter to carry dead weight, or where authorised and venture capital funds are co-invested in these companies.

The potential for adverse consequences we identify above might be particularly acute in certain sectors, such as life sciences, where a quick return is highly unlikely and the capital needs to be very patient.

In our view, if authorised funds are offered relaxations around investor protections such as liquidity, then we wonder if the above concerns may be mitigated by:

- making those relaxations conditional upon the investment firm (perhaps as part of the fund approval or registration process) confirming that it has considered the appropriateness of its fee structure having regard to the percentage of the portfolio to be invested in patient capital and bearing in mind the purpose of the relaxations is to allow for increased investment with the ultimate aim of *supporting growing businesses*; and/or

- requiring the investment firm to provide explanations and risk warnings to its retail investors about its fee structure, having regard to the percentage of the portfolio to be invested in patient capital and in particular explaining the potential effects on investor income and capital receipts (both in respect of quantity and timing of returns) and

assurances that patient capital will be managed patiently with a view to long rather than short term returns.

Reducing the compliance burden on smaller fund managers

The compliance requirements for the operation of an authorised fund are quite rightly more onerous for the protection of retail investors. This is an obstacle to achieving greater levels of direct investment by retail investors in patient capital, as of course many VC fund managers will only have permission to manage the investments of professional investors and would not seek retail permissions bearing in mind the more onerous regime applicable, the expense of which may not be financially supportable from a small VC fund or administratively supportable for a small AIFM with a small staff.

We would contrast the strict regulation in this area with the fast-growing crowd-funding market. This allows retail investors to invest direct in high-risk patient capital with relatively little control and protection. This creates an odd lacuna where the same unsophisticated retail investor is able to invest in and manage his own high-risk patient capital investment, but is unable to do so under the management of an expert VC fund manager who could actively manage that investment for him.

We wonder whether a lighter-touch regime could be possible for specialist patient capital funds, alongside suitable declarations, information and warnings for certain retail investors which could comprise any of:

- requirement that the retail investor is not investing more than 10% of his net investible assets and requirement he has received legal advice;
- requirement that the retail investor understands and accepts loss of retail protections;
- requirement that no more than [x]% of the fund is made up of retail investors.

THE CONSULTATION PAPER

Proposed amendments to COBS 21.3

Question 4:

Do you agree with our proposal to relax the requirement for unlisted securities to be 'realisable in the short term' and to replace this with a liquidity test at the level of the investment fund, as set out above? If not, how could we change it, if at all? Do you think either of the alternative asset-level restrictions would work better?

Question 5:

Do you agree with our proposal to remove, for firms meeting the investor protection conditions, the current 20% on holdings of assets through QIS/UCIS and instead rely on the overall limit of 50%? If not, how could we change it?

We consider that these proposed changes have the potential to support patient capital investment, but we wonder if this will only be fully efficacious if incentivisation of fund managers is adequately addressed. We refer to our general comments, above.

DISCUSSION PAPER

EuSEFs and EuVECAs

The Discussion Paper considers the relatively new EuVECA structure, for funds that intend to invest at least 70% of its capital in innovative SMEs.

Question 9:

Why do you think the specialised funds have not being used in significant volumes?

Some of our fund manager clients report that they do not appear to particularly attract EU investors. Where a UK fund manager is newly competing for EU investment, EuVECA and EuSEF status does allow cross-border marketing but doesn't provide any competitive edge. For a small fund which does not have large sums to invest in marketing into new territories, the ability to market cross-border may be of limited interest.

Question 10:

Are there specific features of these funds which prevent fund managers or investors from using them to invest in UK patient capital?

We note that these structures are determined by European Union rules, and so the scope for making changes may currently be limited. However, in our view the limited uptake of these funds may be due to (i) the required investment conditions and restrictions, which can constrain the investment policy firms might otherwise select and (ii) as discussed above, they do not appear to particularly attract EU investors. These features mean that, in spite of offering the advantages of cross-border marketing, the additional burden of conditions and restrictions may not be worth it in light of limited interest from EU investors in EuSEFs or EuVECAs per se.

Question 11:

Are there other areas where the current regulatory framework creates unnecessary barriers, either directly or indirectly, to investing into patient capital?

We refer to our general comments above.

We think that relaxing the rules on liquidity thresholds is likely to be beneficial in supporting patient capital, provided that fund managers of retail products are incentivised to take a long-term view. Please see comments above.

In addition, we wonder if there is any scope for relaxation of the barriers to small VC investment firms managing some direct retail investment.

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Should you require more information on the responses above please contact Dona Ardeman or Isabel Teare at Mills & Reeve LLP using the details below.

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