

UKSA Guidelines for Venture Capital Trusts (VCTs)

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The following guidelines are proposed so as to improve the management, corporate governance and investment performance of Venture Capital Trusts. More background information on the reasons for these proposals is given in a separate document.

1. Information on Investments in the Annual Report. Rather than meeting the minimum requirements of the Listing Rules for VCTs of listing the largest 10 investments, the Annual Report should contain the following so as to enable investors to get a proper view of the performance of the investment fund:

a - A complete list of all current investments at the year end, showing the nature of the investment (i.e. whether equity, loans, preference shares). In all cases, but particularly so in the case of loans and preference shares, it should indicate the basic terms attached to those investments such as the running dividend yield (coupon), conversion terms, redemption conditions, associated options or warrants and any other special conditions that are likely to affect the value of the investment. Any “non-performing” loans or shares (ie. where interest or dividend payment obligations are not being met) should be indicated and what action is being taken on any breach of the investment conditions should be indicated. Any investments on which the terms have been changed in the previous financial year should also be indicated, with a note provided explaining the change.

All investments listed should show the current valuation and on what basis the valuation has been done (e.g. at cost, comparable quoted companies, further investment at higher price, directors’ valuation, etc).

All investments listed should show the amount invested, and any subsequent partial realisations that have been obtained.

Where there have been substantial partial realisations (>25% of holding), write-offs or reduction in the valuation (>25% of holding) from that at the start of year, or any further investments made in a portfolio holding in the past year, then this should be indicated and the reasons why specified.

In the case of equity investments, the investment list should show the percentage of the company’s equity that the VCT holds.

b - In addition to the list of investments at the year end covered above, the report should also include a list of previous investments made since the formation of the company and realised or written off in the last 10 years, separated into the following sections:

- (i) All investments realised in full or written off in the past financial year. In the case of realisations it should show the realised value (or total expected value where there is some future contingent value), the total investments made, and the dates of the investments. Where a venture capital investment has been realised by the sale of the holding in return for some shares in a listed company then the market price of the resulting listed investment should be shown. Where an investment has been written off in full then the reason for the write off should be given. Totals of all full realisations and full write-offs should be given, including the proportion applicable to the current financial year, and the initial amount invested, plus any subsequent additions, should be shown.
- (ii) As for (i) above for the previous financial year, including totals.
- (iii) As for (i) and (ii) above for the previous 8 years combined, including totals, and showing the year of final realisation or write-off.

Where an investment is realised or written off in stages over a number of years then the investment should be listed in that period of time when it was finally disposed of, and the totals realised and/or written off shown, together with the total invested, for each investment.

2. Provision of Information on Trading Position of Investments. For all investments listed in 1 above, the Annual Report should indicate the nature of the business, include the address of the web site of the company and should give some comments on recent trading. It should also specifically indicate the Sales Revenue, Pre-Tax profits, and Net Asset Value for the last complete financial year which should be no later than 18 months old, and the same information for the immediately preceding year. Note that where EBIT or EBITDA have been used as the basis of valuation of the company, then these can optionally be shown in addition, but not in place of the normal pre-tax earnings figure.

If no accounts have been filed in the last 18 months then figures from the management accounts should be provided and the reason for failing to file accounts with Companies House specified. Note that in addition, due to the limited reporting and filing obligations for smaller unquoted companies, it will be necessary for the VCT to make it a condition of any investment agreement that such information is provided to the VCT and may be published.

If such information cannot be included in the Annual Report for any reason then an explanation should be provided.

It is also recommended that additional background information concerning the activities of the investee companies be provided for the ten largest investments by the fund.

3. Disclosure of Fund Manager's Payment Terms. Full disclosure should be made in the Annual Report of the financial arrangement between the VCT and the Fund Manager, including any fixed or variable fees, bonus arrangements, options or warrants and the nature of any performance criteria to be met.

The Annual Report should also clearly show how the fund management fees for the last financial year have been calculated and should show any irrecoverable VAT thereon separately.

4. Disclosure of Fund Manager’s Contract and Termination Rights. Full disclosure should be made in the Annual Report of any conditions related to the duration of the Fund Manager’s contract including any specified minimum duration and details of any termination conditions including minimum notice terms and/or compensation for premature termination.

5. Variation of Fund Manager’s Contract. Any changes in the Fund Manager’s basis of remuneration in the last financial year should be disclosed in the Annual Report and a vote taken at the subsequent Annual General Meeting on a non-binding resolution to approve the changes. Where the changes are such as are likely to lead to a significant increase in the fees payable to the Fund Manager, then it is also recommended that this change be approved prior to implementation by a motion at an Extraordinary General Meeting (in which case a subsequent approval vote at the AGM is not required).

6. Fund Manager’s Contract Period and Termination. It is recommended that no Fund Manager should be appointed with a minimum contract period of more than 3 years and that thereafter the minimum contract termination notice period should be no more than 6 months. No compensation should be payable to the Fund Manager upon termination, whether premature or otherwise, except for the normal obligations under contract law for compensation on premature termination. The minimum contract period and termination rights should be specified in any “mini-prospectus” that is issued for any initial or subsequent share issues in the company.

7. Continuing Appointment of the Fund Manager. The continuation of the contract with the Fund Manager should be approved by a vote at every Annual General Meeting in the same manner as a vote is taken to renew the appointment of the company’s auditors. This vote to be advisory on the board, rather than mandatory.

8. Recommended Maximum Fund Management Fees. For non-AIM based VCTs it is suggested that the Fund Manager’s basic fee should not exceed 2% of net assets. For those VCTs that primarily invest in AIM stocks, the basic fee should be limited to 1.7% of net assets. Additional performance fees should require a Total Return (ie. growth in net assets with dividends reinvested) exceeding by 2% that on a risk free investment such as index linked gilts and should be capped at 50% on top of the basic fee. Performance-based fee awards should be payable in cash, or by grants of shares that are purchased in the market, and should not take the form of awards of options or warrants.

9. AGM Resolutions. Where resolutions to approve changes to the Fund Manager’s contract terms or remuneration, or votes for continuation of the company are on the same AGM or EGM agenda as other items such as the issue of more shares, then each matter should be the subject of a separate resolution, ie. resolutions should not be combined unnecessarily.

10. Votes for Continuation of the Company. It is recommended that all VCT companies have a term in their Articles that requires a vote for continuation of the company on an annual basis after the first 5 years of the life of the company. Where a further issue of shares is made, then such votes should be suspended only for the minimum period to ensure new investors do not lose their tax reliefs (i.e. 3 years at present).

11. Share Buy-Back Programmes. So as to minimise the share price discount to NAV, all VCT companies should have rights in their Articles to buy back shares in the market and should ensure that a vote implementing those rights is taken at all AGMs. Companies should always have in place a specific and active share buy-back programme that authorises the company's stockbroker to buy-back shares whenever the market bid price discount to NAV exceeds 10%. The general policies to be followed and the objectives of the buy-back programme should be disclosed in the Annual Report of the company. Companies should retain sufficient cash on their balance sheet to ensure that an active buy-back programme can be maintained.

Note that the suggested discount when a buy-back is triggered is based on the bid price being a realistic quotation for the price that ordinary shareholders can obtain when selling a reasonable quantity of shares (e.g. 10,000 shares) via their normal stockbroker - if that is not the case (e.g. because the Normal Market Size is a lesser amount) then the point at which a buy-back is initiated should be changed accordingly.

12. Promotion of Active Trading and Spread Minimisation. VCTs often have large bid/offer share price spreads which are to the disadvantage of shareholders and discourage trading in the shares. Companies should consider all means practical to ensure that spreads are less than 5% including the promotion of alternative share trading facilities such as matched bargain trading which may be more appropriate to the low volumes of trading in VCT shares.

13. Trading by Directors. UKSA certainly believes that it is beneficial if Directors of a company have a non-trivial interest in the shares of the company. However the directors of VCT companies should always trade on an "arm's length" basis in the company's shares, i.e. they should not take advantage of concurrent buying of the shares by the company itself nor take advantage of any knowledge they may have about the market maker's position in the shares.

14. Encouragement of Mergers and Acquisitions. VCT companies should encourage government regulations that permit and simplify the merger of VCT companies without investors losing their tax reliefs.

15. Recommended Cost Maximums. The following guidelines are recommended to ensure that expenses and other costs of VCTs are not excessive:

- a - Director's Remuneration. No more than £50,000 in total for all directors (including VAT and NI where applicable).
- b - Audit fees. No more than £12,000.
- c - Other Administration Expenses. No more than £175,000.
- d - Total Costs. The total expenses plus Fund Manager's charges should not exceed 3.5% of the assets of the company.

The Fund Managers and the board of directors should try to ensure that the Income of the Fund exceeds the Total Expenses so as to ensure that the net assets of the company are not eroded if capital performance of the Fund is poor.

16. Expenses Breakdown. A breakdown should be provided in the Annual Report of all expenses including details of non-audit fees payable to accountants, secretarial and other fees payable to the fund manager or to other parties, legal costs payable to the company's solicitors and any other expenses. A suggested presentation of the breakdown of expenses is as follows (all values supplied should include any irrecoverable VAT):

- a - Director's Remuneration (including NIC where relevant).
- b - Audit fees.
- c - Non audit fees payable to the auditors.
- d - Accounting and book-keeping fees.
- e - Stockbroker fees.
- f - Company secretarial fees.
- g - Fees for legal services and advice.
- h - Fees for other professional advisers.
- i - Commissions payable to IFAs etc, (eg. "trail" commission).
- j - Company Registrars fees.
- k - Printing and distribution of Annual Reports and other shareholder notices.
- l - Other expenses (with a breakdown showing any item of more than £5,000).
- m - A Total of all the above.

Any exceptional costs in any of the above categories that have resulted from such activities as additional share issues, merger activities or corporate restructuring should be separately identified.

17. Charging of Expenses. It is recommended that expenses be shown as a 50% charge against income in the profit and loss statement (ie. 50% charged to capital) as representing the likely split between income and capital return on such funds, unless there are good arguments for it to be otherwise.

18. Shares Repurchased and Impact on NAV Per Share. The Annual Report should show the total amount paid and the number of shares repurchased by the company during the year, and the effect on the Net Asset Value (NAV) per share of the company (ie. the improvement as a result of buying back shares at a discount).

19. Reporting of Impacts on NAV. All annual reports should contain a breakdown that shows the various factors that have impacted on the NAV per share during the year, based on a weighted percentage contribution of:

- a - Income less operating costs.
- b - Share buy-backs.
- c - Permanent and/or realised diminutions in the value of investments (ie. substantial write-offs or provisions against investments).
- d - Sales of investments.
- e - Other revaluations of unquoted investments.
- f - Other revaluations of quoted investments to latest market prices.
- g - Dividends paid.

20. Board Frequency and Attendance. A note in the Annual Report should indicate the total number of board meetings held during the year and indicate the number of meetings attended by each board director.

21. Performance Charts. The Annual Report for the company should show a graph of the Total Return (growth in Net Asset Value plus gross dividends reinvested) over the life of the company (or the last ten years if more than ten years old) in comparison with the FTSE All-Share Total Return Index.. The AIM index should not be used as a comparison, even for AIM based VCTs, as it is not representative of the companies that AIM VCTs can invest in.

22. News Publication. The company should make a RNS announcement as soon as it is aware that any disposal of an investment is likely to increase or decrease the Net Asset Value of the Fund by more than 2%. Likewise such an announcement should be made if any investment ceases trading, is put into receivership or administration or otherwise suffers events that are likely to lead to a substantial write off of the investment in the company where that will decrease the NAV of the fund by more than 2%. Any change of Fund Manager, or notice of termination given to the Fund Manager, should likewise be announced via the RNS service and in addition it should be advised in writing to all shareholders within 3 months.

23. Administration by Fund Managers. It is recommended that the Fund Manager of a VCT should not provide administrative, secretarial or accounting services to the company.

24. Administration Contract Terms. Whether or not administration is provided by the Fund Manager, full disclosure of the contract terms for administration should be provided in the Annual Report of the company, including any termination rights. In addition it is recommended that no administration contract has a minimum contract period of more than one year, and the minimum notice period should be no more than 6 months.

25. Fund Manager's Costs and Other Income. It should be clearly spelled out in the Annual Report what arrangements are in place for the Fund Manager to recover any costs or pass on any fees received that are associated with its investment management activities on behalf of the fund. For example, where investment transactions are aborted, are the due diligence and legal costs charged to the fund? Where introduction or arrangement fees are charged by the Fund Manager to the investee company, and any subsequent "investment monitoring" fees or fees for directors who are employees of the fund manager are charged to the investee company, are these passed on to the fund?

Where such costs or fees are not passed on to the fund then the value of those costs or fees should, with an appropriate breakdown, be included in the Annual Report. Note that it is recommended that all such costs and income should be passed to the fund and that they are covered by the Fund Manager's fee.

26. Co-Investment by Fund Manager or Fund Manager's Staff. The Annual Report should disclose any investment by the Fund Manager, or its staff, or its associates in the investee companies, alongside the VCT fund. If any such investment is permitted then it should be on identical terms, and if additional investment is later required then it should be on a comparable basis. In general, UKSA is opposed to such parallel investments as there is a potential conflict of interest.

27. Independent Valuation of the Fund. UKSA recommends that all portfolio valuations be the subject of an independent review by someone who is experienced in venture capital fund management, and that a formal, written opinion on the valuations is available to shareholders, with a summary published in the Annual Report. This could be by a member of the auditor's staff or by an independent firm if the former have no particular skills in that area.