BRITISH BUSINESS BANK

ENTERPRISE CAPITAL FUNDS

Guidance for Prospective Managers

November 2014

www.british-business-bank.co.uk

ENTERPRISE CAPITAL FUNDS (ECFs)

Contents

PART 1: OVERVIEW

(i) Introduction

This guidance provides advice to those organisations interested in being selected to manage an Enterprise Capital Fund (ECF).

The ECF forms part of the British Business Bank programme which was formerly run by the Department for Business, Innovation and Skills. With effect from 1 November 2014, the ECF, the handling of all pending and future applications for funding under it and all investments made by the ECF to date transferred to British Business Finance Limited ("BBFL"), a wholly owned subsidiary of British Business Bank plc. Accordingly, existing applications and all future applications will be handled by BBFL. Further background on the British Business Bank plc group can be found on the website www.british-business-bank.co.uk.[1]

(ii) Objectives of the ECF programme

The overall aim of the ECF programme is to increase the availability of growth capital to small and medium-sized enterprises (SMEs) affected by the so-called 'equity gap', helping to alleviate what would otherwise remain a significant barrier to enterprise and to productivity growth in the UK economy. This will be achieved by:

- providing taxpayer resources for an investment product that encourages an increased flow of private capital into the equity gap; and
- lowering the barriers to entry for entrepreneurial risk capital managers seeking to channel finance and mentoring to SMEs, so helping to foster the development of a sustainable skills base in this part of the market.

Taxpayer investment in ECFs is allocated through the competitive process described in this Guidance. This will enable BBFL to select proposals that are judged to offer the best overall value for money in achieving our objectives.

(iii) Context: the equity gap

An equity gap arises where businesses with viable investment propositions are unable to attract investment from informal investors or venture capitalists. *Bridging the finance gap: next steps in improving access to growth capital for small businesses*[2] first set out evidence of an equity gap facing businesses seeking to raise modest sums of risk capital and presented the Government's view of the structural causes of this gap. An updated study was conducted in 2009[3].

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[1] Refer also to Legal Notices P43.
[2] http://www.hm-treasury.gov.uk/d/small_business_452.pdf
[3] *www.bis.gov.uk/files/file53949.doc*

The severity of the equity gap varies according to a number of factors; for example, the characteristics of the business seeking investment (such as its business sector, stage of development and location) can be at least as important as the amount of finance being sought.

The ECF programme has been running successfully since 2005. When we sought approval from the European Commission to extend the programme for another 10 years to 2024, it was demonstrated that the equity gap for initial funding rounds of businesses can now extend up to £5 million.

(iv) Key features of Enterprise Capital Funds

This section provides an overview of the key features of ECFs, with fuller details provided later in this Guidance. Prospective managers will also wish to familiarise themselves with the operating conditions set by the European Commission for the new scheme. Attention should be paid in particular to the amendments to the scheme set out in the Commission's approval letter in section 3[4].

(a) Number and size of funds

The number of ECF commitments made by BBFL will depend on the nature of the mandates and the quality of proposals made. There is no minimum fund size that BBFL will support but Prospective Managers will need to demonstrate that the fund size is viable given their proposed investment strategy. There is no maximum fund size for an ECF, but BBFL will commit no more than £50 million of funding to any single fund.

(b) Purpose of funds

Each ECF will be a privately managed fund, established specifically as an ECF, for the purpose of investing equity or quasi-equity (Mezzanine) capital in SMEs affected by the equity gap. ECFs will be fixed-life funds, extendable only with the consent of BBFL and other investors; they will not be 'evergreen' funds that continually recycle investment returns. The instruments of ownership of an ECF will not be tradable on public markets.

To help ensure that ECFs attract additional capital in to the equity gap, rather than merely displacing investment that would otherwise have been channelled through the Enterprise Investment Scheme or Venture Capital Trusts, the Government does not provide tax incentives to ECFs or their investors. Nor will BBFL support propositions that have already raised sufficient private capital to operate as a commercially viable fund.

(c) Fund structures

The fund must be located in the UK or another EU jurisdiction. For the purpose of this Guidance, BBFL is assuming that Prospective Managers will wish to structure their funds as English Limited Partnerships ("LPs"). This is a widely-used structure for funds that are managed by professional fund managers on behalf of 'passive' third-party investors and is likely to be suitable for most Prospective Managers.

Suitably modified, an LP structure might also be appropriate for groups of investors wishing collectively to manage their own portfolio of investments through an ECF. Following consultation, the Government made a series of changes to the financial services regulatory system that should enable an owner-managed ECF to operate without the need for authorisation under that system, under certain pre-defined circumstances. These are described further in Part 2.

(d) Capital flows

BBFL will commit to providing up to 60% of the money in an ECF, or up to two thirds of the money if an ECF is targeting SMEs prior to their first commercial sale (as set out in Part 3 out below). The remainder is to be raised from private investors. In general, funds will be drawn down into each ECF on a 'side-by-side' basis from BBFL and private sector investors, according to their respective shares of the total funding committed to the ECF.[5] Once the ECF has met its expenses and liabilities (including fund management fees), subsequent proceeds from investments will be distributed to investors in the following priority order:

1. **first**, as a prioritised return to BBFL, equivalent to interest charged on the our funds drawn down into the ECF. This rate will be fixed for the life of the fund at the rate prevailing when an ECF mandate is awarded to the Prospective Manager. The rate currently applicable is 3 per cent per annum, but this will be reviewed periodically in light of changes to the UK Government's cost of borrowing;

2. **once all payments under (1) above have been made**, repayment of capital to both the private investors and to us ; and

3. **once all payments under (2) above have been made**, as distribution of profits to private investors, BBFL and (where appropriate) as carried interest to the fund managers.

Prospective Managers must specify the terms for capital repayment under (2) and the profit-sharing ratio and any carried interest arrangements under (3). Repayment of capital under (2) shall be on terms that are no less favourable to BBFL than to the private investors. Further details of the capital flows are given in Part 3. Funds will be expected to offer a fixed profit share to BBFL throughout the distribution of profits (3 above) regardless of any arrangements for profit share (carried interest) to the fund managers.

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[4] http://ec.europa.eu/competition/state_aid/cases/249273/249273_1513304_102_2.pdf
[5] The exception is that, where private capital is being sourced from individual investors, it may be prudent for some or all of that private capital to be drawn down earlier than would normally be the case with institutional investors and potentially placed in an escrow account until it is required.

(e) Investment restrictions

All ECFs must invest within the equity gap as defined above, specifically including a £5 million upper limit on the size of the initial funding round in which an ECF may participate and a requirement that each investment should be predominantly related to, or for the benefit of, the economy of the UK.[6]

Prospective Managers will be required to set out their investment strategy as part of their proposals. This will include a requirement to demonstrate that their strategy will target companies that would otherwise be affected by a shortage in the supply of risk capital. The articulation of investment strategy, including the targeting provisions, will form part of the investment mandate that is included in the legal agreements for each ECF. A Prospective Manager who fails to close their fund on the basis of the agreed investment strategy should not expect to be able to re-negotiate these terms. The proposed investment strategies must therefore be both commercially viable and attractive to investors.

Part 2 of this Guidance provides more detail about these and other restrictions that will apply to all new ECFs. Such restrictions will not be enshrined in legislation, but will be enforced through the Limited Partnership Agreements that govern the operation of each ECF.

(v) The award process

There is no annual target for making commitments to ECFs and the selection process is a rolling one where Prospective Managers are encouraged to approach BBFL at a relatively early stage and then, depending on feedback given, to stay in contact until proposals become 'investment ready'. This iterative process better reflects the commercial nature of ECFs and the need to invest in the strongest teams at the most appropriate time.

An early engagement with prospective management teams is typically a face-to-face meeting in which the team will pitch their credentials, talk through their plans and ask any questions they may have about the ECF programme. Thereafter, the process and timeline will depend on the particular circumstances of the team.

In order for an ECF award to be made BBFL must then receive a formal proposal. Proposals must contain the information set out below (see "Mandatory initial information") and managers will be required to warrant their accuracy. BBFL encourages teams to discuss draft proposals with its Venture Capital Solutions team who will provide feedback as appropriate – except on specific commercial terms such as the management fee and profit share accruing to BBFL which are part of the competitive award process.

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[6] If the investee company has had other state aid in the form of risk capital within 12 months prior to the ECF investment this, together with the ECF's investment (but not any non-aid investment) should not exceed £5m.

(a) Information required

The further information as set out in Part 5 of this Guidance will be required before any ECF award is made. Prospective Managers are advised to review this section carefully to ensure they can provide the level of detail that will be required. BBFL will request a final proposal from teams once due diligence has been undertaken on this information.

Mandatory initial information (no more than 5 Pages)

- Details of the proposed ECF's investment strategy including, target sectors and investment stages, investment structures and any co-investment agreements, length of investment period and proportion of funding reserved for follow on investment.
- Summary CVs (as an annex) of key investment personnel involved in the fund and details of their proposed role within the ECF.
- Details of any investment track record; from the team as a whole and for individuals within the team (supporting information may be included as an annex).
- Details of private investors willing to back the fund (evidence of commitment e.g. letters of support may be attached as an annex).
- Details of the proposed management fee, start-up costs and any other fees and costs that will be charged to the fund and details of all fees likely to be charged to investee companies by the fund or linked organisations.
- Level of BBFL funding sought and level of private investment.
- Details of the proposed fixed profit share (this must be a fixed number that will apply throughout any and all distribution of profits) and how any other profits are to be distributed.
- Acknowledgement that the Prospective Manager has read and can accept the terms of our draft ECF Limited Partnership Agreement.
- Confirmation that the Prospective Manager has read this Guidance and accepts the terms herein.

Potential ECF managers will need to submit an electronic copy of the initial mandatory information detailed above for their proposed ECF, containing the information described above, and including documents that are Word and Excel compatible. BBFL may reject any proposal solely on the basis of this initial information, or at any subsequent stage.

Proposals should be sent to:

info@british-business-bank.co.uk

Prospective fund managers can also contact the ECF team on this email address, but **please note that requests for business advice, direct investment or other support cannot be answered**. Businesses looking for such advice should contact their professional financial advisors in the first instance.

(b) Selection process

Responsibility for selecting Prospective Managers will rest with BBFL. Its decision will be informed by the findings of commercial, financial and legal due diligence and any other information or advice deemed necessary. All those involved in the process will be bound by appropriate confidentiality provisions.

Once approved to operate an ECF, Prospective Managers will have six months to secure their full private capital commitments and put in place the necessary legal documentation to close their funds. BBFL will have the right to withdraw the ECF mandate should that timetable not be met.

It is intended that the draft partnership agreement available on the British Business Bank plc website, as amended to reflect specifically negotiated terms, will be used to establish ECFs. This draft agreement has been updated in the light of experience from earlier funds and should not need to be changed other than to reflect competitive variables.

(c) Confidentiality

All information from Prospective Managers will be treated as commercially confidential. Except where required by law or where the consent of the prospective manager has been obtained, such information will not be disclosed to third parties other than those involved in assessing or advising on the applications or in other aspects of the management or evaluation of the ECF programme. The BBFL will retain applications after the ECF assessment process is completed, for example to support any evaluation of the ECF selection process. This may involve passing certain details to carefully selected external researchers, who would be bound by strict confidentiality provisions.

PART 2: ECF STRUCTURES

This section provides a broad overview of how the limited partnership structures will operate. It considers two variants: the first is most likely to be suitable for funds managed by a third-party fund manager; the second is intended for groups of 'active' business angel investors wishing to manage their own investments through an ECF.

Prospective Managers should note that the legal, tax and regulatory positions will depend on the specific circumstances of each fund and its investors, and are advised to seek professional advice where needed. This Guidance is intended to provide guidance only, and should not be relied upon in place of such advice.

(i) ECFs targeting 'passive' investors

For professional fund managers seeking to manage capital invested by 'passive', third-party private investors, it is expected that the standard limited partnership structure will be appropriate. In this structure, BBFL and other investors in the fund would be limited partners, and the general partner would appoint a fund manager responsible for managing the activities of the partnership. In order to preserve their limited liability, the limited partners do not become directly involved in the management of the fund.

(a) Structure of participation

The limited partnership must be established specifically for the sole purpose of investing as an ECF. The partnership must have a fixed lifetime, though the legal documentation may allow for extension with the consent of BBFL and other limited partners. It is envisaged that most funds will adopt a ten-year lifetime with an option to extend for up to two years, in line with common practice in the venture capital industry, but BBFL may consider alternatives where a suitable justification is provided.

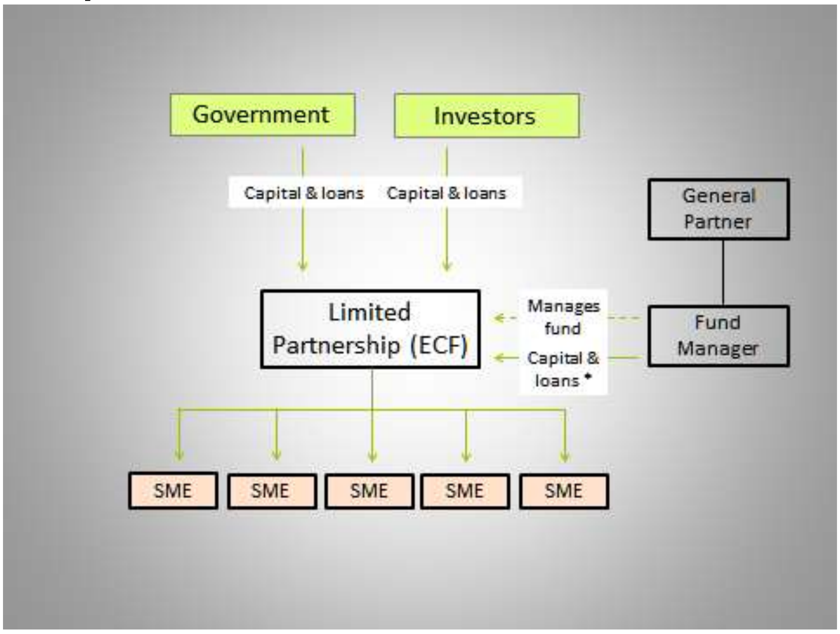
BBFL, other investors and carried interest recipients will each contribute a nominal amount of capital to the partnership, in proportion to their respective shares of the profits of the fund. As in a standard venture capital limited partnership, these capital contributions will constitute a fraction of the total commitments to the fund.

The remainder of commitments will be in the form of loans, to be drawn down into the partnership as and when required by the fund manager. Loans will be non-interest-bearing, although BBFL will be entitled to a 'prioritised return' equivalent to a rate which is at or around the 10 year gilt rate and which will be reviewed periodically in light of changes to this[7]. This prioritised return will be paid to BBFL before the loans are repaid to any investors. The fund manager may also wish to make commitments to the ECF on the same terms as the private sector investors, and this would be viewed as a positive signal of the manager's commitment and belief in the likely

[7] As at April 2014, the rate to be used is 3%. Any changes to this will be published on the BBFL website.

success of the fund. Where this is the case the legal agreements will need to contain provisions to overcome any potential conflict of interests.

Limited Partnership ECF Model



(*b) Fund manager remuneration and other fees*

BBFL recognises that investors typically wish to remunerate fund managers by a combination of:

- a management fee, set at a level that is just sufficient to permit the fund manager to invest and manage the fund effectively; and
- an appropriate carried interest provision. Any hurdle should be set at a level that is stretching but achievable, and the rate of the 'carry' should be no more than is sufficient to create a strong incentive for the fund manager to maximise the financial performance of the fund.

However, this structure may not be appropriate in all situations, and Prospective Managers may want to discuss alternative remuneration structures. If so they will need to explain why the proposed structure is desirable from the perspective of BBFL and other investors in the fund, and they must demonstrate that it provides a clear link between the performance of the fund and the remuneration of the fund manager.

Prospective Managers must also specify the level, structure and timing of any other fees or charges that would be applied, e.g. any application, arrangement and monitoring fees to be charged to investee SMEs. They should also note BBFL's very strong preference for such charges, where levied, to accrue to the fund rather than to the fund manager. Prospective Managers should demonstrate that any such fees are kept to a minimum, so that as much of each investment as possible is available for the SME to use to develop its business, rather than to pay fees back to the ECF. Where fees relate to a specific investor in the ECF, e.g. in the case of commission fees paid to IFAs or intermediaries who introduce investors to the fund, BBFL would expect these to be borne by the investor or manager concerned, and not by the fund as a whole but would again expect these to be kept to a minimum.

As part of each proposal, BBFL will also wish to see projected budgets for the fund manager, to demonstrate that the level of the proposed fees will be sufficient to enable the fund to be properly managed, but not excessive.

(b) Taxation

Limited partnerships should be treated as transparent vehicles for UK tax purposes; the tax treatment of the general partner will depend upon its legal structure.

In developing their ECF proposals, Prospective Managers should consider seeking professional advice as to the potential implications of Chapters 1 to 5 of Part 7 of the Income Tax (Earnings and Pensions) Act 2003 (“ITEPA”) for their proposed structure. A note at Annex A confirms that, for the purposes of determining whether a transfer of value applies within the meaning of Part 7 of ITEPA, the prioritised return on BBFL’s investment in the ECF will be regarded as a commercial return. Accordingly, the terms of BBFL’s investment in an ECF will not, by themselves, confer a transfer of value to the other partners that could be liable to a charge under Part 7. However, this is not to say that a Part 7 charge could not arise for other reasons.

(c) The rights of BBFL as a limited partner

BBFL requires a right to participate in decisions that normally require the consent of the majority of limited partners, such as extending the lifetime of the partnership, replacing the general partner, changing the terms of the partnership agreement or resuming drawdowns and investments following a suspension[8].

Although BBFL will often be investing the majority of the funds into an ECF, it recognises that private investors may be reluctant to invest if BBFL were able to liquidate an ECF or take other major decisions without consulting the other limited partners. For such decisions, the consent of BBFL and a majority of the other limited partners would normally be needed. This should provide reassurance for private investors that, although BBFL is the majority investor in an ECF, it cannot unilaterally act to their disadvantage.

The only exceptions would be in cases where the fund manager has materially breached the terms of the partnership agreement (including the agreed investment strategy) or is otherwise fraudulent or negligent. In such cases, BBFL will require an option to remove the general partner, with or without the consent of the other limited partners. The choice of replacement general partner would need to be agreed between BBFL and the private investors.

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[8] BBFL will require drawdowns and investments to be suspended in certain circumstances, including criminal actions by the general partner or fund manager; failure of the ‘key personnel’ (see Part 3(viii) below) to devote the agreed amount of time to the management of the ECF; and any event that causes the BBFL share of the outstanding loans to the ECF to exceed two thirds. Further details are given in the draft partnership agreement.

(d) Investor Committee

It is envisaged that each ECF would have an Investor Committee, which meets at least twice annually, comprising representatives of BBFL and some or all of the limited partners. This would provide an opportunity for the investors to meet to discuss the performance of the fund with the fund manager. The fund manager could also consult the Investor Committee on specific issues, for example if it were unclear whether a proposed investment fell within the agreed investment policy.

The role of the Investor Committee would be purely advisory. To protect their limited liability, the investors should not participate in the day-to-day management of the partnership's business.

BBFL expects that each representative on the Investor Committee would be remunerated by the investor(s) whom they represent, although Prospective Managers may specify that reasonable travel costs incurred by representatives attending Investor Committee meetings will be charged to the fund.

(e) Interaction with the regulatory system

Limited partnership ECFs with 'passive' investors will normally be collective investment schemes within the meaning of section 235 of the Financial Services and Markets Act 2000 (FSMA). Although the partnership itself will be unregulated, the ECF will appoint a third-party fund manager to establish, operate and in due course wind up the partnership. If the fund manager manages the ECF from the UK, the fund manager will need to be authorised by the Financial Conduct Authority (FCA) to carry on regulated activities, in accordance with FSMA.

As for any other limited partnership venture fund that is a collective investment scheme, promotion of interests in the fund by an FCA- authorised person will be subject to the financial promotion restriction set out in section 238 of FSMA. The ability to make such promotions may depend on the exemptions contained in the Promotion of Collective Investment Schemes (Exemptions) Order 2001. Amongst other provisions, these exemptions allow certain types of promotion to be made to certified 'sophisticated investors' or 'high net worth individuals'. Each of these categories of potential investor is defined terms under the relevant provisions and requires certain criteria to be identified and fulfilled.

Additional exemptions are included at chapter 4 of the Conduct of Business Sourcebook ('COBS') portion of the FCA Handbook. Specifically chapter 4.12.1 R provides exemptions allowing for (amongst others) the promotion of unregulated collective investment schemes to persons who:

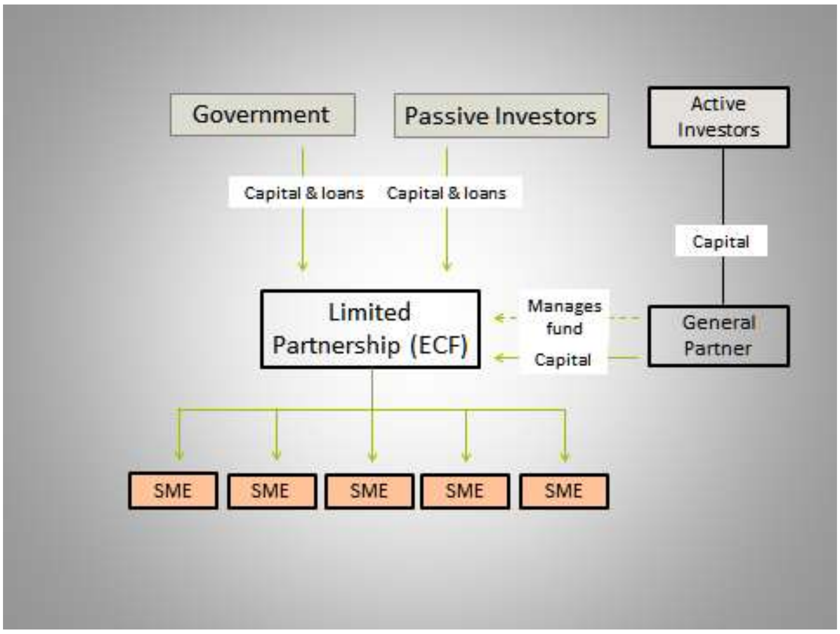
(a) the firm has taken reasonable steps to ensure that investment in the collective investment scheme is suitable;

(b) are an established or newly accepted client of the firm or of a person in the same group as the firm; and

(c) are eligible counterparties or professional clients.

(ii) Business angel-led (Active Investor) ECFs

"Active Investor" ECF Model



A variant of the standard venture capital LP model might also be suitable for groups of business angels seeking to manage their own funds actively through an ECF. The structure outlined here assumes that all private investors have a right to participate in the day-to-day management of the general partner of the ECF.

(a) Structure of participation

As in the standard LP model, it is envisaged that BBFL and private investors would all be limited partners in the fund, agreeing to advance non-interest-bearing loans to the partnership as required and making a nominal capital contribution (pro rata to their loan commitments and profit share).

The private investors would form a limited liability partnership ("LLP") or limited company to act as the general partner, and this vehicle would manage the activities of the fund. The liability of the investors in their capacity as members of the LLP would normally be limited to the extent of their capital contribution to the LLP, which could be a nominal sum.

It is for Prospective Managers to specify the processes by which the general partner would make its investment decisions. BBFL will require these processes to build in suitable safeguards that prevent investment decisions from being taken by a single investor acting alone.

(b) Remuneration to the general partner

As in a standard LP fund, it is likely that the partnership would make regular payments to the general partner to meet the expenses incurred in managing the fund. Prospective Managers should specify the level of these payments in their proposal, but it is envisaged that the costs of managing an angel-led ECF would be substantially lower than for an ECF operated by a third-party, FCA-authorised fund manager.

BBFL does not envisage that there will generally need to be a carried interest for the general partner in the angel-managed model. The carry is offered in the standard LP model to strengthen the incentives for the fund manager to maximise fund profits. In this angel-managed model, the managers (as limited partners) already have a significant financial incentive to maximise the financial return.

(c) Taxation

The limited partnership ECF and an LLP general partner should both be tax-transparent vehicles, whereas a limited company GP is not transparent. The comments in section (i)(c) above, in relation to Part 7 of ITEPA, also apply to this structure.

(d) The rights of BBFL as a limited partner

As with the standard LP model, BBFL envisages that most decisions requiring investor consent would be taken only with the agreement of BBFL and a majority of private investors. BBFL will wish to have the right to remove the general partner (or to require an individual member of the general partner to cease their involvement in the management of the ECF) where the investment policy or other terms of the partnership agreement are breached, or where the general partner otherwise acts fraudulently, negligently or criminally.

BBFL will also require a small number of additional protections in ECFs that are not being managed by an FCA-authorised person. BBFL will wish to ensure that the checks that an FCA-authorised fund manager would normally conduct on investors, for example in relation to money laundering, are carried out. In addition, BBFL will only confirm its offer of funding where it believes that the investors in the ECF have the necessary experience and expertise to manage public funds responsibly. Similar due diligence checks will be applied to any investors who wish to join the ECF after first closing. However, BBFL's checks will be narrower in scope and purpose than those normally carried out by the FCA in their authorisation process, and should not be relied on by any other investors as a substitute for FCA authorisation.

(e) Interaction with the regulatory system

Following consultation[9], the Government has made changes to the financial services regulatory system that enable an angel-managed ECF to exist without the need to have an FCA authorised operator and manager where certain conditions are met[10]. These conditions include:

- the private investors should all be certified 'high net worth individuals' or 'sophisticated investors', as defined in the Financial Promotion Order 2001, at the time they make their commitment to the ECF;
- the private investors should all be members of the LLP general partner, or otherwise have the right to be actively involved in the management of the general partner; and
- the private investors should all have signed statements to the effect that they understand (i) the risks involved in this type of investment; (ii) that the ECF will not be subject to FCA regulation and will not therefore be required to comply with FCA rules; and (iii) that investors will therefore not have recourse to the protections afforded by the financial services regulatory regime.

If and when the ECF is promoted to potential investors as an investment proposition, the Financial Promotion Order 2001 will be applicable where the promotion is carried out by a non-FCA-authorised person. This permits certain types of promotion to be made without the need for the promotion to be approved by an FCA-authorised person, including promotions made to certified high net worth individuals and certified sophisticated investors.

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[9] www.hm-treasury.gov.uk/consultations_and_legislation/business_angel/consult_businessangel_index.cfm
[10] Under previous regulatory rules, the limited partnership would itself be an unregulated collective investment scheme, and the general partner (as operator) would have had to be FCA - authorised.

PART 3: KEY FEATURES OF ECFs

(i) Investment restrictions

This section specifies the investment restrictions that will apply to all ECFs, and that will therefore be written into the partnership agreements. Prospective Managers may commit to more restrictive conditions as part of their proposals, and BBFL will regard this as a very positive feature if the Prospective Manager can demonstrate that it will be constrained to invest in an area where the equity gap is particularly severe. **If these more restrictive conditions are to be considered as part of the assessment process, the Prospective Manager must indicate how they will be incorporated into the partnership agreement.** Schedule 1 of each draft partnership agreement provides some possible suggestions.

(a) Investment sizes – first investment

There is no lower investment limit for the ECF programme as a whole, though in assessing the proposals BBFL will consider the likely interaction between a proposed ECF and existing publicly supported venture funds. Where a proposed ECF is directly targeting a part of the market that is well served by existing suppliers of risk capital (including other publicly-supported funds), BBFL is unlikely to be satisfied that the ECF would be tackling a genuine gap in the market.

Specific criteria for the maximum size of investment are needed to ensure that investments are in the equity gap, and not made as part of syndicates that take the investments beyond the equity gap. At the same time, BBFL recognises the need for some flexibility for ECFs to follow on successful investments, in order to protect their equity stakes from dilution in subsequent funding rounds.

Prospective Managers are welcome to specify tighter criteria to be included in the ECF partnership agreement, but the following restrictions will apply to the first investment made by an ECF in a particular company:

- an ECF may not invest, or agree to invest, more than £5 million in that company and if the company has received investments from other risk finance state aid schemes with a 12 month period then this counts towards that total; and

- an ECF may co invest with other investors, including other ECFs, so long as the total amount invested or agreed to be invested is no greater than £5 million. In complying with the £5 million limit, the ECF must take account of all investors, including the ECF itself (but excluding investors who are only providing debt finance with no equity or quasi-equity elements).

Suitable provisions will be built in to the legal documentation for each ECF to ensure that these restrictions cannot be breached, and further details are given in the draft partnership agreement on the British Business Bank website.

(b) Investment sizes – second and subsequent investments

Within a period of six months from the ECF's initial investment in a particular SME, follow-on investments in that company will be permitted only where the total amount invested in that company (including the initial investment) is no more than £5 million. The ECF will need to take account not only of its own investments on or after the date of initial investment, but also those made by any other investor (except an investor providing only debt finance).

Once that period of six months has elapsed and until the first anniversary of the ECF's initial investment in the company, the ECF will be permitted to follow-on so long as the total invested by the ECF is no more than £5 million.

Following the first anniversary of the ECF's first investment in the company, follow-on investments will be permitted if:

- **EITHER** the cost of all the ECF's investments in the SME will not exceed £5 million;
- **OR** the investment is necessary to prevent or reduce dilution of the ECF's equity stake in the company, **and** the total cost of all the ECF's) investments in the company will not exceed the lower of:
    - 15 per cent of the total ECF fund size; and
    - €15m in total from **all** ECFs[11].
- The ECF may be permitted to invest beyond the €15m aggregate cap applying to all ECFs, up to 15% of the ECF's size, but only on the basis that such an investment is made on a pari-passu basis as between BBFL and the private investors in the fund. [12]
- In making any of the above investments the manager will have to have regard to the nature of the ECF programme as an approved state aid and will need to alert any investee company to this as it may impact the level of investment available from other sources.

[11] This overall cap will include private investments made within the scope of the measure, *i.e.* investors that invest along ECFs and which receive aid, while private investors outside the scope of the measure, *i.e.* independent co-investors which invest in the same SMEs without receiving any advantage, are not to be included in the cap, as they are not recipients of aid.
[12] In order to provide certainty, the €15m aggregate cap will be converted to sterling at the point when BBFL awards an ECF mandate.

(c) Size, sector and location of investee company

An ECF may invest in any company:

- that meets the EU definition of a SME (as amended from time to time);[13]
- that is not a firm in difficulty as defined by the EU[14];
- that fulfils one of the following conditions:
  - it has not been operating in any market;
  - it has been operating in any market for less than seven years following its first commercial sale, which does not include sales made to test the market;
  - it requires an initial risk finance investment, which, based on a business plan prepared in view of entering a new product or geographic market, is higher than 50% of its average annual turnover in the preceding 5 years.
- where the purpose of the relevant investment is, or the application of the proceeds of such investment by the relevant company or undertaking shall be, predominantly related to or for the benefit of the economy of the UK;
- whose equity or other securities are not, at the time of investment, listed on a 'recognised' stock exchange (such as the London Stock Exchange) or otherwise quoted on a non-recognised exchange (i.e. AIM, Ofex or any other market on which prices are quoted publicly);
- that does not operate in any of the restricted sectors referred to in Article 32 of the EC Treaty or in sensitive sectors for which the guidelines on State Aid to promote Risk Capital investments to SMEs do not apply[15]; and
- where the trade of such company is a "qualifying trade" as defined in section s300 Income Tax Act 2007, as amended from time to time [16] or where the company is undertaking research and development with a view to carrying on a qualifying trade.

(d) Investment structures

ECFs will be allowed to structure investments in the most appropriate manner for each deal, so long as:

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[13] See Annex B.
[14] See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:1999:288:0002:0018:EN:PDF
[15] See Annex C.
[16] See Annex D and also http://www.hmrc.gov.uk/manuals/vcmmanual/VCM17030.htm.

- there is an equity component to the investment, or the investment includes warrants or other instruments conferring a right to acquire equity;
- there is a realistic and significant prospect that the investment will earn a material capital gain (and not just an interest yield) for the ECF[17]; and
- the ECF is not using drawdowns to finance the secondary purchase of existing equity, except in accordance with its state aid approval:
    - where the ECF is supporting an MBO or MBI **and** at least 50% of the capital allocated to the transaction will be used to fund the company's growth via the issue of fresh equity **and** following the transaction at least 65% of the issued equity share capital of the portfolio company will be held by persons who were not, directly or indirectly, shareholders of the portfolio company immediately prior to the transaction; or
    - where an ECF is participating in a small capital replacement transaction (limited to £100,000 per transaction per company), in order to facilitate the replacement of a manager or minority shareholder and allow the company to continue with committed shareholders.

(e) Cumulation of state aid

European state aid approval for ECFs was conditional on BBFL taking steps to avoid the cumulation of state aid to a single enterprise. Before investing in any portfolio company, an ECF will therefore need to make the company aware that it is an ECF and that the SME's eligibility for certain other Government risk capital support schemes may be reduced in the future.

(ii) Raising capital

(a) BBFL funding for ECFs

BBFL will be able to commit *up to* £50 million of capital for an ECF. Prospective Managers should note that there is a limited budget for ECFs and so, other things being equal, we will favour proposals requiring a lower commitment from us.

BBFL will be able to commit *up to* two thirds of the capital in a fund where it is targeting SMEs prior to their first commercial sale, meaning that more than half of the fund will be invested in such companies.[18]

[17] This means that debt instruments with warrants may be used only where there is a realistic prospect that the right to acquire equity will be exercised. An ECF will not therefore be able to provide debt finance 'dressed up' as quasi-equity by adding rights to acquire equity that it has little or no intention of exercising: such investment would not target an *equity* gap.
[18] Commercial sales will not include sales made to test a market prior to full commercial launch of a product or service.

BBFL will be able to commit *up to* 60% of the capital in a fund where it is targeting SMEs that are less than seven years past their first commercial sale, or older SMEs that, based on a business plan prepared in view of entering a new product or geographic market, require an initial risk finance investment that is higher than 50% of their average annual turnover in the preceding 5 years.

(b) Sources of private capital

ECFs that are established and operated by an FCA-authorised fund manager will be allowed to raise their private capital from any source permitted by law, so long as the appropriate due diligence has been undertaken by the fund manager and any regulatory requirements are met. Where an ECF has no FCA-authorised manager, BBFL will wish to carry out certain checks in respect of the private investors prior to committing capital to the fund.

ECFs may raise capital from public-sector sources, but BBFL will not provide leverage in respect of such capital and will not provide leverage that takes the overall proportion of publicly-sourced capital in the fund above the limits in 3(ii)(a) above. Other venture capital funds (except fund-of-funds vehicles) will not be allowed to invest in an ECF.

Apart from the public and private capital committed to the fund at final closing, ECFs will not be permitted to raise additional finance from other sources, except where leasing equipment or raising short-term debt for the purpose of maintaining the short-term liquidity of the ECF. General borrowing by the ECF will not be permitted.

(c) Breadth of investor base

Regardless of whether the investors are exercising control over the investment decisions of the general partner or whether an independent fund manager is appointed to take those decisions, BBFL will require that the investor base is sufficiently diverse to safeguard its commercial interests. In general, it is envisaged that:

- Not more than 50% of the private money will come from a single source; and
- At least 50% of the private money will come from sources independent of the manager.

(d) Timing and multiple 'closings'

Successful managers will be required to achieve 'first closing' with commitments of private capital to at least the level agreed in their application, within six months of being advised that their application was successful. BBFL will retain the right to withdraw its offer of investment into the ECF if this condition is not met, or if at any time within the six-month window the ECF is not making satisfactory efforts to secure such commitments.

ECF managers may wish to have more than one closing for their fund. In this case, the first closing must be reached within the six months of being advised their application was successful. The level of BBFL investment in each fund will be fixed at the time the ECF award is made.

Prospective Managers will also be expected to achieve final closing within an agreed period. Six months after first closing may be an appropriate deadline, but Prospective Managers may propose and justify alternatives.

(e) No implied warranty

Any specific reference to the Government, the British Business Bank or BBFL in publicity materials relating to an ECF must be approved in advance by BBFL, except where providing only basic factual information that is already in the public domain, e.g. the amount or terms of proposed BBFL participation in the fund. Under no circumstances should our agreement to participate be described or interpreted as implying any kind of endorsement, warranty or guarantee of performance by the fund, and any promotional materials issued in relation to the ECF must include a warning to that effect.

(iii) Drawdowns

Loan commitments will be drawn down into an ECF on a ‘side by side’ basis from BBFL and the private investors, pro rata to their total loan commitments. It is anticipated that loan commitments from BBFL will be drawn down on an ‘as required’ basis. BBFL will require at least 10 business days’ advance notice of any drawdowns, and will expect ECFs to provide monthly indicative forecasts of likely drawdown requirements.

Prospective Managers wishing to raise private capital from individual investors will need to propose arrangements to satisfy BBFL that the private capital will be available for drawdown when needed. For example, it may be appropriate for some or all of any commitments arising from individual investors to be placed in an escrow account or drawn down into the ECF at the start of the fund’s lifetime.

In the event that a limited partner fails to meet a drawdown notice, it will be liable to pay interest and, unless the default is rectified, the defaulting partner will lose their entitlement to distributions during the lifetime of the fund. Any distributions to that investor at the end of the lifetime of the fund would be limited. However, BBFL does not believe that such punitive provisions should be applied following the death of a limited partner.

Capital that is drawn down into the fund but not yet invested or otherwise expended (e.g. on management fees) must be held on deposit with a major UK clearing bank, except where BBFL approval has been sought and obtained.

Fund managers may wish to cancel outstanding loan commitments if it becomes clear that they will never be drawn down. In such cases, loans will be treated as having been drawn down and repaid immediately.

(iv) Distribution of returns

When an ECF earns a return from an investment, either from interest or dividend payments from an investee SME or from a realisation, it will not be permitted to recycle those funds for further investment (except where drawn down funds have been used to pay the management fee). An ECF will be expected to make distributions once it has the necessary income or capital gains from realisation of its investments and has met its expenses and liabilities (including fund management fees). The three 'tiers' of the distribution are summarised in Part 1(iv)(d) above, and are discussed in more detail now.

1. *Prioritised return to BBFL*

The prioritised return will be equivalent to interest charged on the balance of outstanding BBFL loans to the fund, compounded annually. Payment of the prioritised return may be deferred until the fund has generated the necessary cash flow from its investments and has met its existing liabilities.

2. *Repayment of capital*

Once BBFL has received its prioritised return, outstanding loans may then be repaid to BBFL and the private investors under the terms specified in the proposal, which will be written into the legal agreements. Loan repayments may be made to the various parties on a pro rata basis, or Prospective Managers may specify an alternative arrangement that repays BBFL more quickly.

Where there are amounts of loan commitment still to be drawn down, repayments will continue in this tier until BBFL has been repaid an amount equal to 85 per cent of its <u>total</u> loan commitments (regardless of whether those loan commitments have yet been drawn down). This is necessary to protect BBFL from a position in which early profits are distributed to private investors, and the fund subsequently fails to generate sufficient returns to repay future drawdowns.

3. *Distribution of profits*

Assuming obligations under tiers (1) and (2) above have been met, **all further distributions to investors will be divided between BBFL and all other parties in a fixed profit-sharing ratio.** Prospective Managers must specify BBFL's profit share in their proposals, expressed as a percentage that will apply to <u>all</u> distributions of profit; the remainder will be allocated between the private investors and, where there are carried interest provisions, the fund manager. BBFL's profit share should be a fixed percentage of profit that remains constant throughout all profit distributions.

In order to maximise their chances of success Prospective Managers should strive to offer BBFL a profit share that is:

- **competitive**, in order to provide BBFL with sufficient returns from successful ECFs to cover its losses from ECFs that perform less well; but also

- **realistic**, to demonstrate that their application is viable and achievable. Potential managers should note that, should they prove unable to raise private capital on the terms specified in their application, BBFL would not renegotiate the profit share or other features of the proposal; it would instead expect to withdraw its offer of funding.

In cases where standard carried interest provisions are to be included, profits will be distributed:

(i) **first,** to BBFL and private investors, in line with the profit-sharing ratio, until a certain 'hurdle rate' has been achieved and distributed. The hurdle rate is to be specified EITHER:

- as an amount equal to interest calculated on the daily balances of loans outstanding to BBFL and private investors; OR

- as being just sufficient to ensure that the private investors have received a certain annualised IRR.

In either case, the level of the hurdle and the basis for calculation should be clearly specified. Prospective Managers may choose to provide for a gradual 'catch-up' for the carried interest recipient **<u>from the private investors' share</u>**; and

(ii) **second,** any further profits are divided between BBFL (in line with its fixed profit share), the fund manager (in line with the carried interest share), and the other investors (pro rata to their investments in the fund).[19]

Prospective Managers may specify alternative incentive structures to the standard carried interest provisions if this is more appropriate for their proposals, so long as they can still demonstrate a clear link between fund performance and fund manager remuneration.

(v) Co-investment agreements

ECFs wishing to enter into co-investment agreements with other parties should provide details of the proposed terms of such agreements as part of their initial proposal, including the reasons why the proposed arrangements would be in the interests of the ECF's investors. This might, for example, be appropriate for an ECF

[19] The draft Limited Partnership Agreement also incorporates provisions to protect BBFL and other limited partners from the possibility of over-payment of carried interest in the early years of the fund. Briefly, these provisions involve a portion of any carried interest payments being held in escrow for the recipient until such a time as the possibility of over-payment has passed.

wishing to raise and leverage funds from institutional investors, to be co-invested alongside a group of experienced business angel investors.

Co-investment agreements may also be appropriate where an ECF fund manager is associated with another venture fund and where the investment mandates of the two funds overlap. In these circumstances, it would be appropriate to agree in advance how deals will be allocated and shared.

BBFL has seen many proposals that include provision for an ECF to be managed alongside current or future EIS funds. Whilst this is not precluded under the rules of the programme, Prospective Managers should note that, other things being equal the management of an ECF alongside the management of an EIS fund by the same manager is a less attractive option than one where all funds are invested through the fund. This structure will only be allowed where BBFL can be satisfied that the manager will put in place satisfactory mechanisms to deal with the commercial and governance issues that arise from such an arrangement. In cases where this can be achieved it is still likely to add significant time to the selection process

(vi) Conflicts of interest

There is scope for various conflicts of interest to arise during the lifetime of an ECF. Potential managers will be required to highlight any potential areas where this may be the case, and should propose mechanisms to resolve or manage these conflicts. This will not be regarded as a negative feature of an application, so long as BBFL is satisfied that any conflicts would be handled in a manner consistent with the interests of BBFL and other investors in the ECF. Wherever possible, Prospective Managers should follow commercial best practice in managing potential conflicts. Prospective Managers should note that failure to disclose any material conflict of interest that is subsequently identified in the assessment process will be regarded as a significant negative feature.

(vii) Involvement with investee companies

An ECF may wish to designate one or more individuals to serve as an officer, director or other participant in the management of a portfolio company. Such person, if they are not employed as part of the ECF management team, may receive commercially appropriate director’s fees and properly reimbursable expenses incurred by that person in their capacity as a director, and distributions based on the person’s ownership interest (if any) in the company. The level or basis of calculation of any such fees and expenses should be specified in the application. Any income received by a member of the ECF management team in connection with their involvement with an investee company, or anything else of value received from the portfolio company must accrue for the benefit of the ECF and not the appointed director.

(viii) Key personnel

In this Guidance, 'key personnel' includes any individual whose experience and expertise a Prospective Manager wishes BBFL to take into account when assessing their application. For these individuals, the ECF partnership agreement will include provisions to ensure that the key personnel named in the application actually dedicate the specified amount of time and effort to the ECF.

The partnership agreement will specify the circumstances under which key personnel may be replaced. Such changes will require the consent of the limited partners, including BBFL. Before giving such consent, BBFL will wish to be satisfied that the replacement is at least as well qualified and experienced as the individual being replaced, and will integrate successfully with the rest of the management team. The legal agreements will include a right for the investors (including BBFL) to agree to remove the general partner or suspend new investments by the partnership in the event that satisfactory replacements are not put in place within a reasonable time period.

(ix) Transfer or sale of instruments of ownership in an ECF

It is intended that investors should be committed to retaining their interest in an ECF for the lifetime of the fund, but BBFL recognises that changing circumstances may mean that a private investor wishes to sell or transfer their interest in a fund. On transfer, the recipient will take over the obligation to meet any loan commitments not already drawn down from the vendor (as well as the right to receive repayments of capital and profit share).

BBFL approval will not be required for transfers of ownership where the ECF is operated by an FCA-authorised fund manager who has undertaken an appropriate level of due diligence in relation to the new investor. However, consultation with the investor committee will be required. In the absence of an FCA-authorised manager, BBFL will wish to approve any transfer of partnership interests, for example to assure itself that the new investors are sufficiently experienced to be involved in managing public investments.

BBFL will also wish to retain the right to transfer its interests in an ECF.

(x) Reporting requirements

ECF operators will be required to provide regular reports to BBFL on the progress of their fund and its investments. BBFL is additionally interested in the impact of ECFs upon equity gap investments into SMEs. Therefore the ECF will be expected to provide some additional reporting on SMEs seeking investment. BBFL intends that this should not be particularly burdensome and believes it is best achieved through the completion of an "Investee Summary Sheet" described below. All SMEs seeking investment from an ECF will be required by the ECF manager to submit this information regardless of subsequent investment. This additional information will support future evaluation of the ECF programme and BBFL's analysis of the equity gap.

A business seeking investment from an ECF will be required to provide the ECF with an **Investee Summary Sheet** containing:

- Company Name
- Company Postcode
- Management Team (listing names, years in sector and previous business ownership)
- Companies House Company Registration Number (CRO), or VAT Registration Number
- Product/Service description and 4 digit Standard Industrial Classification (SIC) code(s)
- Date of inception / start up
- Current Revenues (dated)
- Number of full time staff at time of application
- Company plans for the new capital
- Notice that BBFL or its agent may contact company the company for evaluation purposes
- Agreement that a (non confidential) summary of the company's business plan may be used for evaluation purposes

The ECF will be expected to follow the International Private Equity and Venture Capital Valuation Guidelines produced by EVCA[20] when valuing investments and will be required to produce quarterly reporting following the BVCA reporting template[21]. This will cover summary fund data and more detailed portfolio reporting for all investments, including details of investments bought and sold in the period, brief updates of the progress of each portfolio company, valuations of each investment and BBFL's interest in the ECF, and brief details of investment opportunities considered (but rejected) during the period.

In addition to the BVCA best practice BBFL considers that two additional measures from EVCA best practice should be added to the monitoring data requirement:

- a measure of the investee's performance against the fund manager's forecast; and
- the holding period of the investment

The ECF should be prudent and consistent in its valuations and will do this by valuing investments in line with current EVCA guidelines.

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[20] http://www.evca.com/pdf/international_valutation_guidelines.pdf
[21] www.bvca.co.uk

BBFL *may* also require additional reporting data (for example in relation to the employment and turnover of investee companies) to enable it to further evaluate the impact of the ECF programme on equity gap SMEs. Consequently, the ECF should make it a condition of funding that the SME provide such data if and when required.

The quarterly reporting will provide the template and the data required for the ECF's annual report. The annual report, consistent with the BVCA's reporting guidelines, will include an audited profit and loss account and balance sheet.

To enable BBFL to properly budget for its expenditure, the ECF will also be required to provide monthly cash flow forecasts indicating the level and timing of expected drawdowns of BBFL funding for the following three months

All such information received by BBFL will be treated as confidential, although BBFL may wish to release aggregated data on the performance of the ECF programme as a whole. Information relating to specific funds or businesses will be passed to external parties only where required by law or where necessary to support independent evaluation of the ECF programme, and any external researchers would be bound by appropriate confidentiality provisions.

(xi) National Audit Office

The role of the National Audit Office (NAO) is to report to Parliament on the spending of central Government money. It conducts financial audits of all Government departments and agencies and many other public bodies, and reports to Parliament on the value for money with which public bodies have spent public money.

ECFs will be required to cooperate fully with any requests for information from the NAO and, if appropriate, the European Court of Auditors.

PART 4: ASSESSMENT CRITERIA

This section outlines the criteria against which BBFL will assess prospective funds.

The assessment criteria are broken down under four broad headings:

- strength of investment team, relevant experience and expertise;
- investment strategy;
- sources of private capital; and
- financial terms.

Under each heading, there are certain features that must be present in all proposals, and further criteria that BBFL will take into account when assessing them.

Each of the four broad areas will form an important part of the assessment process, and none will be of overriding importance. This means that the successful proposals will not necessarily be those from teams with most experience, or those offering the most generous financial terms; instead, they will be those that offer the best overall value for money in meeting the Government's objectives.

Within each broad heading, assessment criteria are categorised as 'pre-requisite', 'primary' or 'secondary', to indicate their relative weighting in the assessment process.

Where consistent with our overall objective to secure value for public money, BBFL will attach positive weight to applications that contribute to our objective to test a variety of different approaches and to build a balanced portfolio, for example in terms of:

- business models;
- target investor groups;
- investment strategies (e.g. early-stage vs. development capital, sector specialist vs. generalist, local/regional vs. national); and
- approaches to reducing the costs of making equity-based investments.

Even if proposals appear to meet the required criteria, BBFL may still decline to make any award of ECF status if none are judged to offer sufficient overall value for money. BBFL will retain full discretion as to whether, and on what terms, BBFL would make support available.

(i) Strength of investment team, relevant expertise and experience

Pre-requisite criteria

Prospective Managers must demonstrate that the proposed ECF management team is suitably qualified, and collectively possesses the knowledge, experience and capability needed to successfully build, manage and exit a portfolio of private equity investments. Prospective Managers will also need to demonstrate that the team will be able to work together effectively for the life of the fund.

Where specific skills or expertise are lacking in the management team, Prospective Managers must demonstrate how appropriate experience will be brought into the team and must show that the associated costs are fully budgeted for in the financial projections submitted as part of the application. Prospective Managers must outline the staffing requirements of their proposed ECF, and demonstrate that proposed levels of staffing will be sufficient to operate the ECF effectively.

Where the activities of a proposed ECF would fall within the financial services regulatory regime under the FSMA, the Prospective Manager must also demonstrate that they meet the requirements of that Act (for example in relation to FCA authorisation), or have credible plans to do so.

Primary assessment criteria

BBFL will pay close attention to whether the proposed management team demonstrates the potential to succeed in:

- **raising capital** from reputable private sector investors;
- **attracting a flow of quality investment propositions** from businesses seeking risk capital finance;
- **carrying out rigorous 'due diligence'** to assess the suitability of investment propositions put forward by businesses seeking finance;
- **structuring and pricing investments** and **negotiating terms** with investee businesses;
- **providing management support and advice** to investee businesses, for example by helping to develop and implement successful growth strategies;
- **monitoring and reporting** on the performance of the ECF's investment portfolios;
- **realising returns** from investments through third party transactions, including later-round investments, trade sales and initial public offerings; and

- the management team's knowledge and experience of **developing a successful business** and, where relevant, their knowledge and experience of any **specific business sectors** in which the proposed ECF would concentrate its investment activities.

Evidence of past experience against all these criteria is an advantage, but not a pre-requisite: Prospective Managers need to demonstrate that the ECF would have access to all the skills and competencies needed to ensure a good prospect of achieving commercial success.

Secondary assessment criterion

BBFL will have regard to the proposed ECFs' likely contribution to **increasing capacity and developing a sustainable skills base** in the 'equity gap' market. For example, this could apply where fund management teams are coming together to form an ECF, where the ECF is encouraging new hands-on investors into the market, or where it is committed to training and developing staff in particular aspects of equity gap investing.

(ii) Investment strategy

Part 3 described the broad investment restrictions that all ECF investments will be required to comply with. However, it is envisaged that prospective ECFs will operate within a more tightly-defined investment mandate, for example focusing on particular business sectors, stages of development, locations and/or investment tranche sizes.

An ECF's investment strategy should be driven by commercial considerations. Accordingly, BBFL will not favour any particular geographic locations or business sectors over others when assessing the applications. In particular, Prospective Managers should note that there is no specific requirement for ECFs to contribute to the Government's wider objectives for economic development across the regions or in disadvantaged areas. While ECFs are welcome to target businesses in particular regions or localities where they can demonstrate the existence of an equity gap, these proposals will be assessed on the same basis as any other.

Pre-requisite criteria

Prospective Managers must demonstrate that their investment strategy is consistent with the overarching scheme rules, targeting an equity gap, and commercially viable. They must show that the proposed fund has good prospects of delivering a high financial return, and that any potential conflicts of interest will be satisfactorily resolved. They must also demonstrate that the fund manager will be suitably resourced, taking into account both the financial and the non-financial resources available to it.

Primary assessment criteria

Other things being equal, BBFL will favour approaches that demonstrate that the proposed ECF would be targeting a particularly acute part of the equity gap. Where strong evidence can be provided to show that the shortage of capital is especially severe in their target market, this may compensate for other less attractive features of a proposal (such as a lower BBFL profit share). BBFL will pay close attention to the analysis of the existing supply of equity capital available to the target investee businesses, and the level of unserved demand for risk finance amongst those businesses. Prospective Managers should also seek to demonstrate their competitive advantage over existing or potential future participants in their segment of the market.

BBFL will also consider the proposed ECF's capacity to make a non-financial contribution to the performance of the investee businesses, for example by providing management support, mentoring or other relevant expertise. In assessing capacity in this area, BBFL will consider whether the Prospective manager's level of ambition in this area is achievable, taking account of the resources in and available to the management team.

(iii) Sources of private capital

Prospective Managers must describe in as much detail as possible the intended sources of private capital for their proposed ECF. They must specify the target level of privately sourced capital, and the desired ratio of BBFL to private capital in the fund.

Prerequisite criteria

Prospective Managers must demonstrate that the proposed private investors would be investing on a fully commercial basis, for the purpose of maximising their financial return, and have the financial capacity to meet the envisaged level of commitment. Where funds are to be raised from individual investors, Prospective Managers must also demonstrate that suitable arrangements will be put in place to ensure that committed funds will be available for drawdown and investment when required.

Attracting new private capital to the equity gap is an objective for ECFs. BBFL will therefore have regard to evidence that the proposed ECF is likely to attract new flows of private capital into the equity gap, rather than merely displacing capital that would otherwise have been invested in other equity gap funds.

Primary assessment criteria

BBFL will pay close attention to the evidence that the Prospective Manager will be able to raise the level of private funding proposed in the application, from the proposed investor groups and within the timescales set out in Part 1. BBFL will favour applications that are backed by strong evidence of investor appetite from named and verifiable sources. Such evidence might, for example, be in the form of written expressions of interest, letters of intent, or conditional commitments of funding.

In general, BBFL will place greater weight on stronger or more binding commitments, but it will also take account of the fact that it may be easier to secure commitments of capital from some investor groups than others. It will place greater weight on commitments from credible and reliable investors who fully understand the nature of the investment proposition.

(iv) Financial terms

In assessing each Prospective Manager's proposed financial terms, BBFL will consider how different internal rates of return at the level of the underlying investments would translate into financial returns. This assessment will take account of the prioritisation of loan repayments, BBFL's fixed profit share, the level of fund manager remuneration and the proposed ratio of public to private capital. All else being equal, BBFL will prefer proposals where the financial terms deliver it higher returns and lower risk.

Pre-requisite criteria

Prospective Managers must demonstrate that their proposed financial terms are consistent with the distribution 'waterfall' set out in Part 3(iv). They must also provide projected budgets to demonstrate the level of costs that will be involved in managing the ECF. These projections must satisfy BBFL that the management costs will not be excessive, but that sufficient provision has been made to enable the fund to be managed effectively.

Primary assessment criteria

BBFL will consider the arrangements specified for the sharing of loan repayments between it and the private investors, and the ratio specified for sharing of profits between it and the private investors.

The assessment will pay attention to the desired ratio of public to private funding. Lower ratios will be preferred, as they will allow a given amount of public funding to lever in more private funding.

BBFL will also consider the level, structure and timing of management fees, carried interest and any other remuneration to the fund manager and other charges or fees to be levied either on the fund itself or on investee businesses. It will be a negative feature if the proposed level of charges or fees does not appear commercially appropriate, or appears to be to the detriment of either the fund or its portfolio companies. Potential managers should note BBFL’s preference, as set out in the template LPA, for all arrangement fees, deal-related fees and monitoring fees received by the manager in connection with the making or management of any investment to be abated from the management fee and, in effect, accrue to the fund rather than the manager,

BBFL will also have regard to the strength of the link between the financial performance of the fund and the remuneration of those individuals responsible for taking the investment decisions and otherwise managing the fund.

PART 5: INFORMATION REQUIREMENTS

Part 1 set out the mandatory information required in the initial 5 page document. Prospective Managers may like to refer to the information requirements in this section when putting together that document. This Part provides a summary of the key pieces of information that are likely to be required during the process of full due diligence on a potential ECF. This is not intended to be an exhaustive list and BBFL might require any other relevant information.

(i) About the ECF

(a) Fund structure

- Details of the fund structure (limited partnership, limited liability partnership or limited company), and the reasons for this choice.
- Total amount of funding to be committed to the fund, by (i) private investors and (ii) BBFL.
- Proposed term of the fund.

Prospective Managers must highlight and explain any areas in which they would wish to alter significantly the terms of the draft partnership agreement.

(b) Investment strategy

- Details of the proposed ECF's investment strategy. Prospective Managers will need to specify which elements of the strategy are to be written in to the partnership agreement available on the BBFL. Prospective Managers should note that, in assessing proposals, BBFL will have regard only to those elements that can be written into the legal agreements. As a minimum, Prospective Managers will need to provide the following details:
    - overall approach (sector-specific, generalist, opportunist etc.);
    - length of investment period (i.e. the period after which only follow-on investments may be made) and the proportion of total commitments to be retained for follow-on investments and to meet other expenses of the partnership after the end of the investment period;
    - target number and value of investments in each year of the fund's investment period, and in the mature portfolio;
    - target sector(s) for investee companies (if applicable);
    - target stage(s) of development of investee companies;
    - target location(s) for investee companies (if applicable) ;
    - target funding round sizes for the ECF's initial investments, including the likely extent of co-investment or syndication with business angels, venture capital funds and other investor groups. Indicating if any potential co-investors or syndicate partners are in any way connected

with the proposed ECF and, if so, how any conflicts of interest will be managed;
    - target proportion of total commitments to be retained for investment in follow-on funding rounds; and
    - proposed deal structures, including the intended approach to minimising dilution (while remaining within the overall scheme rules).

- A brief analysis of the market in which the ECF is proposing to operate, including an assessment of alternative current and likely future sources of equity capital for the target SMEs, and the extent of unserved demand for such capital.

- A description of the proposed level and nature of ongoing mentoring, management support and other assistance that will enhance the performance of investee businesses. This will include an assessment of the likely costs and time commitments involved, and Prospective Managers will need to demonstrate that the proposals are feasible given the resources available to the ECF.

- An assessment of the *specific* risks associated with the proposed strategy (i.e. ignoring general venture capital market risks).

(c) Fund operation

- Proposed arrangements for the back office operations of the fund manager including compliance, fund accounting and reporting

- Prospective Managers will need to provide details of the decision-making processes, including:

    - the nature and extent of due diligence processes to be undertaken before each investment, including the likely scope and costs of any work to be commissioned from outside experts;
    - any other steps designed to reduce the fixed costs of making investment decisions
    - arrangements in place for managing the portfolio including follow-on investments and exits

- Processes in place to manage conflicts of interest

- Succession and disaster recovery plans

- Details of drawdown arrangements, including the notice periods that will apply to the private investors and the measures to be put in place to ensure that drawdown commitments are met on time.

(d) Sources of private capital

- Prospective Managers should include the following information in their initial proposals and be prepared to supply further supporting evidence if required:

    - the target level of privately-sourced capital;
    - details of the target investor groups; and
    - evidence of investor appetite for their proposed ECF.

(e) Terms of public participation

Prospective Managers should provide the following information:

- the proposed arrangements for the sharing of capital distributions between BBFL and the private investors;
- the proposed arrangements for the sharing of capital drawdowns between BBFL and the private investors; and
- BBFL's profit share, specified as a straightforward percentage as described in Part 3 of this Guidance.

Prospective Managers should be prepared to demonstrate why the proposed financial terms represent the least necessary level of BBFL support to attract private investment into the proposed ECF.

(f) Fee structures

Prospective Managers should set out:

- the level, structure and timing of management fees and other remuneration to the fund manager (including carried interest); and
- details of any other charges or fees to be charged, either to investors or to investee companies. Prospective Managers are asked to note that BBFL's clear preference is for these fees accrue to the fund and not to the fund manager.

(g) Financial projections and budgets

For a limited partnership ECF, or a limited liability partnership ECF that is to be operated by an independent third-party fund manager, Prospective Managers will need:

- full financial projections for the fund management company. These projections should demonstrate that the fund manager will be generating income that is sufficient to cover the costs of managing the fund, but not excessive; and
- full financial projections for the partnership itself, including the financial returns that are expected to accrue to private investors and to BBFL. This should include a sensitivity analysis that shows how returns vary on a range of different assumptions about underlying investment performance.

For a limited liability partnership ECF that is operated by its investors, Prospective Managers should provide:

- a detailed budget showing the projected costs to be incurred by the fund in managing its own affairs, and showing how much of the fund value will be available for investment in portfolio companies; and
- financial projections for the partnership, including the financial returns that are expected to accrue to private investors and to BBFL. This should include a

sensitivity analysis that shows how returns vary on a range of different assumptions about underlying investment performance.

In both cases, spreadsheets underpinning the financial projections, in a format capable of being read by Microsoft Excel, will be required from short listed Prospective Managers.

(ii) About the ECF management team

As explained in Part 3, 'key personnel' includes each individual whose experience and expertise are to be taken into account by BBFL when assessing a proposal. In addition to investment principals, this may include staff with responsibility for reporting, accounting and compliance. For each of these individuals, the relevant information will include:

- their name, full address, contact details, summary curriculum vitae;
- details of authorisation(s) held under FSMA, including a copy of the current Statement of Permitted Business;
- details of existing commitments on their time (including any other venture funds under management) that will impact on their ability to dedicate their time to an ECF;
- details of their proposed role, responsibilities and terms of employment within the ECF, including how much of their time will be devoted to management of the ECF;
- details of their relevant skills, expertise and previous experience;
- details of other venture funds or other equity investment activities in which they are currently engaged, or are likely to be engaged during the lifetime of the ECF;
- details of any directorships held currently or within the past seven years;
- whether they are an undischarged bankrupt, have ever been declared bankrupt or are currently the subject of bankruptcy proceedings; are or have ever been a director of an insolvent company; or have an unspent criminal conviction (other than for minor traffic offences). If the answer to any of these questions is 'yes', this will not exclude them from the application process. However, full details should be provided: applications will be dismissed if BBFL's due diligence reveals that information has been withheld;
- details of any cases of non-compliance by any of the 'key personnel' identified by regulatory authorities or their agents during the course of an audit or other review of compliance procedures; and
- written/signed consent for background checks, including checks of bankruptcy, financial or criminal records, to be undertaken.

Management teams will be asked to provide sufficient details to verify any investment track record of individuals named in their proposal, to provide details of at least 3 referees and to provide consent for BBFL to carry out further background checks and referencing.

BBFL will also be seeking to determine whether the team as a whole will function effectively.

ANNEX A – HM REVENUE & CUSTOMS NOTE ON THE APPLICATION OF PART 7 ITEPA 2003 TO ECFs

Depending on the exact nature of an ECF’s commercial structure, it is possible that one or other person may acquire employment-related securities. Such securities may be a person's interest in a limited partnership or the shares etc. of the target companies into which that partnership invests. It is therefore particularly important to consider the position where an investor in an ECF becomes a director or employee of one or more targets, or receives his opportunity to become a limited partner through his employment in, say, a finance house. In such cases the Memoranda of Understanding between HM Revenue & Customs and the British Venture Capital Association may provide helpful guidance.

The rules in Part 7 of the Income Tax (Earnings and Pensions) Act 2003 identify value being transferred to the holders of employment-related securities by way of remuneration and charge that value to Income Tax and NICs. Generally speaking this is where the employment-related securities are acquired for less than their full, unrestricted, market value and can be triggered on acquisition or where certain events occur after acquisition that achieve a transfer of value to the holder of the securities.

ANNEX B – DEFINITION OF SMEs

In line with the Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (Official Journal L124 of 20/05/2003), a new definition of an SME took effect from 1 January 2005.[22]

To be recognised as an SME under the new definition, a business must have fewer than 250 employees and either annual turnover not exceeding €50m and/or an annual balance-sheet total not exceeding €43m.

Where an enterprise is not autonomous, the employment, turnover and balance sheet of 'partner' and 'linked' enterprises must also be taken into account when ascertaining whether or not the enterprise is a SME. An enterprise is autonomous if:

- it does not have a holding of 25 per cent (in terms of capital or voting rights) or more in another enterprise;

- it is not 25 per cent or more (in terms of capital or voting rights) owned by any enterprise or public body or jointly by several linked enterprises or public bodies, with a few exceptions; and

- does not draw up consolidated accounts and is not included in the accounts of an enterprise which draws up consolidated accounts and is thus not a linked enterprise.

However, generally, venture capital companies may own up to 50 per cent of an enterprise's capital or voting rights without affecting its autonomous status.

[22] The description of the SME definition in this Annex is a brief summary only. The new definition is much longer and more detailed and should be consulted to determine its application to individual enterprises. The European Commission has published a User Guide to the new definition: http://europa.eu.int/comm/enterprise/enterprise_policy/sme_definition/sme_user_guide.pdf

ANNEX C – RESTRICTED SECTORS

ECFs will not be permitted to invest in the following sensitive sectors for which the guidelines on State Aid and Risk Capital do not apply:

(i) synthetic fibres and yarns;

(ii) motor vehicles;

(iii) shipbuilding;

(iv) steel - ECSC products;

(v) steel - non- ECSC products;

(vi) coal;

(vii) transport; and

(viii) the production of agricultural and fisheries products listed in Annex I referred to in Article 32 of the EC Treaty.

ANNEX D – DEFINITION OF "QUALIFYING TRADE"

Most trades qualify, provided that they are conducted on a commercial basis with a view to making profits. A trade will not qualify if one or more excluded activities together make up a 'substantial part' of that trade[23]. The main excluded activities are:

- dealing in land, commodities, financial instruments, or in goods other than in the course of an ordinary trade of retail or wholesale distribution;
- financial activities, property development, or providing legal or accountancy services;
- leasing (including letting assets on hire, except in the case of certain ship-chartering activities);
- receiving royalties or licence fees, except where these arise from an intangible asset such as a patent or know-how, most or all of which has been created by the company (or one of its subsidiaries);
- farming, market gardening, or forestry;
- operating or managing hotels, guest houses, hostels, or nursing or residential care homes; and
- providing services to another company in certain circumstances where the other company's trade consists to a substantial extent in excluded activities.

[23] This will depend on the relevant facts and circumstances, but it is generally considered that an activity makes up a 'substantial part' where it amounts to more than 20 per cent of the trade.

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