Ukie response to
HM Treasury consultation on Tax-Advantaged Venture Capital Schemes

About Ukie

UK Interactive Entertainment (Ukie) is the trade body that represents over 200 businesses and organisations involved in the games and interactive entertainment industry in the UK.

Ukie exists to make the UK the best place in the world to develop and publish games and interactive entertainment. Ukie's membership includes games publishers, developers, console manufacturers and the academic institutions that support the industry. We represent the majority of the UK video games industry.

Executive Summary

This paper will discuss the impact of the tax-advantaged venture capital schemes on the games industry. In doing so, it will set out the importance of games companies in the recent wave of tech start-ups in the UK; discuss the access to finance issues that early stage companies face and the impact of the venture capital schemes; and set out the games industry's needs for the future of these schemes.

Our key points are as follows:

- The tax-advantaged venture capital schemes have been a significant help to those games companies that have used them to secure investment, proving to be effective and well-targeted.
- This success should be built on – the amounts that companies can receive, and individuals can invest, should be increased, particularly for SEIS and EIS.
- There should also be more work to raise awareness of the schemes.
- Although games companies which rely on intangible IP have used these schemes, more work is still needed to improve understanding of IP amongst investors.
- There is a specific issue around the rectification of errors in investment agreements, which has prevented some companies from claiming EIS, which should be addressed.

Introduction

The last few years have seen an unprecedented flourishing of new games companies in the UK. In common with other parts of the creative and technology sectors, a major influence has been the advent of smartphones and tablets and the ease of app development. These innovations have significantly lowered the cost of entry to our industry, at the same time as they have created huge new markets around the world which can be accessed with ease.

These are the reasons that the wider app economy has grown so rapidly, and games have been central to that growth around the world. In the last quarter of 2013, games were responsible for 80% of revenues in major app stores around the world, compared to only 65% in 2012.[1] In the UK, over half of the £500 million that is spent in the app market is spent on games.[2]

After years of rapid growth, large acquisitions are now being seen of tech start-ups across the world, and games are leading here as well. In the last twelve months there have been several major acquisitions of games start-ups, all demonstrating the massive global potential in our industry. Supercell, the Finnish developers of the worldwide hit Clash of Clans, sold a 51% stake for $1.5 billion in 2013.[3] Oculus Rift, creators of a virtual-reality gaming headset, were bought by Facebook for $2 billion.[4] Twitch, the live video-streaming website designed for games, was bought recently by Amazon for just under $1 billion. And most recently of all, Mojang, the creators of Minecraft, were bought by Microsoft for $2.5 billion.[5]

It is clear that there is huge potential in and around games for start-ups to see rapid growth and to make major contributions not just to the economy, but to culture as well.

All of these companies however needed investment throughout their life to enable them to prove their ideas and to continue growing. The incredible growth of start-ups we have seen in recent years also means growth in demand for financing, which has not slowed down.

This rising demand is only likely to accelerate after the recent introduction of Video Games Tax Relief in the UK, which we believe will have a major impact in making the UK an even more attractive place to establish games companies.

Despite the examples of incredible success that are becoming more common, and the added support of tax relief, games development is still a risk-laden business. It is very difficult to predict in advance whether a game, particularly of a new IP from a new company, will be a success. As such, our industry is a perfect example of why schemes such as EIS and SEIS, targeted at high-risk, innovative, high-reward companies in their early stages, are necessary.

If the UK wants to continue to be seen as one of the best places to start and grow a new company to make or sell games, or to provide services for the games industry, the government must continue to work hard to prove its case. That is why this consultation is a welcome recognition of the need to continually monitor and improve the schemes that are in place.

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1 Newzoo: http://www.newzoo.com/insights/global-games-market-will-reach-102-9-billion-2017-2/#hktzYwyfD2QqwLBw.99
2 Research2Guidance
3 http://www.theguardian.com/technology/2013/oct/15/supercell-funding-softbank-gungho-clash-of-clans
4 http://www.theguardian.com/technology/2014/jul/22/facebook-oculus-rift-acquisition-virtual-reality
5 http://www.bbc.co.uk/news/technology-29204518

EIS, SEIS, VCTs and the games industry – need to go further

The overall response to the tax-advantaged venture capital schemes from the Ukie membership has been a positive one.

Those companies who have made use of the schemes to secure finance for their company, and those individuals who have used them to make investments, have all reported that the scheme has been for the most part effective and helpful.

The changes made two years ago, particularly the introduction of SEIS, have been positive in their impact and have begun to help tackling the funding gap that exists for early-stage companies. The higher thresholds on employee numbers and total investment that were introduced in 2012 have also been beneficial, making the schemes apply to a broader range of companies whilst still remaining well-targeted.

However, there are still examples where the move from SEIS to EIS has proved difficult. It is also clear there is still appetite to invest more in many companies, in a way that additional support would unlock.

Even in the two years since the introduction of SEIS, the impact that can be had from £150,000 of investment has reduced. Companies, including games companies, typically seek this money to allow them to prove their product or test their market in a narrow way, before looking for further funding to build the full product and scale their business. However, the money that can be secured under SEIS no longer suffices for many companies' needs. To quote a games developer who has been through the scheme:

> "£150K doesn't buy you what it used to when the limit was set. It's simply not enough to really make anything with or prove anything. The SEIS cap limits the amount that certain funds and high net worth individuals are willing to invest, and companies then really struggle to get early momentum or realize their potential as they are too cash constrained to prove what they need to. Raising the cap will free up much needed funding that will allow more interesting and potentially very successful companies to survive the tough early days intact and then scale rather than sell out too early or fold, due to a lack of funding, not a lack of long term opportunity."

We believe that the government should build on the success of the schemes so far by going further, particularly in relation to SEIS. The thresholds for the amounts that companies can receive, and the amounts that individuals can invest, should be increased for both SEIS and EIS.

In particular, we recommend that the company investment threshold for SEIS be raised to £500,000 per year, or at the very least to £250,000 a year.

Awareness of the schemes

A lack of awareness amongst the games industry that these schemes exist is another significant problem. This is mirrored by a lack of awareness and understanding amongst the investment community of the potential of the games industry in the UK.

A lot of work is already underway to tackle these problems. In particular, Ukie are collaborating with Nesta on a project to create a living map of the UK games industry, which will be an incredible asset in improving investor understanding and confidence in our industry. We expect to the see the first results of that work in the coming weeks.

Ukie ourselves also offer a range of guides to members and non-members, explaining the different programmes and reliefs that exist to help them get access to finance.

However, more always needs to be done.

Although we cannot comment on the awareness amongst other creative and tech industries of these schemes, we believe it is likely that there will be a similar problem elsewhere. Now that SEIS has been in place, and EIS in its new form, for two years, and both have proved to be effective, the time is right not only to push them further, but also to put in place a substantial promotional campaign about the benefits of the schemes, targeted both at companies and at potential investors.

Other potential changes to the schemes

Several questions are asked in the consultation document about potential changes to the schemes, including the impact of the recent changes to European state aid rules. Rather than go through these in detail, we would state the schemes as currently designed appear to be functioning reasonably well for our industry, where they have been used, and we see no reason or potential benefit in changing their structure significantly.

However, some games companies have encountered a problem with an inability to correct mistakes in the drafting of the investment agreement, due to an inconsistency between standard company law and the rules of the EIS system.

This is set out in more detail in the case study in Appendix A. In summary, where a mistake has been made causing shares to not be EIS compliant, when it was intended that they would be, this has not been possible to correct retrospectively despite the agreement of all parties to do so.

There is an inconsistency between the EIS rules and pre-existing law, which should be corrected. This will have to be done in a way, of course, which is not open to abuse. As in the case study below, it should only be possible to make this change where there is clear proof, and agreement from all sides, that the investment was intended to qualify for SEIS/EIS from the beginning, and only failed to be compliant due to drafting errors. It must remain impossible to retrospectively change agreements to qualify for EIS/SEIS if they were not originally intended as such.

Intangible Assets

The consultation document raises the issue of trades exploiting intangible assets, such as intellectual property, and whether they are able to take advantage of these schemes.

As stated above, there are a growing number of games companies who have secured investment through SEIS, EIS or VCTs. All these companies have business models which depend largely on the exploitation of intangible assets. As such, this specific concern has not arisen in our industry.

However, there is a broader related concern: the lack of understanding amongst investors of the nature and value of IP. This was set out in detail in Create UK, the strategy published recently by the Creative Industries Council.[6]

Create UK called for the development of a toolkit to make it easier for investors and businesses to measure the value of IP assets and to more easily compare creative content investment opportunities. A working group is already underway to pursue that recommendation, which must be fully supported by government.

Conclusion

In conclusion, the limited experience of the games industry so far with these tax-advantaged venture capital schemes has been a positive one. This success should be built on, with each of the schemes, and particularly SEIS, having their thresholds expanded.

Another key problem that remains is poor awareness of these schemes, as part of the broader range of options for securing investment. Ukie continue to work hard to help games companies understand and use all those options. Further investment by government in raising awareness of these schemes would likely have a positive impact.

[6] http://www.thecreativeindustries.co.uk/media/243587/cic_report_final-hi-res-.pdf

Appendix A: Problem with Rectification of Errors – statement from games studio

Essentially the problem was that on our second EIS funding round, special rights for EIS holders were accidentally included in our Company Articles which gave them some upside in the event of a winding up of the company (basically, they would benefit from the sale of our assets before other shareholders do).

Note that when you do a funding round, often there are previous rounds in existence where the shareholder's rights have to be ring-fenced to keep them EIS compliant in the future. There will also be multiple classes of new shares issued, some of which will be EIS complaint (such as for Angel investors) and some of which will not be EIS complaint (such as for VC investors) so the whole investment agreement becomes extremely complex to draft. Mistakes are very common, and very easy to overlook, particularly if no legal body is representing the Angel Investors (this is very common, as their investment size of say £50 - £100k is not big enough to merit legal representation).

My understanding is that lots of applications trip up on the Articles/Investment Agreement and then find that they cannot correct the issue after the EIS Shares have been issued.

So for us, after we issued the shares, it turned out they were not EIS compliant despite everyone's good intentions; so we appealed to HMRC to allow us to make them EIS complaint.

In Company Law, our error can be reversed by way of changing the articles and investment agreement retrospectively as long as there was always agreement between the stakeholders for the shares to be EIS friendly -- which there was in our case.

However, in EIS Law, such a retrospective change has no impact because at some stage, in real life, the shares did have those protective provisions. So *even though* the Company Articles could physically be changed and retrospectively applied under Company Law, EIS Law supersedes it and prevents these changes from having any impact at all.

So in a nutshell, if a Startup makes a mistake on EIS provisions they can never fix the problem even if they can prove it was only a technical mistake and rectify it in every other sense.

So in conclusion, I would like HMRC to bring EIS into line with Company Law, so that if mistakes are made that can be rectified lawfully, they are in fact rectified. This will bring the scheme into alignment with its own goals, to encourage investment and growth, and avoid upsetting new investors and forcing businesses to pay over-the-odds for expensive legal input on Articles and Investment Agreements.

NB: the full HMRC case report on this issue can be provided if required.