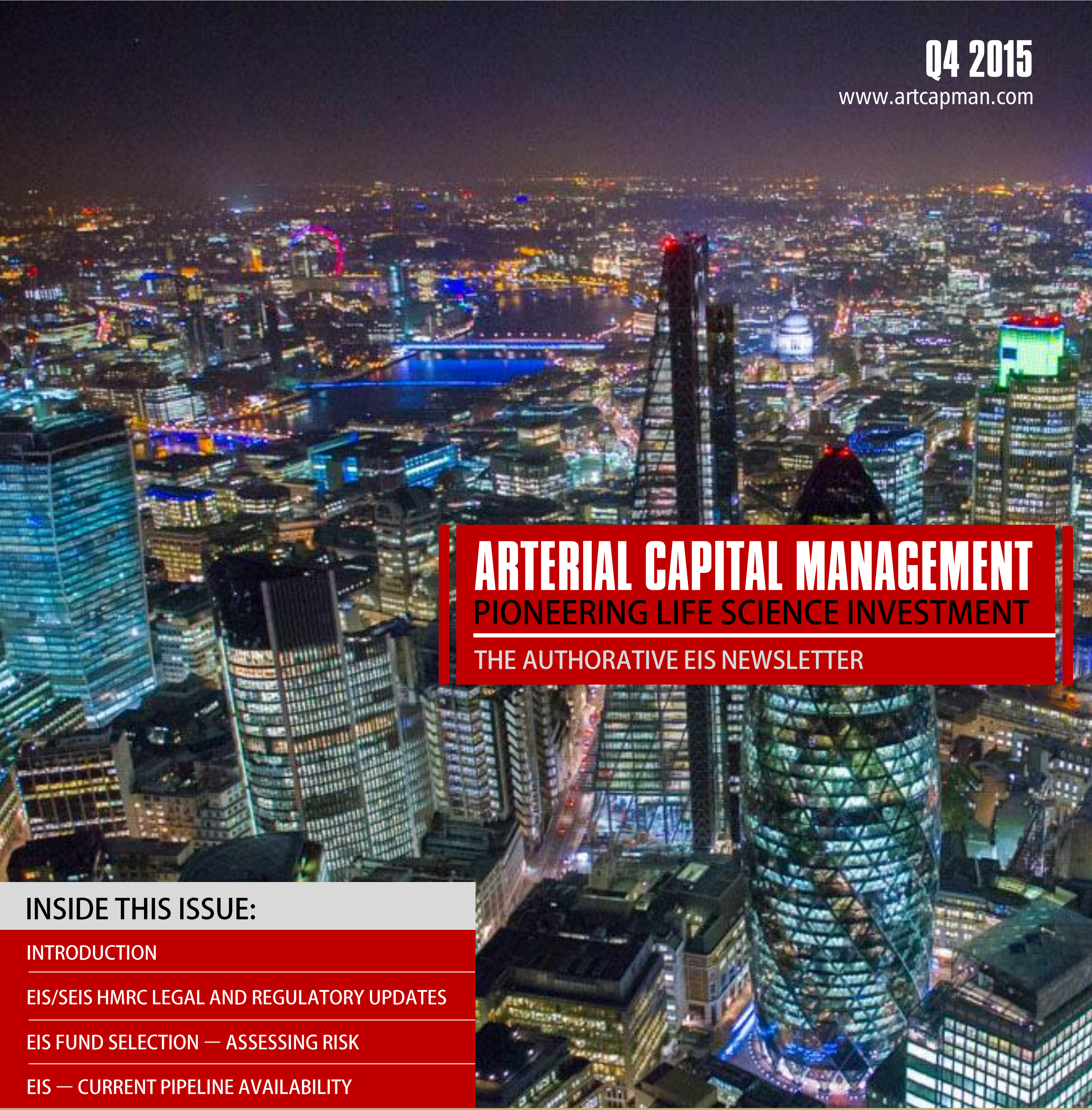

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ARTERIAL CAPITAL MANAGEMENT

PIONEERING LIFE SCIENCE INVESTMENT

THE AUTHORATIVE EIS NEWSLETTER

INSIDE THIS ISSUE:

Investors and their advisors must be prepared that some investments could fail. Arterial is only available through professional advisers for HNW, sophisticated investors who genuinely understand and accept risk. Investors should only invest money they do not need access to, and which they can afford to lose. No investment may be entered into, neither in part nor in whole on the basis of this newsletter. This newsletter not an offer nor an invitation to subscribe. Arterial does not provide or imply investment advice.

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Introduction

Welcome to our latest EIS Newsletter.

This month's edition contains a number of useful regulatory and legal articles for professional advisers, including a summary of two recent EIS appeals heard before the First - tier Tribunal, and commentary from the CIOT regarding the proposed legislative and drafting changes to EIS.

We are pleased to announce that our website has been upgraded with an enhanced EIS portal containing details of our EIS pipeline, transparency on fees and importantly, a testimonials page. Testimonials are published from a wide range of leading FCA firms, professional counterparties, investees and investors, all of whom have dealt with Arterial. Don't just take our word for it as they say, but consider the views of those firms who are familiar with Arterial. No doubt a number of these testimonials will be from firms known to you.

Following the recent fall in value of the Octopus fund, a number of advisers will be giving some thought as to how they assess risk. Our regular feature, The Alternative Approach, will raise a few eyebrows amongst anyone who thought EIS funds were a low risk option. It is a must read for all compliance officers or indeed anyone recommending funds to retail clients as a lower risk entry to the EIS market.

Arterial continue to expand, moving to significantly larger offices in Guernsey and with several new hires strengthening our team. Max Hilton and David Evans, widely respected across the transatlantic investment management community recently joined our Guernsey Executive Board and in London, Patricia Reynolds has joined our European origination team. Patricia is already well-known amongst the UK's leading professional advisers and at Arterial she will focus on European private banks and family offices. Our scientific and investee teams have been strengthened with international appointments from Novartis, ICI and Merck. Also of particular note and pride for Arterial, Dr Ravindhi Murphy, a co-founder of Arterial, has been appointed to the Board of Trustees for the Institute of Cancer Research as a result of her pioneering cancer research at the Royal Marsden Hospital.

The coming EIS season will be an exciting time for professional advisers, but it will be a period that will invariably witness an enhanced focus on asset selection, corporate governance and underlying due diligence. We are absolutely convinced that our high standards are ideally positioned to capitalise upon what will be the next chapter in an ever-evolving regulatory market.

We are proud of the Arterial team and their achievements over the past three years, proud of what our counterparties and investors say about us and proud of the way in which our EIS platforms have the potential to change the lives of hundreds of millions of people around the world. Should you wish to discuss our EIS pipeline or speak with any member of the team, do let us know.

Yours sincerely,

Arterial Capital Management

ARTERIAL CAPITAL MANAGEMENT

EIS/SEIS HMRC Legal and Regulatory Updates

ROBERT AMES - FIRST-TIER TRIBUNAL

Robert Ames was a skydiver, who with some colleagues, established the UK's first indoor skydiving simulator which became known as AirKix.

On 27 January 2005, Mr Ames subscribed £50,000 and around a year later AirKix issued an EIS3 form confirming that the shares qualified for EIS relief.

However, Mr Ames was unable to take advantage of any tax relief as in the relevant year his taxable income was just under £50, obviously well below his personal allowance. Therefore, he was unable to claim any income tax relief on the £50,000 subscription.

In June 2011 he sold the shares at a profit believing there was no capital gains tax on the disposal. However, HMRC begged to differ and opened an enquiry, amending his return to include the gain on the basis that the capital gains tax exemption was available only if enterprise investment scheme relief had been claimed (TCGA 1992, s 150A).

Mr Ames therefore made a late claim for EIS relief which HMRC refused. He appealed, on the basis that the legislation exempted an individual from capital gains tax on disposal, despite having insufficient tax to use all of the enterprise investment scheme relief.

The First-tier Tribunal said it could not "rectify the terms of highly prescriptive legislation in order to include provisions which might have been included but were not actually there". There had to be a claim and the individual's income tax had to be reduced as a result. The taxpayer's appeal was dismissed.

This case has been widely reported and this is a mere summary. However, the case demonstrates the complexity of the EIS legislation, and also that HMRC will look closely at all claims. Individuals who have invested in EIS shares must claim income tax relief even if it does not benefit their tax position.

EAST ALLENHEADS ESTATE - FIRST-TIER TRIBUNAL

East Allenheads Estate Limited ran a grouse moor with a sole shareholder, the well-known hedge fund manager Jeremy Herrmann. Mr Herrmann subscribed for £6.5m of shares in the company and claimed EIS deferral relief. A large proportion of the £6.5m was used to improve the hall and on expensive art and antiques, including a £2.8m painting by the Belgian surrealist artist - Rene Magritte, which was claimed to the tribunal to be in order to attract top quality clients.

Mr Herrmann had already owned the estate prior to establishing the company which acquired the moor. However, Mr Herrmann retained the hall which was used to provide accommodation for guests.

HMRC argued that the relationship between the company and Mr Herrmann regarding the use of the hall were unclear with a number of conflicting explanations. The result being that HMRC took the view that the expenditure was broadly for the benefit of Mr Herrmann, who was known to be a keen shot. Interestingly the topic of motive raised its head once again and HMRC further felt that the investment was motivated by a desire to defer other capital gains above any commercial objectives of the company. HMRC also commented on the unusually large size of the EIS investment and that it was made just days before the investment limit was reduced to £2m.

The tribunal found that the purposes of conferring personal benefits on Mr Herrmann and of making investments in valuable art and antiques could not be regarded as incidental and that as a result EIS deferral relief would not be permitted. The tribunal also pointed out that the company had made losses for a number of years. Furthermore, the tribunal concluded that the requirement that the company must spend at least 80% of the money raised for the purpose of carrying on its trade within 12 months, and the balance of the money raised within a further 12 months for the same purpose, will not be met if at least some of the money was not spent for such purposes (paragraph 1(2)(g) and (h)).

The appeal was dismissed and EIS deferral relief held not to be available in respect of the share subscription.

In summary, East Allenheads Estate shows the importance of ensuring that a company is not tainted by other activities.

UNINTENDED CONSEQUENCES OF FA2015 EIS CHANGES

Professional advisers will already be familiar with the changes to EIS and SEIS announced in the Budget.

However, The Chartered Institute of Taxation (CIOT) has publicly raised concerns that legislation could have unintended consequences, drawing attention to three key points. Firstly, that all EIS investors are independent from the company at the time of the first share issue (excluding founder shares); secondly, changing the cap on total EIS/VCT investment so an individual company can receive up to £15m, or up to £20m for 'knowledge-intensive' companies; and thirdly, and of most concern, that all investments are made for the purpose of 'business growth and development'.

The proposed measures include the expectation that potential investors are 'independent' from the company at the time that their first share was issued which would deny relief where a prospective investor already holds shares in the company. The CIOT believe a carve out for existing shares obtained from personal relationships and a de minimis threshold would be beneficial.

Secondly, whilst we have all welcomed the increase in the overall investment cap to £20m, there appears to be puzzlement at why the increased threshold is being restricted to 'knowledge intensive' companies. The CIOT ask why a growing manufacturing company , for example, should have a £15m cap while a 'knowledge intensive' IT company might qualify for a £20m cap when both could bring benefits to the overall economy. Advice received by Arterial is that unless stated otherwise, all of our investments are 'knowledge intensive'.

Thirdly, and of most concern, is the new requirement that all investments under EIS are made for the purposes of promoting 'business growth and development'. The definition is at best vague and leaves investors, investees and professional advisers unclear as to what the new restriction is aimed at.

In summary, early stage investment remains fragile across the UK and whilst investors are not motivated by the tax reliefs, they are discouraged by uncertainty. We would hope that the coming months will see more clarity of these recent proposals.

OPERATIONAL vs INVESTMENT RISK

ENTERPRISE INVESTMENT SCHEME SELECTION

A thought provoking paper

THE ALTERNATIVE APPROACH

In a common quest for lower risk EIS investments via diversified funds, we ask whether advisers are on the brink of yet another scandal.

The five core tenets of high-quality investment choice are due diligence, selection, governance, business planning and execution. The ability for an investment to deliver on all five tenets will always outweigh the merit of diversification into an EIS fund which holds multiple underlying businesses that lack some or all of those five attributes.

If we consider those core tenets in the future, will advisers avoid the next set of failures in the wake of Arch Cru, Key Data, Harlequin or an onslaught of APNs? Successfully managing risk is the key to success for your clients, and crucially, it is the bedrock of managing the corporate success of your business.

On a technical level, risk may be defined as the probability of a negative event occurring multiplied by the financial loss per event.

Investment risk is quantitative. Bookshelves are full, with authors claiming an edge over their peers. Conversely, operational risk is qualitative. Interestingly, that library bookshelf is rather bare, because whilst Nobel laureates are created by hypothesising about investment risk, at the mention of the words due diligence, the library falls a little more silent. Then again, recent financial history suggests a limited readership demand for books on due diligence.

To take an example in its simplest form, an EIS fund raises, say, £20 million, with a promise to both advisers and their clients of diversification and intrinsically lower risk. But spare a moment to consider what happens to that money. EIS promoters are often rewarded primarily for what they raise rather than the returns they deliver to investors. That is a fairly low starting point when one considers that having raised as much money as possible, the appointed manager now has to invest that money in a given timeframe. Pity the poor EIS fund manager who has received £20m, invested £14m and still has £6m remaining with only a month in which to invest it. This is a month in which his investors will lose some or all of their tax relief and the EIS fund manager will see his switchboard jam with irate IFAs. Now what was that old adage about tax tails wagging investment dogs?

Rather worryingly, these investment timeline pressures are largely centric to the EIS fund market by virtue of poor parliamentary drafting. This is in a way not inherent to other managed funds. Nonetheless, despite this flawed starting point, evidence from the past five years suggests a wildebeest-like migration to collective funds by PI insurers who give their policyholders little choice but to tag along.

Taking a look at specific diversified fund failures, the past five years witnessed the collapse of Arch Cru. Was that failure due to quantitive investment risk? Or was it a qualitative failure/ absence of governance, business planning and execution?

Perhaps if you prefer ‘safe-as-houses’ real estate over wine, what about the rather large, diversified, low risk European property fund that failed to verify numerous statements concerning ownership, which left investors nursing significant losses? Qualitative failure or a simple lack of due diligence and corporate governance?

Then there are countless diversified projects where valuations have been carried out by firms without the necessary experience, and then those valuations are challenged by HMRC. Is that really a poor valuation, or is it poor corporate governance and execution that permitted that valuation firm to be appointed in the first instance?

“Ah” you cry, but “those weren’t EIS funds”, “EIS funds are different”. Really? Only a few weeks ago a well-supported EIS fund from Octopus was reported to have lost approaching half of its value. Poor-quality investments are being blamed and numerous internet blogs are screaming shock horror: "how could this happen to a diversified fund?", with the finger being pointed at investment risk. However, perhaps we should assess this differently. A theoretical argument could counter-claim that this is not investment risk per se. Perhaps the real question that should be asked is not whether the underlying assets were simply a bad investment, but instead, whether the failure was due to one or more of the five core tenets. If so, could or will that be repeated again in another lower risk, diversified fund? And if so, it will be interesting to see the stance taken by both the PI insurers and the regulator as to how much responsibility rests with the adviser's selection.

Now, if you feel this is in the past, let's bring ourselves right up to the present day. In fact, let's think about what you may recommend at your meeting later today. Currently, some advisers are actively promoting a number of diversified, lower risk EIS funds where some of the underlying portfolio selections have a commonality of ownership or financial interests. So, are those funds really diversified or are there intrinsic risks for asset selection, due diligence, governance, business planning and execution? Should those specific funds fail to meet expectations, will investors demand to know why the ownership structure wasn't more transparent in the same way they did following the Key Data scandal when the ownership conflicts started to unravel?

Of course, professional advisers need a reliable method in which to assess those opportunities. Interestingly, the current approach to EIS research is perhaps the next ticking time bomb, due to a potential lack of independence and an utterly outdated, outmoded, unsustainable, fee charging model.

In the current environment it isn't enough to just ask a third party to review an investment if that research firm doesn't have the experience to do so. For example, how big is the research firm? Does their team include international IP lawyers, research analysts, scientists, real estate experts and commercial lawyers? It is rather strange that a project that can take 6-12 months to be independently reviewed by perhaps a team of over 30 people can be assessed by an "expert" in a matter of hours with that reviewer having, little if indeed any, experience of real investments. Yet that is still how absolution is granted by some research firms.

But the loudest tick is not from the quality of EIS research but in the way such independent research is currently obtained. An investment bank has huge restrictions as to how they conduct investment research. In fact, the prehistoric approach of charging (albeit indirectly) both the investee for a positive review and also charging the prospective investor for that research within a bulletin, or selectively choosing not to publish some negative information, has resulted in eye-watering front page fines from the US regulators on the basis of a fundamental conflict of interest. The US Sarbanes Oxley Act has been with us all since 2002, and so why has the spirit of independent, authoritative research been completely ignored by some sectors of EIS research for the past thirteen years?

Despite the repeated evidence of the past five years, some advisers still cry that their investors don't have an appetite for investment risk. Actually, many or even most good clients are quite happy with investment risk as long as they can clearly understand that risk. But they won't tolerate operational and due diligence failings, which is why it is crucial to distinguish between the quantitative and qualitative risk. On the assumption that the EIS recommendation fitted the needs of the client, an investment loss will be borne in a sanguine manner by a philosophical client who understands risk-reward, whereas operational failings will lose the client and in the modern era, generate a lawsuit.

In summary, a diversified EIS fund is not a panacea to risk management or absolution of responsibility. Furthermore, if using third party research, it is essential that the research firm has the breadth and depth of expertise to complete the research robustly, independently and in a way to help to protect the adviser from potential future investor claims. The dust has settled on RDR, and given time, it will settle on APNs too. A well-managed, diversified EIS fund is great for some investors, but not all funds and not all investors. Don't just Know Your Client, but Know Your Investment and Know Your Research Firm too.

EIS – Current Pipeline Availability

The Arterial EIS platform is only available for HNW and Sophisticated Investors as defined in s.48(2), 50 and 50(A) respectively of the FSMA 2000 (Financial Promotions) Order 2005 through FCA (or equivalent) regulated professional advisers. Arterial is only able to work with such regulated professional advisers and do not deal with nor advise private investors under any circumstances whatsoever.

GLUCOSE MONITOR FOR DIABETICS

A world-first, real time, non-invasive, hand-held / wearable device to measure blood glucose with a potential market of nearly 400m diabetics. The device has already been subject to two trials; one at a leading UK hospital as part of a Research Ethics Committee trial, and a larger volunteer study on both diabetic and non-diabetic volunteers. The business benefits from a world-class management team including one director who has returned $550m to shareholders from 3 life science start-ups. Every member of the executive team have a proven track record of leading and delivering multi-billion pound projects to shareholders. Investment of £14.5m, projected exit £500m. **Limited capacity remaining.**

MEDICAL SHARPS BOX

A revolutionary new design for a battery powered sharps box. Needles are instantly heated to 1200 degrees, at which point they drop as waste metal into a lower chamber, thereby meeting a global demand to avoid finger prick injuries for medical staff reducing exposure to viruses such as Hepatitis B and HIV. An added advantage is that the cost of disposal is significantly reduced as the high temperature destroys all human blood and tissue, making this a cost effective proposition. Investment of £9.6m, substantial projected exit. **Limited capacity remaining.**

SMART PAD ECG MACHINE

A world-first, hand-held, fully remote ECG pad which is held against the patient's chest without the need to undress. ECG results are delivered onto a smart screen with the functionality to instantly download the results to hospital records or to email the chart to healthcare professionals for further analysis and interpretation. Investment of £8.2m, substantial projected exit.

FILTRATION SYSTEM

Revolutionary new filtration system for both liquids and air against pathogens. The result of nearly two decades of research, backed by a world leading university with proven and exciting data sets. This project has the potential to herald a new era for everything from blood transfusion to office air conditioning, with efficacy many times more effective than contemporary thinking. Due diligence has taken approaching one year at Cambridge. World class management team with clear commercial objectives to take the project to market. Investment c. £20m, very substantial exit if successful.

Investors and their advisors must be prepared that some investments could fail. Arterial is only available through professional advisers for HNW, sophisticated investors who genuinely understand and accept risk. Investors should only invest money they do not need access to, and which they can afford to lose. No investment may be entered into, neither in part nor in whole on the basis of this newsletter. This newsletter not an offer nor an invitation to subscribe. Arterial does not provide or imply investment advice.

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