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United Kingdom
VENTURE CAPITAL

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This country-specific Q&A provides an overview of venture capital laws and regulations applicable in United Kingdom.

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UNITED KINGDOM
VENTURE CAPITAL

1. Are there specific legal requirements or preferences regarding the choice of entity and/or equity structure for early-stage businesses that are seeking venture capital funding in the jurisdiction?

There are no specific legal requirements mandating the choice of entity or equity structure. However, private companies limited by shares (Ltd) are commonly preferred due to their ease of incorporation, limited liability for shareholders, flexibility, tax efficiency, and alignment with investor expectations. Additionally, this structure allows for the issue of different classes of shares, such as ordinary shares and preferred shares. Preferred shares are typically favoured by venture capital investors as they offer preferential rights, such as priority in liquidation and dividend preferences.

Certain businesses, such as not-for-profits, charities, or social enterprises, might utilise different vehicle types, such as community interest companies (CICs), but this is not typical in the venture capital landscape.

2. What are the principal legal documents for a venture capital equity investment in the jurisdiction and are any of them publicly filed or otherwise available to the public?

The principal legal documents for a venture capital equity investment in the UK typically include the following:

- **Term Sheet**: This essentially non-binding document outlines the proposed key terms and conditions of the investment.
- **Subscription Agreement**: This legally binding agreement formalises the terms and conditions of the investment, including price to be paid for and the number of shares issued, warranties relating to the shares and the investee company (typically given by the investee company and possibly the founders), conditions precedent and closing mechanics.
- **Disclosure Letter:** This letter is prepared by the person(s) giving the warranties in the Subscription Agreement to identify and make known ("disclose") to the investor any exceptions to, or facts or events which may be inconsistent with, those warranties in order to avoid a breach of warranty.
- **Shareholders' Agreement**: This legally binding agreement governs the relationship between the shareholders and the investee company, addressing matters such as board composition, information rights, consent matters, undertakings, restrictive covenants and confidentiality.
- **Articles of Association**: This constitutional document regulates the internal affairs of and sets out the rules and regulations governing the investee company. They are designed to create binding obligations on the investee company and its shareholders, including matters related to share rights (including voting, dividends, liquidation preferences, pre-emption on share issues and transfers, compulsory and permitted transfers and drag, tag and co-sale), shareholder meetings, director meetings and powers, and decision-making procedures.

The Articles of Association must be publicly filed at Companies House as well various share issue documents such as the form SH01 (Return of Allotment of Shares) and shareholder resolution to authorise the share issue. The Subscription Agreement and Shareholders' Agreement are not typically publicly filed and are therefore used for any confidential terms.

3. Is there a venture capital industry body in the jurisdiction and, if so, does it provide template investment documents?

If so, how common is it to deviate from such templates and does this evolve as companies move from seed to larger rounds?

The British Private Equity & Venture Capital Association (BVCA) is the industry body and public policy advocate for the industry in the UK. It serves as a valuable resource for venture capital investors and startups, providing guidance, best practice and template documents including a term sheet, subscription agreement, shareholders' agreement, and articles of association, which are primarily designed for a Series A stage of investment but can be adapted for earlier or later stages.

While these template documents offer a standardised framework for negotiations, it is common for parties to deviate from them to accommodate specific deal dynamics and investor preferences. This deviation often evolves as companies progress from seed to larger rounds, with later-stage investments typically involving more complex negotiations and customised terms. However, industry-standard practices and legal norms established by organisations like the BVCA continue to inform and influence the negotiation process across all stages of venture capital financing.

4. Are there any regulatory frameworks in respect of companies offering shares for sale that need to be considered, for example any restrictions on selling and/or promoting the sale of shares to the general public?

Companies offering shares for sale in the UK must adhere to regulations set by the Financial Conduct Authority (FCA) and legislation such as the Financial Services and Markets Act 2000 (FSMA).

Under FSMA, offering shares to the general public involves various regulatory requirements to ensure investor protection and market integrity, such as the requirement to produce a prospectus. However, FSMA provides exemptions from these requirements in certain circumstances which are often utilised in venture capital transactions, such as offers targeted at investors who meet specific criteria, such as professional investors or high-net-worth individuals.

5. Are there any general merger control, anti-trust/competition and/or foreign direct investment regimes applicable to venture capital investments in the jurisdiction?

Venture capital investments in the UK may trigger scrutiny under merger control and antitrust laws, especially if they involve significant acquisitions or mergers that could potentially reduce competition in the market. The Competition and Markets Authority (CMA) is responsible for enforcing these laws and has the authority to investigate mergers that may harm competition.

Additionally, the UK government has established foreign direct investment (FDI) regimes to safeguard national security interests, including the National Security and Investment Act 2021 (NSIA). Under the NSIA, certain investments (particularly those in which the level of control acquired meets or exceeds certain thresholds and tests) in 17 sensitive sectors such as defence, critical infrastructure, and advanced technology, may be subject to government review and approval.

6. What are the prevailing tax incentives or structures offered to venture capital investors in the jurisdiction, if any?

The UK government offers several tax incentives to encourage investment in startups and early-stage companies including:

- The Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) are two prominent schemes that provide tax relief for unconnected individuals investing in early-stage qualifying businesses. Under EIS, investors can benefit from income tax relief, capital gains tax relief, and inheritance tax relief on qualifying investments. SEIS offers even greater tax incentives for investments in very early-stage startups. These schemes play a significant role in attracting investment capital to the venture capital ecosystem.
- A Venture Capital Trust (VCT) is a type of investment company listed on the London Stock Exchange that pools investors' funds to invest in a diversified portfolio of mostly small, young and entrepreneurial companies in a wide variety of sectors. Investors in VCTs can benefit from tax incentives, including income tax relief on investments, tax-free dividends, and exemption from capital gains tax on profits. VCTs offer opportunities to support small businesses while providing potentially attractive returns, although they are high-risk investments and subject to

specific regulatory requirements.

7. What is the process, and internal approvals needed, for a company issuing shares to investors in the jurisdiction and are there any related taxes or notary (or other fees) payable?

In the UK, the process for allotting and issuing new shares to investors involves several steps:

- **Shareholder Approval**: Depending on the company's articles of association and capital structure, existing shareholders may need to approve the issue of new shares and waive statutory pre-emption rights (or bespoke pre-emption rights contained in the articles), which would otherwise give existing shareholders the right to subscribe for new shares on a pro-rata basis before they are offered to external investors.
- **Board Approval:** Subject to obtaining any necessary shareholder approvals, the decision to allot and issue new shares will need to be approved by the board of directors of the company.
- **Documentation**: Legal documentation, such as board and shareholder resolutions, allotment letters, share certificates, and subscription agreements, will need to be prepared.
- **Filing and Taxes**: Once all approvals are obtained, the shares are allotted to investors upon receipt of payment for the shares. Share certificates are then issued and the statutory registers of the Company are updated. The form SH01 and any shareholder resolutions must be filed at Companies House. Tax and Notary fees are not generally applicable.

8. How prevalent is participation from investors that are not venture capital funds, including angel investors, family offices, high net worth individuals, and corporate venture capital?

The UK startup ecosystem benefits from diverse sources of funding beyond traditional venture capital firms. Angel investors, family offices, high net worth individuals, corporate venture capital, incubators and accelerators all play crucial roles in providing early-stage capital and strategic support to startups, often encouraged by the tax-efficient SEIS/ EIS schemes (see above).

Angel investors, incubators and accelerators, in particular, provide (or help secure) seed funding and mentorship to early-stage ventures, while family offices and high net worth individuals may offer larger investment amounts and industry expertise. Corporate venture capital arms of established companies also contribute to the ecosystem by providing funding, access to resources, and potential strategic partnerships.

9. What is the typical investment period for a venture capital fund in the jurisdiction?

In the UK, the timeframe for a VC investor to realise an exit from the time of investment can vary significantly depending on various factors, including the stage of the company, industry dynamics, market conditions, and the chosen exit strategy. Generally, VC investors typically expect exits to occur within 3 to 7 years from the time of investment, although this timeline can vary widely.

10. What are the key investment terms which a venture investor looks for in the jurisdiction including representations and warranties, class of share, board representation (and observers), voting and other control rights, redemption rights, anti-dilution protection and information rights?

Deal terms can vary widely depending on the negotiation leverage/strength of the parties, the stage of the company, and the macro-economic conditions at the time. Below are some key investment terms that venture capital investors commonly consider:

- **Class of Shares**: Investors often receive preferred or preference shares, which come with certain rights and preferences over ordinary shares. The specific terms of these shares, such as liquidation preferences and conversion rights, are important for investors.
- **Board Representation**: Investors often seek the right to appoint members to the company's board of directors. In some cases, investors may also have the right to appoint non-voting observers.
- **Warranties**: These are statements made by the company and/or founders to the investors about the current state of the business of the investee company, ranging from accounting practices to intellectual property, employment and tax. Warranties focus the minds of the

founders and management on disclosing anything to the investor that might be inconsistent with the warranties enabling the investor to make an informed decision about making its investment.
- **Voting and Control Rights**: Investors may receive certain voting or consent rights on significant company decisions. These are typically known as 'reserved matters' and require an investor majority (with the composition of such majority to be tailored for the relevant investment rounds) consent to certain company decisions, ranging from future fundraisings, adoption of share option pans, dividend payments, acquisitions and disposals (including a trade sale or an initial public offering), incurring debt and amendments to the company's articles of association.
- **Anti-Dilution Protection**: Designed to protect investors from dilution of their ownership stake (and the value of that ownership stake) in a subsequent financing round at a valuation that is lower than the valuation at which that specific investor subscribed for shares (commonly known as a down round). Investors with anti-dilution protection will typically be issued bonus shares to protect the value of their investment. There are various formulas for anti-dilution adjustments, such as full ratchet or weighted average.
- **Information Rights**: Investors typically negotiate to receive regular financial and operational reports. This ensures transparency and helps investors monitor the company's performance.

11. How common are arrangement/ monitoring fees for investors in the jurisdiction?

There is no standard or fixed industry-wide practice with regard to arrangement/ monitoring fees although they are not common practice on venture transactions. The prevalence of such fees depend on the specifics of the deal, the nature of the investor and the stage of investment.

12. Are founders and senior management typically subject to restrictive covenants following ceasing to be an employee and/or shareholder and, if so, what is their general scope and duration?

Restrictive covenants that apply to founders and/or senior management are very common in the UK. These provisions are typically found in the individual's employment agreement with the company (enforceable against the founder in their capacity as an employee) as well as the shareholders' agreement (enforceable against the founder in their capacity as a shareholder). Non-compete clauses prevent the departing founder from working for a competitor or starting a competing business within a certain geographic area for a specified period. Non-solicitation clauses prohibit the founder from soliciting the company's clients, customers, or employees for a specified period. The duration of restrictive covenants in shareholders' agreements and employment agreements can vary but is typically limited to a reasonable timeframe. Courts in the UK generally consider restrictions lasting more than 12 months as potentially unreasonable, but this can depend on the specific circumstances. The UK government has however recently stated that it intends, when parliamentary time allows, to limit the length of non-compete clauses (in employment agreements only) to 3 months, providing employees with more flexibility to join a competitor, or start up a rival business after they have left a position.

13. How are employees typically incentivised in venture capital backed companies (e.g. share options or other equity-based incentives)?

Employees are typically incentivised through compensation structures that align their interests with the success and growth of the company. The most common examples we see are:

- **Equity**: founders or key employees often hold shares which 'reverse vest' to incentivise them to remain with the company for a certain period. Unlike traditional vesting, where shares gradually become owned by an individual over time, reverse vesting involves the potential forfeiture (or the conversion into worthless deferred shares) of already owned shares if certain conditions are not met (including remaining employed throughout the vesting period).
- **Share Options**: a common form of equity-based compensation whereby employees are granted the right to purchase company shares at a predetermined price, allowing them to benefit from the company's future growth if the share price increases beyond that price. Enterprise Management Incentive (EMI)

Schemes are the ‘gold standard’ tax-advantageous share option plans available to UK-based companies and their UK-based employees. They offer employees very advantageous tax benefits, if certain conditions are met.
- **Share Incentive Plans (SIPs):** SIPs allow companies to provide shares to employees as part of a tax-advantaged plan. Employees may acquire shares in the company, which are then held in an employee benefit trust. SIPs are more suitable to larger companies and less common than other incentive methods on the basis that they are typically more expensive to set up and maintain.

14. What are the most commonly used vesting/good and bad leaver provisions that apply to founders/ senior management in venture capital backed companies?

Vesting and good/bad leaver provisions address scenarios where individuals leave the company. Distinguishing between “good leavers” and “bad leavers” determines how an individual’s shareholdings are dealt with upon their departure. Leaver provisions are at the heart of a founder’s personal equity value and are therefore often strongly negotiated by the parties. Below are the most common iterations of these provisions found in the UK:

Vesting:

- Time-Based Vesting: Shares vest over a specified period, typically three to four years, with a one-year cliff. This means that no shares vest until the first anniversary of the investment or commencement of employment, after which a portion then vests monthly, quarterly or annually.
- Accelerated vesting: Acceleration provisions may be triggered in specific events, such as a change of control or acquisition (a share or asset sale). This allows accelerated vesting of some or all of a founder or employees unvested equity.

Leaver Provisions:

- Bad Leaver: Individuals who leave under unfavourable circumstances, such as termination for cause (gross misconduct, dishonesty, conviction of a criminal offence etc.) or voluntary resignation without good reason, may be classified as “bad leavers.” Bad leavers typically forfeit their vested and unvested shares altogether.
- Good Leaver: If an individual is deemed a “good leaver” due to circumstances like resignation for health reasons, retirement, or as a result of constructive dismissal, they may be entitled to retain (or sell) their vested equity, a portion of their unvested equity or have accelerated vesting. The definition of “Good Leaver” is typically phrased as a leaver who is not a Bad Leaver.
- Clawback Provisions: Clawback provisions allow a company to reclaim shares from a good leaver under certain circumstances, such as the discovery of misconduct or violation of post-departure non-compete restrictive covenants.

15. What have been the main areas of negotiation between investors, founders, and the company in the investment documentation, over the last 24 months?

The main areas of negotiation include the following, some of which have been driven by investor caution around uncertain economic trends and the need to focus on safeguarding investment returns:

- **Liquidation Preferences**: The terms of liquidation preferences, which determine the order in which proceeds are distributed in the event of a liquidation or exit, are strongly negotiated. The most common position remains 1x non-participating liquidation preference (meaning the holders of the preferred shares can either be repaid their investment first, ahead of any payment to the holders of ordinary shares, or participate on a pro-rata basis with the holders of ordinary shares). However, over the past 12 months of macro-economic downturn there has been an increase in higher preference multiples, coupled with participation rights (meaning the holders of the preferred shares have the right to be repaid their investment first, ahead of any payment to the holders of ordinary shares, as well as the right to participate in any balance of the proceeds on a pro-rata basis with the holders of ordinary shares).
- **Anti-Dilution Protection**: Anti-dilution provisions protect investors from dilution in subsequent down rounds. The type and extent of anti-dilution protection can be subject to extensive negotiation. The typical position remains a broad based weighted average formula, however as with liquidation

preference, the past 12 months has seen an increase in more investor friendly formulas being used (such the full ratchet formula).

- **Founder Vesting and Leaver Provisions**: As mentioned in question 14, founder vesting and leaver provisions are often one of the main areas of negotiation as these provisions go to the heart of a founder's shareholdings.
- **Investor consent rights**: Also known as "reserved matters", investors are afforded consent rights to approve specific actions by the company. Negotiations may focus on the scope and extent of these reserved matters.
- **Exit Strategies and Rights**: Negotiations often involve discussions on exit strategies, including the timing and method of exit. In particular the provisions surrounding the ability to force and/or veto a sale by way of the drag provisions are often extensively negotiated. Investors typically seek protections against being dragged into an exit transaction that does not meet their internal fund economics or targets.

16. How prevalent is the use of convertible debt (e.g. convertible loan notes) and advance subscription agreement/ SAFEs in the jurisdiction?

Convertible debt instruments such as convertible loan notes (CLNs) and advance subscription agreements (ASAs) have become increasingly prevalent in early-stage financing rounds. These instruments offer flexibility and simplicity for both investors and startups, allowing for quick and efficient fundraising without the need to immediately determine the company's valuation. Convertible loan notes typically represent debt that can convert into equity at a later stage, while ASAs represent future equity rights contingent upon certain trigger events, such as a subsequent equity financing round.

Their popularity stems from their ability to streamline the investment process, defer valuation negotiations (which has been a particular issue over the last 18 months), and (in the case of CLNs) provide investors with downside protection through debt-like features while offering upside potential through equity conversion. Importantly, under an ASA, the investors can still benefit from SEIS/EIS tax relief when the shares are issued (ASAs are never repayable, unlike CLNs, and SEIS/EIS rules require that the capital is at risk).

Simple Agreements for Equity (SAFEs) are also becoming increasingly popular particularly with US investors. They are very similar to ASAs but based on the form produced by Y Combinator, a US startup accelerator.

17. What are the customary terms of convertible debt (e.g. convertible loan notes) and advance subscription agreement/ SAFEs in the jurisdiction and are there standard from documents?

Customary terms include:

- **Conversion Mechanism**: specifies the conditions under which the instrument converts into equity, such as a qualified financing round or maturity date.
- **Conversion Discount**: offers a discount on the price per share paid on the next round, upon conversion, to compensate for the risk of early investment, typically between 10-30%.
- **Valuation Cap**: sets a maximum valuation at which the instrument converts into equity, ensuring investors receive a fair share of future upside.
- **Interest Rate**: in the case of CLNs only, determines the interest rate payable on the principal amount of the loan until conversion or repayment.
- **Maturity Date**: specifies the date upon which the instrument matures, potentially triggering conversion or repayment.
- **Investor Rights**: outlines any additional rights or protections afforded to investors, such as information rights or observer rights.

While there are no standard form documents for convertible debt and ASAs/SAFEs in the UK, templates and model agreements are available from various sources, including law firms, industry associations, and online platforms.

18. How prevalent is the use of venture or growth debt as an alternative or supplement to equity fundraisings or other debt financing in the last 24 months?

Venture or growth debt is prevalent in the UK and has gained increasing popularity in the UK as an alternative or supplement to equity fundraisings, particularly in the last 24 -36 months. This trend is driven by several factors, including the increasing availability of debt financing options tailored to the needs of high-growth startups and the desire of founders to preserve equity ownership. Venture debt provides startups with non-dilutive capital to fuel growth, bridge financing between equity rounds, or fund specific projects or acquisitions. It is often used in conjunction with equity financings to extend runway and enhance financial flexibility without diluting existing shareholders.

19. What are the customary terms of venture or growth debt in the jurisdiction and are there standard from documents?

Venture or growth debt typically has an interest rate that is higher the interest rate for traditional bank loans, reflecting the higher risk associated with startups or companies in the growth stage. Rates can be fixed or variable, and may include a base rate plus a margin.

The term of the loan can vary (three or four years is typical), with the loan repayments sometimes beginning with an interest only period followed by monthly payments of principal and interest.

Venture or growth debt is secured debt. Lenders typically take first ranking senior security over the key assets of the borrower's group, including bank accounts, shares and intellectual property – and require any other indebtedness of the borrower's group to be subordinated to their debt.

Venture debt loan agreements typically allow the borrower to prepay the loan before the final repayment date (but with a prepayment fee), with it often being stipulated that the loan can only be prepaid in whole and not in part.

The loan agreement will also set out events of default and the remedies available should such an event occur, which (if enforced) would typically result in all repayments under the loan being immediately due and payable.

Lenders of this type of debt also typically require warrants, which are an instrument that gives the holder the right (but not the obligation) to purchase company shares at a specified price within a specific period of time (often with a long stop date of 10 years). These are issued by the company and the price at which the warrant holder has the right to buy the shares is called the subscription price or exercise price and is often linked to the price paid by investors in a recent or future equity financing.

While there are no universally accepted standard forms for venture or growth debt transactions in the UK a typical venture debt loan agreement is a more straightforward document than a traditional LMA style loan agreement.

20. What are the current market trends for venture capital in the jurisdiction (including the exits of venture backed companies) and do you see this changing in the next year?

The UK remains a hub for venture capital investment, drawing both local and global investors due to its dynamic startup scene, top-tier universities, and government support. However, 2023 saw a significant drop in deal activity compared to the COVID-era boom. Economic uncertainty, fuelled by factors like rising inflation and bank borrowing rates amid global crises, has led to decreased venture capital investment worldwide as well as an increase in rescue rounds and down rounds, with the complexities these bring. Investors are cautious about uncertain economic trends in 2024, resulting in more careful deal-making and a focus on safeguarding investment returns.

Despite these challenges, the UK's strong track record in successful startups and available capital signals a positive investment outlook. The introduction of new BVCA template documents in 2023, which have been widely taken up, aims to further standardise and streamline financing rounds, potentially attracting more US and other overseas investment to the UK.

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