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An introduction to EISs and SEISs - Part 2

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Introduction

Part I of our two-part series on the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) regimes provided a general introduction and brief summary of the two schemes and the criteria applicable to each in order to qualify for certain tax reliefs. This Part II deals with the regulatory aspects of setting up and managing an EIS fund.

From a tax relief perspective, EIS funds are either approved or unapproved by HMRC. An HMRC-approved fund is one which allows investors to qualify for tax relief upon investment in the fund and the fund prospectus is reviewed by HRMC. An HMRC-unapproved fund means that investors can only qualify for tax relief when the fund makes an eligible investment. The terms approved and unapproved apply to HMRC registration and are relevant only to the tax treatment of the investments; they have no bearing from a regulatory perspective. The following information on the regulatory aspects of setting up and managing an EIS fund set out in this note relates to all EIS funds.

Structure of an EIS fund

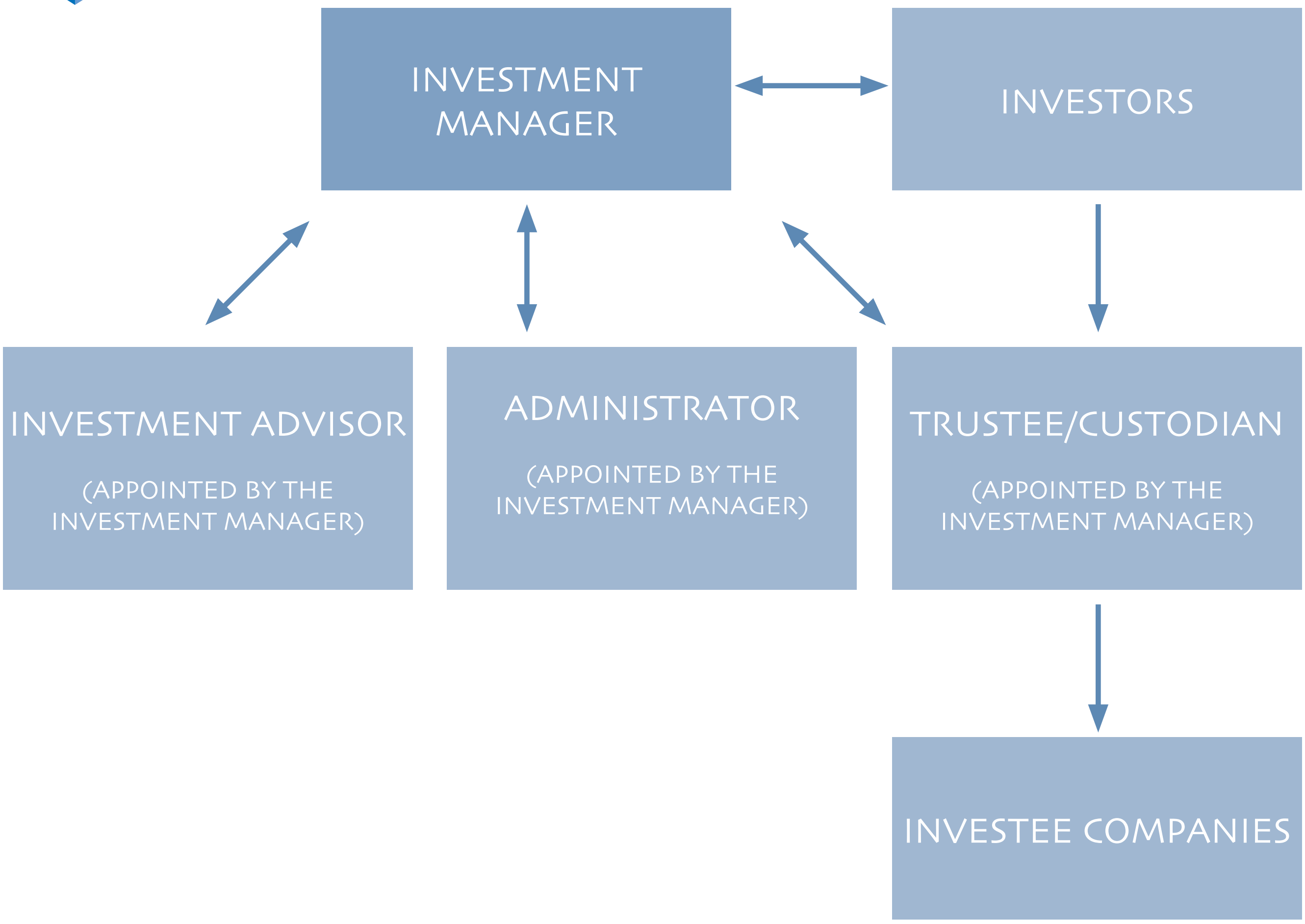
An EIS fund is not a fund in the generally acknowledged sense, in that it is not a separate legal entity, but operates as a series of separate discretionary investment management agreements between an investment manager and each investor, under the terms of which the investment manager invests in individual qualifying companies on the investors' behalf. The investors are the individual owners of shares in the relevant investee companies in proportion to their respective investment and these shares are usually held on their behalf by a trustee or custodian. Each investor is required to have a direct ownership interest in an identifiable number of shares in each investee company in order to qualify for the tax benefits.

Investment process

By investing in an EIS fund, an investor can take advantage of the experience and knowledge of the investment manager, who will seek investment opportunities, carry out relevant due diligence on each potential investee company and calculate the potential risk and return for investors. The investment manager will then manage the investments during the life of the fund, providing investors with regular reports and portfolio valuations. The life of the fund can vary; however, as described in Part I, shares in qualifying companies must be held for at least three years in order to qualify for EIS tax relief.

Service providers

The EIS fund will be managed by the investment manager, which must be appropriately authorised (see further below). The trustee or custodian is generally appointed by the investment manager and will hold the legal title to the shares in the investee companies as a nominee for the investors. The investment manager will also appoint an administrator to provide fund administration services, including calculating portfolio valuations, dealing with distributions to investors and providing accounting services to the fund. The investment manager may also appoint an investment advisor to identify investment opportunities and to provide investment advice and research services. A typical EIS fund structure and the interaction between the investment manager, the service providers and the investors can be seen from the diagram below:



Documentation

The main documents for an EIS fund are:

(i) an offering memorandum, which will include the following information: the investment objective of the fund, the investment process, life of the fund and exit strategy, details of the service providers, fees and risk factors; and

(ii) a discretionary investment management agreement – as mentioned above, each investor will enter into an identical individual agreement with the investment manager authorising the investment manager to manage the investor's portfolio in accordance with the investment objective and strategy as set out in the offering memorandum.

Typical fees

The investment manager may charge some or all of the following fees:

(i) set up costs;

(ii) annual management fee;

(iii) annual performance fee; and

(iv) other costs and expenses, including the costs of the custodian and administrator and, if applicable, the costs of any other service provider.

FCA Authorisation

In order to manage the investors' portfolios, an investment manager must be authorised and regulated by the Financial Conduct Authority to manage investments. Other regulated activities involved in managing an EIS fund include holding client money, safeguarding and administering investments and potentially arranging, advising or dealing in investments. It is possible for an investment manager to outsource these additional activities if it does not have the necessary permissions to carry them out itself. As an EIS fund is not an alternative investment fund for the purposes of the AIFMD (please see further below), the investment manager will be authorised as a MiFID investment manager. If you would like more information on setting up as an investment manager, please see our publication entitled 'How to set up an Investment Manager in the UK' at: www.cummingslaw.com/publications2.

Similarly, if the investment manager appoints an investment advisor to provide investment advice on potential fund opportunities, the investment advisor will also need to be appropriately authorised by the FCA. For more information, please see our publication entitled 'How to set up an Investment Advisor and Arranger in the UK' at: www.cummingslaw.com/publications2.

A further point to consider as regards authorisation is the category of investor targeted by the fund; the investment manager must ensure that it has the correct regulatory permissions to manage investments on behalf of retail clients as well as elective professional clients (each as defined in the FCA Handbook), where appropriate. Under MiFID, it is more difficult to categorise investors as elective professional clients, as those clients must meet an additional qualitative test; thus, in reality and to avoid limiting exposure of the fund, retail client permissions will be required to run an EIS fund. The investment manager will be subject to additional regulatory rules with regard to those investors who are retail clients.

AIFMD considerations

The Alternative Investment Fund Managers Directive (AIFMD) is an EU directive aimed at introducing a harmonised regulatory framework across the EU for EU-established managers (AIFMs) of alternative investment funds (AIFs). The AIFMD defines an AIF as any collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorisation pursuant to the UCITS Directive. This wide definition covers many types of fund (regardless of structure), including hedge funds, property funds, joint ventures, family office vehicles, closed-ended funds and unregulated collective investment schemes generally.

An EIS fund is not a collective investment scheme for the purposes of the Financial Markets and Services Act 2000 (FSMA), as it benefits from an exemption created by HM Treasury, but an AIF, albeit a collective investment undertaking, is not the same as a collective investment scheme, although the two concepts overlap considerably. Thus, a fund which is not a collective investment scheme can still be an AIF for the purposes of the AIFMD.

An AIF is an investment undertaking which pools together capital raised from investors to invest it on a collective basis. The pooled return concept is particularly relevant here. As described above, an EIS fund is structured as a series of individual investment management agreements between the investment manager and each individual investor and each investor is the beneficial holder of the shares in each investee company. Further, as each investor is required to have a direct ownership interest in the shares, each individual investor portfolio is capable of being a bespoke managed account. An individual investment management arrangement, such as a managed account, falls outside the definition of an AIF, as there is no pooling and thus no collective investment undertaking, and in principle does not give rise to an AIF.

The management of a portfolio of investments or other property on an individual client-by-client basis is therefore covered by MiFID rather than the AIFMD: see further PERG 16.2 of the FCA Handbook.

Advantages and disadvantages of an EIS fund

As referred to briefly above, the main advantage (other than the tax benefits) of investing in an EIS fund is the ability for investors to diversify their portfolios while potentially benefitting from the skill, knowledge and experience of the fund manager. The investor will benefit from the resources of the investment manager and portfolio exposure and the process for selecting potential opportunities can be simpler, quicker and more efficient for those subject to time constraints.

The disadvantages of investing in an EIS fund are similar to investing in EIS qualifying companies on an individual basis, which include:

(i) an investment in an EIS fund must be seen as a medium to long-term investment in order to qualify for the EIS tax reliefs;

(ii) shares in the investee companies are likely to be illiquid and there is no secondary market;

(iii) the general risks of investing in an unlisted company;

(iv) potential lack of clarity over underlying investments from the investment manager;

(v) the limited operating history of the fund; and

(vi) the dependence on the key individuals of the investment manager.

If you would like to discuss this further, please contact Claire Cummings at Claire.Cummings@cummingslaw.com or on 020 7585 1406.

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