A look at...

Alternative Investment Fund Managers Directive

- in the context of the Enterprise Investment Scheme.

December 2013

"For those involved in operating, managing or investing in the UK's Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS), the arrival of AIFMD raises a number of critical questions regarding the status and promotion of these types of 'funds'."

Overview

The arrival of the Alternative Investment Fund Managers Directive (AIFMD) on 22 July marked the beginning of a new, more tightly controlled, regulatory environment for fund managers of alternative investment funds (AIFs). The Directive applies not only to European Economic Area (EEA) based fund managers but also to non-EEA fund managers of AIFs established in the EEA or whose units or shares are marketed in the EEA.

AIFMD is establishing high standards of business conduct for fund managers, and is introducing detailed rules on delegation, transparency, disclosure, remuneration, debt and reporting.

Even 'smaller' fund managers will be subject to certain notification and monitoring requirements brought about by AIFMD. For the purposes of the Directive, smaller fund managers are considered to be those managers of funds whose assets under management do not exceed €100m (c.£84m) (or in the case of managers of closed-ended and unleveraged funds, assets under management less than €500m (c.£420m).

In the context of AIFMD, we are asking ourselves:

- Are EIS and SEIS caught by AIFMD, and if so, how?
- How do the regulatory issues arising from a European directive impact on EIS, a UK initiative?
- Key to fund management under AIFMD is the requirement for an independent risk management function. How does this impact on EIS, if at all?
- How and to whom can EIS and SEIS 'funds' be promoted?
- How can EIS and SEIS continue to grow in the context of AIFMD?
- What is the way forward for EIS funds?

Background to EIS

EIS is a UK initiative designed to help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to UK-based investors who purchase new shares in those non-quoted companies. The scheme was first introduced in 1993-94 as a successor to the Business Expansion Scheme and, since then, has been successful in attracting investment into a variety of business types.

According to the HMRC publication Enterprise Investment Scheme Statistics, released on 28 December 2012, since the establishment of EIS, over 18,500 companies have benefitted from the scheme and over £8.6 billion of funds have been raised. For the most recent three year period available, FY2008-9 to 2010-11, companies registered in London and the South East benefitted from the lion's share of investment, attracting 48% and 17% respectively.

During this same period, the sectors which benefitted most from EIS, attracting 30% of investment, included medical, educational, property and recreational business services. (These are denoted together as 'Other Services' by the report.) The 'High-Tech' sector has also faired well, attracting 23% of investment in the FY2008-9 to 2010-11 period; this sector includes specialist areas such as instrument engineering, some chemicals, R&D, and computer consultancy. The 'Business Services' sector attracted 19% of the investment available for this three year period, channeling funds to the likes of consulting engineers, other professional and technical services, financial services and insurance and other business activities.

(For more information, see http://www.hmrc.gov.uk/statistics/enterprise/eis-commentary.pdf)

An update on these figures is due to be published by HMRC at the end of this year, but it is fair to say now that the FY2012-13 increase in investment limits to EIS – particularly raising the investment limit per company from £2m to €5m - and the introduction of its sister initiative, SEIS, have both led to a marked increase in investor interest and fund sector activity.

It is not difficult to see, therefore, why we think EIS is a good thing. The initiative is beneficial for the economy on many levels, driving investment in directions where alternative funding sources may not be available and tempering any perceived issues around investing in start-up companies. The EIS Association (EISA) says:

"The Government must continue to promote these excellent schemes which albeit over the long-haul are beginning to show their longevity and solid capability to the benefit of the small cap marketplace."

EIS in the Context of AIFMD

A key question for those involved in EIS investment is the one of market categorisation and fund promotion; many in the market are confused as to what type of product EIS is and where exactly it sits in relation to other investment types.

Two important decisions have served to shape the character of EIS in the past year:

First, the relaxation of the EIS limits last year, particularly raising the investment limit per company from £2m to £5m, saw a marked increase in EIS fund offerings to the market. This raised important questions in the fund community as to what in a regulatory sense these funds constitute. Additional questions arose about what role the funds' managers and operators were conducting. The distinctions were important in defining the investor community to which such funds could be marketed and also in determining the permissions applicable to the funds' managers and operators.

Secondly, in June this year, after months of speculation, the Financial Conduct Authority (FCA) decided not to specifically target EIS and SEIS in its ban on the promotion of UCIS and certain close substitutes (together known as non-mainstream pooled investments (NMPIs)) to the vast majority of retail investors ("ordinary retail investors") in the UK. However, EIS and SEIS funds are still caught by this if they are structured as UCIS.

Meanwhile, developing in the background, the FCA's own consultation process on AIFMD succeeded in bringing to the fore concerns from the market about how EIS might be caught by the new Directive. In its Policy Statement 13/5, Implementation of the Alternative Investment Fund Managers Directive, the FCA said:

“a respondent wanted the guidance to focus on the difference between proper individual portfolio management arrangements (where an investor entrusts a manager with a sum of money to be invested in EIS shares on a discretionary basis, based on the individual circumstances of the particular investor) and EIS funds, where the manager would not be making investments on the basis of their suitability for any individual investor."

This point is of particular interest to us and something that we consider further at the end of this paper.

EIS in the Context of AIFMD (continued)

Now, with the introduction of AIFMD in July, the FCA has declared that EIS and SEIS funds which are managed in the same way for all the investors are "properly considered to be CIUs" and therefore AIFs potentially caught by the new directive. In its Policy Statement 13/5 and related Perimeter Guidance, the FCA describes and reiterates a CIU as:

- not having a general commercial or industrial purpose;
- pooling together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors from investments; and
- having a collective group of unit holders or share holders with no day-to-day discretion or control.

As far as fund promotion is concerned, the situation at the time of writing is that EIS and SEIS can be promoted to ordinary retail investors only if they do not fall within the definition of NMPI and therefore no more restricted than before in how they may be promoted. Any changes in the UK to the promotion of NMPIs will affect the marketing of EIS funds if the EIS fund is a UCIS (although few currently are).

"The exclusion of EIS and SEIS funds from the FCA's ban applies to those that are not structured as unregulated collective investment schemes."

EIS, the 'Fund' Concept and the Question of Risk

Current EIS legislation is primarily aimed at companies, however, it does recognise the fund concept in a very restricted format. Hence, an HMRC approved EIS fund must invest 90% of monies raised across a minimum of four companies within 12 months of the investment opportunity closing. One further condition for HMRC approved funds is that all investments have to be pro-rated across all investors, actually giving them the character of a CIU and therefore, potentially, an AIF.

The advantage of an HMRC approved fund is that tax relief is given to the investor on investing into the fund but the consequences of missing one or all of these conditions (and thus succumbing to 'clawback' and/or deferral of relief) means that few such approved funds have ever been launched. The market is therefore made up largely of unapproved EIS funds.

The advantage of unapproved EIS (and SEIS) funds is that they are not bound up with the restrictions applicable to approved funds and so can adopt a more flexible investment strategy. However, the obvious downside is the lack of access to tax relief on investing into the fund, as tax reliefs for unapproved funds are only available on investment into the underlying companies.

In addition to the issue of structure and tax reliefs, is the point that EIS investment encourages a fund type structure in order to spread investor risk when investing in the higher risk companies at which EIS is aimed. The funds industry has long appreciated this, hence the many unapproved EIS, and now also SEIS, funds in existence.

Our question is whether or not the attractiveness of the HMRC approved funds could be improved in order to increase the number of approved EIS funds in the market. Or, put another way, whether the criteria for EIS and SEIS approved funds could be relaxed, for the purpose of encouraging more investment into them. Although AIFMD is likely to affect very few managers of EIS and SEIS funds (because it is intended for fund managers, where no leverage is used, with assets under management of more than €500m) we feel it is appropriate to raise this question in light of the introduction of AIFMD and the concern raised about the distinction between a bespoke discretionary management arrangement service of EIS company shares and EIS funds structures as CIUs.

EIS, the 'Fund' Concept and the Question of Risk (continued)

The need for legislative change regarding approved EIS funds is being championed by Members of the EISA, with the organisation pointing out that other alternative investment types, such as venture capital trusts (VCTs) and enterprise capital funds, "can make use of debt instruments and other measures to improve the structure and economics of their investments." The body also notes that without HMRC approved status, "it is virtually impossible for EIS investors to invest alongside VCT or other VC investors..."

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EIS Fund as AIF

For the purposes of AIFMD, new EIS funds (approved or otherwise) will need to be assessed to determine whether they are AIFs - as will all existing EIS funds, with a variation of permission by the FCA possibly being required by their managers.

As a caution, the FCA warns: “it is important to remember that even if a business is a CIU that does not necessarily mean it is an AIF.” To be an AIF, it must meet all the criteria of an AIF, set out in AIFMD. The key is whether the undertaking has a defined investment policy. Furthermore, if the undertaking is structured like a typical fund then that “points toward it being an AIF”.

According to the FCA’s Policy Statement 13/5, other factors are:

- whether an offer to invest in an undertaking is marketed as an investment in a fund;
- whether there is a defined mechanism for winding up or distribution of investment returns at a particular time or over a designated period (applicable perhaps if the undertaking is open-ended) allowing an investor to redeem his interest within a reasonable time;
- whether the CIU outsources its core operations to a third party;
- whether it has the skill and expertise to monitor and control the outsourced work;
- whether it has an external manager; and
- whether the CIU’s business is to invest in businesses carried out by others without having control over the management over those businesses.

Although the above points help to paint a picture of what an AIF looks like, the FCA advises that none of these factors are conclusive in determining whether a CIU is an AIF. At the same time, its Policy Statement 13/5 states that for EIS funds “the manager would not be making investments on the basis of their suitability for any individual investor. Hence it is likely that an EIS fund should be considered to be a CIU and an AIF (if all the other conditions of an AIF are met)."

For EIS and SEIS funds that are AIFs, this means that, depending on their manager’s assets under management, they would need to have separate managers and custodians (depositaries) and the managers would need to employ risk and investment management techniques more commonly associated with the regulation of other types of ‘high risk’ alternative investments, such as hedge funds.

There is, however, some relief in that EIS and SEIS portfolios, where they are not run as single funds (even though they may often co-invest the funds of a number of clients), will not be caught by the Directive. We therefore expect the EIS and SEIS market to move further in this direction i.e. bespoke discretionary management arrangements.

Which Way for EIS Funds?

The FCA have always said that each case needs to be considered on its merits. Now, very helpfully they have provided more guidance on what to look for. Whilst it is helpful to have the clearer statement by the regulator, it is unlikely to be the end of the matter as existing funds are reviewed, not least because of the spectrum of funds in existence.

For EIS funds, there are tax and regulatory consequences of being both a CIU and an AIF, and potential changes to these (European legislative) regimes will no doubt have an effect on how these funds are promoted in the UK.

For new funds in the process of being launched - if they fall within the full scope of AIFMD and require a manager and a depositary both independent of each other and needing to be authorised with the appropriate permissions - the Directive may bring a new layer of cost.

In conclusion, the question has to be asked, will AIFMD and EIS funds manage to co-exist going forward? There are several factors to consider, including whether the EIS 'fund' is a CIU or a bespoke discretionary management arrangement, whether the fund is approved or not, the operational implications of AIFMD for fund managers and any associated cost implications for the fund. It may be that approved funds - if they are caught by AIFMD and introduce a further layer of cost and regulatory complexity - remain the less favoured option despite their advantages in terms of accelerating tax relief. In this event, will we see an increasing shift towards bespoke discretionary management arrangements, where investors end up having non-identical portfolios?

The EISA has already raised awareness with HMRC over the issue of control over newly formed companies, the concern being that certain unintended control consequences

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could impact negatively, particularly in relation to SEIS; and we have also suggested the idea of a two stage advance assurance process for Business Investment Relief, which HMRC has been promoting in conjunction with EIS, and we understand that some progress has been made with HMRC in this direction. However, it is our view that further lobbying needs to be done with the industry's policy makers and regulatory bodies, in order to bring about the necessary changes for the continued growth of the EIS and SEIS funds sector. We urge small fund managers and professional advisers working in this arena to get involved in the debate.

The benefits to the economy of a successful and evolving, small funds market are readily apparent. As already outlined above, according to the most recent statistics available, since the establishment of EIS, over 18,500 companies have benefitted from the scheme and over £8.6 billion of funds have been raised. That said, we cannot overlook the fact that changes to EIS may also require EU sanction, and change would therefore take time. Treasury could well respond to any lobbying or pressure to relax the criteria for approved funds by simply pointing to the example of VCTs which already largely act in this capacity, with investors qualifying for the same 30% tax relief albeit capped at £200k rather than £1m.

With the right policy changes, there may be a chance for EIS and SEIS funds and their managers to retain their level of strategic flexibility (and their consequent attractiveness to investors) whilst at the same time complying with – and growing within – the new regulatory order alongside other forms of alternative investment.

Thompson Taraz

47 Park Lane
London
W1K 1PR

T: 020 7907 8777
F: 020 7907 8770

info@thompsontaraz.co.uk
www.thompsontaraz.co.uk

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