

EIS Funds & FSCS

Member Briefing: EISA Regulatory Committee

July 2021



A divergence of views arose in recent times as to whether FSCS jurisdiction can apply to EIS Funds or whether EIS Funds are automatically excluded given their structure.

This divergence brought with it some potential reputational risk for the industry, particularly if it meant that investors were incorrectly being told there is FSCS cover when there is none.

Given the risk of consumer detriment and reputational damage if there is no FSCS cover for investors in EIS Funds, we felt it important to secure a clear message from the regulator. After communications with both the FSCS and FCA, we have now received confirmation of the position: **it is possible for investors in EIS Funds to make compensation claims on FSCS in the event of the failure of the FCA authorised firm managing that fund should the fund manager go into default**

We are aware members have received differing messages on this subject from different parts of the FCA in the past. It is important to flag that there may be circumstances for a particular fund that means an exception to this rule of thumb can be made and where FSCS coverage does not apply. However, the area where the divergence of views seems to have arisen is centred around an argument that investors are not covered by FSCS simply because they are investing in an EIS Fund / an AIF. We now understand that this argument is unlikely to hold much weight.

We set out below our understanding based on the communications with the FSCS and FCA. This guidance is intended to be a helpful steer for Members in relation to EIS Funds based on what we have learnt. Neither the FSCS or FCA comments can be relied upon as legal advice and they have asked us to remind Members that they should seek their own advice.

1. An FCA regulated EIS fund manager (the AIFM) can have claims made against them relating to the management of an AIF

Claims on FSCS need to relate to particular activities. In the world of investments, these activities are called *protected investment business* and they are set out in [COMP 5.5.1R](#).

The regulated activity of *managing an AIF*, when performed by an FCA authorised firm, is *protected investment business* because it is *designated investment business*. The exception to this rule, for unauthorised funds domiciled in the UK, is where the fund is structured as a body corporate which is not a collective investment scheme (CIS). An example of this would be a VCT. However, EIS Funds are unable to be structured as body corporates so this exception does not apply. As a result, when managing an EIS fund the activity of the FCA authorised firm in *managing an AIF*, is *protected investment business* which means it falls within the jurisdiction of the FSCS.

2. A claim can be made by an investor

Not all persons can, however, make a FSCS claim relating to this activity. [COMP 4.2.2R](#) contains a list of persons who cannot claim against the FSCS and this includes the fund itself, the manager of the fund and any depositaries. The list of persons excluded from making a claim does not include private investors and so private investors should be able to make a claim. .

Some may argue that the fund managers (AIFMs) treat the fund they manage as their client for regulatory purposes, and this is true. However, you do not need to be a client in order to make a claim on the FSCS. [COMP 5.5.5.1R\(1\)](#) states that the protected investment business, in this case the AIF management, needs to be done “with, or for the benefit of the claimant”.

“If all the other relevant conditions in COMP are satisfied, an investor in an AIF who has a claim against the manager of the AIF in connection with the regulated activity of ‘managing an AIF’ may be able to claim compensation from the FSCS.” *FCA*

“...“with, or for the benefit, of the claimant” is broader in scope than a client relationship.” *FSCS*

The FSCS confirmed this phrase makes the application broader than meaning the client of the firm and we would view it as hard to argue in any fund scenario that the management of that fund is not being done for the benefit of the investors.

The claimant must have a claim against the manager (see Notes below). In EIS Funds, where the investor is contracting with the manager, we think it hard to argue that there is insufficient connection between the fund manager’s activity of managing the fund and the very investor they are contracting with for any claim to arise irrespective that the manager treats the fund as its client.

3. The structure of an EIS Fund does not mean that the FSCS does not apply

As mentioned above, for UK unauthorised funds such as EIS, a claim can be made against the manager as long as the fund is not a ‘body corporate and not a CIS’.

Some firms may have spotted that in COMP 12A.3 there is a special provision that allows investors in collective investment schemes to look through the scheme to the manager in order to make a claim. This express provision exists for CIS only and so does not apply to EIS Funds. However, we have been informed that the existence of this look through provision for CIS does not mean that managers of other types of funds are unable to receive claims from investors.

If the investor in an EIS Fund has a claim against the FCA regulated manager, and their claim relates to *protected investment business* (e.g. the fund management) undertaken for their benefit, they can claim based on COMP 5.5. set out above and do not need a specific look through provision.

Next steps



If your documentation already advised investors that they may be covered by FSCS, subject to eligibility, for any claims against the manager of the EIS Fund, then you may need to make no changes.

We would suggest retain wording such as ‘investors may be covered’ as there may be individual circumstances relating to a specific investor where there is no cover. Equally FSCS is not a protection against poor investment performance.

If you had taken the view that there was no cover for FSCS, you may want to discuss this with your legal or regulatory advisers armed with the additional information above and plan what steps to take next.

If your position on FSCS does change, next steps would typically involve updating investor documentation. Reference to FSCS cover can usually be found in brochures (risk section), Information Memorandums/ T&Cs and the Key Information Document (KID) document. You may also want to check websites, teasers, adviser guides, answers to DDQs etc.

You will also want to consider, in advance, what impact adding your income and AUM levels from EIS Funds may have on your fees and levies return which is submitted in February. We have not discussed with the FCA whether a change in the fees and levies return will mean any retrospective adjustment to fees paid in previous years, but please note that this could be a possibility. It is therefore worth taking a look at your firm’s position sooner rather than later so that you can plan for all potential outcomes.

Notes



Key assumptions made by the Committee when communicating with the FCA and FSCS:

- EIS Funds are Alternative Investment Funds (AIFs), and are not collective investment schemes, body corporates or a discrete portfolio management service
- Managers of EIS Funds (AIFMs) are authorised by the FCA, which makes them a *relevant person* (another essential criterion for a claim to be made to FSCS)
- The Managers of EIS Funds undertake the activity of *managing an AIF* from a location in the UK
- The location for EIS Funds is the UK, as they would be considered to be “otherwise domiciled” in the UK.

Other notes:

- This does not mean that all private investors will be *eligible claimants*.
- FSCS only considers claims where the relevant person, in this case, the EIS fund manager, is ‘in default’

- The claim (in very broad terms) must be in respect of a civil liability owed by the relevant person to the claimant. This means that as long as the claim is also in connection with *protected investment business* the claim could be based on a breach of rules or a claim under the general law such as breach of contract or negligence where it is in connection with that business. For example, this could be where the EIS Fund manager has breached the terms of a client agreement with an investor.