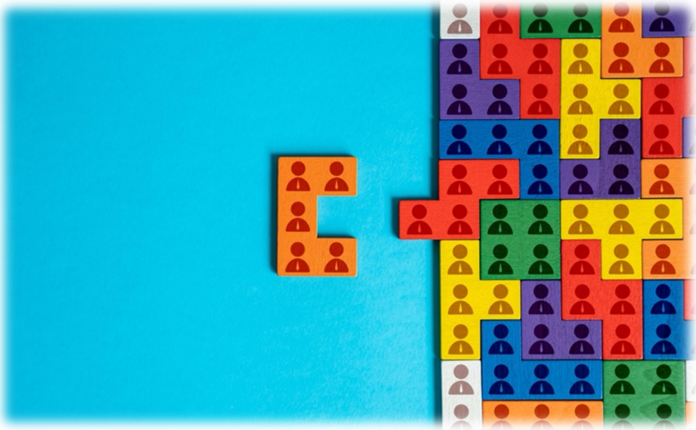
Deal-by-deal syndicated investment platforms

Avoiding categorisation as unlawful collective investment schemes



The Court of Appeal's recent decision in *KVB Consultants Ltd v Jacob Hopkins McKenzie Limited [2024]* serves as a timely reminder that authorised persons cannot escape investor compensation claims by relying on contractual restrictions imposed on their appointed representatives ("**ARs**"). This is particularly relevant where appointed representatives undertake the heavy lifting of investor identification, due diligence and deal closing, but fail to ensure that investors are properly classified as professional clients.

Similarly, it is submitted, ARs syndicating deal-by-deal investments on hosted platforms cannot hide behind their platform administrator's characterisation of arrangements as something other than a collective investment scheme if that is what they truly are.

Theirs is a joint enterprise where substance matters more than form, and both parties bear joint responsibility to follow Ariadne's thread out of the labyrinth of financial services legislation to avoid the 'notoriously stringent regulatory requirements' imposed on collective investment scheme operators.

To do otherwise is a high risk venture for both the regulated administrator who hosts the platform and the AR if their joint enterprise is found to be the unlawful promotion and operation of a collective investment scheme.

Regulatory Framework

No person may carry on regulated activities in the UK unless they are FCA authorised or exempt. Contravention constitutes a criminal offence.

Authorised persons may only operate within their FCA permissions and the promotion of investment activity is restricted to promotions made by authorised persons or approved by persons specifically authorised to approve third party promotions.

An 'investment' includes 'any asset, right or interest'.

Authorised persons must conduct investment business according to COBS Rules, which distinguish between client categories. The default is the 'retail client', defined as someone who is not a professional client or eligible counterparty. Professional clients include 'per se professional clients' (entities required to be authorised in financial markets) and 'elective professional clients' (where appropriate procedures ensure financial sophistication and understanding of reduced investor protection).

COBS Rules require firms to act honestly, fairly and professionally in clients' best interests, ensure communications are fair and clear, and for retail clients, take reasonable steps to ensure investment suitability through adequate client assessment.

Unauthorised persons become exempt if they are appointed as an AR by an authorised person who accepts responsibility for the AR's regulatory compliance, reducing the FCA's regulatory oversight burden.

Collective Investment Scheme Restrictions

Authorised persons are generally prohibited from communicating invitations to participate in collective investment schemes or approving third-party communications relating to a collective investment scheme they couldn't make themselves. Contraventions give rise to damages claims.

Collective investment schemes are defined as follows:

(1) In this Part "*collective investment scheme*" means any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

(2) The arrangements must be such that the persons who are to participate ("participants") do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.

(3) The arrangements must also have either or both of the following characteristics–

(a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;

(b) the property is managed as a whole by or on behalf of the operator of the scheme.

(4) If arrangements provide for such pooling as is mentioned in subsection (3)(a) in relation to separate parts of the property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another.

(5) The Treasury may by order provide that arrangements do not amount to a collective investment scheme–

(a) in specified circumstances; or

(b) if the arrangements fall within a specified category of arrangement.

The definition is drafted in an open-textured way with a high level of generality and uses words such as 'arrangements', 'property of any description' and 'day-to-day control over the management of the property', each of which have a wide meaning. Its application depends on the specific facts of the case and in the event of a dispute those facts will have to be determined by a court of law on the evidence before it. Once those facts are found, then it is unlikely that an appellate court will set those findings aside unless the judge was plainly wrong.

Since contravention may constitute criminal offences, the definition must not be interpreted to include matters not fairly within it. There is also a statutory defence if a person is able to show that he took all reasonable precautions and exercised all due diligence to avoid committing an offence.

Navigation Challenges

Avoiding arrangements within this definition, alternatively, finding safe passage through Treasury-designated exemptions or demonstrating that all due diligence was taken, requires careful navigation, especially when judged after investor losses.

Boilerplate documentation without proper consideration is inadequate.

All alternative investment funds are collective investment schemes unless exempted, but not all collective investment schemes are alternative investment funds. Managers with AIF permissions but without separate collective investment scheme permissions cannot manage schemes that aren't AIFs.

Platform administrators without discretion over deal-by deal share trading may avoid managing an AIF but face operational difficulties obtaining timely individual investor approval for transactions.

EIS Fund Exemption

EIS funds benefit from a specific exemption and can avoid collective investment scheme classification and if they also comply with the EIS rules governing bare trusts HMRC will permit EIS relief to flow through the nominee arrangements to the underlying beneficial investors in proportion to the amount they invest.

Compliance comes at a cost though.

Investors must have the right to withdraw their uninvested cash at any time and their EIS investments after seven years; both conditions providing a measure of consumer protection against unwarranted fees. So too with EIS tax relief, investors must have the right to withdraw or modify any authority granted to their nominee to exercise any of the rights and powers attaching to the legal title of the shares they own and also the individual right to terminate the bare trust of the legal title to their shares without the collective authority of the other beneficial owners participating in the same arrangement.

These requirements may be commercially unattractive.

Not all deal-by-deal syndicated investment platforms will be EIS funds able to take advantage of the regulatory exemption.

Alternative Platform Structures

So can a sidecar deal-by-deal syndicated investment platform be established which is not a collective investment scheme? To answer this question, it helps to explore first what doesn't work.

Imagine a scenario where in their platform agreement investors accept contractual responsibility for day-to-day decision taking but also agree that investor decisions are to be taken at meetings of investors which will only be quorate if all investors attend and where an effective investor direction is only possible if it is unanimously approved by all investors. As a mechanism for ensuring that investors exercise actual day-to-day control over the management of their property this is likely to prove largely ineffective almost all, if not all, of the time.

The Supreme Court in *Asset Land Investment Plc v FCA [2016]* established that actual day-to-day investor control matters, not notional rights. Substance trumps form.

Platform agreements giving investors theoretical decision-making responsibility while requiring unanimous approval from fully-attended meetings would likely fail this test, as such mechanisms would be largely ineffective in practice.

FCA guidance clarifies that day-to-day control means having power to decide property management daily. While management can be delegated, control must be retained. Each participant must individually have day-to-day control - having consultation rights or direction-giving authority alone is insufficient.

Generic mandates or powers of attorney typically indicate devolved management rather than participant control.

Non EIS Statutory Exemption

For non-EIS investments, the first statutory exemption in the *Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001* offers a pathway. Arrangements avoid collective investment scheme classification if:

- Each participant is entitled to a part of that property and to withdraw that part at any time

- Contributions and profits aren't pooled

- Property is managed as a whole only because individual parts aren't bought/sold separately except when participants join/leave

The non-pooling requirement typically applies to deal-by-deal platforms anyway, as investors typically want to identify specific shareholdings for inheritance tax business relief after two years' ownership.

The last requirement is best illustrated by the example of a stock broker who bundles his clients orders together for sales and purchases but otherwise provides an individual portfolio management service in respect of his clients' portfolios or manages them all as an alternative investment fund, that is to say, as a '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 all those investors'.

The critical issue, if collective investment scheme classification is to be avoided, is that shares cannot be managed 'as a whole' beyond bulk trading.

Therefore, platform administrators exercising general management powers collectively risk losing this exemption.

For example, if platform administrators exercise the voting rights attaching to shares other consent rights within investment documentation on behalf of all investors, they will be managing the shares 'as a whole' and will exceed the exemption boundary. This creates practical difficulties for platform operations requiring shareholder approvals because it would mean platform administrators cannot, for instance, sanction a cancellation of share capital to create distributable reserves with which to fund buybacks, nor exercise votes on behalf of shareholders to authorise the issue of new shares if there are two or more classes of shares.

Practical Solution

A viable solution exists ensuring efficient platform administration that avoids collective investment scheme classification while enabling functional shareholder resolutions with minimal administration.

This approach should remain individually revocable by each investor, though revocation is unlikely in practice. By following this route, administrators exercise no voting discretion and avoid managing shares collectively.

Combined with the administrator or AR separately advising the investee company, their joint enterprise should have the ability to take all day-to-day decisions to order things as they sees fit in the vast majority of typical circumstances.

Joint Responsibility

Returning to the *KVB Consultants case* , the court determined that contractual limitations on AR scope were ineffective attempts to prescribe activity conduct rather than genuine authority limitations. When principals entrust client classification decisions to ARs, they cannot escape responsibility when ARs err while claiming credit when they succeed. The principal retained responsibility for correct professional client classification and AR supervision and so the onus was on the principal to supervise the activities and systems of its AR.

Similarly, since platform syndication represents a joint enterprise between authorised principals and their ARs, it would be prudent to assume that there is also an onus on the AR to ensure that the arrangements for the operation of the platform do not make the platform administrator and their AR joint tortfeasors in the criminal offence of unlawfully promoting and operating a collective investment scheme.

Successful deal-by-deal syndicated platforms require integrated regulatory coordination between their platform administrators and their ARs, as both parties are accountable for regulatory compliance and neither may hide behind contractual limitations or mischaracterisation of the relevant arrangements.

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