When is an investment scheme a CIS?

By Jeanette Burgess and Andrew Northage (14 May 2015)

The Court of Appeal has sought to explain the characteristics that make an investment scheme a CIS.

When is an investment scheme a CIS?

Establishing or operating a collective investment scheme (**CIS**) is a regulated activity under section 19 of the Financial Services and Markets Act 2000 (**FSMA**). As such, a person establishing or operating a CIS must be appropriately authorised. Breach of section 19 is a criminal offence and the person concerned may be required to disgorge profits or compensate investors. There are also significant restrictions on how interests in a CIS may be lawfully marketed.

It is therefore important for those establishing or operating investment schemes to have a clear understanding of whether the scheme in question is a CIS. The investors too will want to know whether the regulatory protection afforded to investments in CISs will apply to their investment.

Section 235(1) of FSMA states that CIS "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".

In addition, the participants must not have day-to-day control over the management of the property and one or both of the following characteristics must be present for the arrangements to amount to a CIS:

- the contributions of the participants and the profits or income out of which payments are to be made to them are pooled (section 235(3)(a))
- •the property is managed as a whole by or on behalf of the operator of the scheme (section 235(3)(b)).

The issue for the Court of Appeal in **Financial Conduct Authority v Capital Alternatives Limited and others [1]** was whether investment schemes constituted CISs by reason of exhibiting either one or both of the section 235(3) characteristics.

There were two schemes in issue - the African Land scheme and the Carbon Credits scheme.

Under the African Land scheme, investors were allocated subleases of plots in a rice farm by African Land Limited. The plots were segregated from each other but were managed and harvested by a single company. The management agreement between African Land Limited and the management

company made no provision for services to be rendered to investors on an individual basis and investors received a return based on the harvest from their particular plot.

Under the Carbon Credits scheme, investors were allocated individual plots in forests in Australia, Sierra Leone and Brazil. In the Australia scheme, investors were to receive the carbon credits generated by their specific plots. In the other two schemes, carbon credits were to be shared pro rata to the size of their plots.

African Land scheme - in the High Court

At first instance, the trial judge found, in respect of the African Land scheme, that there was no pooling of income or profits generated by the rice plots. The characteristic identified in section 235(3)(a) was absent. However, he went on to find that the plots were managed as a whole and, indeed, the purpose of segregating the plots was simply to avoid the scheme being classified as a CIS. The characteristic identified in section 235(3)(b) was therefore present.

Carbon Credits scheme - in the High Court

The trial judge found in respect of all three Carbon Credits schemes that management decisions were not taken according to the separate interests of the individual investors. Section 235(3)(b) was therefore satisfied. In addition, in the case of the Sierra Leone and Brazil schemes, there was a pooling of contributions and income which meant that section 235(3)(a) was also satisfied.

The defendants challenged these findings before the Court of Appeal, which dismissed the appeals in respect of each scheme.

African Land scheme - in the Court of Appeal

The Court upheld the judge's finding in the African Land scheme that there was no pooling of income or profits. There were some standardised deductions but these made no significant difference to the sums received by individual investors.

On the question of whether the property was "managed as a whole" within the meaning of section 235(3)(b), the trial judge had erred in saying that to fall outcome the subsection it was necessary that individual management had to be "substantial". Rather, it was necessary, first, to identify the property, and second, to establish what the management of that property was, that was directed towards income and profit generation. It was not necessary that there should be no individual management for arrangements to fall within section 235(3)(b), only that the nature of the scheme, in essence, was managed "as a whole" and the extent of individual management was relevant in determining this. Applying that test, the Court had no doubt that the farm was indeed managed as whole - there was no economic rationale for segregating the plots, the farm manager had complete autonomy over the management of the farm and he managed each plot without reference to the individual investors.

Carbon Credits scheme - in the Court of Appeal

On the Carbon Credits scheme, the Court made the additional point that what mattered was the substance of the scheme and not how it was dressed up. The scheme documentation might provide

for the distribution of income or profits on an individual basis but the court would consider how the scheme was actually operated in practice to determine its true nature. The documentation for the Australia scheme did not specify how the scheme was to work in practice; the evidence indicated that there was no pooling. This was not the case in respect of the Sierra Leone and Brazil schemes, where there was no suggestion that consideration had ever been given to measuring the carbon credits attributable to individual plots. In respect of all three schemes, the evidence was that they were managed as a whole - there was no provision for individual investor input into management nor was there evidence of any such input in practice.

The decision highlights the great care that must be taken to ensure that an investment scheme does not amount to a CIS, if that is the intention. The court will look at the substance of the arrangement rather than its form.

Unfortunately, despite this decision, it is still not really clear what the expression “managed as a whole” means. It is clear that each case will, as one would expect, turn very much on its own facts. We now know that it has nothing to do with a requirement that investors’ involvement must be substantial.

The Walker Morris Financial Services Team has a depth of experience in advising on the compliance aspects of investment schemes in general, and CISs in particular. If you are either a promoter or operator of a scheme, or an investor in a scheme, and need to understand the regulatory position, we would be delighted to hear from you.

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[1] [2015] EWCA Civ 284