

## FCA Call for Input on Crowdfunding Regulation

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### Summary and implications

In February 2014, the Financial Conduct Authority (FCA) implemented rules that specifically related to the regulation of the crowdfunding industry in the UK (see our [briefing](#) on these rules). The FCA then published an interim review of the crowdfunding industry in February 2015 (see our [briefing](#) on this interim review). The FCA now plans to conduct a full post-implementation review of the crowdfunding industry and, on Friday 8 July 2016, published a “Call for Input” relating to this review.

In 2014, the FCA stated that it intended to carry out a full post-implementation review of the crowdfunding industry in 2016. Therefore, this call for input was expected and is the first stage of the review process. The 2014 rules were implemented to provide adequate consumer protection to investors, whilst at the same time continuing to allow access to this innovative method of funding. However, now that the UK crowdfunding market is more established, the FCA says it is “considering whether the rules need to be changed to reflect its current scale and status and risks to investors”.

Over the coming months the FCA will carry out research into the crowdfunding industry. The responses to the FCA’s Call for Input will be taken into account by the FCA in relation to understanding the crowdfunding industry. The FCA also plans to analyse market trends and firms’ business models as part of this review.

### Growth in the industry

The crowdfunding market has grown rapidly since 2014 (when the FCA implemented specific rules for this market). The FCA has stated in the Call for Input that there are 23 FCA-authorized firms and 11 appointed representatives operating investment-based crowdfunding platforms. Meanwhile, nine firms are FCA-authorized to offer loan-based crowdfunding platforms and a further 88 firms have applied to the FCA for authorisation.

### Investment-based crowdfunding

When the 2014 crowdfunding rules entered into force, firms operating investment-based crowdfunding platforms were subject to the standard FCA rules that apply to authorised investment firms. In addition, the FCA implemented marketing restrictions that related to the types of investments that are marketed on investment-based crowdfunding platforms, known as “non-readily realisable securities”). We have outlined these rules in more detail in an earlier [briefing](#).

The FCA has identified the following areas as the initial focus of its review into investment-based crowdfunding:

Conflicts of interest	The management of conflicts of interest between the platform and investors. Firms are already supposed to have policies in place to identify and manage conflicts of interest. However, a conflict example the FCA has identified relates to the platform wishing to list as many projects as possible to maximise profit, which may conflict with the interests of investors who would expect a higher standard of due diligence.
Due diligence standards	The current crowdfunding rules do not set out any specific levels for due diligence. Instead, the rules allow the flexibility for firms to develop their own approach to due diligence. The FCA says it is “potentially concerned” that this approach is not working.

	<p>The FCA intends to consider whether this flexibility continues to be the best approach, or whether minimum specified due diligence standards should be applied. The example suggested by the FCA refers to having business plans reviewed by an independent third party.</p>
Client classification	<p>When taking on an investor, the crowdfunding rules provide that a firm must classify the investor to ensure that they fall within a category which is permitted to access and invest through the platform.</p> <p>As part of the post-implementation review, the FCA plans to assess how well firms are meeting this requirement. It is worth noting that in relation to other areas the FCA has said that it may publish additional guidance, however on this point the FCA has said “we will consider taking further action with firms, either to ensure appropriate redress or to sanction the firm”. This suggests that this area will be a particular focus of the post-implementation review.</p>
Client assessment	<p>When platforms take on an investor, the current crowdfunding rules also provide that the platform must assess the knowledge and experience of each individual so that the platform can determine whether the service or product is appropriate for the investor. This is referred to as the “appropriateness test”.</p> <p>The current crowdfunding rules do not set out how the appropriateness test should be performed. However, it is common for the appropriateness test to take the form of a questionnaire, with questions that relate to the projects that are available on the specific crowdfunding platform, which effectively checks that investors understand what they are investing in.</p> <p>As part of the post-implementation review, the FCA has stated that it is “planning an in-depth assessment of how firms operating investment-based crowdfunding platforms are meeting this requirement and whether the outcomes are fair”. The FCA then states that, depending on its findings, it may provide guidance to help firms implement an appropriateness test that satisfies the requirements and delivers the right outcomes.</p>
Disclosure	<p>This is another area of likely focus for the post-implementation review. At the current time, firms are required to provide investors with information so that they are reasonably able to understand the nature and risks of investment and, consequently, make investment decisions on an informed basis.</p> <p>The FCA is concerned that the current standard of disclosure is not delivering adequate standards of consumer protection. If the findings of the review prove that this is the case, the FCA has stated that “we will consider the full range of options, including rules to introduce additional requirements and potentially, mandatory disclosures of information and risk warnings.”</p> <p>One particular concern highlighted by the FCA relates to crowdfunding platforms that, when setting out how much money has been raised so far on a particular project, include money that has been raised on the platform and also from other sources outside of the platform. The FCA has stated that there is a concern that this practice can lead investors to believe there is more interest in an investment opportunity than is actually the case.</p>

## Loan-based crowdfunding

Loan-based crowdfunding has grown a significant amount in recent years, with nearly £2.4bn invested in the UK during 2015, compared with just £480m during 2013 (as outlined in [Nesta's 2016 report on the alternative finance industry](#)). The FCA took over the regulation of the lending and consumer credit industry from the Office of Fair Trading on 1 April 2014 and since then it has been working to bring these activities within the wider UK regulatory regime.

The FCA has focused on the fact that investor protection rules for loan-based crowdfunding are currently lighter than for investment-based crowdfunding. Rather than being subject to the client classification rules and “knowledge and appropriateness” test which investment-based crowdfunding platforms must comply with, investor protection in relation to loan-based crowdfunding is covered by the general FCA marketing rules – i.e. that any promotion of loan-based opportunities must be carried out in a way that is fair, clear and

not misleading. The FCA has identified that these rules alone may not be sufficient to protect investors' interests and it is considering whether to require loan-based crowdfunding platforms to assess the knowledge and experience of prospective investors and also check whether investors fall within certain categories before they are allowed to invest. This would bring loan-based crowdfunding within a similar regulatory regime to investment-based crowdfunding, and seems to be an indication that the FCA considers the risks to investors in the two different types of crowdfunding to be comparable. This is a significant change to the regulatory regime for loan-based crowdfunding platforms and, if implemented, will require the overhaul of investor take-on procedures on loan-based crowdfunding platforms.

Additionally, the FCA has outlined its understanding of certain loan-based crowdfunding offerings, in particular models where platforms pool investor monies and returns across investment opportunities and also where platforms offer investors 30-day notice periods to get their money back after investing. The FCA considers that the pooling of monies raises the risk that platforms are operating collective investment schemes (CIS), which would mean they should be subject to the much more stringent regulatory rules for CIS. The FCA has clarified that firms which have permission to operate an electronic system in relation to lending are not regarded as operating CISs, however they may still be managing an "alternative investment fund" (to which different rules apply). The FCA has stated that it will review whether regulation should be altered in view of loan-based crowdfunding becoming too similar to asset management. In relation to 30-day redemptions offered by some platforms, the FCA is concerned that these offerings amount to a default risk for investors, as in reality the platforms would be unable to realise money from lending should too many investors attempt to withdraw their money at once – in effect a maturity mismatch. The FCA has also identified the risk that loan-based crowdfunding platforms are behaving like banks, by accepting investment deposits and also offering short redemption periods without having the capital requirements or investor protection measures that banks are required to have. The FCA is considering existing arrangements and may implement changes to regulation to deal with these risks.

Other areas of the FCA's focus for loan-based crowdfunding are outlined in the table below:

Disclosure	<p>Under existing "fair, clear and not misleading" rules, loan-based crowdfunding platforms must ensure that platforms provide investors with enough information so that they can understand the nature of investments and can therefore take investment decisions on an informed basis.</p> <p>As with investment-based crowdfunding, the FCA is considering whether it would be appropriate to enforce minimum standards of disclosure and rules on timings of those disclosures – in particular information about default rates or information which will allow investors to see the likelihood of default based on loan type.</p>
Financial promotions	<p>The FCA has identified that some loan-based crowdfunding platforms are not complying with financial promotion rules, in particular where risks are not properly drawn to the audience's attention, or loan-based products are being likened to savings or deposit bank accounts.</p> <p>For an overview of the FCA's rules for financial promotions made over the internet or using social media, which will be relevant for almost all loan-based crowdfunding platforms, see our <a href="#">briefing</a> on those rules.</p>
Contingency planning	<p>The current FCA rules require loan-based crowdfunding platforms to have arrangements in place which mean that, if the actual platform collapses, investors will still be paid money as a result of the underlying loan-based investments they are party to. The FCA is considering tightening these rules based on its assessment of whether or not they are robust enough to protect investors in the event of platforms failing.</p>

FSCS cover	<p>The FCA has confirmed that investments made on loan-based crowdfunding platforms are not covered by the Financial Services Compensation Scheme (FSCS), meaning that investors will not receive compensation where either a borrower who they lend to is unable to repay or where a loan-based crowdfunding platform fails. Investors may be protected where their money is held as client money by the relevant platform.</p> <p>The FCA has stated that the additional costs of funding FSCS cover for loan-based crowdfunding platforms and underlying investments would be disproportionate, but it will consider whether this approach will remain in the future.</p>
Innovative Finance ISAs	<p>In April 2016 it became possible to include loan-based crowdfunding opportunities within the Innovative Finance ISA wrapper. The FCA has identified that there is a risk that, as a result of this, retail investors are entering into loan-based crowdfunding opportunities without fully understanding the risks, because they trust the ISA brand. The FCA will consider whether this is actually the case and may amend its rules accordingly.</p>
Mortgages	<p>The FCA is concerned that if loan-based crowdfunding platforms begin offering loans relating to residential mortgage contracts then there may be a gap in regulations between the loan-based crowdfunding regime and the mortgage and home finance regime (for example, this would mean that there would be no person responsible for assessing affordability or meeting other lending responsibilities). The FCA has stated that it intends to apply the usual Mortgage and Home Finance standards to loan-based crowdfunding platforms, even where the lender is not acting in the course of business.</p>
Creditworthiness assessments	<p>The FCA has stated that it is concerned that firms are not carrying on adequate creditworthiness assessments of borrowers as part of their loan-based crowdfunding offerings, which creates risks for investors. The FCA will be considering whether additional rules may be required to mitigate and reduce these risks.</p>

A key area of concern for many loan-based crowdfunding platforms is the interplay between their activities and the UK consumer credit regime. The UK consumer credit regime imposes significant rules on persons who are "lending in the course of business", including the requirement to become regulated by the FCA to carry on those activities, as well as being subject to the rules in the FCA's Consumer Credit Sourcebook. Loan-based crowdfunding within which lenders are not lending in the course of business is subject to fewer requirements and the FCA has stated that it will be considering whether this arrangement is still appropriate in view of new loan-based crowdfunding models which have emerged in the market.

## Next steps

The FCA has asked for firms to engage with the Call for Input by responding to 22 questions it poses. Firms are invited to do this by 8 September 2016. Following this feedback the FCA may release a consultation paper outlining proposals for changes to the regulatory regime.

The Call for Input provides firms with clarification in a number of key areas and also highlights that the FCA will be scrutinising certain aspects of business models in the future. In particular the FCA has stated its intention to look in more detail at how firms promote their platforms and products. This is a good opportunity for firms to ensure that their offerings are compliant with current FCA rules.

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