BUSINESS LAW INTERNATIONAL

Business Law International

Vol 20 No 2 pp 91–190 ISSN 1467 632X **May 2019**

Published by the Legal Practice Division of the International Bar Association

VOL 20 NO 2 MAY 2019

Regulation of Crowdfunding in the UK: Past, Present... and Future

Kirstene Baillie*

UK regulators are well known for maintaining comprehensive, sound regulation. For new business models, they ensure that they 'plug the gaps' in existing regulation where necessary, with a key focus being on ensuring investor protection. In the evolvement of the regulation of crowdfunding, this is all clearly evident.

This article looks at the current regulation for investment-based crowdfunding and loan-based crowdfunding and then discusses the proposed changes in regulations that the UK Financial Conduct Authority (FCA) has recently proposed.

Background

Crowdfunding developed in order to allow non-traditional investors to obtain access to investment opportunities, perhaps for the first time, and to allow startups and small to medium-sized enterprises (SMEs) to obtain funding for investment and operations through the internet. The term though comprises a variety of business models.

Some remain essentially unregulated, for example, donations-based models, where people give money to enterprises or organisations whose activities or purchases they wish to support; and prepayments or rewards-based models, where people give in order to receive a reward, service or product (although some regulated payment services may be provided in connection with these, in which case the Payment Services Regulations 2017 may be relevant).

* Kirstene Baillie is a partner at Fieldfisher.

This article focuses on the two types of model that require providers to have authorisation from the FCA: investment-based crowdfunding and loan-based crowdfunding.

The UK accounts for 75 per cent of European crowdfunding and peer-to-peer (P2P) lending activity,[1] and the government and the FCA are now focusing efforts on adapting regulation to suit the constantly evolving crowdfunding business models. UK crowdfunders will be concerned by any EU proposals regarding the regulation of crowdfunding[2] and of course Brexit implications. For the present, though, attention is focused on the specific and imminent FCA proposals for improved regulation, and so on UK regulatory changes.

Investment-based crowdfunding

The investment-based model covers people investing directly or indirectly in new or established businesses by buying shares or debt securities, or units in an unregulated collective investment scheme. It has always been within the scope of UK regulation.[3]

It involves a firm carrying on 'regulated activities' in the investment business space for which FCA authorisation is required. The UK's long-established regulated activity of 'arranging deals in investments' under the Regulated Activities Order (RAO) is wider than the later invented Markets in Financial Instruments Directive (MiFID) activity of 'receipt and transmission of orders'. It effectively catches all manner of intermediation between investor and investment where the investments are within the scope

1 John Glen, HM Treasury, letter to House of Lords European Union Committee regarding Proposal on European Crowdfunding Service Providers (ECSP) and Business, 18 July 2018.

2 The UK government has continued to engage in the progress of the EU proposal for a regulation on European crowdfunding service providers. The EU's direction of travel may be towards changing the proposal into a minimum harmonising directive rather than an opt-in regulation. The EU proposal appears to be moving towards the UK position, with a preference for national regulators to regulate crowdfunding and the majority of Member States agreeing with the UK that the €1m limit on offer size should be raised to a higher threshold. The UK is continuing to argue that there should be clearer differentiation between investment-based crowdfunding platforms and platforms for P2P lending, as well as including further differentiation on the regulatory requirements applying to platforms depending on what specific activities they undertake – see John Glen, HM Treasury, letters to the European Union Committee and European Scrutiny Committees Treasury regarding Proposal on European Crowdfunding Service Providers (ECSP) for Business, of 13 December 2018, http://europeanmemoranda.cabinetoffice.gov.uk/files/2018/12/EST_to_HOL_EU_Committee_-_ECSP_131218.pdf.

3 The UK's Financial Services and Markets Act 2000 (FSMA) and the statutory instrument that sets out the scope of regulated activities under that Act: the Financial Services and Markets Act 2000 (Regulated Activities) Order (RAO).

of 'investments', a term that encompasses all manner of unlisted equity and debt securities.

The first point to note, therefore, is that an investment crowdfunding platform firm will have Part 4A permission from the FCA (or in some cases be an appointed representative of a firm that has permission) to carry on the following activities:

- arranging (bringing about) deals in specified investments under Article 25(1);
- agreeing to carry on a regulated activity under Article 64; and
- if there are pooled models offered, establishing, operating and winding up an unregulated collective investment scheme and/or managing an alternative investment fund (AIF).

It is possible for there to be placing activities and these might also involve:

- making arrangements with a view to transactions in investments under Article 25(2); and
- dealing in investments as agent (Article 21).

It is conceivable that models may also involve advising on investments under Article 53 and/or managing investments under Article 37 (although these are not typically involved). Some involve the arranging, safeguarding and administration of assets but that is more typical with mainstream platforms than for investment-based crowdfunding ones.

The second area to consider is the restrictions on financial promotions. From the outset, the FCA's concern was that the 'wrong type of investor' might invest in unlisted shares or debt securities, although they indicated that they had no evidence of this. Essentially, the FCA takes the view that there is a high possibility that a company will fail and so 100 per cent capital losses will result. Ideally, investors should therefore be advised or properly informed and be able to carry out appropriate due diligence on the investment opportunities offered, to ensure that they understand and can assess what is involved.

Having taken the view that the risks applying to units in unregulated collective investment schemes, warrants and derivatives were not dissimilar to those that applied to unlisted shares or debt securities, the FCA then introduced some rather complicated provisions. In order to provide proportionate consumer protection and fairness for competing firms and products, the FCA's Policy Statement 14/4 in March 2014 covered not only the regulatory approach to crowdfunding over the internet but also the promotion of non-readily realisable securities generally by other media.

There has been a longstanding view that retail investors should only see liquid listed assets. The FCA's initiatives in its Conduct of Business Sourcebook (COBS) – devising COBS 4.7.7 and revising COBS 4.12 for

restricting the promotion of non-mainstream pooled investments – clearly demonstrate this.

To describe better the illiquid shares and debentures that the FCA intended to cover, it introduced the term 'non-readily realisable security', which applies to securities that are not:

- readily realisable securities (broadly listed securities and government securities);
- packaged products (broadly regulated collective investment schemes, life policies, investment trust saving schemes and stakeholder and personal pension schemes) for which an established regime already applies; or
- 'non-mainstream pooled investments' (which term includes units in unregulated collective investment schemes, units in qualified investor schemes, securities issued by a special purpose vehicle other than an excluded security, a traded life policy investment and rights or interests to such investments) – for which COBS 4.12 already applies.

COBS 4.7.7 restricts direct offer financial promotions (but not other promotions) to retail clients, so that a firm may communicate or approve such a promotion relating to a non-readily realisable security only:

1. in circumstances where the firm is itself complying with the COBS 9 suitability rules for the promoted investment or the retail client has confirmed that it is a retail client of another firm that will do so. This effectively covers those who receive regulated investment advice or investment management services from an authorised person. Or;
2. if there is a retail client that is a corporate finance contact or venture capital contact. Or;
3. if neither of the previous instances applies, if both the following conditions are satisfied:
   (a) the retail client recipient is one of the following:
      – a high net worth investor in accordance with COBS 4.7.9;
      – a sophisticated investor in accordance with COBS 4.7.9;
      – a self-certified sophisticated investor in accordance with COBS 4.7.9.

      For any of the certified high net worth investors, certified sophisticated investors or self-certified sophisticated investors under COBS 4.7.9, the individual must have signed, within a period of 12 months ending on the day on which the communication is made, a statement as appropriate for the relevant category of investor as set out in COBS 4.12.6, 7 and 8 respectively substituting unlisted shares and unlisted debt securities for non-mainstream pooled investments.

      A 'restricted investor' in accordance with COBS 4.7.10 covers a retail client who certifies that he will not invest more than ten per

cent of his net investable financial assets in such assets – and so will effectively only invest money that does not affect his primary residence, pensions and life cover.

[The restricted investor statement must be valid at the time of communicating the promotion. Firms can integrate the client certification and the appropriateness test requirements mentioned below if they wish. However, it does need to be a pre-promotion process.]

(b) The second condition is that the firm itself, or the person who will arrange or deal in relation to the unlisted share or unlisted debt security, will comply with the rules on appropriateness under COBS 10 or equivalent requirements for any application or order that the person is aware, or ought reasonably to be aware, is in response to the promotion.

Generally, the FCA expects fair, clear and prominent risk warnings. It is necessary for a crowdfunding site to pay particular attention to drafting appropriate risk warnings for each promotion, reflecting the differing circumstances for the particular investors and audiences for that crowdfunding site.

Further, there are disclosure and due diligence expectations regarding investee companies. 'Accurate, sufficient information' is required of the investee companies in order that investors can understand the extent to which an investment places his capital at risk. This should include information about the lack of a secondary market and, where compensation scheme arrangements are mentioned, information about the lack of recourse to the Financial Services Compensation Scheme (FSCS) (although there is the possible right to complain first to the firm and then, if relevant, to the Financial Ombudsman Service).

To satisfy (longstanding) financial promotion rules, sufficient detail needs to be included about the benefits and risks involved, including the due diligence carried out in respect of the investee company, the extent of that due diligence and the outcome of any analysis.

Obviously, in respect of Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) investments, there also needs to be a clear explanation of the tax treatment – and that it depends on an individual's circumstances and might change over time.

Also, there is a need for management of expectations. There is always the issue of potential of a mismatch between the expectations of investors as to how far the investments appearing on a crowdfunding site have been vetted and the realities of what is commercially feasible within the budget constraints that must apply when only relatively small amounts of money are being

raised. This area needs some careful thought – simply drafting disclaimers in the terms and conditions for a crowdfunding business will not provide a watertight solution or be capable of protecting from reputational risk.

For those of us with long experience of the FCA's approach on investor protection, none of these conclusions was particularly surprising. The upshot is that investment-based crowdfunding sites needed to develop detailed compliance procedures for promotions and disclosures to enable investors to make informed decisions.

The third area to review is the particular challenges of investee companies using these crowdfunding sites.

UK securities laws have generally worked on the assumption that companies fall within one of two models: private unlisted companies, which would typically be expected to have only a small number of shareholders, and public limited companies (plcs) where the shares would be held more widely, and which would often be publicly listed. The crowdfunding model cuts across this assumed dichotomy in that it looks to raise money from a potentially large number of investors by making an extremely public offer, but often the companies are small and not ready to fulfil the expectations of a plc. The issue most notably services in relation to two longstanding legal requirements:

1. UK company law restricts the company from undertaking a public offering of its shares or loan securities unless the company is a plc, which requires greater detail of formality in how a company is operated and also brings dealings in the company's shares within the ambit of the Takeover Code.
2. A company offering its transferrable securities to the public is required to publish and register a prospectus under the Public Offers of Securities Regulations unless an exemption applies.

Various legal structures and business models have been developed to avoid the consequences of these rules but some of these are better founded than others – generally it would be preferable for the company to be a plc and for one of the exemptions to the Public Offers of Securities Regulations to apply – and note that these exemptions have recently been revised (implementing part of the EU Prospectus Regulation[4]) as of 21 July 2018.

Loan-based crowdfunding

In contrast, regulation for the new area of loan-based crowdfunding or 'peer-to-peer lending' had to be invented.

The loan-based crowdfunding model involves a situation where consumers lend money in return for interest payments and repayment of capital over time.

4 Prospectus Regulation EU 2017/1129.

The FCA introduced something to plug the gap for such crowdfunding models pursuant to its CP13/13 and Policy Statement PS14/4 from 1 April 2014.

A new regulated activity was inserted as Article 36H of the RAO, covering 'operating an electronic system in relation to lending'. In order that it could ensure adequate protection for lenders alongside this, the FCA developed regulations designed to ensure that there were appropriate measures to protect borrowers. Peer-to-peer lending platforms were required under the Consumer Credit Sourcebook (CONC) in the FCA Rules to provide adequate explanations of key features of lending arrangements before the arrangements were set up and should later provide notices to borrowers of any sums in arrears and default consequences.

Article 36H only covers Article 36H agreements meeting certain conditions, including meeting either Condition 5 or Condition 6. Condition 5 is that the lender is an individual or relevant person. Condition 6 includes that the borrower is an individual or relevant person, and the lender provides the borrower with credit less than or equal to £25,000, or the agreement is not entered into by the borrower wholly or predominantly for the purposes of a business carried on or intended to be carried on by the borrower. ('Relevant persons' include a partnership consisting of two or three persons, not all of whom are bodies corporate, or an unincorporated body of persons that does not consist entirely of bodies corporate and is not a partnership.) Operating an electronic system in relation to lending that is facilitating loans between lenders and borrowers who are not individuals or certain types of non-corporate business and where the amount borrowed is over £25,000 or the borrowing is for business purposes is not captured by the regulated activity.

Where a borrower on a loan-based crowdfunding platform is an individual, as defined in the Consumer Credit Act (CCA) as a consumer or sole trader or small partnership (or other unincorporated body) borrowing less than £25,000 for the purposes of the borrower's business, the credit agreement will be a regulated credit agreement unless a specific exemption applies. If the investor (as lender) is lending in the course of a business (which is likely to be the case for institutional investors and possibly some other cases), the agreement is subject to the full requirements of the CCA and the investor will need FCA authorisation and to comply with the rules in CONC applicable to lenders. In addition, the peer-to-peer platform will need authorisation for the Article 36H activity where, among other things, the platform facilitates persons becoming a lender and a borrower under an Article 36H agreement.

If the lending is not in the course of business, the agreement may still be a regulated credit agreement but is a 'non-commercial agreement' for the purposes of the CCA. In addition, the lender will not need FCA authorisation

for lending. For example, the non-commercial lender will not need to comply with the CCA requirements on pre-contract credit information or the form, content and execution of the credit agreement. To address this gap in borrower protection, the FCA introduced new rules in CONC specifically for P2P platforms.

The disclosure rules are not overly prescriptive but are designed to give a high-level indication under COBS 14.3.7A. The RAO and the Financial Promotion Order were amended to include Article 36H agreements within the scope of the FCA's rules, so websites and details of loans will be considered to be financial promotions subject to the FCA's rules. In addition, owing to concerns about performance information, use of the words 'guaranteed', 'protected' or 'secure' and comparative information, which are frequently debated topics in relation to traditional investment routes, are applied to loan-based crowdfunding under specific rules, and need careful attention. There is no ban on these or other specific terms, but firms can only use terms such as 'protected' or 'secure' or make comparisons of returns to saving accounts where that is fair, clear and not misleading. This is using the (oldest) approach possible, which is ensuring that disclosure text provided to investors is fair, clear and not misleading. It is hardly new but arguably just slightly more difficult to apply to some new business models.

FCA core provisions are applied, including conduct of business rules around disclosure and promotions, in particular, minimum capital, client money protection, dispute resolution and a requirement for firms to take reasonable steps to ensure that existing loans continue to be administered if the firm goes out of business. Cancellation rights may arise under the Distance Marketing Directive, with the FCA taking the view that, where required to be offered, the practical approach is for the right to cancel to attach to the initial agreement rather than to each loan contract.

Even post-PS14/4, however, the protections put in place for loan-based crowdfunding are not the same as for most authorised firms. The changes outlined above were moves in the right direction but not all the way. The system developed was designed to be proportionate and appropriate for the market in the risks it carried. In certain areas there is a weaker approach than for other areas of business. For example:

- It was thought that minimum capital standards and requirements for firms to have arrangements in place to administer loans in the event that the platform should fail provided adequate protection for now. The capital must be at least £50,000, or more for bigger firms, but nonetheless it is still not the same as other established regulated businesses might have.
- The Financial Services Compensation Scheme (FSCS) does not apply for P2P lenders.

The FCA's initial view was that a loan-based crowdfunding platform would generally be of lower risk than that made via investment-based platforms, but they would keep this approach under review and consult further if necessary.

Prospective regulatory developments?

The remainder of this article focuses on how regulation may develop in the UK in the light of the FCA's Post Implementation Review, its Feedback Statement 16/13, and their Consultation Paper 18/20 (CP18/20) on crowdfunding platforms issued in July 2018.[5]

The FCA now acknowledges that crowdfunding is becoming an important alternative source of finance for companies and consumers, and that there should remain significant differences between the two types – investment-based and P2P lending crowdfunding platforms. They plan to recalibrate the applicable regulatory regimes to fit how they see these business models evolving:

- For investment-based crowdfunding platforms, the current regime will continue with a few clarifications where poor compliance with existing rules has been observed.
- For both investment and loan-based crowdfunding, there will be more prescriptive requirements on the content and timing of disclosures. Generally, there has been identification of some poor communication and marketing material with inadequate explanation of risks, insufficient information provided and insufficient ongoing disclosures, with opaque charging structures.
- For P2P platforms, there is a package of new rules and guidance now proposed in the light of the wider and more complex range of business models which are now in the marketplace. We consider these in the following section.

Reinforcing P2P lending platform regulation

If implemented as proposed in CP18/20, there will be a significant increase in the level of regulation of P2P lending platforms, varying depending on the type of platform.

The FCA is now seeking to characterise platforms as: *conduit* models, where the platform undertakes due diligence on the person/business seeking investment and decides whether to offer them on the platform, and the investor is responsible for choices made about the prospect of return on an individual loan or investment; *pricing* models for which the platform

5 At the time of writing (14 February 2019), no update on the CP18/20 proposals has been published by the FCA.

is responsible for accurately pricing a loan and the investor is responsible for making choices made from the platform's advertised interest rates for individual loans; and *discretionary* models where the investor chooses from the platform's advertised targeted rates of return and the platform allocates investment on behalf of the investor to achieve the advertised targeted rate of return.

Risk management systems for pricing a loan

To help enable P2P platforms to price the credit risk of the loans they facilitate at origination and over time, new minimum prescriptive rules will be introduced. A platform will have to gather sufficient information about the borrower to be able to assess competently the borrower's credit risk, to categorise borrowers by their credit risk in a systematic and structured way (taking into account the probability of default and the loss if there is default) and set the price of the agreement so that it is fair and appropriate, and reflects the risk profile of the borrower.

The new information-gathering rules can be met by complying with the existing requirements, which may apply for a creditworthy assessment under the CONC Rules or the proposed affordability assessment under the Mortgages and Home Finance Conduct of Business Sourcebook (MCOB) Rules now proposed in CP18/20, so the platform will already need to gather sufficient information to consider affordability for the borrower. In connection with risk management, therefore, a platform can meet the proposed information-gathering rules by complying with these other existing requirements. It then needs to integrate them and use that information as part of its risk management framework.

If there is a target rate of return for a P2P portfolio offered to investors, the FCA views this as outside discretion on behalf of investors and so the platform must have a reasonable basis to conclude that the return it is advertising can reasonably be achieved within the risk parameters originally advertised. If a platform categorises loans depending on risk and advertises target rates of return relating to these, it has to have a risk management framework that is adequate, and platforms will be required to keep under review assessment of outcomes against expectations. The FCA is now viewing this as offering a *complex financial service* and so requiring controls commensurate with such. The FCA in fact indicates that some platforms may find it more appropriate to simplify their business model rather than upgrade their systems and controls. As a minimum, platforms must revalue loans that have defaulted as part of demonstrating that a P2P platform's risk management framework is adequate to assess price and value over time.

This will apply to P2P platforms that set the price of a loan because investors rely upon the platforms to price agreements fairly and appropriately. For other (conduit) platforms, the FCA thinks that, while the rules will not be mandatory, it would be good practice to consider whether, depending on their particular business model, they need to apply the same principles to ensure that investors have access to adequate information.

Governance standards

These should be improved in general so that they are comparable to those applicable to firms conducting certain types of investment business, so systems and control requirements will have to be upgraded.

P2P platforms will have to establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment. Depending on the nature, scale and complexity of its business and the nature and range of services undertaken in the course of that business, they are to be required to have independent risk management, compliance and internal audit functions.

No fixed threshold has been given where these additional requirements become applicable but obviously the larger platforms operating a business model that sets the price and choosing the investor's portfolio to generate a target return are more likely to be required to meet these requirements. Any that do not have independent functions should be able to demonstrate why it is not proportionate to have these and also to be able to demonstrate that, nonetheless, they have effective compliance and risk management policies and procedures in place.

Under the existing UK FCA Approved Persons Regime where independent risk management and audit functions are appropriate, responsibility will be allocated at a senior level and individuals will have to be approved to perform the relevant governing function under the existing controlled functions regime. Compliance officers are already required to be approved under the Approved Persons Regime.

Also, the recently published Policy Statement[6] in relation to the Senior Managers and Certification Regime (SM&CR) will apply to all crowdfunding platforms from 9 December 2019. This is a major initiative designed to enable firms and regulators to hold people within regulated businesses to account – encouraging staff to take personal responsibility and to improve conduct at all levels within an authorised firm. Under the new Certification Regime, instead of the Approved Persons Regime Controlled Function 28 for systems and controls, the Certification Regime may, and the conduct of rules will, apply to these individuals – for example as a material risk-taker or significant

6 FCA Policy Statement 18/14 July 2018: Extending the Senior Managers & Certification Regime to FCA firms.

management function in relation to compliance oversight, existing Control Function 10 of the Senior Managers Regime will apply.

Improved management of conflicts of interest

While there will be no new rules, there is reiteration of concerns about the requirements to identify and prevent or manage conflicts of interest. The FCA is looking for visible improvements to platform systems and controls to manage conflicts of interest.

Relevant only for a limited part of an investor's portfolio

With recognition that many of the types of loans facilitated by P2P platforms are inherently risky, with a high risk of loss, the FCA is now taking steps to ensure that investors are not over-exposed to the asset class. Specifically, they will require P2P platforms to communicate promotions only to certain types of retail clients: those that are certified or self-certified sophisticated investors; those that are certified as high-net-worth investors; those who confirm before a promotion is made that they will receive regulated investment advice or investment management services from an authorised person in relation to the services the investment promoted; or those that certify that they will not invest more than ten per cent of their net investor portfolio and P2P agreements.

Where no advice is to be given to retail clients, platforms must comply with the rules on appropriateness in COBS 10 so that they ensure that investors are assessed to have the knowledge and experience to understand the risk involved before they can invest.

Planning for closure, and consolidation

It is expected that a number of P2P platforms may exit and there may be some consolidation in the marketplace. The FCA proposes to strengthen the existing rules so that a platform must have arrangements in place to ensure that the P2P agreements they facilitate can be managed if the platform ceases to carry out the functions itself. Guidance is to be included that concerns the detailed arrangements – for example, in some instances, prior informed consent should be obtained from investors. Any platform contemplating ceasing to manage and administer P2P loan arrangements must notify the FCA in writing and additional guidance will make this clear.

Platforms will need to have a P2P resolution manual containing the information about their operations that would assist in resolving the platform

in the event of its insolvency – so there has to be advance planning, setting out all relevant details of the nature of the business and its documentation – and IT systems and possibly proprietary software.

Views are requested on whether mandating additional prudential requirements for P2P platforms is also necessary to protect investors in the event of platform failure – but at the moment no formal proposals are made for this.

Improved disclosures

To improve the disclosures to investors, the FCA is going to require more specific disclosure requirements so as to reduce the risk of poor disclosures. There is a risk this is a sensible checklist of items to include, which varies depending on the type of platform, will not of itself improve the disclosures made but, nonetheless, it should be a helpful checklist.

Ongoing disclosures are included in this initiative. Customers must have access details of each P2P agreement they have entered into on an ongoing basis, including risk categorisation and whether there has been default by the borrower. The FCA proposes that a platform must at least carry out a valuation of a P2P agreement following a default.

Contingency funds

Where platforms offer contingency funds or provision funds designed to top-up payments made to investors in the event of a borrower defaulting, the FCA will require further disclosures of a prominent standard risk warning to make it clear to investors that the operation of such a fund does not guarantee payment in the event of defaults. If a platform wants to offer a guarantee to investors, it would need to consider buying insurance instead. Secondly, the platform would need to explain how that particular contingency fund would be funded, governed, who would hold its money and generally how it would operate, and how the money would be treated in the event of the platform's insolvency.

Perhaps some of the rather 'informal' arrangements to date will need to be reformulated into more suitable propositions, which are then clearly explained to platform users. Platforms would need to publish quarterly certain facts about how a contingency fund is performing.

Where a platform sets the price, outcome statements to be published

Where a platform sets the price, which applies both to pricing platforms and discretionary platforms but not conduit platforms, the FCA proposes that there must be an 'outcomes statement', published within four months of the end of each financial year, with the expected financial default rate of all P2P agreements with platforms facilitated by risk category, a summary of the assumptions used in determining expected future default rates and, where the platform offers a targeted rate, the actual return achieved. There will be a definition of what constitutes default for this purpose, which is likely to be where a loan would have defaulted and when the borrower is past the contractual payment due date by more than 90 days or 180 days of property loans.

If and when the new rules come into force, there is expected to be a six-month implementation period so that P2P platforms have time to adjust.

The risk of arbitrage

The proposed changes outlined above demonstrate a response from regulators to the evolving P2P marketplace, and more widely the general growth of new types of platforms and developments in distribution models in the investment arena. Nonetheless, this still leaves wider concerns of potential for arbitrage.

More complicated P2P business models are being developed and the risk is that they can increasingly look similar in substance to other existing types of regulated activities. If so, it is important that the relevant regimes for those existing types of regulated activities should be followed. As the FCA points out, to do otherwise, they would do so 'without being subject to the same regulatory requirements or offering the same consumer protection'. If the FCA concludes that there is likely to be consumer detriment, it will consider introducing additional rules to reduce or remove the potential for that risk for arbitrage.

Some of the proposals in CP18/20 start – but note only start – to level the playing field in some of the conduct of business provisions:

Investment management and investment funds

The FCA is not just concerned about blurred lines across to the asset management business model but the fact that some business lines are, in effect, avoiding the full panoply of regulation that currently applies to asset management conducted under an asset management business model. The

FCA clearly wants to explore this further and the extent to which P2P is becoming a substitute for asset management.

The risk of investment-based crowdfunding platforms in some way offering some form of informal collective investment scheme that could be an unregulated collective investment scheme of itself (as widely defined for UK law purposes) was always understood.

In January 2016, HM Treasury purposefully amended secondary legislation so that firms carrying on the activity of operating an electronic system in relation to lending (Article 36H) were not regarded as operating collective investment schemes. In the 2015 Explanatory Memorandum for this provision, HM Treasury took the view that the two business models were distinct and regulated according to different frameworks and, since there was some overlap both in the activities the operators of such systems carried on and in the way in which the two were defined, this might create uncertainty about the framework under which a firm ought to be regulated. The uncertainty was undesirable and therefore a statutory instrument was introduced whereby, if a P2P lending platform were also considered to be a collective investment scheme, it would not also be a collective investment scheme. It was thought inappropriate given that the UK had a specific regulatory regime for P2P lending platforms under which they were considered to be regulated proportionately, and consumers were provided with appropriate protection to have double regulation.

The issue now is that that view is probably being revisited – and will possibly be changed. What some are trying to do is have some 'pooling exercise' in the middle, whether it is the platform itself or some fund in the middle. Article 36H should probably not, of itself, provide a regulatory solution.

Also, remember that the UK now has two investment fund definitions: the second one is the EU alternative investment fund (AIF) definition under the Alternative Investment Fund Managers Directive (AIFMD). AIFMD provisions sit on top of the old UK collective investment schemes (CIS) regime and the long-established constraints on promoting unregulated collective investment schemes. So, there is currently a risk that a platform can constitute an alternative investment fund for which there ought to be appropriate treatment under AIFMD provisions – with some person managing an AIF.

Deposit taking/banking

We have a clear message from the FCA that avoiding the full panoply of banking regulation when in fact there is banking activity of accepting deposits being undertaken is not an approach that it will allow to continue.

There is a certain point where, if you push activities too far, you end up going into the mainstream. So, might loan-based crowdfunding activities be expected to reach in to deposit taking? Are loan-based crowdfunding platforms accepting deposits?

When first considered in FCA CP13/3, it was presupposed that the loan agreements facilitated on the platforms were generally made between investors and borrowers, so the failure of the platform of itself might not necessarily lead to losses. So, it seemed that loan-based crowdfunding platforms would not be operating as banks themselves (although arguably replicating such). Monies received from the client for the purposes of lending out to borrowers and repayments from borrowers to be provided back to clients, whether received physically or electronically, would be regarded by the firm as holding it as client money held by the firm for and on behalf of the client in relation to investment business. Consequently, the FCA decided to apply client money rules from the Client Asset Sourcebook (CASS) with some minor amendments.

This can be distinguished from where a platform might be operating a lending business or where any business operates through a platform. In that scenario, there can be accepting of deposits and so banking business that requires FCA permissions. The FCA's view expressed in its 28 February 2017 'Dear CEO' letter is that 'where a borrower uses funds provided via a loan based crowdfunding platform for on-lending, they are likely to require a permission to accept deposits'.

Regulation 5 of the RAO on accepting deposits is very straightforward (and always has been):

> 'Accepting deposits as a specified kind of activity if:
> (a) money received by way of deposit is lent to others, or
> (b) any other activity by the person accepting the deposits is financed wholly, or to a material extent, out of the capital of, or interest on, money received by way of deposit.'

Focus has always been paid to the 'accepting deposits' element with the rest of the text explaining that, rather than looking at the issue of 'lending on to others'. Nonetheless, the text in paragraph (a) indicates that accepting deposits covers 'money received by way of deposits which is lent to others'. It is this first limb of the Regulation 5 accepting deposits definition on which the FCA is now relying in order to indicate, and potentially prevent, some of the expansions of loan-based crowdfunding platforms operating only under Article 36H. The key issue to address is whether or not there is a lending business that takes money from others (whether directly or through a crowdfunding platform) and then lends the borrowed funds on to others.

There has been recognition by government that, where a business borrows funds via a P2P platform, there is a risk that in some circumstances the business might be carrying on the specified activities of accepting deposits. This is thought inappropriate as most P2P borrowers are unlikely to be financial services firms. To create some certainty in this area, a recent statutory instrument makes it clear that businesses meeting certain specified conditions are not to be properly regarded as accepting deposits by way of business and do not need to be authorised or exempt persons to carry out that activity lawfully. P2P platforms, though, do need to make sure that the conditions specified are met so that they are not facilitating unlawful deposit taking. This development does not address the issue of P2P lending models themselves arguably accepting deposits. If some P2P lending models wish to build their business models out into what is really accepting deposits, they need to move into the mainstream area of accepting deposits – as indeed some are starting to do.

It is important to look at the various issues more holistically across the spectrum of alternative offerings – including some that should more properly belong in the asset management or banking sector. In all cases, as ever where it perceives there to be difficulties, the FCA can rely upon the FCA's Principles and Threshold Conditions in reviewing the activities of authorised firms. A platform that does not hold the correct permission could lead that platform itself to be acting in a manner inconsistent with FCA expectations for regulated firms and may be in breach of:

- Principle 6: treating customers fairly; and
- Threshold Conditions 2E (suitability) and 2F (business model).

How should advisers advise?

This author has always advised clients devising financial services and products to comply with the *spirit* of regulation. This is particularly important for innovative offerings such as some crowdfunding platforms – both in the current situation where we are awaiting rule changes but are aware of FCA concerns, and indeed in responding to those rule changes once they are finalised.

Crowdfunding platform providers – and their advisers – would be well recommended to try and work *with* the regulator and to embrace the relevant regulations so as to work out how best to anticipate how their offering meets the evolving regulatory objectives and expectations: past, present... and future.