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ALERT

Asset Management

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Call for Input on the Post-Implementation Review of the FCA's Crowdfunding Rules

1. Summary

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The Financial Conduct Authority (the "FCA") published a post-implementation review of its crowdfunding rules on 8 July 2016 (the "Paper"). The Paper is a "call for input" to invite readers to engage with the review, to offer feedback on the issues outlined in the Paper and to provide their thoughts on the sector. The Paper comes after the FCA committed (in March 2014) to carrying out a full post-implementation review of the crowdfunding market and regulatory framework in 2016 to identify whether further changes are required.

The Paper comes two years after the FCA started to regulate loan-based crowdfunding in April 2014. The FCA did so by creating a new regulated activity (contained in Article 36H of the FSMA 2000 (Regulated Activities) Order 2001[1] (the "RAO")): "operating an electronic system in relation to lending". Most investment-based crowdfunding activity was already subject to FCA regulation as the activity typically amounts to one of the following: arranging deals in specified investments (article 25(1), RAO); agreeing to carry on a regulated activity (article 64, RAO); or establishing, operating or winding up an unregulated collective investment scheme (article 51(1)(a), RAO).

Over the coming months, the FCA will be conducting work with firms to collect evidence on potential risks and address any knowledge gaps, and will carry out additional research into the market as a whole to inform the review.

The Paper reviews the market size and growth of the crowdfunding industry, and then splits into an analysis of recent market developments in loan-based crowdfunding and investment-based crowdfunding. The Paper concludes with a list of 22 questions. The FCA would like to receive comments by 8 September 2016 and will consider publishing a consultation paper with proposals for rule changes if this is justified by the evidence in the review.

2. Market Size and Growth

The Paper highlights that the crowdfunding market has grown rapidly from 2014. While an estimated £500m was invested on regulated crowdfunding platforms, over the course of 2013, an estimated £2.7bn was invested over the course of 2015. There are now over 100 platforms in the market or seeking authorisation. There are currently nine firms that are fully FCA-authorised to operate as loan-based crowdfunding platforms and the FCA is currently considering 88 applications from firms. Additionally, 23 FCA-authorised firms and 11

[1] SI 2001/544.

appointed representatives operate investment-based crowdfunding platforms. At the time of the FCA's 2015 interim review of the sector, there were 14 authorised firms and 11 appointed representatives.

The equity-based crowdfunding market has also grown rapidly in recent years, but is still relatively small compared to the £16.7bn in retail sales of investment funds over the course of 2015.

3. Loan-based Crowdfunding

One emerging feature of loan-based crowdfunding platforms is a broader pooling of credit risk. A core characteristic of loan-based crowdfunding is the matching of multiple lenders to a single borrower with many lenders making small (micro) loans to meet a borrower's (macro) borrowing requirement. Those lenders effectively share in the risk if the borrower is unable to repay its loan. However, platforms are also increasingly developing models that provide for pooling of such risk across the lenders on a platform as a whole. This pooling and other factors may mean that some firms operating loan-based crowdfunding platforms are also operating collective investment schemes.

The Treasury amended secondary legislation in January 2016 so that firms carrying on the activity of operating an electronic system in relation to lending are not regarded as operating collective investment schemes. While these developments may have benefits to investors, there are potentially blurred lines between loan-based crowdfunding and other business models, such as asset management. This creates a risk of regulatory arbitrage under which firms may conduct business that looks similar to asset management but under a regulatory regime that was not designed for asset management business models.

The FCA also notices maturity mismatch products on loan-based crowdfunding platforms. With these, borrowers borrow on the usual terms, for loan periods of, say, five years, but investors invest in products that aim to allow investors to take out their money after a 30-day notice period.

Another development that the FCA has spotted is an evolution in the type of investors on loan-based crowdfunding platforms, with an increase in institutional investors. A 2015 Nesta report notes that 26% of business loans and 32% of consumer loans were funded by institutions in 2015. As part of this, the FCA is also beginning to see the development of asset-backed securities based on the loans on P2P platforms. The FCA would be concerned if institutional investors are granted any favourable treatment in investing compared to less knowledgeable or less experienced retail investors (for example, the chance to review and invest in loans before retail investors can do so).

Furthermore, the FCA is concerned that the availability of P2P investment through ISAs and pensions may create a change in the investor base toward retail investors who are less experienced or knowledgeable, who trust the ISA "brand", and who may not fully appreciate the risks involved.

The FCA notes that it also continues to see P2P financial promotions that are not compliant with the FCA's financial promotion rules across all types of media.

4. Investment-based Crowdfunding

Some of the trends seen for loan-based crowdfunding are also visible in investment-based crowdfunding. For example, the Nesta report reveals increasing institutional investment in investment-based crowdfunding platforms.

Nesta also reports that a number of new financial products have been introduced on investment-based crowdfunding platforms, including mini-bonds, convertible notes, REITs and accelerator funds.

The FCA notes that the current rules require firms to check a retail client's knowledge and experience to assess their understanding of the risks (the appropriateness test) and to classify the client under certain criteria before communicating direct offer promotions (client categorisation). Where the firm determines through its appropriateness test that the investment may not be appropriate, given the client's knowledge and experience in the relevant investment field, the firm is required to clearly warn the client. As part of the post-implementation review, the FCA is planning an in-depth assessment of how firms operating investment-based crowdfunding platforms are meeting the appropriateness test requirement and whether the client outcomes are fair.

The FCA also intends to assess how well firms are meeting the client classification requirements and on what basis they are making assessments about whether clients meet the specified criteria.

Where the FCA finds poor consumer outcomes (for example, clients being assessed as "sophisticated" where they do not understand the risks or are unable to conduct necessary additional due diligence), the FCA will consider taking further action with firms, either to ensure appropriate redress or to sanction the firm.

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If you have any questions on the Paper and the FCA's post-implementation review, then please do reach out to your usual Ropes & Gray contact.

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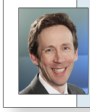

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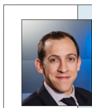

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