Crowdfunding regulation

Thank you for your letter of 1 June 2016 regarding the regulation of crowdfunding. You ask a number of questions in relation to the regulation of crowdfunding by the FCA, which I address below. I have also included some background to give more information about how our thinking on this subject is developing.

As you know, the FCA regulates two types of crowdfunding: investment-based and loan-based, the latter more commonly referred to as peer-to-peer (P2P). Investment-based crowdfunding has always been regulated by the FSA and FCA. The FCA began regulating P2P in April 2014; prior to this, it was regulated by the OFT. At the same time as P2P became regulated by the FCA, we reviewed our rules for investment-based crowdfunding to ensure they were providing adequate and proportionate protections that would not act as barriers to entry, or significant regulatory burdens.

The crowdfunding market in 2014 was small but growing rapidly, and the growth of the sector is something we have been watching very closely. We recognise that crowdfunding can provide beneficial competitive pressure to firms offering more traditional sources of finance to the advantage of consumers as investors and as borrowers, but that it also poses risks to consumer protection which need to be managed. Our rules were designed with this balance in mind. Specifically they focus on ensuring appropriate disclosure to investors of the risks; proper protection of client money (while held by the platform); and sufficient capital being held to allow for an orderly wind-down of the platform. They do not, however, seek to impose requirements equivalent to those of banks in terms of liquidity or capital, for example.

Different platforms and loans carry different levels of risk. Consumers who invest via P2P platforms do not have access to the Financial Services Compensation Scheme (FSCS), and investments are higher risk than holding money on deposit; consumers who invest may lose some or all of their investment.

We regard investment-based crowdfunding as a high-risk investment activity. Our rules restrict promotion of these types of investments to those who have received advice, particular types of experienced or sophisticated investors or ordinary investors who confirm they will not invest more than 10 per cent of their net investable assets. FSCS protection will only apply should the platform fail to meets its obligations, for example if they issue misleading
communications; those who invest are not protected if they lose their money simply because the underlying investment fails.

The FCA recognised in 2014 that the rapid development of the sector meant our rules would need to be kept under review. We, therefore, committed in 2014 that a full post-implementation review of the regime, as it applies to both P2P and investment-based crowdfunding, should take place in 2016 to ensure the rules remained appropriate. This was discussed by our Board in May and we will be publishing a discussion paper and call for input as the first stage of this review in the coming weeks. A consultation paper will then follow should we feel changes to rules are necessary.

We remain cautious about the risks posed to consumers by P2P firms. The P2P firms that were previously regulated by the OFT and received interim permissions are currently going through the FCA's full authorisation process and we are carefully scrutinising firms' business models and practices to ensure that the firms are compliant with the regime and rules currently in place to protect consumers. Our ongoing supervision of, in particular, financial promotions, also reflects the growth of the P2P market and announcement of the Innovative Finance ISA, which we recognise could lead to an increase in retail consumer investments in the products provided by P2P firms.

In relation to your specific questions, adopting your numbering:

1. The obligation to provide accurate information rests with the firms. As part of our assessment of firms, we assess whether they convey information that is clear, fair and not misleading in accordance with our rules on financial promotions. The existing rules on disclosure provide that both P2P and investment-based crowdfunding firms must provide information to retail clients on the nature and risks of their investment in sufficient detail to enable the client to take investment decisions on an informed basis. Since October 2014 we have considered 27 cases of P2P financial promotions, 12 of which have resulted in promotions being amended or withdrawn, and 10 cases of investment-based promotions, 9 of which have resulted in promotions being amended or withdrawn. We continue to monitor this area.

2. There are commercial incentives on P2P firms to lend to creditworthy borrowers to ensure that their proposition continues to be attractive to investors. Where the borrower is an individual, or certain forms of small businesses, the P2P platform also has to comply with our creditworthiness rules, which are the same as those applying to professional lenders. In essence, the platform has to consider the creditworthiness of a potential borrower, including the potential for commitments under the loan to adversely impact the borrower's financial situation and the ability of the borrower to make repayments as they fall due. Different borrowers will, however, have different risk profiles and that is reflected in returns which are potentially available to investors.

We have not stipulated levels of due diligence which investment-based crowdfunding platforms must undertake. Instead we have provided flexibility to firms to develop their own approach. In some cases, for instance, it may be appropriate for investors to undertake their own analysis of possible investments. In other cases the firm running the platform will undertake more of the analysis on behalf of investors. Our current rules allow either approach but we require firms to make it clear to potential investors what analysis has been undertaken so investors can determine how much extra work they need to do.

3. For investment-based crowdfunding, our current rules require firms to assess the level of knowledge, experience and understanding of the investor where they have not
received financial advice. They do this by asking the client to provide information regarding their knowledge and experience in the investment.

For P2P lending, during our initial consultation in 2014 the evidence showed a high level of investor understanding of the risks involved. As such, we did not require the same level of assessment of knowledge and experience. We do have concerns that the evolution of firms’ business models into more complex arrangements could have impacted on the level of consumer understanding, and so we are proposing to carry out research to test the current levels of understanding of the risks involved as part of our review.

4. The crowdfunding sector remains relatively small in comparison to other regulated sectors, although it is estimated that P2P business lending was the equivalent of 3.9% of new loans lent to SMEs based on the BBA’s 2014 baseline figure.¹ Should firms continue to focus their business on consumers who could ordinarily seek finance from traditional sources, we would expect to see increased competition over interest rates and customer service and a growing choice of finance providers.

The FCA recognises that the growth in crowdfunding provides potential benefits to consumers, businesses and investors but that this growth also comes with increased levels of risk posed to the same groups. We remain focused on ensuring consumers are protected, whilst promoting effective competition. Our ongoing review is part of this process.

Yours sincerely

Tracey McDermott
Acting Chief Executive

¹ Nesta, Pushing boundaries, the 2015 UK alternative finance industry report, February 2016: http://www.nesta.org.uk/sites/default/files/pushing_boundaries_0.pdf