

Possible FCA Handbook changes to reflect the introduction of the Innovative Finance ISA and the regulated activity of advising on peer-to-peer agreements

November 2015



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We are asking for comments on this Discussion Paper by 31 December 2015.

You can send them to us using the form on our website at:
www.fca.org.uk/your-fca/documents/discussion-papers/dp15-06-response-form.

Or in writing to:

Jason Pope and Susan Cooper
Strategy and Competition Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf

Email: dp15-06@fca.org.uk

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Abbreviations used in this paper

COBS	Conduct of Business Sourcebook
FAMR	Financial Advice Market Review
FCA	Financial Conduct Authority
HM Treasury	Her Majesty's Treasury
IFISA	Innovative Finance Individual Savings Account
ISA	Individual Savings Account
P2P agreement	Article 36H agreement, as defined in Article 36H(4) of the RAO
RAO	Regulated Activities Order
RDR	Retail Distribution Review

1. Overview

Introduction

- 1.1** In this discussion paper, we set out our initial thinking about possible changes to our Handbook to make sure our regulatory approach takes account of two proposed legislative developments that will impact on the regulated loan-based crowdfunding sector.
- The first development arises as the Government plans to allow loan-based crowdfunding investments (Article 36H agreements in the Regulated Activities Order (RAO), usually known as peer-to-peer (P2P) agreements)¹ to be included in Individual Savings Accounts (ISAs), in a new component to be known as an Innovative Finance ISA (IFISA).² The new IFISA is expected to be available from 6 April 2016.
 - The second development arises as the Government plans to amend the RAO to make the provision of advice about loan-based crowdfunding investments that are RAO article 36H agreements (P2P agreements) a regulated activity.
- 1.2** This paper is published on the understanding that legislation will be brought forward and made by Parliament. It will be necessary for the FCA to review its proposed approach once that legislation is made. In light of the expected legislative timetable, however, we are publishing this paper now to communicate to stakeholders as early as possible our preliminary thinking about the changes to our Handbook which might be made to reflect these developments.

Who does this paper affect?

- 1.3** This paper will be of interest to:
- consumers and consumer organisations
 - financial advisers
 - firms operating loan-based crowdfunding platforms
 - firms that wish to manage IFISAs
 - trade bodies that represent stakeholders in this market
 - compliance consultants and other firms that assist stakeholders

¹ Loan-based crowdfunding is a term that applies to peer-to-peer (P2P) lending, peer-to-business (P2B) lending and business-to-peer (B2P) lending, but is generally referred to as P2P lending.

² HM Treasury, *ISA qualifying investments: consultation on including peer-to-peer loans* (July 2015): <https://www.gov.uk/government/consultations/isa-qualifying-investments-consultation-on-including-peer-to-peer-loans/isa-qualifying-investments-consultation-on-including-peer-to-peer-loans>

Context

- 1.4** Crowdfunding is a way in which individuals, organisations and businesses, including business start-ups, can raise money through online portals (called crowdfunding platforms) to finance or re-finance their activities. Money can be donated or invested in various ways by both individuals and businesses. Some crowdfunding activity is unregulated, some is regulated and some is exempt from regulation. This paper focuses on the regulated loan-based crowdfunding sector.³
- 1.5** We generally regulate firms that operate loan-based crowdfunding platforms. Individuals can use these to lend money to other individuals or businesses, or businesses can use them to lend to individuals or other businesses, usually in the hope of receiving a financial return in the form of interest payments, together with repayment of capital. We took on responsibility for regulating loan-based crowdfunding on 1 April 2014 (other than most business-to-business lending).
- 1.6** The rules we have introduced to protect consumers investing in this part of the crowdfunding market focus on the provision of information to consumers. This information helps them to assess the risks associated with loan-based crowdfunding, understand who will ultimately borrow the money and make informed decisions. Firms operating loan-based crowdfunding platforms must also comply with other FCA core consumer protection requirements. For example, client money must be protected and firms must meet minimum capital standards. We also require firms running these platforms to have resolution plans in place that mean, in the event of the platform collapsing, loan repayments will continue to be collected so those lending money do not lose out.
- 1.7** In order to take account of the introduction of the IFISA, and anticipating that advising on P2P agreements (i.e. providing advice related to investing in loan-based crowdfunding) becomes a regulated activity, we will need to amend certain provisions in the FCA Handbook.
- 1.8** The proposals in this paper are designed to advance the FCA's objectives of:
- securing an appropriate degree of protection for consumers
 - promoting effective competition in the interests of consumers
 - protecting and enhancing the integrity of the UK financial system

Summary of our proposals

The introduction of the Innovative Finance ISA

- 1.9** At this time we consider that we may wish to take the following steps in connection with the introduction of the IFISA:
- introduce guidance on how the disclosure rules in COBS apply to firms in relation to investments in P2P agreements held in an IFISA wrapper (e.g. in relation to disclosing information about the non-transferability and illiquidity of the investments)
 - introduce guidance on the disclosures which should be made to prospective investors in P2P agreements held in an IFISA wrapper (including in relation to the application of client money rules), when facilitated on platforms operated by firms with an interim permission

³ In this consultation, we focus on the investment or lending aspects of loan-based crowdfunding. Additional rules apply in relation to platform operators' relationships with borrowers.

Advising on P2P agreements

1.10 At present providing advice on P2P agreements is not a regulated activity. The Government has indicated, in its consultation paper, that it intends to lay an amendment to the RAO before Parliament so that only authorised persons may provide such advice with effect from next April.

1.11 In anticipation of this change, and to ensure an appropriate degree of consumer protection, we consider that we may consult on applying the suitability rules in the FCA Handbook to advice on P2P agreements. We may also consult on taking steps to ensure that such advice is not at risk of being influenced by the payment of commission. We consider that we may wish to make the following changes to our rules:

- amend the application of the suitability rules
- ban the payment or receipt of commission in relation to investment in article 36H agreements

Equality and diversity considerations

1.12 Consumers in vulnerable circumstances may face particular problems engaging with financial services.⁴ We have undertaken an equality impact assessment and consider that loan-based crowdfunding platforms generally, and access to them via IFISAs, may carry particular risks for some people with protected characteristics under the Equalities Act 2010 such as:

- Those with learning difficulties or cognitive limitations, who may have limited capacity to understand fully the risks associated with loan-based crowdfunding.
- Individuals approaching retirement and considering their options under the new pension freedoms, who may choose to invest in loan-based crowdfunding, failing to realise it is a much higher-risk alternative to buying an annuity.
- Individuals in retirement, who may have significant sums in savings and may be concerned about low interest rates. This may lead them to search for higher yields elsewhere, which in turn may lead them to invest significant amounts in loan-based crowdfunding platforms, potentially taking inappropriate levels of risk with their money.
- Young and inexperienced investors, who may be attracted to the concept without a full understanding of the risks involved, especially in the web-based and 'social-networking' environment of crowdfunding.

1.13 To mitigate these risks, we propose to focus in particular on the quality of firms' disclosure, including financial promotions, to ensure that risks are adequately disclosed. See also our Discussion Paper, *Smarter consumer communications*, in which we emphasise the importance of developing communications that are suitable for the intended audience.⁵

1.14 We will continue to consider the equality and diversity implications of the proposals during the consultation period and will revisit them when we publish the rules for consultation. In the interim we welcome feedback on these matters.

⁴ See, for instance, FCA Occasional Paper no. 8, *Consumer vulnerability* (February 2015): www.fca.org.uk/static/documents/occasional-papers/occasional-paper-8.pdf

⁵ DP15/5, *Smarter consumer communications* (June 2015): www.fca.org.uk/static/channel-page/dp-smarter-comms/dp-smarter-comms.html?utm_source=smarter-comms&utm_medium=smarter-comms&utm_campaign=smarter-comms#sc2

Next steps

- 1.15** When the legislation has been finalised, we will publish a consultation paper seeking feedback on the rules we propose to introduce. In order for the rules to be ready to take effect on April 2016, the consultation period for that paper will be short, so we are publishing this discussion paper to begin the discussion now.
- 1.16** If you have comments on the issues raised in this paper or would like to meet to discuss them with us, please send us your comments by 31 December 2015. To submit a response, please use the online response form on our website or write to us at the address on page 2.
- 1.17** We plan to arrange discussions with stakeholders over the next few months to discuss our high-level plans as set out in this paper. If you want to participate in those discussions, please contact us.
- 1.18** We aim to publish a policy statement making final rules in March 2016.

2. The Innovative Finance ISA

- 2.1** In this chapter we outline our early thinking on the possibility of introducing guidance to clarify how existing financial promotion and disclosure rules apply to firms when communicating about IFISAs.

Guidance

- 2.2** We currently consider that we may need to introduce new guidance that will be relevant to firms involved in selling loan-based crowdfunding investments in an IFISA wrapper, whether they are advisers, ISA managers, firms running loan-based crowdfunding platforms or other firms that distribute IFISAs to investors.

Guidance on disclosing information about the Innovative Finance ISA

- 2.3** We have existing rules and guidance on the information we expect to see disclosed to consumers about investments made via loan-based crowdfunding platforms.⁶
- 2.4** We may need to add further guidance about the information we expect firms to provide to consumers, which will apply when investments are to be held in an IFISA wrapper. We consider this guidance may be necessary as there are particular risks relating to IFISAs about which prospective investors will need to be made aware.
- 2.5** The guidance could clarify, for example, that firms should disclose the following:
- the tax consequences if a loan held in an IFISA is not repaid, or if the ISA manager or firm operating the platform fails
 - the procedure applying, and tax consequences arising, if an investor wants to withdraw an investment from an IFISA wrapper
 - the procedure for transferring part or all of the assets held in an IFISA wrapper from one ISA manager to another, and how long this is expected to take

Guidance on disclosing information on firms with interim permission

- 2.6** Firms that held an appropriate Office of Fair Trading (OFT) licence to operate a loan-based crowdfunding platform in March 2014 were, broadly speaking, able to register for an interim permission from the FCA to continue conducting this regulated activity from 1 April 2014. Having an interim permission ensures firms can remain in the loan-based crowdfunding market until we consider their application for full authorisation. If interim permission firms are able to offer IFISAs from April 2016 we are likely to propose additional guidance. We do not yet know if interim permission firms will be able to become ISA managers, or whether P2P agreements

⁶ COBS 14.3.2R and COBS 14.3.7AG

facilitated on platforms operated by firms with an interim permission will be eligible for inclusion in an IFISA. If they are, we are likely to consider additional guidance, as indicated below.

- 2.7** Most firms with interim permission that run loan-based crowdfunding platforms should have submitted their applications for full authorisation by the end of October 2015. We are required to have considered applications for authorisation within six months (where the application is complete) and within 12 months (where the application lacks key information). This means that the applications for full authorisation of some interim permission firms will likely still be under consideration when the IFISA is introduced.
- 2.8** Given the timeframe of the planned legislation, there is a risk that an interim permission firm may register as an ISA manager to offer IFISAs from April 2016 if permitted by the legislation, but may not be granted full authorisation subsequently. This may be because, for example, they withdraw their application or fail to meet our threshold conditions. At this point, any such firm's interim permission would lapse and they would not be able to continue operating their platform or administering loans facilitated through it.
- 2.9** To mitigate the risks to consumers that may arise, we could introduce guidance on the information we expect firms to disclose to clients in their financial promotions and other materials, when investing in an IFISA with or through a firm that holds interim permission. This information could include:
- the additional risks consumers are taking when investing via a firm with interim permission
 - the risk that investments may not deliver the tax benefits expected or perform as expected if the firm does not go on to attain full authorisation
 - the risk that FCA rules would generally no longer apply to a firm that fails to obtain full authorisation. In particular, client money held by the firm would no longer be subject to regulatory protection

Q1: Do you have any comments on our initial thoughts about introducing guidance on disclosures for the Innovative Finance ISA?

3. Advising on loan-based crowdfunding

- 3.1** In this chapter we consider some of the implications that may arise if the RAO is amended to make it a regulated activity to provide advice about loan-based crowdfunding investments.

Suitability requirements

- 3.2** Loan-based crowdfunding platforms match people or businesses looking to borrow money with investors willing to lend that money while expecting repayment of capital and interest payments. At present, providing advice to potential investors on entering into P2P agreements is an unregulated activity. Under the likely proposed changes to legislation, only authorised persons will be able to provide such advice.
- 3.3** We are likely to consider applying relevant sections of our Handbook to firms giving investment advice on P2P agreements. As with the provision of advice on other investments, these firms would need to ensure that they take reasonable steps to ensure that personal recommendations are suitable for their clients.⁷
- 3.4** We also wish to consider applying rules to ban the payment and receipt of commission. As with other investments subject to these rules, advisers would need to have a charging model for advice to invest that does not rely on the payment of commission. The rule changes would also prevent the payment of commission to platforms such as those run by self-invested personal pension schemes.

The Financial Advice Market Review

- 3.5** A joint HM Treasury and FCA project, the Financial Advice Market Review (FAMR), is looking into the provision of financial advice in the UK.⁸ FAMR will consider the current regulatory and legal framework governing the provision of financial advice and its effectiveness in ensuring that all consumers have access to the information, advice and guidance necessary to empower them to make effective decisions about their finances.
- 3.6** FAMR will run to a similar timetable as this consultation. The proposed date of legislative changes that make providing advice about investing in P2P agreements a regulated activity means that we cannot delay our work until the FAMR recommendations are published. If the review's recommendations lead to changes to any of the rules on which we are consulting, those would need to be addressed at a later date.

⁷ FCA rules in relation to the suitability of advice are set out in COBS 9.

⁸ A call for input was published in October to invite feedback: www.fca.org.uk/static/documents/famr-cfi.pdf

Capital requirements

- 3.7** Earlier this year, we consulted on new capital requirements for personal investment firms.⁹ We expect to publish the final rules before the end of 2015. We will confirm if the new capital requirements will have any specific implications for firms advising on loan-based crowdfunding investments when we consult on those rules next year.

Other matters

- 3.8** It is not yet clear what form the new regulated activity will take. It could, for example, be introduced as an amendment to the existing 'advising on investments' activity, or a wholly new activity. If it is the latter we will need to consider how other aspects of the regulatory framework apply to firms providing investment advice about loan-based crowdfunding. We would need to consider, for example:
- the requirements for firms to employ people with the skills, knowledge and expertise necessary for the responsibilities allocated to them
 - the regular reporting obligations for firms
 - the provisions about the calculation and payment of regulatory fees by firms

Options we are not currently considering

- 3.9** At this time we do not regard it to be proportionate to make advice on P2P agreements subject to all requirements arising from the Retail Distribution Review (RDR). In particular, we do not think it would be appropriate to:
- require firms holding themselves out as independent financial advisers to consider investment in P2P agreements when making personal recommendations to clients
 - require advisers to have appropriate qualifications specific to this type of business (standard qualification requirements for advisers will still apply) if they wish to recommend investments offered on loan-based crowdfunding platforms

Requirements under the Retail Distribution Review

- 3.10** Under the RDR, firms holding themselves out as independent financial advisers must consider all 'retail investment products' which are capable of meeting the investment needs and objectives of a retail client when making recommendations to such a client.
- 3.11** Products within scope of the 'retail investment product' definition are packaged investment products, rather than direct holdings of investments like shares. Investing in loan-based crowdfunding, on the other hand, generally involves direct investment. Pooled investments in crowdfunding assets – such as crowdfunding investment trusts – are already within the scope of the retail investment product definition.

⁹ CP15/17, *Capital Resources Requirements for Personal Investment Firms (PIFs)* (May 2015): www.fca.org.uk/static/documents/consultation-papers/cp15-17.pdf

3.12 We consider that there is a difference between most retail investment products and direct investments in loan-based crowdfunding and, therefore, do not plan to amend the 'retail investment product' definition to include P2P agreements. We do not think that all advisers will be in a position to advise on P2P agreements as a matter of course and so we do not think it is appropriate to require independent financial advisers to consider P2P agreements at this stage.

3.13 This would mean that firms holding themselves out as independent under the RDR would not be obliged to consider P2P agreements when recommending investments to a client.

Requirements for qualifications

3.14 At this stage we do not plan to introduce specific additional qualifications requirements for those who provide advice about investing in P2P agreements. If, in future, advice about investing in loan-based crowdfunding becomes more commonplace and our supervision work reveals concerns with the quality of that advice, we could review this position and may consider introducing new requirements.

Q2: Do you have any comments on our initial thoughts about rules for firms which provide advice on investing in P2P agreements?

Annex 1

List of questions

- Q1:** Do you have any comments on our initial thoughts about introducing guidance on disclosures for the Innovative Finance ISA?
- Q2:** Do you have any comments on our initial thoughts about rules for firms which provide advice on investing in P2P agreements?

Financial Conduct Authority



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25 The North Colonnade Canary Wharf
London E14 5HS
Telephone: +44 (0)20 7066 1000
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