Financial Conduct Authority

Consultation Paper CP13/13**

The FCA's regulatory approach to crowdfunding (and similar activities)

October 2013

Contents

We are asking for comments on this Consultation Paper by 19 December 2013.

You can send them to us using the form on our website at: www.fca.org.uk/your-fca/documents/consultation-papers/cp13-13-response-form.

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Abbreviations used in this paper

CMAR	Client Money and Asset Return
CP	Consultation Paper
DMD	Distance Marketing Directive
FCA	Financial Conduct Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act
HMRC	Her Majesty's Revenue and Customs
MiFID	Markets in Financial Instruments Directive
OFT	Office of Fair Trading
PD	Prospectus Directive
PRA	Prudential Regulation Authority
UCIS	Unregulated collective investment scheme
WACC	Weighted average cost of capital

1. Overview

Introduction

1.1 Crowdfunding is a way in which people, organisations and businesses (including business start-ups) can raise money through online portals (crowdfunding platforms) to finance or re-finance their activities and enterprises.

1.2 On 1 April 2014, the regulation of the consumer credit market will transfer from the Office of Fair Trading (OFT) to the Financial Conduct Authority (FCA), including responsibility for regulating 'loan-based crowdfunding', also known as peer-to-peer lending platforms.[1] This consultation paper (CP) is part of a series of papers which will determine the FCA's approach to the regulation of consumer credit activities. In this paper we propose regulations designed to protect investors, where other papers consider appropriate measures to protect borrowers.[2]

1.3 Crowdfunding already falls within the scope of regulation by the FCA if it involves a person carrying on a regulated activity in the UK, such as arranging deals in investments, or the communication of a financial promotion. So, if a crowdfunding platform enables a business to raise money by arranging the sale of unlisted equity or debt securities, or units in an unregulated collective investment scheme, then this is 'investment-based crowdfunding' regulated by the FCA and the firm operating the crowdfunding platform needs to be authorised.[3]

1.4 Our present rulebook was not designed with crowdfunding in mind, so in this CP we are consulting on a revised approach to regulating firms that operate investment-based crowdfunding platforms or market unlisted equity or debt securities.

Who does this consultation affect?

1.5 The paper will be relevant to any consumers and consumer organisations with an interest in crowdfunding and similar activities.

1.6 From the industry, this CP affects firms that operate loan-based crowdfunding platforms on which consumers can invest in loan agreements, and firms that plan to do so. At present, we have identified 25 such firms.

1 This is the activity detailed in article 36H of the Regulated Activities Order as 'operating an electronic system in relation to lending': www.legislation.gov.uk/ukdsi/2013/9780111100493

2 *High-level proposals for an FCA regime for consumer credit*, CP13/7, March 2013 www.fsa.gov.uk/static/pubs/cp/cp13-07.pdf and *Detailed proposals for the FCA regime for consumer credit*, CP13/10, October 2013, www.fca.org.uk/static/documents/consultation-papers/cp13-10.pdf.

3 Exemptions may be available. For example if the firm operating the crowdfunding platform is an appointed representative of an authorised person or an Enterprise Scheme they will not need to be directly authorised.

1.7 This CP also applies to firms, and their appointed representatives, that operate investment-based crowdfunding platforms on which consumers can buy investments such as unlisted equity or debt securities, or units in an unregulated collective investment scheme, and firms that plan to do so. At present, we have identified ten firms and 11 appointed representatives that operate such crowdfunding platforms.

1.8 This CP also applies to any firm that, using any media, communicates direct offer financial promotions for unlisted equity or debt securities to retail clients, who do not receive regulated advice or investment management services in relation to those investments, and who are not corporate finance contacts or venture capital contacts.

Context

1.9 While the OFT currently regulates consumer credit arranged via loan-based crowdfunding platforms, there is little regulatory protection for investors in loan agreements at present. From next year, the FCA aims to provide appropriate protection both for consumers who provide the money loaned, and consumers who borrow money via loan-based crowdfunding platforms.

1.10 We do not currently regulate firms running loan-based crowdfunding platforms, but we do already regulate firms operating investment-based crowdfunding platforms, and firms marketing unlisted equities and debt securities. At present, in addition to the usual core standards that apply to all firms, to protect investors we have imposed restrictions on firms applying for authorisation to operate an investment-based crowdfunding platform. These restrictions were considered on a case-by-case basis but tend to place limits on the type of client with whom firms may transact. These limits restrict firms to dealing with professional clients and retail clients who are either sophisticated or high net worth. Our aim has been to protect retail investors who lack the knowledge, experience and resources to cope with potentially significant losses when investing through these platforms, or in unlisted equities or debt securities by other means.

1.11 Our present conduct of business rules were not designed with crowdfunding business models in mind. The current approach of applying restrictions on an individual firm basis at the authorisation stage is not a long-term solution. Therefore, in this CP we are proposing a new approach to the regulation of investment-based crowdfunding activities. Our proposals should mean crowdfunding investment opportunities are available to more retail investors than currently, but with appropriate safeguards to check that investors are able to understand and bear the risks involved.

1.12 We have also considered our competition objective in approaching our regulation of this sector and the promotion of new forms of investment. Our proposals seek to provide adequate consumer protections that do not create too many barriers to entry or significant regulatory burdens for firms.

Summary of our proposals

1.13 Crowdfunding is a term that encompasses a range of business models. With some models, 100% capital loss is more likely than not, but others appear more benign. However, making any investment via crowdfunding platforms does tend to involve higher risks than those that apply to more traditional investments and deposits. Our approach reflects this – we aim to provide appropriate and proportionate consumer protection and standards that can be applied fairly to differing types of firm.

Loan-based crowdfunding

1.14 At present, we consider that investment via loan-based crowdfunding platforms is generally of lower risk than that made via investment-based platforms. We recognise that the market has the potential to develop new and innovative models in the future, however, where the risks, and possibly the rewards, are higher. We will keep our approach under review and consult further if necessary.

1.15 The regime we propose to introduce in 2014 is based on our approach for investments and is, primarily, a disclosure-based regime. Our proposals will require firms to ensure that investors have the information they need to be able to make informed investment decisions and that all communications are fair, clear and not misleading. In addition to this, to protect investor interests, we are consulting on a set of core requirements for firms. These are:

- minimum prudential requirements that firms must meet in order to ensure their ongoing viability
- firms should take reasonable steps to ensure existing loans continue to be managed in the event of platform failure
- rules that firms must follow when holding client money, to minimise the risk of loss due to fraud, misuse, poor record-keeping and to provide for the return of client money in the event of a firm failure
- rules on the resolution of disputes, and
- reporting requirements for firms to send information to the FCA in relation to their financial position, client money holdings, complaints and loans they have arranged

Investment-based crowdfunding (and similar activities)

1.16 We are proposing to change our approach to the regulation of firms operating investment-based crowdfunding platforms. We aim to make this market more accessible to retail clients, to help foster competition and to facilitate access to alternative finance options, while still aiming to ensure that only investors who can understand and bear the risks participate in the market.

1.17 Our proposals are not expected to affect:

- firms carrying on designated investment business that is corporate finance business or venture capital business when they communicate with corporate finance contacts or venture capital contacts, and
- firms carrying on regulated activities for professional clients

1.18 In this CP we are proposing to restrict the direct offer financial promotion of unlisted shares or debt securities[4] by firms to one or more of the following types of client:

- retail clients who are certified or self-certify as sophisticated investors, or
- retail clients who are certified as high net worth investors, or
- retail clients who confirm that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorised person, or
- retail clients who certify that they will not invest more than 10% of their net investible portfolio in unlisted shares or unlisted debt securities (i.e. excluding their primary residence, pensions and life cover)

1.19 Where advice is not provided, we will expect firms to apply an appropriateness test before selling them promotions for unlisted equity or debt securities. This is to ensure that only those clients who have the knowledge or experience to understand the risks can invest.

1.20 Where crowdfunding platforms allow investment in units in unregulated collective investment schemes, the existing marketing restrictions will apply.[5]

1.21 In summary, we are proposing the following measures.

- **Loan-based crowdfunding:** we propose to apply core FCA provisions, including conduct of business rules (in particular, around disclosure and promotions), minimum capital requirements, client money protection rules, dispute resolution rules and a requirement for firms to take reasonable steps to ensure existing loans continue to be administered if the firm goes out of business.
- **Investment-based crowdfunding:** we propose limits on the ability of firms to promote these platforms and a requirement that, where no advice has been provided, firms check that customers understand the risks involved.

FCA statutory objectives

1.22 These proposals are designed to advance the FCA's objectives of:

- securing an appropriate degree of protection for consumers, and
- promoting effective competition in the interests of consumers

4 The websites of firms operating investment-based crowdfunding platforms are direct offer financial promotions for unlisted shares or debt securities.

5 Firms may only promote these schemes to certain types of customer. We have recently consulted on changes to these restrictions. *Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes*, FCA PS13/3, June 2013: www.fca.org.uk/static/documents/policy-statements/ps13-03.pdf. The rules were made in the *Unregulated collective investment schemes and close substitutes instrument* 2013, FCA 2013/46: http://media.fshandbook.info/Legislation/2013/FCA_2013_46.pdf

Equality and diversity considerations

1.23 We consider that crowdfunding platforms may carry particular risks for some people with protected characteristics under the Equalities Act 2010.

- Those with learning difficulties or mental capacity limitations may have limited capacity to understand fully the risks associated with crowdfunding.
- Individuals reliant on pensions and lacking disposable income are more likely to have significant sums in savings, to be concerned about low interest rates on savings and to be searching for higher yield elsewhere, which may lead them to invest significant amounts on crowdfunding platforms, potentially taking inappropriate levels of risk with their money.
- The web-based and social-networking nature of crowdfunding could also pose a risk to young, inexperienced investors who may be attracted to the concept without a full understanding of the risks.

1.24 To mitigate these risks, we propose to place a particular focus on the quality of firms' disclosure, including financial promotions, to ensure that risks are adequately disclosed and benefits are not emphasised without a prominent indication of the downside potential.

> **Q1: Do you have any comments on our assessment of the equality and diversity considerations?**

Future plans

1.25 At present we distinguish between loan-based and investment-based crowdfunding models, and are proposing a lighter-touch approach for loan-based platforms. This is based on our observation that, in general, loan-based crowdfunding activities appear to be of lower risk than investment-based activities.

1.26 Following the introduction of our rules, we will monitor the market closely. If we identify problems we will act quickly to reduce the risk of harm to consumers, either through supervision and enforcement action with individual firms or by introducing new rules. For example, we are able to ban financial promotions – including websites – if we consider that they do not meet our standards and, if necessary, we can introduce temporary product intervention rules without consultation to make changes to the regime. We also plan to conduct a formal review of the crowdfunding regime in 2016.

Next steps

What do you need to do next?

1.27 We want to know what you think of our proposals. Please send us your comments by **19 December 2013**. The FCA is due to introduce consumer credit regulation on 1 April 2014. Before this date and this consultation, we have sought to engage with key stakeholders as far as possible, discussing our concerns and developing thoughts with them. Consequently, we anticipate that many of the proposals in this consultation will be familiar to key stakeholders. We are happy to meet with interested parties during the consultation period to help them understand our proposals and will, as ever, consider requests for extending the deadline if necessary.

How?

1.28 Use the online response form on our website or write to us at the address on page 2.

What will we do?

1.29 We will consider your feedback and publish our rules in a Policy Statement in February or March 2014.

2.
Regulatory considerations

2.1 In this chapter we comment on the types of crowdfunding activities that are or will be subject to FCA regulation, and those which are unregulated. We also comment on regulatory considerations that apply to loan-based and investment-based crowdfunding, the timetable, and our assessment of the key risks.

Distinguishing between regulated and unregulated crowdfunding

2.2 It is not always clear when crowdfunding activities fall, or will fall, within the scope of FCA regulation. Depending on the business model, it is possible that firms will fall within the scope of the Payment Services Regulations 2009. In this chapter, we aim to clarify when firms running crowdfunding platforms will need authorisation by the FCA and when they do not. As ever, it remains the responsibility of firms to assess whether they fall within our regime and to apply for authorisation if necessary.

2.3 We have identified five main types of crowdfunding.

- Donation-based: people give money to enterprises or organisations whose activities or purchases they want to support.
- Pre-payment or rewards-based: people give money to receive a reward, service or product (such as tickets for an event, an innovative product, a download of a book or a new computer game).
- Exempt: people invest or lend money using organisations or investments that satisfy the requirements in statutory exemptions to be considered exempt from the need for FCA authorisation or regulation (such as Enterprise Schemes or withdrawable shares issued by Industrial and Provident Societies).
- Loan-based: people lend money to individuals or businesses in the hope of a financial return in the form of interest payments and a repayment of capital over time (this excludes some business-to-business loans).
- Investment-based: people invest directly or indirectly in new or established businesses by buying shares or debt securities, or units in an unregulated collective investment scheme.

Unregulated activities

2.4 The FCA does not regulate firms that only operate donations-based, pre-payment or rewards-based crowdfunding platforms. These firms do not need FCA authorisation.

Exempt activities

2.5 The FCA does not regulate organisations or activities if statutory exemptions apply to exempt them from the need for FCA authorisation or regulation. For example, if certain requirements are met, the FCA does not regulate Enterprise Schemes, or Industrial and Provident Societies marketing their own withdrawable share issues.

2.6 Firms thinking of using exemptions will need to consider the relevant legislation and their business models carefully to ensure they do not engage in business for which they need authorisation.

Regulated activities

2.7 We regulate firms operating crowdfunding platforms if, in doing so, they are carrying on a regulated activity,[6] without an exemption applying. For example, firms need to be authorised if they are:

- arranging (bringing about) deals in specified investments (article 25(1)), agreeing to carry on a regulated activity (article 64), or
- establishing, operating or winding up an unregulated collective investment scheme (article 51(1)(a))

2.8 From April 2014 there will be a new regulated activity of 'operating an electronic system in relation to lending' (article 36H) (i.e. operating a loan-based crowdfunding platform).[7]

2.9 It is possible for a firm operating a crowdfunding platform to carry on other regulated activities, such as the 'placing' activities that are typically carried on by stockbroking firms: making arrangements with a view to transactions in investments (article 25(2)), dealing in investments as agent (article 21), advising on investments (article 53), or managing investments (article 37).

2.10 In summary, firms operating investment-based crowdfunding platforms are already subject to our regulation, and firms operating loan-based crowdfunding platforms will be subject to our regulation from next April.

2.11 Appointed representatives of authorised firms are exempt from the need for authorisation for regulated investment-based crowdfunding activities (but not loan-based activities) for which their principal has accepted responsibility.[8] The principal firm is responsible for ensuring their appointed representatives' activities, systems and controls comply with the FCA Handbook.

6 Regulated activities are specified in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(SI 2001/544) as amended.

7 The new activity only applies to loans meeting certain criteria. These include: the investor and/or borrower must be i) an individual; ii) a partnership consisting of two or three persons not all of whom are bodies corporate; or iii) an unincorporated body of persons which does not consist entirely of bodies corporate and is not a partnership. This means that business-to-business loans that do not meet these criteria will not be regulated by the FCA.

8 It is currently only possible for principal firms, not appointed representatives, to perform the new regulated activity in relation to loan-based crowdfunding.

2.12 Some crowdfunding platforms provide access to 'social investments', 'ethical investments' or 'environmental investments'. These are investments offered with the objective of providing, in part or in full, a wider non-financial benefit rather than a purely financial (capital growth/income generation) benefit for investors. If an activity falls within the scope of FCA regulation because it involves arranging the sale of unlisted shares, for example, then, regardless of the investment objective, our rules apply in the same way they apply to any other regulated activity.

> **Q2: Do you agree with our assessment of unregulated, exempt and regulated crowdfunding activities?**

FCA regulation of crowdfunding and transitional provisions: the timetable

2.13 The timeframe for introducing rules in relation to crowdfunding is challenging. As we want firms to have adequate time to adjust their business models, we are proposing a series of transitional provisions.

2.14 The following summarises our proposed transitional approach to the future regulation of loan-based crowdfunding.

- Firms with a valid OFT licence on 31 March 2014 will be able to continue carrying on the consumer credit activities for which they are licensed until they become fully authorised (which they must apply to do by 1 April 2016), as long as they notify us of some basic information and pay a fee. This is consistent with the approach we are adopting for the credit activity performed by these platforms. These firms will be granted an 'interim permission'. Loan-based crowdfunding firms that do not yet have a consumer credit licence from the OFT may, therefore, like to consider applying for one now to simplify their introduction to regulation by the FCA.

- Before 1 April 2016, all firms with an interim permission that want to carry on regulated activities should have applied for approval of individuals carrying on certain controlled functions and full authorisation.

- New firms running loan-based crowdfunding platforms from 1 April 2014 or firms that do not hold a consumer credit licence from the OFT on 31 March 2014 will need to apply immediately for full authorisation and approval for individuals carrying on certain controlled functions.

- Minimum prudential requirements will not start until a firm is fully authorised.

- We are proposing to introduce a transitional period for certain rules, allowing firms with an interim permission until 1 October 2014 to adjust their processes to meet the standards required by these rules.

2.15 For investment-based crowdfunding (and similar activities) we are proposing to introduce a transitional period allowing firms and their appointed representatives the option of either complying with the new rules from 1 April 2014, or complying with existing rules until 1 October 2014 and then applying the new rules from that date.

> **Q3: Do you agree with our proposals for transitional periods?**

Investing money via loan-based crowdfunding platforms in the course of business

2.16 We have been asked how the new regulated activity applies where the investor is a financial services firm and is providing finance in the course of business.

2.17 The Consumer Credit Directive requires us to ensure that firms lending by way of business are correctly authorised. Our interpretation is that it is not sufficient for us to regulate only the platform on which the credit is facilitated: firms lending in the course of business via loan-based crowdfunding platforms still need to be authorised as they are carrying on a regulated activity.

2.18 Our Handbook already sets out guidance on what it means to be acting 'by way of business'.[9] This notes that, whether or not an activity is carried on by way of business is ultimately a question of judgement that takes account of several factors (none of which is likely to be conclusive). These include the degree of continuity, the existence of a commercial element, the scale of the activity and the proportion which the activity bears to other activities carried on by the same person but which are not regulated.

Risks to investors

2.19 In this section we describe the key risks we have identified for investors on crowdfunding platforms.

Risks applying to all types of crowdfunding activity

Consumer understanding, inexperience and behaviours

2.20 Investors need to be able to understand the risks to which they will be exposed, and the different approaches followed by different platforms, before making a decision to transact. In most cases there will be a significant degree of information asymmetry in place with the consumer knowing very little about the investment on offer. Most investors on crowdfunding platforms do not receive advice, therefore we consider the information that will be disclosed on crowdfunding platforms about the investments and services offered to be the main way consumers will understand the value of the product and the charges that will apply.

2.21 With traditional savings and investments products currently offering poor returns, consumers may be enticed by promises of high returns apparently available through crowdfunding. As a fairly recent market development, inexperienced investors may not adequately assess the risks involved. They may not appreciate the differences between traditional investments or deposits and the riskier crowdfunded loan agreements and investments. For example, they may not realise that deposits are protected by the Financial Services Compensation Scheme (FSCS) and loan-based crowdfunding is not.

Conflicts of interest

2.22 Firms running crowdfunding platforms are subject to a number of conflicts of interest that could lead to consumer detriment. For example, if platform remuneration is linked to transactions (as is usually the case), and if new platforms are seeking to establish a presence in the market quickly, new firms may be motivated to downplay risks and over-emphasise possible returns.

9 See chapter 2.3 of our perimeter guidance: http://fshandbook.info/FS/html/FCA/PERG/2/3

Fraud and money laundering

2.23 Fraud is a key risk facing investors looking to lend or invest on crowdfunding platforms. To mitigate this risk, some firms that operate crowdfunding platforms appear to have more rigorous due diligence processes in place than others. If there are numerous or high-profile instances of fraud this will affect the confidence that consumers have in the crowdfunding sector. Firms will need to ensure they have systems and controls in place to mitigate the risk of their sites being used for money laundering.

Platform failure and poor administration

2.24 Platform failure may harm investors. Existing loans and investments will still need to be administered, with repayments or dividends allocated appropriately among investors and late payments by borrowers followed up. If the firm running the platform goes out of business, responsibility for this could fall to individual investors but, particularly where their stake in a particular investment is small, it may not be economical for them to do so.

Risks applying to loan-based crowdfunding

Non-repayment of loans

2.25 The main risk facing investors on loan-based crowdfunding platforms is non-repayment of capital or non-payment of interest, either because of borrower default, fraud or firm failure. These risks will vary and mitigating them will depend on the level of due diligence carried out by the platforms and the investors. A number of firms operating loan-based crowdfunding platforms have adopted approaches to reduce the risk of default, including the following:

- only dealing with borrowers with good creditworthiness
- putting contingency funds in place that aim to cover lost capital in the event of borrower default, and
- facilitating secured loans, where there is collateral that may be sold to repay capital

2.26 However, firms carry out differing levels of due diligence and have differing approaches to vetting and accepting borrowers, so there will be models carrying greater and lesser amounts of risk. For example, platforms facilitating short-term, high-interest loans would be offering higher risk investments.

The Financial Services Compensation Scheme

2.27 When consumers deposit money with banks or building societies they are protected by the FSCS if the firm is in default and cannot meet claims against it. Consumers who invest in loan agreements do not have equivalent access to the scheme.

Risks applying to investment-based crowdfunding

2.28 Overall, we consider investment-based crowdfunding to be high risk.

Start-up business failures

2.29 Research indicates that around 50% to 70% of business start-ups fail completely.[10] So consumers investing in such companies need to understand that it is likely they will lose 100% of any money invested. To assess and mitigate this risk a due diligence assessment should be carried out on the persons seeking funding. As indicated in our guidance for consumers, this could be carried out by the firm operating the crowdfunding platform or by the investor, or both.

Unauthorised advice

2.30 In some cases, firms operating a crowdfunding platform may be making a personal recommendation. Firms will need to carefully consider their business model to avoid unintentionally giving advice, simplified advice or providing a discretionary portfolio management service. If investment advice is given by a firm then authorisation for this activity will be required and firms will need to comply with the relevant rules.

Professionals pick the best offers

2.31 Professional investors may know more about investment in some enterprises and be better able to select the best investments, leaving options with higher risk or poor value to retail investors. So that they can make decisions on an informed basis, retail investors need to be satisfied that they have enough reliable information to enable them to understand:

- the nature of the investment or service offered
- the nature of the parties involved
- the risks applying, and
- the charges that will be payable

No dividends and equity dilution

2.32 Investors in unlisted shares in a start-up or young company, even if the company remains a going-concern, face the risk of never receiving a return on their investment if those controlling the company decide not to issue dividends. And, if the business is sold or becomes listed, investors may find their share in the profits is reduced if the value of shares is diluted by subsequent issues of new shares. Investors need to understand that they will have almost no control over these decisions.

No secondary market

2.33 After purchasing unlisted equity in a company, even if it remains a going-concern, investors will usually find there is no, or only a limited, secondary market for their investments. Consumers investing in such equity need to understand that they will probably have to wait until an event occurs, such as the sale of the company, a management buy-out or a flotation, before getting a return. Consumers should realise that, in the event of their death, ownership of these investments will probably need to be transferred to their beneficiaries.

> **Q4: Do you think there are other risks relating to crowdfunding that we should consider and seek to address?**

10 The Office of National Statistics, *Business Demography 2011*, 13 December 2012, shows UK five-year survival rate for businesses born in 2006 and still active in 2011 was 45% (failure rate 55%). The health industry five-year survival rate was 60% (failure rate 40%), but the hotel and catering five-year survival rate was 35.7% (failure rate 64.3%). http://www.ons.gov.uk/ons/dcp171778_291893.pdf Figures are consistent with the one- and three-year survival rates published for firms registered between 1995 and 2004 in the Department of Trade and Industry 2007 publication *Survival Rates of VAT-registered enterprises*, 2007, suggesting that the 2008 financial crisis has not unduly affected the failure rates. http://stats1.bis.gov.uk/ed/survival/htm/Key%20Results1.htm

3. Loan-based crowdfunding

3.1 In this chapter we outline our proposals for the protection of investors using loan-based crowdfunding platforms. We propose to treat investments on these platforms in a similar manner to other investments, making them subject to similar rules.[11]

3.2 The regime we envisage will apply the FCA principles for businesses and set core requirements for firms in terms of their capital position, treatment of client money and dispute resolution. Beyond that, we are consulting primarily on the introduction of a disclosure-based regime that requires firms to ensure that all communications are fair, clear and not misleading. We are also proposing a requirement for firms to have in place measures to protect investors in the event of platform failure.

Investments on loan-based crowdfunding platforms

3.3 The risks facing the people lending money on loan-based crowdfunding platforms differ from the risks facing borrowers using the same platforms and our regulatory approach needs to recognise their needs and apply a tailored set of protections. We therefore believe it is necessary to consult on the introduction of rules that protect both investors and borrowers.[12]

3.4 In this paper we refer to the people lending money as 'investors' and the transaction from their point-of-view as an 'investment'. We have chosen to do this, rather than to refer to them as 'lenders' and their transaction as 'lending' to avoid confusion with regulated firms that lend money. We consider this the right approach even though the new regulated activity, and consequently some of the Handbook text on which we are consulting, refers to these clients as 'lenders'.

3.5 We plan to treat investments on loan-based crowdfunding platforms largely as we do other designated investments. Rules that apply to firms arranging transactions in designated investments will therefore also apply to firms running loan-based crowdfunding platforms. One implication of this is that firms running loan-based crowdfunding platforms will need to refer to two conduct of business rulebooks: one that sets rules for investors and one for borrowers.

11 For readers new to FCA regulation, this guide helps explain the different components of our Handbook: www.fca.org.uk/static/documents/handbook/readers-guide.pdf

12 For more information on our proposals for rules to protect borrowers, see *High-level proposals for an FCA regime for consumer credit*, CP13/7, March 2013 and *Detailed proposals for the FCA regime for consumer credit*, CP13/10, October 2013.

The Financial Services Compensation Scheme

3.6 We are not proposing to include loan-based crowdfunding platforms within the remit of the FSCS. When looking at the amount of loss investors might suffer if a platform failed and the amount that would be covered by the FSCS, it is not clear that there is justification to include them within the FSCS jurisdiction. Further, customers are likely to think their money is protected to a much greater extent than is the case. Even if recourse were available, the FSCS could only provide protection if:

- an FCA-authorised firm has failed and cannot meet claims against it
- the claimant is eligible to claim to the FSCS
- the claim relates to an activity protected by the FSCS, and
- the firm owes a civil liability to the claimant, e.g. it is liable to the claimant for breach of contract or in negligence. Proving this is likely to be difficult.

3.7 In practice, cover might be available in limited circumstances only, for example if either the platform or the bank in which the money is held (prior to investment) failed before the money was invested. Customers affected in these ways should already be protected to an extent.

- In the first situation, our client money rules provide for the return of client money to clients in the event of a firm's insolvency (see the section below for more detail of this process).
- In relation to the second situation, where a bank fails, bank deposits are already subject to FSCS jurisdiction so further protection is unnecessary. So long as the client money account is set up in accordance with our client money rules, each client will have beneficial ownership of their own money within the client account and will, therefore, be protected by the FSCS.[13]

3.8 We are proposing a change to the participant firm Glossary definition which will make it clear investment on loan-based crowdfunding platforms is not within the FSCS remit. As described later in this chapter, in the section on disclosure rules, we also expect firms to disclose the lack of access to the FSCS to potential investors.

Q5: Do you agree that we should not include loan-based crowdfunding platforms within the remit of the FSCS?

Our proposals for the regulation of investment on loan-based crowdfunding platforms

3.9 In the following sections we set out our approach to regulating firms that operate loan-based crowdfunding platforms. The description is intended as a helpful summary for firms of some of the key concepts in our rules. It is not a complete description of the relevant rules and firms must refer to the Handbook to ensure compliance.

13 The FSCS can pay each client up to £85,000 per failed institution. Depositors may still receive a share of their savings above this limit following any distribution of assets as part of the insolvency process for a failed bank. This would be a matter for the insolvency practitioner to determine and any recovery would, by necessity, vary according to the circumstances of the specific failure.

Related areas on which we are consulting

3.10 In the first consultation on the regulation of consumer credit.[14] We have made it clear that a range of high level requirements apply. These include:

- the threshold conditions for authorisation
- the FCA Principles for Businesses
- senior management arrangements, systems and controls, and
- general provisions

3.11 While the earlier consultation focused on consumer credit activities, these high-level regulations will apply both to the consumer credit activities and the investment activities of firms running loan-based crowdfunding platforms.

Prudential standards

3.12 We set requirements on the amount of prudential resources authorised firms must hold to help them withstand any future financial shocks.

3.13 We aim to set prudential resource requirements (which we refer to as 'prudential standards') that reflect the financial and business risks posed by firms. Due to the relative infancy of this market we have tried to minimise the burden that our prudential standards will have on firms, especially in the early years of our regime. As a result, we are proposing to transition our regime over several years, so it only comes fully into force on 1 April 2017.

What are prudential standards and why are they important?

3.14 Prudential standards have two key elements:

- prudential requirements, which are the obligations we place on firms to hold certain amounts of specified financial resources for regulatory purposes, and
- prudential resources, which describe what financial resources a firm actually holds

3.15 Comparing the amount of prudential resources a firm holds with its prudential requirement tells us if a firm is meeting its requirement or not.

3.16 Prudential standards are important because they aim to minimise the risk of harm to consumers by ensuring that firms behave prudently in monitoring and managing business and financial risks. Experience tells us that if a firm is in financial difficulty or it fails, it can cause harm and disruption for consumers. A firm under financial/prudential strain is more vulnerable to behaving in a way that increases the probability of consumers suffering loss. Prudential standards support the FCA's statutory objectives and conduct responsibilities of firms by aiming to ensure that firms have sufficient prudential resources to cover operational and compliance failures and/or pay redress.

14 *High-level proposals for an FCA regime for consumer credit*, CP13/7, March 2013

3.17 The FCA approach document *Journey to the FCA* outlines the FCA's prudential vision and how the FCA prudential approach will aim to minimise the risk of consumer harm as a result of firms being under financial stress, while also improving the strength and integrity of the financial system.[15]

Why are we proposing prudential standards for loan-based crowdfunding?

3.18 When developing our proposals we weighed up the harm that consumers might face if a firm was to be under financial stress against the cost of introducing prudential requirements. We believe that the risk inherent in loan-based crowdfunding firms means that prudential standards are a key regulatory tool in minimising harm to consumers.

3.19 In terms of harm, we consider loan-based crowdfunding firms to pose a high risk to consumers because they may hold and/or control client money before lending this money to the borrowers. Firms holding client money typically need more time to wind-down. Furthermore, if a firm were to fail, it is extremely likely that there will be loan contracts that have not matured. Having prudential resources gives firm's time during which they can continue providing their services while updating and transferring records, thereby improving the opportunity for a more orderly wind-down or transfer of business to another firm.

3.20 There are similarities between loan-based and investment-based crowdfunding platforms. They are both intermediary platforms facilitating investment opportunities where investors' money is at risk of loss. The main difference is the underlying instrument. Investment-based crowdfunding firms are already subject to prudential requirements and, therefore, to ensure a degree of equivalence, we believe that firms running loan-based platforms should also be bound by prudential standards.

Prudential standards for loan-based crowdfunding firms

3.21 In summer 2013 we asked a number of firms running loan-based crowdfunding platforms for information on their operations. We thank all firms that took the time to respond and have used the information they provided to inform our policy on this and other matters. As a result, we believe that we have been able to design an appropriate regime for firms captured by our proposals. We have striven to design a regime that:

- is not overly complex, and
- balances the need to protect consumers while at the same time aiming to facilitate market competition

3.22 We propose that the prudential requirements for firms subject to our rules will be the higher of:

- a fixed minimum amount, and
- a percentage of a volume-based measure

3.23 The **fixed minimum** amount that firms will be required to hold in our full regime will be £50,000. However, firms will not have to meet this requirement until 1 April 2017. Until then there will be a transitional fixed minimum requirement for firms of £20,000. For more information on firms' requirements before 1 April 2017, please see the transitional provisions section below.

15 FCA, *Journey to the FCA*, October 2012: www.fca.org.uk/your-fca/documents/fsa-journey-to-the-fca

3.24 The **volume-based** measure is a percentage of the total amount of loaned funds on the platform. To take into account economies of scale this percentage will reduce if more funds are loaned on the platform. This will be calculated as the sum of the following:

- 0.3% of the volume of loaned funds up to £50m
- 0.2% of the volume of loaned funds above £50m up to £500m, and
- 0.1% of the volume of loaned funds above £500m

3.25 Firms will be subject to the volume-based measure when they become fully authorised. This measure will be calculated annually based on the firms' accounting reference date and will consist of all funds that are being lent by investors to borrowers.

3.26 We believe that the metric 'total amount of loaned funds' is the most appropriate in aligning a firm's prudential requirement with the risk of harm that the firm poses to consumers. For example, the metric captures:

- the likelihood of firms holding large amounts of client money at any point in time
- the length of time it will take to wind-down a firm, and
- the complexity of the firm including its size and number of customers

3.27 We also propose to require firms to recalculate their prudential requirement if the total value of their loaned funds increases significantly (more than 15%). If this increase causes a change to the firm's prudential requirement, the firm must notify the FCA so we can ensure their prudential requirements are always up-to-date and accurate.

3.28 To ensure compliance with our rules, a firm's prudential resources have to be greater than their prudential requirements at all times. Failure to comply with these requirements could result in enforcement action.

3.29 If a firm is subject to more than one prudential regime (i.e. they are already prudentially regulated by the FCA or the PRA), they must meet the higher of the requirements to which they are subject.

Prudential resources

3.30 Under our proposals firms will use the following equation to calculate their prudential resources. This approach is similar to other existing FCA prudential regimes.

Table 1: How firms will calculate their prudential resources

Prudential resources calculation	Share capital + reserves + interim net profits[16] + eligible subordinated debt – investments in its own shares – intangible assets – investments in subsidiaries – interim net losses

Q6: Do you agree with th Prudential standards proposed for loan-based crowdfunding firms? If not, what amendments would you make and why?

16 Interim net profits must be verified by the firm's external auditor, net of tax, anticipated dividends or proprietors' drawings and other appropriations.

Transitional provisions

3.31 We are not proposing to apply the prudential requirements to all firms at the same time. In line with the proposed prudential rules for debt management firms, we propose that existing OFT-regulated loan-based crowdfunding firms will not be subject to our prudential standards until they become fully authorised.

3.32 Firms that do not have a consumer credit licence before 1 April 2014 will not be part of our interim permission regime. These firms will need to be fully authorised and will be immediately subject to our prudential standards.

3.33 We are conscious that, initially, firms may find it challenging to meet our prudential requirements. Therefore, we propose to allow a period of transition for all firms, whether they hold an interim permission or are fully authorised from 1 April 2014.

- Until 1 April 2017, the fixed minimum prudential requirement for firms will be £20,000. This will reduce barriers to entry for firms in the early part of our regime and also provide firms with adequate time to prepare for, and to meet, our full prudential standards regime from 1 April 2017.
- And, until 1 April 2017, firms will not need to deduct 'investments in subsidiaries' and 'intangible assets' when calculating their prudential resources.

Table 2: How firms will calculate their prudential resources under our transitional arrangements

Prudential resources calculation up to 31 March 2017	Share capital + reserves + interim net profits + eligible subordinated debt - investments in its own shares - interim net losses

Table 3: Summary of prudential standards regime for loan-based crowdfunding firms

Transitional regime (until 31 March 2017)	**Full regime (from 1 April 2017)**
Higher of:	Higher of:
Fixed minimum = £20,000	Fixed minimum = £50,000
Variable volume-based measure =	Variable volume-based measure =
• 0.3% of the volume of loaned funds up to £50m	• 0.3% of the volume of loaned funds up to £50m
• 0.2% of the volume of loaned funds above £50m up to £500m, and	• 0.2% of the volume of loaned funds above £50m up to £500m and
• 0.1% of the volume of loaned funds above £500m	• 0.1% of the volume of loaned funds above £500m

Table 4: Timeline of transitional arrangements

1 April 2014

- Firms with 'interim permission' will not be subject to our transitional prudential regime until they become fully authorised.
- New firms from 1 April 2014 will have to be fully authorised and therefore subject to our transitional prudential regime (higher of the fixed minimum of £20,000 or the volume-based measure and only deduct certain items from their financial resources calculation).

1 April 2016

- All interim permission firms will be fully authorised by the FCA and subject to our transitional prudential regime.

1 April 2017

- The transitional arrangements will fall away and all firms will be subject to the full prudential regime.

Q7: Do you agree with the transitional approach proposed for the prudential requirements for loan-based crowdfunding firms?

Client money rules

3.34 Firms that hold client money in relation to investment business are subject to the client money rules contained in our Client Assets sourcebook (CASS).[17] These rules require firms to ensure adequate protection of client money when the firm is responsible for it.

3.35 For loan-based crowdfunding platforms, money received from a client for the purposes of lending out to borrowers and repayments from borrowers to be provided back to clients – whether received physically or electronically – will be regarded, while the firm is holding it, as client money held by the firm for or on behalf of the client in relation to investment business. The firm holds this money as trustee and must therefore make adequate arrangements to safeguard it. We therefore propose to apply the existing client money rules (for investment business) to this activity with some minor amendments. We recently consulted on changes to the client money rules and other sections of CASS in CP13/5.[18] We encourage readers to read this other consultation as it will also be relevant for the loan-based crowdfunding market. However, firms running loan-based crowdfunding may be subject to the existing Client Assets sourcebook for a period before any changes following CP13/5 come into force. They may, therefore, need to future-proof their systems to accommodate any changes made following CP13/5.

17 http://fshandbook.info/FS/html/FCA/CASS/7

18 FCA, CP13/5, *Review of the client assets regime for investment business*: www.fca.org.uk/static/documents/consultation-papers/cp13-05.pdf, July 2013

3.36 The table below gives an indication of some of the main rules that we propose to apply to firms operating loan-based crowdfunding platforms, based on our understanding of the business models we have observed.[19] The second column indicates where we have proposed changes to the relevant area of rules in CP13/5.

Table 5: Applying client money provisions to loan-based crowdfunding platforms

Requirements	Relevant sections of CP13/5
Firms must notify us each year of their current classification as small, medium or large for the purposes of client money rules.[20] This classification exercise has implications for the frequency of client money reports and senior management responsibility for client money procedures.[21]	No changes are proposed to these provisions.
Firms classed as medium or large are required to have a single member of staff approved to take responsibility for CASS oversight.[22] Firms classed as small must allocate this responsibility to a member of the firm's governing body.	No changes are proposed to these provisions.
Firms holding client money have a fiduciary duty to their clients and can only pay out money in such a way as discharges this duty.[23]	See the sections on 'Money ceasing to be client money' and 'Transfers of business' (paragraphs 4.39 to 4.47).
Firms must have adequate organisational requirements to safeguard clients' rights.[24]	No changes are proposed to these provisions.
Firms must deposit client money at an appropriate institution (for firms running loan-based crowdfunding platforms, this will be a bank)[25] and undertake relevant due diligence in relation to this third party.[26]	See the following sections: • 'Client bank accounts (general)' (paragraphs 4.56 to 4.62) • '"Unbreakable term" deposit accounts' (paragraphs 4.63 to 4.66) • 'Immediate segregation' (paragraphs 4.67 to 4.70) • 'Physical receipt and allocation client money' (paragraphs 4.74 to 4.81) • 'Prudent over-segregation' (paragraphs 4.82 to 4.86)
Firms must keep records and accounts so they can always distinguish client money held for one client from client money held for another. To meet this requirement, firms must conduct internal and external reconciliations.[27]	See the section on 'Reconciliations and record keeping' (paragraphs 4.104 to 4.122).

19 For the sake of clarity, since firms running loan-based crowdfunding platforms will be undertaking investment business, they will be subject to all of CASS as relevant. The table is not exhaustive and, if a firm undertakes any other investment business than loan-based crowdfunding, all the relevant rules will apply.

20 Firm classification under CASS 1A.2 is based on an annual stratification exercise. Firms holding less than £1m in client money are classed as CASS small firms, firms holding an amount of client money greater than or equal to £1m but less than or equal to £1bn are CASS medium firms, and firms holding more than £1bn in client money are CASS large firms.

21 For more information see chapter 5 of FSA, PS10/16, *Client Assets Sourcebook (Enhancements) Instrument*, www.fca.org.uk/static/pubs/policy/ps10_16.pdf, October 2010

22 Controlled Function 10A, listed in SUP10A.4.4R

23 CASS 7.2.15R to 7.2.17R

24 CASS 7.3

25 The rules also permit firms to invest the money into units of Qualifying Money Market Funds as a method of segregation; however, this is subject to certain conditions such as a firm having the relevant permissions.

26 CASS 7.4.1R to 7.4.12R, CASS 7.4.14G to 7.4.17G and CASS 7.4.22G to 7.4.23G

27 CASS 7.6

Requirements	Relevant sections of CP13/5
Client money must be held under statutory trust.[28]	None of the proposed changes is relevant to firms running loan-based crowdfunding platforms.
Firms must, when opening a client bank account, obtain the bank's acknowledgement that the money in the account is held for the firm's clients and that the bank cannot recover the firm's debts from the client bank account.[29]	See the section on 'Acknowledgement letters' (paragraphs 4.123 to 4.133).
Firms must carry out internal reconciliations of records and accounts of client money. We would expect loan-based crowdfunding platforms to use method 2 under paragraph 6 of CASS 7 Annex 1G.	See the section on 'Reconciliations and record keeping' (paragraphs 4.104 to 4.122).
A set process when dealing with client money in the event of firm failure, or in the event of the failure of the bank where a firm holds client money.[30]	See the chapter on 'Prioritising speed' (Chapter 2).
Firms must be able to retrieve a CASS Resolution Pack as set out. This information will help an insolvency practitioner if there is a primary pooling event.[31]	No changes are proposed to these provisions.

Q8: Do you agree that firms running loan-based crowdfunding platforms should be subject to our client money rules?

Transfers of client money on a going-concern basis

3.37 We are not planning to make any changes to our rules to provide for the transfer of client money if a platform wishes to stop performing its role. Depending on the circumstances, to discharge its duties to the client money it holds, a firm might be subject to existing provisions in CASS or in the proposed rules at CASS 7.2.17BR of the draft instrument in CP13/5. This rule provides relatively strict requirements for a transfer of client money. Alternatively, a firm could simply arrange for payments under existing loans to be routed through another party (in accordance with any contracts in place) and ensure any remaining money held by the firm is paid to investors before cancelling its permissions.

Client money in the event of an insolvency or a primary pooling event

3.38 On certain events, such as an insolvency, CASS provides that a primary pooling event will occur. Our client money distribution rules (CASS 7A) provide for how to distribute client money to clients following a primary pooling event. We are not proposing any changes to these rules in view of crowdfunding and similar activities, but this section gives an overview of how we would expect this to work.

3.39 It is important to note that while the client money rules provide for the return of money to clients if a firm fails, they do not amount to a compensation regime. Clients share any shortfall in the amount of client money held at time of the primary pooling event on a pro-rata basis, and the insolvency practitioner's costs of distributing client money to clients is paid for out of the pool of client money, also borne by clients on a pro-rata basis. Also, a shortfall could be due to losses relating to a different type of business carried out by the firm.

28 CASS 7.7
29 CASS 7.8
30 CASS 7A
31 CASS 10 CASS Resolution Pack

3.40 We would expect, under our rules, that the money held by a platform at the time of a primary pooling event, including money repaid by borrowers but not yet paid out to investors, should be repaid by the insolvency practitioner acting on behalf of the failed platform to the relevant investors. This is because all repayments by borrowers should go towards repaying the loans they have taken, so we would expect this money to be paid to investors (less any fees due to the firm). We do not envisage that payments will be made to borrowers where they have paid money to the platform and this has not yet been paid to investors, i.e. we are not proposing to make borrowers clients of the platform. This is because we think that there may be risk transfer in the contracts, which is to say that the borrower’s obligation to make a repayment is discharged under the contract when the borrower makes a payment to the platform.

Q9: Do you agree that money held by the failed platform at the primary pooling event should be returned only to relevant investors?

Q10: If contracts do not provide for risk transfer in the way described above, should CASS include a rule to require this in order to protect borrowers?

3.41 Money received after a primary pooling event should not be pooled with the money held prior to the pooling event, and should be held in accordance with CASS and paid to the relevant client (investor) without delay. If the failed firm wishes to cancel its permissions, it may need to ensure that payments from the borrowers could be re-routed appropriately so that the platform did not receive any more money due to investors. At this point, the firm could then cancel its permissions – it is unlikely that the firm’s permissions would be cancelled if it was continuing to receive money from clients. Alternatively, if the firm, under our proposals for a platform’s arrangements in the event of its failure, is able to administer the repayment of existing loans on the basis of the fees collected from borrowers, the firm could simply continue to return any money due to investors.

Q11: Do you agree with our understanding of how money received after a primary pooling event will be treated?

Client money in the event of failure of a third party

3.42 We refer to failure of a third party, such as a bank that holds the client money account, as a secondary pooling event. In this event, the firm may, depending on the circumstances, have to:

- repay clients (or pay the money into another client bank account) an amount equal to any shortfall as a result of the bank's failure, or
- calculate the amount lost and each client's pro-rata share in that loss

3.43 Firms must notify the FCA as soon as possible of secondary pooling events.

3.44 Investors may have recourse to the FSCS if the bank at which the client money account is held fails. This depends on a number of factors, including whether or not the bank in question is an FSCS participant firm. Clients may be able to claim for losses (see the section of this chapter on the FSCS for more detail) depending on the circumstances.

Protections in the event of failure of the firm running the platform

3.45 Our proposed capital requirements should reduce the probability of the failure of firms running loan-based crowdfunding platforms but there is still a possibility that this may happen in the future.

3.46 As the loan agreements facilitated on these platforms are generally made between investors and borrowers, the failure of the platform might not necessarily lead to losses in itself. However, the costs of the insolvency practitioner distributing the money to clients must be paid for out of the pool of client money, and any loss must be shared on a pro-rata basis so investors could suffer a loss if there is not sufficient money to complete the distribution.

3.47 If a platform does fail, existing loans must still be administered and this may be difficult for individual investors. With some platforms, for example, investors do not know the identity of the borrowers to whom they have lent money. An investor's stake in a particular loan may be small, meaning that it is not economic to chase missing payments. These factors may encourage borrowers to default on loans leading to a real risk of harm to consumers. There is anecdotal evidence that this has happened in the past when platforms have gone out of business.

3.48 So we are proposing to introduce a rule that firms must have arrangements in place to ensure that loans continue to be administered if the firm goes out of business. In such an event we would expect the following actions to take place:

- client money should be distributed to investors under our client money rules
- a new client bank account should be set up to receive ongoing payments for existing loans under our client money rules
- no new loans should be made and existing loans will remain valid under their original terms, and
- the firm's arrangements to manage those existing loans, apportioning repayments to the right investors and following up late repayments or borrower defaults should come into effect

3.49 The arrangements could be with another loan-based crowdfunding platform firm, a debt administrator or funded by ongoing fees taken from repayments on existing loans but a contract should exist to allow a smooth transition of responsibilities to the new administrators.[32]

3.50 The rules we are proposing aim to ensure the alignment of the firm's arrangements in the event of platform failure with the client money rules, so that the two work together and are not in conflict.

> **Q12: Do you agree that firms operating loan-based crowdfunding platforms should be required to have arrangements in place so that existing loans continue to be administered in the event of platform failure?**

Cancellation rights

3.51 The Distance Marketing Directive (DMD) requires that most financial services contracts made at a distance (that is, without the simultaneous physical presence of the supplier or intermediary and the customer) give customers the right to cancellation, without penalty and without giving a reason. Where this applies, customers generally have the right to withdraw their money within the first 14 calendar days. The DMD does not allow consumers to waive this right.

3.52 Cancellation rights may, therefore, be available to investors on loan-based crowdfunding platforms unless an exception exists.

- There is no right to cancel distance contracts for investments whose price depends on fluctuations in the financial market outside the firm's control.[33] Therefore, where platforms include a secondary market and investors are able to sell their interest in a loan at prevailing market prices, there is no automatic right to cancel the contract.

- The DMD cancellation rights only apply to services provided to consumers.[34] Investors who are investing money via loan-based crowdfunding platforms in the course of business are not regarded as consumers and do not benefit from the DMD cancellation rights.

- The cancellation period need not be adhered to in circumstances where the performance of a contract has been fully completed by both parties at the consumer's request before the right of withdrawal is exercised.[35]

3.53 So, the DMD creates 14-day cancellation rights for consumers investing on platforms that offer no secondary market. Where there is a secondary market, consumers wishing to access their capital early can do so. In other cases, it seems appropriate that consumers have a period of time at the start of the contract to change their minds.

32 If the administration firm is to be set up and funded from ongoing fees taken from repayments on existing loans, it needs to have the relevant authorisation and firms should consider what happens as the pool of existing loans reduces over time. Since there will be no new loans, the fee income will fall over time and firms must be able to administer the existing loan book until it is fully closed.

33 COBS 15 Annex 1 1.10R(1)

34 The term *consumer* is defined here: http://fshandbook.info/FS/glossary-html/handbook/Glossary/C?definition=G210

35 COBS 15 Annex 1 1.10R(2)

3.54 In these cases, we recognise that it is not feasible to allow each investor the chance to withdraw from a particular loan agreement after agreeing to fund it. We think that the cancellation period should attach to the investor's decision to register with a platform rather than to investment in a specific loan.[36] In effect, therefore, it seems likely that firms without a secondary market at present and which choose not to introduce one will elect to run one of two systems:

- either a firm may allow consumers to invest in loan agreements but repay them their money within the first 14 days, if requested,[37] or
- consumers will not be able to invest money in loan agreements within the first 14 days of registering with a platform

3.55 Firms running loan-based crowdfunding platforms should note that they are already subject to the DMD under the Financial Services (Distance Marketing) Regulations 2004 and should already comply with it, where appropriate.[38] As such, the general transitional period that we plan to grant to firms with an interim permission will not apply to cancellation rights.

> **Q13: Do you agree with our interpretation of the Distance Marketing Directive cancellation rights for firms operating loan-based crowdfunding platforms?**

Disclosure rules

3.56 The core concept at the heart of our disclosure requirements is that all communications from the firm must be fair, clear and not misleading.[39] This central concept is explained further with a set of rules that apply when the firm is communicating to a retail client.[40] All such communications must, for example, be accurate and provide sufficient information for the client's needs. Communications must include a fair and prominent description of relevant risks where benefits are discussed. They must be presented in a manner likely to be understood by the target audience. And they must not downplay important information and warnings.

3.57 From our initial review of the market, we are concerned that a number of platforms would be in breach of these requirements. See Annex 4 for further detail on the findings of our review. Common issues we observed include:

- a lack of balance, where disclosures emphasise benefits without a prominent indication of risks
- insufficient information disclosure leading to a potentially misleading or unrealistically optimistic impression of the product, and
- downplaying important information

36 Under the 'successive operations' principle in COBS 15 Annex 1 1.11R

37 Firms must repay consumers without undue delay and no later than within 30 calendar days. The firm may deduct money for any service provided before the cancellation. This amount must be proportionate to the service provided and must not act as a penalty for cancellation.

38 www.legislation.gov.uk/uksi/2004/2095/contents/made

39 Principle 7 and COBS 4.2.1R(1)

40 Retail clients are defined in COBS 3.4. In short, a retail investor is a client who is neither a professional client nor an eligible counterparty. Professional clients and eligible counterparties are defined in COBS 3 and, generally speaking, are institutional clients and individuals who invest by way of business. Our general rule for firms communicating with retail clients appear in COBS 4.5.2R.

3.58 Websites sometimes, for example, have a banner headline rate of return that is often in double figures, without an explanation of the impact of charges, default rates and taxation. In some cases, it appears that the actual returns to customers can be substantially less than the headline rate. Information on product risks has been obscured when on a separate page or at the end of a long page of information, relying on investors to click through to it or scroll down. Some websites only provide risk warnings after customers register.

3.59 We have also observed that some websites refer to the investments in loan agreements almost as if they are deposits. For example, the use of comparisons with deposit rates and references to investors as 'savers' may be problematic. Investing via loan-based crowdfunding platforms is of higher risk than making a deposit and it is not comparing like-with-like to refer overtly to lower deposit returns without explaining these risks. In some cases, too, actual returns after charges and expected default rates may be lower than the returns on deposits.

3.60 Firms need to review their websites and change some of these misleading practices. We will be paying close attention to communications and remind firms that we have the ability to ban financial promotions – including websites – if we consider that they do not meet our standards.

3.61 In the following sections we set out some of our key requirements for information that has to be disclosed and how it must be disclosed.

Information about the firm

3.62 Retail clients must receive certain information about the firm, including:

- contact details
- a statement that the firm is authorised[41]
- details of what performance reports the client can expect
- the firm's conflicts of interest policy
- information on costs and charges, and
- details of the firm's client money safeguards[42]

3.63 The firm must also have a written basic agreement with the client setting out the essential rights and obligations of the firm and the client.[43] This information must be supplied in good time before the firm provides a service and the client makes a transaction.

41 Firms should refer to the appropriate forms of words set out in GEN 4 Annex 1 R or GEN 4 Annex 1A R as appropriate

42 COBS 6.1

43 COBS 8.1

Information about the service

3.64 We are not proposing to mandate the form and content of investment disclosure documents as we do with some other investments commonly used by retail clients (such as the key investor information document for collective investment schemes or the key features documentation that must be provided with, for example, life policies and personal pension schemes). We do not believe that the different models adopted by loan-based crowdfunding platforms fit easily into the standardised format of these documents so we do not propose to require firms to follow them at this time. Instead, we propose to apply existing high-level requirements to require firms to ensure that they provide an adequate description of the investments' nature and risks.[44] Under this approach, firms need to provide relevant information to enable the investor to make informed investment decisions.

3.65 We consider the following to be relevant aspects for disclosure:

- The key risk facing investors is borrower default. It remains to be seen, for example, how the investments will perform if interest rates increase and borrowers struggle to repay other debts with variable rates.[45] Investors should understand the current default rate, any expectations for future default rates, and how reliable the estimates are. Investors should also know that current and expected default rates may not remain stable.

- Different firms employ different approaches to due diligence. We expect it to be clear to investors how much due diligence has been conducted and whether the investor should be conducting further research of their own.

- Some platforms grade the level of risk associated with particular loans. Where this is the case, investors should be told what the different levels of risk mean and how borrower creditworthiness has been assessed. Where platforms do not offer different risk grades for the loans they make available, they should still make clear to investors what level of risk is being taken.

- Some platforms offer secured loans, others do not. It should be clear to investors whether their loan is secured. If it is, it should be clear how the loan is secured, how the underlying asset is valued and how the asset would be treated in the event of platform failure.

- Platforms often focus on rates of return available. Customers must understand what the actual rates of return are likely to be after charges and expected default rates.

- The way taxation is calculated for investors transacting on loan-based crowdfunding platforms must be set out clearly. Investors must understand what tax obligations they face and what impact tax will have on the return on their investment.

- Since there is no standard practice across the market, it should be clear how the firm defines what is meant by a 'late payment' and 'default on a loan'. Firms are obliged to act in the best interests of customers and these definitions should be reasonable.[46] We would not expect, for example, a loan to be classed as in 'late payment' rather than in 'default' if a substantial period has passed.

44 COBS 2.2 and COBS 14.3

45 While interest rates on loans facilitated by loan-based crowdfunding platforms are generally fixed over the term of the loan, other economic conditions are not. For example, an individual borrower with a mortgage on the average standard variable rate (3.56% in June 2013) might struggle to meet ongoing payments if the Bank of England base rate (0.5% in June 2013) increased to the long-term average of around 4% and the full increase were passed on to mortgage borrowers.

46 Principle 6 and COBS 2.1.1R(1)

- The process to be followed when loans enter default should be clear. Again, there is no industry standard and customers should know how far the platform will go to secure payment and where responsibility lies for chasing non-payment and arranging intervention from debt collection agencies.

- Platforms should make clear what would happen if an investor wants to exit from an investment before its maturity. There may be a secondary market, for example, but any limits or risks should be disclosed. Alternatively, if there is no option to sell out of an investment early, this should be disclosed.

- It should be clear to investors what would happen if the firm running the platform fails. In particular, the lack of recourse to the FSCS should be explained clearly.

- As discussed below in the section on dispute resolution, the process for making complaints and recourse to the Financial Ombudsman Service should be set out.

3.66 As well as general disclosures of the nature and risks of investment on the platform, depending on the platform structure, there may also be specific information about loans that should be disclosed. This information could include:

- the expected rate of return from a specific loan, taking account of charges, expected default rates and the possible implications of taxation, and

- where investors are choosing to make loans to specific borrowers, the creditworthiness assessment (required under the consumer credit rules) should be disclosed to investors

3.67 As each loan-based crowdfunding platform can have an entirely different business model, this list should not be regarded as exhaustive. Firms should consider what disclosures are relevant in light of the nature and risks of their platform.

3.68 As with the information about the firm, this information must be supplied in good time before the client makes a transaction. While information need not be supplied all at one time, it is essential that all communications meet the high-level requirements. In particular, firms should not supply information on benefits without also providing a fair and prominent indication of risks at the same time. We do not expect to see only benefits described on the first pages that a consumer views, with information on the risks of investment only supplied later in the customer journey, perhaps only after the customer has registered with the platform.

Financial promotion rules

3.69 An invitation or inducement to engage in investment activity, communicated in the course of business, is a financial promotion.[47] A financial promotion that specifies the manner of response or includes a form by which any response may be made is regarded as a 'direct offer financial promotion' in our rules.[48] Promotions on platforms that allow online transactions are, clearly, within the scope of these definitions.

47 More information on our expectations for financial promotions is available here: www.fca.org.uk/firms/being-regulated/financial-promotions

48 COBS 4.7

3.70 Unless they have identified that an exemption applies, firms should have processes in place to ensure they comply with the financial promotion rules when communicating or approving financial promotions.[49] They should keep a record of all financial promotions that they communicate or approve.[50]

3.71 In particular, direct offer financial promotions must contain all appropriate information about the investment so that the client is reasonably able to understand the nature and risks involved and, consequently, to make investment decisions on an informed basis.

Performance information

3.72 If firms provide information on past performance or future performance, they must do so in accordance with certain rules.[51]

- Where past performance information is provided (such as default rates over the last six months), it must not be the most prominent feature of a communication; there must be a warning that past performance may not be repeated; and, to avoid cherry-picking the best data, the information must include past performance for complete 12-month periods, showing information for at least five years' performance where that is available, or the full period where it is not.

- Future performance (including estimated future default rates), must be based on reasonable assumptions and objective data, not past performance; the effect of fees and other charges must be disclosed; and, there must be a prominent warning that such forecasts are not a reliable indicator of future results. If objective data is not available, it will not be possible for firms to give future performance information.

Guarantees, protections and security mechanisms

3.73 Our rules and guidance detail how firms should explain terms that imply the existence of security mechanisms.[52] In order to provide fair, clear and not misleading disclosures, when using terms such as 'guaranteed', 'protected' or 'secure', or referring to contingency funds, firms should provide information to make it clear what these terms mean for the consumer. They should, in particular, explain any limits that apply. If they do not, consumers could misunderstand what is actually offered.

Comparative information

3.74 We have noticed some platforms in the loan-based crowdfunding market include comparisons between interest rates and deposit account rates. Our rules state that comparative information must be meaningful and presented in a fair and balanced way, comparing like with like.[53]

3.75 As loan-based crowdfunding is not directly comparable to holding money on deposit, given the additional risks, we consider that some loan-based crowdfunding platforms would be in breach of our rules if they applied today. If such comparative data is presented in future, to be compliant, it should be accompanied by a fair and prominent indication of the risks of loan-based crowdfunding relative to the risks applying to deposits. This indication should not be disguised, diminished or obscured, but should carry equal weight to the comparison and not, for example, be relegated to small print or a separate page of the website.

49 COBS 4.10.1G
50 COBS 4.11.1R(1)
51 COBS 4.6
52 COBS 14.3.5R and 4.2.5G
53 COBS 4.5.6R

Periodic reporting

3.76 Firms are also obliged to send information to customers on an ongoing basis.

- Unless otherwise agreed by the client, the firm must supply the client with relevant information on transactions executed on their behalf.[54]
- Where the firm holds a designated investment or client money for a client, it must send the client a statement at least once a year, setting out details of holdings at the end of the relevant period.[55]

> **Q14: Do you have any comments on our proposed approach to regulating disclosures on loan-based crowdfunding platforms?**

Dispute resolution and access to the Financial Ombudsman Service

3.77 We are proposing that investors who are unhappy with the service they have received from a firm have the right to complain. In the first instance, they should complain to the firm.

3.78 All firms must have a formal complaints procedure to follow when customers complain.[56] Details of the process should be available on the website.

3.79 If firms receive a complaint, they must investigate it diligently, fairly and promptly to decide whether the complaint should be upheld and whether any remedial action should be taken or redress paid. Firms have eight weeks to make an initial review and respond to the complainant. After that point, the complainant may take the complaint to the Financial Ombudsman Service.[57]

3.80 The Financial Ombudsman Service considers complaints that fall within its jurisdiction by reference to what is, in their opinion, fair and reasonable in all the circumstances of the case, taking into account relevant law and regulations, guidance and standards, codes of practice and, where appropriate, what they consider to have been good industry practice at the time. As we are proposing to introduce a transitional period during which our Conduct of Business rules will not apply, the Financial Ombudsman Service will still consider complaints in the interim but will not refer to our Conduct of Business rules to help make decisions.

3.81 Since we are consulting primarily on the introduction of a disclosure-based regime for loan-based crowdfunding, claimants might argue that they would not have invested if disclosures by the platform had not been misleading. It is particularly important for firms to ensure that their disclosures are fair, clear and not misleading.

> **Q15: Do you agree that firms running loan-based crowdfunding platforms should be subject to our dispute resolution rules?**

54 COBS 16.2

55 COBS 16.4

56 http://fshandbook.info/FS/html/FCA/DISP/1

57 There are limits on the type of complaint that may be considered by the Financial Ombudsman Service. There are time limits and the Financial Ombudsman Service may only consider complaints that relate to: activities of a firm carried on from an establishment in the UK; and a complaint from an eligible complainant. We are proposing to add a new category to our eligible complainant rules to allow consumers to complain about investments on loan-based crowdfunding platforms.

FCA reporting requirements

3.82 Firms running loan-based crowdfunding platforms will already be subject to a number of reporting requirements under the consumer credit regime. To help us monitor the market with respect to investments on these platforms, we are proposing to introduce further reporting requirements.

Financial position reports

3.83 Data on authorised firms' financial standing is necessary to help us check that businesses remain viable and to act as an early warning of possible problems in the market. We propose that firms should submit information to us on a quarterly basis. This information should cover the firm's balance sheet, profit and loss, and capital position.

3.84 We also propose to introduce a requirement for firms to notify the FCA if the value of loaned funds increases significantly (i.e. 15%) within 12 months from the last return submission date. This may happen, for example, as a result of a takeover of another loan-based crowdfunding business. This proposal will ensure that firms' prudential requirements are always relevant and at a level that accurately reflects the risks that the firm poses to consumers.

Client money reports

3.85 To ensure adequate protection for client money, we propose that firms report on their client money approach to us. As for other firms, our proposed requirements depend on the size of the firm. We propose that:

- firms classed as medium or large under CASS complete a Client Money and Asset Return (CMAR) each month,[58] and
- firms classed as small under CASS must notify the FCA annually of their highest client money balance for the previous year

Regular reports on investments

3.86 We propose that firms submit quarterly reports to us to help us monitor investor experience and provide an early alert to problems or changes in the risk profile of the market as a whole. We are consulting on the introduction of a new form for firms running loan-based crowdfunding platforms to gather information on:

- aggregate investor experience, looking at all loans arranged over the quarter, and
- where firms identify different categories of loans – either in terms of their level of risk or the period for which they run – for each category:[59]
  - information on the number of investors
  - the amount invested
  - the proportion invested into unsecured loans
  - the average interest rate for new loans
  - the average default rate over the last quarter, and

58 SUP 16 Annex 29R

59 The form on which we are consulting includes space to capture information on ten categories of loans. From our review of the market, we believe that this should be sufficient.

- where firms have contingency funds to cover bad debts, information on the total amount held in the contingency fund and details of what proportion of outstanding loans this covers

Complaints reports

3.87 To enable us to supervise the market adequately and highlight risks, we also believe that firms should submit data on complaints. In line with other firms, we propose that loan-based crowdfunding platforms should provide us, twice a year, with a complete report concerning complaints about investments on the platforms received from eligible complainants.[60]

3.88 To complete the complaints return regarding investor complaints, we would expect firms to classify peer-to-peer loan agreements as:

- 'investments' for the table on 'Complaints closed and total redress paid during the reporting period', and
- 'investment management/ services (inc. platforms)' for the table on 'Complaints opened'

Q16: Do you have any comments on the reporting requirements we propose for firms running loan-based crowdfunding platforms?

60 DISP 2.7

4. Investment-based crowdfunding (and similar activities)

4.1 In this chapter we outline proposals to revise our regulatory approach to firms operating investment-based crowdfunding platforms, and firms with similar non-internet-based businesses selling unlisted equities or debt securities in the UK.

4.2 At present, to protect consumers, we have placed individual restrictions on firms operating investment-based crowdfunding platforms at the point of authorisation, so that the risks applying to their particular business models have been mitigated. In this CP, we are proposing a revised approach that aims to make investment-based crowdfunding more accessible to a wider, but restricted, audience of consumers.

4.3 Our proposals will apply requirements to all firms that promote and sell unlisted shares or debt securities. They will apply to authorised firms and their appointed representatives. They will apply to firms that use the internet, the telephone, meetings, mailings or any other media to communicate and transact with consumers. We expect this approach to facilitate competition between firms that operate crowdfunding platforms or other comparable business models. We think this media-neutral approach is fair and proportionate to the risks.

4.4 Given our consumer protection objective, our aim is to ensure that only those retail investors who can understand and bear the various risks involved are invited to invest in unlisted shares or debt securities. If firms target this wider but still restricted audience of retail investors appropriately, this may result in greater access to alternative (non-bank) finance options for businesses seeking finance.

4.5 Our proposals do not affect firms that only communicate with, or carry on regulated activities for, professional clients or eligible counterparties.

Unregulated collective investment schemes

4.6 Some firms arrange the sale of units in an unregulated collective investment scheme (UCIS). These schemes provide exposure to underlying assets, such as loans or shares, with a professional fund manager sometimes making day-to-day investment decisions.

4.7 We consider UCIS to carry particular risks. They are not subject to the rules for regulated collective investment schemes that govern, for instance, investment and borrowing powers, disclosure of fees and charges, management of conflicts of interest, a prudent spread of risk, and other investor safeguards. Risks to capital may also be opaque and performance information may be unavailable or unreliable. Governance controls may be weak, heightening the potential for a product to fail.

4.8 For these reasons, legislative and regulatory restrictions apply to the marketing of UCIS[61] so these products may only be marketed to certain types of investor. In our supervisory work we have seen many UCIS promotions that failed to meet our requirements, exposing ordinary investors to significant potential for harm. To address this we have made new rules that will come into force on 1 January 2014, designed to limit promotion of UCIS primarily to:[62]

- professional clients
- retail clients who are certified or self-certify as sophisticated investors, and
- retail clients who are certified as high net worth investors.

4.9 We do not propose to change our current approach to the promotion of UCIS, as we think it should provide for a proportionate level of consumer protection. The UCIS promotion restrictions apply to firms operating crowdfunding platforms in the same way they apply to any other type of firm that markets and sells units in a UCIS.

Corporate finance and venture capital business

4.10 We have not identified any market failure in the corporate finance business or venture capital business sectors. So, these proposals are not expected to apply to firms carrying on designated investment business that is corporate finance business or venture capital business when they communicate with corporate finance contacts or venture capital contacts. This will be the case so long as the firms do not, in the course of carrying on a regulated activity, provide a service to such contacts, such as arranging deals in specified investments, which would change their status.

Direct offer financial promotions for unlisted equities and debt securities

4.11 The risks facing investors that invest in unlisted shares or debt securities are significant. They are similar to the risks that venture capital contacts and corporate finance contacts face when choosing to invest in private equity. As explained in Chapter 2 of this CP, when investors invest directly or indirectly in unlisted shares or debt securities, there is a high probability that the company invested in will fail, and 100% capital losses will result. So, ideally, investors should be advised, or properly informed and able to carry out appropriate due diligence on the investment opportunities offered, to ensure they can understand and assess what is involved.

4.12 The information we have on investors in crowdfunded investments indicates that they tend to be high-net worth individuals with investment experience. This observation is consistent with the fact that investment-based crowdfunding often gives access to Enterprise Investment Scheme or Seed Enterprise Investment Scheme tax reliefs. It is higher-rate tax payers who gain most benefit from such schemes.

61 Section 238 FSMA

62 *Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes*, FSA CP12/19, August 2012: www.fca.org.uk/static/pubs/cp/cp12-19.pdf and FCA PS13/3, June 2013: http://www.fca.org.uk/static/documents/policy-statements/ps13-03.pdf. The rules were made in the *Unregulated collective investment schemes and close substitutes instrument* 2013, FCA 2013/46: http://media.fshandbook.info/Legislation/2013/FCA_2013_46.pdf

4.13 We have no evidence to show that the wrong type of investor is investing in unlisted shares or debt securities. It is possible our current regulatory approach is effectively preventing this. However, we have historically identified instances of non-compliant promotion of unlisted shares by firms using mailings or telephone-based business models. We expect the proposals outlined in this CP to minimise the risk of such promotions in future.

4.14 In addition to the marketing restrictions that apply to firms promoting UCIS, we also impose marketing restrictions when firms promote warrants or derivatives.[63] However, unless a restriction has been imposed at the authorisation stage, when a firm promotes an unlisted share or debt security there is currently no marketing restriction in place.

4.15 In our view the risks applying to units in a UCIS, warrants and derivatives are not dissimilar to those that apply to unlisted shares or debt securities. So, to provide proportionate consumer protection and fairness for competing firms and products, we are proposing to apply marketing restrictions to firms that promote unlisted shares or debt securities, by whatever media, unless the recipient is a corporate finance contact, a venture capital contact, an advised client or a non-retail client.

4.16 *Investor restrictions*: We are proposing to require firms that communicate direct offer financial promotions for unlisted shares or debt securities to ensure that they communicate such promotions to only the following types of retail client:

- retail clients who are certified or self-certify as sophisticated investors
- retail clients who are certified as high net worth investors
- retail clients who confirm before a promotion is made that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorised person, or
- retail clients who certify that they will not invest more than 10% of their net investible portfolio in unlisted shares or unlisted debt securities (i.e. excluding their primary residence, pensions and life cover)

4.17 *Assessing appropriateness*: Where no advice is to be given to retail clients, we also propose to require firms that communicate direct offer financial promotions for unlisted shares or debt securities, whether by internet-based means or by other media, to ensure that the rules on appropriateness are complied with before they arrange or deal in relation to the investment. This should ensure that clients are assessed as having the knowledge or experience to understand the risks involved before they can invest. This approach is in line with the rules we apply to firms that market warrants and derivatives, and it is consistent with the MiFID-derived rules that apply to MiFID firms when they sell complex financial instruments on a non-advised basis.

Q17: Do you agree with our proposals to revise our approach to investment-based crowdfunding platforms?

63 See COBS 4.12 and COBS 4.7.6R.

Annex 1
Market failure and cost benefit analysis

The market

Background

1. Crowdfunding is a way people, organisations and businesses (including business start-ups) can raise money through online portals (crowdfunding platforms) to finance or re-finance their activities and enterprises. Firms operating loan-based or investment-based crowdfunding platforms can give business start-ups access to investors.

2. The market tends to display significant 'network effects', which means that the attractiveness of the platform to investors and borrowers increases the higher the number of investors or borrowers/issuers using it. Platforms generally need to have a sufficient number of clients on either side of the market – investors providing the funding on one side and borrowers/issuers seeking funding on the other – to be commercially viable. Investors are often willing to pay more for access to a larger range of investment opportunities as this provides them with an increased ability to diversify their holdings and manage portfolio risk.

3. Firms operating crowdfunding platforms have an advantage over many other financial institutions in that they have low fixed and transaction costs that they can pass on to investors and borrowers/issuers. Given their reliance on technology and the absence of physical infrastructure (such as branch networks), platforms have limited fixed costs, such as rent or salaries. Equally, transaction costs can be lower compared to banks because the platform's IT system allows investors and borrowers/issuers to transact without the need for staff involvement or advice. The fact that firms operating crowdfunding platforms enjoy a lower cost base explains why it can potentially offer greater returns to investors.[1]

Size

4. The crowdfunding industry has seen strong growth. This is particularly true for loan-based crowdfunding which, according to Datamonitor, recorded a compound annual growth rate of approximately 80% between 2005 and 2012.[2] Loans to individuals for their personal use account for most loan-based crowdfunding at present. However, loans to businesses also represent a significant amount. In 2012, according to Datamonitor, there was £221m of loans outstanding to individuals and £119m to businesses.[3]

1 http://www.wiseclerk.com/group-news/services/lendingclub-lending-club-cost-advantage-over-banks/
2 Datamonitor 2013, *Peer-to-peer: filling the lending gap*, page 9
3 Datamonitor 2013, page 9

5. Despite its growth, loan-based crowdfunding remains small compared to the market for unsecured personal loans (UPL) in the UK overall. In 2012, loan-based crowdfunding gross lending was approximately £350m, compared to UPLs for the UK of approximately £27bn. According to some sources, gross loan-based crowdfunding in the UK is expected to rise by 136% between 2012 and 2013, and estimated to account for 1.3% of UPLs in 2013.[4] This compares to around 1% of UPL for 2012.[5]

6. To place the loan-based crowdfunding market into context for investors, we have also considered the size of the UK investments markets as a whole. Investment Management Association statistics show that £744bn was held in investment funds under management in July 2013. Investment via loan-based crowdfunding platforms therefore accounts for around 0.04% of investment funds under management.

7. The market for investment-based crowdfunding is significantly smaller, totalling approximately £10m in 2012 and may raise double that amount in 2013. The investments tend to be in start-up enterprise and young businesses. As most start-ups fail in the early years, we estimate that investors will lose all investment capital around 50% to 70% of the time.

8. Investment-based crowdfunding has been slower to develop than loan-based crowdfunding. Some of the firms operating investment-based crowdfunding platforms have only recently been authorised and are still in the process of setting up their trading operations. Those that are already operational have seen a significant increase in their trading volume in the last year. No public figures are available.

9. At present, the FCA has authorised ten firms to carry on regulated activities in relation to operating an investment-based crowdfunding platform. There are also eleven appointed representatives of authorised firms that operate platforms and a number of firms in the process of applying for authorisation. We estimate that there are around six firms whose businesses involve the selling of unlisted shares or unlisted debt securities, without advice, using non-internet-based media. So, we expect these proposals to affect no more than around 30 firms.

Market share

10. Market share data is available for loan-based crowdfunding only. This information is set out below. Looking at the five largest platforms, the market is currently structured as follows.[6]

Table 6: The current market structure

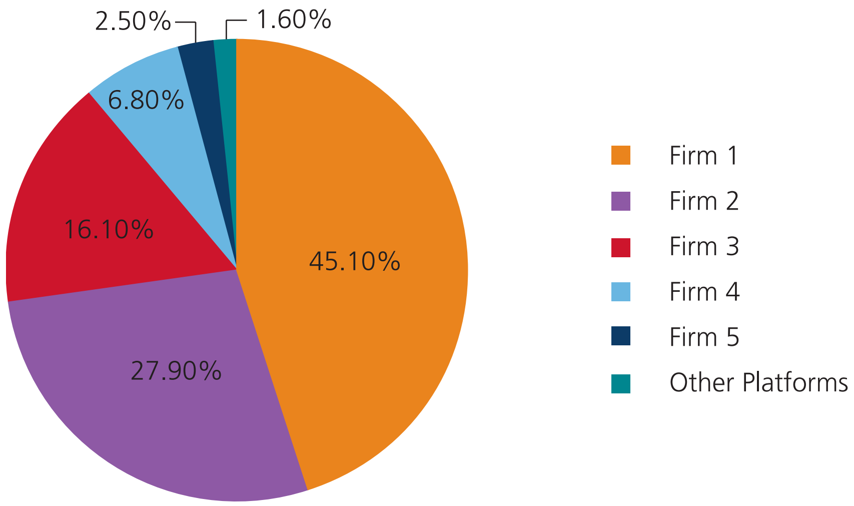
	Loans to date	Loans outstanding
Firm 1	£348m	£160m
Firm 2	£134m	£99m
Firm 3	£92m	£57m
Firm 4	£31m	£24m
Firm 5	£10m	£9m

Source: www.p2pmoney.co.uk/companies.htm, 19 August 2013

4 Datamonitor 2013, page 10 and 11; Mintel, *Personal loans*, UK, January 2013, page 45
5 Datamonitor 2013, page 11 and 14
6 As this market is evolving rapidly, this information is an approximation only.

11. The following chart, based on the evidence available for loan-based crowdfunding, shows the relative market share of the five largest providers in the market.

Table 7: Current market structure in loan-based crowdfunding



12. We note that, on the basis of the information currently available, the five largest providers have a combined market share of over 90%. One provider could be considered to hold a market share of over 40%. Despite its significant recent growth, crowdfunding can be considered to be an emerging market. We therefore expect that continued growth is likely to attract future competitive entry. This is particularly true given low barriers to entry relative to other financial institutions. Market shares therefore need to be seen in the context of the market's overall contestability.

Market entry

13. As noted above, investment-based crowdfunding has been slower to develop compared to loan-based crowdfunding.

14. The market for loan-based crowdfunding is characterised by competitive entry (see Table 8). This has been largely confirmed by the responses we received from firms, which showed that some platforms entered the market recently and are still developing their business proposition.

Table 8: Entry since 2005

Year	Number of new platforms
2005	1
2009	1
2010	4
2011	3
2012	6
2013	11

Source: www.p2pmoney.co.uk/companies.htm, 19 August 2013

15. Firms that responded to our survey are optimistic about future growth prospects and have expectations of significant expansion. Firms reported that they hope to see increased institutional investment, as well as growth in the retail market, and the ability to arrange larger loans than at present. Some firms have told us that, in recent years, investment has grown at a rate of 100% per year and that they expect to see this trend continue.

16. Investment on crowdfunding platforms may increase in the next couple of years as the markets becomes more established. The regulation of the market may contribute to this. In its report into loan-based crowdfunding, NESTA observed that, if half of the richest 10% of the UK population invested an average 13% of their financial wealth in loan-based crowdfunding platforms, it would raise £37bn.[7] Assuming an average three-year investment term, this would raise £12.3bn a year, representing 1.65% of investment funds under management. This does not take account of other types of investor such as ordinary retail investors or institutional investors.

Market exit

17. Information on investment-based crowdfunding is limited. We are not aware of any firm having exited the market.

18. In loan-based crowdfunding, five platforms suspended trading between 2011 and 2013.[8] We understand that, on most of these platforms, no investors lost money as a result of the suspension. There is, however, some evidence of consumer harm in relation to one suspension. Unverified estimates suggest this platform had arranged 30 loans, worth around £20,000, and it is believed that the model failed because it conducted inadequate assessment of borrower creditworthiness and had problems with payment, collection and debt recovery.

19. Overall, however, default rates on loan-based crowdfunding platforms are low. Default rates for many of the platforms currently in the market are less than 1%.

The investment contract

20. A number of different crowdfunding models operate in the market.

- Loan-based crowdfunding can work through syndicating loans, that is, each loan is funded by multiple investors. Investors bid for pieces of the overall loan amount, indicating how much they would like to lend and what interest rate they would like to receive. Other models exist in the market. Some firms do not allow investors to make active investment choices. Instead, the platform matches investors to borrowers automatically using their stated investment criteria such as interest rate, credit rating, distribution frequency at which they are prepared to lend.

- With investment-based crowdfunding, most models allow investors to invest in the unlisted shares or debt securities of specific businesses. These investments may be eligible for Enterprise Investment Scheme (EIS) or seed EIS tax relief. In the other investment-based models, investors are offered units in an unregulated collective investment scheme and fund managers make investment decisions on behalf the investors.

Q18: Do you have any comments on our analysis of the crowdfunding market or further information about it?

7 National Endowment for Science, Technology and the Arts (NESTA), *Banking on each other: peer-to-peer lending to business, evidence from Funding Circle*, April 2013: www.nesta.org.uk/library/documents/Peer-to-peer-lending-report.pdf

8 www.p2pmoney.co.uk/companies.htm

Market failure analysis

21. Based on the available evidence, we judge that there are three principal market outcomes that could harm investors:

- credit and investment risk is mispriced
- default of the crowdfunding platform provider, and
- fraud

22. We analyse in this section the drivers of such poor market outcomes for investors, namely:

- information asymmetries
- behavioural biases, and
- illiquidity in the secondary market

Credit and investment risk is mispriced

23. The key risk facing investors is borrower or issuer default. Investors may suffer harm if they underestimate credit or investment risk, or overestimate the financial returns. The underlying market failures – information asymmetries, behavioural biases and illiquidity in the secondary market – are the same for both loan-based and investment-based crowdfunding.

24. Credit and investment risk can be mitigated by carrying out due diligence checks on the person or organisation seeking funding. This can be done by the firm operating the crowdfunding platform or, depending on resources and expertise, the investor, or both the platform and investor.

25. Credit and investment risk may be the result of inherent information asymmetries between investor and borrower/issuer, as well as platform and borrower/issuer. Information asymmetries exist because neither the platform, nor the investor, has full information about the potential borrowers/issuers. Some investors may also lack the resources and expertise to carry out due diligence assessments of potential borrowers/issuers (where investors have a choice over how their funds are invested).

26. In crowdfunding markets, information asymmetries, and credit and investment risk, can be exacerbated if the incentives investors and platforms face are not aligned. For example, to build sufficient scale to achieve commercial viability, platform providers might be incentivised not to carry out adequate due diligence of potential borrowers/issuers. The absence of adequate due diligence by platform providers or investors might harm investors.

27. However, the network effects mean the platform provider needs to acquire a sufficiently large number of investors and borrowers/issuers, which it can only do by building reputation. A track record of low levels of default signals to the market that the platform takes due diligence seriously. Only in this way can platforms build sufficient investor demand over time.

28. We also note that investors can make repeat purchases and learn from their investment decisions. This is particularly true for loan-based crowdfunding. This underlines the importance of reputation as a market-correcting mechanism: platforms have to attract investor demand. If they fail to do so (as a result of low levels of due diligence leading to the development of a poor reputation in the medium to long-term, for example), investors may switch to alternative providers of investment. Crowdfunding platforms can only remain commercially viable if they continue to attract investment, and some platforms have taken steps to reduce these risks. For example, some loan-based models have created contingency funds to cover lost capital in the event of borrower default.

29. Building market credibility and maintaining reputation are market-based mechanisms that can address, to a degree, the information asymmetry and incentive issues identified above. However, the effects of reputation and learning are effective only if there is transparency for investors, in particular on:

- business models
- expected and actual default rates
- due diligence procedures, including assessment of credit risk, and
- management of non-repayments

30. Where reputation and learning is insufficient, better disclosure of information can help investors make more informed assessments of whether crowdfunding investments are suitable for them. It can also help reduce the risk of potential fraud.

31. A secondary market can, where it exists, potentially mitigate some aspects of risk. Where an investor has become aware that risk has been underestimated or the assessment of the expected return was overoptimistic, a secondary market allows the sale of the investment. As noted above, through repeat purchases investors can come to a better understanding of the overall level of risk they are taking.

32. A further factor in potentially creating poor outcomes for investors is that investors' behaviour might not be fully rational. Economic literature has identified a number of biases in investors' behaviour that can, under certain circumstances, lead to sub-optimal investment decisions. These can combine with the information asymmetries and misaligned incentives as identified above. Biases that are likely to be relevant to crowdfunding includes:

- Overconfidence: where investors decide on investment in a single recipient of funds they may be overconfident, i.e. the investor may overestimate their ability to assess risk. This could lead to financial loss.
- Anchoring: this occurs when investors base their evaluation and purchase decision exclusively on one fact (such as, for loan-based crowdfunding, the headline rate of return), not taking costs (such as fees or tax) into account.

- Herding: investors may be using sub-optimal rules of thumb to make investment decisions. Shen et al (2010), for example, found that investors on Prosper.com are interpreting the level of investor interest in a proposition to infer something about the quality of the overall investment.[9] That is, the more investors show interest in a particular investment, the more other investors will assume that it is a good investment. Such behavioural biases might be particularly relevant to the auction model where investors effectively bid against each other to invest. Not all crowdfunding platforms have models that allow this herding behaviour, but it is possible with some of the current UK models.

33. Biases like these may impact on investment decisions. For example, a loan-based platform may create an anchoring bias by focusing marketing on gross investment returns compared to those offered by savings products. However, gross returns are not always an accurate reflection of the actual return compared to relatively low-risk savings accounts. To compare with savings accounts, crowdfunding investors need to consider the potential rate of default, charges, commissions, the cost of waiting for access to their capital, and the fact that their investments are not protected by the FSCS.

34. Lack of investor sophistication may be exacerbated by behavioural biases, which are likely to interact and reinforce each other. They may result in insufficient due diligence on the part of the investor and/ or platform.

Default of the platform provider

35. A platform will be at risk of default if its revenues are not enough at least to cover operating costs. Platform revenue is usually linked to transactions, and so profitability depends on the ability to acquire a sufficiently large number of investors and borrowers/issuers, and thus deliver a significant number of transactions.

36. Platforms might be incentivised to build market share by risky short-term business strategies (perhaps by conducting little or no due diligence on borrowers/issuers). For example, one strategy could be to grow market share by accepting high-risk borrowers/issuers that other firms would not. This would increase the risk that the borrower/issuer defaults. As borrowers/ issuers default the fee income received by platforms would fall, and there would be a risk of shortfall relative to operating costs. Furthermore, the platform's reputation could deteriorate, making it harder to attract new investors. Reduction in revenues and number of investors could lead a platform to default, leaving investors facing financial loss. Such an outcome may be the result of information being asymmetrically distributed and the incentives of the platform and the investor not being aligned. Investors not knowing what commercial strategies the platform is pursuing are unable to assess this risk.

37. Unless funds are kept in a segregated account, the investor runs the risk of losing client money protections. In case of a platform's default, the contract between the investor and the borrower/ issuer remains valid. However, some investments might be hard to track and investors with only a small exposure to a particular investment may not have an incentive to do so.

9 Dawei Shen, Coco Krumme and Andrew Lippman 2010, *Follow the Profit or the Herd: Exploring social effects in peer to peer lending*, presented at IEEE International Conference on Social Computing, MIT

Fraud

38. In the context of crowdfunding, fraud can take place at various stages in the process and will be something for the criminal justice system to address.

39. We note that reputation, as identified above, can play an important role in generating market-based solutions to combat fraud. It is in firms' interests to implement mechanisms to reduce the opportunity for fraud, since individual instances of fraud could have negative reputational effects for the industry as a whole. As a result, many crowdfunding platforms scrutinise each applicant project before listing it, an effort which signals credibility to potential investors.

40. We recognise that market-based mechanisms to combat fraudulent activities might not always be sufficient, however. The measures proposed in this CP are designed to help minimise the risk of fraud. For example, enhanced due diligence and disclosure requirements may help reduce fraudulent funding requests or the setting up 'rogue platforms'.

Cost benefit analysis

Introduction

41. FSMA, as amended by the Financial Services Act (2012), requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs, together with an analysis of the benefits' that will arise if the proposed rules are made. It also requires us to include estimates of those costs and those benefits, unless these cannot reasonably be estimated or it is not reasonably practicable to produce an estimate.

42. The CBA follows the same structure as the CP, so the costs and benefits are presented separately for loan-based and investment-based crowdfunding platforms. We consider the incremental costs and benefits that will occur as a result of our proposals, relative to a situation where the proposals are not implemented (i.e. the baseline).

43. The baseline is current market practices and the existing regulatory position. For loan-based crowdfunding there is very little regulatory protection for investors at present, so the CBA takes as a baseline only current market practices. For investment-based crowdfunding we currently impose restrictions at authorisation stage on a case-by-case basis for some firms, and our rules apply marketing restrictions to firms promoting unregulated collective investment schemes. These regulatory requirements make up the baseline for the investment-based crowdfunding firms.

44. For loan-based crowdfunding platforms, we are proposing:

- minimum capital requirements
- rules on client money
- arrangements in the event of platform failure
- rules on disclosure, including financial promotions
- rules on the resolution of disputes, and
- reporting requirements to the FCA

45. For investment-based platforms, we are proposing:

- marketing restrictions to all firms that promote unlisted shares or debt securities, by whatever media, unless the recipient is a corporate finance contract or a venture capital contract, and
- a requirement on firms to ensure that the rules on appropriateness are complied with before they communicate direct offer financial promotions for unlisted shares or debt securities

46. Overall we expect 55 firms to be affected by our proposals: 25 firms likely to be conducting loan-based crowdfunding activities; and 30 conducting investment-based crowdfunding or similar activities.

47. In the loan-based crowdfunding market, five out of the 25 firms account for over 95% of outstanding loans. These firms are referred to the CBA as 'large firms' and the remaining 20 are referred to as 'small firms'. In the investment-based crowdfunding market, all the firms are small, so we have not broken them down by size in the same way.

48. We recognise that this is a fast-growing market and more firms may be affected by the rules in the future. In the CBA we estimate the costs per firm and the total cost to the industry is based on the current population of firms.

49. To inform our analysis we have used information in the public domain, reviewed market reports, and spoken to a number of firms in the market. For investment-based crowdfunding we relied primarily on information provided by firms in the sector, as the publicly available information is very limited. For the loan-based crowdfunding, in addition to other sources, we conducted a survey of 23 firms for information on their current procedures and details of their cost models. We had 13 responses, four from large firms and nine from small firms. We consider that information is representative of the market. Where the survey did not provide evidence, we have drawn data from CBAs in previous CPs produced by the FCA and FSA.

Costs

Direct costs to the FCA

50. The requirements that will give rise to incremental costs to the FCA are:

- IT changes to incorporate reporting requirements, with regard to capital and default rates, in the FCA reporting system.
- Processing additional applications for approval of the individual responsible client money oversight for loan-based crowdfunding platforms (CF10A).[10]

51. Regarding IT changes, we have identified that the most efficient solution will be to include the forms within the GABRIEL reporting system. As firms will already be obliged to submit other forms on GABRIEL, it does not make sense to introduce a different reporting regime for these two new forms. We expect the cost to the FCA for developing these new forms to be up to £500,000. The cost is likely to be lower than this, however, as the forms will be developed as part of the consumer credit project, which is introducing a number of new forms, so will benefit from economies of scale.

10 Controlled function 10A listed in SUP10A.4.4R

52. In the case of the requirement for there to be an approved person for client money oversight for firms running loan-based platforms, candidates of CASS large firms often undergo a face-to-face interview with us. However, we do not anticipate any crowdfunding firms to be CASS large firms, so there is unlikely to be any interview costs. According to our survey data, approximately eight firms could be classified as CASS medium firms, for which we would have to process applications. At a cost of £40 per application, this gives a total of £320.[11]

53. The rest of the proposals discussed in this CP are not expected to generate material incremental costs to the FCA.

Incremental compliance costs to loan-based crowdfunding platforms

54. Compliance costs are the direct costs firms incur to comply with our proposals. Table 9 summarises the estimated incremental compliance costs per firm separately for small and large firms.

55. Small firms are expected to incur additional one-off costs and ongoing annual costs of up to £25,000. Large firms are expected to incur one-off costs of up to £20,000 and ongoing annual costs of £30,000. The higher one-off cost for small firms is mainly driven by the cost for establishing arrangements in case of a failure and cancellation rights. We expect large firms to already have such arrangements in place, which is why their costs in this area are estimated to be lower.

56. To help put these incremental costs into context, we also express them as a proportion of current annual operating costs. For small firms, one-off and ongoing costs are 4% of operating costs. For large firms, one-off costs are 2% of operating costs and ongoing costs are 3% of operating costs.

57. The total industry cost is estimated to be about £600,000 in one-off costs and £650,000 ongoing costs, based on 20 small and 5 large loan-based crowdfunding platforms.

Table 9: Estimated incremental compliance costs of our proposals per firm for loan-based crowdfunding platforms (figures rounded to the nearest £500)

	One-off costs		Ongoing costs per year	
Incremental costs	**Small firms**	**Large firms**	**Small firms**	**Large firms**
Capital requirements	£3,000	£1,000	£3,000	£16,000
Client money requirements	£1,500	£3,000	£4,000	£6,500
Arrangements to administer loans in the event of platform failure	£3,000	Minimal	£3,000	Minimal
Cancellation rights	Up to £4,000	Minimal	Up to £10,000	Minimal
Disclosure requirements	£10,000	£10,000	£500	£500
Dispute resolution processes	£2,500	£2,500	£2,000	£4,000
Reporting requirements	Minimal	£2,500	£500	£2,500
Total (rounded)	**Up to £25,000**	**£20,000**	**Up to £25,000**	**£30,000**

11 Based on CP10/9, *Enhancing the Client Assets Sourcebook*, March 2010: www.fsa.gov.uk/pubs/cp/cp10_09.pdf

Capital requirements

58. Changes in capital requirements are expected to generate one-off costs as firms raise additional capital, carry out reviews to ensure that the capital requirements are met, and meet ongoing costs from holding the capital.

59. We anticipate that there will be limited one-off costs to familiarise firms with our financial requirements. We anticipate that each firm will need one day of review by a compliance director and assume a cost per hour of a compliance director's time of £80,[12] or about £600 for an eight-hour day.

60. Our estimates of capital impact are based on data collected from our survey. The firms we are describing as 'small' have less than £10m in loaned funds, while those described as 'large' have more than £10m in loaned funds.

61. In estimating how much capital firms need to raise, we base our calculations on firms meeting the full regime requirements of holding a fixed amount of £50,000 or a percentage of the volume of loaned funds, whichever is greater. We looked at the current capital that firms are holding, based on the survey data and identified whether a shortfall would exist in each firm. Based on this approach, we assume that 25% of small firms and 40% of large firms already meet our capital requirements.

62. For firms that do not meet our requirements, we estimate that small firms will need to raise on average £55,000,[13] and large firms will need to raise on average £300,000. This capital will need to be raised over the course of the implementation period from April 2014 to April 2017. In calculating this figure we assume that firms may hold a 20% capital buffer over their minimum requirement to ensure that they are able to withstand any unexpected costs without breaching their capital requirement.

63. Firms have several ways to raise the necessary capital. We expect large firms to be more likely to raise additional capital through retained earnings and so avoid external costs of raising capital. Small firms, however, may have to borrow. Firms that will have to borrow will incur additional one-off costs such as legal fees and other administrative costs. In the Consumer Credit CP (CP 13/10), Europe Economics estimated these costs to be 4% of the additional capital raised.[14] Based on this, we estimate a one-off cost for raising capital of £2,200 for small firms.

64. Firms will also incur an ongoing opportunity cost from holding the additional capital. In deriving an annual cost for holding these additional capital funds, we assume a weighted average cost of capital (WACC) of 5.25%. This is based on the estimated WACC that has been used for debt management firms by Europe Economics in the consumer credit consultation paper.[15] We estimate that the average annual ongoing cost to firms of prudential requirements is approximately £2,900 for small firms and £15,750 for large firms.

12 Standardised hourly rates for management costs (including overheads) are drawn from *Real Assurance Estimation of FSA Administrative Burdens*, June 2006: www.fsa.gov.uk/pubs/other/admin_burdens_report_20060621.pdf. To account for growth in income since then, hourly costs have been increased in line with average earnings as per the Office of National Statistics *Index of labour costs per hour*, Q1 2013, and rounded to the nearest ten.

13 This figure is above the £50,000 minimum because the small firm cut-off (i.e. £10m in loaned funds) is above the cut-off which firms would use to transfer from the fixed minimum to the volume-based measure.

14 http://www.europe-economics.com/publications/final_europe_economics_report_03-10-13.pdf

15 As both debt management firms and loan-based crowdfunding platforms operate within the consumer credit market they are effectively intermediaries.

65. We believe that our estimates are conservative because anecdotal evidence suggests that more firms may already meet our prudential requirement proposals and, therefore, the overall costs to the industry of our proposals may be lower than presented here.

Client money requirements

66. To estimate the cost relating to client money requirements we have classified the firms into CASS large, medium or small. Of the firms that responded to our survey, 30% would be classed as CASS medium firms (holding more than £1m in client money but less than £1bn) and the remainder would be classed as CASS small firms (holding less than £1m in client money). If we assume this proportion is representative of the entire market, we estimate that eight of the current 25 platforms in the market are classed as CASS medium firms and the remainder as CASS small firms. For presentation purposes in the CBA all the CASS medium firms are classed as 'large' and all the CASS small firms are classed as 'small'.

67. The survey responses suggested that most of the firms (80%) are already broadly compliant with our client money requirements. Given the nature of the business undertaken by these firms, we anticipate that most will already have some degree of systems in place to enable them to distinguish clients' money from their own and to know how much money they are holding for each client in order to track payments. So we expect that most firms will already be able to meet some requirements, but there may be incremental costs incurred in order to meet specific rules.

68. To assess these costs we relied on assumptions we made and information we collected for CBAs in CP 11/13 and CP 11/16.[16] However, previous analyses of costs often apply to firms that are much larger and more complex than loan-based crowdfunding platforms according to our understanding of current business models and market analysis.

69. We expect costs applicable to loan-based crowdfunding platforms to be similar to those applicable to the smaller financial services firms we have considered in previous analyses. They will not, for instance, be comparable to the costs that would be incurred by a large investment bank. This means that sometimes, based on our understanding of the present market and business models, we have estimated costs equivalent to (or in some cases less than) those in the previous CBAs.

70. In addition, we have assumed that where previous CBAs included estimates or survey data relating to both holding client money and custody assets that half of the costs were due to each of these different activities. Accordingly, we have halved such costs as we do not believe any loan-based crowdfunding platforms will be holding custody assets or will have permission to do so.

71. Based on this information, we estimate that all firms will incur a one-off cost of approximately £600 in familiarising themselves with the CASS rules. This cost is estimated based on an assumption that the compliance director of each firm will have to spend one eight-hour day at a cost of £80 per hour.

72. In addition we estimate one-off costs of around £700 for small firms and £2,500 for large firms and ongoing costs of about £4,000 and £6,500 respectively, for meeting the CASS requirements (excluding the reporting requirements).

16 CP11/13, *Authorised professional firms and legal services reform*, July 2011: www.fsa.gov.uk/pubs/cp/cp11_13.pdf and CP 11/16, Recovery and Resolution Plans, August 2011: www.fsa.gov.uk/static/pubs/cp/cp11_16.pdf

73. Table 10 shows how we derived these costs. The explanatory notes to the table give further details about how we have used data from CPs 11/13 and 11/16 to assist us when thinking about the costs to firms running loan-based crowdfunding platforms. The table does not cover the cost of reporting requirements which are covered at a later section in the CBA and the cost of distribution rules.

Table 10: Estimated incremental compliance costs of client money requirement per firm

	One-off costs		Ongoing costs	
Incremental costs	**Small firms**	**Large firms**	**Small firms**	**Large firms**
Firm classification as CASS small, medium or large	Minimal	Minimal	Minimal	Minimal
Approved persons for CASS oversight[17]	Minimal	£260[18]	Minimal	Dependent on staff turnover
Setting up and maintaining bank accounts with an appropriate bank to segregate client money[19]	£180[20]	£180	£1,440[21]	£1,440[22]
Record-keeping and regular reconciliations of client money holdings[22]	£90[23]	£90	£1,300[24]	£1,300
CASS Resolution Pack[25]	£400	£2,000	£200	£2,000

17 This takes into account that CASS small firms only need to allocate an existing approved person to this responsibility whereas, for CASS medium firms, the firm will need to apply for the individual to be approved for the CF10A function.

18 This figure is from the Real Assurance Estimation of FSA Administrative Burdens report (page 20 under Application for approval of approved persons in controlled functions), based on the estimated cost of preparing and submitting the application and some additional costs. This figure has been increased in line with the retail prices index as per the Office of National Statistics Consumer Price Indices 16 July 2013. This does not take into account additional costs for example if the application is not straightforward. In addition, as these firms will not be CASS large firms, we do not anticipate any interview costs for CF10A candidates.

19 These cost estimates are based on a firm carrying out initial and ongoing due diligence of banks, opening new client money bank accounts and the process firm creating acknowledgement letters and corresponding with the banks accordingly. It is also based on a firm following the proposed record keeping and reconciliation requirements.

20 We assume two hours of administrative staff time at £10 per hour and up to two hours of review by a compliance director at £80 per hour, giving an overall cost of £180 per firm.

21 We assume administrative staff time of one hour per week at £10 per hour and up to one hour's review by a compliance director each month at £80 per hour. This gives a monthly total of £120, which is an annual cost of £1,440 per firm.

22 This cost estimate is based on a firm maintaining up-to-date records and regular internal and external reconciliations of their client money holdings. We are assuming that most firms will already have adequate arrangements in place and carry out checks of their records that enable them to distinguish client money from their own, and know how much money they hold for each client. Our recent survey responses indicated that a large majority of firms already carry out equivalent reconciliations, with 45% of these respondents confirming that they perform these checks daily. Nevertheless, we recognise that some firms may have to make minor changes to their accounting systems/processes to meet the prescribed reconciliation requirements and we have reflected this in the costs.

23 We assume one hour of administrative staff time at £10 per hour and up to one hour of review by a compliance director at £80 per hour, giving an overall cost of £90 per firm.

24 On the basis that a firm performs daily reconciliations we assume 0.5 hours of administrative time at £10 per hour. This is an annual total of £1,300 per firm.

25 Information is from the CBA survey carried out for CP11/16. We have used the lower bound figures for the one-off and ongoing costs as these are more likely to be in line with smaller firms with a single type of business and relatively simple arrangements. The figures are derived directly from firms' responses on the survey data.

Incremental costs	One-off costs Small firms	Large firms	Ongoing costs Small firms	Large firms
Client Money Audit[26]	N/A	N/A	£940[27]	£1,640[28]
Total (rounded)	£1,000	£2,500	£4,000	£6,500

74. The distribution rules are not relevant in the day-to-day business of a firm. These rules are intended to deal with distributing client money to clients after a primary pooling event (for example, when a firm fails) or arrangements for when a secondary pooling event occurs (when the bank at which a firm holds client money fails).

75. The costs of distributing client money, normally done by an insolvency practitioner, are met from the client money held by the firm at the date of the primary pooling event. The cost of the distribution will depend on factors such as the complexity and duration of the distribution. Compliance with the other rules (particularly the record-keeping requirements and the CASS Resolution Pack) contributes to reducing the potential delays to the distribution process and losses as a result of poor administration, record-keeping, etc., but the exact circumstances vary in each case.

76. We use the existing rules for costs relating to client money requirements. We note, however, that large sections of CASS are under consultation in CP13/5 and loan-based crowdfunding platforms will be subject to the new rules in the future. If the final rules following CP13/5 consultation are introduced before loan-based crowdfunding platforms rules, we may reconsider the costs in this analysis in the policy statement.

Arrangements to administer loans in the event of platform failure

77. Many of the firms (46%), including all of the large firms, that responded to our survey already have arrangements in place to ensure that existing loans continue to be administered if the firm goes out of business. So only small firms are expected to incur an incremental cost from making the necessary arrangements. We estimate it will take five eight-hour days for the compliance director to set up processes and make these arrangements. We assume a cost per hour of a compliance director's time of £80, so we calculate the one-off cost for making these arrangements to be £3,000.

78. The ongoing cost for keeping these arrangements in place will vary. Based on the survey responses, we recognise that firms can choose how they comply with our proposals. An in-house solution is possible where they manage a large enough portfolio of loans that generates a fee income sufficient to cover the cost of a skeleton staff to run down the loan book. Alternatively they could have a contract with a third party to step in and administer loans in the event of platform failure.

26 We have made similar assumptions about hours of work needed for associated tasks as in CP11/13, again using the assumptions of hourly rates of pay used in this paper.

27 Here we have assumed five hours of work by an auditor to produce the report at £140 per hour and three hours of staff administrative work at £10 per hour and review of the findings of the report by two committee members at £105 per hour. Audit and committee costs are based on figures in CP 11/13.

28 We have made the same assumptions as for small firms but assuming twice as long for an auditor to produce the report.

79. Firms that follow the in-house solution are not expected to incur any cost for funding the administration arrangements, as respondents to our survey stated that ongoing income from existing loans should cover the costs of ongoing administration. However, we recognise that this option is likely to be feasible only for larger firms. A contract with a third party is expected to be more expensive, but easier for smaller firms.

80. Small firms are expected to pay an annual fee to a third party to introduce safeguards in the event of platform failure. Responses to the survey indicated that this fee may be about 0.1% of the amount invested in loans. For small firms the average total amount invested in loans is £2.5m, so we estimate that a fee to the administrator will be around £2,500 per year.

81. We also expect directors to review these processes on a regular basis. Assuming they spend one eight-hour day on this each year and their time costs £80 per hour, this leads to an annual cost of approximately £600 per firm.

Cancellation rights

82. From our review of the market, it does not appear that firms are currently offering investors a cancellation period when arranging investments.

83. Of the 25 current platforms, eight have secondary markets (including all of the largest platforms) and 17 do not. Large platforms already have processes in place to comply with the requirements so are not expected to incur any material cost.

84. The small platforms that do not have secondary markets will have to amend their processes so that investors are able to cancel their contracts within the first 14 days. A number of choices are open to them. They could:

- introduce a secondary market, or
- introduce a 14-day cancellation right for investors, then:
  - allow immediate investment but repay capital to any investor wishing to cancel during the period, or
  - only allocate money to loans for new investors at the end of that period

85. The following shows the likely incremental costs for firms under each of these options. Assumptions on working hours are based on discussions with web programmers.

- *Adding secondary market functionality:* we estimate a one-off cost of 20 days of web programming to add secondary market functionality to platforms. We assume a cost per day of web programmer time of £200.[29] This would mean that adding a secondary market to a platform could create a one-off cost of around £4,000. We also estimate ongoing costs of four hours per day to oversee the functioning of the secondary market. We estimate a cost per hour of £10 for administration work in small to medium firms, so the annual ongoing cost per firm of this option would be £10,000. It appears that, as platforms mature, they prefer to offer a secondary market, so in the long term most platforms are likely to aim to introduce a secondary market.

29 Assuming an annual average salary of £40,000: salary-track.jobs.theguardian.com/salary/Web-Developer-title-salary. Overheads of 30% are added in accordance with the Standard Cost Model of the Better Regulation Executive.

- *Allowing immediate investment but repaying those who cancel early:* we estimate a one-off cost of ten days of web programming to track new investors. At a cost of £200 per day, this would create a one-off cost of £2,000 per firm. There would also be ongoing costs involved in arranging cancellations, effectively buying investors out of loans. We do not collect information on the number of products cancelled during the initial period in other parts of the market. However, we understand that the rate of cancellation is low, with an upper boundary of 3%. Assuming that 3% of new investors were to cancel their contracts in the first 14 days and that the average investment during this period is no more than £1,000, this would suggest an average cost to firms of £30 per investor (although this is a transfer back to the investor). Thus the ongoing cost will vary with the number of new investors a platform deals with each year. On average, small platforms currently have 150 investors, but most of them have been operating for less than a year, so it is difficult to make forecasts of the likely flow of new investors. However, to illustrate how the costs might change we assume 100 new investors per year. This would lead to an annual cost of £3,000 for a platform following this option. This option would also mean that platforms take a stake in the loans they arrange, which may be unattractive to them.

- *Allocating money for new investors only after the 14-day cancellation period:* a one-off cost of five days of web programming is estimated, at around £1,000. Ongoing costs are estimated to be minimal as the system should run automatically. A member of staff could spend two days per month to monitor the system, creating an ongoing cost of around £240. This is the least expensive option in terms of costs to the firms but may lead to higher indirect costs for investors if they are keen to invest their money quickly, and the delay causes a reduced return.

Disclosure requirements

86. Our initial review of loan-based crowdfunding websites suggests that many of them (large and small) will need to be comprehensively reviewed and updated to meet our expectations. The one-off cost will encompass training costs for staff, time for review and approval from compliance directors, and the time spent amending websites.

87. We anticipate the need for two days of training for compliance directors. We assume, as before, a cost per hour of a compliance director's time of £80, and a daily cost of a trainer in the financial sector of £200,[30] leading to an estimated training cost of approximately £1,500 per platform.

88. Financial promotions, including websites, must be reviewed and approved by the firm's compliance director. We have assumed that it will take ten working days for directors to complete this process. We also assume it will take ten days of web programming to update websites. As before, we assume a cost per hour for a director of £80 and a cost per day of web programmer time of £200. This would mean that website review and reprogramming could cost around £8,000 per platform. Thereafter, we expect disclosure to be reviewed regularly as part of business as usual processes, so ongoing costs should be minimal.

30 Assuming an annual average salary of £35,000: http://salary-track.jobs.theguardian.com/salary?kw=trainer&lo=&type=permanent. Overheads of 30% are added in accordance with the Standard Cost Model of the Better Regulation Executive and numbers are rounded at the nearest hundred

89. Firms are obliged to retain records of the financial promotions they approve or communicate. Based on information in CP06/19, which included analysis of the costs of additional recordkeeping requirements, we estimate aggregate additional ongoing costs for firms of £500 per year as a result of the proposals.[31]

Dispute resolution processes

90. To date, there have been few complaints by investors on existing platforms. Ten respondents to our survey reported having no complaints in the last 12 months. The remaining three had received fewer than ten each over the last 12 months. However, many platforms are in their early months or years of trading and complaints may only arise some years after the business is in operation. Additionally, the current low level of complaints may be partly explained by the fact that loan-based platforms are currently unregulated and thus there is no channel by which formal complaints can be made to an independent body.

91. Under our proposals, firms will need to formalise complaint-handling processes, document and disclose those processes, and have trained complaint handlers who are able to assess complaints to our expected standards. Investors will also be able to refer a complaint to the Financial Ombudsman Service if they are not satisfied with the firm's response, generating additional potential ongoing costs to firms.

92. We estimate it will take three working days for the compliance director to develop and document complaint-handling processes. We assume a cost per hour of a compliance director's time of £80, so the one-off cost for arranging these processes will be approximately £2,000 per firm. We also expect directors to review these processes on a regular basis. Assuming they spend half-a-day (four hours) per year, this leads to an ongoing annual cost of approximately £300 per firm.

93. We anticipate the need for one day of training for one or two complaint handlers. We assume a cost per hour of £10 for small to medium firm administration. We assume a daily cost of a trainer in the financial sector of £200, leading to a cost of approximately £300 to £400 per firm.

94. To estimate of the cost of reviewing and responding to complaints, we need an estimate of the number of complaints a firms will handle per year. As discussed before, to date most firms have had no complaints. However, we expect them to receive more complaints in the future as their business evolves. We are unable to provide a confident estimate on how many complaints each firm might have in the future.

95. However, for illustrative purposes, we assume that small firms have a complaints rate of 3% per number of investors and large firms have a rate of 0.07%.[32] Currently, small firms have on average 150 investors and large have on average 15,000 investors. Based on that, we estimate that the average number of complaints a year will be five for small firms and ten for large firms. We assume an average cost per complaint to a firm of £300,[33] resulting in an annual ongoing cost for each firm to resolve complaints of approximately £1,500 for small firms and £3,000 for large firms.

31 *Reforming conduct of business regulation*, CP06/19, FSA, October 2006: www.fsa.gov.uk/pubs/cp/cp06_19.pdf. A median cost of £400 was calculated per firm for additional paper storage costs each year. To account for inflation since then, this figure has been increased in line with average service costs as per the Office of National Statistics *Services Producer Price Indices*, Quarter 2 2013 Dataset.

32 This is triple the complaints rates reported to us in the survey responses. However, as most of the firms have not received any complaints, there is insufficient data for a better estimation.

33 In CP11/10 the estimated average cost of a complaint to a firm is £300. FSA, CP11/10, *Consumer complaints: The ombudsman award limit and changes to complaints-handling rules*, May 2011: www.fsa.gov.uk/pubs/cp/cp11_10.pdf.

96. In addition, firms will have to pay an annual fee to the Financial Ombudsman Service (ombudsman service) based on their annual income. From the information reported to us in the survey, we estimate that this fee will range from £50 for small firms to £250 for large firms. Firms must also pay a case fee of £550 per complaint taken to the Financial Ombudsman Service, plus any redress where a case is found in the claimant's favour. We cannot estimate an amount of redress for each complaint as this will be determined on a case-by-case basis. To give an estimate on the possible costs to the ombudsman service, we assume that 10% of the complaints a firm will receive in a year might go to the ombudsman service.[34] Given our previous assumptions, small firms will have one complaint sent to the ombudsman service and large will have two. The first 25 cases per firm taken to the ombudsman service each year do not incur a case fee, so under this scenario we expect that the vast majority of firms will not have to pay case fees.

97. However, firms will have to respond to complaints when they go to the ombudsman service. We estimate that firms will incur a cost of £300 per complaint. So small firms will incur a cost of £300 and large a cost of £600 a year.

98. Summarising all ongoing costs for dispute resolution, costs for small firms are estimated to be around £2,000 a year and for large firms around £4,000 a year.

Reporting requirements

99. We expect the information required under our reporting proposals to be easily accessible: it is likely to be used by firms for their own purposes as part of their management information. Costs incurred in submitting this data to us should, therefore, be reasonable.

- We propose that firms must submit information to us each quarter on their capital position to assist our ability to monitor the market. Using information from the CBA in CP10/09, which involved a broadly comparable scenario, we assume that there will be no one-off system costs to produce these returns and estimate that it will take four hours for each firm, small or large, to complete the return (so 16 hours a year). Assuming, as before, a cost per hour of £10 for administrative work, this should lead to a cost of approximately £150 per firm each year for this form.

- We are proposing that platforms classed as CASS medium firms must, like other firms categorised in this way, submit a client money and asset return to us each month. We assume that there will be one-off system costs of £2,500 to make arrangements to produce these returns.[35] We estimate that it will take each firm four hours to complete the return each month (two hours of administration and two hours of review by compliance directors), leading to an estimated cost of £2,000 a year per firm.

- Under our proposals, firms classed as small under CASS must notify the FCA annually of their highest client money balance for the previous year. We estimate that there will be no one-off system costs and that, as only a small amount of information is requested in this form, it will take no more than one hour for each firm to complete the return.[36] This will lead to costs to each firm of £10 a year.

34 Based on the latest published semiannual figure of complaints, around 3.5m (www.fca.org.uk/firms/systems-reporting/complaints-data/aggregate-complaints-data) and the last published of annual complaints by FOS, around 500,000 (www.financial-ombudsman.org.uk/publications/ar13/index.html).

35 CP10/09 assumed one-off costs to CASS medium and large firms of £5,000 to prepare the CMAR for client money and the safe custody of client assets. As firms running loan-based crowdfunding platforms will only be responsible for client money, not for carrying out custody business, we assume one-off costs of £2,500 for these firms.

36 Information is from CP11/04, *The Client Money and Asset Return (CMAR): Operational implementation*, February 2011: www.fsa.gov.uk/pubs/cp/cp11_04.pdf. This included discussion of the costs to small firms of completing a similar regulatory return.

- We also propose that firms must submit a report twice each year on their complaints experience. Again, we assume that there will be no one-off system costs and, based on the amount of information required in the form, estimate that it will take two hours for each firm to complete the return (so four hours a year). This will lead to costs to each firm, small or large, of £40 a year.

- Finally, we propose that firms should submit quarterly reports to us on loans arranged and investor experience. We assume that there will be no one-off system costs and estimate that it will take four hours for each firm to complete the return (so 16 hours a year). This will lead to costs to each firm of £160 a year.

Incremental compliance costs to firms operating investment-based crowdfunding platforms (and similar)

100. We estimate that our proposals will affect a maximum of 30 firms:

- directly authorised crowdfunding firms
- firms with appointed representatives that operate crowdfunding platforms
- firms with telephone-based share selling businesses, and
- firms in the process of applying for authorisation

101. Table 10 summarises the estimated incremental one-off and ongoing cost per firm. Firms are expected to incur mainly one-off costs to meet our proposals.

102. The total industry one-off cost is estimated at approximately £90,000, based on an assumption that 30 firms will be affected by our proposals.

Table 11: Estimated incremental compliance costs of our proposals per firm for investment-based crowdfunding platforms

Proposals	Estimated one-off cost	Estimated ongoing cost
Client certification	£2,000	Minimal
Client assessment	£1,000	Minimal
Total	**£3,000**	**Minimal**

Client certification

103. We estimate that amending the systems and controls at these firms to introduce or amend existing client certification and assessment processes will result in modest one-off costs of five days of web-based programming or equivalent, and five days of staff training per firm. We assume that the cost per day of a web programmer's time is £200 and that staff training will also cost £200 per day. So the total one-off cost per firm is £2,000. We expect that the ongoing costs of implementing these proposals will be minimal as they mainly involve changes to online systems.

Assessment of client knowledge and experience

104. We envisage that firms will design automated systems to assess client knowledge and experience to check understanding of risks, also known as the 'appropriateness test', that can be incorporated into their websites or back office processes. So, firms will face one-off compliance costs in relation to IT systems changes. We estimate that this may involve one-off costs of five days of web-based programming or equivalent. We estimate a total initial cost of £1,000 per firm. This probably over-states the costs, however, as some firms already have processes that come close to, or fully meet, the new requirements we are introducing. We estimate that the ongoing costs of implementing these systems will be minimal as they will mainly involve online systems or equivalent.

Benefits

105. The regulatory proposals will result in benefits for both investment- and loan-based crowdfunding.

106. Benefits for investment-based crowdfunding platforms will arise by relaxing restrictions which will allow the market to grow.

107. Benefits for loan-based crowdfunding platforms will arise by addressing the potentially harmful outcomes for consumers we identified in our market failure analysis:

- mispricing of credit and investment risk
- default of the platform leading to losses on investment, and
- fraud

108. The economic arguments made in the market failure analysis indicated that market-based mechanisms such as maintaining reputation might be insufficient in addressing the failures in the market and protecting consumers. Requirements for firms to provide more disclosure, allow investors to cancel their investment, make arrangements in case of default, hold a minimum level of capital and segregate client assets are expected to generate additional benefits by reducing the risk of harm to consumers.

Benefits in the loan-based crowdfunding market

Reduction in mispricing of credit risk

109. The disclosure requirements of the proposed regime – which will cover issues of financial promotion (such as firms clearly signalling expected default rates and charges), due diligence arrangements, and cancellation rights – will reduce informational asymmetries and the associated risk of consumers mispricing credit risk. In particular, improved disclosure will allow investors to be able to assess more accurately such risks, enabling them to make better investment decisions, reducing potential consumer detriment and drive more effective competition in the market.

110. As noted in Annex 4, our internal review found that almost all existing firms would have been non-compliant with at least some of the rules that will be introduced. These existing inaccurate promotional activities, therefore, are likely to be attracting unsuitable investors by exploiting the behavioural biases identified in the market failure analysis.

111. We expect one of the most significant benefits relating to our disclosure rules to arise as new regulation reduces the incidence of misleading headline returns and comparisons with deposit accounts. We expect, for example, that advertised headline rates used by firms to promote their products will fall by up to 5% as they will now be quoted net of charges and should take account of expected default rates.

112. The other proposed enhanced information disclosures aim to help investors make more informed assessments of the overall credit riskiness of a potential investment on a loan-based crowdfunding platform. They will be able to make better decisions on whether such an investment is suitable for them.

113. The proposed requirements in this area are not prescriptive in terms of format so each platform will adopt a different approach to meet them. The effectiveness of the policy will rely on whether the disclosed information will be readily available and understandable by recipients. The web-based nature of crowdfunding means that for disclosure to be effective, the information will need to be easy to find on the webpage and to appear at the appropriate stage of the investment process.

114. FCA supervision and enforcement will be required to increase the likelihood of platforms adopting good disclosure practices. Financial reporting requirements, if effectively acted upon, are expected to assist the FCA's supervision objectives and incentivise firms to comply.

115. Better decision-making is most likely to benefit less sophisticated investors. It is this group that is likely to be making poor decisions under the current unregulated regime. And it is these investors who are most likely to change behaviour (i.e. exit the market) following the introduction of our new disclosure regime. Less sophisticated investors will therefore be better off under the new regime, having gained a more accurate insight into the risk/reward balance of the investment.

116. Based on the available evidence, we consider that 5% to 10% of current investors on loan-based platforms, across the market as a whole, can be considered 'less sophisticated'. To estimate the potential benefits in this area we assume that 5% of investments on platforms are currently made by less sophisticated investors and that their funds can be considered as mis-invested. At current market size, this equates to an annual total of £16m of mis-invested funds. We assume that the financial promotion and other disclosure measures introduced will reduce the incidence of such mistakes among less sophisticated investors by 50%. We therefore estimate that the amount of mis-invested funds is likely to fall by around £8 million a year.[37] The proportion of this £8 m that is a benefit to deterred investors depends on the extent to which their ex ante decision-making is improved with the additional information.

Benefits from reduced harm associated with platform failure

117. By requiring firms to hold financial resources, our proposals for prudential standards will lead to a reduced chance of platform failure as firms will face stronger incentives not to act imprudently. In the absence of regulation requiring firms to hold adequate financial resources, firms are more likely to find themselves in financial difficulty and, therefore, vulnerable to behaviour that advances the interests of the firm to the detriment of consumers (e.g. mis-selling or using client funds for business purposes).

37 The social benefit accruing via this mechanism would necessarily be lower than £8m, since even investors who make decisions based on misleading information will gain some return from their investment. However, this figure indicates the scale of the possible benefits.

118. If platform failure does occur, prudential standards increase the likelihood of an orderly wind-down. Financial resources give firms' time during which they can provide continuity and completion of services and/or updating and transferring records/books of business.

119. Our client assets proposals will further reduce consumer harm if a platform fails as client assets will be ring-fenced. Regular reporting and record-keeping requirements will help to ensure that a firm's records are up-to-date, which will assist an insolvency practitioner to protect clients' money held by the firm. The CASS Resolution Pack should help by ensuring the relevant practical information and records are readily accessible to the insolvency practitioner, facilitating faster return of client money in cases of platform failure.

120. To quantitatively estimate the benefits associated with the proposed regime in this area, it would be necessary to forecast the likely platform default rates. To date, there has been only one platform failure. Based on our understanding of firms' business models and the current levels of capital held and ring-fencing arrangements in place, we judge that the probability of more platforms failing in the absence of the proposals is not insignificant.

121. There is not enough historical data available on crowdfunding to forecast likely platform default rates as it requires selecting a set of microeconomic (i.e. balance sheet information, audit reports) and macroeconomic (i.e. GDP, interest rates, unemployment rate) data, and then linking the default probability with these variables.

Reduction in fraud

122. Prudential standards will reduce the likelihood of fraud in the market. Without these measures, there is a greater likelihood for unscrupulous 'hit and run' fraudulent entry to exploit consumers for short-term gain. This problem is exacerbated in emerging financial markets, such as crowdfunding, where consumers might have less market knowledge.

123. Disclosure of due diligence procedures may also help reinforce the need for firms to take action to reduce the potential for fraud. Fraudulent activity will cause consumer harm directly as well as undermining the integrity of the market. However, investors have only limited power to bring benefits via this mechanism. Therefore for fraud to be effectively reduced, FCA supervision will be required.

124. To estimate the incremental benefit from reduction in fraud, we would need data on the current occurrence of fraud in the market. However, levels of fraud in this market are not currently reported. Consequently, we are unable to provide an estimate of the likely reduction in fraud brought about by the proposed regime. However, as described in the market failure analysis, we judge that fraud may be a key risk facing investors looking to lend or invest on crowdfunding platforms.

Benefits in the investment-based crowdfunding market

125. For some investment-based crowdfunding platforms, the proposed regime relaxes some previous restrictions on the type of investor that may invest in such platforms. There is likely to be an increase in the investor base eligible to make such investments. This will bring benefits insofar as it will allow the market to grow and potentially foster competition.

126. The size of this benefit will depend on investment-based platforms' response to the new regulatory regime. However, we expect the overall impact on the market to be minimal, since broadly the same groups of potential investors will be targeted. We will consider responses from the consultation in order to further analyse impacts in this area.

Benefits applying to both investment- and loan-based crowdfunding

127. The regulation of crowdfunding may increase general investor confidence, leading to an overall increase in investment in crowdfunding relative to the baseline in which the proposed regime is not introduced. The magnitude of an increase in investor appetite following regulation is difficult to estimate. A survey of over 2,000 adults and 300 SMEs carried out on behalf of the rebuildingsociety.com suggested that currently 17% of investors would consider P2P and that this proportion will increase to 26% when the sector is regulated.[38] If invested funds increased by the proportion implied by responses to this survey then the current annual investment of £350m could increase to £535m as a result of increased investor appetite following regulation.

Wider economic impacts

Market exit/entrance and changes in pricing as a result of increased regulatory burdens

128. The compliance costs estimated above will increase the operating costs of the loan-based and investment-based crowdfunding platforms. This could have indirect effects on the market. For example, firms may change their approaches to pricing or exit the market as a result of increased compliance costs.

129. The magnitude of such impacts, however, will depend on the relative size of the compliance cost that each firm incurs. As presented above, compliance costs are expected to be minimal for investment-based crowdfunding, so this section focuses mainly on impacts on the loan-based crowdfunding market. For firms operating in the loan-based crowdfunding market, compliance costs are expected to have a small but potentially significant impact on operating costs. We estimate that the compliance costs as a proportion of annual operating costs are:

- 4% (small firms) and 2% (large firms) for one-off costs, and
- 4% (small firms) and 3% (large firms) for annual costs

130. We expect the estimated compliance costs to be a material consideration only for small platforms. These costs may result in some small firms exiting the market. Additionally, some potential future entrants to the market may be deterred from entry by the costs of the new regulatory regime.

131. Firms remaining in the market may pass on some or all of the increase in cost to their customers (investors and borrowers), by changing prices. Which set of customers will be affected depends on the relative price elasticities of demand of investors and borrowers. However, based on our estimates of compliance costs, we expect the overall price impacts on platforms' customers (both investors and borrowers) to be minimal.

Impacts on innovation

132. The impact of compliance costs on innovation can be twofold. First, the costs could increase barriers to entry and with it lower market contestability. With fewer firms entering (or potentially entering), the pressure on the incumbent firms to innovate may be reduced. However, given our market understanding, we judge that the most innovative start-up firms are likely to overcome the estimated additional costs, and thus we do not expect the overall impact on innovation in the crowdfunding market to be material.

38 rebuildingsociety.com, *One in four consider P2P schemes post-2014 FCA regulation,* 03 June 2013: www.rebuildingsociety.com/one-in-four-consider-p2p-schemes-post-2014-fca-regulation/

133. Second, there may be wider impacts on innovation due to the reduction in funds invested on platforms as a result of the introduction of the proposed regime. There could, for example, be knock-on impacts on SMEs planning to borrow from crowdfunding platforms. Around one-third of the current funds lent on crowdfunding platforms goes to SMEs. Therefore, some SMEs that would otherwise receive funding through this route might no longer be able to.

134. We estimated above that around £8m a year will not be invested in loan-based platforms as a result of the rules. If one-third of these funds would have gone to SMEs, then the SME market is losing at most around £2.6m. Given that the average loan finance sought by SMEs is £180,000[39] in the last six or 12 month period, the reduction of funds by £8m may affect around 14 SMEs a year.

135. This could have a significant cost for the wider economy as unfunded SMEs will no longer be able to realise the benefits, including innovation, associated with their business. We note, however, that the economic impact will depend on how many of these innovative SMEs would have survived long enough to realise the expected benefits, if they had been able to secure the funding. Market evidence shows that, of start-up SMEs receiving funding, one out of three exits the market in the first three years.

Unintended consequences/impacts on investors

136. An unintended consequence of the proposed regime will be the deterrence of some loan-based investments that would otherwise have gone ahead and benefited both the platform and the investor. This impact will arise when a 'sophisticated' investor who understands the risk and likely return is deterred simply by the additional burdens imposed by the new proposed disclosure regime. They may, for example, lose interest in the investment option as they are required to scroll through additional information.

137. As part of our firm survey exercise, we asked firms for their assessments of the risk described above. Firms' responses indicated that a prescriptive approach to disclosure (for example, mandating a specific form of disclosure) that appears early in the investment process would pose greater risks of deterring otherwise sound investments. Conversely, firms indicated that a non-prescriptive approach would present minimal risk. We therefore expect that our proposed regime – which is not prescriptive on the detail of disclosure that firms must publish – will not result in this cost being material.

138. We expect that the risk of deterring sound investments for investment-based crowdfunding is negligible. The proposed regime is likely to increase the scope of the market to which the investment opportunity is available and we expect the formal appropriateness test to be effective in identifying those consumers for whom such investments are unsuitable, based on evidence from our supervisory experience of such tests for current MiFiD firms.

Changing focus of competition in the market

139. Overall, we consider that the proposed regime is likely to have a beneficial impact on the effectiveness of competition. In particular, the proposed disclosure requirements are likely to improve rivalry between firms as risks and returns become more transparent and comparable across platforms and investors can make better informed choices. We therefore expect competition to become more effective as it will focus on risk-adjusted return.

Q19: Do you have any comments on our cost benefit analysis for the proposed regulatory approach to crowdfunding?

39 *BIS SME Access to external finance*, January 2012: www.gov.uk/government/uploads/system/uploads/attachment_data/file/32263/12-539-sme-access-external-finance.pdf

Annex 2
Compatibility statement

1. We are required by section 138I(2)(d) of FSMA to explain why we believe our proposed rules are compatible with our strategic objective, advance one or more of our operational objectives, and have regard to the regulatory principles in section 3B of FSMA. We are also required by section 138K(2) of FSMA to state whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.

2. This annex also sets out our view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way that promotes effective competition in the interests of consumers (section 1B(4) of FSMA). This duty applies in so far as promoting competition is compatible with advancing our consumer protection and/or integrity objectives.

Compatibility with the FCA's regulatory objectives

3. The proposals in this CP are intended to advance our operational objectives of consumer protection and effective competition. We consider our proposals to be compatible with these objectives because:

- They are based on our assessment of the risks of different platform models and the needs of consumers in these markets. The rules on which we are consulting are focused on mitigating these risks and providing adequate consumer protection by helping investors to better identify and manage the risks of investing on crowdfunding platforms and to take investment decisions on an informed basis. We consider that our proposals will also reduce the risk of platform failure and fraud in these markets.

- We recognise that crowdfunding has a role to play in the wider economy and it is our aim to develop, as far as possible, a proportionate framework of rules that focuses competition on the most beneficial aspects while reducing the possibility of ineffective competition. The rules we propose are aimed in particular at enhancing the quality of disclosure by firms, allowing investors to make better investment decisions, and ultimately to drive competition in these markets.

The need to use our resources in the most efficient and economic way

4. The approach on which we are consulting provides a more comprehensive view of what our expectations are.

Proportionality of burdens or restrictions imposed on persons or on carrying on an activity

5. We believe we are putting forward a proportionate approach that sets an appropriate level of investor protection while minimising, as far as possible, the impact on competition, including competitive entry.

The desirability of sustainable growth in the economy of the UK in the medium or long term

6. We see crowdfunding as a sector that is likely to continue to grow and may start to exert competitive pressure on other markets. As such, its significance in the medium- to long-term may increase. Consequently we have sought to deliver a set of proposals that is proportionate and ensures a sufficient degree of investor protection, while minimising, as far as possible, the impact on competition and its long-term growth prospects.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons

7. We recognise that each crowdfunding platform differs from others. So we are not making detailed rules that apply the same standards to all firms. Instead, our approach imposes high-level rules that apply in a manner proportionate to the business model affected, and the specific risks to which customers will be exposed.

8. We are not mandating specific disclosures at particular points in time. Instead, our rules require firms to decide what information must be supplied, given the risks applying, to enable potential investors to make an informed investment decision. We also recognise that loan-based crowdfunding tends to expose investors to less risk than investment-based platforms, so we are not consulting on the same requirements for both sectors.

The responsibilities of senior management

9. Since the approach we are proposing sets high-level standards, rather than mandating specified actions, we are placing an obligation on firms' senior management to ensure that the processes they use provide adequate protection for investors. The high-level appropriateness test obligations, for example, must be tailored to the nature and risks of the platform, the underlying investments and the needs of the target investors.

The desirability of publishing information relating to persons

10. We do not consider that the rules will have an impact on this.

The principle that we should exercise our functions as transparently as possible

11. We have met with industry representatives and firms several times over the course of 2013 as we developed our proposals. We also surveyed firms running loan-based crowdfunding platforms to ask for information on their current models, in order to help us assess the impact of the measures on which we are consulting.

The general principle that consumers should take responsibility for their decisions

12. The approach on which we are consulting will place the onus on consumers to take responsibility for their actions and investment decisions. While we aim to reduce both the probability and impact of failure of crowdfunding platforms in the future, our proposed rules focus on ensuring that firms disclose adequate information to allow investors to make informed investment decisions.

Expected effect on mutual societies

13. At present, there are no mutual societies involved in the provision of regulated crowdfunding activities so there should be no direct impact. If a mutual society were to enter the sector, they would be expected to comply with our rules in the same way as other regulated crowdfunding firms.

Compatibility with the duty to promote effective competition in the interests of consumers

14. The FCA has a duty to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (section 1B(4) FSMA). This duty applies insofar as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.

Loan-based crowdfunding

15. As noted above, loan-based crowdfunding is likely to continue to grow and may start to exert competitive pressure on neighbouring markets, including consumer and business loans provided by other financial institutions.

16. In developing the proposals on which we are consulting, we considered a range of other options. These included:

- restricting the ability of firms to promote loan-based platforms in the same manner as investment-based platforms, and
- requiring firms to apply an appropriateness test

17. We take the view that, currently, competition is not as effective as it could be since investors lack consistent information about borrower risk, including information on the risk of platform default and/or fraud. To illustrate, current promotions can imply to investors that crowdfunding investment products could be considered substitutes for deposit accounts. Our proposals will help investors make informed decisions and put them in a place to drive competition in this market.

Investment-based crowdfunding

18. Before deciding on the options on which we are consulting, we considered a range of other measures, including:

- maintaining the current approach of restricting firm permissions on a case-by-case basis at authorisation, and
- restricting the ability of firms to promote investment-based platforms only to professional clients, sophisticated retail investors and high net worth retail investors

19. We consider that our rules may assist in making investment-based crowdfunding more attractive to investors. This is because additional information disclosure in particular will permit investors to come to a better understanding of the investment risks. The appropriateness test will also assist in ensuring that only investors with the required knowledge or experience invest.

20. The changes proposed in this paper also address the fact that, at present, some platforms are subject to different regulatory requirements determined on a case-by-case basis at authorisation stage, which could distort competition.

Legislative and Regulatory Reform Act 2006 (LRRA)

21. We are required under the LRRA to have regard to the principles in the LRRA and to the Regulators' Compliance Code when determining general policies and principles and giving general guidance (but not when exercising other legislative functions).

22. We have also had regard to the Regulators' Compliance Code for the parts of the proposals that consist of general policies, principles or guidance.

23. We have engaged with firms throughout this process and consider that the proposals are proportionate to the potential market failures identified.

Q20: Do you have any comments on the compatibility statement?

Annex 3
List of questions

Q1: Do you have any comments on our assessment of the equality and diversity considerations?

Q2: Do you agree with our assessment of unregulated, exempt and regulated crowdfunding activities?

Q3: Do you agree with our proposals for transitional periods?

Q4: Do you think there are other risks relating to crowdfunding that we should consider and seek to address?

Q5: Do you agree that we should not include loan-based crowdfunding platforms within the remit of the FSCS?

Q6: Do you agree with the prudential standards proposed for loan-based crowdfunding firms? If not, what amendments would you make and why?

Q7: Do you agree with the transitional approach proposed for the financial requirements for loan-based crowdfunding firms?

Q8: Do you agree that firms running loan-based crowdfunding platforms should be subject to our client money rules?

Q9: Do you agree that money held by the failed platform at the primary pooling event should be returned only to relevant investors?

Q10: If contracts do not provide for risk transfer in the way described above, should CASS include a rule to require this in order to protect borrowers?

Q11: Do you agree with our understanding of how money received after a primary pooling event will be treated?

Q12: Do you agree that firms operating loan-based crowdfunding platforms should be required to have arrangements in place so that existing loans continue to be administered in the event of platform failure?

Q13: Do you agree with our interpretation of the Distance Marketing Directive cancellation rights for firms operating loan-based crowdfunding platforms?

Q14: Do you have any comments on our proposed approach to regulating disclosures on loan-based crowdfunding platforms?

Q15: Do you agree that firms running loan-based crowdfunding platforms should be subject to our dispute resolution rules?

Q16: Do you have any comments on the reporting requirements we propose for firms running loan-based crowdfunding platforms?

Q17: Do you agree with our proposals to revise our approach to investment-based crowdfunding platforms?

Q18: Do you have any comments on our analysis of the crowdfunding market or further information about it?

Q19: Do you have any comments on our cost benefit analysis for the proposed regulatory approach to crowdfunding?

Q20: Do you have any comments on the compatibility statement?

Annex 4
Loan-based crowdfunding platform website review

1. We are proposing a primarily disclosure-based regime to provide protections for consumers investing via loan-based crowdfunding platforms. In August 2013 we reviewed 21 of the platforms currently available.

2. In our review we considered only the publicly available websites without signing up to any of the sites. As explained in Chapter 3 of this paper, loan-based crowdfunding platform websites are classed as direct offer financial promotions under our rules. We reviewed the websites against the requirements set out in COBS 4, which we propose to apply to these firms.

3. We concluded that all firms have work to do in order to meet our expectations. At a high level, we are looking for promotions to meet the following standards.[40]

   - It is important for all website promotions to present complete and meaningful information in a clear, balanced and straightforward manner so consumers understand the proposition and all relevant risks.

   - Firms need to ensure that this information is present at every relevant stage of the customer journey.

   - At present we are concerned that investors are not able to make an informed choice about the investment or make comparisons easily. Therefore, firms run the risk of causing harm to consumers.

4. Firms are not yet regulated by us so do not have to meet our rules. But, we are expecting to see improvements to communications by the time our rules come into force. Our aim in publishing this information is to help firms understand our expectations and make improvements.

Main areas of concern

5. None of the websites we reviewed fully met our standards for fair and balanced promotions.[41] In particular, the risks of investment were downplayed. Some of the larger platforms perform better than others but many simply highlight the upsides of investment and provide very little mention, if any, of the risks.

40 More information is available here: www.fca.org.uk/firms/being-regulated/financial-promotions

41 COBS 4.5.2R

6. Many platforms used misleading and potentially unfair comparisons with bank deposits.[42] Platforms tended to use high headline rates of return as a key selling point, though actual rates of return may be substantially lower.

7. No firm met our requirements in full for the fair disclosure of past and future performance in relation to current default rates and expected future default rates.[43] We will expect more detail on the reference period used and the source of information. Where past performance information is provided on default rates, and we think it should be provided, firms may choose their own reference period but must also supply data for 12-month periods covering at least the previous five years, where it is available.

8. We saw some important information mis-presented, with warnings missing or downplayed on most platforms.

   - As investors need to declare their earnings from the platform as taxable income, there should be an accurate summary of taxation and the consequences of tax on investment returns.
   - Where a product or service places capital at risk this should be clear.
   - The risk of fraud and money laundering should be explained.
   - Platforms state that investors' monies are generally held in segregated accounts but often no further information is available. For example, it may be relevant for some investors to know with which institution the client account is held so as to keep overall financial exposure within the FSCS limits.
   - It should be made clear to investors whether they can access their money early.
   - Investors need to understand what happens if a borrower is late in payment or defaults on the loan.
   - Where firms operate contingency funds, investors should understand what would happen if that fund were exhausted.
   - It should be clear when there is no recourse to the Financial Ombudsman Service (at present) or the FSCS.

9. Few sites mentioned that investors should seek advice if they have any questions on whether this is a suitable investment.

10. Most firms also use social media to promote their services. These individual sites, blogs, tweets and posts must still meet our expectations on compliance with all our financial promotion rules and the fair, clear and not misleading principle.

42 COBS 4.5.6R
43 COBS 4.6

Appendix 1
Draft Handbook text

PEER-TO-PEER LENDING, UNLISTED SHARES AND DEBT SECURITIES INSTRUMENT 2013

Powers exercised

A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) the following sections of the Act:

(a) section 137A (FCA's general rule-making power);
(b) section 137B (FCA general rules: clients' money, right to rescind etc.);
(c) section 137R (Financial promotion);
(d) section 137T (General supplementary powers); and
(e) section 139A (FCA's power to give guidance); and

(2) the other powers listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook;

B. The rule-making powers listed above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the Handbook

D. The modules of the Financial Conduct Authority's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Senior Management Arrangements, Systems and Controls sourcebook (SYSC)	Annex B
Interim Prudential sourcebook for Investment Businesses (IPRU(INV))	Annex C
Conduct of Business sourcebook (COBS)	Annex D
Client Assets sourcebook (CASS)	Annex E
Supervision manual (SUP)	Annex F
Dispute Resolution: Complaints sourcebook (DISP)	Annex G

Citation

E. This instrument may be cited as the Peer-to-Peer Lending, Unlisted Shares and Debt Securities Instrument 2013.

By order of the Board of the Financial Conduct Authority
[*date*]

This instrument takes account of the changes made in the Unregulated Collective Investment Schemes and Close Substitutes Instrument 2013 (FCA 2013/46), and proposed in the Review of the client assets regime for investment businesses (CP13/5) and the Detailed proposals for the FCA regime for consumer credit CP13/10.

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

designated investment

a *security* or a contractually-based investment (other than a *funeral plan contract* and a right to or interest in a *funeral plan contract*), that is, any of the following *investments*, specified in Part III of the *Regulated Activities Order* (Specified Investments), a *P2P agreement*, and a *long-term care insurance contract* which is a *pure protection contract*:

…

designated investment business

any of the following activities, specified in Part II of the *Regulated Activities Order* (Specified Activities), which is carried on by way of business:

…

(db) *operating an electronic system in relation to lending* (article 36H) but only in relation to facilitating a *person* becoming a lender under a *P2P agreement* and in relation to the supplemental activities in article 36H(3)(a), (b) and (d).

…

loaned funds

(in *IPRU(INV)*) any funds that have been provided to borrowers under a *P2P agreement* through an *operator of an electronic system in relation to lending*.

P2P agreement

(1) (in relation to a borrower) in accordance with article 36H of the *Regulated Activities Order*, an agreement between one person (“the borrower”) and another person (“the lender”) by which the lender provides the borrower with credit (within the meaning of article 60L of the *Regulated Activities Order*) and in relation to which the borrower is an *individual* and either:

(a) the lender provides credit (within that meaning) of less than or equal to £25,000; or

(b) 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.

(2) (in *SYSC*, *IPRU(INV)* 12, *COBS*, *CASS*, *SUP* and *DISP*) in accordance with article 36H of the *Regulated Activities Order*, an agreement between one person ("the borrower") and another person ("the lender") by which the lender provides the borrower with credit (within the meaning of article 60L of the *Regulated Activities Order*) and in relation to which either the lender is an *individual*, or if the lender is not an *individual*, the borrower is an *individual* and either:

(a) the lender provides credit (within that meaning) of less than or equal to £25,000; or

(b) 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.

participant firm (1) (except in *FEES* 1 and *FEES* 6) a *firm* or a *member* other than:

…

(j) … ~~.~~ ;

(k) … ~~.~~ ;

(l) an *operator of an electronic system in relation to lending* in respect of *operating* the system.

…

Annex B

Amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC)

In this Annex, underlining indicates new text and striking through indicates deleted text.

4.1.8 G …

Operators of electronic systems in relation to lending: arrangements to administer loans in the event of platform failure

4.1.8A R An *operator of an electronic system in relation to lending* must take reasonable steps to ensure that arrangements are in place to ensure that *P2P agreements* facilitated by it will continue to be managed and administered, in accordance with the contract terms, if at any time it ceases to carry on the activity of *operating an electronic system in relation to lending*.

4.1.8B R Any arrangements made under 4.1.8AR must be notified to lenders under *P2P agreements*:

(1) when such arrangements are made; or

(2) if later, when the lender first becomes a lender under a *P2P agreement* with that operator; or

(3) if the arrangements are changed, when that change is made; and

(4) if the arrangement involves another *firm* taking over the management and administration of *P2P agreements* if the operator ceases to *operate the electronic system in relation to lending*, the notification to lenders must inform lenders of the identity of the *firm* with which the arrangements have been made and how that *firm* will hold the lenders' *money*.

4.1.8C G Arrangements to ensure *P2P agreements* facilitated by the *firm* continue to be managed and administered may include:

(1) entering into an arrangement with another *firm* to take over the management and administration of *P2P agreements* if the operator ceases to *operate the electronic system in relation to lending*; or

(2) holding sufficient collateral in a segregated account to cover the cost of management and administration while the loan book is wound down; or

(3) entering into an arrangement for another *firm* to act as guarantor for the *P2P agreements* which includes a legally enforceable arrangement to meet the costs of the guarantee in full; or

(4) managing the loan book in a way that ensures that income from *P2P agreements* facilitated by the *firm* is sufficient to cover the costs of managing and administering those agreements during the winding down process, taking into account the reduction of the loan pool and fee income from it.

4.1.8D G When designing its arrangements, a *firm* should take into account insolvency law to ensure that the insolvency of the *firm* does not prejudice the operation of arrangements that the *firm* has put in place.

Operators of electronic systems in relation to lending: title transfer

4.1.8E R An *operator of an electronic system in relation to lending* must not accept, take, or receive the transfer of full ownership of *money* relating to *P2P agreements*.

…

TP2: Firms other than common platform firms, insurers, managing agents and the Society

(1)	(2)	(3)	(4)	(5)	(6)
	Material to which the transitional provision applies		Transitional provision	Transitional provision: dates in force	Handbook provisions: Coming into force
…					
2.4 [FCA]	*SYSC* 4.1.8AR to 4.1.8ER and 4.1.9AR	R	An *operator of an electronic system in relation to lending* who holds an interim permission under article 56 of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No 2) Order 2013 need not comply with the rules listed in column (2) until 1 October 2014.	From 1 April 2014 to 30 September 2014	1 April 2014

Annex C

Amendments to the Interim Prudential sourcebook for Investment Businesses (IPRU(INV))

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Transitional Provisions

1 **Table Transitional provisions applying to IPRU(INV)**

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision coming into force
…					
10	*IPRU(INV)* 12	R	*IPRU(INV)* 12 does not apply to a *firm* with interim permission under article 56 of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2013 (S.I. 1881/2013)	Indefinitely	1 April 2014
11	*IPRU(INV)* 12.2.4(1)R	R	The amount is replaced with £20,000	From 1 April 2014 to 31 March 2017	1 April 2014
12	*IPRU(INV)* 12.3.5R	R	b = items 1,4 and 5 in the Table of items which must be deducted from a *firm's financial resources* (see *IPRU(INV)* 12.3.3 R	From 1 April 2014 to 31 March 2017	1 April 2014

Insert the following new chapter after Chapter 11. The text is all new and is not underlined.

12 Financial resources requirements for operators of electronic systems in relation to lending.

12.1 Application and purpose

Application

12.1.1 R This chapter applies to an *operator of an electronic system in relation to lending*:

Purpose

12.1.2 G This chapter amplifies the *threshold condition* 2D (Appropriate resources) by providing that a *firm* must meet, on a continuing basis, a basic solvency requirement. This chapter also builds on *Principle* 4 which requires a *firm* to maintain adequate financial resources by setting out appropriate requirements for a *firm* according to what type of *firm* it is.

12.1.3 G Prudential standards have an important role in minimising the risk of harm to consumers by requiring a *firm* to behave prudently in monitoring and managing business and financial risks.

12.1.4 G More generally, having adequate financial resources gives the *firm* a degree of resilience and some indication to consumers of creditworthiness, substance and the commitment of its owners. The *rules* in this chapter aim to ensure that a *firm* has financial resources which can provide cover for operational and compliance failures and pay redress, as well as reducing the possibility of a shortfall in funds and providing a cushion against disruption if the *firm* ceases to trade.

Relevant accounting principles

12.1.5 R A *firm* must recognise an asset or liability, and measure its amount, in accordance with the relevant accounting principles applicable to it for the purpose of preparing its *annual financial statements* unless a *rule* requires otherwise.

12.2 Financial resources requirements

General solvency requirement

12.2.1 R A *firm* must at all times be able to meet its liabilities as they fall due.

General financial resource requirement

12.2.2 R A *firm* must ensure that at all times its *financial resources* are not less than its *financial resources requirement*.

Financial resources requirement: firms carrying on other regulated activities

12.2.3 R The *financial resources requirement* for a *firm* carrying on one or more *regulated activities* in addition to *operating an electronic system in relation to lending,* is the higher of:

(1) the *financial resources requirement* which is applied by this chapter; and

(2) the financial resources or own funds requirement which is applied by another *rule* or by directly applicable legislation of the *EU* to the *firm*.

Financial resources requirement

12.2.4 R The *financial resources requirement* for a *firm* to which this chapter applies is the higher of:

(1) £50,000; and

(2) 0.3% of the volume of *loaned funds* up to £50 million, 0.2% of the volume of *loaned funds* above £50 million up to £500 million, and 0.1% of the volume of *loaned funds* above £500 million.

12.2.5 R When calculating 12.2.4R(2), the *firm* will use its last *accounting reference date*. If the amount in *IPRU(INV)* 12.2.4R(2) is greater than the amount in *IPRU(INV)* 12.2.4R(1), this will be the *firm's financial resources requirement* for the next 12 *months.*

Determining the total value of loaned funds outstanding

12.2.6 R The total value of *loaned funds* outstanding is the total amount of funds that are currently being provided to borrowers under *P2P agreements* through an *operator of an electronic system in relation to lending*.

12.2.7 G If the *firm* has 30,000 individuals each lending £100,000, the total value of the firm's *loaned funds* outstanding is £3,000,000,000. If the *firm* does not carry on any other *regulated activity* to which another higher financial resources or own funds requirement applies, its *financial resources requirement* is:

0.3% x 50,000,000 = £150,000

\+ 0.2% x 450,000,000 = £900,000

\+ 0.1% x 2,500,000,000 = £2,500,000

Financial resources requirement = £3,550,000

Recalculating the financial resources requirement

12.2.8 R If the *firm* experiences a greater than 15% increase in the total value of *loaned funds* outstanding within a 12 *month* period, it must recalculate its *financial resources requirement* using the higher total value of *loaned funds* outstanding.

12.2.9 R A *firm* must notify the *FCA* of any change, or any likely change, in its *financial resources requirement* within 14 *days* of that change, or it becoming aware that the change is likely, whichever is the earlier.

12.3 Calculation of financial resources

12.3.1 R A *firm* must at all times have available the amount and type of *financial resources* required by this chapter (see *IPRU(INV)* 12.3.2R) from which it must deduct certain items (see *IPRU(INV)* 12.3.3R).

12.3.2 R Table: Items which are eligible to contribute to the financial resources of a firm

	Item	Additional explanation			
1.	*Share* capital	This must be fully paid and may include:			
		(1)	ordinary *share* capital; or		
		(2)	preference *share* capital (excluding preference *shares* redeemable by shareholders within two years).		
2.	Capital other than *share* capital (for example, the capital of a *sole trader*, *partnership* or *limited liability partnership*)	The capital of a *sole trader* is the net balance on the *firm's* capital account and current account. The capital of a *partnership* is the capital made up of the *partners*':			
		(1)	capital account, that is the account:		
			(a)	into which capital contributed by the *partners* is paid; and	
			(b)	from which, under the terms of the *partnership* agreement, an amount representing capital may be withdrawn by a *partner* only if:	
				(i) he ceases to be a *partner* and an equal amount is transferred to another such account by his former *partners* or any *person* replacing him as their *partner*; or	
				(ii) the *partnership* is otherwise dissolved or wound up; and	
		(2)	current accounts according to the most recent financial statement.		
		For the purpose of the calculation of *financial resources*, in respect of a *defined benefit occupational pension scheme*:			
		(1)	a *firm* must derecognise any *defined benefit asset*;		
		(2)	a *firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*, provided that the election is applied consistently in respect of any one financial year.		

	Item	Additional explanation
3.	Reserves (Note 1)	These are, subject to Note 1, the audited accumulated profits retained by the *firm* (after deduction of tax, dividends and proprietors' or *partners*' drawings) and other reserves created by appropriations of share premiums and similar realised appropriations. Reserves also include gifts of capital, for example, from a *parent undertaking*.
		For the purposes of calculating *financial resources*, a *firm* must make the following adjustments to its reserves, where appropriate:
		(1) a *firm* must deduct any unrealised gains or, where applicable, add back in any unrealised losses on debt instruments held, or formerly held, in the available-for-sale financial assets category;
		(2) a *firm* must deduct any unrealised gains or, where applicable, add back in any unrealised losses on cash flow hedges of financial instruments measured at cost or amortised cost;
		(3) in respect of a *defined benefit occupational pension scheme*:
		(a) a *firm* must derecognise any *defined benefit asset*;
		(b) a *firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*, provided that the election is applied consistently in respect of any one financial year.
4.	Interim net profits (Note 1)	If a *firm* seeks to include interim net profits in the calculation of its *financial* resources, the profits have, subject to Note 1, to be verified by the *firm's* external auditor, net of tax, anticipated dividends or proprietors' drawings and other appropriations.
5.	Revaluation reserves	
6.	Subordinated loans/debt	Subordinated loans/debt must be included in *financial resources* on the basis of the provisions in this chapter that apply to subordinated loans/debt.

Note:

1 Reserves must be audited and interim net profits, general and collective provisions must be verified by the *firm's* external auditor unless the *firm* is exempt from the provisions of Part VII of the Companies Act 1985 (section 249A (Exemptions from audit)) or, where applicable, Part 16 of the Companies Act 2006 (section 477 (Small companies: Conditions

	Item	Additional explanation
	for exemption from audit)) relating to the audit of accounts.	

12.3.3 R Table: Items which must be deducted from financial resources

1	*Investments* in own *shares*
2	*Investments* in *subsidiaries* (Note 1)
3	Intangible assets (Note 2)
4	Interim net losses (Note 3)
5	Excess of drawings over profits for a *sole trader* or a *partnership* (Note 3)
Notes	1. *Investments* in *subsidiaries* are the full balance sheet value. 2. Intangible assets are the full balance sheet value of goodwill, capitalised development costs, brand names, trademarks and similar rights and licences. 3. The interim net losses in row 4, and the excess of drawings in row 5, are in relation to the period following the date as at which the capital resources are being computed.

Subordinated loans/debt

12.3.4 R A subordinated loan/debt must not form part of the *financial resources* of the *firm* unless it meets the following conditions:

(1) it has an original maturity of:

(a) at least five years; or

(b) it is subject to five years' notice of repayment;

(2) the claims of the subordinated creditors must rank behind those of all unsubordinated creditors;

(3) the only events of default must be non-payment of any interest or principal under the debt agreement or the winding up of the *firm* and such event of default must not prejudice the subordination in (2);

(4) the remedies available to the subordinated creditor in the event of non-payment or other default in respect of the subordinated loan/debt

must be limited to petitioning for the winding up of the *firm* or proving the debt and claiming in the liquidation of the *firm*;

(5) the subordinated loan/debt must not become due and payable before its stated final maturity date except on an event of default complying with (3);

(6) the agreement and the debt are governed by the law of England and Wales, or of Scotland or of Northern Ireland;

(7) to the fullest extent permitted under the rules of the relevant jurisdiction, creditors must waive their right to set off amounts they owe the *firm* against subordinated amounts owed to them by the *firm*;

(8) the terms of the subordinated loan/debt must be set out in a written agreement that contains terms that provide for the conditions set out in this *rule*; and

(9) the loan/debt must be unsecured and fully paid up.

12.3.5 R When calculating its *financial resources*, the *firm* must exclude any amount by which the aggregate amount of its subordinated loans/debts exceeds the amount calculated as follows:

a - b		
where:		
a	=	Items 1 -5 in the table of items which are eligible to contribute to a *firm's financial resources* (see *IPRU(INV)* 12.3.2R)
b	=	Items 1- 5 in the table of items which must be deducted from a *firm's financial resources* (see *IPRU(INV)* 12.3.3R)

12.3.6 G *IPRU(INV)* 12.3.5R can be illustrated as follows:

(1)

Share Capital	£20,000
Reserves	£30,000
Subordinated loans/debts	£10,000
Intangible Assets	£10,000
As subordinated loans/debts (£10,000) are less than the total of share capital + reserves – intangible assets (£40,000) the *firm* need not exclude any of its subordinated loans/debts pursuant	

to *IPRU(INV)* 12.3.5R. Therefore, total *financial resources* will be £50,000.

(2)

Share Capital	£20,000
Reserves	£30,000
Subordinated loans/debts	£60,000
Intangible Assets	£10,000
As subordinated loans/debts (£60,000) exceed the total of share capital + reserves – intangible assets (£40,000) by £20,000, the *firm* should exclude £20,000 of its subordinated loans/debts when calculating its *financial resources*. Therefore, total *financial resources* will be £80,000.	

12.4 **Notification requirements**

12.4.1 G

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
IPRU(INV) 12.2.10R	A change or likely change, in a *firm's financial resources requirement*.	The *financial resources requirement* as recalculated	A greater than 15% increase in the *firm's* total value of the amount of *loaned funds* within a 12 *month* period	Within 14 *days* of the trigger event

Appendix 1: Glossary of terms for IPRU(INV) 12

If a defined term does not appear in the *IPRU(INV)* glossary below, the definition appearing in the main Handbook Glossary applies.

financial resources	a *firm's* financial resources as calculated in accordance with *IPRU(INV)* 12.3 (Calculation of financial resources).
financial resources	an amount of *financial resources* that a *firm* must hold as set out in

requirement	*IPRU(INV)* 12.2 (Financial resources requirements).

Annex D

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

2.2.-1 R …

(2) This section applies in relation to other *designated investment business* carried on for a *retail client*:

(a) in relation to a *derivative*, a *warrant*, an *unlisted share*, an *unlisted debt security*, a *P2P agreement*, or *stock lending activity*, but as regards the matters in *COBS* 2.2.1R(1)(b) only; and

…

…

4.7.5A G …

Warrants and derivatives

4.7.6 R …

…

Unlisted shares and unlisted debt securities

4.7.7 R (1) Unless permitted by *COBS* 4.7.8R, a *firm* must not *communicate* or *approve* a *direct-offer financial promotion* relating to an *unlisted share* or an *unlisted debt security* to or for *communication* to a *retail client* without the conditions in (2) and (3) being satisfied.

(2) The first condition is that the *retail client* recipient of the *direct-offer financial promotion* is one of the following:

(a) certified as a 'high net worth investor' in accordance with *COBS* 4.7.9R;

(b) certified as a 'sophisticated investor' in accordance with *COBS* 4.7.9R;

(c) self-certified as a 'sophisticated investor' in accordance with *COBS* 4.7.9R;

(d) certified as a 'restricted investor' in accordance with *COBS* 4.7.10R.

(3) The second condition is that *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 (see *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 *direct offer financial promotion*.

4.7.8 R A *firm* may *communicate* or *approve* a *direct-offer financial promotion* relating to an *unlisted share* or an *unlisted debt security* to or for *communication* to a *retail client* if:

(1) the *firm* itself will comply with the suitability *rules* (*COBS* 9) in relation to the *investment* promoted; or

(2) the *retail client* has confirmed before the promotion is made that they are a *retail client* of another *firm* that will comply with the suitability *rules* (*COBS* 9) in relation to the *investment* promoted; or

(3) the *retail client* is a *corporate finance contact* or a *venture capital contact*.

4.7.9 R A certified high net worth investor, a certified sophisticated investor or a self-certified sophisticated investor is an individual who has signed, within the period of twelve months ending with the day on which the communication is made, a statement in the terms set out in the applicable rule listed below, substituting “unlisted shares and unlisted debt securities” for “non-mainstream pooled investments”

(1) certified high net worth investor: *COBS* 4.12.6R;

(2) certified sophisticated investor: *COBS* 4.12.7R;

(3) self-certified sophisticated investor: *COBS* 4.12.8R.

4.7.10 R A certified restricted investor is an individual who has signed, within the period of twelve months ending with the day on which the communication is made, a statement in the following terms:

“RESTRICTED INVESTOR STATEMENT I make this statement so that I can receive promotional communications relating to unlisted shares and unlisted debt securities as a restricted investor. I declare that I qualify as a restricted investor because:	
(a)	in the twelve months preceding the date below, I have not invested more than 10% of my net assets in unlisted shares or unlisted debt securities; and
(b)	I undertake that in the twelve months following the date below, I will not invest more than 10% of my net assets in unlisted shares or unlisted debt securities.

Net assets for these purposes do not include:	
(a)	the property which is my primary residence or any money raised through a loan secured on that property;
(b)	any rights of mine under a qualifying contract of insurance; or
(c)	any benefits (in the form of pensions or otherwise) which are payable on the termination of my service or on my death or retirement and to which I am (or my dependants are), or may be entitled.
I accept that the investments to which the promotions will relate may expose me to a significant risk of losing all of the money or other property invested. I am aware that it is open to me to seek advice from an authorised person who specialises in advising on unlisted shares and unlisted debt securities. Signature: Date:”	

…

10.1.2 R This chapter applies to a *firm* which *arranges* or *deals* in relation to an *unlisted share*, *unlisted debt security*, *derivative* or *warrant* with or for a *retail client* and the *firm* is aware, or ought reasonably to be aware, that the application or order is in response to a *direct offer financial promotion.*

…

14.3.1 R This section applies to a *firm* in relation to:

(1) *MiFID or equivalent third country business*; and

(2) the following *regulated activities* when carried on for a *retail client*:

(a) making a *personal recommendation* about a *designated investment*; or

(b) *managing investments* that are *designated investments*; or

(c) *arranging*, (*bringing about*) or *executing* a *deal* in a *warrant*, *unlisted share*, *unlisted debt security* or *derivative*; or

(d) engaging in *stock lending activity*~~;~~ or

(e) *operating an electronic system in relation to lending*, but only in relation to facilitating a person becoming a lender under a *P2P agreement*.

…

P2P agreements

14.3.7A G Examples of information a *firm* should provide to explain the specific nature and risks of a *P2P agreement* include:

(1) expected and actual default rates in line with the requirements in *COBS* 4.6 on past and future performance;

(2) a summary of the assumptions used in determining expected future default rates;

(3) a description of how loan risk is assessed, including a description of the criteria that must be met by the borrower before the *firm* considers the borrower eligible for a *P2P agreement*;

(4) where lenders have the choice to invest in specific *P2P agreements*, details of the creditworthiness assessment of the borrower carried out in accordance with *CONC* 5.5;

(5) whether the *P2P agreement* benefits from any security and if so, what;

(6) a fair description of the likely actual return, taking into account fees, default rates and taxation;

(7) an explanation of how any tax liability for lenders arising from investment in *P2P agreements* would be calculated;

(8) an explanation of the *firm's* procedure for dealing with a loan in late payment or default;

(9) the procedure for a lender to access their money before the term of the *P2P agreement* has expired;

(10) an explanation of what would happen if the *firm* fails, including confirmation that there is no recourse to the Financial Services Compensation Scheme.

…

TP2: Other Transitional Provisions

(1)	(2)	(3)	(4)	(5)	(6)
	Material to which the transitional provision applies		Transitional provision	Transitional provision: dates in force	Handbook provisions: coming into force
2.-2	*COBS*, with the exception of	R	An *operator of an electronic system in relation to lending* who	From 1 April 2014 to 30 September	1 April 2014

	COBS 15		holds an interim permission under article 56 of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No 2) Order 2013 need not comply with the rules listed in column (2) until 1 October 2014	2014	
…					
2.-1A	*COBS* 4.7.7R to *COBS* 4.7.10R	R	A *firm* may comply with the *rules* in *COBS* 4.7 as they were in force at 31 March 2014	From 1 April 2014 to 30 September 2014	1 April 2014
…					
2.4-A	*COBS* 10.1.2R	R	A *firm* may comply with the *rules* in *COBS* 10 as they were in force at 31 March 2014	From 1 April 2014 to 30 September 2014	1 April 2014
…					

Annex E

Amendments to the Client Assets sourcebook (CASS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

7.6A.14B R A *firm* must not use the *individual client balance method* in relation to that part of the *firm's* business which consists of *operating an electronic system in relation to lending* except as part of a *non-standard method of internal client money reconciliation*.

…

At the end of CASS TP 1 Transitional Provisions, insert:

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
…					
11	*CASS* 7 and *CASS* 7A	R	The rules listed do not apply to an *operator of an electronic system in relation to lending* who holds an interim permission under article 56 of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No 2) Order 2013.	From 1 April 2014 to 30 September 2014	1 April 2014
12	*CASS* 7 and 7A	R	Apply in relation to *money* held by an *operator of an electronic system in relation to lending* who also benefits from *CASS* TP1 [11] on 1 October 2014 (being *money* to which *CASS* 7 and 7A would not otherwise apply) to the extent that such *money*: (a) relates to existing business which was entered into before 1 April 2014 and if entered into on or after 1 April 2014 would be *money* relating to a *P2P agreement*; or	Indefinitely	1 April 2014

			(b) relates to *P2P agreements* facilitated by the *firm* on or after 1 April 2014 but before 1 October 2014.		

Annex F

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text and striking through indicates deleted text.

16.12.4 R Table of applicable rules containing *data items*, frequency and submission periods

RAG number	*Regulated Activities*	Applicable *data items*	Reporting frequency/ period	Due date
...				
RAG 4	• managing investments • establishing, operating or winding up a collective investment scheme • establishing, operating or winding up a stakeholder pension scheme • establishing, operating or winding up a personal pension scheme • managing an *AIF* • managing a *UCITS* <u>*• operating an electronic system in relation to lending*</u>	*SUP* 16.12.14R *SUP* 16.12.15R	*SUP* 16.12.14R *SUP* 16.12.16R	*SUP* 16.12.14R *SUP* 16.12.17R
…				

…

In the table in 16.12.15R, between IPRU(INV) Chapter 11 and IPRU(INV) Chapter 13, insert the following new column with the following entries in the appropriate places.

16.12.15 R The applicable *data items* referred to in *SUP* 16.12.4R according to type of *firm* are set out in the table below:

…	…	<u>IPRU (INV) Chapter</u>	…

		12	
Annual report and accounts	…	No standard format (note 13)	…
Balance sheet	…	FSA029	…
Income statement	…	FSA030	…
Capital adequacy	…	FIN069	…
Client money and client assets	…	FSA039	…
Information on *P2P agreements*	…	FIN070	…

…

In the table in 16.12.16R after FIN067 and before Section A RMAR insert the following new rows

16.12.16 R The applicable reporting frequencies for *data items* referred to in *SUP* 16.12.15R are set out in the table below according *firm* type. Reporting frequencies are calculated from a *firm's accounting reference date*, unless indicated otherwise.

FIN069					Quarterly
FIN070					Quarterly

In the table in 16.12.17 R after FIN067 and before Section A RMAR insert the following new rows

16.12.17 R The applicable due dates for submission referred to in *SUP* 16.12.4R are set out in the table below. The due dates are the last day of the periods given in the table below following the relevant reporting frequency set out in *SUP* 16.12.16R, unless indicated otherwise.

FIN069				20 *business days*		
FIN070				20 *business days*		

…

SUP 16 Annex 24 R Data items for SUP 16.12R

FIN069: Financial resources requirements for operators of an electronic system in relation to lending

			A	B
	Financial resources			
1	Qualifying ordinary share capital (excluding preference shares)			
2	Qualifying preference share capital			
3	Eligible LLP member's capital, sole traders capital or partnership capital			
4	Reserves			
5	Share premium account			
6	Interim net profits			
7	Revaluation reserve			
8	Subordinated loans/debt			
9	Less:	Investment in own shares		
10		Investments in subsidiaries		
11		Intangible assets		
12		Interim net losses		
13		Excess LLP member's drawings		
14		Excess subordinated loans/debt		
15	Total deductions			
16	Financial resources			

Annual calculation of financial resources requirement

		A	B
17	Total amount of loaned funds		
18	0.3% of first £50m of loaned funds		
19	0.2% of loaned funds between £50m and £500m		
20	0.1% of loaned funds above £500m		
21	Variable financial resources requirement		
22	Total financial resources requirement		

Financial resources test

23	Surplus / Deficit of financial resources	

FIN070: Information on P2P agreements

		A At start of the reporting period	B New during the period	C Withdrawn during the period	D At end of the reporting period
1	Number of investors				
2	Amount invested into loans				

3	Proportion invested into unsecured loans over period	
4	Average interest rate net of charges and expected defaults over period	
5	Average expected default rate over the period	
6	Average actual default rate over the period	

7	Do you operate a contingency fund?	

If the answer to 7 is "yes" complete the answers to 8 and 9, otherwise go to question 10

8	Total amount held in the contingency fund at the end of the period	
9	Amount held in the contingency fund as a proportion of total loans outstanding at the end of the period	

10	Do you allow investors to choose from different loan categories which have different rates of return and expected default rates?	

If the answer to 10 is "no" then do not complete the reminder of the form

If the answer to 10 is "yes" please complete the following information for the loan categories attracting the greatest amount of money, starting with the category raising the greatest amount of investment over the period, up to a maximum of ten.

11

	A Description of category	**B** Total number of investors over the period	**C** Total amount invested over the period	**D** Proportion invested into unsecured loans over the period	**E** Average interest rate net of charges and expected defaults over period	**F** Average expected default rate over the period	**G** Average actual default rate over the period
1							
2							
…							
n							

SUP 16 Annex 25G Guidance notes for data items in SUP 16 Annex 24R

FIN069: Financial resources requirements for operators of an electronic system in relation to lending

Introduction

The purpose is to provide a framework for the collection of information required by the *FCA* as a basis for its supervision function. It also has the purpose to help the *FCA* monitor *firms*' capital adequacy and financial soundness. This data item is intended to reflect the underlying *financial resources requirements* contained in *IPRU (INV)* 12 (as they apply to an *operator of an electronic system in relation to lending*) and facilitates monitoring against the requirements set out there.

Defined Terms

Terms referred to in these notes where defined by the Companies Act 2006, as appropriate, or the provisions of the *firm's* accounting framework (usually UK GAAP or IFRS) bear that meaning for these purposes. Interpretive provisions of the *Handbook* apply to this guidance in the same way as they apply to the *Handbook.* The descriptions indicated in these notes are designed simply to repeat, summarise or amplify the relevant statutory or other definitions and terminology without departing from their full meaning or effect.

- The data item should comply with the principles and requirements of the *firm's* accounting framework, which will generally be UK GAAP (including relevant provisions of the Companies Act 2006 as appropriate) or IFRS.
- The data item should be provided on a solo basis (not on a consolidated basis).
- For a *sole trader*, only the assets and liabilities of the business should be included.
- The data item should be consistent in agreement with the underlying accounting records.
- Accounting policies should be consistent with those adopted in the statutory annual accounts and should be consistently applied.
- Information required should be prepared in accordance with generally accepted accounting standards.
- The data item should not give a misleading impression of the *firm*. A data item is likely to give a misleading impression if a *firm* wrongly omits or includes a material item or presents a material item in the wrong way.
- The requirement that any figures be audited does not apply to small companies exempted from audit under the Companies Act 2006.

Currency

You should report in sterling. Figures should be reported in 000s.

Data Elements

These are referred to by row first, then by column, so data element 2B will be the element numbered 2 in column B.

Description	Data Element	Guidance
Financial resources		
	1 to 14	The figures entered in this section should be consistent with those entered in FSA029 submitted for the same reporting period.
Qualifying ordinary *share* capital (excluding preference shares)	1 B	For a definition of this term, see *IPRU(INV)* 12.3.2 R – Item 1 (1). This includes share premium account.
Qualifying preference *share* capital	2 B	For a definition of this term, see *IPRU(INV)* 12.3.2 R – Item 1 (2)
Eligible *limited liability partnership* member's capital, *sole traders* capital or *partnership* capital	3 B	For a definition of this term, see *IPRU(INV)* 12.3.2 R – Item 2
Reserves	4 B	For a definition of this term, see *IPRU(INV)* 12.3.2 R – Item 3. This does figure does not include the share premium account.
Share premium account	5 B	For a definition of this term, see *IPRU(INV)* 12.3.2 R – Item 3.
Interim net profits	6 B	For a definition of this term, see *IPRU(INV)* 12.3.2 R – Item 4
Subordinated loans/debt	8 B	For a definition of this term, see *IPRU(INV)* 12.3.2 R – Item 6. Insert gross figure prior to any excess deductions in *IPRU(INV)* 12.3.5 R
Investments in *subsidiaries*	10 A	For a definition of this term, see *IPRU(INV)* 12.3.3 R – Note 1
Intangible assets	11 A	For a definition of this term, see *IPRU(INV)* 12.3.3 R – Note 2
Interim net losses	12 A	For a definition of this term, see *IPRU(INV)* 12.3.3 R – Note 3
Excess *limited liability partnership* member's drawings	13 A	For a definition of this term, see *IPRU(INV)* 12.3.3 R – Note 3
Excess subordinated loans/debt	14 A	Insert the figure which is calculated in *IPRU(INV)* 12.3.5 R. For further guidance, please see *IPRU(INV)* 12.3.6 G (2)
Total Deductions	15 B	The sum of cells 9A to 14A
Financial resources	16 B	The sum of cells 1B to 8B minus total deductions (15B).
Annual calculation of financial resources requirement		
Total amount of *loaned funds*	17 B	The *loaned funds* definition is any funds that have been provided to borrowers under a *P2P agreement* through the *operator of an electronic system in relation to lending*.
0.3% of first £50m of *loaned funds*	18 A	Insert the figure that equals 0.3% of the volume of *loaned funds* up to £50m. For further guidance, please see *IPRU(INV)* 12.2.7 G
0.2% of *loaned funds* between £50m and £500m	19 A	Insert the figure that equals 0.2% of the volume of *loaned funds* above £50m up to £500m. For further guidance, please see *IPRU(INV)* 12.2.7 G

0.1% of *loaned funds* above £500m	20 A	Insert the figure that equals 0.1% of the volume of *loaned funds* above £500m. For further guidance, please see *IPRU(INV)* 12.2.7 G
Variable financial resources requirement	21 A	The sum of cells 18A to 20A.
Total *financial resources requirement*	22 B	The higher of the base requirement *IPRU(INV) 12.2.4 R (1)* or the variable requirement (21A)
Financial resources test		
Surplus / deficit of financial resources	23 B	16 B – 22 B

FIN070: Information on P2P agreements

Introduction

The purpose of this data item is to provide a framework for the collection of information required by the FCA as a basis for its supervision activities. It will help the FCA monitor investor experience and alert us to problems or changes in the risk profile of the market as a whole.

Data Elements

These are referred to by row first, then by column, so data element 2B will be the element numbered 2 in column B.

Description	Data Element	Guidance
Total number of investors/ average returns		
Number of investors at the start of the period	1 A	The total number of investors registered with the platform who have funded loans at the start of the period
New investors during the period	1 B	The number of new investors who register with the platform and fund loans over the period
Number of investors withdrawing over the period	1 C	The number of investors who cancel their registration over the period
Number of investors at the end of the period	1 D	The total number of investors registered with the platform who have funded loans at the end of the period
Amount invested at the start of the period	2 A	The total amount loaned at the start of the period
New money invested during the period	2 B	The amount of new money invested in loans during the period
Money withdrawn during the period	2 C	The amount of money withdrawn from the platform by investors over the period
Amount invested at the end of the period	2 D	The total amount loaned at the end of the period
Proportion invested into unsecured loans over period	3 A	The proportion of the amount shown in 2 B accounted for by unsecured loans
Average interest rate net of charges and expected defaults over period	4 A	The average interest rate expected by all investors over the last quarter, net of all relevant charges and allowance for expected defaults. Do not make any deductions for

		tax not paid at source
Average expected default rate over period	5 A	The average expected default rate across all loans over the last quarter
Average actual default rate over period	6 A	The average default rate across all loans over the last quarter
Answer the next two questions if you operate a contingency fund that aims to cover defaults		
Total amount held in the contingency fund at the end of the period	8 B	The total amount held in the contingency fund at the end of the period
Amount held in the contingency fund as a proportion of total loans outstanding at the end of the period	9 B	The amount held in the contingency fund at the end of the period expressed as a percentage of the total amount of outstanding loans
If you do not allow investors to choose from different loan categories which have different rates of return and expected default rates, do not provide any further answers **If you do, please complete the following information for the loan categories attracting the greatest amount of money, starting with the category raising the greatest amount of investment over the period, up to a maximum of ten**		
Description of category	11 A	Describe the key characteristics of the category
Total number of investors over the period	11 B	The number of investors who fund this category of loans over the period
Total amount invested over the period	11 C	The amount of money invested in this category of loans during the period
Proportion invested into unsecured loans over period	11 D	The proportion of the amount shown in 11 C accounted for by unsecured loans
Average interest rate net of charges and expected defaults over period	11 E	The average interest rate expected by investors for this category of loans over the last quarter, net of all relevant charges and allowance for expected defaults. Do not make any deductions for tax not paid at source
Average expected default rate over period	11 F	The average expected default rate for this category of loans over the last quarter
Average actual default rate over period	11 G	The average default rate for this category of loans over the last quarter

Annex G

Amendments to the Dispute Resolution: Complaints sourcebook (DISP)

In this Annex, underlining indicates new text and striking through indicates deleted text.

2.7.6	R	To be an *eligible complainant* a *person* must also have a *complaint* which arises from matters relevant to one or more of the following relationships with the *respondent*:
		…
		(15) the complainant is <u>either</u> a *borrower* <u>or a lender</u> under a *P2P agreement* and the *respondent* is the *operator of an electronic system in relation to lending*.

Financial Conduct Authority

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