Financial Conduct Authority

Feedback Statement

FS16/13

Interim feedback to the call for input to the post-implementation review of the FCA's crowdfunding rules

December 2016

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In this statement, we report on the main issues arising from the call for input to the post-implementation review of the FCA's crowdfunding rules and set out our next steps.

We have developed the statement in the context of the existing UK and EU regulatory framework. We will keep the policy under review to assess whether any amendments will be required due to changes in the UK regulatory framework, including because of negotiations following the UK's vote to leave the EU.

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Abbreviations used in this paper

CCA	Consumer Credit Act 1974
CP	Consultation Paper
FCA	Financial Conduct Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act (2000)
ISA	Individual Savings Account
SPV	Special purpose vehicle

1. Overview

Introduction

1.1 Crowdfunding is a way people, organisations and businesses, including business start-ups, can raise money through online portals to finance or re-finance their activities. These portals, commonly known as 'crowdfunding platforms', act as brokers between those looking to invest and those looking to raise money.

1.2 We regulate:

- **loan-based crowdfunding platforms**,[1] through which people and institutions lend money to consumers or businesses in the expectation of a financial return through interest payments and repayment of capital over time
- **investment-based crowdfunding platforms**, through which people invest in non-readily realisable shares or debt securities issued by businesses

1.3 We published an interim review of the crowdfunding market in February 2015.[2] We noted that the market had grown rapidly but, at the time, we did not regard market changes to be sufficient to justify a change in our rules, either to strengthen consumer protection or to relax the requirements that apply to firms. Since then the market has continued to grow and evolve and we believe now is an appropriate time to consider once again whether rule changes are needed.

1.4 In July this year, we published a call for input to launch the post-implementation review.[3] The call for input summarised market developments since 2014 and some of our emerging concerns. In this paper, we summarise the feedback we received.

1.5 Based on our review of this feedback, together with our supervision of crowdfunding platforms currently trading and our consideration of applications from platforms for full FCA authorisation, we believe we need to modify our rules in a number of areas. While the review is ongoing, we plan to consult early next year on rules to address some of the more immediate concerns.

1 Loan-based crowdfunding is also known as peer-to-peer and peer-to-business lending.

2 *A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media,* February 2015: www.fca.org.uk/publication/thematic-reviews/crowdfunding-review.pdf

3 *Call for input to the post-implementation review of the FCA's crowdfunding rules*, July 2016: www.fca.org.uk/publication/call-for-input/call-input-crowdfunding-rules.pdf

Who does this affect?

1.6 This paper will interest consumers and consumer organisations considering investments through loan-based and investment-based crowdfunding platforms, and similar investment offers such as the offline marketing of mini-bonds, and consumers and businesses that have entered, or plan to enter, loan agreements as borrowers.

1.7 It will also be of interest to:

- firms that operate or plan to operate loan-based crowdfunding platforms (sometimes called 'peer-to-peer' platforms) on which consumers and businesses can make loans or borrow money
- firms that operate or plan to operate investment-based crowdfunding platforms on which consumers can buy investments, such as equity or debt securities (for example, bonds or debentures) not listed or traded on a recognised exchange
- firms that market non-readily realisable equity or debt securities to retail clients outside online investment crowdfunding platforms
- trade bodies which represent crowdfunding firms
- firms that compete for business with crowdfunding platforms

Context

1.8 We published new rules to protect investors on loan-based and investment-based crowdfunding platforms in February 2014, which, subject to certain transitional provisions, generally came into force on 1 April 2014.[4] Our aim was to set a proportionate framework of rules that ensured investor protection without impeding innovation and growth in the market.

1.9 The regime we introduced reflected that the crowdfunding market was relatively new and had the potential to improve competition by helping to provide alternative sources of finance for individuals and businesses seeking to raise funds.

1.10 When we introduced the rules, we said we would conduct an interim review of the rules after one year and a full post-implementation review of the regime in 2016. We are conducting that review at the moment, using information gathered through our supervision and authorisation of crowdfunding platforms. We held a roundtable with firms, trade bodies and consumer organisations and have commissioned consumer research to ensure we hear from a broad range of stakeholders.

1.11 The call for input, published earlier this year, invited views on possible risks that may be emerging for investors and the market. It also asked whether we should consider new rules in any areas, and whether borrower protections are adequate or should be enhanced. The call for input closed on 8 September 2016. In this paper, we summarise the feedback we received and set out our plans for further work.

4 *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media: Feedback to CP13/13 and final rules* (PS14/4), March 2014: www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf. Separately, we published rules to protect borrowers in *Detailed rules for the FCA regime for consumer credit including feedback on FCA QCP 13/19 and 'made rules'* (PS14/3), February 2014: www.fca.org.uk/publication/policy/ps14-03.pdf.

1.12 This paper sets out our initial observations only. The post-implementation review is ongoing and we are gathering further evidence to support it. We are investigating how firms currently operating regulated platforms are meeting our existing requirements and conducting research into the needs, expectations and understanding of the fund raisers and investors who use crowdfunding platforms.

1.13 While some issues are common to both loan-based and investment-based crowdfunding these are two distinct markets subject to largely separate regulatory regimes.

1.14 In our view, aspects of the loan-based crowdfunding market currently pose some risks to our objectives. We perceive risk of regulatory arbitrage in the loan-based sector, and potential for investors to misunderstand the nature of the products offered. While investment-based crowdfunding is facilitated entirely by fully-authorised firms, most loan-based crowdfunding firms, including the largest ones, have so far operated under interim permissions.[5] Where firms operating under interim permission fail to meet the standards for full authorisation, this presents risks to their existing borrowers and lenders which require careful management.

1.15 Our focus is ensuring that investor protections are appropriate for the risks in the sector while continuing to promote effective competition in the interests of consumers. Based on our findings to date, we believe it is necessary to strengthen the consumer protections provided by our rules while continuing to ensure we promote competition in the sector. We plan to consult next year on new rules to address these concerns.

Summary of feedback

1.16 We received 90 responses to the call for input from firms, lawyers, compliance consultants, trade bodies and consumers. We also held a roundtable on 7 September 2016, with representatives from firms, trade bodies and consumer organisations to discuss the issues set out in the call for input.

1.17 Chapter 3 of this paper summarises the feedback about loan-based crowdfunding platforms. Chapter 4 provides information on feedback about investment-based crowdfunding platforms.

Next steps

1.18 We believe there is evidence of potential investor detriment and we intend to publish a Consultation Paper in the first quarter of 2017 proposing new rules. Chapter 5 sets out our proposals in more detail. While our primary focus is the loan-based market, we have concerns across both loan-based and investment-based sectors and will propose new rules for both.

1.19 Over the coming months, we will continue research into the market. This research will enable us to understand if other concerns set out in the call for input, flagged by respondents, or reflected in our own experience of regulating these markets represent a source of potential consumer detriment that we should act to mitigate. If so, we will publish a second consultation proposing further rule changes.

5 An interim permission allows firms to trade whilst their application for full authorisation is being determined.

2.
The current regulatory framework

2.1 Our aim in conducting the post-implementation review is to continue to ensure that the market in crowdfunding develops in a sustainable fashion that provides appropriate consumer protections and allows competitive forces to operate in the interests of consumers. Over the course of our work so far we have become concerned that there may be risks to achieving this outcome and we are considering how best to mitigate these through a combination of our regulatory tools, including possible rule changes. In doing so we will be proportionate to the potential detriment and we see this building on the regime already in place for the crowdfunding sector, rather than a revolutionary approach.

The current regime

Firms seeking to enter the market

2.2 Firms must seek authorisation from the FCA before they can provide regulated financial services in the UK. They must apply for permissions that cover their intended activities and must meet the threshold conditions set out in the Financial Services and Markets Act 2000 (FSMA). The threshold conditions include, for example, having adequate resources and a suitable business model. These requirements apply to all firms we regulate, including those that wish to operate crowdfunding platforms.

2.3 Some of the crowdfunding firms applying for authorisation have not yet demonstrated they meet the minimum standards set by the threshold conditions. Whilst we are actively working with firms to support them during the application process, and will continue to do so, it is ultimately the responsibility of firms to ensure they meet the threshold conditions and are ready, willing and organised to commence regulated business. We will refuse authorisation to firms where they are not able to demonstrate they meet the required regulatory standards.

2.4 Some business models we have seen from crowdfunding applicants include aspects that are the same or similar to those in the investment management and banking sectors. We are therefore concerned about the significant risk of arbitrage in parts of the industry and expect crowdfunding firms applying for authorisation to ensure their activities fall within the scope of the permissions for which they have applied.

Firms in the market

2.5 Once firms are in the market, they must continue to meet all relevant regulatory standards and provide appropriate levels of consumer protection. Based on our experience of regulating both loan-based and investment-based platforms we are concerned that firms may not always meet our expectations.

Loan-based crowdfunding and investment-based crowdfunding

2.6 For both loan-based and investment-based crowdfunding platforms, for example, we see the following issues:

- it is difficult for investors to compare platforms with each other or to compare crowdfunding with other asset classes due to complex and often unclear product offerings
- it is difficult for investors to assess the risks and returns of investing via a platform
- financial promotions do not always meet our requirement to be 'clear, fair and not misleading', and
- the complex structures of some firms introduce operational risks and/or conflicts of interest that are not being sufficiently managed

Loan-based crowdfunding

2.7 Based on our experience of supervising firms in the loan-based crowdfunding market operating under interim permissions, we have a number of concerns. For example:

- Certain features introduce risks to investors that are not adequately disclosed and may not be sufficiently understood by investors. For example, the use of provision funds may obscure the underlying risk to investors, which may result in investors believing that platforms are providing an implicit guarantee of the loans they facilitate.
- The plans some firms have for wind-down in the event of their failure are inadequate to successfully run-off loan books to maturity.
- We have challenged some firms to improve their client money handling standards.

2.8 The possibility of a high-profile platform failure is seen by firms as the biggest risk to the ongoing viability of the sector.[6]

2.9 We continue to use a range of tools to address these points. This includes supervision of existing firms and consideration of applications for authorisation against current standards. As set out in Chapter 5, we also plan to consult in early 2017 on rule changes to address some of our priority concerns.

Possible future changes

2.10 We are conducting research into the market and the consumers who use it. This will help us determine whether or not further intervention is required, including further rule changes. For example, we could consider:

- applying additional controls to more complicated business models, or
- setting investment limits to cap potential consumer harm

2.11 We plan to report in mid-2017 with the final conclusions of the post-implementation review. As ever, we will only consult on rule changes where there is evidence of potential consumer detriment and the benefits outweigh the costs. As part of this assessment, we will consider the impact of measures on sustainable growth in the UK economy in the medium or long term.

6 57% of firms said that collapse of one or more of the well-known platforms due to malpractice carries a high risk to growth in a survey cited in Nesta and University of Cambridge, *Pushing Boundaries, the 2015 UK alternative finance industry report*, February 2016: www.nesta.org.uk/sites/default/files/pushing_boundaries_0.pdf

3.
Loan-based crowdfunding

3.1 In this chapter, we summarise feedback from the call for input received about the loan-based crowdfunding sector.

Recent market developments

Q1: Do you consider there is the potential for regulatory arbitrage with banking business? If so, what measures should be considered to address it?

3.2 In the call for input, we summarised some changes we have observed in the loan-based crowdfunding market since 2014. We highlighted two trends that may create a risk of regulatory arbitrage with other financial services sectors:

- There appears to be increased pooling of credit risk for investors, which has the potential to create a blurred line between loan-based crowdfunding and asset management. This creates a risk of regulatory arbitrage where firms conduct what is essentially asset management business, but under a regulatory regime not designed for this.
- We are also seeing maturity mismatch products begin to be offered on platforms. With these, borrowers borrow on the usual terms for loan periods of, say, five years, but investors invest in products which aim to allow them to take out their money after a certain notice period or initial term. These investment products have similarities with banking business, where banks lend money on longer terms than savings account notice periods.

3.3 We asked for views on these developments and received 44 responses. Respondents generally agreed that firms should have appropriate permissions and be regulated according to the activities they undertake. Respondents also felt it vital that loan investments are not promoted as equivalent to bank deposits.

Potential arbitrage with banking

3.4 Eleven industry and investor respondents suggested that maturity transformation does not technically occur in the sector because platforms are not leveraged, do not create money and are not systemically important. Further, it was felt that terms and conditions generally make clear that investors need to exit their investments to receive their capital. Such respondents generally felt firms that promise investors instant access or give the impression of a guarantee would be making unclear, unfair or misleading promotions.

3.5 However, eight other respondents suggested that, even if maturity transformation does not technically occur, there are a number of similarities with banking business. For example, investors are exposed to unknown borrowers and are reliant on the platform's due diligence in a manner not fundamentally different from bank depositors. One respondent felt continued operation of a platform constitutes an implicit guarantee of liquidity, which firms might have to underwrite with liquidity buffers or by becoming deposit-takers and being regulated as such. Other respondents considered that regulating firms as deposit-takers would be disproportionate and would threaten the viability of the sector. Others suggested that current client money and prudential requirements are sufficient to address any problems.

Potential arbitrage with investment management

3.6 Eleven respondents, including some firms, saw a stronger possibility of arbitrage with investment management business because of firms operating provision funds, offering auto-bid options, channelling investment through special purpose vehicles (SPVs) or offering fixed rate products. Conversely five industry respondents felt that the arbitrage opportunity in this area is overstated given the amount of regulation with which firms need to comply. Finally, one response questioned what consumer detriment would be addressed by treating activities such as auto-bidding or provision funds as creating collective investment schemes.

Other matters

3.7 A general point made by industry respondents was that the trends identified in the call for input as relatively recent (such as institutional investment, assignment, provision funds, self-select lending and auto-bidding) have been features of the market since the regulatory framework was established.

Our response

While some of the features of the market noted in the call for input existed in 2014, they have grown in significance and firm structures have grown in complexity. In addition, business models are becoming more complicated and look increasingly similar in substance to other, existing regulated activities, but without being subject to the same regulatory requirements or offering the same consumer protections. We will continue to examine the feedback received, and to consider firm business models, as part of our ongoing authorisation and supervision work. If it appears that consumer detriment is likely, we will also consider introducing additional rules to reduce or remove the potential for arbitrage.

Changes to the investor base

Q2: Do you have any concerns about, or evidence of, differences in the treatment between retail and institutional investors?

3.8 The amount of institutional investment through loan-based crowdfunding platforms has substantially increased since 2014. We asked for thoughts on the possible impact of this and received 50 responses.

Evidence for preferential treatment for institutional investors

3.9 We received 13 responses from both investors and firms discussing instances in which institutional investors, high net worth individuals and parties related to a crowdfunding platform had, in their view, sought or received inappropriate preferential treatment. Examples included:

- early, exclusive or effectively exclusive access to loans, provided either explicitly or by means such as the timing of auctions
- greater access to information about borrowers provided by the originating platforms
- the option to opt-out from lending to segments of the market, for example, on a sector basis

3.10 Further, two respondents noted cases in which retail investors were exposed to loans pre-screened and rejected by institutional investors without knowing this, and one investor claimed a firm could not provide a sufficiently clear explanation for how their loans were allocated between institutions and individuals. Two more responses warned of significant tensions where both institutional and retail investors are allowed to invest in whole loans. One respondent suggested that, even where institutional investors are granted no preferential treatment, competition for their funding may, over time, skew firms' origination towards higher-risk/higher-return propositions in a manner that is not transparent for retail investors.

3.11 One respondent pointed out that not all pre-selection of loans by institutions should be treated in the same way. For example, regional restrictions on the investment by institutions with a localised remit (such as a Local Enterprise Partnership) should not be seen as constituting preferential treatment.

Potential for detriment from preferential treatment

3.12 Nine industry responses claimed that, as a matter of good practice, industry culture and self-regulation, no preferential treatment is given to institutional investors. Seven respondents argued that, under our current framework, firms are already required to treat customers fairly and should understand what this means.

3.13 Ten respondents argued that platforms should be able to offer different terms to institutional investors, as long as retail investors are made explicitly aware of the institutions' role. In their view, institutions bring important liquidity and scrutiny to the market, to the benefit of retail investors, and need to be compensated appropriately for their role.

Our response

While we cannot comment on individual reports of preferential treatment in this feedback statement, nevertheless the responses to this question raise concerns that some firms may not be managing their conflicts of interest adequately. We also believe it is unlikely to be possible to employ such arrangements and treat customers fairly. We will consider individual reports and wider implications in our ongoing supervision of the sector. In addition, as set out in Chapter 5, we are conducting research that will provide more data on the profile of investors. We will consider further intervention if we find that current business practice is creating a significant risk of consumer detriment.

Q3: Have you seen any initial evidence that the ISA wrapper has led to consumers not fully appreciating the risks involved in Innovative Finance ISA investments?

3.14 It became possible to hold loans facilitated by fully-authorised platforms in Innovative Finance ISA wrappers from 6 April 2016. We asked if the availability of investment through ISAs and pensions may create a change in the investor base towards less experienced or knowledgeable retail investors, who trust the ISA 'brand' and who may not fully appreciate the risks involved. We received 46 responses.

The understanding of ISA investors

3.15 Not everyone agreed that Innovative Finance ISA investors were likely to be less sophisticated. Five industry respondents noted significant demand among existing investors who, they claimed, had a good understanding of the asset class, and another respondent saw no evidence of lesser sophistication. Such firms pointed to the fact that less sophisticated investors could already invest money but have not.

3.16 Four respondents suggested that Innovative Finance ISA investors are likely to be less sophisticated as the ISA 'brand' is seen as a mass market product. Two felt Innovative Finance ISA investors might be specifically at risk due to under-diversification. One said investors would be likely to underestimate risks and another thought that they may not appreciate the different risks involved in different types of loan on offer (e.g. property crowdfunding and unsecured loans). Three respondents felt additional disclosure was the answer and one felt advice was a better route to market. Two felt current rules were adequate.

3.17 Twenty-one respondents claimed that it is not yet possible to comment on consumers' understanding of the Innovative Finance ISA as not all firms operating loan-based crowdfunding platforms have full authorisation.

Our response

Our work before introducing the regime in 2014 suggested that current, active investors have greater understanding of the sector and its risks than those who do not invest in it. We are undertaking research into investors' knowledge, experience, expertise, behaviour and expectations. This will help us test whether the market has changed since 2014.

We do not believe past investment in other investments, such as stocks-and-shares ISAs, means that investors necessarily appreciate the liquidity risk, under-diversification risk and operational risks on platforms. We are therefore concerned about any significant change to the investor population that could arise.

On the evidence submitted to us so far, we believe the Innovative Finance ISA is likely to appeal to a significant number of investors, primarily those already engaged with the sector. We expect the Innovative Finance ISA to compete for funds with both cash ISAs and stocks-and-shares ISAs as investors search for yield. However, we do not have evidence that a significant share of the existing ISA investor population is likely to choose to become crowd investors instead.

Evolution of credit offerings

3.18 While the post-implementation review and call for input are primarily focused on the investor experience of crowdfunding platforms, we do have some potential concerns about borrowers' position under consumer credit agreements or mortgage contracts on loan-based crowdfunding platforms.

> ***Q4:*** ***Are there differences in borrower protection between commercial and non-commercial agreements that would be best addressed by applying additional rules to platforms, or are the existing rules adequate?***

3.19 Where institutional or other investors lend to consumers or some small businesses in the course of business, they need to be authorised for consumer credit lending and are subject to FCA consumer credit rules and the Consumer Credit Act 1974 (CCA). However, where lending is not in the course of business, the agreement is a 'non-commercial agreement' for CCA purposes and only limited CCA requirements apply: the investor does not need FCA authorisation, and FCA rules do not apply to them (although some rules apply separately to the platform). We asked respondents if they believe there is a need for additional rules in this area. We received 36 responses.

The treatment of borrowers under commercial and non-commercial agreements

3.20 Half of the responses said that a harmonised treatment of borrowers under commercial and non-commercial agreements is desirable and that as a matter of practice firms aim to provide the same experience under both.

3.21 The industry's strong preference (in 11 responses) appears to be that borrower protection requirements should apply only to the firm operating the platform as to apply these in certain circumstances to investors as well was complex and duplicative. Just two respondents called on us to apply the same requirement to investors.

3.22 Ten respondents felt it should be the total amount that a borrower borrows, not the amount borrowed under a single agreement, which should determine their treatment in financial regulation.

Investor and borrower protections

3.23 Some respondents debated the balance between investor and borrower protections in our rules. Two respondents felt firm incentives to drive origination, coupled with inappropriate fee structures, could lead to lax underwriting standards. Another two felt requirements should be the same as in bank lending.

3.24 While one respondent called on us to focus on protecting investors and avoid over-regulation of borrowing, another saw a risk that disintermediation of lending, driven by loan-based crowdfunding, will mean small and medium enterprises have no access to generic advice to obtain the right finance. One respondent added that it may be appropriate for firms to notify borrowers if their agreement is unregulated and what this means.

The need for additional FCA rules or guidance

3.25 Nine respondents felt our current rules to protect borrowers were adequate. Three others suggested that the CCA requirements on form and content are not fit for purpose as they can lead to unclear customer communications and apply disproportionate penalties for firms, relative to potential customer detriment.

3.26 Four respondents called for clearer guidance on lending in the course of business; how the regime applies to residential mortgages; and whether it is possible for a loan to be both an article 36H loan and a debenture. Finally, one respondent called for an improvement to our glossary definition of a 'borrower' in relevant rules, which they believed was circular.

Our response

The definition of the term 'non-commercial agreement' is in the CCA ('a consumer credit agreement or a consumer hire agreement not made by the creditor or owner in the course of a business carried on by him'). The form and content rules for regulated credit agreements are set out in CCA secondary legislation.

The FCA is under an obligation to review the retained CCA provisions and to report to Government by April 2019. We published a Call for Input in February.[7]

We will consider the calls for guidance and to review the 'borrower' definition in our ongoing work.

Q5: Do you agree with our analysis of the key developments in the loan-based crowdfunding sector over the last two years?

3.27 We asked for general observations about key developments in the loan-based crowdfunding sector since 2014. We received 44 responses.

Residential mortgage contracts

3.28 One market development noted in the call for input was the potential for loan-based crowdfunding platforms to offer residential mortgage contracts. Were this to occur, certain current FCA rules regarding mortgages would not apply if investors are not lending by way of business. Nineteen respondents agreed with the suggestion that this discrepancy should be closed, while two disagreed.

Other market developments

3.29 Some respondents also reported:

- the recent growth in secured property lending, particularly for bridging loans and property development
- that the market started with platforms acting as brokers matching lenders and borrowers but its development over time has led to a lack of clarity for investors about what different platforms offer, and investors are largely unaware of the implications of various models
- that many firms in the market are not very experienced in dealing with regulation and are driven by the opportunity to 'disrupt' existing financial services firms but this has led to a diverse and innovative market expanding rapidly in a manner that has made it vulnerable to poor standards

7 Call for input: review of retained provisions of the Consumer Credit Act, February 2016: www.fca.org.uk/publication/call-for-input/call-for-input-review-retained-provisions-consumer-credit-act.pdf

- that it is not clear what will happen to the sector when economic conditions change, such as if interest rates are raised in the future

Our regulatory approach and market developments

3.30 One respondent suggested we could regulate different loan-based crowdfunding platforms in different ways, depending on whether they offer simpler business models or more complicated propositions.

3.31 Two respondents said that further innovation and ongoing changes to business models may be in the interests of consumers. Two others said that different platforms have very different models and the regulatory regime needs to be kept flexible to avoid imposing disproportionate costs.

Our response

We plan to analyse the matters mentioned by respondents in our ongoing work. As always, we will seek to avoid inappropriate or disproportionate regulatory standards and we will only consult on new rules if the benefits outweigh the costs.

To address a potential discrepancy in mortgage lending, we propose to consult on applying the usual mortgage lending standards to platforms where the investor/lender is not acting by way of business and the platform facilitates residential mortgage contracts.

New business models

Q6: Are you aware of current or emerging risks that firms' current infrastructure, systems and controls might not be adequate to deal with?

3.32 The market has grown and evolved rapidly, increasing the risk that firms' infrastructure, systems and controls may not be adequate. We asked for views on the development of the sector received 46 responses.

Risks identified by respondents

3.33 Fourteen respondents said they are not aware of current or emerging risks that warrant additional regulatory attention. Other respondents flagged various risks:

- concerns about the long-term viability of firms
- there may be too many firms in the market, leading to a potential for consolidation in the future and a need for firm wind-down plans to be fit for purpose, particularly where money is held within an ISA wrapper
- commercial pressure and conflicts of interest may lead firms to relax creditworthiness and underwriting standards, leading to increasing credit risk
- inadequate controls in some firms may lead to inadequate due diligence or poor quality

financial promotions

- debt recovery systems may not be adequate in all firms
- the firms operating platforms are generally themselves young operations and inexperienced in matters such as risk management
- cyber-attacks on platforms are possible
- property loans arranged on platforms can carry significant risks to investors
- insider trading or market abuse is possible, particularly where firms operate secondary markets
- lack of access to banking services may create over-reliance by firms on a few payment services companies

Our regulatory approach to the market

3.34 Five respondents said that if we were to increase regulatory requirements, particularly prudential requirements, this would be a barrier to entry and may add unnecessary costs. To these respondents, loan-based crowdfunding represents an important form of competition to mainstream lenders and should not be made subject to the same regulatory standards as the risks are felt to be different.

Our response

We will take account of these responses in our work, both in day-to-day supervision and in ongoing research for the post-implementation review.

Other comments about the development of the loan-based crowdfunding sector

Q7: ***Do you have any comments on our concerns over the development of new loan-based crowdfunding business models? Have there been other specific developments that are relevant to the high-level standards summarised above?***

3.35 The call for input summarised some developments we have seen in business models. These include, for example, increased pooling of credit risk. We invited feedback on whether respondents had concerns about this and other matters, and received 45 responses.

Concerns raised by respondents

3.36 Thirteen respondents made comments about the market's development away from its origin as a service to match investors and borrowers. Increasingly, the market is using features such as maturity mismatch, automatic allocation and re-allocation of investments, and provision funds. Respondents said this is leading the market to share the features, and possibly the risks, of unregulated collective investment schemes. Respondents suggested mechanisms to control potentially problematic developments, including prohibiting certain features, third-party assessment of platform risk, additional disclosures, or requiring third parties to administer provision funds to avoid conflicts of interest.

3.37 Two respondents said it is important for the FCA to examine the sector's diversification into near-prime and subprime borrower markets. One respondent noted that different platforms have different approaches to creditworthiness assessment and some have almost no credit experience. And another noted marked differences in firms' abilities to deal with defaulting loans, so felt that additional regulatory scrutiny may be warranted.

3.38 Some respondents made points about the firms' client money-handling arrangements. One noted that firms may also hold money concerning unregulated activities and it may be useful to allow such money to be held within designated client money accounts. Another suggested that the current rules are complicated in their application to loan-based crowdfunding platforms and simplification would be welcomed. One asked if, as well as client money being protected by FCA rules, the loans themselves should be treated as client assets and subject to relevant protections.

3.39 One respondent noted that some firms operating platforms have yet to make a profit and questioned their long-term viability. Another respondent called for higher prudential requirements to be introduced, as the current standards were felt to be unlikely to reflect operational and legal costs.

3.40 Eight respondents argued against developing burdensome regulations, which may damage the market.

3.41 Some respondents made points about the legislative position on loan-based crowdfunding and the detailed criteria under which a platform is seen as fulfilling one regulated activity rather than another. Similarly, some respondents made points about the process for firms seeking authorisation. These issues pertain to our approach to authorising firms, which is outside the scope of this review, but we have shared the responses with that area.

Our response

We continue to conduct research and analysis into the market to inform our thinking on the extent market development gives rise to potential consumer detriment.

Disclosures and financial promotions by crowdfunding firms

Q8: Do you have any comments on the standards of disclosure on loan-based crowdfunding platforms?

3.42 Our high-level rules require firms to provide potential investors with information so they are reasonably able to understand the nature of the investment and associated risks. The rules require firms to provide enough information so investors can make informed investment decisions and information must be fair, clear and not misleading. This means in practice it must be:

- accurate
- balanced

- sufficient for the needs of the investor
- presented in an understandable way, and
- important information and warnings must be given clear prominence

3.43 There is existing guidance in our rules to indicate to firms the types of disclosure we expect to see in order to satisfy the rules. This includes information on expected and actual default rates and how firms assess creditworthiness. Within this high-level framework, we leave flexibility for firms to determine what information to disclose and how best to disclose it, taking account of their offering and target customer base.

3.44 We have some concerns about how some firms are presenting information to investors (for example, we have seen unbalanced presentation of risks and misleading comparisons with savings accounts and banking) and asked stakeholders for their views.

Improving the quality of disclosures

3.45 We received 51 responses, ten of which said current standards and requirements are appropriate. Four respondents said increased supervision and enforcement of the current rules could raise standards.

3.46 Thirty-six respondents said that, to improve standards, the FCA could clarify its expectations further. Nine of these respondents said they would prefer guidance to new rules.

3.47 One respondent said that they are not convinced the disclosures discussed in the call for input would provide any meaningful assistance to investors, since risks depend on the nature of the borrowers and the security, if any, provided.

Our response

We remain concerned that standards of disclosure do not meet our expectations. To aid firms and to raise standards, we plan to consult on additional provisions to provide a consistent minimum basis for investor disclosures.

Our regulatory approach

Q9:* *Are our current financial promotion rules for loan-based crowdfunding promotions proportionate? If not, can you please provide examples?

3.48 We invited comment on whether the current rules about financial promotions are appropriate and proportionate and received 41 responses.

3.49 Twenty-three respondents felt the current rules are appropriate and proportionate. Some areas were raised, however, where greater clarity could be achieved:

- three respondents said that, while they think the existing rules are appropriate, detailed guidance would help firms raise standards

- three said that increased FCA supervision might also help
- one said it may be sensible to include cross-references between the investment and consumer credit communication rules, since both are likely to be relevant to firms
- one suggested that, while the rules generally are robust, further disclosure could be mandated where firms offer provision funds or maturity mismatch products and to require returns to be consistently calculated

3.50 Four respondents said that it should be possible to describe loan-based crowdfunding as 'savings' since it is possible to invest in loans via the Individual Savings Account (ISA).

3.51 Two respondents said that, in light of problems observed in promotions, the FCA should consider introducing a public awareness campaign or additional requirements for firms. Another respondent agreed that additional disclosures should be mandated, and drew attention to guidance published by the Australian Securities and Investments Commission as good practice.[8]

3.52 Two respondents questioned the legislative framework which sets limits on situations in which financial promotions may be communicated, particularly in light of the desire by business borrowers to encourage investment on social media.

3.53 One response said that firms provide so many risk warnings that they lose impact.

Our response

We will consider the points raised in these responses during our planned consultation on additional rules for the disclosure and financial promotion of crowdfunding to investors.

We do not agree that loan-based crowdfunding could be described as a 'savings' product. We believe detriment is possible if investors regard loan-based crowdfunding as a type of deposit as the risks, particularly to capital, are different.

Section 21 of FSMA prohibits the communication of financial promotions unless certain conditions are met. Businesses should not communicate invitations or inducements to invest unless they meet they conditions in the Act.

The regulatory approach to social media

***Q10:** Is our approach to online and social media promotions proportionate? Do you have any suggestions as to how to improve our rules or approach on promotions?*

3.54 We also asked for comments on our approach to online and social media promotions and received 31 responses.

8 *Marketplace lending (peer-to-peer lending) products*, information sheet 213, Australian Securities and Investments Commission, March 2016: http://asic.gov.au/regulatory-resources/financial-services/marketplace-lending/marketplace-lending-peer-to-peer-lending-products/

The regulatory approach to social media

3.55 Of the 14 respondents who agreed that the current approach is proportionate, four suggested greater guidance would help. One respondent said the approach is workable but needs more active supervision.

3.56 Nine respondents said, however, that we should revisit our approach to the regulation of social media promotions. They said our current approach is too restrictive. The following points were raised:

- the requirement for each promotion to be standalone compliant with the rules is particularly problematic on social media
- it would help if, when using character-limited media, firms could use hyperlinks to pages with meaningful risk warnings that must be read before investment
- it would help if we could provide further detail on what constitutes a 'direct offer financial promotion'

3.57 One respondent said that, given identified concerns with promotions, the FCA should consider further rules for promotions in this sector. Two other respondents suggested that mandatory risk warnings should be included, even within promotions communicated using character-limited media.

Our response

The FCA consulted in 2015 on guidance on using social media for financial promotions.[9] Our work on Smarter Consumer Communications is also relevant.[10] In the section of that paper dealing with risk warnings and other required statements in social media, we said that 'we will be undertaking further work and testing in this area and would welcome further discussion with firms on new and innovative approaches.' Respondents interested to discuss this further may wish to contact us, using the contact details in the Smarter Consumer Communications paper.

Investor understanding

Q11: Should we require loan-based crowdfunding platforms to assess investor knowledge or experience of the risks involved? What would a proportionate requirement look like?

3.58 Firms running investment-based crowdfunding platforms must check whether investors meet certain criteria before being able to invest money. They must also assess whether prospective investors, who do not take regulated advice, have the knowledge or experience to understand the risks involved. We asked whether we should consider applying the same approach for loan-based crowdfunding and received 48 responses.

9 *Social media and customer communications: the FCA's supervisory approach to financial promotions in social media*, finalised guidance 15/4, March 2015: www.fca.org.uk/publication/finalised-guidance/fg15-04.pdf

10 *Smarter consumer communications*, feedback statement 16/10, October 2016: www.fca.org.uk/publication/feedback/fs16-10.pdf

Applying investment-based crowdfunding marketing rules to loan-based crowdfunding platforms

3.59 Most respondents noted differences between investment-based and loan-based crowdfunding. They said that loan-based crowdfunding is simpler and more stable, and that consumer understanding is better. For these respondents, it is preferable to focus on ensuring adequate disclosure of risk warnings.

3.60 However, 12 respondents said that we should apply the same requirements as for investment-based crowdfunding platforms. Five respondents said that, while it is preferable to focus on disclosure standards for more straightforward models, there may be some more complicated loan-based crowdfunding models where checks of investor understanding may be useful.

Other recommended approaches

3.61 Other options were also recommended. One respondent said that only retail clients who have sought and received professional advice should be able to invest. Another respondent suggested that investors should be obliged to sign a statement that they understand the risks of capital loss before they can invest. One suggested that, if an investor says they are new to loan-based crowdfunding, they could be provided with additional guidance on the process.

Our response

The research for the review may corroborate feedback from those respondents who said that retail investors have sufficient knowledge of the risks involved in loan-based crowdfunding. However, if we find that investors do not understand the risks, particularly of the more complicated business models, we will consider the need for further rule changes.

Competition

Q12: What effect do you think loan-based crowdfunding has had on competition in lending and investment/savings markets?

3.62 We were keen to explore the extent to which respondents think loan-based crowdfunding can provide effective competition in lending and investment/savings markets. We received 48 responses.

The impact of loan-based crowdfunding on competition

3.63 Many respondents noted limited direct impact on mainstream lenders given the loan-based crowdfunding sector, though larger than the investment-based crowdfunding sector, remains small. One respondent commented that there may be more competition between loan-based crowdfunding and challenger banks.

3.64 Other respondents said that loan-based crowdfunding can provide significant support to small and medium-sized enterprises if high street banks reach sector, geographic or individual business concentration limits on what they can lend.

3.65 Some respondents said that merely by providing additional choice, the loan-based crowdfunding sector is improving competition.

3.66 Six respondents felt loan-based crowdfunding is providing beneficial competition through the more direct consumer engagement allowed using online tools and this may improve service standards in mainstream lenders.

3.67 Five respondents noted benefits in providing a new investment form which could have a positive effect on the market and wider economy.

Our response

As the market share of loan business accounted for by the loan-based crowdfunding sector remains small, there appears to have been only limited direct impact on traditional lenders to date. As some respondents observed, however, in some sectors or parts of sectors – such as lending to small and medium enterprises – the sector is growing faster and provides more competition to traditional lenders.

Improving competition

Q13: Where do you think regulations could be amended to increase confidence in loan-based crowdfunding markets, encourage the development of the markets in the interest of consumers or increase competition by removing uneven playing fields?

3.68 We received 49 answers in response to this question.

3.69 Nine respondents said that improved disclosures and mandatory disclosure of specified information would help overcome the lack of awareness among consumers of the risks involved. Two suggested that market data compiled and published by the FCA may assist in this, and two suggested greater guidance from the FCA concerning the regulatory position on loan-based crowdfunding to assist intermediaries. Another suggested that the creation of an appropriate performance benchmark by funds investing in crowdfunding loans would improve confidence.

3.70 Eight respondents suggested that it is important to keep the regulatory position appropriate and proportionate, allowing firms to develop systems, including provision funds and auto-investment features, which benefit investors. Six respondents said the existing regulatory regime is appropriate. If additional oversight is desirable, this could take the form of, for example, increased supervision of current rules, additional guidance to firms or working with the industry to improve consumer understanding.

3.71 One respondent suggested that platform co-investment would help align platform and investor interests. Another said that this would not be desirable as it would create conflicts of interest.

3.72 One respondent suggested that loan investments could be added to the 'retail investment product' definition so independent financial advisers would be obliged to consider them when recommending investments.

3.73 One respondent said that the sector is under-regulated, with low levels of consistency across business activities and lending standards, and poor quality disclosures. Four others said the FCA should address concerns over regulatory arbitrage.

Our response

The FCA has an operational objective to promote effective competition in the interests of consumers. We recognise that crowdfunding and, given its size, particularly loan-based crowdfunding, has the potential to exert beneficial competitive pressure on the market for consumer and small business lending.

As we continue with the post-implementation review and in our ongoing work in the crowdfunding sector, we will take account of responses to this question.

Wind-down plans

Q14: Do you have any comments on the resolution plans of firms operating loan-based crowdfunding platforms?

3.74 We require firms to have resolution plans in place so that, if a platform fails, loan repayments will continue to be administered and investors should not lose money solely as a result of the platform's failure. We asked for views on the wind-down plans in place received 39 responses.

3.75 All responses agreed with the need for resolution plans to be in place, with five saying that current regulation seems sufficient and two others saying that the details should be agreed by firms with their auditors.

Improving wind-down plans

3.76 Five respondents said that wind-down plans should involve backup providers, rather than relying on firms managing their own wind-down. Four noted, however, that there are few firms in the market that would be able to act as backup providers and this could act as a barrier to entry to new firms.

Regulatory requirements for wind-down plans

3.77 Six respondents said FCA expectations are difficult to understand under the current rules. Two others suggested further rules or guidance from the FCA would help. One respondent said that capital requirements for firms should be significantly higher. This could help manage how firms enter administration and the execution of wind-down plans.

Disclosure of plans to investors

3.78 Two respondents said that most platforms do not publish sufficient information about their wind-down plans to allow investors to understand their purpose or to compare platforms.

Our response

We are concerned that, in practice, wind-down plans may not work as expected, and may be inadequate to enable a loan book to be administered to conclusion in the event of platform failure. To help guard against this, we propose to consult on strengthening the rules in this area.

Other issues

Q15: Are there any other matters we should take into account in the post-implementation review of loan-based crowdfunding?

3.79 Finally, we asked for views on any other matters regarding loan-based crowdfunding. Fifty-one respondents provided additional commentary. A range of issues were raised, including:

- **The FCA's approach to regulation**: Fourteen respondents said that the sector is still becoming established and encompasses many business models. They said that the FCA should continue to encourage its growth and should not seek to impose a prescriptive, one-size-fits-all approach to regulation.

- **The Financial Services Compensation Scheme (FSCS)**: Investors do not have recourse to the FSCS for the failure of borrowers to meet loan payments. Investors also do not have any recourse to the FSCS if a firm operating a loan-based crowdfunding platform fails. Thirteen respondents said that it would be premature for a young industry and risks investor misunderstanding if we include loan-based crowdfunding within the FSCS remit. Five respondents said that extending the FSCS remit may be appropriate, perhaps by creating a separate compensation scheme for the sector.

- **Terminology**: Five respondents recommended that the FCA treat investment-based and loan-based crowdfunding separately, using different terms for each market, and publishing separate papers dealing with each sector. But one respondent said that loan-based crowdfunding does not represent a lower-risk than investing in debt securities on investment-based crowdfunding platforms and it would be preferable simply to have a single regime. This would be based on the requirements for firms running investment-based crowdfunding platforms. Another said that, as more and more models have entered the alternative financing market, the crowdfunding term has become more diluted and asked if the FCA can encourage a consistent use of terms across the sector.

- **FCA rulebook structure**: Two respondents said the FCA could provide greater assistance to the industry, for example, by creating a separate rulebook for the loan-based crowdfunding sector or by publishing details of its supervisory work with individual firms to raise standards in others.

- **The ability to sell an interest in a loan before maturity**: One respondent said that the FCA should give greater focus to the ability of investors to sell out of a loan before maturity on secondary markets. They said it is important to ensure sufficient information is provided about loans and risks. Four said that the FCA should consider the operation and safety of provision funds operated by some platforms. And another said that there should be rules to limit or require disclosure of maturity mismatch.

Our response

We will continue our review to analyse the market and will consider the issues flagged by respondents to this question.

We are conducting a separate review into the way that the FSCS is funded and will decide whether, following market growth and development and, having regard to any concerns that might be raised by respondents to that consultation, the position for loan-based crowdfunding should be changed.

The FCA is only responsible for some parts of the crowdfunding market in the UK and cannot control terminology use across all sectors. Our preferred approach is to refer to all platforms as crowdfunding, whether they focus on the investment-based or loan-based sectors, or both. We note that our use of terminology is consistent with that of the EU institutions.[11] Some issues now under review – such as the increasing use of platforms to facilitate asset management-style activity – cut across both sectors. We therefore propose to retain our terminology and to continue to deal with both sectors in the same documents.

11 See, for example, the ESMA opinion on investment-based crowdfunding, December 2014 (www.esma.europa.eu/sites/default/files/library/2015/11/2014-1378_opinion_on_investment-based_crowdfunding.pdf), the EBA opinion on lending-based crowdfunding, February 2015: (www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf) and the Commission's working document on crowdfunding in the EU capital markets union, May 2016 (http://ec.europa.eu/finance/general-policy/docs/crowdfunding/160428-crowdfunding-study_en.pdf).

4.
Investment-based crowdfunding

4.1 In this chapter, we summarise feedback from the call for input about the investment-based crowdfunding sector. This sector is smaller than the loan-based crowdfunding sector and has not seen as much evolution of business models in the last couple of years. It is also subject to some additional rules compared to loan-based crowdfunding. While we have identified some issues about the investment-based crowdfunding market, most of our attention at this time is on issues in relation to loan-based crowdfunding.

Market developments

Q16: What other market developments should we take into account in our review of the investment-based crowdfunding sector?

4.2 We asked if any developments in the investment-based crowdfunding sector should be considered in the review. We received 29 responses. Six noted that business models vary greatly and we need to consider each on a case-by-case basis, taking account of their complexity and risk profile. Respondents noted that a broader range of asset classes, notably real estate, is now available for investment through platforms.

Institutional investment

4.3 Six responses said the increase in institutional investment has been a recent development. One said that platforms should disclose cases where there is investment by institutional investors or platform operators. Three respondents said that growth is likely in indirect investment in crowdfunded securities (via investment funds or investment companies).

The Financial Ombudsman Service

4.4 One respondent noted the low number of complaints to the Financial Ombudsman Service about investment-based crowdfunding and questioned whether there are new risks to be addressed through changes to the rules.

Secondary markets

4.5 Five respondents said that they expect to see secondary markets develop on investment-based crowdfunding platforms. While this would provide increased liquidity, one observed it also carries potential for risks if, for example, institutional investors can exploit information asymmetry to the detriment of less knowledgeable retail investors. Two respondents said that some equities promoted are complex and may be misunderstood by the average investor, giving institutional investors an advantage. Two respondents said that venture capital investors are likely to have more information available than retail investors on crowdfunding platforms.

Mini-bonds

4.6 Two respondents felt that mini-bonds may benefit from closer regulatory scrutiny.[12] The respondents were concerned that these can have complicated characteristics and ordinary retail investors may struggle to understand the risks involved.

Real estate investment

4.7 An investor raised concerns with the development of real estate crowdfunding models involving SPVs where they said there may be gaps in our regulation.

The regulatory framework

4.8 One respondent said that several firms in other jurisdictions are seeking to set up operations in the UK, partly because of the current regulatory framework, which they said is appropriate for current risks.

Our response

While the FCA has placed great weight on promoting innovation in financial services in general, we are growing increasingly concerned about the speed of change in the investment-based and loan-based sectors. In particular, we are concerned about the potential for arbitrage with other financial services, such as asset management. We are aware of the risks flagged by respondents and will continue to explore them, and other matters, as we conduct research for the post-implementation review.

We consulted in a separate paper on investment in certain types of pooled investment vehicle SPVs.[13] The aim of this consultation was to address a potential anomaly in the rules that allowed for different regulatory treatments when an SPV is involved. We are considering feedback to the consultation and our next steps.

Managing conflicts of interest

Q17: Do you have any comments on the management of conflicts of interest on investment-based crowdfunding platforms?

4.9 Firms operating crowdfunding platforms must manage conflicts of interest, between clients raising money and clients investing money, and between their interests and their clients' interests. If conflicts of interest cannot be managed or avoided, they must be clearly disclosed to consumers so they can assess whether they wish to continue the investment despite the conflict of interests. The call for input sought views on whether these conflicts are well managed, and we received 29 responses.

Possible conflicts of interest

4.10 Two respondents said they do not see any conflicts in their firms' operations and eight others said the current requirements are adequate.

12 A mini-bond is essentially a type of debt security, mostly issued by small businesses, with a maturity of around three to five years.
13 See Chapter 8 of CP16/17, *Quarterly Consultation Paper no.13*, July 2016: www.fca.org.uk/publication/consultation/cp16-17.pdf

4.11 Six respondents observed that the FCA has tended to regard both investors and fundraisers as clients of the platform. They said that this differs from the usual approach when dealing with corporate finance and venture capital contacts. These respondents note that this gives rise to a potential conflict of interests, since firms are simultaneously dealing with consumers on both sides of a transaction.

4.12 Two respondents said that, for various reasons, it appears platform incentives are more closely aligned with issuers than investors. This conflict could lead to investor detriment where securities are issued at the highest price possible rather than at a price that reflects the true value of the venture. One respondent suggested that improved disclosure of the risks involved and likely probability of investing in a successful campaign may help.

4.13 Six respondents said that the interests of the firm running a platform could be better aligned with investor interests by partly linking the firm's remuneration with the ultimate success of the fundraising entities. They noted that some platforms earn much of their remuneration by charging a percentage of the amount invested, rather than regularly or linked to successful exit. This might mean that firms are incentivised to undertake less due diligence and to list more business.

Disclosure of relevant information

4.14 Four respondents said it is important for conflicts (including platform ownership or interest in the fundraiser) and fees to be disclosed adequately to avoid consumer detriment. One respondent, however, noted that some firms are confusing risk management disclosure with the management of conflicts of interest.

4.15 Two respondents questioned whether platforms are making all information available to investors and market commentators to allow adequate assessment of the investment venture that is being pitched. Two respondents identified a conflict of interests where some investors, including employees of the firm running the platform, can invest in shares on different terms than those offered to the 'crowd'. One of these responses noted that some platforms allow the owner/director of the platform to invest alongside or before other investors.

Investment in firms running crowdfunding-platforms

4.16 One respondent questioned whether platforms should be allowed to raise finance for themselves on the platform, or to stop competitor firms from raising funds.

Our response

We believe it is important that crowdfunding platforms treat those on both sides of the transactions they facilitate as clients. This does not create conflicts of interest; it clarifies that conflicts of interest are likely and must be considered appropriately.

Once conflicts of interest have been identified, firms must seek to manage them. Avoiding a conflict is one way to manage it. Disclosure of a conflict may only be considered if the firm cannot manage it in order to avoid consumer detriment. The disclosure should make clear that the firm cannot manage the conflict and that investors are likely to suffer detriment.

We will take account of the feedback to this question, both in our day-to-day supervision of the sector and in our work on the post-implementation review.

Due diligence standards

Q18: Do you have any comments on current due diligence standards for investment-based crowdfunding platforms?

4.17 Our current rules do not set out the specific levels of due diligence with which firms operating investment-based crowdfunding platforms must comply. Instead we have provided flexibility to firms to develop their own approach. We ask firms to make it clear to potential investors what analysis has been undertaken so investors can determine how much extra work they need to do. The call for input sought views on how this works in practice. Thirty-three respondents addressed this question.

Due diligence standards on platforms

4.18 Three respondents said that current due diligence standards are below those that would be expected for professional investors but most respondents said that standards are appropriate.

FCA mandated minimum due diligence standards

4.19 In the main, most respondents said the FCA should not impose minimum due diligence standards. Only four respondents were in favour, with one saying this should be the case only for larger fund raises. Similarly, of the respondents who considered the option for third-party responsibility for reviewing pitches, two were in favour and seven against the idea. Five respondents, however, said that practical guidance on FCA expectations may be of benefit and three said that enhanced FCA supervision of current rules may help raise standards.

4.20 Five respondents said that, while it should be for firms to determine what due diligence they undertake, this should be clearly disclosed to potential investors. Three, however, said they do not see enough information in practice.

Other matters

4.21 Five industry respondents said the FCA should not refer to blogs and market commentators in the media, which may be sensationalised or subject to their own conflicts of interest. Instead, they recommended we focus on industry data.

Our response

We will continue to analyse due diligence standards in the ongoing post-implementation review. As set out in Chapter 5, we are considering consulting on further rules on disclosure and may consider options for specific disclosures about the due diligence process, even if we do not go on to prescribe minimum due diligence standards.

To gain a rounded picture of the market, we will continue to consider all sources of data, including social media, consumer feedback and media commentary but will not give undue weight to any one source of information.

Client assessment

Q19: What do you think of the current client assessment standards on investment-based crowdfunding platforms?

4.22 The current rules require firms to check a retail client's knowledge and experience to assess their understanding of the risks and to classify the client under certain criteria before communicating direct-offer financial promotions. The call for input invited feedback on how these rules work in practice.

General comments

4.23 Of the 32 responses to this question, 21 said that current standards are appropriate. Four respondents felt the investor assessment process is too light, however. One noted that the process can take less than one minute to complete and it is not clear how well the assessment works in practice.

Possible additional requirements

4.24 Seven respondents said the FCA should mandate how the tests are performed with more prescriptive rules or by providing more detailed guidance. One said that the client assessment process needs to be tailored to the specific nature of the business undertaken on each platform. Some ideas for additional requirements include:

- One respondent said that, when a firm deals with retail investors who have relatively low declared incomes, they should monitor the investor's activities and take steps if they seek to invest a large amount disproportionate to income.
- Another respondent suggested that there should be a minimum investment size of, say, £250, to limit exposure to the market by people who cannot afford to take the high level of risk.
- One response suggested doing more to ensure investors spread their investment as diversification can help to mitigate risk.

Certification requirements

4.25 Eight respondents said it was never intended that the 'certified sophisticated investor' or 'high net worth investor' tests should involve assessment by the platform of whether investors meet the criteria. Doing so, they said, would add significant costs.

Suggestions to change the 'restricted investor' category

4.26 Two respondents suggested changes to the client assessment approach under which firms must assess whether a potential investor meets specified criteria before communicating a direct-offer financial promotion. These respondents suggested changes to the restricted investor category.[14] For example, they suggested that all investors could invest up to a certain amount.

Other matters

4.27 One respondent suggested that the liability of firms for advice in this market should be reduced to encourage advised sales. Another respondent said that the client assessment process is not required at all.

14 Restricted investors are asked to confirm they will invest less than 10% of their net assets in this type of security.

Our response

Responses to this question revisited many issues raised when the current approach was introduced in 2014. The current rules aim to strike a balance between granting ordinary retail investors (who may lack the knowledge, experience and resources to understand and cope with the risks) freedom to invest in high-risk investments while providing appropriate investor protections. As part of our research to support the post-implementation review, we will survey consumers to find out if this balance is being maintained. If it is not, we may revisit the client assessment rules in the future.

Several respondents questioned if firms must assess whether clients meet criteria to be considered high net worth or sophisticated, as suggested in the call for input. Firms should note the guidance in COBS 4.12.9G and 4.12.10G. This guidance cross-refers to the Principles and client's best interests rule and states that:

- where the certified high net worth investor statement is being used, firms should take reasonable steps to ascertain that the retail client does, in fact, meet the income and assets criteria, and
- where the certified sophisticated investor statement is being used, firms should carry out the assessment with due skill, care and diligence, having regard to the general nature of the investments and the level of experience, knowledge and expertise the retail client being assessed must possess in order to be fairly and reasonably assessed and certified as a sophisticated investor

Even without this guidance, it is unclear how a firm could meet its obligations to act honestly, fairly and professionally in accordance with the best interests of its clients if they certify them as high net worth or sophisticated without undertaking any analysis.

The certified high net worth investor and certified sophisticated investor statements derive from secondary legislation.[15] The legislation requires the person making the communication to believe, on reasonable grounds, that the promotion's recipient is a high net worth individual. Regarding the certified sophisticated investor statement, however, it requires a third party to make the assessment of the client.

We will consider, given the responses, if there should be greater supervision of the client assessment process because of the misunderstanding by firms and concerns expressed by some respondents that current market practice is insufficient.

Disclosures and financial promotions

Q20: What do you think of the current standards of information disclosure on investment-based crowdfunding platforms?

15 The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 and the Promotion of Collective Investment Schemes) (Exemptions) Order 2001.

4.28 We asked for thoughts on current standards of disclosure on investment-based crowdfunding platforms and received 35 responses.

The current regime

4.29 Fifteen respondents felt the current regime and standards were appropriate. Eleven said that FCA expectations should be higher with more rules, and two respondents said that it would be preferable to have guidance on the risks that should be disclosed.

Supervision of the rules

4.30 Three respondents said that they have seen instances where some financial promotions do not meet existing disclosure standards and the FCA should do more to supervise the rules.

Clarity over the source of money invested

4.31 Firms tended to say that it would be difficult to provide information on money contributed by people connected with the business or ongoing information on the number of businesses that go on to fail or successful exit. Other respondents, however, called for this information to be available to help investors make more informed investment decisions.

Clarity over the ongoing responsibilities of platforms

4.32 One respondent suggested that, while firms operating nominee structures have a role to monitor fundraisers after the issue of securities, other platforms operate an introduction model and only facilitate the fundraising. They suggested that such platforms should be clear that they do not represent investors' interests after the fundraising and investors need to monitor their investments and, if necessary, enforce shareholder rights individually.

Our response

As set out in Chapter 5, we plan to consult in the first quarter of 2017 on more rules for disclosures by firms operating investment-based crowdfunding platforms. We will take account of feedback to this question and put forward proposals. For example, we will give further thought to requiring disclosure of information about funding sources and the ongoing responsibilities of the platform.

Innovative Finance ISAs

Q21: Should we mandate the disclosure of risk warnings in relation to non-readily realisable securities held within Innovative Finance ISAs?

4.33 In 2015, the Government consulted on allowing assets sold on investment-based crowdfunding platforms to be held within the Innovative Finance ISA wrapper.[16] This development has the potential to lead to changes in the investor base and may encourage less experienced or knowledgeable people to invest. We asked whether respondents thought that the FCA should mandate disclosure of risk warnings for investment-based crowdfunding Innovative Finance ISAs.

16 HM Treasury, *ISA qualifying investments: consultation on whether to include investment based crowdfunding*, July 2015: www.gov.uk/government/consultations/isa-qualifying-investments-consultation-on-whether-to-include-investment-based-crowdfunding/isa-qualifying-investments-consultation-on-whether-to-include-investment-based-crowdfunding and *ISA qualifying investments: response to the consultation on whether to include investment based crowdfunding*, November 2015: www.gov.uk/government/uploads/system/uploads/attachment_data/file/479564/crowdfunding_response_web.pdf.

Mandatory disclosures of risks

4.34 There were 28 responses to this question, of which 18 agreed that there should be mandatory disclosures. A further five respondents said they accept the premise but think such disclosure should be required for all stocks-and-shares ISAs or Innovative Finance ISAs. Four firms considered the current high-level requirements to disclose all relevant risks are sufficient and that there is no need for prescription. They cautioned against overly-prescriptive disclosure rules as these generally create unforeseen consequences.

Our response

As part of the consultation planned for next year, we will consider the need for mandatory disclosures for non-readily realisable securities held within Innovative Finance ISAs.

Other issues

Q22: Are there any other matters we should take into account in the post-implementation review for investment-based crowdfunding?

4.35 Finally, we asked for any other matters respondents wished to bring to our attention about investment-based crowdfunding. We received 25 responses raising a number of issues:

- **Monitoring fundraiser performance**: One respondent said that we should consider how investors can get mandatory updates on the performance of businesses that raise funds, to help deal with situations where the business does not deliver on its plans and has no prospects of doing so.
- **Independent research**: One respondent suggested encouraging affordable independent research into fundraisers be provided to support investor due diligence.
- **General observations**: While eight respondents raised areas of concern where they felt additional work is needed, six felt the current regime is generally working well. Four respondents felt investor protection could be enhanced by increased supervision by the FCA of the current regime, rather than new rules.

Our response

We will consider the feedback to this question as we continue the review.

5. Next steps

5.1 The post-implementation review is continuing. This paper is an interim report to summarise what we have been told so far in response to the call for input. In this chapter, we set out our next steps in the completion of the post-implementation review including our intention to consult on new rules in some areas.

Continuing research

5.2 We are gathering further evidence to support the post-implementation review. We are investigating how the market has changed since the rules were introduced in 2014. We are also conducting research into the needs, expectations and understanding of the fundraisers and investors who use crowdfunding platforms.

5.3 To support our analysis of market developments, we have several work-streams in place:

- We are conducting a review of the business models and practices at some firms to collect evidence on potential risks and address any knowledge gaps.
- To assist with our monitoring of the sector, we are analysing third-party market data alongside other information sources.
- We are also drawing from our work authorising and supervising firms in this sector.

Initial findings from our supervisory work

5.4 We are conducting work with firms to collect evidence on potential risks and address any knowledge gaps. This work, which is still in progress, has covered about two thirds of the loan based crowdfunding market by volume, across the personal, business and property-lending sectors.

5.5 Some of the interim results from our work on loan-based crowdfunding are as follows:

- We found inadequate disclosures about risk and loan performance.
- Firms are testing the boundaries of the regulated crowdfunding perimeter, which introduces the risk of arbitrage with investment management or banking activities.
- Firms' desire to maintain confidence in platforms has occasionally led to firms acting in a non-transparent manner, masking true loan performance and exposing investors to risks. This has included management intervening to influence the performance of loans (e.g. by covering arrears) or otherwise acting to support the platform (e.g. lending to provision funds).

- Firms have limited scope to increase market share with their current products and are instead targeting growth through new products or in new markets. This brings the risk of operating in unfamiliar markets without appropriate expertise, exposing longer-term investors to unforeseen lending risks.

- Consumers may not realise they do not have the usual protections as borrowers, where agreements are non-commercial, and firms may not make them aware of this.

- Institutional investors could bring benefits for retail investors (e.g. due diligence) but better controls are needed to mitigate the risks – particularly around conflicts of interest.

- Some platforms allow investment in loans formed on other platforms, which can make it harder for investors to conduct due diligence or to understand the level of risk they are taking. Failure of one firm could also cause problems for other firms in the market where investors in one platform are exposed to loans on a third-party platform.

5.6 Some of the interim results from our work on investment-based crowdfunding include:

- Concerns about inadequate disclosures on investment-based crowdfunding platforms and the downplaying of risk.

- Due diligence standards vary from firm-to-firm and not all firms explain their due diligence processes on their websites.

- None of the platforms we reviewed provided an assessment of the valuation of a pitch, although they did challenge the figures proposed by fundraisers.

- Not all firms aligned their business models with the possible future success of businesses raising finance (and, ultimately, the investors).

- Not all firms had an effective internal control system in place with regards to the processes used for approving or communicating financial promotions.

- Not all firms satisfied the requirements to conduct an appropriateness test to assess whether investors have the knowledge or experience to understand the risks involved in the investment.

5.7 Our ongoing supervision of the market will help us determine whether there is a need for further rule changes.

Consumer research

5.8 The Cambridge Centre for Alternative Finance at Cambridge Judge Business School, University of Cambridge, is working with us to carry out research with the investors and fundraisers on investment-based and loan-based crowdfunding platforms.[17] This research will collect and analyse data from investor and fundraiser surveys, qualitative interviews and crowdfunding platforms' transactional databases.

5.9 This will help us understand the needs and objectives of the people and organisations served by the crowdfunding sector. We will also compare this information with our understanding of

17 *Financial Conduct Authority and the University of Cambridge to review the alternative finance industry*, September 2016: http://insight.jbs.cam.ac.uk/2016/joining-forces-to-review-the-alternative-finance-industry/

the market in 2014, when the current regime was introduced, to see if the customer base has changed.

Proposals for new rules

5.10 Through our work to date, we have identified some specific concerns for which we consider there is potential for consumer harm to warrant consulting on additional rules. We are planning to consult on the following areas.

Loan-based crowdfunding

- Under our current rules, firms should have arrangements in place such that, in the event of their failure, existing loans continue to be administered. Our experience of authorising and supervising firms suggests that wind-down plans could be improved to reduce the risks to investors of the plans not operating as expected. We propose to strengthen the rules and plan to consult on additional requirements.

- Some firms operating loan-based crowdfunding platforms allow investment in loans originated on other platforms. Where the firm acts as an aggregator and does not originate loans, this is less likely to represent a risk to our objectives. However, where other firms allow cross-investment, we are concerned that this may give rise to risks to investors as the failure of one platform may have a direct impact on the viability of others. We plan to consult on additional requirements or restrictions on cross-investment.

- In the call for input we discussed our plans to consult on extending the usual mortgage-lending standards to loan-based crowdfunding platforms where the investor/lender is not acting by way of business. This was received positively by respondents and we will now proceed with the consultation.

Loan-based crowdfunding and investment-based crowdfunding

- We have concerns about the quality of communications with potential investors, particularly financial promotions. We remain concerned that standards of disclosure do not meet our expectations. As well as ongoing supervision of existing rules, we plan to consult on more prescriptive rules on the content and timing of disclosures we expect to see.

5.11 Our aim is to consult in the first quarter of 2017 and to publish the final rules in the summer of 2017.

Potential consultation on further rule changes

5.12 The consumer and market research should be completed early in 2017. At that stage, we will be able to complete the post-implementation review and determine whether further consultation on rule changes is needed. If necessary, we will be able to publish a second consultation on rule changes in mid-2017, with any such rules coming into force in 2018.

Annex 1
List of non-confidential respondents

Abundance Investment Limited

AltFi Data

Asset Match Limited

Assetz Capital

Association of Investment Companies

Association of Mortgage Intermediaries & Association of Finance Brokers

Association of Professional Compliance Consultants

Beauhurst

BondMason Ltd

Building Societies Association

BWB Compliance, Bates Wells Braithwaite

Compliancy Services Ltd

Council of Mortgage Lenders (CML)

Crowdcube

Crowdsurfer Ltd

DBA Group Ltd

DFW LLP

Downing LLP

eMoneyUnion

European Specialty Finance

Federation of Small Businesses

Financial Services Consumer Panel

Focus2020 Ltd

Fox Williams LLP

Funding Circle Limited

Funding Knight Limited

GLI Finance Limited

Goji

Howard Kennedy LLP

Institute of Chartered Accountants in England and Wales

Invest and Fund Ltd

Kession Capital Limited

Keystone Law Limited

Landbay Partners Ltd

Legal Alternative Limited

Lending Works Limited

LendInvest

Madiston LendLoanInvest

Money & Co

MoneySavingExpert.com Limited

Nabarro LLP

Neyber Ltd

OakNorth Bank Limited

Octopus Co-lend Limited

Peer-to-Peer Finance Association

Property Partner

Rangewell Limited

Seedrs Limited

Syndicate Room Ltd

The Crowdfunding Centre

ThinCats

TISA

Triodos Bank NV

UK Crowdfunding Association

VentureFounders Limited

Vestd Ltd

Victory Park Capital Advisors, LLC

Wealth Harbour Services Ltd

Wheatfromchaff Ltd

Yorkshire Building Society

Zopa Limited

Financial Conduct Authority

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