The regulation of loan-based crowdfunding platforms

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Financial Services analysis: Charles Leveque, partner at Harbottle & Lewis examines the recent consultation paper on rules to simplify client money requirements for firms that operate electronic systems in relation to lending (P2P platforms) and hold both regulated and unregulated client money accounts.

Original news

FCA proposes crowdfunding money rule change, LNB News 21/01/2016 121

The Financial Conduct Authority (FCA) is proposing to change its client money rules for companies which operate electronic systems in relation to peer-to-peer lending (ie P2P platforms), and hold both money for clients in relation to regulated P2P agreements under FCA client money rules, known as CASS 7, and money for clients in relation to unregulated lending.

What is the background to the consultation paper?

In broad terms, the consultation addresses the regulation surrounding the holding of monies by loan-based crowdfunding platforms that facilitate personal, as well as business, loans.

Since April 2014, the FCA has regulated the activities of certain digital platforms that facilitate loan-based crowdfunding. Typically these platforms allow individuals, businesses and/or institutions to lend to other individuals or businesses through the platform.

For a platform to fall within the scope of the FCA's regulation, the following criteria (in addition to others not considered here) must be met—either:

- the lender to the platform must be an individual, or
- the borrower who borrows through the platform must be an individual (or a small partnership or unincorporated entity)

In addition, the borrower must be either:

- borrowing less than £25,000 from the lender, or
- borrowing other than predominately for the purposes of a business

Loans of this kind are usually described as 'peer-to-peer' or 'P2P'. In contrast, loans that do not meet these conditions—such as a loan financed by businesses or institutions and made (through the platform) to businesses—are not regulated and referred to as 'business to business' or 'B2B'.

As a result of being regulated by the FCA, platforms that operate P2P loans are subject to a number of the FCA's regulations. These include the important obligation to categorise monies received from lenders and borrowers as 'client money' which is subject to the detailed rules set out in Chapter 7 of the Client Assets sourcebook (CASS 7).

Under CASS 7, client money is subject to a number of safeguards that are designed to ring-fence it if the regulated firm becomes insolvent. At their most basic level, these rules require the regulated firm to:

- segregate client money from other funds
- maintain adequate organisational arrangements to minimise the loss or diminution of client money
- diversify the holdings of client monies, and

keep adequate records and accounts to enable easy and quick identification of client monies

Why is the FCA consulting on this issue?
This consultation results from the FCA’s recognition that many platforms operate a mixture of P2P and B2B loans and that, for such platforms, it can be logistically complex to segregate, as is currently required by CASS 7, amounts to be lent and/or repaid under P2P loans from amounts to be lent and/or repaid under B2B loans. This is particularly the case where a platform decides to spread the risk of a borrower’s default amongst a number of different lenders (where the loan can, depending on the arrangements, be made up of a mixture of P2P and B2B loans). The consultation therefore proposes changes to CASS 7 so that the rules accommodate this kind of arrangement.

What are the main provisions of the consultation?

The proposed changes set out in the consultation do not ease the regulatory requirements in any way. Rightly, the FCA views the client money protections as a fundamental element of the P2P regulatory framework.

The consultation does, however, introduce additional flexibility for platforms that hold money in relation to both P2P and B2B loans by permitting them to elect to hold all lenders’ monies subject to the requirements of CASS 7 (and not just P2P monies). It is important to note that this would be an election and not an obligation. Platforms operating mixed loans would not be required to hold all lenders’ monies as client money in accordance with CASS 7. If they wish, such platforms can continue to hold monies in relation to P2P loans as segregated client money, separate from monies held on account of B2B loans.

Those platforms that make the election would not then be required to segregate P2P monies from B2B monies. Such platforms would, however, be required to hold all money on account of loans as client money subject to the same requirements as those currently applicable to P2P monies.

What actions will loan-based platforms have to take should the provisions be implemented?

Loan-based crowdfunding platforms that operate both P2P and B2B loans will need to determine whether their processes, policies and procedures which currently exist (as a result of the current requirement to separate amounts destined for P2P and B2B borrowers and lenders) could be streamlined as a result of the proposed changes. If so, such platforms should prepare for the possibility of electing to hold all loan monies as client money under CASS 7.

To make an election, these platforms will need to notify the FCA and all their lender clients in writing. This notification will presumably be interpreted as good news by lenders of B2B finance because the election will afford additional protections to their funds.

What should lawyers be advising their clients?

Lawyers should be advising their platform clients to conduct a commercial analysis of the burden of segregation of P2P monies from B2B monies.

Those platforms that make the election to treat B2B monies as client money should be advised that:

- All lender monies in relation to B2B monies will need to be held as client money—it will not be possible to treat B2B monies that form part of mixed B2B/P2P loans differently from B2B monies that are used to finance whole loans.
- They will not be able to rely on the professional client opt-out (an election that certain sophisticated clients can make which reduces certain of the regulatory requirements for the platform), and
- They may be able to make use of the trustee firm rules which would reduce the number of CASS 7 rules that apply to B2B monies.

Charles Leveque advises on corporate transactions relating to both publicly listed and private companies, including mergers and acquisitions, fundraisings (both on and off market), joint ventures, corporate re-organisations and public offerings of securities. Charles has advised crowdfunding platforms and has spoken and written widely on crowdfunding and alternative forms of finance.

Interviewed by Barbara Bergin.
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