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FCA Publishes Consultation Paper on Loan-based Crowdfunding Platforms and Segregation of Client Money

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Financial Services and Regulation

On January 21, 2016, the Financial Conduct Authority (FCA) published a consultation paper (CP16/4) on the segregation of client money by firms that operate loan-based crowd funding platforms. The FCA is consulting on rules to simplify client money requirements for firms that operate electronic systems in relation to peer-to-peer ("P2P") lending platforms and which hold both regulated and unregulated client money accounts.

Background

Crowdfunding is a method by which people, organisations and businesses (including business start-ups), can raise money through online portals (also known as crowdfunding platforms) to finance or re-finance their activities. Money can be donated or invested in various ways by both individuals and businesses. Some crowdfunding activity is unregulated, whilst some is regulated and some is exempt from regulation. CP16/4 focuses on the regulated loan-based crowdfunding sector, which includes P2P lending.

Currently, an investor's money held by a firm in relation to P2P agreements (being money to be lent or received in repayments) would fall within the definition of client money for the purposes of the client money rules in the Client Assets Sourcebook ("CASS") 7. Accordingly, it must be segregated from the firm's own money and other money. The FCA has found that some firms find the existing rules burdensome, as firms in the P2P industry have generally not developed systems that distinguish between money held for the purposes of P2P agreements and the money held for business-to-business ("B2B") agreements. The FCA says that on insolvency, co-mingling the money in a way that is not compliant with CASS could cause significant delay and expense in returning client money, which would lead to consumer detriment.

The FCA has found that many firms want to offer the protection afforded by CASS to all lenders, including both those entering into P2P agreements and those entering into B2B agreements and wishing to hold all monies belonging to lenders together. However, the FCA also notes that some firms may prefer to hold money for clients of their B2B lending activities, involving only "whole loans" from one business to another business, separate from other client money - that is, client money relating to P2P agreements and "mixed loans".

The FCA's Proposals

With this in mind, the FCA is proposing to allow firms that hold money in relation to both P2P and B2B agreements to be able to elect to hold all lenders' monies under CASS 7, if they wish to do so. Firms would then be able to hold P2P and B2B money together, segregated from the firm's money, without breaching the CASS rules and without having to distinguish

between P2P and B2B agreement money. The FCA does explain, however, that if a firm does make the election to hold all P2P and B2B monies under CASS 7, then all lender monies in relation to B2B agreements would need to be held as client money under CASS 7 and the firm would not be able to reply on the professional client opt out. In addition, the FCA is proposing to extend its existing restriction against firms taking on full ownership of lender monies under title transfer arrangements, so that it covers the scope of the election. The FCA believes that the proposal is likely to reduce the burden of compliance with CASS for certain firms.

The FCA believes that the proposal will not adversely affect the level of consumer protection currently enjoyed by clients of P2P agreements and will overall ensure greater consumer protection by reducing complexity. B2B agreements will continue to fall outside the regulatory regime, so where firms are able to comply with the current rules, no additional action will be required. Where firms do decide to make the proposed election, they would need to keep a record of that decision and would need to notify the FCA and all their lender clients in writing. On ceasing the election, firms would need to notify B2B clients and the FCA. The FCA says that it believes that this would result in "only minimal costs" for firms.

In addition, the FCA is proposing new guidance which clarifies that where a firm operating a loan-based crowdfunding platform holds money that has not yet been invested for a client, this should be treated as client money held under the CASS Rules, unless the circumstances are such that it could never be invested in relation to a P2P agreement (for example, under an agreement with the client that its money would only be lent under a B2B agreement). For loan repayments, firms will be able to continue to use the "mixed remittance rule" (CASS 7.13.31R), which allows a firm to receive a single loan repayment from a borrower into a client bank account and remove any B2B monies at the firm's next daily reconciliation.

Appendix 1 to CP16/4 contains draft Handbook text implementing the changes, including a draft of the proposed Client Assets Sourcebook (Amendment) Instrument 2016. CP16/4 also contains a cost benefit analysis and a compatibility statement.

The consultation period closes on February 11, 2016. The FCA says that it is aiming to publish a policy statement implementing final rules in March 2016.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Financial Services and Regulation practice group:

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