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Crowdfunding  
and FCA  
Authorisation



# Crowdfunding and FCA Authorisation

## Introduction

Crowdfunding can be described as a means of raising finance for individuals, firms, charities or activities by bringing them together with potential lenders or contributors via an electronic platform or website.

There are a number of categories of crowdfunding, which can generally be summarised as follows, but only the last two categories need to be regulated by the FCA:

- (1) donations and reward-based crowdfunding;
- (2) statutory exemptions-based crowdfunding;
- (3) loan-based crowdfunding; and
- (4) investment-based crowdfunding.

Category (1) relates to financing for charities or other similar non-profit organisations and payments made in return for a reward, service or product, such as concert tickets or a new innovative product. Category (2) relates to Enterprise Investment Schemes, which satisfy the necessary conditions for exemption for authorisation by the FCA.

The remainder of this note generally relates to categories (3) and (4), as both of these types of crowdfunding require FCA regulation.

## FCA regulatory approach

The FCA published a consultation paper in October 2013, detailing its proposed approach to the regulation of firms operating online crowdfunding platforms or other similar activities. Following its consultation, the FCA's rules relating to crowdfunding came into effect on 1 April 2014, subject to certain transitional arrangements.

The new rules relate to both loan-based and investment-based crowdfunding, albeit that investment-based crowdfunding was already

regulated by the FCA prior to 1 April 2014. The new rules proposed by the FCA in respect of investment-based crowdfunding relate to promotion, namely that these investments should only be promoted to those who understand the inherent risks or have the financial capacity to bear any losses.

Unlike investment-based crowdfunding, loan-based crowdfunding is a consumer credit activity and the FCA took over the regulation of consumer credit from the Office of Fair Trading in April 2014.

## Loan-based crowdfunding

Loan-based crowdfunding facilitates loans between individuals and individuals and businesses. The former is more familiarly known as peer-to-peer (P2P) lending, the latter as peer-to-business lending.

### *Article 36H RAO: operating an electronic system in relation to lending*

The relevant regulated activity relating to loan-based crowdfunding is set out in Article 36H of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("RAO"). Article 36H RAO establishes that P2P platforms are carrying out a regulated activity if they are facilitating lending and borrowing between two individuals or between individuals and businesses under an article 36H agreement (see further below) i.e. operating an electronic system in relation to lending. A person must not operate an electronic system in relation to lending unless he is an authorised person or an exclusion applies.

Firms holding an appropriate Office of Fair Trading licence to operate loan-based crowdfunding platforms before 1 April 2014 were allowed to apply for interim permission to continue conducting the activity pending application for full FCA authorisation. Firms with interim permission have been allotted a time



window by the FCA, generally between August and October 2015, during which time they must have applied for full FCA authorisation or lose their authorised status. Those firms entering the market after 1 April 2014 are required to seek full FCA authorisation from the start.

An 'article 36H agreement' is an agreement between the borrower and the lender by which the lender provides the borrower with credit and the condition in either (i) or (ii) is satisfied:

- (i) the lender is an individual or relevant person; or
- (ii) the borrower is an individual or relevant person and
  - (a) either the lender provides the borrower with credit less than or equal to £25,000; or
  - (b) the agreement is not entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower.

A 'relevant person' means a partnership of two or three persons or an unincorporated body (which is not a partnership).

Thus, if neither (a) nor (b) is satisfied, then the agreement is not an article 36H agreement and the article 36H regulated activity will not be applicable.

### **FCA authorisation**

In addition to the usual regulatory business plan required when applying for FCA permissions, a P2P platform must have an operational or close to operational website and adequate financial resources. The minimum capital requirement is currently £20,000, but this will increase to the higher of £50,000 or a percentage of loaned funds from 1 April 2017. In addition, the platform must have resolution plans in place such that, in the event of the platform failure, loan repayments will continue to be collected and the loan will be managed until maturity.

Platforms holding client money will need to be authorised to hold client money, which they will hold as trustee, and the monies will be held subject to the FCA's client money rules as set out in CASS.

### **Advertising and promotion**

Any promotions (such as print, broadcast or online advertising) must be fair, clear and not misleading and promotions that are not can be banned by the FCA. Any comparison of a P2P loan interest rate with a regular savings account rate must also be fair, clear and not misleading. Further, information provided about the platform must be clearly presented and all communications must be presented in a way that can be easily understood. The rules require firms to ensure that investors have enough information to make informed investment decisions and platforms must not play down risks or warnings.

### **Financial Services Compensation Scheme**

Investments made via a P2P platform are not covered by the Financial Services Compensation Scheme, which should be made explicitly clear to potential investors, because the FCA considers that the regulatory capital and resolution plans in place in case of platform failure should be sufficient to protect investors. However, this will be reconsidered as part of the FCA's review in 2016.

### **Investment-based crowdfunding**

Investment-based crowdfunding is used for capital raising by new or established businesses and investors invest directly or indirectly by buying shares or debt securities not listed on any recognised exchange or units in unrecognised collective investment schemes, collectively referred to by the FCA as 'non-readily realisable securities'.

As these securities are not listed and carry significant risks, the new rules introduced by the FCA, referred to above, relate to their distribution. The new rules, which came into effect on 1 October 2014, include marketing restrictions, with the result that firms may only



make direct offer promotions to retail clients who meet certain criteria, namely investors who:

- (i) qualify as high net worth or sophisticated investors (within the meaning of the FCA rules); or
- (ii) take regulated advice from an authorised person; or
- (iii) confirm they will invest less than 10% of their net assets in this type of security; or
- (iv) are a venture capital contact or corporate finance contact; or
- (v) professional clients.

Firms are also required to check whether the customer understands the risks of the relevant investment if they do not take regulated advice.

It should be noted that the Companies Act 2006 prohibits shares in a private limited company being offered to the public, thus businesses raising capital on a platform are generally constituted as public limited companies.

### **FCA authorisation**

As mentioned above, investment-based crowdfunding already fell within the scope of FCA regulation prior to the introduction of the new rules in April 2014. The authorisations generally required for a platform provider operating the investment-based model are 'arranging deals in investments' pursuant to article 25 RAO and holding client money pursuant to article 40 RAO and as referred to in the loan-based crowdfunding section above.

### **Other applicable legislation**

In addition to the regulatory and supervisory role of the FCA, other legislation which is applicable in relation to the promotion and marketing activities of crowdfunding platforms includes:

### **Consumer Protection from Unfair Trading Regulations 2008**

The 2008 Regulations control every form of promotion and marketing activity to consumers and require that all information must comply with the following conditions:

- (i) it must not be aggressive;
- (ii) it must not be unfair; and
- (iii) it must not be misleading.

### **Consumer Rights Act 2015**

This Act applies to all consumer contracts which provide a service to the consumer from 1 October 2015. The Act will apply to P2P platforms as the platform is providing the consumer with an opportunity to lend. The Act imposes a statutory duty requiring all services provided to a consumer to be performed with reasonable care and skill, a breach of which could lead to a claim in damages. The Act does not govern the terms and conditions of the consumer contract, but does set out how the contract should be presented i.e. the terms must be plain, clear, intelligible and transparent. If a term is ambiguous, the courts are required to give it a meaning which is most favourable to the consumer. The courts also have the right to determine whether a term is fair or unfair and, if a term is found to be unfair under the Act, it follows that this is likely to be an offence under the 2008 Regulations as well.

### **Next Steps**

The FCA has carried out a review of its regulatory regime for crowdfunding and related promotional activities and published its report of that review in February 2015. The report concluded that the FCA does not see a need to change its regulatory approach to crowdfunding, but will carry out a full-post implementation review in 2016 to identify whether any changes are required at that stage.

If you would like to discuss this further, please contact Claire Cummings at [claire.cummings@cummingslaw.com](mailto:claire.cummings@cummingslaw.com) or on 020 7585 1406.

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