



19 December 2013

Our ref: ICAEW Rep 175/13

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Dear Mr Pope and Ms Cooper

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

ICAEW is pleased to respond to your request for comments on *The FCA's regulatory approach to crowdfunding (and similar activities)*.

Please contact me or Philippa Kelly (philippa.kelly@icaew.com and 020 7920 8446) should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

THE FCA'S REGULATORY APPROACH TO CROWDFUNDING (AND SIMILAR ACTIVITIES)

Memorandum of comment submitted in December 2013 by ICAEW, in response to the Financial Conduct Authority's consultation paper, The FCA's regulatory approach to crowdfunding (and similar activities), published in October 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *The FCA's regulatory approach to crowdfunding (and similar activities)*, published by the Financial Conduct Authority in October 2013, a copy of which is available from this [link](#).

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. ICAEW members working in a broad range of disciplines have strong views on the subject of the consultation. We have taken into account views from, inter alia, members of the ICAEW's Corporate Finance Faculty and Financial Services Faculty, as well as a number of members running, or with experience of investing in, small businesses.
5. The Corporate Finance Faculty contributes to policy development and many consultations by international organisations, governments, regulators and other professional bodies. The faculty's professional network includes 6,000 members and more than 70 member organisations. Its membership is drawn from major professional services groups, specialist advisory firms, companies, banks, private equity, venture capital, law firms, brokers, consultants, policy-makers and academic experts. More than 40 per cent of the faculty's membership is from beyond ICAEW. The faculty provides a wide range of services, events and media, including its magazine *Corporate Financier*. The faculty initiated the development of the first international Corporate Finance qualification (including the 'CF' designation) for practitioners and launched a Diploma in Corporate Finance with the CISI in 2012.
6. The Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from the 25,000 ICAEW members specialising in the sector and provides a range of services and provides a monthly newsletter *FS Focus*.
7. ICAEW believes that sustainability is one of the biggest challenges facing business today. Our sustainable business thought leadership work examines the action, activities, and obligations of businesses in achieving a sustainable world. We work at the forefront of debate around how markets can promote sustainable business and how this creates opportunities for our members and the wider business community.

MAJOR POINTS

8. We agree with the principle that crowdfunding platforms should be regulated and should operate within a reputable framework as opposed to 'under the radar'. All platforms should however have a duty to verify the existence of the businesses seeking finance due to the inherent high risk of fraud. Businesses seeking to raise finance via platforms will include start-ups and businesses for which that source is the only option. Mainstream finance providers would typically describe the advantages and disadvantages of types of finance and platforms

should not be any different. The platforms should thus be obliged to set out the implications to businesses of raising funds through particular forms of crowdfunding.

9. We mostly agree with the proposals for loan-based crowdfunding although it is unfortunate that the client money regime that platforms will have to adopt from 1 April 2014 is likely to change significantly. We have also identified areas where transparency can be further enhanced, such as risk transfer.
10. We find the proposals for investment-based crowdfunding problematic for a number of reasons.
11. We do not agree that the risks facing investors in unlisted shares or debt securities, such as those promoted via investment-based platforms, are similar to the risks faced by venture capital and corporate finance contacts when choosing to invest in private equity. In fact the risks are higher while a lesser degree of due diligence is possible on investment opportunities offered. We believe that where a business is seeking to raise funds above a certain higher level (eg £1 million), there should be a requirement for the platform to secure quality due diligence which should be made available to all potential investors. We recognise that it is likely for good quality, independent advice to cost more than the investment in the majority of cases.
12. We believe that the proposals for investment-based crowdfunding ignore the true nature of the crowdsourcing model and consequently, do not address the needs of the population of micro companies seeking to raise finance. The proposals will impose a framework that does not enable start-up businesses to access limited amounts of capital at reasonable cost and nor does it satisfactorily protect those who are prepared to incur speculative or discretionary expenditure by providing small amounts of money to such businesses. The endorsement of FCA regulation will give the wrong impression and it would be better not to impose regulation on investments on crowd funding platforms below a de minimis threshold, eg £1,000 - £2,000, which can be reviewed.
13. Conversely by allowing an individual to self-certify that they will invest no more than 10% of net assets (as defined in 4.7.1 of the amendments to COBS) in non-readily realisable securities via an investment-based platform, the current proposals do not strike a consistent balance between ease of access and risk with other activities covered by the FSMA 2000. A marked example would be the level of disclosures and health warnings for AIM issues even where these are not public offerings. This approach has foreseeable negative consequences.
14. It is likely that crowdfunded investors will only ever hold a small minority of shares in the business with no substantial voting rights and are unlikely to be able to exercise significant influence, even if they were able to act as a cohesive group. This causes us some concern, as with no ability to control or influence a vote, the 'crowdfunders' could lose or have dramatically altered their rights through reorganisation of capital structure, impacting their future return. Collective shareholding by an organisation representing the interests of minority shareholders will not, in our view, resolve this problem.
15. We are also concerned that the intention to capture firms selling 'mini' or 'retail' bonds in the new regime has not been clearly communicated. A wide spectrum of established businesses seeks to raise funds via such bonds and would not necessarily expect that this consultation paper affects them. We believe that the application of the proposed regime should be communicated separately.
16. As mentioned at our meeting on 11 December, we believe that an insufficient amount of time has been allowed for this consultation. The proposals relate to forms of finance and diverse business models with a relatively short record in major economies, including the UK, and whose potential impact merits more detailed consideration. The resulting regime may be a missed opportunity to develop crowdfunding into a sustainable source of finance for

businesses that have few other options, including ones that are based in remoter areas or outside financial centres.

RESPONSES TO SPECIFIC QUESTIONS

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

17. The assessment does not consider the business that might use these platforms and which is unaware of, or cannot understand, the implications of raising funds in this manner.

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

18. At present, yes, but it will be important to remain open to reviewing the assessment as these forms of finance (and, indeed, the variety of business models) evolve and alternatives emerge.

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

19. A transitional period is certainly required as platforms are regulated for the first time. While six months is sufficient time to have begun implementing changes to business models, controls and processes that will be required in order to comply with the new regulation, it may not be long enough to assess the effectiveness of the operation of these controls and processes and make the necessary improvements.
20. With regard to the transitional period relating to compliance with the client money (CASS) rules, a longer period may be needed given the current state of flux of the rules. We understand that a policy statement on the revised CASS regime will not be available until March 2014 at the earliest. This gives rise to some concern that firms applying this detailed regime, which can be onerous to small businesses, may not be able to comply by 30 September 2014 depending on the actual date of the new regime being unveiled. This is considered further in our answer to question 16.
21. The FCA has consulted a number of existing platforms, businesses and investors. Other relevant parties may not have been involved in this engagement. We believe that there is a need to communicate the forthcoming changes to the regulatory regime in the manner of other recent campaigns eg pensions auto enrolment.

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

22. We agree with the risks set out in chapter 2 but consider that they are not a complete list.
23. We do not agree with the assessment in para 4.11 that the risk of investing via a crowdfunding platform is similar to the risk of venture capital or private equity investment. Regardless of the level of formal due diligence available for review by potential investors, funds can be committed via a crowdfunding platform without any personal contact between the investor and the individuals involved in the business. Successful investors in small companies typically bring oversight, trade contacts and other advantages to a business that they often know well. Venture capital investors typically reduce their investment risk by getting to know the principals involved in the company and understanding their personal capabilities and motivation. In addition they reduce the possibility of individuals simply walking away from a business via service agreements.

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

24. We agree that loan based crowdfunding, also described as peer to peer lending, should not be within the scope of the FSCS. The FSCS protects consumers undertaking low risk savings activity. Lending money over a peer to peer platform to earn an enhanced rate of return is not the same activity as saving by means of a deposit at a bank or building society.
25. Peer to peer platforms frequently compare their rates of return to that of high street bank deposit interest rates, but we do not feel that this is a like for like comparison. The risks associated with peer to peer lending and the fact that it lies outside the protection of the FSCS should be made very much clearer to consumers than is currently the case by the platform, and we believe this should be required within the FCA's future rules.

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

26. We agree.

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

27. We believe that in order to ensure a level playing field the transitional provisions should exist for both the fixed minimum and volume based requirement. Introducing the volume based requirement in full at the point of authorisation could be unfair to larger firms.

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

28. We agree that loan-based crowdfunding platforms should be subject to the client money rules where the firm holds money on behalf of the investor (lender) before it is passed to the borrower, and repayments received. However, given that the client money regime for investment businesses is currently subject to the most far reaching changes since before the financial crisis, we would urge the FCA to consider the final rules (expected March 2014) before making a decision on their applicability to loan-based crowdfunding platforms, and how best to allow the platforms to transition to the new regime.

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

29. We agree with the proposal set out in para 3.40 that money repaid by borrowers to the platform should be repaid by the insolvency practitioner to investors.

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

30. We agree that risk transfer as described should be made transparent in order to protect the borrower where payments are made to a platform in good faith in the period immediately preceding failure. Given that there will be no dialogue between the contracting parties (investor and borrower) this information should be freely accessible to both parties before they enter into the contract.

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

31. Yes.

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

- 32.** We agree that firms operating loan-based crowd funding platforms should be required to have arrangements in place so that existing loans continue to be administered if the platform fails. We are aware that, while many firms already have such arrangements in place, these vary greatly. Some types of arrangement may be more suited to others to deal with the practicalities of handling the run off of the loan book. We note the regulatory approach to failure in other areas is to require the regulated firm to have a fund in place to cover a specified time period of running costs in the event of failure to allow operations to be wound up. Given the varying loan durations, we do not know if this would be practicable for crowdfunding platforms. There would also be reducing income over time, where no new loans are able to be made, and the book runs off, meaning that fixed costs of administering the portfolio would become more burdensome as time went on.
- 33.** We agree that it is of utmost importance that the rules dealing with platform failure do not compete with the client money rules.

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

- 34.** We agree with the proposal in para 3.53.
- 35.** However, in relation to para 3.54, it will be unhelpful and confusing for consumers to permit firms without a secondary market to choose between two very different systems for allowing the consumers to change their mind at the start of their contract.

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

- 36.** We support the approach.

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

- 37.** We agree.

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

- 38.** Broadly, yes, we agree that the scope of the information that platforms should report to the FCA should include financial position, client money, investments and complaints.
- 39.** Where these requirements capture firms which will be being regulated for the first time, and may not have a named FCA contact, but deal solely with the contact centre, we would urge the FCA to be proportionate in their approach to the first year of reporting to enable firms to refine their reporting processes. Where controls and processes around reporting are being put in place for the first time, it may be more likely that there will be breaches as these evolve, which will be resolved in subsequent reporting cycles.
- 40.** We think the costs of reporting may be underestimated, based on the time elapsed since the estimated figures in CP10/09 and the need to source additional expertise to help smaller platforms deal with the CASS regime and fulfil the potentially more costly audit requirements under the new CASS rules.

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

41. We believe that the approach lacks vision in that it fails to facilitate businesses seeking to raise small amounts of funds by accessing individuals willing to make limited speculative expenditure. There is an opportunity for the approach to genuine crowdsourcing to go further and enable more businesses to access finance in this way.
42. The consultation paper states that platforms generally need to have a sufficient number of clients on either side of the market to be commercially viable (Annex 1, para 2). Yet the proposed requirement that promotions are not even communicated to prospective clients unless they meet one of the restricted types, both reduces consumer choice and makes it harder for platforms to attract potential investors and borrowers or issuers.
43. Certain clarifications are also lacking or would benefit from enhanced communication; eg:
- the intention to change the regime for 'mini' or retail bonds;
 - the definition of 'net investible portfolio'; and
 - the nature and extent of due diligence to be carried out by a platform on the businesses seeking backing.

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

44. We have no further comments.

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

45. As mentioned in our response to Q16, the cost benefit analysis does not include the costs relating to a client money audit.

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

46. The compatibility statement does not address the potential rewards to businesses from funding provided through small amounts of investment via a regulated platform.

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