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## FinTech in the UK: Regulating Disruption

**By Ronnie Yearwood, Shehram Khattak, Jonathan Lawrence and Sonia Gioseffi**

The United Kingdom Government's Chief Scientific Adviser in its 2015 FinTech Report considered "FinTech" as the integration of "*finance and technology in ways that will disrupt traditional financial models and businesses and provide an array of new services to business and consumers. The hybridisation of technology with the traditional process of finance - working capital, supply chain, payments processing, deposit accounts, life assurance and so on - replaces traditional structures and ways of working with new technology-based processes.*"<sup>1</sup>

In 2015, it was estimated that the FinTech industry in the UK and Ireland was worth £20bn and the fastest growing region for FinTech globally.<sup>2</sup> The Chancellor of the Exchequer of the UK declared that the Government's intention was to make the UK the FinTech capital of the world.<sup>3</sup> As the Chancellor stated, "I want the UK to lead the world in developing FinTech. That's my ambition - *short and sweet.*"<sup>4</sup>

This insight aims: (1) to analyse the "newness" of the FinTech space, with a focus on crowdfunding/marketplace lending and (2) to discuss some of the legal issues for the industry in the UK, particularly in relation to "fair, clear and not misleading" communications.

### There is nothing new under the sun

At times it may appear from the way the FinTech sector is described or commented on, that it is a brand new phenomenon floating outside the rules, conventions and regulations that have governed banks, finance, money, trading and service providers in the loan and capital markets for hundreds of years.

Crowdfunding or marketplace lending are terms that loosely refer to the growing industry of internet-based alternative lending platforms for consumers and businesses. Although such platforms are part of the "new" FinTech space, the principles underlying them have been a standard part of the financial market for many centuries, and the concepts on which they are based (such as joint ventures or donations) may be traced even further back. A prominent example is that of Joseph Pulitzer who launched a fundraising campaign in his newspaper, *The New York World*, to raise US\$250,000 to fund the plinth on which the Statue of Liberty stands, offering rewards such as gold coins for the largest

<sup>1</sup> FinTech Futures: The UK as a World Leader in Financial Technologies: A Report by the UK Government Chief Scientific Adviser, March 2015, page 5 (Our emphasis in italics)

<sup>2</sup> *Ibid*

<sup>3</sup> See for example:

Remarks by the Chancellor of the Exchequer at the Bank of England Open Forum, 11 November 2015 (and as reported in the media: Peter Campbell, "Osborne wants London to be 'global centre for fintech'", *Financial Times*, 11 November 2015)

Speech by the Chancellor of the Exchequer, the Rt Hon George Osborne MP: "Chancellor's speech at the launch of the new trade body for FinTech, 'Innovate Finance'", 6 August 2014 (<https://www.gov.uk/government/speeches/chancellor-on-developing-fintech>)

<sup>4</sup> See speech by the Chancellor of the Exchequer, the Rt Hon George Osborne MP: "Chancellor's speech at the launch of the new trade body for FinTech, 'Innovate Finance'", 6 August 2014 (<https://www.gov.uk/government/speeches/chancellor-on-developing-fintech>)

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donors.<sup>5</sup> The new element in today's crowdfunding industry is the use of the internet and technology, generally to seek and deploy capital.

In the current market, the process of raising money and lending money has partially moved from physical offices to the internet, as driven by information technology to a large degree. However, the underlying dynamics of borrowing and lending will still be familiar to anyone in the loan and capital markets sector. The UK Financial Conduct Authority (FCA) has stated that there are "different models [of crowdfunding] and, as the market is still evolving, it is possible that new types of platforms and new risks will emerge."<sup>6</sup> The point is that risks still exist in a lender-borrower scenario, whether in the more traditional loan agreement or via a crowdfunding/marketplace lending platform. In other jurisdictions, such as the United States, given the changes in the laws, there are additional risks: for example, having lower thresholds on investors who may invest in small start-up companies. Also, there are the risks of new products and new participants entering the market. Not only may the products be unfamiliar, but the participants may have yet to develop market sophistication, for example in relation to appropriate valuation methods.<sup>7</sup> Certain new products developed within the FinTech space may have a high risk profile and have limited regulatory oversight, for example the on-sale of packages of consumer loans.

Understanding where to locate the "newness" in the numerous FinTech business models is essential to understanding how to advise FinTech firms on the donor, lender or borrower side. The novelty can be located in the technology itself, and in the extraction of services that larger banks would perform, which may now be done singularly by various FinTech companies. The risks and rules of each area still exist, but now compliance has been devolved to other smaller companies. What we may be witnessing is simply a shifting risk profile that will, in time, reveal its own organisational and legal challenges.

The technology increases the speed of transactions, while simultaneously making it less difficult for new market entrants. While novel, market participants need to show caution and not allow a risk-free aura to evolve around FinTech providers. This could have the potential of promoting an artificial narrative between new/old lending and borrowing, as if risks have been all resolved because of the apparent newness of the *Tech* in *FinTech*. FinTech still has to exist and function in what is a very old sector that dictates the flow of money and information, that is, the *market*. Market participants (businesses, consumers and regulators) must know the rules by which they engage with each other.

### Disruptive, but the rules still apply

A FinTech firm may be disruptive in their technology and their product offering. That disruptive nature, however, does not mean a FinTech firm or its related products/services

<sup>5</sup> See <http://www.bbc.co.uk/news/magazine-21932675> (25 April 2013)

<sup>6</sup> See <http://www.fca.org.uk/consumers/financial-services-products/investments/types-of-investment/crowdfunding>

<sup>7</sup> See, Goncalo de Vasconcelos, "Valuations In Crowdfunding: Are We All Barking Mad?", *Forbes* (27 May 2015) (<http://www.forbes.com/sites/goncalodevasconcelos/2015/05/27/valuations-in-crowdfunding-are-we-all-barking-mad/#2715e4857a0b4d62b61944c6>)

In the article (page 2 of printed version) it was reported, for example, the problems with valuation in the FinTech sector and the effect on professional and non-sophisticated investors: "Camden Town Brewery first raised finance from the crowd at a valuation of £75m. Shortly after, it raised money from the professionals at £50m. Camden Town Brewery not only reduced its valuation for the professionals but also, and more worryingly, the professionals got preference shares with downside protections whereas the crowd got shares without any of the downside protections."

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escape the rules that generally govern other market participants. Recently, the US Securities and Exchange Commission adopted its long-anticipated “Crowdfunding Regulation”, which governs the offer and sale of securities pursuant to Section 4(a)(6) of the Securities Act of 1933, as amended. This included provisions on the regulation of “funding portals” and brokers that facilitate the offer and sale of securities in the crowdfunding space. Under the rules and through the “cloud”, an expanded category of investors (the “crowd”) can invest in the securities of, and provide capital to, issuers, particularly start-ups and other small businesses.<sup>8</sup> The US regulators have developed a new regulatory framework for crowdfunding, whereas, in the UK, the regulators appear to be currently applying existing principles within the prior framework. The FCA has stated that crowdfunders were providing “misleading or unrealistically optimistic impression of the investment”<sup>9</sup> to consumers with little experience in investing. However, it has been reported that the “FCA is [still] keen to promote innovative financial technology as well as individual investing in stock markets, and is understood not to want to kill off the fledgling sector.”<sup>10</sup>

The FCA introduced an Innovation Hub, the purpose of which is to allow “new and established businesses - both regulated and non-regulated - to be able to introduce innovative financial products and services to the market.”<sup>11</sup> It also plans to expand its Project Innovate initiative launched in October 2014 by introducing the Regulatory Sandbox (the “**Sandbox**”), as a “safe space” where businesses “can test innovative products, services, business models and delivery mechanisms without immediately incurring all the normal regulatory consequences of pilot activities”.<sup>12</sup> The Sandbox will become operational in spring 2016.<sup>13</sup> It remains to be seen whether market players will use the Sandbox, especially if there are concerns about back-door regulation through directly sharing their methods and technology with the regulator or whether such players see benefits in having the regulator generally “bless” the products and services from inception. Furthermore, at some point, there may have to be an examination of the (unintended) consequences of the Sandbox, which may engender a close relationship between firms and the regulator while at the same time affecting the freedom of innovation within firms and removing the distance between firms and regulators. However, given the Sandbox, the UK provides possibilities for all market participants to contribute to this emerging sector. While we recognise that the *tech* is new, risks have not and will not disappear and firms, such as crowdfunding/marketplace lending

<sup>8</sup> See K&L Gates Legal Insight: Joining the Crowd: SEC Adopts Final Crowdfunding Regulations - Part I and II

(<http://www.klgates.com/joining-the-crowd--sec-adopts-final-crowdfunding-regulations---part-i-11-10-2015/> and <http://www.klgates.com/joining-the-crowd-sec-adopts-final-crowdfunding-regulations--part-ii-issuers-11-19-2015/>).

<sup>9</sup> See “A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media”, *Financial Conduct Authority*, February 2015, page 8 (<http://www.fca.org.uk/static/documents/crowdfunding-review.pdf>) (“FCA review of the regulatory regime for crowdfunding”)

See also, “FCA rebukes equity crowdfunding companies”, (Judith Evans and Emma Dunkley) *Financial Times*, 3 February 2015

<sup>10</sup> “FCA rebukes equity crowdfunding companies”, (Judith Evans and Emma Dunkley) *Financial Times*, 3 February 2015

<sup>11</sup> See <https://innovate.fca.org.uk/>

<sup>12</sup> See “Regulatory sandbox report”, *Financial Conduct Authority*, November 2015 (<https://www.fca.org.uk/your-fca/documents/regulatory-sandbox>)

See <http://www.fca.org.uk/news/regulatory-sandbox>

<sup>13</sup> *Ibid*

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platforms and those using the platforms to raise capital, must be aware that protecting the consumer is still paramount and a primary concern of the FCA.

### Website and financial promotions: *Fair, clear and not misleading*

The FCA in its 2013 consultation paper on its regulatory approach to crowdfunding<sup>14</sup> stated that the “core concept at the heart of our [its] disclosure requirements is that all communications from the firm must be fair, clear and not misleading”.<sup>15</sup> The FCA identified a number of areas where firms were failing to be fair, clear and not misleading, which included:<sup>16</sup>

- A lack of balance, where disclosures emphasise benefits without a prominent indication of risks
- Insufficient information disclosure leading to a potentially misleading or unrealistically optimistic impression of the product
- Downplaying important information
- A banner headline rate of return that is often in double figures, without an explanation of the impact of charges, default rates and taxation
- Information on product risks obscured when on a separate page or at the end of a long page of information, relying on investors to click through to it or scroll down
- Only providing risk warnings after customers register
- Referring to the investments in loan agreements almost as if they are deposits

Later in the FCA 2015 review<sup>17</sup> in relation to investment-based platforms and loan-based crowdfunding platforms, the issues appear to persist. Notably, the FCA stated that the websites of firms provided “*insufficient, omitted or the cherry-picking of information, leading to a potentially misleading or unrealistically optimistic impression of the investment*”.<sup>18</sup>

The FCA has been clear that they will continue to monitor financial promotions in the space and will take action where firms fail to meet the requisite standards.<sup>19</sup> It is, therefore, imperative that FinTech firms pay due care and attention to their communications to consumers via their web-based platforms. Materials should be carefully reviewed and scrutinised to ensure that they can meet the test to be fair, clear and not misleading. At a high level, this means that website promotions should present information that is “complete and meaningful”.<sup>20</sup> Information should also be “balanced” and “straightforward” so that consumers can comprehend the risks of investing.<sup>21</sup> The

<sup>14</sup> *FCA Consultation Paper CP13/13\*\**, “The FCA’s regulatory approach to crowdfunding (and similar activities)”, October 2013 (<https://www.fca.org.uk/your-fca/documents/consultation-papers/cp13-13>) (“*FCA Consultation Paper CP13/13\*\**”)

<sup>15</sup> *FCA Consultation Paper CP13/13\*\**, para 3.56

See also *Conduct of Business Sourcebook* 4.2.1R(1) and *FCA Principles of good regulation*, Principle 7 (Openness and disclosure) which reads: “We should publish relevant market information about regulated persons or require them to publish it (with appropriate safeguards). This reinforces market discipline and improves consumers’ knowledge about their financial matters.”

<sup>16</sup> *FCA Consultation Paper CP13/13\*\**, para 3.56 - 3.60

<sup>17</sup> See note 9, “FCA review of the regulatory regime for crowdfunding”, para 53 - 58

<sup>18</sup> *Ibid*, para 54

<sup>19</sup> *Ibid*, para 59

<sup>20</sup> *FCA Consultation Paper CP13/13\*\**, Annex 4, para 3

<sup>21</sup> *Ibid*

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overall point is that the consumer must have information on the firm and the financial products at every relevant stage of the consumer process so that they can make “informed choices” about the investments and also make comparisons with other investments.

Furthermore, some of the legal and policy issues for crowdfunding/marketplace lending platforms to also consider include:

- The current review of the Prospectus Directive
- Cybersecurity ranging from customer information to platform integrity
- Data protection
- Technology-related risks from platform failure to protection of intellectual property rights
- Insurance coverage at a corporate and individual level
- Disaster planning: platform/technology failure or an investor run on the platform
- Misrepresentation in advertising and other materials

### Conclusion

Without doubt, FinTech companies are in some ways deconstructing the services offered by larger banks. However, risks are not resolved because of the *tech*, as information and financial products are marketed and sold via web-based platforms, social media or other technological applications. Consumers still need to be clearly informed about the firms and the financial products being offered. Firms must still ensure that they adhere to the principle that their communications are “fair, clear and not misleading”. It is, therefore, better for a FinTech firm to apply and take advice on best practice in this regard, which saves money and time in the interim, than to wait either for enforcement from the regulator or for market failure to drive responses.

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