

The UK Government's new Innovative Finance ISA

The UK Government is to introduce the Innovative Finance ISA ('IFISA'), which will enable an investor to pay into a tax-free ISA wrapper payments made by a borrower under a loan facilitated by an authorised P2P platform. An individual will be able to lend up to the ISA allowance threshold (currently £15,240). Lucy Frew and Chris Boylan of Kemp Little discuss the IFISA.

The IFISA is brought into being through an amendment to the Individual Savings Accounts Regulations 1998¹. Also, the RAO² will be amended to make advising on P2P agreements a regulated activity (RAO article 53(2)). The new IFISA and new regulated activity necessitate a number of the changes to the FCA's rules and guidance, with the FCA due to publish a policy statement making final rules in March in time for the IFISA's launch on 6 April 2016.

The new IFISA will not be extended to include equity crowdfunding investments - a type of investment that is often seen as similar to, but is in fact very different to, P2P lending. The loans that are eligible for IFISA inclusion are loan-based crowdfunding ('LBC') investments, specifically 'Article 36H agreements' as defined at Article 36H(4) of the RAO, usually referred to as P2P loans.

Broadly speaking, an Article 36H agreement is an agreement between a borrower and a lender by which the lender provides the borrower with credit and either: (i) the lender is an individual; or (ii) the borrower is an individual and the loan is £25,000 or lower and the agreement is not entered into by the borrower wholly or predominantly for the purposes of

the borrower's business.

An individual will be able to set up an IFISA via an FCA-authorised P2P platform. Firms operating regulated P2P platforms carry on the activity of 'operating an electronic system in relation to lending' as specified in Article 36H of the RAO.

Current regulatory regime

The FCA took over responsibility from the Office of Fair Trading for regulating firms that operate LBC lending platforms on 1 April 2014. Individuals can use these platforms to lend money to other individuals or businesses, or businesses can use them to lend to individuals, in the hope of receiving a financial return in the form of interest payments, together with repayment of capital. The FCA does not regulate donation-based crowdfunding or firms when they operate platforms that facilitate corporate-to-corporate loans that fall outside the scope of an Article 36H agreement.

In 2014 the FCA introduced rules and guidance to protect consumers investing in the regulated part of the LBC market. For LBC, these provisions focus on requiring that certain information is provided to consumers. The aim is to ensure information is given to consumers to help them assess the risks applying to LBC, understand who will ultimately borrow the money invested, and to make informed decisions. Firms operating regulated LBC platforms must also follow other core consumer protection requirements in the FCA Handbook. For example, client money must be protected and firms must meet minimum capital standards. The FCA also requires firms operating these platforms to have resolution plans in place so that, should the firm operating the platform collapse, loan repayments under P2P agreements will continue to be

collected and those lending money do not lose out.

New regulatory regime

To reflect the introduction of the IFISA, and the fact that providing advice on investing in P2P agreements will be a regulated activity, the FCA is amending certain definitions, adding guidance, and extending the application of certain provisions in the FCA Handbook. The FCA published a Discussion Paper (DP15/6) in November 2015 and a Consultation Paper (CP16/5) in February 2016 outlining the proposed changes to the FCA handbook to incorporate the new IFISA and the new FCA-regulated activity of advising on P2P agreements. In particular, the FCA will:

- Add guidance on existing disclosure rules to clarify what information firms should disclose in relation to IFISAs. This guidance requires firms to disclose details about the potential tax disadvantages arising if a consumer invests in a P2P agreement, held in an IFISA, which is not repaid. Firms should also disclose the potential tax disadvantages if the firm operating the platform fails as well as the procedure applying, tax consequences arising, and timeframes if an investor wants to cash in a P2P agreement held in an IFISA wrapper. Firms should also explain the procedure for transferring some or all of the P2P agreements held in an IFISA wrapper from one ISA manager to another and how long this may be expected to take.

- Apply FCA rules on suitability to firms making personal recommendations in relation to P2P agreements. The FCA will treat advice to invest in P2P agreements in broadly the same way as other regulated advice. The new activity will be included

within the definition of ‘advising on investments’ and added to the list of ‘designated investment business.’

- Apply rules that ban the payment or receipt of commission by firms in relation to personal recommendations involving advice on P2P agreements. The FCA will make advice provided to retail clients in relation to investment in P2P agreements subject to the rules that ban the payment or receipt of commission for personal recommendations, and the rule on inducements. As is the case when advising on other investments, advisers will need to have a charging model for advice in relation to P2P agreements that does not rely on the payment of commission. The commission ban will apply only to personal recommendations to invest in P2P agreements. It is not extended to other situations, such as unadvised sales arranged on aggregator websites via firms who do not provide regulated advice.

- Ensure that financial advisers who advise on P2P agreements are appropriately supervised and assessed as competent to carry out that activity (including attaining an appropriate qualification). The FCA will not require advisers to hold qualifications specific to this type of business.

- Provide consumers who receive advice on P2P agreements with access to the Financial Ombudsman Service and Financial Services Compensation Scheme (‘FSCS’).

The FCA is not currently proposing that firms holding themselves out as independent should be obliged to consider P2P agreements when recommending retail investment products but may review this approach in future.

Provisions in the FCA Handbook that apply to ISAs generally, such as rules relating to a consumer’s

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cancellation rights, and client money, will apply to IFISAs in the same way as they apply to stocks and shares ISAs. The effect of the cancellation rules will differ depending on the nature of the firms’ business models, and whether the investment is considered a distance contract or a non-distance contract.

Firms that recommend investments to clients are generally required to meet minimum capital resources requirements and, in some cases, to hold a minimum level of professional indemnity insurance. Firms that advise on P2P agreements will be subject to these requirements in the same way. The rules will be changed to ensure that firms given permission to advise on P2P, if already authorised remain subject to the same prudential sourcebook when calculating their prudential requirements. Firms that only wish to advise on P2P agreements will be treated as personal investment firms and subject to the rules in IPRU(INV).

Impact on firms

All firms now need to assess their regulatory status to determine whether they need to become authorised or extend their existing authorisation and on how the changes to the FCA rules impact their business models. Firms with permission to carry on the current RAO Article 53 activity of ‘advising on investments’ will be treated as having that permission automatically varied, with effect from 6 April 2016. From that date, such firms’ permissions will be varied to include both the activity of ‘advising on investments’ (recast as the RAO Article 53(1) activity) and the new RAO Article 53(2) activity of ‘advising on Article 36H agreements’ (except where a firm is not lawfully able to carry on the new activity). This change will be

displayed on the Financial Services Register, so firms impacted by this variation will not need to take any action.

It will be possible for a firm to provide advice on P2P agreements by becoming an appointed representative of an authorised firm with appropriate permissions. Firms without an existing permission to advise on investments for the purposes of Article 53 of the RAO that want to provide regulated advice on P2P agreements from 6 April 2016, will need to apply for permission to carry on the new activity in Article 53(2) of the RAO.

Firms that are currently operating a LBC platform on an interim permission from the FCA, until it considers their application for full authorisation, will not be able to offer the new IFISA until they are fully authorised by the FCA.

Future developments

The inclusion of P2P lending in the IFISA, and the associated tax break, is likely to accelerate growth in the P2P lending sector. According to the P2P Finance Association the P2P lending market has doubled over the past year, with cumulative lending of £4.4 billion in the last quarter of 2015 compared with £2.2 billion in the same period of 2014. However, there is inherent risk involved. With so many new entrants it is those firms that can set themselves aside with the correct level of customer offering and security that will rise quickest to the top.

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1. Statutory Instrument 2015/TBC Individual Savings Account (Amendment No.2) Regulations 2016.
 2. Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (‘RAO’).