

**Online Peer-to-Peer Lending Regulation: Justification, Classification and
Remit in UK Law**

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as a thesis for the degree of
Doctor of Philosophy in Law
August 2016

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Abstract

Despite its benefits, online peer-to-peer lending bears the risks associated with traditional forms of institutionalised lending. However, because individuals have taken over the role of the institutional lender, and the institutional participant in this form of lending takes a step back by acting only as an intermediary between the borrowers and lenders, ordinary individuals are left to bear the type of risks that institutions have traditionally borne, but without the same means of doing so. There has been little academic analysis of the role and form that regulation should take in the regulation of peer-to-peer lending and most discussions centre on the American regulatory experience.

This thesis sets out to examine the theoretical classification of online peer-to-peer lending and the theoretical and practical justifications for regulating it. The aim is to ascertain the most appropriate way to regulate peer-to-peer lending, taking into account the underlying conceptual model which underpins it. The study adopts a theoretical analysis of P2PL participants and regulation based on the concepts of consumer protection and paternalism. It includes a doctrinal analysis of the UK peer-to-peer lending legislation and regulation to identify, describe and explain the rules pertaining to the industry. It also uses a comparative approach to compare P2PL with existing forms of financial lending and similar (dis)intermediated forms of transacting between individuals to show that online peer-to-peer lending is a unique form of intermediated transaction.

The thesis argues that it is important that regulation displays an understanding of the underlying conceptual framework of the business model it aims to regulate. In doing so, it also argues that the peer-to-peer lending users are more than just 'consumers'. They demonstrate a shift in the conception of individuals from consumers to prosumers because they participate in the production side of the services they receive. It goes further than existing discussions of prosumption by positing the concept of the 'lendsumer' to give a more accurate account of the role and experiences of peer-to-peer lenders and the effect this has on their transactional relationships and the risks they face because of this role. Based on this analysis, the thesis shows that the UK regulatory regime has limited suitability because it lacks awareness of the underlying prosumption model of peer-to-peer lending, focusing only on the business-to-consumer aspects. Consequently, it does not resolve all the issues resulting from the tripartite, participatory nature of the peer-to-peer lending transaction.

In light of these findings, the thesis proposes the regulatory use of two main concepts and highlights their implications for peer-to-peer lending regulation. The first is the 'lendsumer' as a new paradigm of the consumer which has implications for the regulatory protections afforded to the P2P lenders. The second is the use of gatekeeper liability, adapted to online peer-to-peer lending, as a way to affect these protections in light of the particular vulnerabilities and risks experienced by the peer-to-peer lender.

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Acknowledgements

I offer my sincerest gratitude to my supervisor, Dr Onyeka Osuji, to whom I am intellectually indebted. His unfailing patience, support and guidance from the inception to the final stage of my thesis, enabled me to develop an understanding of the subject and see it through to completion.

For the inspiration and encouragement to start and complete this study I am profoundly grateful to my dad, Dr Larry Amajuoyi and my uncle, Dr Walter Ofonagoro, not just because of the wise counsel they have provided me throughout my life, but also for encouraging me to aim for the greatest heights in all I pursue and more importantly, for believing in me.

I am thankful to my friends and colleagues who over the years took the time to discuss this topic with me and provided me with valuable insights. I am especially grateful to my good friend Priscilla Effah for her encouragement and support.

I am indebted to my siblings, Adaugo and Lawrence Amajuoyi, for their patience, constant support and encouragement throughout my studies. However, I owe my deepest gratitude to my mum, Mrs Joy Amajuoyi, for all the help, love and support she has given me throughout my studies. Thank you for all your help and for reading through my thesis multiple times.

Last, but in no way, least, I remain ever grateful to God, for his grace remains ever sufficient unto the cause.

I. Introduction

1.1 Context: The Emergence of P2P Form of Financial Intermediation

Peer-to-peer lending (P2PL) is a fast-growing financial service industry, which enables individuals to borrow and lend to each other. It has existed within the peripheral lending economy for centuries in the form of friendly societies, payday loans and microcredit. Like P2PL these institutions were, and still are, forms of lending between members of the community, friends and neighbours,¹ but unlike P2PL they exist predominantly in the physical world. However, lending between individuals has 're-emerged' on a larger scale because people are more able to connect and interact through organised networks on the internet and due to the recent financial crisis which caused banks to tighten their guidelines on lending.² It has been acclaimed as a phenomenon which could help fill the space left by traditional banks in the lending industry in the wake of the financial crisis because of their weariness in relation to lending,³ by providing people with an alternative option for borrowing and saving. The combination of these factors has meant that consumers and small businesses, who have found it difficult to obtain credit following the crisis, now have an alternative means of doing so.⁴ The significance is that P2PL platforms have the potential to become mainstream competitors to institutional forms of lending and raising capital. However, as the P2PL industry grows and wields a greater share of the consumer lending market, a growing number of individuals will use platforms to lend and borrow credit and, consequently, be exposed to the risks. This raises the important questions of whether and how regulation steps in to regulate those risks in the interests of the people who will be using the platforms' services and whether such regulation adequately considers the risks and business model.

¹ Alex Brill, 'Peer-to-Peer Lending: Innovative Access To Credit And The Consequences Of Dodd-Frank' (2010) 25 Wash L Found L Backgrounder 1, 1.

² *ibid.*

³ Margareta Pagano, 'Peer-to-peer lending boom could make banks obsolete' *The Independent*, (London, 17 December 2012) <<http://www.independent.co.uk/news/business/news/peertopeer-lending-boom-could-make-banks-obsolete-8421241.html>> accessed 20 January 2013.

⁴ Jack R Magee, 'Peer-to-Peer Lending in the United States: Surviving after Dodd-Frank' (2011) 15 NC Banking Inst 139, 40; Alan Krueger, 'In Credit Crisis, Some Turn to Online Peers for Cash' (*Economix Blog*, 14 October 2008) <<http://economix.blogs.nytimes.com/2008/10/14/in-credit-crisis-some-turn-to-online-peers-for-cash/>> accessed 8 July 2012.

P2PL is a form of financial intermediation because of the platforms' role of facilitating lending between different parties, and the industry performs a similar role to more traditional forms of financial intermediation such as bank lending. In traditional forms of lending, institutions such as banks and credit unions enable borrowers to raise capital by transforming the funds deposited by savers into loans. P2PL differs from this because the platforms' role does not include such transformation of capital and they do not contractually participate in the actual lending transaction. Although, they are involved in the administration of the loan – which is where their level of intermediation or involvement can be said to be highest and in which their potential for accountability or liability for wrongs or failures carried out on their platforms can be found, as will be argued in Chapter Five.

However, because of the platforms' role of simplifying the lending process by removing the need for other intermediaries, such as brokers and banks and their role of facilitating direct lending between individuals, P2PL can be framed within the context of the movement towards financial disintermediation. Financial disintermediation aims to remove intermediaries from a process, supply chain or market. In the context of P2PL, the intermediaries are removed from the lending process. Other examples of financial disintermediation include the raising of capital in the capital markets instead of using banks. Although, the extent to which this applies can be questioned because other intermediaries can be found operating within the capital markets also, such as fund managers and brokers. Indeed, Lin has pointed out that despite the rhetoric of disintermediation, many attempts to disrupt and disintermediate financial transactions actually create new intermediaries because of the way the financial markets are connected.⁵ This implies that if disintermediation is only partial or non-existent, platforms are able to distance themselves from accountability towards individual P2PL transactions. This means P2P lenders can find themselves in a situation where although they bear the risks faced by traditional lenders, e.g. loan default and the inability to recover debts, they do not have the capacity to do so themselves and instead rely on a non-contractual party, i.e. the platforms to do so for them. Consequently, most of the control within the P2PL process remains with a third party, except

⁵ Tom CW Lin, 'Infinite Financial Intermediation' (2015) 50 Wake Forest Law Review 643, 644.

there are little to no contractual rights of enforcement against them for failure to perform their role in the P2PL process as platforms do not provide guarantees against such lending risks.

A subset of the disintermediation movement, in which P2PL also exists, is the collaborative or sharing economy. The sharing economy is the collective name for peer-to-peer markets which enable supply-side flexibility and use technological innovations like the internet and smartphone applications.⁶ Technological innovation enables businesses to simplify market entry for suppliers whilst supply-side flexibility means that users can enter and exit the available supply of service providers at will.⁷ For example, Uber, the smartphone application links passengers directly with independent contractors who drive private cars rather than employees driving company vehicles.⁸ It also enables drivers to easily add or remove themselves from the available pool of drivers through the smartphone application.⁹ Similarly, Airbnb represents disintermediation within the hotel industry as it enables individuals to host guests in their spare rooms or apartments by listing their availability on the Airbnb platform.

Other examples include eBay and Alibaba which are online platforms that enable individuals to buy and sell products directly with each other on a consumer-to-consumer basis. They are disintermediated in the sense that these sale transactions transpire directly between sellers and retailers in the absence of wholesalers and stores. Facebook is another example, it is a social networking platform which enables people to connect with each other online and share videos, messages and photographs. It has been used by individuals to raise money for other people, such as the case of Katie Cutler setting up a fundraising page and raising £300,000 worth of donations for Alan Barnes, a man who was

⁶ Georgios Zervas, Davide Proserpio and John Byers, 'The Rise of the Sharing Economy: Estimating the Impact of Airbnb on the Hotel Industry' (Social Science Research Network 2016) SSRN Scholarly Paper ID 2366898 2 <<http://papers.ssrn.com/abstract=2366898>> accessed 18 July 2016.

⁷ *ibid.*

⁸ Alex Rosenblat and Luke Stark, 'Uber's Drivers: Information Asymmetries and Control in Dynamic Work' (Social Science Research Network 2015) SSRN Scholarly Paper ID 2686227 2 <<http://papers.ssrn.com/abstract=2686227>> accessed 18 July 2016.

⁹ Zervas, Proserpio and Byers (n 6) 2.

assaulted outside of his home in Low Fell, Gateshead;¹⁰ and even to livestream real-life events directly to millions of other users, as in the case of Diamond Reynolds livestream of the aftermath of her boyfriend's shooting at the hands of police in Minnesota, USA.¹¹ In the same vein, P2PL simplifies the process of lending by creating an online space for ordinary people to loan their money to other people; the online mechanism of the platform streamlines this process by cutting transaction and overhead costs typically associated with bricks-and-mortar institutional lending.

A significant difference between traditional forms of intermediation and disintermediated services within the sharing economy is that the intermediaries no longer operate on a purely business-to-consumer (B2C) model. Rather, there is an emphasis on C2C-type intermediated roles. P2PL exists within the same context of C2C intermediation in the financial sector. The movement away from focusing on the business towards empowering individuals reflects the same philosophical idea underpinning the concept of consumer responsabilisation: empowering consumers so they can protect their own interests. However, despite this transition giving individuals the opportunity to do more for themselves, their exposure to supply-side production roles traditionally performed by businesses exposes them to similar risks because of their increased participation in the production of their own services or products. This necessitates a consideration of how these risks can be mitigated by regulation to protect their interests.

Another key issue of the type of disintermediation exhibited by the sharing economy is the extent to which the platforms can be held legally or otherwise accountable for the conduct of users of their intermediary services. The disintermediation of the services has led some platforms within the sharing economy to downplay such responsibility. For example, Uber often claims to be “just an app,” which enables drivers to become more entrepreneurial, however, it

¹⁰ BBC, 'Alan Barnes: Fundraiser Katie Cutler Meets Mugging Victim' *BBC News* (Tyne & Wear, 1 February 2015) <<http://www.bbc.co.uk/news/uk-england-tyne-31080227>> accessed 18 July 2016; Chris Brooke and Hugo Gye, 'Disabled Mugging Victim to Buy New Home as Donations Reach £280,000' *Mail Online* (1 February 2015) <<http://www.dailymail.co.uk/news/article-2935072/Disabled-4ft-6in-mugging-victim-buy-new-home-donations-exceed-200-000-mark.html>> accessed 18 July 2016.

¹¹ Hannah Kuchler, 'Facebook's role as live broadcaster questioned' *Financial Times Weekend* (London, 9/10 July 2016) 6.

has considerable control over how the drivers carry out their jobs such as monitoring, predictive and real-time scheduling management, implicit and explicit rules about driver performance.¹² Similarly, the innovative development of Facebook's live broadcasting service, Facebook Live and Twitter's Periscope, which provides a similar service, and their use by individuals to record live footage of events such as riots, the aftermath of terrorist attacks and the above police shooting case, has led to calls for these platforms to employ senior editors to manage the uploaded content or to be regulated in the same way traditional news broadcasters and newspapers are for their editorial responsibilities.¹³ This highlights the fact that despite the rhetoric of disintermediation, platforms within the sharing economy often do still play a significant role within C2C transactions. This suggests they can and should be held responsible for failures within the service by their users. This is demonstrated in more detail in relation to P2PL in Chapter Five.

The chief form of P2PL is an unsecured consumer loan transaction brokered by an online platform. The platform facilitates direct finance between individuals by enabling them to lend and borrow money from each other without the intermediation of institutional lenders such as banks and credit unions.¹⁴ Zopa is a leading P2PL platform in the UK. Its operations provide a typical idea of how online P2PL platforms operate. However, P2PL is an industry with varying business models and more are bound to be formulated as the industry continues to grow. What follows is a description of how Zopa works.

In the UK, and indeed worldwide, Zopa was the first online P2PL website.¹⁵ Others include Ratesetter and Funding Circle in the UK and Prosper in the U.S.A. Set up in March 2005, it stands for 'zone of possible agreement,' which is the range between the lowest one person is prepared to get for something, and the highest

¹² Rosenblat and Stark (n 8) 3.

¹³ Kuchler, (n 11) 6.

¹⁴ Brill (n 1) 1; Magee (n 4) 139; Andrew Verstein, 'The Misregulation of Person-to-Person Lending' (2011) 45 UCDL Rev 445, 452.

¹⁵ Seth Freedman and Ginger Zhe Jin, 'Do Social Networks Solve Information Problems for Peer-to-Peer Lending? Evidence from Prosper.Com' (2008) NET Institute Working Paper <<http://papers.ssrn.com/abstract=1304138>> accessed 10 December 2013; Ana Cecilia Briceño Ortega and Frances Bell, 'Online Social Lending: Borrower-Generated Content' (2008) 4 <<http://aisel.aisnet.org/amcis2008/380>> accessed 10 December 2013.

another person is prepared to give up for something.¹⁶ There are three participants in online P2PL: platforms, borrowers and lenders. On Zopa, users set up an account and register as either a lender or borrower, usually using pseudonyms. Borrowers fill out an application like a bank application form, and give Zopa permission to access data on them. A combination of information that borrowers provide and information that Zopa purchases from Equifax and Credit Bureau enables Zopa to score borrowers with a unique credit scoring. The four categories are A*, A, B and C, A* being the borrowers with the highest credit score. This enables the platform to manage risk of default for the lenders because by investigating the borrowers' reliability and ability to repay debts, they can minimise the probability that lenders will experience losses from delinquent payments. It also decreases this chance by filtering out the worst or poorest type of borrower from the good ones that have some form of profit potential.

Borrowers seeking a loan request a quote by stating how much they want to borrow and for how long. Zopa matches this information with potential lenders, who have previously set out the conditions on which they are prepared to lend. For example, their interest rates, the length of time they are prepared to lend for and the credit ratings of the borrowers that they wish to lend to.¹⁷ The Zopa lending FAQs suggest that lenders can decide their own interest rates by looking at what other lenders are doing. Thus, in the spirit of providing a truly direct, consumer-to-consumer exchange, Zopa takes a background role and provides them with the information to make their own choices. The lenders therefore choose to lend at their own risk.

Compared with traditional bank lending which is funded by customers' bank deposits and lent out to other bank customers unknown to the depositors, lenders on Zopa are invested with greater decision-making responsibilities.¹⁸ As with most lending platforms, Zopa is not party to the loan contracts that it matches. Zopa's role is merely to facilitate the making of contracts by managing risk, ensuring that the losses suffered by lenders is as low as possible and within the expectations it has set, and providing information to the participants. So, whilst lenders have

¹⁶ Zopa, 'Frequently Asked Questions' <<http://uk.zopa.com/help/help-faqs-interested#regulated>> accessed 11 February 2013.

¹⁷ Evan Davis, Interview with Gile Andrews, Chief executive of Zopa, 'Alternative Finance' *The Bottom Line* (BBC, February 17, 2013).

¹⁸ Ana Cecilia Briceño Ortega and Frances Bell (n 15).

increased involvement in the lending process, they must bear the risk of a borrower failing to repay their loan themselves.

Zopa also spreads risk by diversifying the lenders' funds. Whilst the average lenders on Zopa lend £5,000, this can be spread across numerous borrowers in units of £10.¹⁹ Zopa assembles the cheapest loan it can out of these £10 units and presents them to the borrower as a quote. Each loan is unique to the borrower's request for a quote and assembled in real time, so the loans are not pre-packaged products which are sold to the borrower.²⁰

The main selling point of P2PL is that it saves money by eliminating the intermediating bank, consequently borrowers are offered much lower interest rates and lenders can expect higher returns.²¹ Borrowers benefit because P2PL provides individuals, small businesses and entrepreneurs with access to credit when they may be excluded from traditional loan sources.²² Meanwhile, investors can diversify their portfolios, thus reducing risk.²³ Unlike traditional securitisation markets where loans are packaged into complex bundles and sold to investors, online P2PL investors can see all the details related to each loan.²⁴ So P2PL platforms promise a simpler, more transparent lending landscape where P2P borrowers (P2PBs) know who they are liable to and P2P lenders (P2PLs) know which borrowers owe them money.²⁵

1.2 Research Problems

Despite its benefits, P2PL still bears the risks associated with traditional banking forms, including: money-laundering; consumer privacy and data protection concerns; terrorism financing and identity theft caused because P2PL platforms connect borrowers and lenders over matters of shared identity. The risk of

¹⁹ Zopa, 'Frequently Asked Questions' <<http://uk.zopa.com/help/help-faqs-interested#regulated>> accessed 11 February 2013.

²⁰ *ibid.*

²¹ Verstein, (n 14) 457; Magee (n 4) 143.

²² Magee (n 4) 145; Verstein (n 21) 460.

²³ Magee (n 4) 139; Verstein (n 21) 460.

²⁴ Jane J Kim, 'Peer-to-Peer Lender Relaunched - MarketWatch' (*The Wall Street Journal*, 28 April 2009) D5 <<http://www.marketwatch.com/story/peer-to-peer-lender-relaunched>> accessed 5 July 2012.

²⁵ Verstein (n 14) 463.

fraudulent borrowing may be higher online.²⁶ It is also unlikely that individual P2PLs will have adequately researched or understood the risks of P2PL, so inexperienced lenders may be susceptible to intentional misleading²⁷ particularly in models where their decisions to lend are based on personal stories presented by borrowers describing the purpose of their borrowing.

Further, in the event of default, lenders are dependent on the platforms and the businesses they contract to recuperate losses from defaulting borrowers.²⁸ In the worst case scenario where the platform collapses, lenders cannot independently pursue debt collection.²⁹ Even if they did, because online users are often anonymous, identifying them and their location may prove difficult.³⁰ On one hand, this is beneficial as it prevents the spread of personal information and the use of intimidation to recuperate unpaid debt. On the other hand, platforms are notoriously bad at recuperating debt,³¹ for example when Quakle, a UK P2PL platform, collapsed in 2011 many lenders were left with minimal chance of recovering their money.³² This is particularly the case because in the UK, lenders of P2PL platforms are not covered by the Financial Services Compensation Scheme (FSCS). The FSCS is a compensation fund of last resort for customers of financial services firms authorised by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), regulatory institutions set up by the UK government to regulate financial services and ensure consumer protection.³³ The FSCS may pay compensation to customers where a business has stopped trading or is in default and it protects such things as deposits, insurance policies and home finance.³⁴ These are issues that need to be considered in any regulatory regime hoping to limit the risks associated with P2PL

²⁶ *ibid* 470.

²⁷ Verstein (n 14) 466.

²⁸ Eric C Chaffee and Geoffrey C Rapp, 'Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry' (2012) 69 *Washington and Lee Law Review* 485, 506.

²⁹ *ibid*.

³⁰ Chris Reed, *Making Laws for Cyberspace* (Oxford University Press 2012) 50.

³¹ Chaffee and Rapp (n 28) 506.

³² Robert Powell, 'The Truth behind Quakle's Collapse' (21 December 2011) <<http://www.lovemoney.com/news/credit-cards-current-accounts-and-loans/loans/13799/the-truth-behind-quakles-collapse>> accessed 12 February 2013.

³³ Financial Services Compensation Scheme, <<http://www.fscs.org.uk/what-we-cover/about-us/>> accessed 25 November 2013

³⁴ *ibid*.

online and provide adequate protection for both lending and borrowing consumers of the financial service.

However, the current regulatory status of P2PL around the world is not uniform as it differs. Some countries have managed to fit it within existing financial regulatory structures, for example, in the USA, P2PL has been classified as securities and is regulated under that body of law, with the U.S. Securities and Exchange Commission (SEC) requiring that P2PL platforms register as issuers under the U.S. Securities Act of 1933³⁵. In other countries either P2PL has not developed enough for it to be considered a regulatory concern or they have only just started considering P2PL as a phenomenon that requires regulation. For example, in the UK, under the previous Financial Services and Markets Act 2000 (FSMA) regime, P2PL was not regulated despite its existence in the financial market since 2005. As a business model P2PL did not fall within the categories of activities that the FSMA regime considered regulated and nothing was done to bring it under financial regulations in the UK. However, since April 2014 it has been regulated by the FCA, which replaced the FSA in April 2013³⁶ and a new regulatory activity of “operating an electronic system in relation to lending” has been imposed³⁷ to regulate the P2PL platforms with the aim of protecting P2P lenders and borrowers.

Current P2PL regulation in the UK focuses on national operation, i.e. both platforms and customers that are based in the UK and not foreign nationals. There has been a distinct lack of desire to harmonise national regulation with other countries’ existing regulations. The fact the UK regime considers P2PL as a form of lending activity, whereas the USA has regulated it as a form of securities investment, may preclude a UK-based platform from easily transferring its operations to the USA and vice versa. This is because no specific consideration has been made for the potential globalisation of P2PL. As P2PL platforms are based online, rather than in a particular physical place of operation, and because people can access a website from anywhere in the world, it is typically differences

³⁵ Verstein (n 14) 448.

³⁶ Simon Read, ‘Peer-to-Peer Lenders Get a Boost from Regulation’ (*The Independent*, 8 December 2012) <<http://www.independent.co.uk/money/spend-save/peertopeer-lenders-get-a-boost-from-regulation-8393637.html>> accessed 21 March 2013.

³⁷ Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No2) Order 2013, SI 2013/1881 3 36(H).

in national regulations that inhibit the international operation of online businesses like P2PL platforms. However, whether the actual regulations themselves, will preclude the use of P2P platforms by foreign nationals, thus inhibiting the growth of the platforms into international P2PL sites rather than just national or regional ones, will depend on their terms. This does highlight one potential problem with the regulation of an online lending business that needs to be considered.

Contrary to some claims, the online P2PL system has not completely ridden the lending market of intermediaries, as the platforms intermediate between lenders and borrowers that use their service. Many platforms, use auction mechanisms with which lenders can compete with each other to lend to particular borrowers and although the lending activities are considered to be direct P2PL, detailed examination of the cash flow movements on such sites, indicates that the cash does not move directly from the lender to the borrower, and the repayments from the borrower to the lender.³⁸ Rather, platforms tend to take on an intermediary role and take commission for their operations.³⁹ Their basic intermediary role is that of exchange facilitation.⁴⁰ Online P2PL therefore also necessitates a consideration of the regulation of intermediaries and what their liabilities to their customers should be. In the interests of lender protection, regulations may need to consider in greater detail whether it is worth holding P2PL platforms liable as third parties for the conduct of P2PL participants. This is an issue that the FCA has not looked at in its new rules.

Online P2P platforms may rely on credit ratings of the borrowers provided either by third party credit ratings agencies or by themselves, to inspire the trust of lenders in the borrowers' ability to pay back. Albeit, the final decision lies with the lender who chooses the risk level of the borrower he or she decides to lend to. One possible question therefore, is whether online P2PL platforms can ever be held liable for losses suffered by lenders e.g. because of reliance placed on incorrect or misleading credit ratings. Theoretically, there are two ways this could happen: holding the platforms liable for the poor advice given about the borrowers through the credit ratings. This would require either the establishment of a

³⁸ Arvind Ashta and Djamchid Assadi, 'An Analysis of European Online Micro-Lending Websites' (2010) 6 *Innovative Marketing* 7, 8.

³⁹ *ibid.*

⁴⁰ Ashta and Assadi, (n 38) 16.

fiduciary duty of care towards the lenders, or it may require holding platforms liable for communicating misleading or incorrect information which was originally provided by the borrowers. For example, the information gathered from borrowers to produce the credit ratings or through the additional information posted on the P2PL discussion boards.

With regards to the first method, the common law shows that it is possible, but unlikely for platforms to be held to have a fiduciary duty to P2PLs. Borrowing from traditional banking lender-borrower dichotomy, the general principle is that unless a firm clearly undertook to advise a customer, there is no duty to provide advice on the suitability or risks of a particular transaction from a consumer's perspective. For example, in *Williams & Glyn's Bank v Barnes*⁴¹ an experienced businessman borrowed £1 million from the bank and his company was heavily indebted to the bank. The company became insolvent and the bank called in the personal loan. The businessman claimed the bank had breached its duty to him in lending the personal loan when it knew the company was experiencing difficulties. The court held that the bank had no duty to advise unless there was a clear assumption of responsibility. As P2PL platforms make it clear on their websites that consumers' funds are at risk and as they do not provide advice about lending suitability, such as which borrower(s) a particular lender should lend to, it is unlikely they can be shown to have clearly assumed responsibility towards the P2PLs.

However, in *Verity and Spindler v Lloyds Bank plc*,⁴² Judge Robert Taylor found that the claimants had specifically sought the advice of a bank manager on the prudence of a transaction and that the bank manager had assumed the role of financial advisor, and been negligent in the advice provided. One factor which established that financial advice had been requested, was that the claimants were financially unsophisticated. Another factor was that the bank's advertising brochure advertised free financial advice.

However, the platforms rarely, if ever, undertake to provide financial advice to lenders for each transaction. Rather, they make it clear to participants that they are not party to the lending transactions. Although they connect lenders with

⁴¹ *Williams and Glyn's Bank Ltd v Barnes* [1981] Com LR 205.

⁴² *Verity and Spindler v Lloyds Bank plc* [1995] CLC 1557.

borrowers, their service does not include providing advice to lenders about the suitability or risks involved in a particular borrower or vice versa. However, the above case implies that even though a platform might outwardly state it does not provide advice, does not preclude it from being found to have done so based on their actions towards the P2PL users. Therefore, platform accountability can be justified by the platform's actual conduct towards its users and not just based on what it says it does.

One reason for regulating online platforms in their capacity as intermediaries is because they have access to information and communicate this information in a way that neither the borrower nor lender does. A platform is in a better position to moderate information provided by borrowers and ensure it is correct because they have access to the borrowers' personal data and identification. In contrast, the lenders are limited to reliance on borrower information provided by the borrowers themselves or the platforms, which in a pseudonymous environment means the information can be difficult for them to verify. Without the platform's involvement, misleading or inaccurate information provided by borrowers would not be distributed to lenders, because platforms use the information provided by borrowers to categorise them into the different risk categories which lenders rely on when making their investment choices. However, whether credit ratings devised by external agencies can be treated as advice that can be misleading is unlikely because platforms either facilitate communication between borrowers and lenders through a forum service or merely communicate information that the borrowers provide themselves during their application process to the lenders.

By analogy, online P2PL platforms could be compared to internet search engines like Google. An internet user who would like to find a web page but does not know its specific internet address or who would like to find a selection of web pages concerning a chosen topic, can use a search engine to do so.⁴³ Google enables users to do this by entering terms in a search field and clicking the search button, meanwhile Google constantly updates an index of billions of web pages which allows it to respond to the users' search requests.⁴⁴ However, Google has no control over the users' search terms or the material available on the various websites it indexes. At one point, Google search results would display two types

⁴³ *Google Inc. v Australian Competition and Consumer Commission* [2013] HCA 1, para 19.

⁴⁴ *Google Inc. v Australian Competition and Consumer Commission* [2013] HCA 1, para 20.

of results, 'organic search results,' ranked in order of relevance to the user's search terms, and 'sponsored links', which is a form of advertisement created by or at the direction of an advertiser who pays Google to display the links.

In the Australian case of *Google Inc. v Australian Competition and Consumer Commission*, the Australian Competition and Consumer Commission (ACCC) sought to establish that Google had contravened s.52 of the Australian Trade Practices Act 1974 directly by producing (in the sense of creating) misleading sponsored links. The section provides that "[a] corporation shall not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive". Google sought to rely on the s.85(3) defence which is that it is a defence if the defendant establishes that he or she is a person whose business it is to publish or arrange for the publication of advertisements and that he or she received the advertisement for publication in the ordinary course of business and did not know and had no reason to suspect that its publication would amount to a contravention of s.52.

The court rejected the ACCC's submission. Each relevant aspect of a sponsored link is determined by the advertiser and the automated response of the Google search engine is determined by the users' search requests. So Google did not author the sponsored links it displayed or published.⁴⁵ It was stated that the nature of the internet and internet technology behind the display of a sponsored link following a consumer's search request, required Google to 'respond' to the request, but this merely amounted to the assembly of information provided by others to display advertisements directed to Google's users. Consequently, Google was seen as merely a means of communication between the advertisers and the consumers.⁴⁶

The High Court allowed the appeal, even though Google staff had assisted advertisers in the selection of keywords that would match their website to the internet users' search terms because it did not demonstrate that Google personnel, rather than the advertisers, had chosen the relevant keywords, created, endorsed or adopted them.

⁴⁵ *Google Inc. v Australian Competition and Consumer Commission* [2013] HCA 1, para 68.

⁴⁶ *Google Inc. v Australian Competition and Consumer Commission* [2013] HCA 1, para 69.

The similarity with online P2PL, is that just as internet search engines match an internet user's search terms to related websites, the lending platform matches a lender's search for a particular grade of borrower, borrowing purpose or other search criteria, to borrowers who correspond with those searches.⁴⁷ As a facilitator, a lending platform has no control over the risk choices of the lenders, and consequently the list of borrowers which are drawn up by the search. The listings that are drawn up cannot be said to be misleading on this basis, particularly because platforms merely communicate the information about borrowers that they provide themselves.

The implication of this case is that online intermediaries will not be held liable for third party information. In the context of P2PL, other than the imposition of a basic duty to verify borrowers' information, if a similar approach were to be adopted as in the Google Inc. case, platforms would not be held liable to lenders for any misleading, deceptive or inaccurate statements provided by borrowers, which cause a loss to the lenders. Additionally, the FCA's objective of ensuring proportionate regulation, combined with the relatively embryonic condition of the P2PL market, means it is unlikely that regulators will consider imposing additional burdens on platforms in the near future. The relationship between regulation and technology is often expressed in terms of a conflict, with technology embodying notions of enterprise and progression whilst regulation is usually associated with bureaucracy which stifles growth and innovation.⁴⁸ This highlights the problem of the need for law and regulation to adapt to changes in technology without creating unnecessary barriers to growth. This is usually accomplished by balancing the regulatory principle of ensuring rules are proportional to the risks associated with the regulated activities, whilst also ensuring there are adequate protections for the consumers.

⁴⁷ Alternatively, the platform also matches borrowers to lenders who have expressed a willingness to lend at their desired interest rates

⁴⁸ Jonathan B Wiener, 'The regulation of technology, and the technology of regulation' (2004) 26 *Technology in Society* 483, 483.

1.3 Research Questions and Methodology

As a result of the problems discussed above, this thesis has investigated two main research questions. The first main research question is: What are the theoretical and practical justifications for P2PL regulation?

The subsidiary questions that have been examined under this question are:

- a. Does P2PL fit within the existing conceptions of consumer and consumer protection?
- b. Does P2PL differ from other existing kinds of financial intermediation?

These questions are necessary because they lay the foundation for future arguments about how P2PL should be regulated. There are many reasons why a phenomenon should be regulated for example, preventing anti-competitive actions between businesses, protecting wider society from the risks associated with business conduct, to ensure the quality of a product and/or to prevent deceptive or unscrupulous practices by both businesses and individuals. Such justifications can impact the form of the regulation, the objects of regulation and its emphasis or direction.

As an example, one reason for the imposition of competition or antitrust laws is to prevent companies from forming monopolies or cartels which give them close to total control of the market sector, because doing so might prevent start-up companies from entering the sector due to the high costs of doing business. Ultimately, the purpose of competition is to create competitive markets that support economic growth and provide consumers with more choice. Consequently, the object of competition law tends to be anti-competitive actions of the business actors being regulated, as opposed to the customers being protected, e.g. Chapter I of the Competition Act 1998 penalises individuals for forming cartels by making them liable to imprisonment for up to five years or imposing fines on them. The competition rules tend to focus on preventing anti-competitive behaviour rather than improving the circumstances of the customers affected by it, which falls under consumer protection rules.

Similarly, if the problem to be resolved are the risks associated with institutional lending on the wider financial market, then regulation is most likely to focus on the bank or depository institution as the object of regulation rather than the customer, for example, capital requirements are imposed on the banks to ensure they are able to sustain operating losses whilst maintaining their ability to honour their customers' deposit withdrawals.

Therefore, it is necessary to understand why a phenomenon needs to be regulated e.g. whether because of the risks it involves or its benefit to society. The sub-questions are also significant because they necessitate a better understanding of the way P2PL works. This contributes to the overarching question of why it needs to be regulated because by understanding how a phenomenon works it is possible to determine the appropriateness of the regulatory approach adopted and the appropriateness of which participant is regulated within the sector. Doing so enables one to determine whether regulation is proportionate and efficient.

The thesis adopts a theoretical analysis of P2PL regulation from the consumer protection and paternalism perspectives. The theories are used as a framework for analysing the justifications for and the appropriateness of existing regulation. They also provide the foundation for analysing the underlying conceptual structure of the P2PL model, for example, using consumer protection to analyse consumer-to-consumer, business-to-consumer and lender-to-prosumer models and what they entail for regulation. Consumer protection law and paternalism are used to justify regulation and to assess whether existing regulation conforms to their principles.

The thesis answers this first question by arguing that paternalism in the form of consumer protection law provides a basic justification for state intervention into the private actions of the P2PL participants because of the risks faced by P2PLs and borrowers in relation to each other, the platforms and the effects of their activities, particularly in relation to the underlying person-to-person structure of the sector. In doing so, the first research question involves the identification and explanation of theoretical and practical justifications for P2PL regulation and the form it should take.

However, the theories of paternalism and consumer protection only provide a partial justification, because in answering the sub-questions, the thesis shows that P2PL is a new and unique form of lending based on a prosumption model of operation rather than on a consumption model of intermediation. The P2PL users do not fit within existing conceptions of what it means to be a consumer and following from this, consumer protection. This is because the person-to-person structure of P2PL has affected a change in the roles, conduct and nature making them more akin to 'prosumers', i.e. consumers who engage not only in the consumption of services but also in the production of the services they wish to consume.⁴⁹ Due to this uniqueness, regulation cannot simply be transposed from similar phenomenon and applied to P2PL as this will create inefficient or inappropriate regulatory measures unsuited to it. Therefore, the justifications for regulatory intervention do not lie in just the protection of the weaker party as suggested by consumer protection theory, or the 'average' consumer as suggested by consumer law, but also on the characteristics and effects of the prosumption model on which P2PL is based.

In answering this first research question, the thesis also incorporates a comparative element in the analysis of P2PL, although it differs in purpose and focus from usual comparative legal analysis. Comparative law is a sub-branch of legal research and, for some comparative lawyers, the aim is to harmonise or unify laws.⁵⁰ Comparative law helps answer the normative question of what the law should be.⁵¹ One of its benefits is highlighting the possibility of achieving the goals of regulation or law through different rules and structures.⁵² By understanding and analysing the similarities and differences between different

⁴⁹ Alvin Toffler, 'The Rise of the Prosumer', *Third Wave* (1984); Marian Salzman, 'Rise of the Prosumer' (2000) 54 *Print* 141; George Ritzer and Nathan Jurgenson, 'Production, Consumption, Prosumption The Nature of Capitalism in the Age of the Digital "prosumer"' (2010) 10 *Journal of Consumer Culture* 13; *ibid*; David Beer and Roger Burrows, 'Consumption, Prosumption and Participatory Web Cultures An Introduction' (2010) 10 *Journal of Consumer Culture* 3.

⁵⁰ John Bell, 'Legal Research and the Distinctiveness of Comparative Law' in Mark Van Hoecke, *Methodologies of Legal Research: Which Kind of Method for What Kind of Discipline?* (Hart Publishing Limited 2013) 157..

⁵¹ John Bell, 'Legal Research and the Distinctiveness of Comparative Law' in *ibid* 158..

⁵² John Bell, 'Legal Research and the Distinctiveness of Comparative Law' in *ibid*..

rules and institutional structures, it is possible to determine how justified a particular rule, policy or strategy is over another.⁵³

In contrast, the thesis does not adopt a comparative approach to the rules and regulations pertaining to P2PL, because other than the American system, there are few established national P2PL regulatory regimes with which to compare the UK approach. The thesis focuses on a comparison of the subjects of regulation rather than on the regulation itself. It uses a comparative approach to compare P2PL with existing forms of financial lending and (dis)intermediated transactions. This is because analysing the similarities and differences between these different forms of business model enables a better level of understanding of the conceptual frameworks on which they are based and the effects of these conceptual frameworks on the industry participants for whom the regulation is ultimately designed to benefit e.g. through consumer protection provisions. This comparison is beneficial for highlighting the differences between industries, which enables the design of regulation to be tailored to the specific industry being regulated, rather than copied and pasting regulatory provisions from similar but conceptually different business models. Overall, the comparative element of the thesis therefore enables an analysis of the appropriateness of existing regulation specifically in relation to online P2PL.

The second main research question for the thesis is: Are current UK regulatory instruments fit to resolve the regulatory difficulties posed by P2PL?

The subsidiary questions that have been examined under this second question are:

- a. What are the assumptions of financial services regulation?
- b. What are the implications of consumer protection for P2PL regulation?

This research question has been chosen because it follows on from the first discussion about why regulation is justified and appropriate for the P2PL industry on a theoretical level to move on to a discussion about the appropriateness of existing regulation on a practical level. This is because by taking into account the reasons behind the need for regulations and the theoretical underpinnings of how

⁵³ John Bell, 'Legal Research and the Distinctiveness of Comparative Law' in *ibid.*.

the sector operates it illuminates the analysis framed by the first research question, by placing it in a practical context so that the implications of the theories can be demonstrated. It focuses the thesis on the issue of how the industry should be regulated which is an important question to ask because P2PL is a relatively new form of lending practice and it is unique in comparison to other forms of lending and intermediation. Therefore, to determine whether the theoretical underpinnings of the industry are properly considered, it is necessary to analyse the form and implications of current regulatory rules pertaining to it and whether the regulation adequately takes these into account.

The research question is also significant because it focuses on the UK regulatory regime. Academic discussions about how P2PL has been regulated are mostly based on its regulation in the USA; very few articles have been written about its regulation in the UK particularly ones which focus on the regulatory implications of the person-to-person model on which it is based.

The study includes a doctrinal analysis of legislation and case law, particularly in relation to the UK P2PL regulatory regime. Doctrinal research is a study of the law and legal concepts and it is the most dominant form of legal research design.⁵⁴ It has been described as a process of analysis⁵⁵ and provides a systematic exposition of the rules governing a particular legal area, it analyses the relationship between rules and it can be used to explain areas of difficulty within them.⁵⁶ The approach is used in this thesis to identify, describe and explain what the current legal and regulatory rules are in relation to online P2PL and the ideologies upon which they are based. Consequently, the second research question involves the contextual analysis of current rules and regulations to determine whether they are fit to resolve the regulatory difficulties posed by P2PL.

The thesis argues that the current UK regulatory regime is partially effective because it focuses on one aspect of the intermediated consumer-to-consumer model on which P2PL is based, i.e. the relationship between the platforms and their users. It is demonstrated that because the regulatory focus is placed only

⁵⁴ Terry Hutchinson and Nigel Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17 *Deakin Law Review* 83, 85.

⁵⁵ Paul Chynoweth, 'Legal Research' in Andrew Knight and Les Ruddock (eds), *Advanced Research Methods in the Built Environment* (1 edition, Wiley-Blackwell 2008) 37.

⁵⁶ Hutchinson and Duncan (n 54) 101.

on the regulation of the platforms' practices or conduct, the regime is based on the business-to-consumer model of transactions and therefore does not reflect the consumer-to-consumer horizontal relationships which exist in P2PL. Due to this assumption the regime does not fully take into account the risks and problems faced by P2PLs and borrowers in relation to each other. Significantly, this shows a lack of awareness or understanding of the disintermediation movement in which P2PL exists.

Overall, the research method used to address the research questions and objectives is the critical analysis of primary and secondary material. In doing so, the thesis adopts the doctrinal and limited comparative methodologies to answer the research questions.

A critical theoretical analysis is more appropriate for a study that focuses on the regulatory issues and the concepts underlying P2PL. As P2PL is a new area for academic legal research, it is difficult to find a body of work that deals specifically with P2PL in the areas set out in the research questions and objectives sections. To overcome this problem, this study draws comparisons with established fields such as banking law, financial services research and other forms of disintermediated alternative finance structures. It also makes use of previous academic and industry studies of P2PL where these are available.

The research is largely library-based and the following materials have been used: books, journal articles, reports, websites, online news articles, case law and legislation.

1.4 Research Objectives

The purpose of this thesis is not to make a judgement on the efficacy or worth of P2PL, nor suggest ways in which P2PL platform operations can be improved to benefit the borrowers and lenders participating in its service. P2PL is an established method of finance which shows no signs of disappearing due to the

year-on-year growth of the industry.⁵⁷ Rather, the scope of this thesis has been to assess how and why P2PL can be regulated now that it is here.

This thesis has three aims. The first is to ascertain the most appropriate way to regulate online P2PL, taking into account its varying models, the rights and responsibilities of its three participants and its online nature. The second aim is to support and enrich regulatory and legal knowledge of P2PL regulation by analysing its regulation in the United Kingdom through the lens of consumer protection and through a comparison with other financial institutions such as banking, consumer credit, and comparable forms of social lending. Finally, the thesis aims to suggest a conceptual framework for the analysis of appropriate online P2PL regulation which is based on the underlying person-to-person model of P2PL.

This thesis is the first known attempt to comprehensively study the theoretical and conceptual underpinnings of the regulation of online P2PL. It will benefit regulators and policymakers seeking to regulate online P2PL by providing them with a greater awareness and understanding of the C2C underpinnings of P2PL and the implications this has on regulation. Governments and regulatory bodies from countries which do not currently regulate P2PL will find this thesis useful because it provides a theoretical and practical foundation for them to base their regulatory policy considerations on. By considering the theoretical justifications for regulation and the conceptual underpinnings of P2PL, the thesis provides a basis for future laws and regulations to be built.

Online P2PL has given rise to regulatory confusion about the most appropriate way to regulate it. However, it has not been subjected to much critical legal analysis outside of the USA, particularly in the UK. Much legal scholarship has centred on U.S. securities law⁵⁸ or on the use of micro finance or P2PL for development.⁵⁹

⁵⁷ Bryan Zhang and others, 'Pushing Boundaries: The 2015 UK Alternative Finance Industry Report' (Cambridge Centre for Alternative Finance 2016) 41 <<https://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/publications/pushing-boundaries/>> accessed 26 February 2016.

⁵⁸ Brill (n 1); Verstein (n 14).

⁵⁹ Kevin E Davis and Anna Gelpert, 'Peer-to-Peer Financing for Development: Regulating the Intermediaries' (2010) 42 *Journal of International Law and Politics* 1209.

A lot of regulatory confusion is caused by the multitude of P2PL models. In addition to this is the problem of how it should be regulated, considering that much of the current financial and banking regulatory systems around the world were not formulated with online P2PL in mind.

There is still a lot of research that needs to be done in the field of regulating P2PL. Most analyses that deal with the regulation of P2PL start from the assumption that regulation is necessary but do not engage with the justifications for or against regulation nor investigate how regulation should treat the individual rights, responsibilities and interests of the lenders/investors, borrowers and platforms that make up the participants of P2PL. There is also little analysis of how the consumer-to-consumer relationships of P2PL may affect the content and nature of regulations. Similarly, although there has been some treatment on the regulation of intermediaries in general,⁶⁰ specific treatment on the regulation of P2PL platforms themselves is scarce, if not non-existent.

Most studies of P2PL are qualitative investigations of its various features and workings involving some sort of empirical analysis. For example, Berger and Gleisner's study empirically examines the intermediation of electronic P2PL platforms and provides insight into the workings of individuals on the platforms, including how individuals operating within the platforms might assume responsibilities over each other.⁶¹ Klafft has investigated whether often inexperienced lenders operating in a pseudonymous online environment are able to obtain an attractive return on their investment.⁶² A number of studies have also focused on the theme of credit risk and trust in the operation of P2PL.⁶³

⁶⁰ Gavin Sutter, 'Rethinking Online Intermediary Liability: In Search of the Baby Bear Approach' (2011) 7 Indian JL & Tech. 33.

⁶¹ Sven Berger and Fabian Gleisner, Emergence of Financial Intermediaries in Electronic Markets: The Case of Online P2P Lending (March, 11 2010). BuR Business Research Journal, Vol. 2, No. 1, May 2009. Available at SSRN: <http://ssrn.com/abstract=1568679>

⁶² Conference on E-Learning, E-Business, Enterprise Information Systems, and E-Government, EEE 2008, H. R. Arabnia and A. Bahrami, eds., pp. 371-375, CSREA Press, Las Vegas 2008. Available at SSRN: <http://ssrn.com/abstract=1352352> or <http://dx.doi.org/10.2139/ssrn.1352352>.

⁶³ Rajkamal Iyer and others, 'Screening in New Credit Markets: Can Individual Lenders Infer Borrower Creditworthiness in Peer-to-Peer Lending?' (Social Science Research Network 2010) SSRN Scholarly Paper ID 1570115 <<http://papers.ssrn.com/abstract=1570115>> accessed 2 February 2013; Enrichetta Ravina, 'Love & Loans: The Effect of Beauty and Personal Characteristics in Credit Markets' [2012] Available at SSRN 1107307 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1107307> accessed 10 December 2013; Mingfeng Lin, Nagpurnanand R Prabhala and Siva Viswanathan, 'Judging Borrowers by the

These empirical investigations and the many others like them that focus on how P2PL works and how it can be improved are useful for the development and critique of the business model. Such details also provide better insight into how P2PL operates and would be insightful to any consideration on how P2PL should be regulated, because to regulate a phenomenon it is essential to know in detail how it works. However, the fact P2PL studies largely approach it from a practical and often business operational perspective also demonstrates there is a need for theoretical analysis of its regulation from the perspective of all three of its participants: the lenders, borrowers and the platforms.

Current academic literature also demonstrates there is a lack of consensus on who should do the regulating; this is demonstrated by the American-focused literature, debating whether it should be the SEC or a new body, the Consumer Financial Protection Bureau (CFPB).⁶⁴ This highlights a central classification problem that needs to be resolved before any meaningful talk of regulating P2PL can go ahead. That is, what classification do P2P loans fall under? In the U.S. P2P loans have been classified as securities, whilst the American trade group, Coalition for New Credit Models have rejected this classification and proffered that P2PL should be regulated as a 'consumer banking service'.⁶⁵

This study is undertaken to fill these knowledge gaps in the P2PL literature by focusing on a theoretical and legal analysis of its regulation in the UK. Seeking to provide a conceptual framework for regulating P2PL, it is imperative to fully understand its historical development; its key participants and how it compares with similar non-bank lending schemes such as payday lending and micro-lending to establish why regulation is necessary and learn from the experience of other forms of fringe lending the pitfalls to avoid and the successes to emulate. It is also necessary to justify the regulation of P2PL and identify which theory of regulation best suits it and from there, what the best regulatory policy to adopt is. This will help to avoid piecemeal regulation which fails to demonstrate an understanding of the subject of its regulation.

Company They Keep: Friendship Networks and Information Asymmetry in Online Peer-to-Peer Lending' (2013) 59 Management Science 17.

⁶⁴ Verstein (n 14).

⁶⁵ Brill (n 1) 4.

This thesis considers it important to realise that the P2PL market involves two different types of consumers who transact with each other through the intermediation of an independent platform. As this is the case, it is necessary to explore the different risks, interests and other vulnerabilities faced by these very different participants. On one hand, there are the borrowers, who are commonly treated as consumers, and on the other there are the lenders, who face different problems but are arguably on an equally vulnerable position. Compared to traditional lending institutions, this thesis will demonstrate that P2PL transactions are performed horizontally, i.e. consumer-to-consumer, rather than vertically, i.e. institution-to-consumer. The consumer protection literature examined however, does not consider consumer protection issues on this horizontal level.

In addition, the literature does not consider how the different consumers of P2PL services should be treated by regulation. This is important because it is necessary for regulation to afford the appropriate protections or facilitations and do so proportionately. This thesis aims to fill this gap through an exploration of the regulation of online intermediaries, from the perspective of P2PL.

Studies indicate that there is a connection between trustworthiness and the perception of credit risk.⁶⁶ The implication for regulation is that to support the growth of this new market, it would need to facilitate an environment of trust so that lenders will continue to fund loan requests. After all, if lenders do not view borrowers as trustworthy, they will be unwilling to risk parting with their savings on P2PL platforms. Rather, they may find other means of investing their savings which does not involve P2PL platforms. These studies do not speak directly about the implications for regulation, and how this relates to the underlying consumer-to-consumer model of financial intermediation that P2PL undertakes, so this thesis will examine the need for regulation to encompass an understanding of the

⁶⁶ Asim Ijaz Khwaja and others, 'Screening in New Credit Markets: Can Individual Lenders Infer Borrower Creditworthiness in Peer-to-Peer Lending?' <<http://dash.harvard.edu/handle/1/4448882>> accessed 10 December 2013; Mingfeng Lin, Nagpurnanand R Prabhala and Siva Viswanathan, 'Judging Borrowers by the Company They Keep: Friendship Networks and Information Asymmetry in Online Peer-to-Peer Lending' (2013) 59 *Management Science* 17; Iyer and others (n 66); Ravina (n 66); Jefferson Duarte, Stephan Siegel and Lance Young, 'Trust and Credit' [2010] Atlanta Meetings Paper <<http://www.sbs.ox.ac.uk/centres/reputation/events/Documents/Siegel%20Paper.pdf>> accessed 9 November 2013.

way P2PL works on a conceptual level between lenders and borrowers and the need to reduce credit risk.

P2PL platforms have been treated by the literature as a method of connecting individual borrowers and lenders so that they can conduct their own private transactions. For example, Brill only comments that before widespread internet access, connecting individual borrowers and lenders in a loan marketplace was impractical, however P2PL platforms now achieve this feat.⁶⁷

Although David and Gelpern investigate the international aspects of regulating P2PL platforms, their analysis concerns charitable and non-profit platform intermediaries like Kiva rather than for-profit platforms like Zopa. Consequently, the regulations they investigate are based on charity and banking law, because micro-financing institutions operate with a charitable and developmental aim, but in some ways behave like banks and investment funds for example, taking funds from investors and assuming a conditional obligation to repay them, although without interest.⁶⁸ They argue that the rise of P2P intermediaries operating within the international finance market requires a change in the regulation of developmental finance. They state this could either be through the refinement of charities regulation in the funders' home state or to include the "new aid intermediaries" within the changing regime for regulating international finance.⁶⁹ This paper is useful for the insights it provides into the international regulation of intermediaries similar to P2PL, however, although they use the same name, their investigation is actually about micro-finance institutions, which operate with different goals in mind to for-profit P2PL.

The literature does not consider the regulation of for-profit P2PL platforms as intermediaries either on a national level or an international level. It also does not consider the regulation of P2PL platforms from the perspective of their users for example, whether regulation should hold them liable to borrowers and lenders that use their services and on what grounds. So far the literature does not consider the platforms' liability to their users e.g. for the borrower information they present on their websites for lenders or how much responsibility they should take for the defaults of borrowers that use their services. However, considering issues

⁶⁷ Brill (n 1) 139.

⁶⁸ Davis and Gelpern (n 51) 1222.

⁶⁹ Ibid 1267.

of liability for P2PL intermediaries is essential because their accountability would create greater confidence in the P2PL market.

1.5 Structural Outline of Thesis

The thesis is divided into six chapters. Following this Introduction, Chapter Two begins with an examination of three theories of regulation, rational choice theory, behavioural economics theory and paternalism, and relates them to P2PL. It focuses on the concepts of paternalism and consumer protection as the principle justifications for state intervention in the regulation of the P2PL industry. It analyses the conceptualisations of consumer protection and consumer law in relation to P2PL and demonstrates that P2PL does not fit within the existing conceptions of 'consumer' and consumer protection because of the underlying P2PL model and the nature of P2PLs who exhibit traits of prosumerism rather than consumerism.

Chapter Three distinguishes P2PL from other types of traditional and alternative forms of intermediation such as payday lending and credit union lending. The chapter compares the similarities and differences between the regulatory concerns of the informal lending schemes discussed, as compared to P2PL. Each comparison demonstrates that P2PL differs from existing forms of financial intermediation.

Chapter Four analyses the current UK P2PL regulatory regime in light of the characteristics of P2PL discussed in Chapters Two and Three. It argues that the regulatory regime is heavily based on the B2C model of business operation which does not accurately reflect how firms within the C2C, 'sharing economy' and P2PL in particular, differ substantially because they are based on separate concepts. However, the UK P2PL regulation only reflects the B2C relationships existing within a P2PL transaction and not the tripartite relationship between the lender and platform, platform and the borrower and the lenders' and borrowers' respectively.

In light of the analysis of the UK's P2PL regulatory regime, Chapter Five suggests two main points. It argues for the use of gatekeeper liability to regulate P2PL platforms, and suggests a new concept of the 'lendsumer' to reflect the

transitional nature of P2PLs and the fact that they are not merely consumers but can also be considered to be prosumers.

Finally, Chapter Six presents the findings and conclusions of the thesis and provides a summary of the answers to the research questions.

2. P2PL and Consumer Law and Consumer Protection Concepts and Paradigms

2.1 Introduction

In order for the legal rules and regulations relating to P2PL to effectively govern its market and participants, the definition and notion of consumer which underpins them must match the economic and technological reality exhibited within the regulated markets in addition to the actual behaviour of consumers.⁷⁰ This is important for online P2PL as it consists of three interacting parties, two of which may be individuals who behave similarly to ordinary consumers. Consequently, it is necessary to identify the nature of the parties, the relationships within P2PL and to see how existing concepts of consumer regulation apply to them. This analysis is carried out across Chapters Three and Four.

The purpose of this chapter is to examine the conceptualisations of consumer protection and consumer law as they relate to P2PL and show that P2PL does not fit within existing concepts and methodologies. It goes on to set the stage for the arguments in favour of the need for a new conception of the consumer considering their increasingly active role in off-and online markets.

Section 2.3 analyses three regulatory philosophies which are the rational choice theory, behavioural economics and paternalism. These theories are discussed in this chapter because they have different effects on the type and direction of protection that regulation based on them would afford individuals, particularly regarding whether regulation should intrude in private transactions by following an interventionist approach. Therefore, to justify a particular regulatory approach for P2PL it is necessary to assess which approach is suitable. For example, RCT assumes that people are rational beings who can choose an outcome that will maximise their welfare. As will be shown, this implies that providing individuals with the required information for them to base their choices on, is sufficient protection. On the other hand, behavioural economics has shown that individuals are not always rational beings and can be misled by their own emotional or

⁷⁰ Anna Butenko and Kati Cseres, 'The Regulatory Consumer: Prosumer-Driven Local Energy Production Initiatives' (Social Science Research Network 2015) SSRN Scholarly Paper ID 2631990 18 <<http://papers.ssrn.com/abstract=2631990>> accessed 19 December 2015.

psychological biases and information asymmetries that exist within a non-perfect market. As discussed in this section, the implication is that a purely non-interventionist regulatory strategy is inadequate. These discussions lead to an analysis of paternalism as a means of justifying the suggestion that regulators should intervene in the private transactions of online P2PL users for their own benefit. Section 2.3.4 charts the seeming recognition of the efficacy of paternalistic intervention within EU and UK retail investment regulation post financial crisis and highlights that despite this change in other areas of retail investment regulation, P2PL regulation does not reflect a similar change.

Having concluded the necessity of interventionist regulation to even the playing field between the three P2PL participants, Sections 2.4 to 2.7 analyse the notion of consumer protection and the established concept of 'consumer' based on EU and UK legal definitions and argues that P2PL users do not fit within this concept. This leads to the discussion in Section 2.8 of how individuals have evolved from being passive consumers to the less established classification of active 'prosumers'. Once again, it is argued that P2PLs do not fit within this classification either and therefore need their own concept to aptly describe their characteristics and behaviours, in light of their increasingly active role in both off- and online markets.

2.2. Risks of P2PL faced by lenders

Namvar has discussed the rise of P2PL as a new and alternative form of investment and describes how P2P loans are being incorporated into investment portfolios for diversification purposes.⁷¹ His analysis considers the risks and benefits involved in investing in unsecured consumer loans such as P2P loans. Examples include the credit and default risks involved in investing in P2P loans. Lenders face credit risks because P2P platforms are not obligated to verify the information they provide them about a potential borrower's creditworthiness and, even though the information may be derived from consumer reporting agencies

⁷¹ Ethan Namvar, 'An Introduction to Peer to Peer Loans as Investments' (Social Science Research Network 2013) SSRN Scholarly Paper ID 2227181 <<http://papers.ssrn.com/abstract=2227181>> accessed 9 November 2013..

like Experian or Equifax, it might be outdated or fraudulent.⁷² As neither the platforms nor government authorities like the FSCS guarantee the loans, lenders face a high degree of risk because the loans are unsecured.⁷³ Likewise, they also bear the burden of default risks. As P2P loans are unsecured they are very speculative investments; in cases of borrower default, there is no guarantee that platforms will be able to enforce the borrower's payment obligations or recuperate missed repayments. Even if they could, the costs of collection are passed on to the lenders reducing their return on investment further.⁷⁴ Namvar's study also provides an overview of the consumer lending market and an overview of the P2P loan market.

Namvar's discussion on the strategy drivers, risks and barriers to investing in P2P loans provides a useful indication of the issues P2PLs face. Like Hulme and Wright, he also touches on the history of P2PL. He traces it back to the Babylonian civilisation although he does not cite any evidence to support this. Namvar presents P2P loans as a new alternative asset class which offers investors a new way to access a profitable consumer lending market in a way that avoids traditional intermediaries – banks. This analysis does not analyse the implications of P2PL for regulation in detail, except to state that regulation should be avoided in order to maintain high growth and yield within the P2PL market. This is similar to arguments put forward by Verstein, Chaffee and Rapp, that regulation should be proportionate and not stifle business innovation. However, by discussing P2PL from an investment perspective, Namvar broadens knowledge on the risks and benefits involved in P2PL in a new way and it provides further insight into the lender experience of P2PL. Greater knowledge of the P2PL lenders' experiences within the industry enables regulation to be appropriate for and reflect the protection or pursuit of the lenders' interests. This is important to ensure regulation does not undermine the participants' interests or encourage activities which unnecessarily blocks access to the P2PL for some lenders.

Several studies of P2PL have centred on the theme of credit risk and trust. Iyer *et al* found that the lenders used both hard and soft information from a borrower's loan application to deduce a borrower's creditworthiness.⁷⁵ Hard information

⁷² *ibid* 14.

⁷³ *ibid* 15.

⁷⁴ *ibid*.

⁷⁵ Iyer and others (n 66). cited in Namvar (n 81)., 7.

being information such as the platform's credit risk assessment of borrowers, whilst soft information is the type of information garnered from the platform's discussion boards. Similarly, Lin *et al* investigated the significance of social networks and how friendship becomes a guide for judging credit worthiness. The authors found that loans which result from those friendships have lower interest and default rates.⁷⁶ This supports the findings of Iyer *et al* that lenders also rely on soft information when making lending decisions. It is also supported by Ravina's study in 2012 which finds that factors such as age, physical attractiveness and race are also considered during lending decisions. In light of the financial crisis and the trend towards responsible lending in its wake, these findings indicate that regulation may need to encourage more responsible or effective decision-making amongst P2PLs. Duarte, Siegel and Young also conducted an empirical study and found that the loan requests of borrowers who are considered untrustworthy are less likely to be funded and the reverse being true for borrowers seen to be more trustworthy.⁷⁷ However, due to information asymmetries existing between the P2PLs and borrowers because borrowers have information the lenders do not, adverse selection bias may still arise.⁷⁸

2.3. Consumer Protection Rationale

Consumer protection regulations are defined as a body of law designed to prevent individuals from taking on excessive risk,⁷⁹ and protect consumers' interests at the individual transaction level.⁸⁰ The underlying idea is that consumers are in an inherently weaker position compared to businesses, and therefore require protection. At this transactional level, protecting a consumer means ensuring that within each agreement or transaction, there are no failures which can undermine consumers' ability to maximise their own welfare.⁸¹ By way of contrast, although competition law also aims to protect consumer interests, the

⁷⁶ Lin, Prabhala and Viswanathan, 'Judging Borrowers by the Company They Keep' (n 66).

⁷⁷ Duarte, Siegel and Young (n 69).

⁷⁸ Namvar (n 81) 14.

⁷⁹ Gerding EF, 'The Subprime Crisis and the Link Between Consumer Financial Protection and Systemic Risk' (2009) available at http://works.bepress.com/erik_gerding/4 at 2; see also Bar-Gill O and Warren E, *Making Credit Safer*, 157 U. Pa. L. Rev. 1 (2008).

⁸⁰ Max Huffman, 'Bridging the Divide? Theories for Integrating Competition Law and Consumer Protection' (2010) 6 Euro C J 7, 7.

⁸¹ *ibid* 9.

approach in which it does so occurs on a macro level, i.e. nation- or worldwide level.⁸² Additionally, it targets firms' practices without necessarily providing rights to consumers. For example, Chapter I of the Competition Act 1998 regulates anti-competitive arrangements such as when businesses within an industry agree to fix selling prices or other trading conditions. This means that whilst competition law targets unfairness or inequality of competition in the free market which ultimately maximises consumer welfare by giving consumers a variety of choices; consumer law is more individualistic because it protects the consumer more directly by giving them exercisable rights against a business or other parties, or enabling them to make free, rational selections from those choices.⁸³ From this perspective, the requirements of competition law and consumer protection law complement their similar goals.

In the field of consumer protection, 'harm' is considered a failure within the individual consumer transaction, and it usually occurs in the origination stage, i.e. the period before and during the entering of the agreement; or within the substance of a transaction.⁸⁴ This explains why most consumer protection regulations like information disclosure, focus on the pre-contractual stage of a transaction. For example, disclosure-based regulation requires information to be accurate and of sound quality to resolve the harm caused by gaps in the consumer's knowledge about the transaction they are about to enter and early cancellation rights to mitigate transactions entered by individuals in the spur of the moment. Such regulations aim to prevent failures which inhibit consumers' ability to enhance their welfare.⁸⁵

There are two main philosophical approaches to consumer protection regulation, RCT and the behavioural approach. Both propose different ways to regulate consumer welfare. The former suggests a non-interventionist approach, whilst the latter suggests the opposite.

⁸² *ibid* 7.

⁸³ Max Huffman, 'Bridging the Divide? Theories for Integrating Competition Law and Consumer Protection' *Euro C J* (2010) 6(1) 7-45 at 11.

⁸⁴ Huffman (n 90) 9.

⁸⁵ *ibid*.

2.3.1 Rational Choice Theory

Rational Choice Theory (RCT) is the idea that people are rational economic beings who, when faced with several choices, will choose the one they believe will maximise their welfare.⁸⁶ Consequently, according to this viewpoint, as individuals are able to make rational choices, the market will reflect the choices of all market participants thus guaranteeing market efficiency.⁸⁷

It has been treated as a mixture between a normative theory and an empirical one. It is normative in the sense that it attempts to define what is rational and empirical in the sense that it makes predictions about the behaviour of rational agents⁸⁸ based on this. Underlying the basic theory are the concepts of rationality and utility. From the rational choice perspective, rationality is understood in terms of the attempt to achieve a goal which one has good reasons to believe are in one's interests as understood by the decision-maker.⁸⁹ This means when an individual makes decisions, they are able to rank various goals based on their respective value or preferences and give reasons for them. This in turn is based on the view that economic rationality or self-interest is the main motivator behind human behaviour,⁹⁰ as opposed to altruistic concerns or actions based on passion or emotion.

The implication of RCT is that information is essential for consumers to make efficient and rational choices. Consequently, proponents of the theory favour a non-interventionist approach to consumer protection regulation. Examples include: information disclosure⁹¹ and the promotion of competition between different businesses,⁹² to provide consumers with an optimum number of choices. For example, information disclosure rules are designed to give individuals the required amount and quality of information they need to make good decisions.

⁸⁶ Folarin Akinbami, 'Financial Services and Consumer Protection after the Crisis' (2011) 29 *International Journal of Bank Marketing* 134, 135.

⁸⁷ Gerald Spindler, 'Behavioural Finance and Investor Protection Regulations' (2011) 34 *J Consumer Policy* 315, 317.

⁸⁸ Richard Warner, 'Impossible Comparisons and Rational Choice Theory' (1995) 68 *Southern California L Rev* 1705, 1706, footnote 5.

⁸⁹ Peter French, 'Agency Theory, Rational-Choice Theory, and Ethics' (1995) 5 *Business Ethics Quarterly* 621, 623.

⁹⁰ *ibid* 621.

⁹¹ Geraint Howells, 'The Potential and Limits of Consumer Empowerment by Information' (2005) 32 *Journal of Law and Society* 349.

⁹² Karen Yeung, *Securing Compliance: A Principled Approach* (Hart Publishing 2004).

This is because, to make a reasoned decision or choice, one needs to have all the facts relating to that decision available. Without this information, the reasons behind a choice may be at best inaccurate or at worst false. Therefore, without information individuals may make decisions that do not lead to the achievement of their goals.

The theory assumes that consumers will have enough information to base their preferences on and their choices will be clear and rational.⁹³ As the theory is based on the concept of rationality and therefore on reasoned choices, and because reasoned choices necessitate access to information relating to a choice, the theory also assumes that when making decisions, consumers will collect and evaluate the information available and base their decisions on this information alone.⁹⁴ This does not account for decisions based on emotional, cultural, or situational biases.

In the context of online P2PL, the RCT would imply that regulation should only ensure platforms provide its users with as much accurate information as is necessary for them to enter the right transactions. In fact, this non-interventionist approach is imbibed by many P2PL business models structured like Zopa, where the platforms are not party to the contract, but merely match consumers to each other and facilitate communication of both private information (credit scoring) and public information (through the discussion boards). The platforms provide lenders with credit reports and in some cases, teach them how to use them. It is then left to the lender to make a choice based on these credit reports and investing heuristics.

However, if the point of consumer protection regulation is to prevent or mitigate harm to consumers, then such protections are limited in scope because they can only help to resolve harms faced by lenders and borrowers at the decision-making stage when they are entering an agreement. It does not help resolve all the market failures faced during the life-cycle of the lending agreement from its start to the point it is repaid. Once the agreement is underway, information-based protections are of little use in resolving the harms faced by P2P users where they do not need to make any decisions as such, but need to be able to enforce their

⁹³ Spindler (n 98) 317.

⁹⁴ *ibid.*

rights under the agreement, e.g. the potential for market failure created by their reliance on the platforms to run smoothly and administer loan agreements efficiently or which arise from the expectations that the loans will be repaid.

An example of this limitation is demonstrated by a recent problem faced by users of some Chinese P2PL platforms. In Guangzhou, China, several cases were reported of female students who having borrowed money through the legitimate P2PL platform, Jiedaibao, were then coerced into sending naked photographs of themselves as collateral for a loan. Lenders had been using P2PL platforms to target university students, many of whom could not obtain credit from traditional lending sources such as banks. The lenders demanded that students provide photocopies of their identity cards, student cards and family data in addition to the nude photographs. Jiedaibao told a local newspaper, *Global Times*, that such demands were private deals between users which the platform could not interfere with, rather their response to the issue was to provide warnings to users about the need to protect their privacy and contact the police if necessary. Other platforms issued warnings to their members to stop obtaining this type of collateral.⁹⁵

One market failure demonstrated by this example is the failure of the platform to ensure trust between P2PLs and borrowers. For the type of business which facilitates transactions between anonymous strangers, part of the platform's role is to reassure lenders that they can trust the borrowers to repay their debt. This role is carried out through the provision of information such as credit ratings and sometimes access to a forum where users can communicate with each other. However, in this case, the information provided was insufficient to inspire such trust and led to further market failures such as breaches of privacy and personal abuse after the loan agreement had begun. This example, though extreme in its nature, shows that not all market failures are caused by lack of sufficient information or the inability to make sound decisions, neither can they all be resolved by regulation which helps to encourage rational decision-making. Therefore, it cannot help to stop at providing consumers with more choices and information. A more effective approach would be to create incentives for platforms

⁹⁵ Clifford Coonan, 'Loan Sharks Demand Nude Photos as Collateral from Students' (*The Irish Times*) <<http://www.irishtimes.com/news/offbeat/loan-sharks-demand-nude-photos-as-collateral-from-students-1.2685631>> accessed 12 July 2016.

to monitor and prevent the type of behaviours that occur when its users interact on the platform. An example of this would be to hold the platform responsible for the illegal actions of its users or for its negligent handling of such cases. However, such protections require a more interventionist approach than the RCT would permit.

The emphasis of the RCT approach on disclosure is limited to pre-contractual events and cannot adequately deal with the outcomes of consumer decisions, such as a platform's inability to recuperate debt from the borrowers. The very term, 'rational choice' implies there are choices to be made, but as demonstrated by the above example, this does not help in situations where the time for making choices has past and the need to implement or enforce those choices arises. Consequently, RCT alone inadequately explains or resolves the variety of market failures that can be experienced by P2PL participants.

2.3.2 Behavioural Economics

One problem with the RCT approach is that in any one transaction, there may be information asymmetries between the contractors, creating opportunities for fraud.⁹⁶ Information asymmetries occur when one party has more or better information than the other. This can lead to the party with superior information taking advantage of the other's lack of knowledge and to adverse selection which occurs when the immoral behaviour taking advantage of the asymmetric information occurs before the transaction. For example, a borrower who knows they cannot afford a P2PL loan but provides false or misleading information to secure a better rating. A second problem caused is moral hazard, where the immoral behaviour takes advantage of the asymmetric information after the agreement has started. For example, the fact a borrower has used a guarantor/collateral to signal his viability as a lending option, could lead to poorer loan performance because the borrower relies on the existence of the guarantor/collateral to fall back on rather than making all the repayments.⁹⁷ Similarly, one party may attempt to deceive the other through false information. E.g. a borrower can commit credit score fraud or document falsification to obtain a loan. It also does not consider the fact that the third party sources of information, in this case the P2PL platforms, may not always be what they seem. In the absence of adequate regulation, it is feasible to conceive of P2PL platforms being used as vehicles for long firm fraud, i.e. when a business is created, and developed a good reputation to win the trust of its customers or suppliers so its owners can defraud them. Such fraud is caused by the lack of knowledge of the customer that the platform is not genuine.

Furthermore, in online P2PL, the lenders' main source of risk information is the credit ratings provided by the platforms or their subcontracted credit ratings agencies. This is because lenders cannot source information about the borrower which they can use to judge their creditworthiness independently of the platform due to the anonymised nature of the transactions on P2PL platforms. The

⁹⁶ Darby MR, and Karni E, 'Free Competition and the Optimal Amount of Fraud' (1973) *Journal of Law and Economics*, 16, 67-88.

⁹⁷ Sumit Agarwal and others, 'Personal Guarantee and Peer-to-Peer Lending: Evidence from China' (Social Science Research Network 2015) SSRN Scholarly Paper ID 2638546 19 <<http://papers.ssrn.com/abstract=2638546>> accessed 13 July 2016.

collapse of Enron and the recent financial crisis has indicated that in some cases the information provided by ratings agencies lack credibility due to the conflict of interests between the issuer who pays for their services and the need to remain objective.⁹⁸ Arguably, this conflict of interests does not apply in the context of online P2PL because borrowers in such markets are not in a position to develop relationships with credit ratings agencies in a way that will affect the transactions. Still, it provides an example of the fact that participants in P2PL transactions must often base their decisions on the risk assessments of other providers of information, which they may not have the ability to verify. Therefore regulation should ensure adequate verification measures are in place, so that consumers get accurate information. The problems created by information asymmetries are particularly important for online P2PL because if taken advantage of they can compromise the trust each party has in the other, which is a critical issue for business models aiming to encourage transactions between strangers⁹⁹ who because they do not know each other, must be facilitated in trusting each other by the platform.

Regulators have attempted to correct information asymmetries either through the provision of increased amounts of information to individuals, or by ensuring the information available is clear and simple to understand. However, this may not always work for P2PL as the participants, being retail investors or ordinary consumers who have decided to try their hand at a new form of investing their savings, may not have much investment or lending knowledge or the expertise necessary to assess the outcome of financial transactions using the economic data provided to them.¹⁰⁰ Large amounts of information then becomes an internal transaction cost which individuals, participating in P2PL for personal rather than business gain, may disregard as too complex or copious.¹⁰¹

The recent mis-sold payment protection insurance (PPI) issue demonstrates this behaviour amongst consumers as does the Financial Ombudsman Service's approach to resolving these complaints. In cases where the consumer was sold PPI on a non-advised basis, i.e. where the financial business only had a duty to

⁹⁸ See McVea H, 'Credit rating agencies, the subprime mortgage debacle and global governance: the EU strikes back' (2010) I.C.L.Q. 701.

⁹⁹ Ashta and Assadi, (n 38) 8.

¹⁰⁰ Spindler (n 98) 318.

¹⁰¹ Spindler (n 98) 322.

provide the information a consumer needed to make an informed choice about whether to have PPI and present it in a clear, fair and non-misleading manner, many consumers either did not read all the terms and conditions of the agreement or they did not take steps to ensure they understood what they were signing, which explains why the policy was mis-sold to them in such cases. It is telling that the Financial Ombudsman Service's approach to these cases is to determine whether a consumer was given adequate information about the product. In deciding this, it looks at whether the financial business had drawn the consumer's attention to the significant features of the PPI policy, rather than just giving them the information. This is in line with their general complaints handling approach which is to look at everything that happened to give rise to the complaint and treat both parties fairly in coming to a decision about how to resolve the issue. This approach is adopted with all complainants regardless of their level of financial acumen judging by their background e.g. whether they are a banker working in the financial industry or a school teacher. Their rationale is that by highlighting the important policy terms, the financial business would have allowed the consumer to make an informed choice.¹⁰²

For example, in the final decision reference number DRN6430714, the case concerned the sale of a regular premium PPI policy sold alongside a credit card in 1998 on a non-advised basis. The Service had to determine whether NatWest had given 'Mr J', information that was clear, fair and non-misleading to put him in the position to make an informed choice. In deciding that the business had not provided sufficient information, the ombudsman had considered the fact that,

"...the leaflet does not contain important information concerning eligibility, any limitations or exclusions which may apply and most importantly the cost of the policy. A footnote indicates that further details will be sent on acceptance...This information is not drawn to the reader's attention but is contained...towards the very end of the leaflet in the section entitled offer terms and conditions. This information is written in small, closely worded text, spread over a number of pages and is very difficult to read. I am not persuaded that this was sufficient to

¹⁰² Financial Ombudsman Service Limited, 'Online PPI Resource - Our Approach to Payment Protection Insurance (PPI) Mis-Sale Complaints' (*Online PPI resource*, 18 April 2016) <http://www.financial-ombudsman.org.uk/publications/technical_notes/ppi-our-approach.html#9> accessed 13 July 2016.

draw Mr J's attention to information which he needed in order to make an informed decision about the insurance he was buying."¹⁰³

The implication of this approach, which focused on the way information was presented and whether key issues were pointed out to the consumer, is that there is an underlying assumption that the average person does not read through numerous pages of information, regardless of how important it is to the transaction at hand. This case highlights that although in theory, providing individuals with information might be a good way to enable them to make rational decisions, in practice, the way individuals behave may be responsible for impeding their ability to make rational decisions.

This example also relates to a second critique of the RCT provided by behavioural economics theorists. Behavioural economic theorists study how social and emotional factors impact the economic decisions of people and institutions. The critique is that people do not always make rational choices or act in ways that maximise their personal welfare. Rather, the simplification of complicated information by using heuristics combined with the natural tendency of people to copy each other's choices,¹⁰⁴ can lead to poor decisions. For example, herding is typical of distorted rational behaviour experienced by all individuals.¹⁰⁵ Therefore, RCT also assumes that individuals are willing to read all the information provided.

A consequence of RCT as it relates to regulation is the proposition that non-intervention is the most appropriate form of regulating the private transactions that people/businesses choose to enter because they are better able to judge for themselves what is good for them than anyone else. Non-interventionist regulations follow from this because they are based on the theory that there is no moral justification for intervening in others' affairs, e.g. because it violates their rights to freedom or respect due to their individual autonomy.¹⁰⁶ Examples include self-regulation or relaxed regulation like 'light-touch' regulation.

¹⁰³ The Financial Ombudsman Service, 'Ref: DRN6430714' (4 October 2013) <<http://www.ombudsman-decisions.org.uk/viewPDF.aspx?FileID=23195#page=1&zoom=auto,-94,848>> accessed 13 July 2016.

¹⁰⁴ Spindler (n 98) 324.

¹⁰⁵ *ibid.*

¹⁰⁶ Alexander Moseley, 'Interventionism', *Internet Encyclopedia of Philosophy* <<http://www.iep.utm.edu/interven/#H4>> accessed 13 July 2016.

However, in practice non-interventionist models of regulation do not always support the idea that because people are rational they should be left to their own devices, including to regulate their own behaviour. For example, prior to the financial crisis, one of the key regulatory approaches adopted in UK was the idea of 'light-touch' regulation. This consisted of a regime based on the idea that governments and regulatory agencies should not intervene in markets rather, they should leave the markets to regulate themselves with the government playing a small role which did not place unnecessary burdens on business.¹⁰⁷ Light-touch regulation usually takes the form of minimal regulation which is business-friendly, and reluctant to interfere with how businesses operate,¹⁰⁸ in this sense, it is non-interventionist. Prior to the financial crisis, the FSA's supervisors assumed that the judgement of a firm's senior management in combination with market discipline should not be questioned by regulators as they could be relied on to deliver efficient outcomes.¹⁰⁹ Consequently, the regulators did not make judgements about what could happen in the future and instead adopted a reactive approach to regulation where they only intervened if there was clear evidence of failings. However, this light-touch regulatory approach failed to control the systemic risks associated with consumer defaults during the financial crisis because it focused on the more observable factors of whether firms' systems and controls were in order rather than on their ongoing safety and soundness.¹¹⁰ This demonstrates that non-interventionist regulation can be ineffective and governments need to have a greater understanding of the regulated industries and firms as well as comprehensive involvement how the sector in question is regulated.

Interventionist consumer protection regulations, which comprise active involvement of the state to ensure the interests of individuals are protected, can help prevent similar risks within the P2PL business model, albeit on a transaction-by-transaction scale, by reducing the incidence of consumer default or at least

¹⁰⁷ Roman Tomasic, 'Beyond "Light Touch" Regulation of British Banks after the Financial Crisis' (Social Science Research Network 2010) SSRN Scholarly Paper ID 1561617 6 <<http://papers.ssrn.com/abstract=1561617>> accessed 13 July 2016.

¹⁰⁸ Folarin Akinbami (n 97) 140.

¹⁰⁹ 'Hector Sants' Prudential Regulation Authority Speech in Full' *The Telegraph* (19 May 2011) <<https://uk.finance.yahoo.com/news/Hector-Sants-Prudential-tele-1679794460.html>> accessed 13 July 2016.

¹¹⁰ *ibid.*

making it more predictable to lenders,¹¹¹ for example, by creating an onus on borrowers to provide more detailed information about their financial situation, including whether they are or have been involved in any IVAs or bankruptcies, the amount of their existing debt and their borrowing history etc. A more interventionist approach might be to limit the number of loans a medium to high risk borrower can take out at any one time on any P2PL platform. This latter suggestion would require communication between platforms and possibly the formulation of a borrower database of open P2PL loans. This could be managed through the P2P Association and governed by data protection laws, accessible only to platform moderators and credit risk agencies, except where borrowers request copies of their personal information.

Operating on the basis of *caveat emptor*, i.e. on the basis that people assume the responsibility to examine and decide for themselves whether to purchase a particular product/service, as is currently the case with many models of online P2PL, places a great deal of responsibility in the hands of inexperienced lenders, and can amount to abandoning them to the risks of the market they operate in.¹¹² In the long run, this may not be good for the market as if P2PL lenders or borrowers build up too much negative experience, they may lose confidence in the P2PL market causing the business model to fail.

Conversely, a purely interventionist approach is unsatisfactory due to its impracticality. It would be expensive to apply, and because of the consumer-to-consumer nature of P2PL business models, with the platform acting as a bystander to the transactions, it would not be practical to implement and monitor. Business models like Zopa's, suggest that a combined approach to consumer protection would be needed to fit most P2PL models. This would involve combining elements of non-interventionist regulation such as information disclosure to enable P2PL users to make informed choices. However in recognition that in a non-perfect world information alone is insufficient to protect individuals from the effects of market failures, it needs to be combined with a more interventionist approach where the regulators supervise the actions of the

¹¹¹ Erik Gerding, 'The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis: Code, Crash, and Open Source' (Social Science Research Network 2008) SSRN Scholarly Paper ID 1273467 21 <<http://papers.ssrn.com/abstract=1273467>> accessed 2 February 2013.

¹¹² Folarin Akinbami (n 97) 15.

platforms and ensure that the rights and interests of P2P users are enforceable. At the start of the transaction, the lenders make their decisions based only on information collated by the platforms from the consumers. Therefore, regulation at this end of the transaction can only intervene in terms of the information that is provided. Where interventionist regulation would be more useful is in providing the lenders with remedies for post-transaction events e.g. borrower default.

2.3.3 Paternalism

In light of the fact some, such as Verstein, have viewed regulation as an unnecessary hindrance to the growth of P2PL because of the costs involved and the risk it might create barriers to entry into the market for new, smaller platforms;¹¹³ and also in light of research such as Hulme and Wright's survey report suggesting that P2PL users tend to be independent and responsible people,¹¹⁴ it is necessary to justify intervening in their private transactions through the regulation of individuals and the P2PL market.

The concepts of paternalism and consumer protection are linked because consumer protection is a regulatory approach resulting from the theory of paternalism. When academics or regulators talk about imposing rules designed to protect consumers, they assume that consumers are incapable of achieving this goal themselves and that the state is in a position to know, understand and implement an individual's interests better than the individual can. This is the case even though the state is a third party, external to the choice to be made by the consumer or the action to be taken. In doing so, the state acts as though it has the right or authority to impose its understanding of individuals' interests over their own conception of their interests. Consequently, when the state intervenes in individuals' private transactions to protect them from the consequences of their actions, e.g. rash decisions leading to poorly made choices, or from market failures such as information asymmetries, the state is adopting a paternalistic stance. It is assuming a parental role towards the consumers, i.e. the state behaves as though it has the right and authority to

¹¹³ Verstein (n 14) 512-513, 529.

¹¹⁴ Michael K Hulme and Collette Wright, 'Internet Based Social Lending: Past, Present and Future' (2006) 11 Social Futures Observatory 19, 29, 91.

govern the individual's actions. It is also because the state is an external party that paternalistic actions need to be justified.

Definition of Paternalism

There is no set definition of paternalism or what amounts to a paternalistic act.¹¹⁵ Although many writers on the subject speak about the same general concept, they are divided about its meaning and therefore about what needs moral justification.¹¹⁶ Reviewing these different definitions highlights the different conceptions about what makes interventionist regulation at first glance problematic.

Dworkin originally defined paternalism as roughly, the interference with a person's liberty of action and such interference is to be justified based on the good, happiness, welfare, interests, needs or values of the person being coerced.¹¹⁷ Liberty of action is the power to determine one's actions without any interference or restraint, i.e. it is based on the notion of an individual's freedom. Underlying the notion of liberty of action is the belief that individuals are endowed with reason and natural rights and these factors give them the capacity to decide for themselves their own life-plans,¹¹⁸ be it choices, goals or actions. This definition assumes that all forms of paternalism are forced on the individual, however this does not consider paternalistic acts which do not involve coercion. A classic example is Homer's *Odyssey* story in which Ulysses instructs the sailors on his ship to tie him to the mast so he could listen to the song of the sirens without falling to the same fate of other sailors who had been driven to shipwreck and destruction in their desire to follow the sound, and ignore any demands he might make to untie him. By preventing Ulysses from acting on his desires to leave the boat, the sailors were acting paternalistically. However, they were doing so in accordance with his freely made request. This demonstrates that

¹¹⁵ Jeremy A Blumenthal, 'Emotional Paternalism' (2007) 35 Fla St UL Rev 1, 6; David L Shapiro, 'Courts, Legislatures, and Paternalism' (1988) 74 Va L Rev 519, 522.

¹¹⁶ David J Garren, 'Paternalism, Part I' (2006) 47 Phil Books 334., 334.

Bernard Gert and Charles M Culver, 'Paternalistic Behavior' (1976) 6 Philos Public Aff 45

¹¹⁷ Gerald Dworkin, 'Paternalism' in Rolf Sartorius (ed) *Paternalism* (University of Minnesota Press, 1983) 19, 20.

¹¹⁸ John Kleinig, *Paternalism* (Manchester University Press 1983) 3.

paternalism does not need to be linked to coercion or force. What can be gathered from this definition therefore, is that the contentiousness of interventionist regulation is the idea that it involves compelling an individual to do something they would not ordinarily do or want to do.

Gert and Culver challenged Dworkin's definition for two main reasons. Firstly, by using the term 'liberty of action' Dworkin had limited the definition of paternalism to acts which interfered with a person's actions or behaviour. Secondly, Dworkin had assumed all forms of paternalism involved coercion. In contrast, Gert and Culver argued that paternalism can occur in the absence of interference with a person's liberty of action and coercion.¹¹⁹ So by limiting the definition of paternalism to acts which involve coercion or liberty of action, Dworkin did not consider the full spectrum of acts which can be characterised as paternalistic.

Dworkin later amended his definition stating that paternalism should be understood more broadly as an interference with a person's autonomy and this interference could range from rational argument to physical force.¹²⁰ This change expanded the definition of paternalism by shifting the focus from 'liberty of action' to 'autonomy.' These concepts differ in meaning. 'Liberty of action' focuses on the idea of freedom in relation to one's actions and behaviours. Consequently, a definition containing this concept perceives paternalism as the deprivation of the freedom to act or behave in a certain way. However, not all acts viewed as paternalistic involve the deprivation of freedom, e.g. providing state benefits to members of society who can no longer work for themselves, or job seekers allowance to members of society currently unemployed but who are looking for a job and need financial assistance in the meantime. In these examples, the state takes over the responsibility of an individual to provide for themselves, but there has neither been any coercion nor has the state deprived them of their freedom to work or provide for themselves.

However, autonomy is the actual or potential ability to exert control over oneself, unlike liberty of action which is simply the freedom to act. To be autonomous an individual's actions must be truly their own, e.g. if A studies medicine because A

¹¹⁹ Bernard Gert and Charles M Culver, 'Paternalistic Behavior' (1976) 6 *Philosophy & Public Affairs* 45, 48, 49; Bernard Gert and Charles M Culver, 'The Justification of Paternalism' (1979) 89 *Ethics* 199, 199–210.

¹²⁰ Gerald Dworkin, 'Paternalism: Some Second Thoughts' in Rolf Sartorius (ed) *Paternalism* (University of Minnesota Press, 1983) 105, 107.

believes doing so offers good opportunities, then A can be said to be acting autonomously. But if A studies medicine because of parental pressure, the decision to choose that course of action was not truly A's due to the outside influence, and therefore cannot be described as autonomous.

Therefore, by changing his definition to use the word 'autonomy' instead of 'liberty of action,' Dworkin incorporated the idea that paternalism did not just impact actions, but it could also affect a person's will. Hence Dworkin's use of the example of rational argument, which does not interfere with a person's ability to carry out a particular action, nor does it necessarily coerce a person to act in a particular way, but it does interfere with their current way of thinking and reasoning. Although the use of the word 'autonomy' means that the definition is broad enough to accommodate scenarios that are usually considered to be paternalistic but which his original definition did not accommodate, the concept of autonomy has the potential to be too broad. This is because it could be argued that an individual's desires and choices etc. can all be said to be partly influenced by factors outside of the agent's control e.g. drug and gambling addictions compel an individual to take drugs and gamble against their better judgement, and an individual's opinions can be moulded by the way the media presents news stories. However, neither case would be viewed as an act of paternalism. However, the shift in focus to autonomy and the removal of the need for coercion, reveals that the main problem with paternalism that this definition highlights is the very fact that it contravenes an individual's will. This takes for granted that individuals' autonomy is the greatest value to be promoted and anything else is of less importance, e.g. the good of society.

In the context of this thesis, in which paternalism is used as a justification of more interventionist P2PL regulation, the implication of this expanded definition is that it indicates that paternalistic regulation not only has the potential to affect a P2PL user's behaviour on a platform in terms of what they can or cannot do, but can also affect their desires, intentions or choices regarding the platform. Although this might seem heinous because of the deprivation of the users' abilities to act and choose outcomes for themselves, in practice, this does not have to be considered a negative prospect. For example, as part of the FCA's aim to protect the users of P2PL platforms, its regulatory regime requires that all platforms must have a certain amount of capital set aside to ensure their liquidity and,

arrangements in place for a third party to take over their role administering loans if the platform itself collapses. This has the potential to influence current or prospective users to have more confidence in the P2PL industry and therefore cause them to adopt P2PL as a way to invest their savings in the case of prospective lenders, or to feel safe enough to lend more of their money on the platforms in the case of current users.

Shapiro has suggested that the underlying element of every definition of paternalism, and a key part of the concept, is that a paternalistic act is one which is carried out to benefit the action's target, whether an individual or a group.¹²¹ Shapiro does not give examples of the different academics' definitions which agree on this point, but it does seem to be an aspect of paternalism most commentators seem to agree on, because what differs in their definitions are other factors such as how that benefit is brought about e.g. whether or not through coercion or whether or not the target gave consent.¹²² For example, Dworkin provides that the reasons for a paternalistic act are the good, happiness, welfare, interests, needs or values of the target. All these things can be said to be things that benefit the target. Similarly, Gert and Culver's definition includes the requirement that the actor believes they are acting for the target's good.¹²³ Likewise, Thaler and Sunstein state that the goal of paternalistic acts is to make the affected parties "better off."¹²⁴

However, he criticises definitions which have as their only requirement the benefit provided by the act as being too broad and to demonstrate this, gives the example of a government operated lighthouse in dangerous waters which benefits the sailors navigating those waters. To consider such a law as paternalistic because of benefit alone would cause the concept to have little value,¹²⁵ no doubt because to define it this way would mean the term could be too broadly applied to any piece of legislation that benefits its targets. Shapiro therefore considers paternalism to include a combination of benefit to its targets and a propensity to continue acting thus, regardless of the target's consent. Coercion may or may not

¹²¹ Shapiro (n 128) 522; Blumenthal (n 128) 6.

¹²² Gert and Culver (n 132) 46–50.

¹²³ *ibid* 49.

¹²⁴ Richard H Thaler and Cass R Sunstein, 'Libertarian Paternalism' (2003) 93 *The American Economic Review* 175, 175.

¹²⁵ Shapiro (n 128) 523.

be a factor.¹²⁶ So according to Shapiro, an action is paternalistic if the actor knows that the target does not consent and may withhold consent if it is asked for.¹²⁷

Similarly, Paul Burrows' definition focuses on the degree of consent expressed by the target. Like Shapiro, he states that an act is paternalistic if the actor pursues it for the target's benefit and would do so knowing the target did not consent. The intention being to persuade, induce, or compel an individual to do something he would not otherwise choose to do, to benefit that individual.¹²⁸ To do something to or for an individual without the individual's consent would normally be viewed with distaste. The discomfort caused by the notion relates to the person's individual autonomy and the ingrained notion that every individual has a right to order their own lives and make their own choices, so that to strip that capacity from someone would take something away from that individual, be it an inherent value or substance or just to infantilize that individual by treating them as though they were children.¹²⁹

In light of this, for an actor to proceed regardless of whether the target provides consent suggests four underlying implications of paternalism where the definition focuses on the concept of consent. Firstly, the actor has the authority to override the target's will, because if not, the action may not be legitimate and therefore impermissible. Secondly, in the actor's mind, there is a good reason for intervening or overriding that will. Although, this second implication depends on the value one places on individual autonomy. For example, in contemporary liberal society, great importance has been placed on the individual,¹³⁰ so there needs to be a good reason for intervention. In comparison, the social order of medieval societies placed more importance on the communal and social needs above the individual's,¹³¹ so undermining a person's autonomy could be justified in relation to the society's good. Thirdly, the reason posited by the actor is more crucial or beneficial than respecting the target's freedom or right to choose for oneself and fourthly, the actor believes they are in the best position to achieve

¹²⁶ David L Shapiro, 'Courts, Legislatures, and Paternalism' [1988] *Virginia Law Review* 519, 523.

¹²⁷ Shapiro (n 128) 525.

¹²⁸ Paul Burrows, 'Analyzing Legal Paternalism' (1995) 15 *Intl Rev L & Econ* 489, 495; Blumenthal (n 114), 6.

¹²⁹ Peter De Marnefee, 'Avoiding Paternalism' (2006) 34 *Philosophy & Public Affairs* 68, 68.

¹³⁰ Kleinig (n 131) 3.

¹³¹ *ibid.*

this outcome. From the perspective of regulators, all these factors are present when they issue rules over a business' activities or intervene on behalf of a consumer in the absence of consent.

However, the more common definition is that a paternalistic act is an action undertaken by a person with the goal of furthering another's good.¹³² The focus placed on the aim of producing some sort of benefit or good, implies that the motivation behind the act is a key factor of the definition, rather than just the end results. Therefore, an action would still be viewed as paternalistic even if the result did not produce the benefit intended. E.g. according to Kronman, generally any legal rule that prohibits an action on the basis that it would be contrary to the welfare of the target is paternalistic; therefore a law requiring individuals to wear seatbelts and helmets is paternalistic.¹³³ This is because one of the central purposes of the law is not just to protect third parties from the target, but to protect the target from themselves by curtailing their power to act in a way that the law deems contrary to individuals' own interests.¹³⁴ Kronman therefore argues that although paternalistic laws are sometimes necessary, when one is adopted, there is an obligation on the lawmaker to explain why the interference is justified in some cases but not in others – this is in order to legitimise the paternalistic action or law and define its limits.¹³⁵ By referring to an obligation on the lawmaker to justify interference, this perspective of paternalism assumes that it is automatically problematic and requires express justification because it is also influenced by the theory that individuals are rational and when making decisions for themselves they will generally choose the best option available to them. These issues of justification are discussed in the next section on the debates surrounding paternalism.

Unlike Burrows and Shapiro, Van De Veer has posited that an act does not require the absence of consent to be paternalistic, because it can still be paternalistic if the target provides the actor with consent. Van De Veer provides the example of a person who thinks he will drink too much at a party and gives his car keys to a friend asking him to hide the keys or somehow prevent him from

¹³² Blumenthal (n 128), 6.

¹³³ Anthony T Kronman, 'Paternalism and the Law of Contracts' (1982) 92 Yale Lj 763, 763..

¹³⁴ *ibid* 764..

¹³⁵ *ibid* 765.

driving home.¹³⁶ Van DeVeer's definition of paternalism is therefore an action which is at odds with the target's preferences at the time of action. Consequently, if the person, now drunk, demands his keys back from his friend and the friend refuses, this denial is a paternalistic act.¹³⁷ This means that consent is not a necessary requirement of a definition of paternalism, what matters is what the target's preferences were at the time of the act and whether at that time, the act contravened them. Rather, this means that the usefulness of the concept of consent in relation to paternalism lies with its ability to add support for why the actor intervened, i.e. as a justification for the paternalism.

However, Van De Veer states that a paternalistic action may be justified by prior consent.¹³⁸ This serves to broaden the definition of paternalism firstly because an action can be paternalistic with or without the target's consent and secondly because for an action to be considered paternalistic, it merely needs to be contrary to the target's preferences when the action is being carried out. This implies that in cases where the target previously provided his or her consent to the action (Time1), the action automatically becomes paternalistic as soon as that consent is revoked, i.e. the recipient changes his mind (Time2). Therefore, within this construction of the concept of paternalism, consent becomes a factor in the legitimisation of the action, since prior consent can justify a paternalistic action, rather than a determinant of what makes an action paternalistic.

This approach to paternalism creates a conflict between an individual's preferences as expressed at different times, i.e. whether the preference expressed at Time1 should be honoured or the changed preference expressed at Time2. This is the issue of the 'multiple selves',¹³⁹ which is the idea that an individual's personality changes over time and that the way a person thought or behaved in the past is different from the way the person thinks or behaves in the present; problems arise when one has to consider which phase of the evolving personality takes priority over the other, i.e. the preferences of the former self or the preferences of the current self.¹⁴⁰ This potentially gives rise to further issues for the justification of a particular paternalistic regulation. Yet, if this definition

¹³⁶ Cited in Blumenthal (n 114), 6.

¹³⁷ Cited in *ibid* 7.

¹³⁸ Cited in Blumenthal (n 128), 7.

¹³⁹ *ibid* 7.

¹⁴⁰ *ibid*.

were applied, any governmental action could be deemed paternalistic in a broader sense at least, because in democratic countries, governments are voted in by the public on the basis that they will act on their behalf regarding various matters. However, as Blumenthal points out, although affecting the target's behaviour or choices is a necessary condition for an act to be paternalistic, it cannot be a sufficient condition because this would mean any governmental action should be considered paternalistic, which is too broad a claim.¹⁴¹

Blumenthal's definition of paternalism involves third party intervention into an individual's behaviour or decision-making processes, with the aim of protecting individuals from the consequences of actual or potential biases in their decision-making process.¹⁴² He goes further by defining a form of paternalism called, 'emotional paternalism,' which is typically governmental conduct which intervenes in an actor's decision-making at Time1 (with previously obtained consent) or Time2 (at a time where consent has been withdrawn), either when that decision-making involves judgements about emotions or emotionally-laden topics, or when it was, or has the potential to be, biased by emotions evoked by the objective of a judgement or incidental, transient moods.¹⁴³ The idea underlying the concept of emotional paternalism is that people's emotions render them vulnerable to poor decision-making. This concept therefore embraces the idea that paternalism does and should protect individuals from themselves regardless of their consent.

However, this definition does not account for the type of regulation which interferes with the target's actions to benefit a target whose autonomy or freedom is not affected by the action. For example, the FCA regulatory regime in the UK provides that businesses of financial services should have a complaints procedure in place to resolve disputes between them and their customers. Compelling a business to have a complaints procedure interferes with its ability to operate in the way it sees fit. Additionally, having such a complaints procedure may detrimentally effect the business, in the sense that it will inflict extra costs on the business e.g. the need to employ and train staff to resolve the complaints; if the complaint is found to be valid the cost of compensating the customer for the

¹⁴¹ Blumenthal (n 128), 9.

¹⁴² *ibid.*, 9.

¹⁴³ *ibid.*, 10.

wrongdoing; and the potential damage to the firm's reputation. On the other hand, the regulatory requirement benefits the customers by giving them the capacity to ensure their complaints are addressed, but the paternalism does not deprive the customer of a freedom nor reduce the customer's autonomy in some way.

Seana Shiffrin's account of paternalism goes some way to addressing this point. She views paternalistic actions as by definition an interference with personal sovereignty.¹⁴⁴ Shiffrin has characterised paternalism as behaviour towards another which meets the following conditions:

- a) It aims to have or avoid an effect on B or his/her sphere of legitimate agency, i.e. the areas or issues that B has the right to control or make decisions about.
- b) It involves the substitution of A's judgement or agency for B's
- c) It targets B's interests or matters that legitimately lie within B's control
- d) It is undertaken because A regards his/her judgement or agency to be (or is as likely to be) superior to B's judgement or agency.¹⁴⁵

One implication of Shiffrin's definition is that there must be a motive behind the action – it must aim to either create a positive impact on the target, or limit a negative one. In this sense, an action cannot be classified as paternalistic simply because it provides a benefit to the target or because it coerces the target to behave in a certain way, rather, it must be designed to do this. There are two key features of Shiffrin's account of paternalism which differentiate her definition from others. Firstly, paternalism does not necessarily involve active interference and secondly, it does not have to involve a specific concern for the target's welfare.

In relation to the first point, unlike the academics discussed above, Shiffrin considers that even an omission can be considered paternalistic because depending on its motive, an omission can also affect an individual's autonomy just like an action can. She provides the example of an individual who asks a friend for help building a set of shelves. The friend refuses because the individual often asks for help to his own detriment, i.e. he is failing to learn the skills needed

¹⁴⁴ Christian Coons and Michael Weber, 'Introduction: Paternalism – Issues and trends' in Christian Coons and Michael Weber (eds) , *Paternalism: Theory and Practice* (Cambridge University Press 2013), 5.

¹⁴⁵ Seana Valentine Shiffrin, 'Paternalism, Unconscionability Doctrine, and Accommodation' (2000) 29 *Philosophy & Public Affairs* 205, 218.

to do things by himself. If the friend voices these concerns and persuades the individual to build the shelves himself, this cannot be paternalistic, but if the friend refuses to help without explaining these reasons to the individual, Shiffrin considers this omission to be paternalistic. The crux of this argument is that in the former scenario, the friend respects his autonomy because by providing the individual with reasons why he should change his mind and act differently, the friend has respected his capacity or right to make decisions about his own actions. Whereas, in the second scenario, the friend has supplanted the individual's judgement about what is good for him with her own.

Regarding the second point, the fact that a paternalistic action/omission does not have to be concerned with the target's wellbeing means that an action can be paternalistic even if the actor's consideration is for a different party. For example, if the actor intervenes with the target's business operations, not out of concern for how well the business is run, but because of concerns with how the business' operations impact its stakeholders, this intervention can be defined as paternalist. Examples of this therefore include environmental regulations which prohibit the flushing of industrial waste into nearby rivers because it could cause disease to society members and be detrimental to the environment. Here, the regulator takes control over a decision that is within the business' domain, how the business should be run, by supplanting the business operators' judgement that flushing waste into rivers is cheaper and therefore more efficient for the business, with the regulator's judgement that it is better to protect the health and safety of members of the society. Therefore, within Shiffrin's definition, the key contention of paternalism is not that the intervening act is done on behalf of the target or for the benefit of the target, rather paternalism occurs because an aspect of the target's autonomy has been taken over.

This review of the definitions of paternalism highlights that there are as many conceptions of paternalism as there are authors of the topic.¹⁴⁶ The aim has not been to posit a new definition to add to the already large pantheon of definitions of paternalism. Rather, by reviewing the different ways that academics have defined and redefined the concept, it highlights the contentions contained within the concept and which demonstrate why paternalistic regulation is in need of

¹⁴⁶ D J Garren, 'Paternalism, Part I' (2006) 47(4) *Philosophical Books* 334, 340.

justifying. This has led Garren to conclude that, “while there is little to no agreement among contemporary authors as to paternalism’s intension or extension, and therefore little to no agreement as to what, precisely, stands in need of moral justification, there is widespread agreement that paternalism however defined – intent or effect, attempted or successful, coercive or non-coercive, consensual or non-consensual,...state or personal, public or private, hard or soft...does give rise to a question of moral justification”¹⁴⁷ because in all definitions as has been seen, paternalism involves the intrusion of an external party, e.g. a regulator, into the private affairs of an individual and this intrusion needs to be justified in order to be considered appropriate. In cases like P2PL which involve multiple parties, each party has interests and goals which might differ or conflict with the other parties’ interests or goals. This means that consumer protection regulation has the potential to harm one party’s interests or supplant their autonomy to benefit the other. Consequently, to expect the regulators to intervene more actively to protect P2P participants even though they have voluntarily agreed to take part in the private loan contracts, requires justification about why such intrusion is appropriate or necessary.

The concepts of rational choice and behavioural economics both elicit debate about the way an individual behaves within the context of their economic or other actions. These discussions are only useful to regulators because by explaining how individuals behave or make decisions or choices, they contribute to answer the question of why a consumer may need regulation and how much. For example, RCT answers this question by saying that either no regulation is needed because the market regulates itself, or little regulation is needed, e.g. the proponents of the provision of information only and the need to make consumers take more responsibility for their actions. In contrast, behavioural economics theory answers the question by implying that more regulation is needed because consumers need extra help in their transactions. In relation to the regulation of P2PL, and consumer protection regulation in general, both theories link to the debate about paternalism because they are often used as a justification for or against it, or more or less of it. The debate about paternalism furthers this

¹⁴⁷ D J Garren, ‘Paternalism, Part I’ (2006) 47(4) Philosophical Books 334, 341.

question because depending on whether it is justified, one can argue for the regulation of a particular behaviour or industry.

Key debates surrounding paternalism

Paternalism is a concept that gives rise to debates concerning several philosophical and political issues including the nature and importance of freedom and autonomy, and the relationship between the state and the individual¹⁴⁸ because of the importance of the individual within modern society and the practical effect of paternalism on autonomy and freedom. It has important practical implications for regulatory policy, because regulation that is considered paternalistic causes a lot of controversy,¹⁴⁹ due to the historic association of paternalism with the limitation of individuals' liberty, freedom and autonomy.

The central debate about paternalism concerns whether it can ever be justified and under which circumstances.¹⁵⁰ Perhaps to soften its blow to the ideals of liberty and autonomy and to curtail negative criticism, paternalism has been divided into different types, mainly hard and soft paternalism. 'Hard' paternalism involves policies and regulations which target knowledgeable and competent agents, whereas 'soft' paternalistic policies are limited to targeting agents who do not act knowledgably or voluntarily,¹⁵¹ e.g. mental patients.

The presumptively problematic nature of paternalism

One of the key issues in the philosophical debate about paternalism is why it is automatically considered always wrong or at the very least always to be avoided. J.S. Mill the key proponent of act utilitarianism, argued against paternalism of any

¹⁴⁸ Christian Coons and Michael Weber, 'Introduction: Paternalism – Issues and trends' in Coons and Weber (n 157)., 1.

¹⁴⁹ Christian Coons and Michael Weber, 'Introduction: Paternalism – Issues and trends' in *ibid.*, 1.

¹⁵⁰ Christian Coons and Michael Weber, 'Introduction: Paternalism – Issues and trends' in *ibid.*, 2.

¹⁵¹ Christian Coons and Michael Weber, 'Introduction: Paternalism – Issues and trends' in *ibid.*, 2.

form except where it is to prevent harm to others.¹⁵² However, the theory of act utilitarianism does not provide much help explaining why paternalism is intrinsically problematic because regardless of how it is defined, paternalism can maximise utility.¹⁵³

However, as Mill argued, individuals can be considered to be in a better position to know where his/her happiness lies and the best way to achieve it. This is a powerful argument against state paternalism, because politicians and regulators are not able to know an individual well enough to understand what is best for that person or tailor a policy specifically for that individual's needs. Additionally, state paternalism in the form of policies and laws apply to the citizenry, so they are too general to be sensitive to the varying interests of their targets.¹⁵⁴ A utilitarian anti-paternalist may therefore argue that the paternalist rarely promotes the good and is never in a position to know when it will.¹⁵⁵

Still, this argument merely demonstrates that paternalism can be ineffective, it does not answer the question of why it cannot be justified or why it is thought to be always wrong. After all, the fact something is ineffective does not mean it should be banned in all situations, it simply points to the need for improvement. This is also the case with arguments that criticise paternalism on the basis that it limits freedom and autonomy, because paternalistic policies may promote the greater good in the long run, e.g., preventing someone from contracting into slavery increases his/her overall freedom.¹⁵⁶ Coon and Weber provide an example of paternalistic policies which act in an anti-paternalistic manner: where the least paternalistic state prohibits its citizens from travelling to various countries to prevent them from being subject to greater paternalism later on.¹⁵⁷ This demonstrates that paternalism can be used to promote non-paternalism, therefore throwing into confusion the argument that paternalism is always bad and should be completely prohibited.

In trying to answer this question, Coon and Weber examine ordinary articulations of anti-paternalism and find that what makes paternalism presumptively wrong

¹⁵² John Stuart Mill, *On Liberty* (Hackett Publishing Company 1978).

¹⁵³ Christian Coons and Michael Weber, 'Introduction: Paternalism – Issues and trends' in Coons and Weber (n 157)., 7.

¹⁵⁴ *ibid.*, 7.

¹⁵⁵ *ibid.*, 7.

¹⁵⁶ in *ibid.*, 8.

¹⁵⁷ *ibid.*, 9.

eludes us.¹⁵⁸ For example, when ordinary people state that “you/the government cannot tell me what’s good for me,” they are stating that paternalism fails to respect the freedom and autonomy of individuals when they impose values on them, e.g. laws which require motorcyclists to wear helmets assume that the risk of injury outweighs the thrill of riding without a helmet whereas some motorcyclists might place more value on the latter.¹⁵⁹ If this mentality was applied to the P2PL landscape, coupled with Hulme and Wright’s analysis of P2PL users as inherently independent and autonomous,¹⁶⁰ some could argue that paternalistic regulation inhibits their ability to exercise that independence and personal autonomy. Consequently, the implication is that regulation of the lenders and borrowers should reflect this e.g. through methods focusing more on information disclosure and financial education.

Shiffrin’s characterisation of paternalism might suggest that it is presumptively wrong because it treats its targets like children. The fourth part of her characterisation is that A undertakes a paternalistic act because A regards his/her judgement/agency to be or more likely to be, superior to B’s judgement/agency.¹⁶¹ Therefore, A like a parent, supposes an authority to make decisions on behalf of B.¹⁶² Whilst assuming authority is not intrinsically wrong, it is the underlying expression of A’s superiority over B through a paternalistic act or decision that most would consider distasteful, because it suggests that B is less intelligent or less able to make decisions for him/herself.¹⁶³

Coons and Weber argue that this point is also dissatisfying because in acting paternalistically, A may not necessarily be expressing an intrinsic superiority over B, but may act paternalistically because they recognise that B is in a particular state or situation where people happen to make frequent mistakes in their reasoning, so the paternalistic act may simply be local, temporary or circumstantial.¹⁶⁴ In this light, a paternalistic act can be construed as a responsive

¹⁵⁸ *ibid.*, 12.

¹⁵⁹ *ibid.*, 9.

¹⁶⁰ Michael K Hulme and Collette Wright (n 127).

¹⁶¹ Shiffrin, “Paternalism, Unconscionability Doctrine, and Accommodation” cited in Christian Coons and Michael Weber, ‘Introduction: Paternalism – Issues and trends’ in Coons and Weber (n 157)., 5.

¹⁶² *ibid.*, 12.

¹⁶³ Christian Coons and Michael Weber, ‘Introduction: Paternalism – Issues and trends’ in *ibid.*, 12.

¹⁶⁴ Christian Coons and Michael Weber, ‘Introduction: Paternalism – Issues and trends’ in *ibid.* 13-14.

action to a recognised need, which is not necessarily a bad thing so long as the action chosen is appropriate and the need is properly identified. This highlights that paternalistic conduct is not fundamentally wrong, rather it is method and reasoning underpinning each act that is deserving of criticism and the same can be said of any form of conduct or regulation.

They also highlight that what anti-paternalists might consider to be objectionable about paternalism is not the expression of superiority over an individual, or that the paternalist may not fully understand the target's interests, rather, for paternalism to be effective it requires the paternalist to use private information to make a public decision. What B considers to make their life worth living or their choice the best one for them, is private information and even if A is in a position to know exactly what these interests are, using them involves a degree of invasion of privacy.¹⁶⁵ Even if it is shown that paternalism does not need an understanding of an individual's personal values to be effective, acting in a paternalistic way without considering a target's own evaluative perspective, demonstrates a willingness to impose values on that target. The implication is that paternalism either amounts to an invasion of privacy or the disregarding of a target's personal values.¹⁶⁶

Justification of Paternalism

Behavioural economics research has identified many decision-making errors that individuals make which has expanded the debate about paternalism. To the extent the errors identified by this body of research leads people to not behave in their best interests, paternalism can be argued to be justified. There are two historic justifications for paternalism. Firstly, scepticism about the ability of certain categories of people to make decisions in their best interests, e.g. the mentally disabled and minors.¹⁶⁷ Secondly, there are situations where even sound-minded individuals may make decisions which are not in their long-term interests.¹⁶⁸

¹⁶⁵ *ibid* 14.

¹⁶⁶ *ibid* 14.

¹⁶⁷ Colin Camerer and others, 'Regulation for Conservatives: Behavioral Economics and the Case for Asymmetric Paternalism' (2002) 151 U Pa L Rev 1211.

¹⁶⁸ *ibid* 1213.

Behavioural economics has added to the paternalism debate by describing ways in which people sometimes fail to behave in their best interests. For example a substantial body of literature investigates the ways people fail to process information; Tversky and Kahneman attribute such failures to people evaluating probabilities based on stereotypes,¹⁶⁹ and Rabin and Schrag find that actors sometimes interpret ambiguous evidence to confirm their current understanding about the world.¹⁷⁰ Another body of literature documents how people systematically make judgement errors about the costs and benefits of their choices, e.g. the extent of loss aversion shown in people's decisions appears not to match their actual experiences of gains and losses.¹⁷¹ Such errors of rationality, demonstrate a need for paternalistic policies which aim to help people make better decisions or behave in their own best interests.¹⁷² This is because the existence of the errors of rationality means if the consumers cannot pursue their own interests something else should step in to do so for them, at least where there is a public interest in doing so.

Commentators have discussed the practical implications of behavioural economics for the law. For example, it suggests an increased role for third parties to help protect people from their own prejudices, particularly with respect to the suitability of paternalistic policies.¹⁷³ It would be worth applying such questions specifically to the regulation of P2PL to analyse on a cost-benefit basis whether paternalistic policies are appropriate for this market. It might be that due to the varied models of P2PL operations and the different levels of risk involved in each type, paternalistic policies may not always be proportionate.

Blumenthal has argued that whilst many scholars agree that individuals' decision-making processes are subject to biases and various failings, discussions have focussed on cognitive biases. He argues that people are probably more susceptible to emotional biases which may also be harder to correct.¹⁷⁴ This is a

¹⁶⁹ Daniel Kahneman, Paul Slovic and Amos Tversky, *Judgement under Uncertainty: Heuristics and Biases* (Cambridge University Press 1982) 5.

¹⁷⁰ Matthew Rabin and Joel Schrag, 'First Impressions Matter: A Model of Confirmatory Bias' (1999) 114 Q J Econ 37, 38-39.

¹⁷¹ Amos Tversky and Daniel Kahneman, 'Loss Aversion in Riskless Choice: A Reference-Dependent Model' (1991) 106 The Quarterly Journal of Economics 1039, 1047-1048.

¹⁷² Camerer and others (n 180) 1218.

¹⁷³ *ibid* 1213; Russell Korobkin, 'Bounded Rationality, Standard Form Contracts, and Unconscionability' (2003) 70 University of Chicago Law Review 1206, 1206.

¹⁷⁴ Blumenthal (n 114), 5-6.

key issue because a paternalistic policy is largely justified because of either a cognitive or emotional bias preventing proper rational reasoning in an individual, and if it is harder to correct an emotional bias, then a paternalistic regulation that is adequate for a cognitive bias, may not be suitable or capable of correcting the emotional one. Therefore, the distinction between cognitive and emotional biases has important consequences for the cost-benefit analysis which should evaluate how appropriate paternalistic intervention is.¹⁷⁵

Thaler and Sunstein have suggested a form of paternalism which is simultaneously libertarian, called 'libertarian paternalism'. This advocates policies which 'nudge' people to make better choices without precluding an option or increasing the costs of choosing it. It is based on a psychological research showing that people's choices are influenced by small aspects of the choice environment. For example, people tend to have a bias towards the status quo rather than to change, so where there is a default option, individuals' choices tend to be heavily influenced by it. Again, people tend to be risk-averse in the face of potential losses, but risk-seeking in light of potential gains, so choice can be influenced by how it is framed – as a loss or a gain.¹⁷⁶ Thaler and Sunstein therefore argue that policy-makers should take such psychological tendencies into consideration and create choice environments where individuals will choose what is in their best interests.¹⁷⁷ This has implications for regulation based on information disclosure because the way the information is framed may have an adverse effect on borrowers and lenders but a positive effect for the industry players who encourage them to lend or borrow on their platform, or vice versa.

Policies which are libertarian paternalistic are paternalistic because they nudge people, and libertarian because they preserve freedom of choice.¹⁷⁸ Thaler and Sunstein give the example of a school cafeteria where food is arranged in a way that common cognitive biases lead people to make healthier choices, although unhealthy food is still served at no extra cost. Such a strategy is paternalistic because it nudges people to make better health choices but does not cause any

¹⁷⁵ *ibid* 6.

¹⁷⁶ Christian Coons and Michael Weber, 'Introduction: Paternalism – Issues and trends' in Coons and Weber (n 157)., 15.

¹⁷⁷ *ibid*.

¹⁷⁸ Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness* (Yale University Press 2008), 5; Christian Coons and Michael Weber, 'Introduction: Paternalism – Issues and trends' in *ibid* 14.

detriment. Libertarian paternalism may therefore fall under Joel Feinberg's definition of 'soft paternalism' where an actor has the right to prevent self-regarding harmful conduct only when that conduct is substantially non-voluntary or when temporary intervention is necessary to establish whether it is voluntary.¹⁷⁹

Soft paternalism so defined, amounts to Mill's first justification of paternalism which concerns the nature of an individual: if the individual's judgement is impaired e.g. because of such things as immaturity or ignorance, to the extent that the individual does not know or appreciate or is incapable of knowing or appreciating the actual or potential harm to himself, then paternalism is justified.

Conversely, anti-paternalists might argue against paternalism even in its soft, 'nudge' form because it is better to leave people to choose freely, without any influences. However, Thaler and Sunstein argue that in many choice situations some organisation or agent must make a choice that will affect the behaviour of others, whether intended or not. So it is not possible to avoid a choice situation where people's choices are influenced in one direction or another. Therefore, arguing against nudging on this basis is a 'literal nonstarter'.¹⁸⁰ Consequently, Thaler and Sunstein justify nudging on the basis that influences on choice are inevitable whether or not they are in favour of the target.

Hausman and Welch have criticised Thaler and Sunstein's libertarian paternalism on the basis that the nudges they propose are either not paternalistic at all or they should not be acceptable to libertarians.¹⁸¹ They argue that some nudges are not paternalistic at all because they merely give advice, information or engage in rational persuasion thus treating their targets as fully competent, unlike paternalism.¹⁸² The rest are paternalistic but do not answer libertarian concerns about the preservation of 'a wider sense of liberty called autonomy', even if they do preserve freedom of choice.¹⁸³ Hausman and Welch argue that to the extent that nudges exploit the individuals' decision-making flaws, they also diminish the control people have over their evaluations and choices because their decisions would ultimately reflect the machinations of the policymaker, not their own

¹⁷⁹ J Feinberg, 'Legal Paternalism' (1971) 1 *Canadian Journal of Philosophy* 105, 113.

¹⁸⁰ Richard Thaler and Cass Sunstein, (n 177) 10-11.

¹⁸¹ *ibid.*

¹⁸² Daniel M Hausman and Brynn Welch, 'Debate: To Nudge or Not to Nudge*' (2010) 18 *Journal of Political Philosophy* 123, 127.

¹⁸³ *ibid* 128.

analysis of alternatives.¹⁸⁴ Consequently, libertarian paternalism might still be at odds with libertarian concerns with liberty.

Blumenthal-Barby argues that making the use of nudges transparent will quash these libertarian concerns.¹⁸⁵ Similarly, Thaler and Sunstein suggest that the use of nudges should be accompanied by a publicity condition, although they do not say how explicit this transparency needs to be.¹⁸⁶ However, as Coons and Weber state, it is not clear how transparency will make a difference because nudges tend to rely on entrenched psychological tendencies that influence peoples' choices subconsciously. So it would probably make it worse if the targets were informed about such nudges. Coons and Weber give the example of a love potion: if A has a love potion that makes B fall in love with him despite her current loathing, the fact that A tells B of the love potion does not mean he is morally justified in using it against B.¹⁸⁷ This is arguably worse than using the love potion without consent, because it forces the recipient to 'watch [themselves] fall victim to such influence.'¹⁸⁸ Transparency will therefore not mitigate nudge the problematic nature of nudge policies.

Coons and Weber go on to argue that transparent choice architecture is more like providing information or giving advice than paternalism.¹⁸⁹ This is because if an individual was made aware that nudge policies would be used to influence their decision-making, then they would be alerted to the existence of their entrenched psychological tendencies and choose to either resist them or not. If this is the case, what leads individuals to make the better choice is that they have been reminded of the importance or value of that choice, and not because of the psychological tendencies in their reasoning that nudge targets.¹⁹⁰

Coons and Weber also state that whereas traditional paternalism takes steps to artificially ensure that it is irrational, from the target's perspective, to make

¹⁸⁴ *ibid* 127–129.

¹⁸⁵ Jennifer S Blumenthal-Barby, 'Choice Architecture: A mechanism for improving decisions while preserving liberty?' in Coons and Weber (n 157). 197.

¹⁸⁶ Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness* (Yale University Press, New Haven, CT 2008), 246-249.

¹⁸⁷ Christian Coons and Michael Weber, 'Introduction: Paternalism – Issues and trends' in Coons and Weber (n 157)., 20.

¹⁸⁸ *ibid* 20.

¹⁸⁹ *ibid* 21.

¹⁹⁰ *ibid*.

suboptimal choices, it does not change the target's fundamental evaluations.¹⁹¹ Examples of traditional paternalistic acts are raising the cost of choosing what is viewed as the bad option or creating incentives for the target to pick the better one. Rather, traditional paternalism changes the external environment of the target in a way that makes their reasoning favour the better option.¹⁹² This is disrespectful in the sense that it disregards the target's ability to make prudent decisions, however it treats individuals as rational by appealing to what they value and what people think they have reason to do. E.g. people see themselves as having reason to seek financial incentives and avoid fines, traditional paternalism appeals to this reasoning. But people do not tend to think they have reason to choose a default or a status quo, rather these are unconscious choices.

Contrarily, libertarian paternalism makes individuals act on things they do not consider to be reasons for doing things. Nudges change individuals' assessment of various choices without appealing to their current values or views on a particular choice. Consequently, libertarian paternalism involves a deeper level of disrespect for the target because rather than just ignoring a target's point of view or turning the viewpoint against the target like traditional paternalism, it views the target's preferences as something to be replaced, removed or changed.¹⁹³ Coons and Weber therefore state that libertarian paternalism does not merely violate rights of autonomy or self-sovereignty, but treats targets as though they are not owed such rights.

This line of argument is supportive of anti-paternalist arguments that paternalistic policies are incompatible with autonomy. But such an argument is so broad that it could even cover the act of persuasion itself, the aim of which is to change, alter or extinguish the target's point of view on a subject.

Camerer, *et al* propose an approach to evaluating paternalistic regulations and doctrines called 'asymmetric paternalism' or 'cautious paternalism'. These are regulations which create large benefits for those who make errors, whilst imposing little or no harm on those who are fully rational.¹⁹⁴ The goal of asymmetric paternalism is to enable boundedly rational consumers make better

¹⁹¹ *ibid* 22.

¹⁹² *ibid* 22.

¹⁹³ Christian Coons and Michael Weber (n 143) 23.

¹⁹⁴ Camerer and others (n 180) 1212.

decisions and align demand more closely with the true benefits they obtain from consumption.¹⁹⁵ However, the authors are not proposing a new method of regulation but a new framework for evaluating the costs and benefits of regulatory options. In this way, they add more precision to the debate about whether market transactions should be presumed to be rational or whether a predictable set of heuristic failings support the case for paternalisms.¹⁹⁶ They argue that a better idea of the costs and benefits of regulation on individual market actors is necessary for the proper design of adequate regulatory mechanisms.¹⁹⁷

Camerer *et al* raise an important issue about the behavioural choices of individuals. I.e. when assessing asymmetric paternalism policies, we should consider whether patterns of seemingly irrational behaviour are mistakes or expressions of stable preference. The correct policy to adopt is one that encourages disclosure, rather than banning the regulated product outright because if an individual continues to choose that seemingly defective option, then it is possible that they have a decent reason to do so, even if it is not clear to the policymaker.¹⁹⁸ They give the example of extended warranties which an economist knows protect only very rare events, but a consumer continues to choose to purchase them despite being educated about this fact through policy initiatives. The authors suggest the debate about paternalism should shift from justifying its use, to analysing whether the benefits of mistake prevention are more than the harms imposed on rational people. This shows regard for the libertarian concern for the preservation of autonomy. Because the regulation of P2PL is still a relatively new area of academic interest, it is still necessary to consider whether this approach is justified.

Contrary to the approaches of Thaler and Sunstein and Camerer *et al*, Garren posits that attempts by contemporary writers to reconcile liberalism and paternalism have either led to the weakening of the liberal commitments to autonomy and neutrality, or to the weakening of paternalistic commitments to the exercise of power over competent adult individuals without their consent for their own good. He argues that the fact either theory has to be weakened highlights

¹⁹⁵ *ibid* 1221.

¹⁹⁶ *ibid* 1251.

¹⁹⁷ *ibid*.

¹⁹⁸ *ibid* 1253.

their incompatibility and “one must choose: liberalism or paternalism. One cannot have both.”¹⁹⁹

In relation to online P2PL regulation, the debate surrounding the justification of paternalism is significant because the design of its regulation must adopt a particular stance and justify it. If the regulations involve a degree of consumer/investor protection, the level of protection and its use needs to be justified in light of the fact that P2PL involves private lending contracts between lenders and consumers which they have freely chosen to enter. Arguably, from a libertarian perspective, the law should allow such individuals to exercise their freedom of contract without any influence on their choices or autonomy, regardless of the potential consequences.

Considering the varied models of P2PL online and the varied interests of the consumers, this thesis prefers the libertarian-paternalistic approach to paternalism, as it represents a compromise between paternalism i.e. intervention and libertarian considerations for freedom of action. This is because it is important to prevent unnecessary risks or problems which can be caused by individuals' choices, and affect themselves or the public at large.

This recognises that although people have an interest in exercising their freedom of choice and liberty, they also have an interest in avoiding bad situations, negative consequences or living out the consequences of their mistakes or errors of judgement. Arguably, this is the basis of the current payment protection insurance mis-selling scandal – consumers who relied on poor, unclear or misleading information provided by businesses and based on their own judgement, are now able to claim redress to put them back into the position they would have been in had the policies not been added to their financial product accounts. Paternalistic policies can help consumers avoid the burden of financial regret.

For practical purposes, a compromise will mean that regulations benefit from both perspectives. On one hand, consumers and the industry are provided with the help they need to thrive by avoiding or mitigating avoidable negative factors and consequences, recognising the idea that industries/markets also benefit from paternalistic or facilitative measures, like antimonopoly competition and entry into

¹⁹⁹ David Garren, 'Paternalism, Part II' (2007) 48 *Philosophical Books* 50, 59.

market rules. On other, consumers and the industry are left with sufficient room to make choices once the playing field has been levelled.

Consequently, this thesis considers paternalism justified where facilitative and preventative measures serve to level the playing field and make the market fairer for all market participants. E.g. by removing information asymmetries, ensuring equal bargaining power, ensuring accountability for misconduct, breach of contract or criminal activity, encouragement or facilitation of vulnerable consumers and small businesses. Once market participants can interact on an equal basis, libertarian principles of freedom, personal autonomy, choice and responsibility apply.

2.3.4 Existing 'Hard' Paternalism Regulatory Shift

The preceding section has shown that although paternalism has a reputation for being presumptively wrong for restricting the beneficiaries' autonomy, in this context by limiting their freedom of contract, it can be justified where it serves to level the playing field between market players, making the market a fairer place.

In spite of the paternalism versus autonomy debate, post-financial regulation within the retail investment and consumer credit markets has shown an increasing tendency towards stronger paternalistic measures. This suggests that regulators and market participants are becoming more open to hard paternalism which infringes on the contracting parties' freedom to contract or behave autonomously. This general trend in current regulation supports the argument that P2PL regulation should also reflect this movement towards more intrusive protections for the lenders and borrowers for the same reasons it has been exhibited in the retail investment and consumer credit markets.

The shift towards interventionist paternalism can be demonstrated by EU and UK regulations before and after the 2008 financial crisis in consumer credit regulation and retail investment regulation and general treatment of retail/household investors.

Information paradigm dominated Pre-crisis regulation

Before the financial crisis, the UK and EU contract law regimes largely followed the principle that the autonomy of private parties in their contractual relationships was paramount and it should be respected.²⁰⁰ This remained the case unless there was a good reason for law and regulation to intervene, for example because the terms of the contract were unfair or for public policy interests such as illegality of the contract.²⁰¹ In both jurisdictions, this freedom of contract approach resulted in reliance on mandatory information rules to protect investors, rather than substantive rules that sought to alter the actions of contractual parties.²⁰²

The approach taken to protect the investor pre-crisis took the form of 'soft' paternalism because through reliance on mandatory information rules, investors are supposed to make better decisions for themselves rather than having their behaviour governed by intrusive content-based mandatory rules.²⁰³ This is exemplified by the 1971 Crowther Committee Report on Consumer Credit which emphasised that there should be as little state intervention as possible, so that the consumer has the freedom to use his/her own knowledge of the consumer credit market to the best of his/her ability and according to what he/she thinks is in his/her best interests.²⁰⁴ The fact that the report influenced the adoption of the Consumer Credit Act 1974 is telling about the general approach to paternalism during this period.

In the area of consumer credit following the crisis the UK's reliance on transparency and information as a way to protect the consumer has gradually given way to a focus on irresponsible lending practices of credit providers. This is exemplified by the UK's borrower-focused affordability assessment. In 2010 the Office of Fair Trading issued guidance to creditors on irresponsible lending. The guidance dealt with the issue of affordability assessments which it called 'a borrower-focused test' in which the creditor assesses the borrower's ability to undertake specific credit commitments in a sustainable manner, without the

²⁰⁰ Olha O Cherednychenko, 'Freedom of Contract in the Post-Crisis Era: Quo Vadis?' (2014) 10 *European Review of Contract Law* 390, 392.

²⁰¹ For examples of UK cases on the subject of illegality and public policy see, *Re Mahmoud and Ispahani* [1921] 2 KB 76; *Trendtex Trading Corporation v Credit Suisse* [1982] AC 679.

²⁰² Cherednychenko (n 213) 392.

²⁰³ *ibid* 393.

²⁰⁴ *Consumer Credit: Report of the Committee/Chairman Lord Crowther*, Cmnd 4596 (London: HMSO, 1971) para 1.3.5.

borrower incurring financial difficulties and/or experiencing adverse consequences because of the borrowing.²⁰⁵ The reason why this measure is intrusive is because in sections 4.8 and 4.26 of the guidance, the OFT recommended that where the affordability test shows that borrowers would be unlikely to meet repayments under a credit agreement in a sustainable way, credit should not be provided. Therefore, the measure dictates to both creditors and borrowers what type of credit agreement they should enter into and under what circumstances. Similarly, the FCA expects mortgage lenders to base their decision to lend on a thorough assessment of the consumer's income and expenditure, and base their decision to lend on the amount of income left after the consumer's expenditure has been deducted, and if the consumer does not have sufficient borrowing capacity, the FCA requires that the lender does not grant the mortgage loan.²⁰⁶

The approach to protection demonstrated by the affordability test is no longer about 'nudging' the consumer by giving them the opportunity to make better decisions through the provision of information, but of taking positive steps to control outcomes. The focus of sustainability by the affordability test is also far-reaching because it requires businesses to consider future events in the life of the consumer such as whether the credit agreement at hand will put them in a worse position in the future, rather than the business considering its own aims in the business deal at hand. This also takes decisions out of the hands of the consumer to businesses by assuming that once the business has taken various factors into consideration, it will be in a better position than the consumer to decide whether or not a credit agreement is suitable for the consumer.

The emphasis on tackling irresponsible lending is a regulatory shift because it demonstrates how regulators no longer expect consumers to bear the sole burden of responsibility as they did before. It is no longer the case that consumers are expected to weigh up the information they are provided by, for example, mortgage providers, and determine whether they are able to fulfil their commitments under the lending agreement. Rather, much of the responsibility

²⁰⁵ Office of Fair Trading, *Irresponsible Lending – OFT Guidance for Creditors*, OFT 1107, March 2010 (updated February 2011), 4.1.

²⁰⁶ Financial Services Authority, *Mortgage Market Review: Responsible Lending*, 2.13, 2.62.

has been shifted to the lenders due to the requirement that they perform suitability assessments.

However, the application of the responsible lending approach to protection comes across some difficulty within the P2PL structure. Whereas the firm usually responsible for carrying out these suitability checks would be the lender or credit broker, in P2PL there is no broker and the lenders are individuals who are not in a position to assess the suitability of the lending from the borrower's perspective. On top of this, the P2P platforms are not a party to the contract and so can distance themselves from the responsibility to carry out suitability checks. The credit checks that they do arrange, often through third party credit reference agencies, are for the sole purpose of ensuring that the borrowers are able to meet credit repayments to assure P2PLs of the safety of investment on the platform. The creditworthiness check, however, is an altogether different test from ensuring that the credit that the borrowers take out is suitable and sustainable for the borrower. For this reason, in order to protect P2PL borrowers from the risks associated with irresponsible lending, P2PL regulation would require even more interventionist measures which involve vesting the 'passive' P2P platforms with the responsibility usually associated with institutional lenders, therefore making them liable for poor lending practices even though they are not the lenders.²⁰⁷

A similar trend towards strong paternalism after the crisis can be seen in the EU regulation of consumer credit, as exemplified by a comparison between the 2008 Consumer Credit Directive²⁰⁸ (CCD) and the 2014 Mortgage Credit Directive (MCD).²⁰⁹ The CCD contains lots of information requirements which the creditor or credit intermediary is expected to comply with at different stages of the credit relationship.²¹⁰ For example, article four details information that firms should mention in advertisements; art. 5 and 6 contain information firms should provide consumers before concluding credit agreements and articles 11, 12 and 18 detail

²⁰⁷ On the topics of the passivity of P2P platforms and the degree of control they exercise within P2P lending transactions, and the use of gatekeeper liability as a method of holding them responsible for the conduct of their users, see Chapter Five sections 5.5 and 5.6.

²⁰⁸ Council Directive 2008/48/EC of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC (Consumer Credit Directive) [2008] OJ L 133/66.

²⁰⁹ Council Directive 2014/17/EU of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (Mortgage Credit Directive) [2014] OJ L 60/34.

²¹⁰ Cherednychenko (n 213) 408.

information that should be provided during the credit contractual relationship.²¹¹ The reliance of these provisions on information provision as a form of protection demonstrates how the CCD is part of the information paradigm of consumer protection.

Indeed, the furthest the CCD goes in intruding on the contractual autonomy of the firms and consumers for the sake of protecting investors is to require the creditor to, “*provide adequate explanations to the consumer, in order to place the consumer in a position enabling him to assess whether the proposed credit agreement is adapted to his needs and to his financial situation, where appropriate by explaining the pre-contractual information..., the essential characteristics of the products proposed and the specific effects they may have on the consumer...*” (Emphasis added).²¹² The provision explains that the purpose of the creditor’s explanation is to enable the consumer to assess the merits of the credit being provided. Therefore, like RCT, the underlying rationale is the consumer in need of protecting is a rational one and is well-equipped to understand and mitigate the risks they face if given sufficient information.

The protective measures of the CCD are also limited by the fact that its scope did not include some key forms of consumer credit including credit cards and loans involving credit of less than EUR 200 or more than EUR 75,000.²¹³ This therefore excluded from protection risky forms of consumer credit such as payday lending which feature frequently revolving credit of relatively small amounts that can trap consumers in a cycle of debt.

In direct contrast to the CCD, following the crisis there has been an awareness that irresponsible lending practices has worsened the problem of consumer over-indebtedness, because it can have a detrimental effect on the individual’s well-being and, on a macro-level, can cause a housing bubble and undermine consumer confidence in the market.²¹⁴ No doubt as a response to this, the MCD created a clear duty of responsible lending for mortgage providers,²¹⁵ which can be seen in art.18(1) that explicitly requires providers to thoroughly assess the

²¹¹ Consumer Credit Directive, arts 5, 6, 11, 12 and 18.

²¹² Consumer Credit Directive, art 5(6).

²¹³ Cherednychenko (n 213) 409.

²¹⁴ *ibid* 410–411.

²¹⁵ *ibid* 411.

creditworthiness of r consumers before concluding credit agreements.²¹⁶ The factors that providers should take into account include any future payments under the mortgage credit and other regular expenditure, the consumer's debts, other financial commitments, income, savings and assets, and future events such as possible reduced consumer income or increased borrowing rate.²¹⁷ Further more, unlike the CCD, art.18(5(a) of the MCD states that the consequence of un-creditworthiness should be a refusal by the creditor to advance credit to the consumer.²¹⁸

Another example of the increased post-crisis regulatory 'hard' paternalism is the use of product intervention techniques across the EU. The underlying rationale of product intervention is that targeting dangerous products once they have been designed, marketed or sold to some consumers will prevent problems from growing and affecting larger numbers of consumers.²¹⁹ This rationale reflects an understanding that prevention is better than cure and that sometimes the service users or contractual parties are not always in the best position to ensure the best outcomes for themselves. The implication for P2PL regulation is that regulatory measures that are designed to prevent bad outcomes before they happen are not a bad thing in and of themselves. This could mean that, although the P2PL market has not yet shown itself to be detrimental to society, it does not mean that it should be left to grow organically without regulators' consideration of harmful risks to borrowers and lenders.

A UK example of the use of product intervention occurs within the retail investment market. According to s.137D of the Financial Services and Markets Act 2000, as amended by the Financial Services Act 2012, the FCA can create temporary product intervention rules where it has identified risk to consumers resulting from a particular product, type of product or practices associated with a particular product or type.²²⁰ Such interventions are only meant to be temporary as they are limited to a maximum duration of 12 months. The product intervention rules can occur through requirements for certain product features to be added, excluded or changed; by imposing restrictions on sales or the marketing of a

²¹⁶ Mortgage Credit Directive, art 18(1).

²¹⁷ Mortgage Credit Directive, Recital 55.

²¹⁸ Mortgage Credit Directive, art 18(5)(a).

²¹⁹ Cherednychenko (n 213) 400.

²²⁰ Financial Services Authority, *The FCA's Use of Temporary Product Intervention Rules: Policy Statement 13/3*, March 2013, 32.

product in relation to some or all types of consumer and, at the most extreme, the FCA can choose to ban the sale or marketing of a product.²²¹ In fact, the FCA has already made use of these powers by banning the promotion of unregulated collective investment schemes (UCIS) in 2013.²²²

As another example, in January 2015, the FCA introduced a price cap on the total amount that high-cost, short-term credit lenders, like payday lenders, could charge.²²³ There are three main elements of the price cap. Firstly, when loans are taken out or rolled over, the interest and fees charged must not exceed 0.8% of the amount borrowed. Secondly, in the event of a borrower defaulting, any fees incurred should not exceed £15. Businesses can charge fees after default, but they should not exceed the amount of the initial loan. Finally, lenders should never charge borrowers fees and charges which amount to 100% of what they borrowed.²²⁴

The cap ensures that consumers do not have to pay back more than twice what they have borrowed. It also ensures that a consumer who takes out a typical loan over a thirty-day period and makes his/her repayments on time, will not have to pay more than £24 per £100.²²⁵ The aim of this measure was to secure an appropriate degree of protection for borrowers against excessive charges in this market.²²⁶ During the consultation period for the price cap, the FCA made clear its intentions that, “*we expect the cap to lead to a reduction in lending and some customers who have previously taken out high-cost short-term loans will no longer get them. ...we believe that, apart from for a short initial period, they will be better off without loans.*”²²⁷ This reflects the ‘hard’ paternalism approach because through the price caps the FCA has intervened in the normal business practices of a particular market purely for what it believes is in the consumer’s best interests. It also reflects an underlying assumption that the FCA, rather than

²²¹ Financial Services Authority, *The FCA’s Use of Temporary Product Intervention Rules: Policy Statement 13/3*, March 2013, 31.

²²² Financial Conduct Authority, *Restrictions on the Retail Distribution of Unregulated Collective Investment Schemes and Close Substitutes. Feedback to CP12/9 Including Final Rules: Policy Statement PS 13/3* June 2013.

²²³ Financial Conduct Authority, ‘CP14/10: Proposals for a Price Cap on High-Cost Short-Term Credit’ (FCA, 15 July 2014) <<https://www.fca.org.uk/publications/consultation-papers/cp14-10-proposals-price-cap-high-cost-short-term-credit>> accessed 12 January 2017.

²²⁴ *ibid.*

²²⁵ Financial Conduct Authority, ‘CP14/10’ (n 236).

²²⁶ *ibid.*

²²⁷ *ibid.*; see also Financial Conduct Authority, *Proposals for a price cap on high-cost short-term credit* (Consultation Paper, CP14/10, 2014).

the consumer, is in a better position to know what is best for the consumer in the long run.

The shift towards a more interventionist approach to regulation in the post-crisis retail and consumer credit markets can also be framed as a change in how regulators in the EU and UK treat retail investors. Indeed, Moloney has argued that following the financial crisis the retail investor is no longer treated by regulators as an empowered, autonomous individual but is now afforded protections usually associated with vulnerable consumers of financial services and investment products.²²⁸

According to Moloney, prior to the crisis, there were two main targets of EU investor protection regulation, the 'consumer of financial services' and the 'small/average/retail investor'.²²⁹ EU regulation tended to treat the targets differently depending on which category they fell into, so a 'consumer of financial services' benefited from more interventionist measures compared to a 'retail investor'.²³⁰ Pre-crisis regulation also tended to focus on products and services related to retail investors e.g. household investment, rather than on mortgage products or consumer credit products that are more typically associated with consumers of financial services.²³¹ Consequently, pre-crisis measures aimed to protect retail investors through the promotion of empowerment, autonomy and choice.²³²

One of the examples Moloney gives is of the changed approach between the MiFID I and II regimes. The former was largely based on disclosure, process-based suitability rules and a principles-based regime and it did not intrude on the retail investors' choices or the products sold to them.²³³ However, the MiFID II differs from MiFID I in that the controls it espouses relate to how the service is delivered to investors, rather than simply empowering investors through disclosure rules.²³⁴ For example, it provides that investment advice must be

²²⁸ Niamh Moloney, 'The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors?' (2012) 13 *European Business Organization Law Review* 169, 173, 177.

²²⁹ *ibid* 172.

²³⁰ *ibid* 173.

²³¹ *ibid* 175.

²³² *ibid*.

²³³ *ibid* 176.

²³⁴ *ibid* 180.

labelled according to whether or not it is provided on an independent basis and whether it is based on a broad or restricted analysis of the market.²³⁵ Additionally, art.7 provides that if the investment advice is provided on an independent basis, the investment firm should assess “a sufficient range of financial instruments available on the market which must be sufficiently diverse with regard to their type and issuers or product providers to ensure that the client’s investment objectives can be suitably met”.²³⁶ This means that investment firms cannot limit advice to financial instruments provided by them or firms having close links with them.²³⁷ This requirement of diversification is interventionist by seeking to improve diversity through intrusive measures than merely providing information and expecting investors to be able to know that they should diversify portfolio themselves.

These post-crisis measures in the EU and UK indicate that there is an increased reluctance to require retail investors’ responsibility for their own choices and protection. Moloney’s argument about the increased “consumerisation” of the retail investor therefore centres on the fact that regulatory measures now place responsibility with investment firms and consumer credit providers,²³⁸ either by regulating the product to be sold through product intervention measures or bans or by ensuring the investor receives advice and not just information for the investor to put to use themselves. According to her analysis, retail investors are “consumerised” not because of what they do, but because the regulatory approach towards them has become more interventionist and precautionary.

If the movement of the regulatory treatment of the retail investor to the consumer domain is associated with a push towards ensuring that financial service providers give them advice, this consumerisation of the retail investor has limited application or use in P2PL. P2PL model operates on the basis that no lending/investment is given. If regulators were to force platforms to provide

²³⁵ Council Directive 2014/65/EU of 15 May 2014 on markets in financial instruments and amending Directive 2002.92/EC and Directive 2011/61/EU Text with EEA relevance (MiFID II), art. 4(a)(i) and art. 4(a)(ii).

²³⁶ Council Directive 2014/65/EU of 15 May 2014 on markets in financial instruments and amending Directive 2002.92/EC and Directive 2011/61/EU Text with EEA relevance (MiFID II), art. 7(a).

²³⁷ Council Directive 2014/65/EU of 15 May 2014 on markets in financial instruments and amending Directive 2002.92/EC and Directive 2011/61/EU Text with EEA relevance (MiFID II), art. 7(a)(i) and (ii).

²³⁸ Moloney (n 241) 180.

lenders or borrowers with advice, they would be forcing a change within the fundamental structure of P2PL, i.e. the element which supposedly ‘cuts out the middleman’ by making the platform a more involved intermediary. As such, using regulation to encourage greater advice to lenders and borrowers is not a useful regulatory tool within P2PL. Chapter 5.6 therefore proposes using gatekeeper liability, a form of civil liability, as one possible method of regulating P2PL platforms for the benefit of lenders and borrowers in a way that truly reflects their role and activities in P2PL.

As previously mentioned, Moloney’s argument that retail investors have become consumers is based not on what they do, but rather, on how they are treated and viewed by regulation. They are no longer treated as responsible and capable of self-governance. Instead, a more paternalistic approach is being taken and they are now being treated the way that ordinary consumers have generally been treated by regulation, i.e. with more intrusive regulation that restricts freedom of contract and autonomy. She mentions that retail investors should not “be seen simply as risk-takers and asset accumulators, but should be regarded as purchasers of products which are increasingly essential for welfare.”²³⁹ Consequently, her view of the consumer as someone who purchases a product based on need is different from this thesis’ conceptualisation of consumer and “lendsumer”.²⁴⁰ The thesis defines consumer and “lendsumer” on the basis of individuals’ actions and behaviours in P2PL transactions rather than regulatory treatment. The analysis of the consumer and prosumer which are examples of this thesis’ perspective grounds the argument that regulation should consider what lenders do and their activities, and, following from this, be more reflective of the fact that P2PLs exhibit traits of both consumers and prosumers. Consequently, protections should be designed to reflect the transitional nature of P2PLs which is unique to business models similar to direct P2PL.

Given the general movement towards the consumerisation of the retail investor in the EU and UK, and the general shift away from a focus on the stability of the retail financial markets towards protection of the investor, it is interesting that the regulation of P2PL focuses largely on ensuring the stability of the platform. This

²³⁹ *ibid* 193.

²⁴⁰ See sections 2.5-2.8 of the thesis for a detailed discussion on the concepts of the “consumer” and “prosumer” and section 5.7 for a discussion of the concept of “lendsumer”.

is to ensure continued consumer confidence in the burgeoning P2PL market. Policy on regulation of P2PL has tried to shy away from highly intrusive measures to ensure adherence to the principle of proportionality – possibly the most intrusive protective measure has been the requirement of firms to have in place arrangements for the loan contracts to be administered by an alternative third party should the platform itself cease to exist. However, it does not go far enough to say what type of arrangements should be made and their quality and degree.²⁴¹ Possibly, these tentative investor protection measures in P2PL are because that as a new market regulators are concerned with not stifling its growth and its business model of operation is exclusive of advice. Therefore, regulators cannot provide the usual interventionist measures exemplified by the post-crisis regulation of the more traditional models in the retail investment and consumer credit markets, which is to bring investment activity under the requirement of providing advice to consumers.²⁴²

2.4 Approaches to Consumer Protection

Norbert Reich distinguishes between three broad approaches to consumer protection as seen over time within developed countries.²⁴³ He calls them ‘pre-interventionist’, ‘interventionist’ and ‘post-interventionist’ philosophies of consumer protection.²⁴⁴ ‘Pre-interventionist’ approaches to consumer protection relate to the model used in developed market economies in the 1950s and 1960s.²⁴⁵ Reich states that pre-interventionist approaches developed from commercial and competition law. It analysed basic assumptions of civil law like caveat emptor and freedom of contract and suggested mild solutions which did not impose specific standards on the content of contractual relations.²⁴⁶ Information was viewed as a key component of consumer autonomy and

²⁴¹ For a detailed discussion of current UK regulation of P2P lending, see chapter 4 and section 4.4 in particular.

²⁴² Moloney (n 241) 180.

²⁴³ Norbert Reich, ‘Diverse Approaches to Consumer Protection Philosophy’ (1992) 14 J Consumer Policy 257.

²⁴⁴ *ibid* 257.

²⁴⁵ *ibid* 257.

²⁴⁶ *ibid* 258.

consumer autonomy could be improved by self-help information systems and government-monitored information systems like labelling.²⁴⁷

'Interventionist' or 'regulatory' policies relate to those implemented in the 1970s.²⁴⁸ The approach is based on a more active role for the state in social relations, i.e. the 'welfare state'.²⁴⁹ The welfare state controlled and changed the traditional principles of freedom of contract, competition and fault liability which were seen to discriminate against the consumer.²⁵⁰ Welfare economic theories dealt with the power aspects of market transactions and tried to re-establish bargaining power through tools like warranties or banning exemption clauses.²⁵¹ Other justifications for the interventionist approach included market failures and the contract law principle of *caveat emptor*,²⁵² which is the idea that consumers assume the responsibility to examine and decide for themselves whether to purchase a particular product or use a particular service.

The interventionist approach was criticised by the economic analysis of law. The Coase theorem posits that so long as there are no transaction costs, the parties involved in a transaction will find the best allocation of property rights through voluntary exchange regardless of the original distribution.²⁵³ This implied that the interventionist approach prevented the efficient allocation of resources and law should only influence the distribution of property rights, but the allocation of resources should be left to the parties themselves.²⁵⁴ This state of affairs could lead to harmful effects for P2PLs who might misinterpret the information they are provided e.g. about the borrowers they choose to invest their money on and therefore choose unsuitable lending opportunities on the P2PL platform.

'Post-interventionist' policies relate to those used in the 1980s which involved a "mixed rationality" of consumer law.²⁵⁵ On the one hand they do not support the deregulation of the markets, however on the other hand such approaches are more reserved in their support of consumers than the interventionist approach.²⁵⁶

²⁴⁷ *ibid* 258-259.

²⁴⁸ *ibid* 257, 260.

²⁴⁹ *ibid* 260.

²⁵⁰ *ibid* 260.

²⁵¹ *ibid* 260-261.

²⁵² *ibid* 261.

²⁵³ *ibid* 262.

²⁵⁴ *ibid* 262.

²⁵⁵ *ibid* 267.

²⁵⁶ *ibid* 267.

For example, post-interventionist approaches to consumer protection like labelling, instructions and warnings serve to avoid stricter standards being imposed on businesses and give the appearance that something is being done to protect the consumer; on the other hand, such information regulations might also be used to make the producer liable in areas where the traditional rules of liability or warranty might not apply.²⁵⁷ Another example of post-interventionist consumer protection regulation includes product liability.

2.5 Meaning of 'Consumer'

This thesis focuses on the EU definition of the consumer which has become influential. Defining "consumer" is important because it establishes who can rely on consumer protection rules and thus the underlying regulatory model.²⁵⁸ The difficulty in forming a definition is exacerbated by the fact that consumers are not a homogenous group and can vary widely depending on their differing tastes, social positions or cultural backgrounds.²⁵⁹ However, the concept can be better identified by looking at the common elements which have been seen to make up the notion of the consumer.²⁶⁰ Therefore, each subsection looks at a different aspect of the consumer. EU law is used to analyse the concept of consumer because many member states' regulations on the subject bear a close similarity to its rules.

One way EU law distinguishes consumers from other members of society is by distinguishing the consumer from a company or an employee. This was the case in *Francesco Benincasa v Dentalkit Srl*.²⁶¹ In that case, the claimant wished to set aside a franchise agreement he had signed with Dentalkit. One point he made was that at the time he concluded the agreement, he was a consumer within the meaning of the first paragraph of article 13 of the Brussels Convention because he was not carrying on a business. The first paragraph of the article defines a

²⁵⁷ *ibid* 270.

²⁵⁸ Butenko and Cseres (n 80) 19.

²⁵⁹ Iris Benöhr, *EU Consumer Law and Human Rights* (Oxford University Press 2013) 16 <<http://www.oxfordscholarship.com/view/10.1093/acprof:oso/9780199651979.001.0001/acprof-9780199651979>> accessed 7 January 2016.

²⁶⁰ *ibid* 17.

²⁶¹ Case C-269/95, *Francesco Benincasa v Dentalkit Srl* [1997] ECR I-3767.

consumer contract as one which is concluded by a person “*for a purpose which can be regarded as being outside his trade or profession.*”

The claimant was therefore trying to take advantage of the wording of the article which does not specifically refer to the point in time the consumer’s trade or profession should relate to, by focusing on his professional status at the time he concluded the agreement. So, as he was not running the franchise as his business at the time he signed the agreement, he sought to evoke the article to protect his pre-contractual status as a non-business owner, i.e. a consumer.

The national court found that the franchise agreement was not a consumer agreement and so could not rely on article 13. Consequently, the question put to the European Court of Justice (ECJ) was whether a claimant could be regarded as a consumer under the article if the relevant contract was concluded not for the purpose of a trade the consumer was *already* pursuing, but for a trade he or she intended to carry out at a future date.

The ECJ, interpreted article 13 more narrowly by equating the purpose of the contract with the consumer’s status. Seemingly, as the goal or intention of the contract was to start a franchise business, the claimant’s purpose of the contract was seen to relate to the claimant’s trade or profession. Therefore, Advocate-General Ruiz-Jurobo Colomer opined that the determining factor was not the subjective situation of the consumer, but his position under the contract, taking into account its scope and purpose.²⁶² The reason being that the same person could be a consumer for certain purposes but an entrepreneur for others.²⁶³

This highlights that one feature of a consumer is that it is a natural person who acts for a purpose which is unrelated to their profession, trade or business.

According to the Directive on Consumer Rights, the definition of a consumer should include the following points:

- a) Natural persons; *and*
- b) Acting outside of their trade, business or profession. (Except for dual purpose contracts which is concluded partly within and partly outside the

²⁶² Case C-269/95, *Francesco Benincasa v Dentalkit Srl* [1997] ECR 1-3767 para 38.

²⁶³ Case C-269/95, *Francesco Benincasa v Dentalkit Srl* [1997] ECR 1-3767 para 38.

person's trade and the trade purpose is not the predominant purpose of the contract).

Regarding the first requirement, EU law tends to adopt the limited notion that a consumer must be a natural person. This is typically the case in EU Directives.²⁶⁴

However, the approach that the consumer is always a natural person reflects the underlying rationale of EU consumer protection law to level the playing field between the person as an individual and a business. This can be seen in the case of *Cape Snc v Idealservice Srl*, where Advocate-General Mischo states that the term "consumer" referred to "an individual, which necessarily implies that a natural person is concerned."²⁶⁵ This demonstrates EU law's insistence that a consumer can only be a natural person and not a legal person e.g. a business. One reason why the EU law definition focuses on the individual might be that the term "consumer" is an economic construct which evolved over time from referring to a buyer, to a customer and finally to a consumer.²⁶⁶

Within the EU a consumer is typically defined as a natural person acting for purposes outside of his/her normal business, trade or profession.²⁶⁷ In *Océano v Grupo Editorial SA v Rocio Murciano Quinero* the ECJ stated that the EU approach to consumer protection is based on the idea that the consumer is in a weaker position compared to the seller particularly regarding bargaining power and knowledge.²⁶⁸ The fact bargaining power and knowledge are highlighted demonstrates that the consumer protection approach leans heavily towards the pre-contractual stage of transactions. Additionally, the seller versus consumer terminology, similar to the business versus consumer/customer terminology

²⁶⁴ See, article 2(1) of Directive 2011/83/EU of the European Parliament and of the Council of 25 October 2011 on consumer rights, amending Council Directive 93/13/EEC and Directive 1999/44/EC of the European Parliament and of the Council and repealing Council Directive 85/577/EEC and Directive 97/7/EC of the European Parliament and of the Council; and article 4(1) of Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010.

²⁶⁵ Opinion of the Advocate-General, 14 June 2001, Case C-541/99, *Cape Snc v Idealservice Srl* [2001] ECR I-9049, 17.

²⁶⁶ Bastian Shüller, 'The Definition of Consumers in EU Consumer Law' in James Devenney and Mel Kenny (eds), *European Consumer Protection: Theory and Practice* (Cambridge University Press 2012) 126 <<http://dx.doi.org/10.1017/CBO9781139003452.011>>.

²⁶⁷ *ibid* 124; see also proposal COM (2008) 614/3, Directives 2005/29/EC, 85/577/EC, 97/7/EC and 99/44/EC.

²⁶⁸ *Océano v Grupo Editorial SA v Rocio Murciano Quinero* [2000] ECR I-4941.

found in most consumer protection regulation, does not fit the P2PL business model of individual-to-individual transactions.

It also reflects the notion that consumers are in a weaker position compared to sellers, in terms of bargaining power and knowledge because they are natural persons. There are two underlying assumptions. Firstly, companies are economically stronger and more experienced in legal matters, better organised and more powerful than individuals and therefore need no protection.²⁶⁹ Secondly individuals are rational beings who would be able to make better decisions if the playing field between them and the business was levelled. This indicates that EU consumer protection law is built on a vertical form of consumer interaction between a business and a consumer, as opposed to business transactions which occur between individuals.

This perspective is reflected in the development of the meaning of “consumer” in English law. Unlike EU law, the definition in the Sale of Goods Act (SGA) 1979 and Unfair Contract Terms Act (UCTA) 1977 originally allowed businesses to be considered consumers. E.g. two requirements needed to be fulfilled for a person to “deal as a consumer” under s.12(1)(a)-(c) of UCTA 1977. Firstly, the party does not enter the contract in the course of a business nor hold themselves as doing so. Second, the other party makes the contract in the course of a business.²⁷⁰ The definitions made in these Acts did not require a consumer to be a natural person.

Consequently, it was possible for the Court of Appeal to hold that a claimant company was dealing as a consumer in *R & B Customers Brokers Co Ltd*.²⁷¹ In this case, the claimant was a private company that bought a car from the defendant finance company for the personal and business use of one of its directors. The claimant rejected the car after discovering that the roof leaked and

²⁶⁹ Case C-240/98, *Océano Grupo Editorial SA V Roció Murciano Quintero* [2000] ECR I-4941.

²⁷⁰ Similarly, the original s.55 of the SGA 1979 defined “consumer sale” as a sale of goods by a seller in the course of a business where the goods are usually bought for private use/consumption and sold to a person who does not buy, or hold out as buying them, in the course of business, sch.1[11](7)(a) and (b) Sale of Goods Act 1979; and in ss.12-15 SGA 1979, references are made to the possibility that a “consumer” could be a business, e.g. s.14(2D) states, “if the buyer deals as consumer...”. The statement implies that the buyer could be purchasing a good in the course of business, from this it is inferred that it is possible for the buyer to be a business as this statement would not be necessary if the definition required that consumers are natural persons.

²⁷¹ *R & B Customers Brokers Co Ltd v United Dominions Trust Ltd* [1988] 1 WLR 321.

the defendant failed to resolve it. The terms of the contract claimed to exclude implied conditions about the condition/quality of the car or its fitness for purpose. However, the claimant argued that the exclusion was invalidated by s.6(2) UCTA 1977 because it was dealing as a consumer. The section disallows sellers from excluding/restricting liability for the quality/fitness of a product when dealing with a consumer. The Court of Appeal construed the meaning of “in the course of business” narrowly so that a transaction must either be integral or entered into as part of the business’ regular course of dealing.²⁷²

However, the definition of “consumer” changed under the Unfair Terms in Consumer Contracts Regulations (UTCR) 1999, which in s.3 required that consumers be “natural persons.” Similarly, s.2(3) Consumer Rights Act 2015 defines “consumer” as an individual acting for purposes wholly or mainly outside that individual’s trade, business, craft or profession. The term “individual” was clarified in paragraph 36 of the Explanatory Notes to mean, “natural person.” Thus reflecting article 2(1) of the Consumer Rights Directive. Consequently, following in the footsteps of EU law, the current UK regime excludes businesses from consumer protection.

Possibly, the exclusion of businesses from the UK definition of “consumer” reflects the EU view that they are not the weaker party. This adds to the argument that paternalism plays a large role in consumer protection. The simple reason for the removal of businesses is that they are not seen as needing protection and, for the moment, regulators do not want to distinguish between different types of business e.g. sole traders compared to large corporations.²⁷³ Overall, the development of the definition in English law demonstrates that the notion of “consumer” is not a static term and further change is not precluded.²⁷⁴

Shüller criticised the EU definition of the consumer arguing that the term should not be defined in terms of whether they are a natural person or not, but by their

²⁷² The result of this case was followed in *Feldaroll Foundary Plc v Hermes Leasing (London) Ltd* [2004] EWCA Civ 747.

²⁷³ The definition has given rise to contentions about how a demarcation would be made between consumers and businesses that could be viewed as a consumer because they are a one-man band. As the CRA 2015 only covers “living” consumers, it complicates the matter of sole traders. See for example, Paula Giliker, ‘The Consumer Rights Act 2015 – a Bastion of European Consumer Rights?’ (2016) 37 *Legal Studies* 78, 82–83.

²⁷⁴ Indeed, one can foresee that at one point, it may be necessary to extract “one-man band” companies as a new type of consumer in need of protection in their own right.

acts and behaviours.²⁷⁵ This suggests that consumers are not the weaker party and thus deserving of attention because they are natural persons, but because of how they act/behave in specific circumstances.²⁷⁶ More specifically, he states that it is the act of buying consumer goods that defines the consumer, not their nature.²⁷⁷ Although Shüller therefore broadens the criteria for what constitutes a consumer by associating it with behaviours, this last point ties the concept of the consumer to the field of contractual sale of goods, assuming that one can only be a consumer when the contract relates to goods sold. However, Shüller's approach is useful because it offers more insight into the consumer by bringing into the discourse what a consumer actually does and how, which opens up the possibility for a more accurate dialogue of why they should be protected.

So, unlike the economic construction of the EU definition of the consumer, which sees them as capable of making rational decisions in their own interests, a definition focusing on the acts and behaviours of consumers recognises, that consumers are not always predictable and may not be able to decide in a rational manner.²⁷⁸ An important factor of consumer behaviour is the situation, e.g. the type of services/goods and the consumer's environment and experience. So, consumer protection law should differentiate different consumer situations to find a balance between protecting the consumer and avoiding business costs.²⁷⁹

This point about the need for a situational conception of consumers, raises several questions about the participants of P2P platforms. An example is what type of relationship exists between P2PLs and P2PBs, i.e. which would be the consumer in this relationship? Both know about the same as the other and suffer from a similar level of information asymmetries, if not the same. Or does consumer protection law not govern this type of relationship although one party, the borrower, is receiving a service from the other i.e. the loan?

It will be argued in a later section that consumer protection law as it stands does not cover this type of relationship, and so needs to adapt to this relatively new form of economic relationship. For now, one response is that because on many platforms, P2PLs and borrowers deal with each other through the services of the

²⁷⁵ Schuller (n 279) 123.

²⁷⁶ *ibid* 123, 124.

²⁷⁷ *ibid* 124.

²⁷⁸ *ibid* 141.

²⁷⁹ *ibid*.

platform intermediary and not actually directly with each other, consumer law would only be relevant in relation to the P2P borrower/lenders' relationships with the platform. Meanwhile, normal contractual rules would govern the relationship between P2PLs and P2PBs, e.g. through the principles of breach of contract, misrepresentation, etc. Nonetheless, these questions do show the gap between the traditional conception of the consumer as an 'economic man' consuming goods/services from a business, and the reality of new forms of online transactions as exemplified by online P2PL.

In relation to the second factor concerning an act outside of the individual's profession, EU law does not specify what it means to be acting outside of one's trade or profession. For example, the issue of whether a businessman who is also a natural person, acting outside of his profession or trade could be a consumer was not covered in *Dietzinger*, where a credit agreement entered by Mr Dietzinger's parents and guaranteed by him, was not considered outside a trade or profession.²⁸⁰

2.6 Concept of 'Average Consumer'

Another way EU law identifies the consumer is by specifying the type of consumer in question. The classification used ultimately depends on the aim of the legislative instrument in question.²⁸¹ For example, EU law generally uses the more restrictive, normative concept of the "average consumer" in its acts and case law. However, in situations where a group of consumers require a higher level of protection, it uses the concept of the "vulnerable consumer."²⁸²

The idea of the 'average consumer' is a useful one because it acts as a benchmark for regulators and courts to refer to when determining who the consumer is and how they are likely to behave. However, it is also a simplistic concept which is not always practical or inclusive.

²⁸⁰ Jules Stuyck, 'European Consumer Law After the Treaty of Amsterdam: Consumer Policy in or beyond the Internal Market?' (2000) 37 *Common Market Law Review* 367, 377; Case C-45/96, *Dietzinger*, [1998] ECR I-119.

²⁸¹ *Benöhr* (n 272) 17.

²⁸² *ibid*; Vanessa Mak, 'Standards of Protection: In Search of the Average Consumer of EU Law in the Proposal for a Consumer Rights Directive' (2011) 19 *European Review of Private Law* 25, 29.

The origin of the concept in ECJ case law was in the case of *Gut Springenheide* where the court described the features of an ‘average consumer’ in relation to whether a statement or description designed to promote the sale of eggs was likely to mislead the average consumer.²⁸³ It stated that the average consumer is someone who is “reasonably well-informed and reasonably observant and circumspect.”²⁸⁴ So the notion is used like a reasonable person’s test as the court is expected to take into account the presumed expectations of the average consumer. The concept was refined in subsequent case law, such that we can build a picture of the ‘average consumer’ as conceived within the EU.

In *Miles Handelsgesellschaft International mbH* the Court of First Instance (CFI) stated that the average consumer’s response is that of all average consumers who are reasonably informed and observant and not just the niche target consumer within the industry in question.²⁸⁵ The case was about the sale of clothing for motorcyclists. The judge stated that even if the relevant group of consumers only consisted of motorcyclists, they would be no more observant than members of the general public when they buy their gear. The broader implication of this statement is to highlight that although different industries might attract people from different sectors of society, with different interests or skills, they are still subject to the same factors which necessitate regulatory protection. For example, although P2PL might attract a type of consumer more risk averse, independent or financially aware than most, they are still subject to the same behavioural and economic challenges as the rest, e.g. information asymmetries and a lack of absolute rationality when making decisions.

However, in relation to how the court measures what the average consumer is, the case of *CeWe Colour AG* stipulated that the average consumer’s features depend on the member state the product or service was advertised in and designed for.²⁸⁶ E.g. if a transaction occurs in the UK, the court should have in mind the characteristics, behaviours or cultural practices of UK consumers in

²⁸³ Case C-210/96 ECR *Gut Springenheide GmbH, Rudolf Tusky v Oberkreisdirektor des Kreises Steinfurt – Amt für Lebensmittelüberwachung*, [1998] ECR I-4657, para 37.

²⁸⁴ *ibid* para 31.

²⁸⁵ Case T-385/03 *Miles Handelsgesellschaft International mbH v Office for Harmonization in the Internal Market (Trade Marks and Designs) (OHIM)*, judgement of the Court of First Instance (Fourth Chamber) of 7 July 2005, para 15.

²⁸⁶ *CeWe Colour AG & Co OHG v Office for Harmonization in the Internal Market (Trade Marks and Designs) (OHIM)*, judgement of the Court of First Instance (Fifth Chamber) of 8 September 2005, joined cases T-178/03 and T-179/03, para 28.

general, not the traits of consumers in Greece or Italy. These two cases show that to determine what the average consumer is, one should look at society in general and not the micro-societies within different industries. This approach can potentially lead to inconsistencies between member states in terms of how they define the 'average consumer'. This is because if national courts take into account their respective social, cultural and linguistic behaviours, the result may be different interpretations of the meaning of 'average consumer' between member states and thus different levels of protection afforded to consumers depending on the member state a case arises in.²⁸⁷ This might not appear to be pertinent to the current state of P2PL which operates largely on a national-level, however the impact would be more clearly felt should the industry start to operate on a multinational/international level.

The characteristics of an average consumer portrayed by Advocate-General Geelhoed in *Douwe Egberts* are:

"...before acquiring a given product (for the first time), a consumer will *always take note of the information on the label* and that he is also *able to assess the value of that information*. It seems to me that a consumer is sufficiently protected if he is safeguarded from misleading information on products and that he does not need to be shielded from information whose usefulness with regard to the acquisition and use of a product he can himself appraise."²⁸⁸

And in *August Storck KG*, the average consumer is viewed as well-informed or at least "averagely informed",²⁸⁹ i.e. he/she has some idea, if not detailed knowledge about the produ/service.²⁹⁰ As noted by Mak, the EU law conception of the 'average consumer' is used as a benchmark for normative evaluation of how a consumer can generally be expected to behave in the circumstances of a given case. The normative nature of the concept is emphasised by the fact that the behavioural traits of the "average consumer" can be determined by the presumed

²⁸⁷ Mak (n 295) 29.

²⁸⁸ Case C-239/02 *Douwe Egberts NV v Westrom Pharma NV and Christophe Souranis*, opinion of Advocate General Geelhoed of 11 December 2003, para 54. Emphasis added.

²⁸⁹ Case T-402/02 *August Storck KG v Office for Harmonization in the Internal Market (Trade Marks and Designs) (OHIM)*, judgement of the Court of First Instance (Fourth Chamber) of 10 November 2004.

²⁹⁰ Rossella Incardona and Cristina Poncibò, 'The Average Consumer, the Unfair Commercial Practices Directive, and the Cognitive Revolution' (2007) 30 J C P 21, 24.

behaviour of the “average consumer” rather than based on a factual expert’s report or research poll.²⁹¹

Whilst these cases refer to a rational consumer in line with the general conception of EU law, there are cases which recognise that the consumer is not always attentive to the product/transaction in question, but is still perceived to belong to the class of the “average consumer”. In *Procter & Gamble v OHIM*, the applicants wished to register a community trademark for white tablets relating to washing machine and dishwasher cleaning products, but the Office for Harmonization in the Internal Market (OHIM) refused because the tablets were not distinctive in character. This decision was upheld by the Third Board of Appeal of OHIM and the CFI which stated that the average consumer would not give a high level of attention to the shape and colour of washing machines and dishwasher tablets since they were everyday consumer goods.²⁹²

These cases demonstrate a dual persona for the average consumer: he/she is both well-informed and observant, yet may have an imperfect understanding of the product or may not pay attention to some features of the product. This creates a situation of impracticality because it is difficult to both conceptualise what exactly the average consumer is and unpredictable as to which one is being referred to, whether the observant consumer or the non-observant one.

Commercial practices do not have a uniform impact on consumers because consumers do not form a uniform group.²⁹³ Consequently, the concept of ‘consumer’ in general does not reflect that consumers do not fall into one clear and unvarying category. This creates problems for a regulatory regime because it is unable to choose an accurate benchmark for the identity of the consumers it regulates within a particular industry. It can also lead to either an overhanded protection regime or an under-regulated one, depending on which way the regime has portrayed the average consumer. E.g. a regime that portrays the average consumer as too reasonable, well-informed and observant might provide too little

²⁹¹ Vanessa Mak, ‘The “Average Consumer” of EU Law in Domestic Litigation: Examples from Consumer Credit and Investment Cases’ (2011) Tilburg Law School Legal Studies Research Paper Series 004/2012, 7 <<https://papers.ssrn.com/abstract=1960603>> accessed 13 December 2016.

²⁹² *Procter & Gamble Company v Office for Harmonization in the Internal Markets (Trade Marks and Designs) (OHIM)*, judgement of the ECJ 29 April 2004, joined cases C-473/01 and C-474/01 [2004] ECR I-5141.

²⁹³ Incardona and Poncibò (n 303) 26.

protection; whilst a regime that portrays them as too vulnerable might lead to too much protection. This suggests that a more finely tuned conception of a consumer in the market/industry is necessary to balance the principles of proportionality and protection in the regulatory regime.

Furthermore, the Unfair Commercial Practices Directive enshrines the ambiguous conception of the average consumer in law by giving it statutory authority.²⁹⁴ The Directive therefore protects the average consumer who is reasonably observant and circumspect, rather than the consumer who is distracted or uninformed about goods or services, or the naïve consumer who is easily persuaded by deceptive advertising or practices.²⁹⁵ In one sense, this means it does not protect the consumers most in need of protection, rather there is an expectation that consumers themselves should meet a certain standard be it of intelligence or rationality before they can expect the benefit of protection. I.e. consumers are expected to always act rationally and responsibly.

The average consumer test often results in forms of weak paternalistic measures e.g. disclosure obligations and ‘cooling-off’ periods.²⁹⁶ However, such measures hint at the awareness that consumers are not always reasonably well-informed, observant and careful, because although disclosure obligations pander to the rationality and intelligence of the average consumer, they also indicate they are not always well-informed. The need for measures like cooling-off periods recognises that individuals can make bad decisions in the heat of the moment, rendering them careless and unobservant. However, these weaknesses do not appear to be accounted for in the conception of the EU average consumer.

The Directive does include protection for “vulnerable consumers”. These individuals are protected by the Directive on the basis of age, mental or physical infirmity or credulity.²⁹⁷ However, as stated by Incardona and Poncibo, the

²⁹⁴ Council Directive 2005/29/EC of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council (‘Unfair Commercial Practices Directive’) [2005] OJ L149/27, para 18; *ibid.*

²⁹⁵ *ibid.* 27.

²⁹⁶ *ibid.* 35.

²⁹⁷ Council Directive 2005/29/EC of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council (‘Unfair Commercial Practices Directive’) [2005] OJ L149/27, art 5(3).

inclusion is impractical and unnecessary.²⁹⁸ This is because if, for example, a product/service targets the elderly, then the average consumer will be determined by the average within this group.²⁹⁹ But if it targets all members of society, it would be impractical to expect businesses to tailor their marketing in a way that would not mislead all the possible vulnerable consumers,³⁰⁰ not least because of the broad range of what constitutes a vulnerable consumer.³⁰¹ Consequently, the inclusion of an exception for vulnerable consumers serves to highlight the problematic idea of the average consumer, because it does not in reality reflect the average consumer.

The case of *Buet* provides a different notion of the “vulnerable consumer” which perceives them as vulnerable in particular circumstances. In that case, the ECJ said that a customer of door-to-door educational enrolment salesmen are more vulnerable than most canvassing consumers, because they are more likely to be behind on their education and wishing to catch up, so they are vulnerable to the sales tactics promoting the educational enrolment which might persuade them with the likelihood of better job prospects.³⁰² Another justification for the ban on canvassing, which is a protective measure, was that because teaching is not a consumer product in daily use, a poorly considered purchase could cause the buyer harm other than mere financial loss that could be more long-lasting. E.g. low quality or unsuitable training could harm their chances of getting a better job or enrolling on further training.³⁰³ This case therefore depicts a consumer who is not vulnerable because of a characteristic of the individual, but because of a certain circumstance. In this sense, it indicates that vulnerability, and by extension the concept of ‘consumer,’ is situational – i.e. a consumer may be vulnerable in cases of the canvassing of educational enrolment courses, but not in situations where they are trying to buy a car.

One question raised by the average consumer concept is, if the typical user of an industry qualifies as an ‘average consumer’, does this mean the law or regulation

²⁹⁸ Incardona and Poncibò (n 303) 29.

²⁹⁹ *ibid.*

³⁰⁰ *ibid.*

³⁰¹ Section 2.7 of this thesis discusses the notion of the “vulnerable consumer” in more detail based on Peter Cartwright’s “Taxonomy of vulnerability”.

³⁰² Case 382/87 *R Buet and Educational Business Services (EBS) V Ministère public* [1989] ECR 1235, para 13.

³⁰³ *ibid.*, para 14.

in question should be designed to suit them and ignore the possibility of the vulnerable consumer? Which benchmark should be used, the average consumer or the vulnerable consumer? Or should there be a two-strand test? For example, the law is x, but if the consumer falls within the category of a vulnerable consumer, then the exception to be applied is y.

Micklitz argues that the EU's involvement in consumer legislation gradually changed the outlook from consumer protection law into consumer law. This meant that the focus shifted from the weak consumer to the average consumer³⁰⁴ – as shown in the above discussion of the EU definition and conceptualisation of 'consumer'. Consequently, the weakest market participant was no longer considered to be "the small man" on the street, but increasingly the private or small business owner.³⁰⁵ The impact is that EU consumer law protects the 'average consumer' rather than the vulnerable one unless it is designed to protect against a particular vulnerability, e.g. door step selling victims who are vulnerable because of a lack of opportunity to inspect goods.

This has been most obvious in the information paradigm that dominated consumer law, for example, by comparing the original Doorstep Selling Directive 85/577/ECC to the Consumer Rights Directive 2011/83/EU and the original Consumer Credit Directive 87/102/EEC with the revised version 2008/48/EC, one can see a development in the obligation to inform.³⁰⁶ The underlying rationale is that the circumspect, informed consumer would be able to make a rational decision based on information received.³⁰⁷ However, whilst such protections might protect the 'savvy' individual, it is different for individuals who cannot process the available information and require information for different reasons.³⁰⁸ Arguably, such individuals might be covered by the EU's concept of the 'vulnerable consumer' however the implication of this "backup category" is that

³⁰⁴ Hans-W Micklitz, 'The Expulsion of the Concept of Protection from the Consumer Law and the Return of Social Elements in the Civil Law: A Bittersweet Polemic' (2012) 35 *Journal of Consumer Policy* 283, 283; Hans-W Micklitz, 'Do Consumers and Businesses Need a New Architecture of Consumer Law? A Thought-Provoking Impulse' (Social Science Research Network 2012) SSRN Scholarly Paper ID 2169226 4 <<https://papers.ssrn.com/abstract=2169226>> accessed 4 March 2017.

³⁰⁵ Micklitz, 'The Expulsion of the Concept of Protection from the Consumer Law and the Return of Social Elements in the Civil Law' (n 317) 285.

³⁰⁶ Micklitz, 'Do Consumers and Businesses Need a New Architecture of Consumer Law?' (n 317) 5.

³⁰⁷ *ibid.*

³⁰⁸ *ibid* 6.

under consumer law such as the consumer protection law regimes of the 1970s and 1980s consumers are not considered to be intrinsically vulnerable, , rather only some groups of consumers require protection.³⁰⁹

The consumer law approach to conceptualising 'consumer' is problematic for extending the concept so broadly as to include many different types of market participant. As stated by Micklitz, one cannot compare the owner of a yacht to an electricity customer who cannot pay his bill and whose provider turns off the power. Consequently, the concept of 'consumer' encompasses the small business person to the vulnerable consumer.³¹⁰ In other words, they all can be classified as consumers even though their respective relationships within the markets they operate in are different and so their levels of vulnerability (if at all) can vary greatly. This points to the need for a consumer (protection) law that is more flexible in how it defines the 'consumer'. It would be impractical to create a different body of rules and regulations for each type of consumer, particularly because each type of consumer can usually be found within a given market. Micklitz therefore proposes a "mobile system of rules" and "conceptual descriptions".³¹¹ The moveable redress system is based on the idea that different rights and obligations can be assigned to different types of consumer.³¹² Consequently, Micklitz highlights four main groups of the consumer: the informed consumer; the responsible consumer who can make use of the information provided to exercise his/her rights; the circumspect consumer, who benefits from market-rectifying mechanisms that grant a minimum level of fairness through mandatory rules; and the vulnerable consumer who, at least in EU law, is usually afforded status-based antidiscrimination rules.³¹³

The idea is that the different types of consumer experience different types of weakness and different levels of values, so a responsible consumer, which according to Micklitz includes the client/small business person requires a legal framework that guarantees "access justice" rather than focusing only on the guarantee of social justice through redistribution. Legal or regulatory provisions which provide "access justice" ensure access to the market so that the

³⁰⁹ *ibid.*

³¹⁰ *ibid* 64.

³¹¹ *ibid.*

³¹² *ibid* 66.

³¹³ *ibid.*

responsible consumer can benefit from the advantages of the variety of products and services.³¹⁴ In contrast, the vulnerable consumer intrinsically requires legal provisions that provide social justice because according to Micklitz, “as an individual, and indeed the weaker party on the market, he needs the protection of the legal system”.³¹⁵

It therefore appears that Micklitz’ differentiated consumer is based on the difference between professional and oftentimes business ‘consumers’ and ‘individual’ consumers, where he associates the vulnerable consumer with individuals. However, these categories and corresponding resolutions to problems do not fit the lenders of P2PL because, like traditional conceptualisations of consumer, Micklitz does not take into account the vulnerabilities arising from the actions of consumers in the market. Rather than regarding them as active participants in the market, the differentiated consumer framework views them as passive recipients of goods and services, Consequently, the vulnerabilities conceived and the corresponding solutions are based on the risks faced by individuals (and small businesses) who are simply on the receiving end, e.g. information risks and inability to access a particular market. Whilst such vulnerabilities affect all forms of consumers – including P2PLs and borrowers – it is not broad enough to contemplate the peculiar risks and vulnerabilities the latter face.

Furthermore, the movability aspect of Micklitz’s solution is that the extent of the personal responsibility of the consumer depends on the extent of autonomy he/she has, and the extent state intervention in contractual relationships to guarantee social or access justice depends on this. Therefore, the burden is on the consumer to use the information provided and to inform the business participant if there are any shortcomings. As such, the responsible consumer would have a higher burden of self-reliance and responsibility than the vulnerable consumer.³¹⁶

³¹⁴ *ibid* 67. The term “access justice” was coined by Micklitz to refer to legal or regulatory provisions that ensure an individual has access to the market they wish to operate in. It is different in meaning to the phrase, “access to justice” which connotes the right to obtain appropriate redress, e.g. through advice agencies, ombudsmen and the courts etc, if not treated fairly under law or regulation.

³¹⁵ *ibid*.

³¹⁶ *ibid*.

Micklitz does not make it clear whether the use of information by the consumer is the sole criterion for determining the consumer's level of responsibility or increased need for protection, although it is the only one mentioned on corresponding obligations on consumers for their protection. As such, even e flexible movability is tied to the information paradigm of consumer law, as the starting point for protection is that help is provided to the consumer in accordance with his/her ability to use the information provided. However, information should not be seen as the starting point, because in some consumer activities it is of no use or bears no relevance to the risks or vulnerabilities faced. For example, once the lending contract is underway, information is no longer of use to the P2PLs, who are henceforth dependent on the platform to perform its task adequately and lack the power to do so themselves.

Based on the concept of the prosumer, which highlights that individuals are not just passive receptacles of services provided to them, but are active participants in the services, this thesis argues for a legal framework that takes into account what the consumers actually do and what arises from their activities specifically.³¹⁷ Therefore, adequate protection needs to be afforded to different types of market participant within their own market of operation. Consequently, this thesis argues for a flexible protection law paradigm that looks at the particular vulnerabilities of the P2PLs and borrowers.

Nonetheless, Micklitz's idea of differentiated remedies is significant. Differentiated remedies means that there should be different remedies depending on the different types of consumer in the particular context. For the responsible consumer, a reasonably prepared package of information which provides pertinent and accurate information would be a suitable remedy., Whereas the right to withdraw or change contractual partners may be of no benefit, the right to access and a minimum standard of services applicable to all would be more appropriate for the vulnerable consumer.³¹⁸Therefore, Micklitz's differentiated consumer approach is a suitable starting point for this thesis' analysis, by

³¹⁷ See sections 2.8 and 2.10 for the discussion on the 'prosumer' concept and section 5.7 for a discussion of the concept of the 'lendsumer'.

³¹⁸ Micklitz, 'Do Consumers and Businesses Need a New Architecture of Consumer Law?' (n 317) 74.

highlighting the fact that the body of consumers is not as homogenous as the concept of 'average' consumer implies.

In response to the question of whether the benchmark for consumer law's conceptualisation of consumer should be the average or vulnerable consumer, it would more practical for there to be a single test – to assume that the average consumer is a vulnerable one, in light of research of behavioural and cognitive psychology studies which show that consumers are not all, and not always, rational.

Arguably, rather than having a strict test for the 'average consumer' based on a fallible conception of the average consumer, it would be better to shift the goal posts slightly by acknowledging that the average consumer is not always rational and observant. Rather, the definition should include the behavioural flaws exhibited by people when carrying out transactions or making purchases. One might go further to argue that the concept should be more flexible and take into consideration both economic and social vulnerabilities faced by the individuals in question, e.g. the inclusion of how much control one has in the specific marketplace activity at the pertinent time as something that should warrant the classification of vulnerability and thus the need for protective measures. This section has shown that the general notion of 'consumer' cannot accurately convey the varying complexities of the individuals who are the end-users of goods/services, whether it is their features or the ways they behave in different circumstances. At best, it only serves as an umbrella description of all those who purchase goods/services.

2.7 Concept of 'Vulnerable Consumer'

The regulation of financial services is usually justified by the need to protect consumers, but consumers are a diverse group and protecting them all is a challenge faced by regulators.³¹⁹ There are two main views of consumer protection, the first is that consumers need to be protected from firms' unscrupulous activities e.g. misleading information or aggressive sales tactics; whilst the other view is that consumers must be protected from themselves.³²⁰

Cartwright's paper on vulnerable consumers focuses on the challenge to design policies which appropriately consider the interests of disadvantaged consumers. For the purposes of his research, he calls them "vulnerable" consumers. A key development of his article is his consideration of the different ways vulnerable consumers should be understood. Cartwright develops a way to classify them which he terms a 'taxonomy of vulnerability'. The aim of Cartwright's taxonomy is to help identify where vulnerability is most likely to arise. The factors of vulnerability which he classifies are: information, pressure, supply, redress and impact vulnerability.³²¹

Cartwright uses "vulnerable" in the relative sense of the word, i.e. consumers as a group may be vulnerable in comparison to other market players like traders, or in comparison to each other. However, he focuses on consumers who are vulnerable in comparison to each other.³²² Additionally, the article focuses on consumers who have the capacity to look after their own interests, but are relatively regarded as vulnerable³²³ or disadvantaged.³²⁴

Cartwright also suggests ways that this taxonomy can be used by regulators and legislators to ensure that the interests of vulnerable consumers are correctly taken into consideration. One example he gives is in the context of redress

³¹⁹ Peter Cartwright, 'The Vulnerable Consumer of Financial Services: Law, Policy and Regulation' (2011) Financial Services Research Forum <<http://www.nottingham.ac.uk/business/forum/publications.aspx>> accessed 9 November 2013, 53.

³²⁰ Roman Inderst, 'Retail Finance: Thoughts on Reshaping Regulation and Consumer Protection after the Financial Crisis' (2009) 10 E B O L R 455, 459–460.

³²¹ Peter Cartwright (n 250) 2.

³²² *ibid* 7.

³²³ *ibid* 7-8.

³²⁴ *ibid* 9.

vulnerability. In some cases, consumers may only be appropriately protected where they can hold businesses to account by obtaining redress. However, this may require knowledge, confidence and resources all of which a vulnerable consumer may not have.

He points out that the law addresses the needs of such consumers largely through the prevention of unfair practices.³²⁵ An example is the Consumer Credit Act 1974 which is the main legislation designed to govern the relationship between lenders and consumer borrowers. Sections 140A to 140D deal with unfair relationships. A court can make an order regarding credit agreements in three situations listed under s.140A, for example, the way the creditor has exercised or enforced any of his rights under the agreement or any related agreement.³²⁶ The provisions provided in this section of the Act allow for maximum flexibility because they do not specify any meaningful way of identifying an unfair credit relationship.³²⁷

Cartwright has stated that the fact consumers of financial services need legal protection is a certainty.³²⁸ They are vulnerable in many ways and the question that should be asked is how they should be protected.³²⁹ There are many legal mechanisms which can be used to protect consumers, and there are very many different types of consumers that need protecting, e.g. sophisticated investors and unsophisticated current account holders, because of this, it needs to be determined “which mechanism should be used to protect which type of consumer in which field of financial services.”³³⁰

Cartwright’s taxonomy provides a useful framework for addressing questions about appropriate regulatory measures in favour of various vulnerable consumers. It also recognises that consumers are not a homogenous group but come in very many forms and experience varying types of vulnerability. This is an important factor for regulators to bear in mind because not all regulatory

³²⁵ *ibid* 10.

³²⁶ The Consumer Credit Act 1974 s 140A(b).

³²⁷ Peter Cartwright, (n 250) 12.

³²⁸ Peter Cartwright, *Consumer Protection in Financial Services* (Kluwer Law International 1999) 3.

³²⁹ *ibid*.

³³⁰ *ibid*.

methods are suitable for each consumer, even within a particular market like P2PL.

2.8 Concept of 'Prosumer'

Previous conceptions of the consumer treated them like “passive receptacles” who could be swayed by appealing messages.³³¹ However, the characteristics of consumers are changing because rather than passively consuming the goods/services they use, they are more involved in the production process.

2.8.1. Origin of the term 'prosumer'

The term 'prosumer' is attributable to Alvin Toffler who dealt with the concept in his book, “The Third Wave”, where he recognised the active participation of consumers.³³² It is an amalgamation of the concepts of producer and consumer and has been defined as an individual consumer who gets involved in the design or production process of a good which the individual will eventually purchase or can envision themselves purchasing.³³³ In this way, the prosumer engages in activities which are traditionally perceived as separate activities carried out by separate parties, i.e. they are simultaneously a producer and a consumer of goods/services. Because of this combination of activities, the prosumer is said to engage in 'prosumption'. A term itself an amalgamation of the concepts of production and consumption and which Ritzer has defined as the interconnected process of production and consumption.³³⁴

³³¹ Salzman (n 49) 141.

³³² Toffler (n 49).

³³³ Emily M Weitzenboeck, 'Looking back to See Ahead: The Changing Face of Users in European E-Commerce Law' (2015) 23 Artificial Intelligence and Law 201, 203.

³³⁴ George Ritzer, 'Automating Prosumption: The Decline of the Prosumer and the Rise of the Prosuming Machines' (2015) 15 Journal of Consumer Culture 407, 408.

According to Ritzer and Jurgenson, prosumption is made up of an equal focus on production and consumption.³³⁵ This suggests that prosumption is different from customer-centred services where companies allow customers to modify elements of the final product,³³⁶ e.g. the colour of a car the customer wishes to purchase, because in such cases the company retains control over the production process.³³⁷ Rather, in prosumption, the customer co-innovates and co-produces the product he/she will eventually consume.³³⁸

2.8.2. Consumption to Prosumption: a brief history of the prosumer

The economies of the developed world have been governed by capitalism for the last few centuries.³³⁹ In its earlier stages during the industrial revolution, and for approximately two centuries after, capitalism focused largely on the production of goods, particularly within factories.³⁴⁰ This was particularly the case during World War Two with the focus on manufacturing war materials with very little for individuals to consume.³⁴¹ The resulting scarcity of consumer goods created a desire for them.³⁴²

During this period, the central principle in contract for sale of goods was *caveat emptor*, i.e. buyer beware. This placed a good deal of contractual risk on the part of the consumer because it was the buyer's responsibility to check the goods before contracting and the buyer who bore the risk of defected goods, except where the defects were unforeseeable.³⁴³ However, the underlying assumptions of the *caveat emptor* principle were that in the eyes of the law, both contractual parties were on an equal footing; each party had a distinct role in the transaction, i.e. one was the seller and the other the buyer; and both parties were seen to have opposing interests, i.e. both wanted the best bargain for themselves.³⁴⁴

³³⁵ Ritzer and Jurgenson (n 49) 13.

³³⁶ Weitzenboeck (n 346) 212.

³³⁷ *ibid.*

³³⁸ *ibid.*

³³⁹ Ritzer and Jurgenson (n 49) 13.

³⁴⁰ *ibid* 13, 14.

³⁴¹ *ibid* 14.

³⁴² *ibid.*

³⁴³ Weitzenboeck (n 346) 205.

³⁴⁴ *ibid.*

The first assumption was based on classical theory of contract which viewed freedom of contract as an expression of the will of contracting parties to choose whether to contract.³⁴⁵ Consequently, the parties to the contract were seen as being in the best position to determine their wills and therefore viewed as self-reliant, self-sufficient and self-determinant.³⁴⁶

From the early 1960s, the production industries started to decline. This period also saw the focus shift from production to consumption with the emergence of large indoor shopping malls as the sites of consumption and the outsourcing of production to other countries like China.³⁴⁷ The consumer society was also aided by the growth of available credit,³⁴⁸ which enabled people to spend and thus consume more. The consumer society did not replace production, but it was no longer the priority.³⁴⁹

The classical contractual principle of *caveat emptor* also became tempered by consumer protection legislation because the rise of mass-production and mass-consumption made the view that producers and consumers had equal bargaining power unsustainable.³⁵⁰ Examples of the early consumer protection legislation were President John F. Kennedy's Consumer Bill of Consumer Rights, based on an address to congress on 15 March 1962, which conferred such rights as the right of consumers to safety, to be informed, to choose and to be heard.³⁵¹ Similarly, in the EU, the European Commission 1975 Programme for Consumer Protection and Information Policy recognised five basic consumer rights which included the rights to protection of economic interests, redress, representation and to information and education.

Whilst the consumer protection regime recognised that producers and consumers did not have equal bargaining power, as with classical contract theory, the regime was structured around the idea that producers and consumers had distinct roles within the transaction and opposing interests. It was therefore largely tailored to

³⁴⁵ *ibid.*

³⁴⁶ *ibid.*

³⁴⁷ Ritzer and Jurgenson (n 49) 15.

³⁴⁸ *ibid* 16.

³⁴⁹ *ibid.*

³⁵⁰ Weitzenboeck (n 346) 206.

³⁵¹ *ibid* 207.

suit the traditionally passive consumer who did not actively engage in the production process and simply consumed.

However, from late 2007 to 2008, during the global recession, consumption and production began to decline and there were signs that the prosumer society was challenging the separate consumer and producer societies.³⁵² Yet for Toffler and Ritzer, prosumption has always existed.

According to Toffler, over time there have been three types of societies which have existed in waves, each wave taking over the previous one. The First Wave was dominated by the settled agricultural society. Prosumption was the predominant form of economy in this pre-industrial society. The Second Wave of the industrial age society followed, featuring mass production, mass education, mass media, mass distribution and consumption; and it began with the Industrial Revolution in western Europe. According to Toffler, it was during this period that marketization drove a wedge into society separating the two functions into the separate entities of 'producer' and consumer'.³⁵³ However, society is moving towards the Third Wave which consists of the rise of the prosumer and prosumption³⁵⁴ once again.

Similarly, Ritzer has argued that it was the Industrial Revolution that separated production and consumption. However, rather than the forms of society existing one after the other, they have never been fully distinct.³⁵⁵ For example, during the height of the age of production, producers consumed raw materials like coal and timber to manufacture the final products and consumers produced their meals.³⁵⁶ And consumers have often contributed to the production of the goods and services they consume by being put to work, e.g. with the onset of fast-food restaurants, consumers carried their own trays of food to their tables and filled their own drinking cups before sitting down to eat them, likewise in supermarkets, consumers have been encouraged to use self-service checking machines to buy the products they eventually consume. So, prosuming activity always existed, but was slight during the production-focused period.

³⁵² Ritzer and Jurgenson (n 49) 17.

³⁵³ Alvin Toffler, *The Third Wave* (William Morrow 1980) 266.

³⁵⁴ *ibid* 265.

³⁵⁵ Ritzer and Jurgenson (n 49) 17.

³⁵⁶ *ibid*.

2.8.3. Factors of the change from consumer to prosumer

There is both a cultural and economic cause for transition from consumer to prosumer. In relation to the cultural cause, society has latched on to the idea that there is a need for self-empowerment and the emphasis is on personal rights.³⁵⁷ Linked to this is the increasing desire of people to be in control of their own affairs, whether in the workplace, school or the doctor-patient relationship.³⁵⁸ Consequently, the structural relationships between consumers and businesses/professionals is changing from a hierarchy of leadership which sees the business/professional exercising all the control within the relationship and the consumer being passive, to a partnership-based structure, which sees the business or professional having to justify their decisions and solicit input from the 'consumer'.³⁵⁹ An example of this is the doctor-patient relationship where doctors no longer dictate treatment to patients, but provide them with options and explain the options to them.

In the context of the P2PL industry, the industry thrives off and is rooted in this zeitgeist. It is built around the type of people who want to take control of their finances and savings by taking control away from banks and traditional financial institutions. Some people prized the concept or encouraged it as a way of punishing the banking industry for their reckless behaviour leading to the 2008 financial crisis. In this way, the P2PL users exhibited their empowerment and exercise of non-passive control within their transactions.

Therefore, if as Shüller argued, one cannot define 'consumers' by their nature but by their acts and behaviour, the fact that the way the consumer acts and behaves is different from before, means the concept of 'consumer' needs to change.

The second factor of this transition is economic. Firstly, the development of technology and cheap labour has caused a shift in the focus of global capitalism from concerns about the need to make lots of products quickly, i.e. production, to

³⁵⁷ Salzman (n 49) 141.

³⁵⁸ *ibid.*

³⁵⁹ *ibid.*

the need to get consumers to purchase goods to prevent the failure of the company i.e. consumption.³⁶⁰

Secondly, it is cheaper to get consumers to do the work of consumption themselves in the form of self-service ticket machines in train stations or self-service check-out machines in supermarkets.³⁶¹ P2PL for example, is akin to self-service lending and borrowing; the intermediary takes a step back in comparison to traditional lending institutions, to give people more control. Both factors have resulted in the empowerment of the consumer transforming them from being the passive consumer to the more active 'prosumer'.

Salzman described a prosumer as cash-rich, time-poor, demanding, socially aware and demanding of full and transparent access to information.³⁶² However, it is questionable whether these features are any different from the traditional conception of the consumer enshrined in law. The EU law definition can accommodate this concept of 'prosumer' because of its underlying assumption of the 'average consumer'.

The prosumer represents the blurring of lines between production and consumption, because they participate in the production of the goods and services they consume.³⁶³

A distinguishing feature of prosumers is that unlike consumers, they are made to work for the things they consume. According to Dujarier, there are three main types of work that a prosumer does which helps categorise them, directed self-production, collaborative co-production and organisational work.³⁶⁴

Directed self-production entails situations where consumers produce for themselves using tools and support provided by the supplier, e.g. vending machines, ATM machines and eating from a tray in fast food restaurant.³⁶⁵ These situations are usually imposed on the consumer, so the consumer is made to

³⁶⁰ *ibid.*

³⁶¹ *ibid* 153.

³⁶² *ibid.*

³⁶³ David Beer and Roger Burrows, 'Consumption, Prosumption and Participatory Web Cultures An Introduction' (2010) 10 *J Consum Culture* 3, 4 and 6.

³⁶⁴ Marie-Anne Dujarier, 'The Three Sociological Types of Consumer Work' (2014) 0 *J Consum Culture* 1.

³⁶⁵ *ibid* 6.

work to consume and bears the burden of time, money and travel. Therefore, the consumer is forced to become a prosumer.

Collaborative co-production involves unpaid profit-making work.³⁶⁶ E.g. crowdsourcing, where tasks are outsourced to crowds of people across the world who can act as a remote, unpaid workforce.³⁶⁷ This category also includes the use and market exploitation of information captured about individuals online either passively using traces left on websites, mobile phones and GPS, or deliberately through surveys ³⁶⁸. Additionally, user-generated content also falls under this category of work carried out by the prosumer. E.g. when bloggers write articles (blog) or post videos of themselves (vlog) reviewing different goods/services, or providing instructions for their audience on how to use them, they generate advertising revenue for companies which they may or may not benefit from financially.

The final category of work is organisational work. This type of work indirectly collaborates with the production side of transactions because it aims to produce a practical response in the main producer which is subjectively and socially acceptable.³⁶⁹ For example, when the consumer, deliberately avoids buying their car fuel from companies with dubious moral practices e.g. the failure to clean up oil spillages. For this type of work to succeed, consumers must work, in the sense of testing, comparing, researching, writing and negotiating with the business, all the while facing obstacles put in place by marketers like exit barriers, confusing rates and loyalty programs designed to persuade them into adopting the behaviours the marketers and businesses expect.³⁷⁰

2.8.4. The identity of prosumers

The question remains, who or what is the prosumer? The notion of consumer was defined according to its nature as a person and the purpose of the transaction, i.e. the fact the transaction was carried out for personal rather than for business,

³⁶⁶ *ibid* 8.

³⁶⁷ *ibid* 8–9.

³⁶⁸ *ibid* 9.

³⁶⁹ *ibid* 11.

³⁷⁰ *ibid*.

trade or professional purposes determined whether a contract was a consumer contract or whether an individual was a consumer. Contrarily, the conceptualisation of the prosumer tends to be centred on the prosuming work that they carry out. So a prosumer is someone that puts in work towards (produces) what they wish to or will eventually consume. Likewise, a prosuming transaction is one which either requires or encourages the actor to produce and consume.

Early examples of prosumption include fast food restaurants requiring their customers to be their own waiter by carrying their food to their table or car, or sandwich bars like Subway requiring consumers to choose the content of their meals³⁷¹ by adding extras like different sauces and toppings. Other examples of prosumption include consumers becoming their own bank cashier using ATM machines and their own check-out assistants in supermarkets using self-service check-out machines.³⁷²

Examples of prosumption can also be found online in a less material form because of the web 2.0 version of the internet. In terms of the development of the internet, web 2.0 is second generation internet and it contrasts with web 1.0 because it facilitates user-generated content, whereas previously, content was created by internet providers like AOL and Yahoo.³⁷³ In contrast, web 2.0 has been crucial to the development of the means of prosumption because it lets users produce content collaboratively.³⁷⁴ For example, Wikipedia, a website where users create, edit and update the encyclopaedic entries; social network websites like Facebook, blogs and micro-blogging sites like Twitter; eBay a website where consumers and retailers create the marketplace; YouTube, a website where users create and upload videos for consumption, and Amazon, an online shopping centre where internet users do the work of ordering products and writing reviews.³⁷⁵

Online business transactions can be identified by the parties to a transaction. The typical categories are business-to-business, business-to-consumer and

³⁷¹ Ritzer and Jurgenson (n 49) 19.

³⁷² *ibid* 18.

³⁷³ *ibid* 19–20.

³⁷⁴ *ibid* 20.

³⁷⁵ *ibid* 21.

consumer-to-consumer transactions.³⁷⁶ In most electronic commerce, the prosumer is often perceived as falling under the category of participant which follows the '-to-'³⁷⁷ i.e. the role traditionally played by the consumer of being the recipient of goods/services. However, they can often display the characteristics associated with the participant before the '-to-'³⁷⁸ through their capacity as producers. Consequently, the prosumer blurs the roles of consumer and producer within transactions.

However, as under the consumer society, the corporations still control the major resources online.³⁷⁹ Although participants take on the role of the producer, the profit and potential for profit e.g. through branding, remains with the corporations, even though they have taken a step back and allow the participant to do a lot, if not all the work,³⁸⁰ they would normally do, for free.

Consequently, even in scenarios where the prosumer takes on the role of the entity before the '-to-' in a transaction, the move from consumer to prosumer has not placed them on an equal footing with the business. This is particularly the case in consumer-to-consumer transactions online, where the business takes a step back and seemingly no longer belongs to that transactional structure, only facilitating the consumers in the production and consumption of their own goods/services; yet retains hold of the major resources required to fully carry out the transaction.

2.9. P2P lenders and borrowers

2.9.1. Users of P2PL

Hulme and Wright³⁸¹ provide a comprehensive analysis of P2PL which surveys its historical background and the reasons for its re-emergence in the financial scene. They analyse the concepts of community and individualism and find that

³⁷⁶ Weitzenboeck (n 346) 203.

³⁷⁷ *ibid* 204.

³⁷⁸ *ibid*.

³⁷⁹ Ritzer and Jurgenson (n 49) 26.

³⁸⁰ *ibid* 26, 27.

³⁸¹ Michael K Hulme and Collette Wright (n 127) 13.

P2PL offers a new type of financial relationship which attracts the type of individual that desires on the one hand, financial services which are based on community ideals such as 'good faith', ethicality and a varying desire to participate in communities, where financial exchanges are based on principles of altruism, transparency and personal social responsibility. For example, in their survey of Zopa users, they found that 54% of lenders and 85% of Zopa borrowers thought of Zopa as "exceptionally transparent", whilst 73% of the people that completed their survey on the general banking industry felt that mainstream financial services should be more transparent about the organisations they invest in.³⁸² Hulme and Wright have stated that they believe this transparency leads members to view "social lending" schemes to be acting in 'good faith' with care for the individual and with a philosophy that looks beyond the transactional nature of the financial relationship.

On the other hand, these individuals also have a higher level of individualism facilitated by the self-educative effect of the internet, in that they are looking for innovative financial solutions that give them a greater sense of control and empowerment. Overall, the authors argue that concepts of the individual within community, transparency and ethicality are all pivotal to P2PL schemes and provide the ideological underpinnings of this form of financial exchange.

Hulme and Wright argue that although there are many financial motivations for using social lending schemes, the ethical and social principles they reflect are the main attractions for users.³⁸³ For example, they state that if a borrower defaults, it negatively affects the lenders' expected return which according to their research, results in a feeling of obligation and duty to repay.³⁸⁴ However, experience has shown that this is not always the case. For example, Quakle, the now defunct P2PL platform based its operations around a similar, social philosophy stating, "Quakle believes that social bonds strengthen confidence and make borrowers more likely to repay".³⁸⁵ This was not the case due to practical realities including the fact that many of its borrowers were already in a poor

³⁸² *ibid* 8.

³⁸³ *ibid*.

³⁸⁴ *ibid*.

³⁸⁵ Robert Powell, 'The Truth Behind Quakle's Collapse' (21 December 2011) <<http://www.lovemoney.com/news/credit-cards-current-accounts-and-loans/loans/13799/the-truth-behind-quakles-collapse>> accessed 12 February 2013.

financial state before they started using the service. Many were borrowing from the P2PL site to repay existing payday loans.³⁸⁶

This shows that operating P2PL on the principles of trust, transparency, altruism, and consumer responsibility alone, is insufficient to ensure P2PL schemes work smoothly in the interests of the participants. Research on the limits of human rationality, literacy and learning has shown that there are limits to consumer learning.³⁸⁷ There are challenges involved in trying to instil new habits and skills in consumers, for example, behavioural research has shown that consumers select differently from the same options depending on the context and how their choices are framed.³⁸⁸ Additionally, educating them is often compromised by the conflicting interests of firms' to exploit irrational consumer behaviours.³⁸⁹ Therefore, there is a tension between consumer responsibility and firms' competitive pursuit of profit. It also suggests there is a need for regulation to ensure that the principles which form the basis of P2PL are enforced and complied with – it is not adequate to rely on individuals or platforms to enforce them.

Hulme and Wright's findings on the type of people that use P2PL are that the users of P2PL are individuals who are inherently responsible or autonomous. As to the form regulation should take, the implication is that the regulation of P2PL users should reflect this characteristic by delegating some sort of responsibility or placing on them an onus to protect their own wellbeing within the market, e.g. through the responsabilisation of the consumers through education, transparency and information disclosure. However, this too has its limits. Responsibilisation of the consumer is discussed further below.

2.9.2. Ideals/Goals of P2PL

³⁸⁶ *ibid.*

³⁸⁷ Toni Williams, 'Empowerment of Whom and for What? Financial Literacy Education and the New Regulation of Consumer Financial Services' (2007) 29 *Law & Policy* 226, 244.

³⁸⁸ *ibid* 245; see also, Samuel Bowles, 'Endogenous Preferences: The Cultural Consequences of Markets and Other Economic Institutions' (1998) 36 *Journal of Economic Literature* 75; Matthew Rabin, 'Psychology and Economics' (1998) 36 *Journal of economic literature* 11.

³⁸⁹ Williams (n 400) 224.

Davis and Gelpern's study of P2PL focuses on its use for development; it is useful because the regulatory concerns are not just domestic in nature but treat the international aspects of P2PL regulation.³⁹⁰ E.g. they discuss the interests of key players on the international lending platform such as the home state, host state, recipients of the funds and donors and present the regulation of P2PL within the structures of two different bodies of law, charity and banking. This provides a different perspective on the nature of P2PL.

An analysis of the charitable, not-for-profit use of P2PL as found in micro-financing can be used to compare the communal and altruistic motives of lenders within the for-profit P2PL structure. These ideals were also highlighted by Hulme and Wright in their discussion of the type of people who engage in social lending which represents them as sophisticated and independent people who appreciate community values and altruism/philanthropy.³⁹¹

However, financial services regulation does not reflect consumer interests of investing or purchasing from an ethical, altruistic or trust-based institution. Financial services regulation tends to emphasise principles of consumer protection and competition moderated by the principle of proportionality. E.g. the FCA's regulation of P2PL in the UK, is primarily disclosure-based. In the FCA's consultation paper on its approach to crowdfunding, it stated that for loan-based crowdfunding, e.g. the approach followed by Zopa, "[their] approach will require firms to ensure that investors have the information they need to be able to make informed investment decisions and that all communications are fair, clear and not misleading."³⁹² They also state that, "[Their] proposals seek to provide adequate consumer protections that do not create too many barriers to entry or significant regulatory burdens for firms."³⁹³ The underlying implication is that consumer interests are secondary regulatory concerns and the interests for business are primary.

This highlights that where consumers are concerned, the emphasis of regulation is to enable them to act independently, but free of various perceived dangers, i.e. regulation for consumers tends to be protective. However, where businesses are

³⁹⁰ Davis and Gelpern (n 62).

³⁹¹ Michael K Hulme and Collette Wright (n 127) 13.

³⁹² Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding (and similar activities)* (Consultation Paper, CP13/13, 2013) para 1.15.

³⁹³ *ibid* para 1.12.

concerned, regulation can be both protective and facilitative of their interests. For example, laws and regulations have been designed to protect small businesses by ensuring that competition and entry into markets is fair; whilst also facilitating business through principles of proportionality, and the legal principles behind limited liability companies which make it easier and less risky to do business.

2.10. Comparison between P2P lenders and consumers

The previous sections provided an in depth look at the main components making up a consumer. To summarise, consumers are generally understood to be natural persons, who act for non-business/professional/trade purposes, to obtain goods or services for consumption or use. They are reasonably well-informed and reasonably observant, prudent and they are passive recipients of the activities of producers.

2.10.1. P2P lenders' role during the formation of the loan

P2PLs tend to be natural persons who act for a purpose which does not relate to their profession, trade or business. However, there are some platforms which do allow institutions to lend, such as Zopa. The underlying rationale of the principal that consumers are natural persons is to reflect the idea that consumers need protection to level the playing field between the individual intending to consume and the business providing the product of consumption. P2PLs also face uneven playing fields. Although they are the suppliers of the money in relation to the borrowers, they are reliant on the borrowers to provide accurate details about themselves and this, through the intermediation of the platform. This reliance creates an uneven playing field because they have no control or involvement over parts of the service provision e.g. limited knowledge and bargaining power.

Shüller argues that it is what the consumer does and how they behave that makes them a consumer – e.g. the act of buying consumer goods.³⁹⁴ For example,

³⁹⁴ This reflects the definition of “consumer sale” in the original s.55 of the SGA 1979 which referred to the sale of goods which are usually bought for private use/consumption to a person

P2PLs are targeted by businesses to an extent – they are made aware of and attracted to P2PL platforms through online advertising mediums: 27% of lenders through online advertising and 33% through online intermediaries like MoneySupermarket. It's assumed they react to such advertising in the same way as ordinary consumers of goods or financial services and so are subject to the same behavioural tendencies when receiving, understanding and acting on them. They are primarily motivated by the interest rates that they can obtain on a platform – 78% of P2P consumer lenders saw this as a very important factor whilst 22% saw this as an important factor.³⁹⁵ Although platforms can use these rates to attract lenders, such rates can be misleading depending on a platform's accuracy in reporting them, or level of scrupulousness. When making their choices of which platform to use and basing their decision on such interest rates, P2PLs as natural persons can be subject to behavioural biases which might lead them to make irrational decisions.

The use of auto-bidding/lending tools by lenders on P2PL platforms such as Unbolted and Bondora,³⁹⁶ suggests a passive characteristic, showing reliance on the platform's machinations and not on the lender's own productive skills. This is similar to the ordinary bank depositor who places money into his bank account in reliance that the bank will pay the interest each month/year. In this respect, the behaviour of lenders who select this option are similar to ordinary consumers.

If consumption is one of the key aspects of what makes a consumer, P2PLs are consumers in respect of their relationship with the platform. In this context, they make consumer-like decisions when choosing a platform to lend on, they are dependent on the platform to fulfil their role i.e. connect them with worthy borrowers, administer the loan smoothly and pursue debtors etc. They can also exercise consumer powers if they are dissatisfied with the services of the

not buying them in the course of business. Consequently, the original definition reflected the role and behaviour of an individual rather than their nature.

³⁹⁵ Bryan Zhang, Liam Collins and Peter Baeck, 'Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014' (University of Cambridge 2014) 44 <<https://issuu.com/cambridgejbs/docs/2014-uk-alternative-finance-benchma>> accessed 26 February 2016.

³⁹⁶ The P2P lending platform Bondora provides potential lenders with two lending options. They can opt to be "passive lenders" who automate their investments with Bondora's Portfolio Manager by selecting their portfolio manager settings and adding the necessary funds to their account. Alternatively, they can opt to be "active lenders" who use an interface called API, to access the Bondora system programmatically. Active lenders on Bondora have to take steps to learn more about API and contact Bondora to do so. They are advised to gain more experience using Bondora and only to become an active lender if they are lending larger sums of money.

platform, e.g. they can remove their funds from the platform and invest it elsewhere. However, their consumer tendencies are linked to their relationship with the platform.

The extent to which P2PLs can be said to be consumers regarding their relationship with the borrower is questionable. On the one hand, they enter the transaction with the borrower directly because the platform is not part of the contract. The good they receive from the borrower is the repayment of the loan with interest and they receive this good largely in a personal capacity. However, their engagement with the borrowers are limited on P2PL platforms as their money is divided amongst numerous borrowers and their engagement with borrowers is not always directly with the borrower, particularly on platforms where the users are hidden behind a veil of anonymity. In most cases, the platform acts as some kind of conduit between the lenders and borrowers. In this sense, P2PL cannot always be described as purely P2P.

However, the similarities between P2PLs and consumers are largely surface ones and there are several differences which serve to distinguish them. For example, unlike consumers, P2PLs are not mere targets of marketing for consumption, nor does their role only include providing key information to businesses which they can use to develop their services/products. Although both parties are integral to their respective transactions, they are important in different ways. E.g. the importance of consumers lies in the information that businesses can gather from them, which will be used by the business to develop their product or service. Consequently, many businesses invest in market research such as surveys to find out direct from consumers the type of products they would like to use and why. Another example, is the use of online cookies which track internet users and are used to help businesses tailor their website, services and advertising to suit a particular customer. In contrast, a P2PLs role is more integral to the service, such that without them, the service would not exist. As platforms do not lend money and are not party to the lending agreement, the lenders role is elevated in importance because without them there would be no money to finance the platform's loans. P2PLs therefore have the additional capacity of monetary support because the fact they lend has become a key characteristic of P2PLs.

Similarly, another way in which the role of P2PLs is different from consumers is that their level of participation in the transaction is significantly higher. In ordinary customer transactions, there is always a degree of customer participation.³⁹⁷ In the context of the service marketing literature Bitner *et al* have said that in many services, customers play vital roles in creating service outcomes and ultimately in either improving or reducing their own satisfaction and the value received.³⁹⁸ They produced a framework depicting the different levels of participation required of customers across varying services, which is useful here to compare the levels of participation of consumers compared to P2PLs.

According to their framework, the low level of participation benchmark is exemplified by services where all that is required of the consumer is their physical presence during the service delivery stage of the transaction.³⁹⁹ At this level, the products consumed tend to be standardised, the service might be provided regardless of any individual purchase and the consumer's only contribution might be to make payment. Examples of this level of consumer participation are consumers who purchase airline tickets or attend theatre productions. In both cases, a consumer only has to buy their ticket to receive the service, but the plane will still fly and the actors will still perform, even if the consumer does not attend. This is not so with P2PL. Firstly, each P2P loan is tailored to the individual lender's specifications and are therefore not standardised products which are created and packaged before being sold to them by the platform. Secondly, more input is required from the lenders for the transaction to go ahead. Even in examples where lenders choose the autolend form of lending, where the platform automatically lent on their behalf, the lender still has to first join the platform's community, transfer the funds, select their criteria and after the start of the transaction, monitor the loans themselves to ensure the autolending still matches their personal lending criteria, and if not, they alone must take action to update and change this. Consequently, P2PLs do not fit the low category of participation because their involvement is significantly higher.

³⁹⁷ Andrea Ordanini and others, 'Crowd-Funding: Transforming Customers into Investors through Innovative Service Platforms' (2011) 22 J Serv Mgmt 443, 466.

³⁹⁸ Mary Jo Bitner and others, 'Customer Contributions and Roles in Service Delivery' (1997) 8 International Journal of Service Industry Management 193, 193.

³⁹⁹ *ibid* 194.

The moderate level of participation is where a consumer's input is needed for the creation of the service.⁴⁰⁰ Customisation of standard products and services occur at this level, and whilst the consumer's inputs are necessary for a good quality outcome, it is the business that delivers the service, not the consumer. Services at this level also require the consumer to make the purchase to proceed.⁴⁰¹ For example, a consumer getting a haircut at a salon must give the hairstylist information (the input) about what style he/she desires. Depending on the quantity and quality of information provided by the consumer, the hairstylist may or may not produce the desired style, or a style that meets the consumers' expectations in terms of quality.

On the face of it, this degree of participation appears to suit P2PLs, particularly those who chose the autolend options of their platforms, because if one considers the input as the lenders' selection of their lending criteria, then the quality of the loans the platforms find for them depends on the information they provide to the platform. So if the lender does not adequately gauge his/her risk appetite, or erroneously decides to put all their savings into the platform at once, the quality of the loans sourced by the platform may later turn out to be of poor quality in relation to the lender's expectations and in terms of the latter scenario, the platform will use all of the lender's available funds.

However, looking at it this way only focuses on the service provided by the platform to the lender, rather than on the service the platform is ultimately designed to enable, i.e. the creation of a loan contract between individuals. Therefore, a key difference between this level of consumer participation and the participation of a P2P lender is that at this level within consumer transactions, after the service has been designed, it is the business that delivers it to the consumer. Whereas within P2PL, the main service that is provided is the loan service and this is delivered by the lender through the provision of the loan funds. Thus, the lender plays a part in designing the loan and delivering it to the borrower, albeit through the administration of the platform.

The last level of Bitner *et al*'s framework of participation is the high level of participation, where the customer co-creates the service/product. At this level, the

⁴⁰⁰ *ibid.*

⁴⁰¹ *ibid.*

consumer's inputs are compulsory and co-create the outcome, because without their active participation, the service cannot be created.⁴⁰² Consequently, if the consumer does not fulfil their role, the service itself is affected.⁴⁰³ Examples of this level of participation include personal training sessions where if the consumer refuses to take part in the exercises or carry out the tasks set out for him/her, the goals of the service will not be achieved, i.e. the consumer will not lose weight.

Within these categories of participation, consumers can play a number of roles, e.g. they could provide inputs such as information, effort, physical possessions or co-creation of the service/product etc.,⁴⁰⁴ which impact the productivity of the organisation through the quantity and quality of their inputs.⁴⁰⁵ They could also be a contributor to the quality of the service and their own satisfaction e.g. in services like education where the extent of their co-operation can impact the quality of the education they receive.⁴⁰⁶ Lastly, consumers could also play the role of competitor to an organisation, which is where the customer can choose between purchasing the product/service from the seller/service provider or, if they have the skills, producing the products/services themselves.⁴⁰⁷ Where they choose the latter, they become a competitor to the company. An example is the current trend of individuals who desiring natural products, create their own skincare and haircare products from ingredients they have in their own homes, rather than using store-bought varieties.

The first role is a common role carried out by P2PLs. To an extent, they also take part in the second role of contributing to the quality and their own satisfaction with the service, because without their input and without them making the right choices or decisions, they cannot expect to get the full value of the service from the platform. However, P2PL introduces another dimension which impacts this role, i.e. an element of chance involved in P2PL. This is because P2PLs are also dependent on the actions of P2PBs and their ability to carry out their side of the bargain efficiently, as well as the platform. Therefore, a tripartite dependency in the provision of the P2PL service provided exists.

⁴⁰² *ibid.*

⁴⁰³ *ibid* 195.

⁴⁰⁴ *ibid.*

⁴⁰⁵ *ibid.*

⁴⁰⁶ *ibid.*

⁴⁰⁷ *ibid* 198.

What all levels of participation in this framework have in common is that the service/product that the consumer participates in the delivery of, will eventually be consumed by that particular consumer. Even in cases where the product is intended to be a gift, it is still consumed by the purchaser because it is used by the purchaser as a gift to someone else.

However, in P2PL, lenders contribute to the production of each loan by designing the loan through their lending criteria selections. They are also involved in the service delivery stage and provide the loan funds. The lenders therefore play a significant role in P2PL because without them the platforms would not be able to realise revenues from the business model, and the borrowers would not be able to raise finance on the platform to realise their goals.⁴⁰⁸ This shows that although P2PLs do engage in consumer-like activities, their level of participation is higher. It is also different, because they take on a more expanded role – that of the investor.⁴⁰⁹

Whereas a consumer participating in online surveys or being tracked can be said to be participating or co-producing, the role of P2PLs has transformed into something more than mere participation. Consumers participate by exercising their purchasing power, contrarily P2PLs' participation is central to the business model and diversification on the platform.

P2PLs are also different from ordinary consumers because they blur the lines between production and consumption. Their role involves a mixture of entrepreneurship, i.e. productive action and social network participation, which is an activity typically associated with consumers e.g. on social media websites like Facebook and twitter.⁴¹⁰ They engage in production activity through the selection of loan initiatives to fund and their lending criteria, the provision of the funds required to effectuate the loan and in the monitoring of the lending transaction during the loan term. They decide to produce and fund a loan rather than taking out a loan themselves or putting their money in a bank account as an ordinary consumer would do. In doing so, they also decide to bear the risks associated with lending activity as opposed to the risks typically borne by a consumer.

⁴⁰⁸ Ordanini and others (n 411) 462.

⁴⁰⁹ Ordanini and others (n 411) 464.

⁴¹⁰ *ibid* 444.

At the same time, they engage in social network participation through the fact that on most platforms, each loan is funded by a large network of lenders who have selected similar lending criteria within the platform's community. This network is not put together by the lenders themselves, rather they are matched by the platform without their direct involvement or choice. In this sense, their participation level is low and matches that of the ordinary consumer. Hence, based on what P2PLs do, their capacity is a hybrid of consumer and lender, i.e. a "lendsumer" The same individual could be a consumer for certain purposes but an entrepreneur for others. This concept of "lendsumer" is discussed in more detail in sections 2.10.3. and 5.7.

Although consumers can participate in the design and delivery of a service, they typically do so for their own benefit. On the other hand, although P2PLs take part in providing the lending service they are not the individuals who are going to consume the service,⁴¹¹ the borrowers are. Despite this, the lenders' provision of the lending service is integral to them receiving a benefit from it. They are therefore simultaneously producers and consumers, but what they are producing is not what they are going to consume. This makes them different from ordinary consumers who may participate actively, and from prosumers who produce what they are going to consume. P2PLs produce a product/service to consume the profits made from it. In other words, they fund a loan which will be consumed by a different individual, the borrower, to consume the interest made on the loan. Therefore, in P2PL the production and consumption outcomes of the lender are separate elements of the transaction. The loan is separate from the interest rate as one element goes to the borrower, and the other to the lender. By way of comparison, unlike bank consumers who inadvertently fund loans produced by a bank and reap a small proportion of the interest gathered from them, P2PLs are not separated from the production side of a lending transaction because they fund the loan knowingly and with their own funds, which in itself involves various levels of decision-making and positive action.

The fact that P2PLs make different evaluative decisions also makes them different from ordinary consumers.⁴¹² The risks a consumer has to consider are

⁴¹¹ *ibid* 446.

⁴¹² *ibid*.

related to purchase and product-choice decisions.⁴¹³ For example, the risk that a product may be faulty or inappropriate for their needs, such as the risk that a builder hired to carry out some home improvements will carry out the work he has been contracted to do in a timely fashion and to a quality degree. Such risks are different from the risks relating to investment decisions made in support of the generation of an offering as happens in P2PL.⁴¹⁴ In P2PL, when lenders make a decision to lend, they have to take into consideration the level of risk they are capable of exposing themselves to, they also have to evaluate the likelihood of a particular loan offering or selection of lending criteria is likely to yield their desired economic outcome based on the amount they are willing to put into the transaction. This is more complex than a consumer having to decide whether a product is worth the price already advertised for it, because in this scenario, a consumer typically only takes into consideration the amount they have to spend, whether they want to spend it now or later, and if they can get a similar product elsewhere for a cheaper price. These evaluations are based on the products shown or described to them and which are easily verifiable as soon as they are delivered to the consumer, and the price of the product is predetermined. It might also be argued that consumers face a degree of price uncertainty also, because ordinary consumers might be incapable of efficiently determining the true cost of the product. However, this problem is heightened in the P2PL context because the product they buy into, is not standardised and therefore difficult to compare to other products. Also, there is no guarantee it will produce their desired outcome because the borrower may not repay the loan. Consequently, whether the cost of the lending transaction was worth the price they paid for it, is not as easily verified and cannot be truly known until the loan has run its full term. Therefore, P2PLs must bear and evaluate different types of risks than consumers.

Two other differences are worth mentioning in brief. Under current models of P2PL, group participation is integral to the activity, particularly as there is typically little other way to diversify within this mode of investment. Secondly, P2PLs' purposes are different from consumers. Whereas consumers consume, P2PLs

⁴¹³ *ibid* 447.

⁴¹⁴ *ibid*.

produce in order to patronise others, be part of a communal social initiative and to invest.⁴¹⁵

⁴¹⁵ *ibid* 461.

2.10.2. P2P lenders' role during the administration of the loan

The previous section has shown that during the formation of the loan when the lender designs and creates the loan, the lender is very different from an ordinary consumer, in terms of their role, capacity and decision-making. However, once the loan is underway, the lenders experience a high level of dependency on the platform, not least because it is the platform not the lender, who administers the loan. For example, lenders on eMoney Union,⁴¹⁶ a P2PL platform operating in the UK, depend on the platform for administration of the loan in many ways. The borrowers' repayments are secured on property or by eMoney Union's eProvision fund. They are reliant on the platform to chase late payments and in cases of non-payment, the platform puts in a claim to the eProvisionFund on the lenders' behalf to ensure that they do not suffer a loan repayment default. However, there is no guarantee that the claim will succeed as it is subject to sufficiency of money in the fund. In addition, P2PLs are dependent on the platform to keep their money safe in the case that it ceases to trade.

Similarly, Unbolted,⁴¹⁷ a UK P2PL platform, which allows borrowers to borrow against collateral of value, it is the platform, rather than the lenders, that determines the value of the asset lent against by partnering with selected firms that are internationally recognised for creating or managing auctions for a particular category of assets. The platform uses its partners' mid-range value estimate to determine the value of the asset. So lenders depend on the platform and its associates to accurately value the asset lent against. In addition, the asset is under the control of Unbolted during the term of the loan and lenders do not have private access to it. If the borrower defaults, the platform puts the asset up for auction and the funds received, less charges for selling it through a third-party auctioneer, are used to pay off the outstanding loan principal and interest. Therefore, the lender is also dependent on the platform's ability to sell the asset at the best value for money on their behalf.

These examples demonstrate how once the loan offering is underway, the capacity of P2PLs falls back to that of a consumer because they are dependent

⁴¹⁶ eMoneyUnion, 'eMoneyUnion. Peer to Peer Platform with the Best Rates' <<https://www.emoneyunion.com/>> accessed 19 April 2016.

⁴¹⁷ Unbolted, 'Unbolted' <<https://unbolted.com/uk/>> accessed 19 April 2016.

on the platform for most of the main aspects of lending: payment collection, payment chasing following default and ultimately, the sustainability of the platform. These are all aspects of lending which the P2P lender does not have control over.

In this context, whilst at the start of the process lenders make a choice about what loan offering to create, when it comes to using a particular platform, they act in the form of a consumer. This is because they are purchasing a product (the service of the platform) and they are subject to similar risks that consumers are, i.e. the reception of inadequate services. In addition, their participation level at this point is similar to ordinary consumers because they are passive recipients of the platform's service, whose only recourse is to withdraw their funds and transfer them to another platform or form of savings/investment (bearing the financial loss that withdrawal costs).

2.10.3. Comparison between P2P lenders and retail investors

The discussion in section 2.3.4 about retail investors demonstrated that they are increasingly being treated as consumers by regulators. This is significant for the classification of P2PLs because it is arguable that there is little difference between P2PLs and retail investors and so P2PLs should also be regulated like consumers. However, the preceding sections have shown that P2PLs, being different, cannot be categorised as consumers. This section goes further and explains why P2PLs are fundamentally different from ordinary retail investors. The main point is that P2PLs should be viewed as a specific subset within the general category known as 'retail investor'.

Ordinarily, 'retail investor' is a difficult concept to pin down.⁴¹⁸ David Lawton, the previous FCA Director of Markets, Policy and International, described retail investors as having longer term horizons, investing regular savings, pension contributions, wind-falls like inheritance and desirous of broad exposure to some

⁴¹⁸ Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press 2010) 30
<<http://search.proquest.com/docview/755155870/42571C785FCC4C07PQ/6>> accessed 5 January 2017.

investment risk to get a greater return.⁴¹⁹ More specifically, Huertas defines 'retail investor' as a non-regulatory/legal and generic term for individuals, who whilst acting outside of the course of their ordinary business, can be categorised under MiFID II as either retail clients or professional clients.⁴²⁰ He distinguishes the term from 'retail client' as used in MiFID II, which means any natural or legal person to whom an investment firm provides investment or ancillary services⁴²¹ and who is not a professional client.⁴²² Generally, the term is used similarly to Huertas' description to describe individuals who buy and sell securities for their personal account. Similarly, Warren Buffett, a well-known investor has defined investing as "...laying out money now to get more money back in the future."⁴²³

Retail investor can also be defined by contrasting it with institutional investor. In *Monitor Audio Limited*, the tribunal judge stated that, "...the usual sense of an institutional investor connoting an institution whose function is to invest on behalf of others in a wide range of ways, as opposed to a private or retail investor." Therefore, retail investors do the opposite - they invest on their own behalf.

As P2PL concerns individuals who lend their own money to other individuals to receive a return on their investment, P2PLs can broadly be described as 'retail investors'. However, whereas P2PLs' investment lies in the loans they make to P2PBs, ordinary investors usually invest in a broader range of assets such as bonds, where the investor loans his/her money to a company or a government in exchange for a return; stocks and shares in companies, where the investor buys a stake in a company in the hope that the value of the shares, which can fluctuate, will increase and in return receive an income called a dividend. Investors can invest by buying shares directly, but the more common approach is for them to invest indirectly through an investment fund such as a workplace pension. Other

⁴¹⁹ Financial Conduct Authority, 'Investment Funds, Markets Liquidity and the Investor' (FCA, 24 March 2016) <<https://www.fca.org.uk/news/speeches/investment-funds-markets-liquidity-and-investor>> accessed 1 April 2017.

⁴²⁰ Michael Huertas, 'Capital Markets Union and the Need for Greater Retail Investor Participation in Financial Markets: Is Now the Time for an EU-Wide ISA?' (2016) 31 *Journal of International Banking Law and Regulation* 481, 494, footnote 1.

⁴²¹ Definition of 'client' defined in, Directive 2014/65 on markets in financial instruments and amending Directive 2002/92 and Directive 2011/61 [2014] OJ L173/349 (MiFID II) art. 4(1) para 9.

⁴²² Definition of 'retail client' defined in, Directive 2014/65 on markets in financial instruments and amending Directive 2002/92 and Directive 2011/61 [2014] OJ L173/349 (MiFID II) art. 4(1) para 11.

⁴²³ Carol J Loomis, *Tap Dancing to Work: Warren Buffett on Practically Everything, 1966-2013* (Penguin Publishing Group 2012) 166, 167.

assets include commodities, collectibles and structured products. Therefore, different are both the assets invested in and, the entities receiving the investment—typically businesses rather than other people.

Investments can be sold to retail investors through either a non-advised or advised sale. A non-advised sale occurs when the investor does not receive any advice but buys the investment directly from the product provider. The FCA⁴²⁴ defines a ‘non-advised’ sale as one where the firm gives objective information to potential customers and leaves them to make the decision about whether to proceed on their own. In contrast, the FCA states that an ‘advised’ sale is where the investor receives an explanation about why a product or provider suits the potential customer’s demands and needs.⁴²⁵ Such advice can be obtained from an independent financial advisor who recommends products from a whole range of financial product providers, or an appointed representative who is only able to recommend a product from a limited range of product providers.

During an advised sale, the advisor is expected to find out the customer’s circumstances and assess the customer’s attitude to risk before making a suitable recommendation. An advisor can consider how long the customer wishes to invest for, the amount of capital available for investment and ensure that the customer’s capital is spread across different investments. Consequently, whereas P2PL is at present, invariably undertaken on a non-advised basis, retail investors tend to have a choice about whether to invest with or without advice.

The way P2PLs and ordinary investors usually invest also differs in terms of the channels used and actions taken as exemplified by investing through buying of stocks, mutual funds and using online investment portfolio manager.

Individual investors can buy stocks through many channels. They can purchase them online. The investor usually pays either a flat fee or a percentage of the purchase price for each transaction and the method is largely non-advised. Stocks can be purchased through a stockbroker, whose role it is to buy and sell stocks and other securities on behalf of retail investors in return for a service fee.

⁴²⁴ Financial Conduct Authority, ‘FCA’ (*FCA*) <<https://www.fca.org.uk/>> accessed 24 April 2017.

⁴²⁵ Financial Conduct Authority, ‘Advised and Non-Advised Sales’ (*FCA*, 18 April 2016) <<https://www.fca.org.uk/firms/advised-non-advised-sales>> accessed 2 April 2017; Donia O’Loughlin, ‘When Is a Non-Advised Sale Legitimately Not Advice?’ (*FT Advisor*, 13 August 2013) <<https://www.ftadviser.com/2013/08/12/opinion/blogs/when-is-a-non-advised-sale-legitimately-not-advice-s9H8JzEfuwiDW2IQ8Fgy8H/article.html>> accessed 2 April 2017.

In the UK stockbrokers are regulated by the FCA and must first obtain a recognised qualification from the FCA's Appropriate Qualifications Table, such as a Level 6 Diploma in Wealth Management from the Chartered Institute for Securities and Investment.⁴²⁶

Retail investors also invest through mutual funds that buy groups of stock for investors. Rather than owning the stock the investor owns a share in the fund and pays an annual fee. Therefore, a mutual fund is a pool of money provided by individual investors, companies and other organisations.⁴²⁷ To this extent, mutual funds seem similar to P2PL because in the latter, the lenders money is similarly pooled to fund a single loan. Mutual funds have a particular investing style, strategy or purpose, for example a fund can invest purely in emerging markets. They are actively managed by fund manager who monitors the stocks and bonds within its portfolio. This means that the investor's only role is to choose a fund that suits their investment criteria and style, they do not need to analyse financial statements or information or monitor their investments.

In the UK, there are two main types of retail fund, open-ended funds and closed-ended funds. Most open-ended retail funds are established as an undertaking for collective investment in transferable securities (UCITS) governed by Directive 2009/65/EC on undertakings for collective investment in transferrable securities (UCITS Directive). These can be sold by fund managers or through third party distributors such as independent financial advisors whether on advised or non-advised basis. The FCA subjects the funds and their managers to regulation under its Collective Investment Schemes Sourcebook (COLL).⁴²⁸ Regulations relate to insider dealing, money laundering, short selling, market abuse and derivatives. UCITS can be sold to all types of investors including retail investors.

Investors can also invest through an Exchange Traded Fund (ETF) which is an inexpensive way to profit from stocks.⁴²⁹ ETFs usually track the performance of

⁴²⁶ Training and Competence Sourcebook, TC App 4 Appropriate Qualification tables, s.4.1.1 Part 2.

⁴²⁷ Joshua Kennon, 'The Basics of Mutual Funds' (*The Balance*) <<https://www.thebalance.com/mutual-funds-101-356319>> accessed 24 April 2017.

⁴²⁸ Collective Investment Schemes Sourcebook, COLL 2.1.5 G, COLL 5.2 R.

⁴²⁹ Jeff Reeves, 'ETFs: A Cheap Way for Anyone to Play the Market' (*USA Today*, 13 February 2016) <<https://www.usatoday.com/story/money/personalfinance/2016/02/13/etfs-cheap-way-anyone-play-market/79305972/>> accessed 25 April 2017; Chris Flood, 'ETFs in Demand after Brexit Vote' (*FTfm*, 24 June 2016) <<https://www.ft.com/content/18386d12-39fa-11e6-a780-b48ed7b6126f>> accessed 25 April 2017.

an index of stocks like the FTSE 100 or the MSCI emerging market index, and try to replicate them by investing in the same assets at the same or similar proportions. The price of the ETF rises and falls with the index it tracks. As the ETF tracks the index, retail investors are saved the time and expense of having to do so themselves. Buying ETFs also enables them to invest in a range of markets that they may not be able to access individually.

'Nutmeg' is an example of an online wealth manager which creates an investment portfolio based on ETFs for investors. It targets investors of all levels of financial acumen. However, their sales pitch makes it clear that their main target are retail investors: "You don't have to be a stock market expert to have an investment portfolio. You just have to know your financial situation, risk tolerance and how much you want to invest. We do the rest."⁴³⁰ For a similar reason, investors can start with an investment as little as £500 for each portfolio, or "pot" created. However, investments below £5,000 require a minimum monthly contribution of £100. Investors can invest in as many pots as they want for different purposes such as buying a home or saving up for a car. If investors choose to invest with Nutmeg, they do not have to do anything. Nutmeg helps them determine what type of portfolio is suitable for them, based on the investors' objectives and risk tolerance. All decision-making in relation to the investment is made by Nutmeg's investment team. This includes the decision about which underlying securities to invest in and to buy and sell shares. The investor does not have to consent to every single transaction. Instead, when investors sign the terms and conditions, they agree for Nutmeg to take full responsibility of their investment. Essentially, the only thing the investor does is to tell Nutmeg about themselves and select a risk level.

These investment examples show that one way in which P2PLs differ from retail investors is in the asset that they invest in. P2PLs' investment is in the form of a loan. They lend their money to another individual with the expectation that it will be repaid with interest. This is very different from the stocks, bonds and mutual funds that individual investors tend to invest in because their expectations and level of reliance on other parties regarding their respective investments are different. For example, retail investors have little control over the final value of

⁴³⁰ 'Investing for Beginners | How to Start Investing - Nutmeg' <<https://www.nutmeg.com/new-to-investing>> accessed 31 March 2017.

their investment, which essentially boils down to chance. However, although P2PLs themselves have no control over their investments because this lies with the platform, the likelihood of them receiving their money back and the interest is dependent on the borrowers meeting their repayment requirements on time and in full. To an extent this in turn depends on the management skills of the platforms, e.g. whether they are skilled at judging the creditworthiness of potential borrowers, whether they adequately collect funds and keep them in a safe, separate account, and whether they pursue borrowers who are in arrears or default. These are much more preventable and/or controllable factors than the value of stocks, bonds, indexes and commodities. Essentially, for P2PL the risk lies in whether all parties carry out their end of the bargain— an issue which can arguably be more easily governed by adequate regulation than the value of traditional stocks,

Another difference between traditional retail investors and P2PLs is that unless they are purchasing and monitoring their stocks directly, most retail investors depend on a firm to do this for them, i.e. they have very little input in investment decisions. Nutmeg investors provide a clear example of this. Based on what they do, Nutmeg investors can be categorised as consumers in the classical sense. They have a very low level of participation: the underlying business model is business-to-consumer and they are reliant on Nutmeg's actions at all stages of the investment process. The same can be said of other forms of retail investment which occur through the intermediation of an institutional investor or wealth management fund such as workplace pensions, pension funds, mutual funds, which are all typical investment routes for retail investors. The only role of retail investors is to purchase the investment service and at no point during the investment process do they prosume, which distinguishes them from P2PLs.

As mentioned in Section 2.10.3. P2PLs can satisfy the general classification of 'retail investor'. However, as Lin argued, investors are not a homogenous group.⁴³¹ Aside from the classical archetype of 'reasonable investor', investors can fall within a number of different profiles in the real world of finance. In his original typology of investor paradigms which Lin calls 'cross-cutting' a single investor might fall within more than one classification at a time.⁴³² These include:

⁴³¹ Tom CW Lin, 'Reasonable Investor(s)' (2015) 95 Boston University Law Review 461, 518.

⁴³² *ibid* 466.

the reasonable investor who is understood to be the perfectly rational actor of neo-classical economics and until relatively recently, was the archetype of investor protection regulation. The irrational investor, according to behavioural economics literature, is capable of rational decisions, but also influenced by emotions, biases and heuristics. The active investor categorisation relates to ownership style and investor timeline. Rather than passively investing in a company like the reasonable investor who is expected to be a long-term investor that uses a buy-and-hold strategy, active investors either attempt to influence the business underlying their investment or invest for short periods of time e.g. amateur day traders and high-frequency investors. The sophisticated investor refers to investors of above-average wealth and financial acumen, particularly professional investors like investment banks, hedge funds and pension funds and their respective asset managers. By definition, retail investors do not fall within this bracket and likewise the entity investor which is not a private or natural person according to the reasonable investor paradigm, but a legal creation.

Finally, in this typology is what Lin calls the cyborg investor.⁴³³ This is because due to advances in financial technology, the modern financial marketplace is increasingly becoming less dependent on human input for trading stocks and increasingly relies on machines or tools which use complex algorithmic programs to execute investment decisions much faster than any human can.⁴³⁴ The impact of the technological advancements is such that even ordinary investors can use websites or software that make investment decisions for them, and enable ordinary investors to invest in riskier private offerings which have historically only been available to wealthy investors.⁴³⁵ Lin therefore argues that as the investor marketplace has changed drastically due to the increased use of technology to invest, there is need for a new investor typology of “algorithmic/cyborg investor”.⁴³⁶ The rationale is a dissonance between the singular paradigm of the homogenous reasonable investor and the reality of a much more diverse profile of the investor which necessitates a re-examination of investors and investor

⁴³³ *ibid* 466–475, 499.

⁴³⁴ *ibid* 495–496.

⁴³⁵ *ibid* 497; Russell Taylor, ‘Investment Technology: Simpler Systems’ (*FT Advisor*, 22 March 2017) <<https://www.ftadviser.com/investments/2017/03/29/investment-technology-simpler-systems/>> accessed 3 April 2017; John F Wasik, ‘Sites to Manage Personal Wealth Gaining Ground’ *The New York Times* (10 February 2014) <<https://www.nytimes.com/2014/02/11/your-money/sites-to-manage-personal-wealth-gaining-ground.html>> accessed 3 April 2017.

⁴³⁶ Lin, ‘Reasonable Investor(s)’ (n 446) 499.

protection.⁴³⁷ In other words, the classical, dominant typology of the reasonable investor becomes outdated in the face of new participants to the changing financial marketplace.⁴³⁸ The significance is that it highlights the need for investor regulatory paradigms to adapt to the changes in the marketplace for regulation to remain relevant and up-to-date.

This equally applies to the P2PL market. Although Lin's typologies largely refer to investors' behaviours, the analysis of consumers in this chapter has shown that participants can and should also be analysed in relation to their roles and activities in their respective transactions, particularly the responsibilities, conduct, vulnerabilities and risks they may face. Therefore, although P2PLs fit within the general definition of 'retail investor', a paradigm which is more specific to P2PL is consumer-to-consumer (C2C) marketplaces and differentiates them from the marketplaces of retail investors of stocks and pension funds. Arguably, the protections required should specifically relate not just to the general behaviours of most retail investors, but also to their specific activities and vulnerabilities whilst engaged in P2P loan transactions.

This is important because the post-financial crisis regulatory treatment of retail investors in the EU and UK increasingly considers them as consumers. Although this provides them with greater protections than they were previously getting under the pre-crisis rational investor paradigm, the protections do not see the full picture because they are limited to scenarios typical of B2C transactions/business models. P2PLs are a specific subset within the general classification of 'retail investor' requiring a new, specific and accurate typology which Chapter Five discusses in more detail.

2.10.4. Comparison between P2P lenders and prosumers

As P2PLs cannot be categorised as consumers, an alternative is to classify them as prosumers. Section 2.8 demonstrated that the essential characteristics of prosumers are that they are self-sufficient; they take on part of the job the producer would normally do; they produce goods/services for personal

⁴³⁷ *ibid* 515.

⁴³⁸ *ibid* 500.

consumption; they carry out various types of work and they are active participants.

In highlighting the differences between consumers and P2PLs, the previous section already demonstrates some of the main similarities between P2PLs and prosumers. Namely, during the loan formation stage of the P2PL transaction, P2PLs' level of participation is substantially higher than the ordinary consumer's and they take on the part of the transaction that the producer would normally do. E.g. in the formation side of the transaction, the lenders display their self-sufficiency through their reliance on their own resources e.g. decision-making and evaluations. This section therefore highlights some further similarities and differences between P2PLs and prosumers.

One way P2PLs are similar to prosumers is in the work they do during the formation of the loan agreement. At this stage of the transaction, they appear to engage in directed self-production and collaborative co-production. Directed self-production is where the business provides individuals with the tools and support needed for them to produce the good/service for themselves. A similar situation can be found on P2PL platforms, where the platforms provide the lenders with the tools they need to select their lending criteria and thus design their own lending investment.

However, unlike in most cases of directed self-production, P2PLs are not forced to carry out this work, rather they engage in P2PL because of the independence it offers them. For example, in most instances of directed self-production e.g. eating from a tray in a fast food restaurant, the production activity is built into the service, so even if the prosumer did not want to eat from a tray and instead decided to sit at the table and wait for a waiter to attend them, because there are no waiters to attend them, the individual would be compelled to follow the usual fast food process and serve themselves. Consequently, prosumers carrying out directed self-production have no choice but to do so because prosumption is built into the service. In contrast, although presumptive activity is built into P2PL, the lenders engage in it willingly. This is demonstrated by the UK Alternative Finance Benchmarking Report 2014 which found that some of the factors which the lenders surveyed thought were important or very important were the ability to choose how much to lend and for how long (94% of those surveyed) and the ease

of use of the lending model (98% of those surveyed).⁴³⁹ In other words, the most important factors were the ones which gave them independence and made them self-sufficient on the platform.

Similarly, it could be argued that P2PLs are prosumers because they carry out collaborative co-productive work. This type of work occurs when businesses outsource tasks to crowds of individuals possibly across the world, who take on the role of a voluntary workforce. This can be seen within the type of P2PL model where a single loan is funded by a large crowd of lenders as these models are reliant on group participation to work effectively and the task of credit lending is outsourced to the crowd of P2PLs. The lenders do not necessarily choose to collaborate with other lenders, this is often an intrinsic part of the lending model. Neither do they choose who to work with as the platform automatically decides this by matching lenders with similar lending criteria. The platforms do not put money into the loans themselves, rather they outsource this task to P2PLs. Therefore they are prosumers in this sense. Technically, one could say the platform makes them work, but the lenders do not receive payment from the platform for being its crowdsourced 'workforce' – their job being to provide money which ultimately benefits the platform owners. However, the reward they receive is the interest they earn from lending their own money out to borrowers.

This relates to the economic cause of the transition of individuals from consumers to prosumers highlighted by Salzman.⁴⁴⁰ P2PL reflects the economic factor of change towards prosumerism which is that it is cheaper to get consumers to do the work of production, because rather than offering loans themselves, platforms shift a large portion of the lending role and risk onto consumers therefore making them lenders. This makes running a financial institution cheaper to run and it is reflected in the higher interest rates that platforms can use to entice lenders to their website. On their websites, platforms often state that the cause of these favourable interest rates for both lenders and borrowers is the fact that they have cut out the middleman, by whom they are referring to the banks. However, in

⁴³⁹ Bryan Zhang, Liam Collins and Peter Baeck (n 409) 41. The UK Alternative Finance Benchmarking Report is a joint research project between Nesta, the University of Cambridge and the University of California, Berkeley. It comprehensively studies the alternative finance market in the UK, which consists of the crowdfunding, P2P lending and invoice trading markets. The research is the first of its kind to be carried out on a country-wide level using empirical data gathered from questionnaire-based survey.

⁴⁴⁰ Salzman (n 49) 141.

reality they are referring to themselves. This is because, if they had set up as simply an online alternative to the banks, they would have to bear the costs of operating as a lending institution which lends money to consumers, including a lending license. These costs would then be passed on to their borrowers. But by making individuals work as lenders, the platforms have eliminated these costs. Therefore, P2PL reflects prosumerism because the business forces or encourages consumers to do their work for them. Essentially, P2PL is akin to self-service lending and borrowing with the intermediary appearing to take a step back in comparison to traditional lending institutions to give participants more control. These two elements of work and ostensibly extra control within the transaction makes P2PLs similar to prosumers.

However, despite carrying out similar types of work as prosumers, the position occupied by P2PLs during the design of a service and within the transaction is different from a prosumer's. According to Bandulet and Morasch's interpretation of Alvin Toffler's prosumer, the purpose of prosumers was for consumers to become more involved in the design and manufacture of products in a way that could be made to individual specification based on implicit or explicit information about the customer's preferences.⁴⁴¹ But this falls short of what P2PLs do. During prosumption of services, the individual might participate by providing the producer with information which they can use to tailor the design of the service to suit their general customer base and in so doing become co-producers. For example, prosumers providing information inputs might contribute to a business improving the service they later give to their general customer base or to that customer specifically.

Contrarily, the information P2PLs provide during loan creation is not used by platforms to create improved and/or more customised loans in the future which still remain standardised packaged loans, rather it is used by the P2PLs themselves to create an investment that he or she wants and is comfortable with. Therefore, whilst with prosumption, there can still be a distinct producer who uses the information provided by the prosumer, with the consumer only taking part in the design and manufacturing process, in P2PL the individual actually takes over

⁴⁴¹ Martin Bandulet and Karl Morasch, 'Would You Like to Be a Prosumer? Information Revelation, Personalization and Price Discrimination in Electronic Markets' (2005) 12 *International Journal of the Economics of Business* 251, 251–252.

the design process. They design and create the loan product they want to invest in and it is the platform's job to realise that creation by matching it with the loan design created by borrower. If the lender's design matches that of a single or multiple borrowers' design, a loan agreement is created. In some pure P2PL contexts, the P2P lender does this match making themselves by picking a borrower to lend to, e.g. on Folk2Folk where P2PLs can choose to lend to a particular borrower rather than choosing the autolend option which would match them to multiple borrowers based on their chosen criteria. In P2PL, the lender is more than just a prosumer, because he/she takes over the position in the service/product design process typically occupied by the business. The P2P lender designs and produces the loan by setting the lending criteria and providing the funds for it, the platform then matches this design to other similar loan designs created by numerous other lenders and borrowers.

Section 2.8.1. of this thesis has highlighted that a prosumer is generally considered to be an actor who is simultaneously a producer and consumer of goods or services. The term is designed to recognise that the activities of the production process and consumption process of a good or service are not always separate activities carried out by separate parties. This has led to prosumers being defined as an individual consumer who is involved in the design or production process of a good which the individual will eventually purchase or can see themselves purchasing.⁴⁴² However, this definition does not apply to P2PLs for a number of reasons. Firstly, P2PLs produce a service which as lenders, it is not possible for them to consume – unless they are lending to themselves on the platform, which is unlikely. Rather a separate party consumes their service. Consequently, the individual who becomes his own check-out assistant at a self-service check-out machine, or the Wikipedia user who creates, edits and updates the encyclopaedic entries of Wikipedia both have something in common which the P2P lender does not, which is that they both produce for their own benefit.

Secondly, although the P2PLs' role involves production, because they are not consuming the product they are producing, they are not simultaneously producers and consumers of a single product or service, as prosumers are. From the P2PLs' perspective, the transaction does involve them producing and

⁴⁴² Weitzenboeck (n 346) 203.

consuming, however, they produce a loan that a different individual is eventually going to consume and the lenders consume the ultimate benefit of this which is the interest rates that the other party will pay them in return for their lending services. Their role therefore involves replacing traditional lenders such as a bank or building society during the formation of the loan. This replacement involves taking on similar risks and having to make similar decisions when producing the loan. Traditionally an institutional lender would produce the loan and reap the rewards, but in this context, the P2P lender does.

However, once the loan has been formed, the P2PLs then revert to the position of a consumer due to their relationship of dependence on the platform to administer the loan effectively. Therefore, it could be said that the lenders consume two separate things, firstly the borrowers' interest payments and secondly the platform's services. Neither of which are simultaneous to the initial lending service being produced by the lenders, but rather are sequential to it.

P2PLs are similar to consumers in terms of their dependency on an intermediary. As they rely on the efficiency and quality of the job performed by the platform, they are consumers of those goods. On a different level, they are also consumers because at certain points in the P2PL process, they act like consumers. For example, they choose which platform to lend on and they rely on the platform's reputation as a marker of whether or not to lend on it, e.g. if a platform has a poor reputation of handling defaults, then lenders may choose to invest with a different platform. If no lender wants to lend on a particular platform, eventually there will be no money to fund the loans on that platform and the borrowers will go to a different platform or lending institution to borrow, and ultimately this might lead to the failure of the platform. In this sense, P2PLs still wield the same powers over businesses/intermediaries that consumers do. It is yet to be seen how likely a run on the platform would be, if that is even possible.

Therefore, whilst P2PLs also combine both producer and consumer capacities, they do so in a different way to prosumers. A more accurate way of describing their role and capacity is to call them 'lendsumers'. This is a combination of the words 'lender' and 'consumer' and reflects the fact that they take over the production role of traditional lenders, but are also consumers. It is more specific than the term 'prosumer' because by referring to their lending capacity specifically, it highlights that the only difference between P2PLs and consumers

is their lending capacity. Once this role has been accomplished in a given transaction, they revert back to consumers. This in turn recognises the fact that P2PL is a long-term activity which involves different stages, during which the users' roles and capacities experience a change. In a sense, P2PLs could be described as transitional prosumers.

2.11 Conclusion

This chapter has demonstrated that the assumptions of RCT fail to explain how individuals behave and make decisions in practice. Behavioural theory provides a more accurate depiction of human behaviour because rather than being based on one factor, i.e. the idea that consumers are rational beings who make rational decisions based on what is in their self-interest to do, it takes into account the fact that there are other factors that might influence a person's behaviours or actions when making decisions. Behavioural theory is not without its critics, but the point here is to emphasise that people are not perfectly rational, knowledgeable and they do not exist in a perfectly ordered market. Behavioural theory reflects this better than rational theory and the implication is that regulatory measures should also reflect this through adoption of mechanisms tailored towards consumer actions and behaviours.

It has also shown that the concept of 'consumer' is unclear. To make regulation workable, EU law has used the average consumer test. But this is not accurate in light of behavioural economic research. Consequently, a suggestion is for regulation to adopt a more situational approach. For example, this is by considering what the average consumer is within the P2P industry, what the problems they face are and how regulators are to protect consumers from them or limit their effects.

However, the idea of the consumer is a changing one. Writers like Maloney and Micklitz demonstrate that the way consumers are conceived by regulation is increasingly changing following the 2008 financial crisis: the former in relation to consumer treatment by regulation and the latter in the way that regulation no longer sees the consumer as vulnerable per se, but provides protection for the 'average' consumer. Furthermore, out of the idea of the consumer, the concept of the prosumer developed to recognise the fact that the party to a transaction that has traditionally been perceived as passively receiving the goods and services from a separate organisation, can and often does engage more within the transaction.

There is no specific conception of the prosumer beyond the fact that they are a combination of producer and consumer. However, the combination is a dynamic

and fluid one depending on their role and actions in the transactions. It is by their role that they can be identified and on the basis of their role and behaviours that regulation of the relevant industry should focus.

P2PLs display a hybrid of the characteristics of both consumers and producers/entrepreneurs. This is more evident when comparing the different stages of the loan transaction. During the formation of the loan contract the P2P lender displays the trait of a producer or entrepreneur because the degree in which they participate in the transaction is greater than an ordinary consumer in a comparable scenario, e.g. as compared to a consumer bank depositor. They also display a number of other differences to ordinary consumers e.g. the fact that they are not mere targets of businesses, and the type of roles, activities and evaluative decisions they make are different. However, when deciding which platform to lend on, they make the type of decisions and bear the type of risks an ordinary consumer makes. In addition, once the loan is underway, their capacity and role is more like a consumer than that of a prosumer because of their increased dependency on the platform. Whilst this section therefore shows that P2PLs are not mere consumers and are therefore different from them, it also highlights the fluidity of the role and capacity of P2PLs within any one online P2PL transaction. These factors should be taken into account by any regulation that seeks to protect, facilitate and/or advance their interests.

3. P2PL and Financial Intermediation, Concepts and Practice

3.1. Introduction

Modern finance operates within a vast ecosystem of interconnectedness. That is, there are few, if any, financial institutions or participants that can exist or operate without the intermediation of another. In other words, no financial institution is an island.⁴⁴³ E.g. company employee pensions are often managed and invested by fund managers; insurance companies underwrite loans for banks; stock exchanges are intermediaries which provide investors with liquidity by acting as a market where they can buy and sell shares, similarly, stock brokers facilitate trades between investors on the stock market. Therefore, there are many dimensions of intermediation within the financial markets, with some financial intermediaries operating within others as in the above stock exchange example and others operating in networks of different intermediated actions e.g. J.P. Morgan Chase, a large American banking institution acts as a meeting point for varieties of counterparties through the wide range of services and products it provides including commercial and investment banking, trading, clearing, lending and prime brokering.⁴⁴⁴ Some have even described money as a form of financial intermediation because money makes financial transactions easier⁴⁴⁵ than for example, bartering on trade. Therefore, financial industries and transactions exist within the complex context of intermediation.

In one form or another, the key role of financial intermediaries is to act as middlemen who collect capital from savers and reallocate it in an investment or asset.⁴⁴⁶ According to McCoy, they can be categorised in two groups, namely 'retail'/'primary' intermediaries who serve individual households or nonfinancial businesses or 'wholesale'/'secondary' intermediaries who serve financial institutions.⁴⁴⁷ P2PL platforms fall within the retail category because they largely serve individual consumers rather than institutions like banks.

⁴⁴³ Lin, 'Infinite Financial Intermediation' (n 5) 643.

⁴⁴⁴ Tom CW Lin, 'Financial Weapons of War' (2015) 100 Minnesota Law Review 1377, 1382–1383.

⁴⁴⁵ Lin, 'Infinite Financial Intermediation' (n 5) 646.

⁴⁴⁶ Patricia A McCoy, 'Degrees of Intermediation' (2015) 50 Wake Forest Law Review 551, 552.

⁴⁴⁷ *ibid.*

P2PL exists within this world of intermediation not just because it is a form of intermediation itself, because it acts as a market for individuals to lend and borrow from each other; but also because the industry players are connected with the wider financial market. For example, the more scrupulous platforms use external credit rating companies to assess the worthiness of prospective borrowers and they translate this information sourced from the borrowers and credit rating agencies to the lenders. Similarly, platforms use bank accounts to store P2PLs' funds prior to investment and the profit they make from operating the platform, and the borrowers use bank accounts to store the funds received from lenders. Consequently, it is not possible to say that the P2PL industry is completely cut off from traditional forms of finance and bank lending, rather, they are a new link in the wider financial intermediation chain. A similar point is made by Lin who highlighted that despite the many attempts of innovators to disrupt or disintermediate financial transactions, they usually end up adding more intermediaries to the existing pantheon, because of the interconnected nature of finance.⁴⁴⁸

As most forms of financial activity comprises intermediation, it is possible to argue that P2PL is nothing new and the platforms should be regulated in the same way as any other online intermediated exchange. However, online private finance between individuals is still in its early days. Although it has existed in many offline forms around the world for a long time, e.g. friendly societies, credit unions, microcredit institutions and esusu, regulatory bodies at least within the UK are still only getting used to the idea of them. An example of this is the fact that the regulation of P2PL platforms only started in April 2014.⁴⁴⁹ As a result of the relatively recent introduction of both the subject matter of the regulation and the regulation itself, it is still too early to determine whether the regulation effected by the FCA in relation to P2PL is or will be effective in dealing with the issues arising from the concept and practice of P2PL, at least until they arise; by which time of course, it may be too little too late.

In the previous chapter, the thesis examined the place of P2PL within current conceptions of consumer protection law and consumer law particularly the

⁴⁴⁸ Lin, 'Infinite Financial Intermediation' (n 5) 644.

⁴⁴⁹ Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No2) Order 2013, SI 2013/1881, art. 36(H).

various notions of the consumer and prosumer. Just as it distinguished P2PL users from these notions, the purpose of this chapter is to distinguish P2PL platforms from traditional and alternative financial intermediation models. It does this by detailing the historical origins of P2PL and explaining why P2PL should be considered as financial intermediation. The chapter then compares P2PL platforms and intermediation models that act similarly to or perform similar roles to P2PL platforms, specifically traditional bank lending, credit unions, payday lending, crowdfunding, esusu/isusu lending and eBay marketplace transactions. In doing so, it answers sub-question b) of the first research question, i.e. whether P2PL differs from existing types of financial intermediation, by arguing that it does. Therefore, the significance of this chapter is providing further justifications for regulating P2PL differently.

3.2. Historical origins of P2PL

There is a consensus within the literature that P2PL is not a new phenomenon, but has existed in various forms throughout history. Brill states that P2PL emanated from microcredit principles which have been used for centuries in countries like Ghana and India.⁴⁵⁰ Microcredit institutions involve the provision of small, short-term loans to provide access to credit to poor and often ignored entrepreneurs who are often ignored or refused credit by traditional lending institutions.⁴⁵¹ Brill traces formal microfinance to the Irish Loan Fund of the 1700s which was created to help impoverished Irish citizens like modern microfinance institutions.⁴⁵² He states that although most microfinance institutions are non-profit organisations, their successes have drawn for-profit companies into the sector, such as Prosper, a P2PL platform based in North America.⁴⁵³ However, he posits that P2PL relates to financial transactions that bypass traditional intermediaries by directly connecting borrowers and lenders.⁴⁵⁴

⁴⁵⁰ Brill (n 1) 139, 142.

⁴⁵¹ *ibid* 139.

⁴⁵² *ibid* 142-143.

⁴⁵³ *ibid* 143.

⁴⁵⁴ *ibid* 139.

On the other hand, Hulme and Wright trace the development of modern P2PL back to friendly societies which originated in Britain in the 1600s,⁴⁵⁵ because the two main roles of friendly societies were mutual support and financial assistance.⁴⁵⁶ They highlight the welfare oriented approach to these goals and the collectivism that underpinned the operations of friendly societies.⁴⁵⁷ They state that social lending displays similar concepts of community and collective advantage that underpinned friendly societies.

Overall, there is no real consensus about the historical origins of P2PL, various countries around the world have had their own versions of social lending as mentioned by Brill and evidenced by Hulme and Wright's discussion of friendly societies. However, comparisons can be drawn between the participants and operations of each form of social lending and other disintermediated services such as esusu and eBay.

3.3 P2PL as Financial Intermediation

P2PL platforms exist within the context of financial intermediation. This is because their role is to act as an intermediary between individuals using their platform services as lenders and borrowers. The platforms do this by enabling these two parties to create a financial relationship. In the absence of P2PL platforms, individuals could lend and borrow from each other directly. However, this requires a relationship built on the trust that the money borrowed will be paid back in full and on time. Linked to this need for trust, is a need for transparency. Before the individual lender lends the money, they need to have information about the borrower readily available which will enable them to predict the likelihood of them getting their money back. For example, when friends/family lend or borrow from each other, they already have a relationship of trust built over time and based on their knowledge of their friend/relative, which they can rely on to base their lending decision. However, it is possible that because of the time it takes,

⁴⁵⁵ Michael K Hulme and Collette Wright (n 127) 13.

⁴⁵⁶ *ibid.*

⁴⁵⁷ *ibid* 13,14.

and the depth of a relationship, necessary to build a relationship of trust between families and friends, such lending is not done on a large or commercial scale.

Online P2PL is done on a vaster scale than family and friendship-based direct lending and it involves numerous strangers who do not have the time or transparency to build relationships of trust. This is where the platforms themselves come in. They provide platform users with economies of scale because they help spread the costs of financial research and make asset monitoring easier⁴⁵⁸ than if the lenders and borrowers were to try and interact directly. By deduction, their role is essentially to speed up the building of a relationship between strangers, albeit simply financial, by securing the trust between the two parties which will enable the individual lenders to willingly part with their money to people they do not know. They do this by ensuring the credit worthiness of the borrowers, to make them more trustworthy; facilitating the transfer of the lenders' money to borrowers; facilitating the borrowers' repayments; and if necessary, pursuing the borrowers for unpaid debts to the lenders.

Platforms also perform typical intermediary functions. E.g. they offer lenders risk-reduction through the diversification enabled by their pooling of investments.⁴⁵⁹ They also leverage their financial expertise and unique knowledge of the borrowers' circumstances to create platform credit ratings which the lenders rely on. This in turn helps lenders put a more accurate price on each transaction than if they were to try to judge the borrowers' credit worthiness by themselves. They are also like more established types of financial intermediaries because they act as conduits for liquidity and exchange⁴⁶⁰ in the marketplace that they create. In this function, they are similar to stock exchanges which create markets for buyers and sellers of securities and help to make trades efficient.⁴⁶¹ This highlights further the fact that P2PL platforms are intermediaries.

Emphasising this point is important to any argument that P2PL platforms should be regulated in the context of their intermediary role. This is particularly the case because the P2PL industry is often couched in terms of the disintermediation of

⁴⁵⁸ McCoy (n 461) 553.

⁴⁵⁹ *ibid.*

⁴⁶⁰ Lin, 'Infinite Financial Intermediation' (n 5) 648.

⁴⁶¹ *ibid.*

financial institutions or traditional bank lending, i.e. cutting out the middleman. For example, a March 2014 article by *The Economist* spoke of “Banking without banks”⁴⁶² and in February 2014, Simon Cunningham of *Lendingmemo*, an online magazine relating to P2PL explained that Wells Fargo, one of the largest banks in the world, was afraid of P2PL because of the threat of disintermediation, following its ban on staff investment on platforms as reported⁴⁶³ in the *Financial Times*.⁴⁶⁴ The type of disintermediation usually associated with P2PL is therefore one of removing the bank from the lending picture.

However, such discussions neglect two things, firstly, although the banks are visibly removed from the lending scene, they are still involved in the P2PL industry through their role as a depository for the platforms’ accounts and the P2PL users. On a normal basis this role might seem insignificant to the way the industry works, however, this is one of the means through which the P2PL industry is connected with the rest of the financial industry. This might affect the P2PL industry, e.g. in the worst-case scenario of if the lenders’ funds are stored in a bank which experiences a run on the bank, or which fails in the event of another systemic crisis. This is by no means meant to suggest that this is a regular occurrence, rather it is meant to point out that the P2PL industry remains an intermediation-based industry that also remains connected with the rest of the financial market through a network of intermediation. Therefore it might still be vulnerable to systemic crisis within the market depending on how widespread and terrible they are. This idea is supported by Lin, who argues that financial intermediation is infinite because disintermediation has proven to be elusive despite the many financial innovations attempting to accomplish it.⁴⁶⁵ This is largely because what really happens tends to be an exercise in “substitutive disintermediation” and layering, where financial innovations merely replace older

⁴⁶² ‘Banking without Banks’ [2014] *The Economist* <<http://www.economist.com/news/finance-and-economics/21597932-offering-both-borrowers-and-lenders-better-deal-websites-put-two>> accessed 8 July 2016.

⁴⁶³ Simon Cunningham, ‘Why Wells Fargo Is Terrified of Peer to Peer Lending’ (*LendingMemo*, 26 February 2014) <<http://www.lendingmemo.com/wells-fargo-peer-to-peer-lending/>> accessed 8 July 2016.

⁴⁶⁴ Tracy Alloway and Arash Massoudi, ‘Wells Fargo Bans Staff from Investing in P2P Loans’ *Financial Times* (20 January 2014) <http://www.ft.com/cms/s/f3135594-7f82-11e3-b6a7-00144feabdc0,Authorised=false.html?siteedition=uk&_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2Ff3135594-7f82-11e3-b6a7-00144feabdc0.html%3Fsiteedition%3Duk&_i_referer=http%3A%2F%2Fwww.lendingmemo.com%2Fdbe0d2083a1e406ec12652b93e41c9ba&classification=conditional_standard&iab=barrier-app#axzz4DlvznU13> accessed 8 July 2016.

⁴⁶⁵ Lin, ‘Infinite Financial Intermediation’ (n 5) 655.

forms of intermediation. The second point missed by focusing on the 'removal' of banks from the lending process, is that P2PL merely replaces direct bank intermediation with platform intermediation, so it does not eliminate intermediation from its process.

Therefore, although P2PL platforms are not party to the lending contracts eventually formed it is vital they are properly regulated in a way that considers their role as intermediaries. This is because they play such a large role in the formation and management of the P2PL relationship between lenders and borrowers, as well as the P2PL agreement. Consequently, both the formation and management stages of the relationship should fall under appropriate and effective regulation for the protection of the borrowers and lenders.

3.4 Traditional Banking Intermediation

P2PLs can be distinguished from other actors that perform similar lending roles to them. This section highlights the differences between P2PLs and traditional bank lenders, whose role they have overtaken in the P2PL context.

P2PLs have different roles from traditional lenders such as banks given that they are much more simplified. Whereas the P2P lender simply has to produce the money to be lent, choose their lending parameters and monitor the automatic lending process, a traditional lending institution first has to engage in asset transformation. This means collecting money from their depositors and then converting these short-term borrowings into long-term loans.

Due to the bank's asset transformation role, traditional bank lenders also face different risks to P2PLs. E.g. bank lenders face the inherent risk that if numerous depositors demand their deposits back at the same time in a run on the bank, the bank will not be able to repay them because their money is tied up in long term loans and it only has a fraction of the depositor's money in liquid cash. An example of a bank run occurred in 1931 following the failure of Creditanstalt Bank in Austria which led to a run on the German mark, UK sterling and then the US dollar. This triggered further bank runs in America and was partly responsible for the Great Depression. A more recent example of a run on the bank occurred on

14 September 2007 when Northern Rock, a British bank, arranged an emergency loan facility from the Bank of England and claimed this was the result of short-term liquidity problems. The resulting bank run occurred after news reports of a liquidity crisis. The financial crisis that ensued ended with Northern Rock being nationalised.

Due to the risk of bank runs, the first fundamental role of bank lenders' is to be skilled at identifying the borrowers least likely to repay a loan and more importantly, to lend wisely and monitor borrowers to prevent the moral hazard of borrowers choosing not to repay the loan. A bank's ability to gather information about investments and choose between good and bad loans efficiently effects its ability to offer a return to its depositors.

Although P2PLs also face the risk that a borrower might not repay the loan, they do not face the risk of a run on a bank because the money they lend out on a platform is their own. Therefore, lending ethically is not a priority concern for P2PLs because at first glance, their lending decisions only affect their own finances and not an entire nation's.

Another difference is that banks act as depositories of other people's savings.⁴⁶⁶ If there was nowhere to safely deposit funds, individuals would not be able to effectively save.⁴⁶⁷ Whereas banks act as depositories where people can store their savings, P2PLs are the savers who have the money which needs to be saved or invested. So they do not perform the function of holding money. Rather, by engaging in P2PL they have chosen to place their money in another institution that is not a bank. This highlights that institutional lenders and P2PLs play fundamentally different roles in their lending capacity.

In this sense, P2PL could not feasibly replace the need for banks as has previously been claimed by some platforms, because if there were no more banks, there would be nowhere for the P2PLs to deposit the income they make on the P2PL platforms. Of course, they could choose to perpetually recycle the interest they earn into further investments, but because of the relative illiquidity of the money lent on platforms, it is unlikely they will be able to put all the money they own into P2PL investments. Neither would it be sensible, since to protect

⁴⁶⁶ Philip Wood, *The Law and Practice of International Finance* (University Edition edition, Sweet & Maxwell 2007) 8.

⁴⁶⁷ *ibid* 8–9.

themselves from risk they would need to diversify where they store their money. Consequently, there is still a place for traditional banks in the P2PL process even if it is indirect and P2PLs do not play the exact same type of role.

Another role carried out by banks which P2PLs do not do is to pool the money of many depositors and make them available for credit.⁴⁶⁸ P2PL is more individualised than this. P2PLs do not perform this function. As with normal banking, the P2PLs make their savings available for the platform intermediary to do the pooling. In relation to this, part of the bank lender's decision-making process is to decide which borrowers are creditworthy and to distinguish between good borrowers and bad ones. This does not form part of the P2P lender's decision-making process because the platform has already distinguished between the good and bad borrowers. As shown in Annexe One, the P2PLs of all the platforms reviewed, are dependent on the platform to perform credit checks and background searches on the borrowers. In contrast, the P2P lender's decision only involves a consideration of his/her own personal appetite for risk and the type of borrowers, as already categorised by the platform, which they think are most likely to give them good returns based on this.

Another role carried out by bank lenders is to connect borrowers and lenders, therefore acting as an intermediary between the two. This process is meant to make it easier, cheaper and faster than if individuals were to try to pool their resources by themselves.⁴⁶⁹ However, the P2PLs do not perform this function, rather the P2PL platform does. For example, the P2P lender does not have to solicit borrowers like banks do by advertising the availability of their savings to be lent out, the platform does this for them. Similarly, the P2P lender does not worry about reputation management to ensure that borrowers find them a reliable lender, e.g. one who will not harass them for early repayment, change the terms of the agreement or make borrowing money unnecessarily difficult – in other words, a lender who will provide them with certainty. Instead, the P2PLs rely on the platform's reputation to obtain borrowers to lend to.

Banks also provide more expert management than P2PLs because they have better evaluation and monitoring abilities because of training and their experience

⁴⁶⁸ *ibid* 9.

⁴⁶⁹ *ibid*.

in dealing with numerous borrowers and economies of scale.⁴⁷⁰ In contrast, P2PLs typically lack the financial and screening expertise of traditional banks to judge financial risk and information. Their ability to do so is key to the viability of the industry.⁴⁷¹ However, in their study on the ability of P2PLs to infer borrower creditworthiness, Iyer *et al* found that within a given credit category, P2PLs were able to deduce one-third of the differences in creditworthiness that are captured by a borrower's exact credit score – although in their study, they were assuming that the borrowers' actual credit scores are a largely accurate depiction of their creditworthiness.⁴⁷² This also highlights that unlike traditional lenders, P2PLs are dependent on the platforms and credit ratings agencies to gather the important information about the borrowers' likelihood and ability to repay.

Iyer *et al*'s results suggest that despite not being financial experts, P2PLs can partly infer underlying borrower creditworthiness, although this inference is incomplete. The lenders learn more from standard banking variables which are financial and 'hard' information compared to the information voluntarily supplied by borrowers which could just be false and not easily verified.⁴⁷³ The standard banking variables are verified information and more reliable for example, the borrower's number of current delinquencies, debt-to-income ratio and the number of credit inquiries in the last six months.⁴⁷⁴ But they are also able to learn from the softer voluntary information provided by borrowers, e.g. the maximum interest rate a borrower posts that they are willing to pay on a loan.⁴⁷⁵ Therefore, to an extent, P2PLs are able to evaluate borrower creditworthiness and act on these decisions, but unlike traditional lenders, they do not gather this information themselves. Rather, P2PLs tend to rely on the platform for most of the traditional lenders' roles.

Although over time a P2P lender could build up some experience and expertise about P2PL in general, they still will not have access to the same level of information that a bank has relating to borrowers, because the platform performs the role of gathering, analysing and administering the borrowers' repayments. Consequently, whilst P2PLs might gain more skills at predicting outcomes within

⁴⁷⁰ *ibid.*

⁴⁷¹ Iyer and others (n 66) 1.

⁴⁷² *ibid* 2.

⁴⁷³ *ibid* 3.

⁴⁷⁴ *ibid* 2.

⁴⁷⁵ *ibid* 3.

the confines of the roles and positions they play in P2PL, there will always be the same information asymmetries that they would suffer from regardless of how long they have been involved in P2PL.

In addition to the different roles that P2PLs have in comparison with traditional lenders, both entities face lending risks. Some are similar but they can be differentiated. For example, banks do not hold the money deposited with them on trust for the depositors, i.e. the money deposited is not immune from the private creditors of the bank.⁴⁷⁶ Rather, the banks use the money for on-lending and so are debtors to their depositors. A bank's ability to repay depends on their ability to collect the loans from its borrowers.⁴⁷⁷ Similarly, money placed by P2PLs for use on a platform is a risk because it is not held on trust for the lender as there is no guarantee the borrower will repay. The difference between these risks however, is that the P2PLs are not accountable to a third party if the loan transaction fails.

As previously referred to, banks have a higher systemic importance than P2PLs. They are at the centre of risk whereas P2PLs are not. Banks take deposits from the public and hold people's money, they provide credit liquidity for the economy by providing commercial loans and they are inter-connected with each other e.g. through inter-bank deposits and payment systems.⁴⁷⁸ It will therefore be easier to let a P2PL platform fail than a bank because the extent of the credit liquidity provided by P2PLs to society at large is relatively small. For example, in 2015 P2PL consumer lending platforms facilitated £909 million worth of loans to over 213,000 individual borrowers,⁴⁷⁹ whereas according to the Bank of England, the monthly net consumer credit flow excluding student loans was £0.7 billion in the three months leading up to February 2015 alone.⁴⁸⁰

On the other hand, they are like banks in the sense that they do provide some sort of credit liquidity to members of the public. For example, a borrower seeks a loan because they need liquidity. P2PL enables that borrower to achieve liquidity for a period of up to three to five years depending on the platform. Similarly,

⁴⁷⁶ Wood (n 481) 10.

⁴⁷⁷ *ibid.*

⁴⁷⁸ *ibid* 333.

⁴⁷⁹ Bryan Zhang and others (n 60) 41.

⁴⁸⁰ Bank of Scotland, 'Trends in Lending - April 2015' (Bank of England 2015) 7 <<http://www.bankofengland.co.uk/publications/Pages/other/monetary/TrendsinLending/2015/aprilpublication.aspx>> accessed 9 July 2016.

although P2PL platforms are not linked to each other, P2PLs are linked to each other because their money is pooled to create a loan. However, within the context of P2PL, this is a positive thing because it aids with diversification.

Finally, P2PLs experience different relationships with the other P2PL participants in comparison to mainstream lenders. The relationship between the bank and depositor is a contractual one which can be expressed as a 'debtor-creditor' relationship, because once the bank accepts deposits from their customers they become their debtor.⁴⁸¹ The relationship between the P2P lender and the borrower is a contractual debtor-creditor one also however, their position in the intermediated lending chain is different. In mainstream lending, the saver/depositor is at the beginning of the chain and is the ultimate lender. They are followed by their debtor, the bank, who is also the lender. In turn, the bank is followed by the borrower who is a debtor to the bank. In contrast, the P2P lender is at the beginning of the P2PL intermediated lending chain as the lender, they are followed by the platform who acts as the distributor of the funds and finally the borrower who is their debtor. So the relationship between the P2P lender and borrower is debtor-creditor, but the relationship between the P2P lender and the platform is something altogether different. It could be described as service provider-consumer.

Consequently, although the borrower's role stays slightly the same, the P2P lender's role and responsibilities increases because it takes on some of the traditional lender's responsibilities/roles but remains in the same position as a normal consumer in the lending chain. Consequently, it also retains some of the vulnerabilities of ordinary consumers whilst taking on some of the responsibilities of traditional lenders, and therefore some of the risks. All this occurs without the buffer that ordinary consumer depositors have of FSCS backing for their deposits, or even mainstream banks who have often been bailed out by central banks across the world during financial crises.

The extent to which the role of P2PLs is different from normal consumers of bank lending in a similar point in the lending chain is that they have different roles. Under common law, the bank customer only has two duties: to use reasonable

⁴⁸¹ Wood (n 481) 333.

care in drawing cheques so as not to mislead the bank or facilitate forgery⁴⁸² and to notify the bank of known forgeries or misuse of the account.⁴⁸³

In conclusion, the comparison between P2PLs and traditional lenders such as banks has shown that although they carry out similar lending activity, and P2PLs find themselves facing similar lending risks, they are ultimately quite different because despite their prosuming activity which leads to greater participation in the lending activity, P2PLs still retain aspects of the consumer at different stages of the lending process. This is highlighted by their dependency on the platform during the administration stage of the loan agreement and initially at the start of the lending process where the P2PLs rely on the platforms ability to collate accurate information about the borrower. This dual capacity is reflective of the P2PLs' characteristic as a transitional prosumer, i.e. "lendsumer" which is discussed in detail in Section 5.7.

3.5 Credit Unions

This section looks at credit unions in the UK and explains their background and form. The aim of this is twofold. Firstly, it will identify the similarities and differences in the nature of credit unions and P2PL. Secondly, based on this analysis, it will identify whether credit unions are based on a consumption or prosumption model and whether it is similar to the P2PL model.

This section therefore contributes to the overarching argument of Chapter Three that P2PL is similar to some alternative lending models in various ways, but as they are completely different business models, the regulatory focus should be different. It does this by distinguishing credit unions from P2PL. Consequently, the comparison between them centres on the main characteristics of the credit union lending model and their members

Credit unions have been chosen as a comparison with P2PL for several reasons: both are alternative forms of lending to traditional bank-based lending; both have consumers at their focus – or in the case of credit unions, their members; and

⁴⁸² See *London Joint Stock Bank Ltd v Macmillan and Arthur* [1918] AC 777.

⁴⁸³ See *Greenwood v Martin's Bank Ltd* [1933] AC 51.

both can be said to be loosely based on similar social and economic ideals, such as self-reliance and empowerment of the user.

3.5.1 Definition of a credit union

Credit unions (CU) have been defined as a non-profit and democratic⁴⁸⁴ 'financial intermediation cooperative' where its members are both the owners of the institution and the consumers and suppliers of its loanable funds.⁴⁸⁵ Membership of a CU is therefore formed, in the words of Smith *et al*, of both 'member-borrowers' and 'member-savers'⁴⁸⁶ and the CU acts as an intermediary between the two.

In this regard, a slight comparison can be drawn between CUs and P2PL platforms. Although P2PL platforms are for-profit organisations and therefore not owned by their members, the key participants are both borrowers and savers/lenders. P2PL participants do not have the same level of stakeholder control as credit union members; because of the lack of ownership of the organisation they do not have a direct say in the way the business is run. Similarly, the relationship between P2PL participants and the platform is not as close as the relationship between credit union members' relationship with their credit union, where the main aim is to benefit its members. However, both organisations' participants are drawn from the same broad pool of consumers, those who wish to lend, save and invest; and those who wish to borrow.

As CUs are member-owned businesses, they form part of a type of business organisation which is owned by those who directly benefit from its operations, as opposed to being owned by its shareholders.⁴⁸⁷ Therefore these types of businesses are typically owned and controlled by members who are from one of three stakeholders: producers, employees and consumers.⁴⁸⁸

The main role of CUs is to offer its members the means to save and obtain loans at a reasonable rate of interest in the local community.⁴⁸⁹ In the UK, the movement is quite small in comparison to other jurisdictions like North America and Ireland

⁴⁸⁴ Nicholas Ryder, 'Out with the Old and in with the New?: A Critical Analysis of Contemporary Policy towards the Development of Credit Unions in Great Britain' [2005] J B L 617, 618.

⁴⁸⁵ Donald J Smith, Thomas F Cargill and Robert A Meyer, 'Credit Unions: An Economic Theory of a Credit Union' (1981) 36 The J of Fin 519, 519.

⁴⁸⁶ *ibid*.

⁴⁸⁷ Johnston Birchall, *People-Centred Businesses* (Palgrave Macmillan 2010) <<http://0-www.palgraveconnect.com.lib.exeter.ac.uk/pc/doi/10.1057/9780230295292>> accessed 30 August 2014.

⁴⁸⁸ *ibid* 4.

⁴⁸⁹ Ryder, 'Out with the Old and in with the New?' (n 499) 618.

and traditionally it has been administered by unpaid volunteers, although this is not always the case as exemplified by the City of Plymouth Credit Union which first employed paid staff in 2002.⁴⁹⁰

3.5.2. The form/structure of credit unions and how they operate

Credit unions operate by collecting savings from their members through their deposit savings accounts and from this pool of funds it makes available loans to its member-borrowers.⁴⁹¹ They are therefore formed of persons who combine as customers and deal among themselves.⁴⁹² However, although they tend to be single-stakeholder in nature, e.g. a union of employees of a particular company or a union of residents of a certain community, a credit unions' membership often contains people who have more than one identity within the credit union i.e. being both a customer (saver) and a small business or sole trader (borrower).⁴⁹³

Credit unions' main sources of income are the loans they make to their members.⁴⁹⁴ They have as their basis a self-help philosophy which can be seen in their provision of education and advice to their members⁴⁹⁵ and the legal obligation for members to share a common bond.⁴⁹⁶ The common bond is the aspect of CUs that creates the community relationship and identity within a credit union which binds its members together in a non-financial relationship. A common bond can be based on geography, association and occupation.⁴⁹⁷ A member must first prove that they fulfil the common bond requirement before they can join the credit union.⁴⁹⁸ The requirement of the common bond is designed to be a protection against default or dishonesty⁴⁹⁹ on the assumption that if members

⁴⁹⁰ City of Plymouth Credit Union, 'City of Plymouth Credit Union - About' <<https://cpcu.org.uk/about>> accessed 13 December 2016.

⁴⁹¹ Ryland A Taylor, 'The Credit Union as A Cooperative Institution' (1971) 29 *Review of Social Economy* 207, 207; Ryder, 'Out with the Old and in with the New?' (n 499) 618.

⁴⁹² Henry W Wolff, *Co-Operative Banking: Its Principles and Practice with a Chapter on Co-Operative Mortgage-Credit* (P S King & Son 1907) 50.

⁴⁹³ Birchall (n 502) 4.

⁴⁹⁴ Nicholas Ryder and Andrew H Baker, 'Credit Unions as Mortgage Providers?' [2004] *Conv* 109, 109.

⁴⁹⁵ Nicholas Ryder, 'Credit Unions in the United Kingdom: A Critical Analysis of Their Legislative Framework and Its Impact upon Their Development' [2003] *J B L* 45, 45.

⁴⁹⁶ Birchall (n 502) 3.

⁴⁹⁷ *ibid.*

⁴⁹⁸ *ibid.*

⁴⁹⁹ *ibid.*

know each other, they are going to experience some sort of social pressure not to disappoint the other members of their community by failing to repay a loan.

Once a person has been approved as a member, they receive a shareholding in the credit union. Within CU, shares are the same thing as savings, so the more a person saves the more shares they hold within the union. However, each member has equal voting rights regardless of the amount of shares they hold.⁵⁰⁰ Shares are affordable because each one is valued at £1. CUs pay a dividend on the shares each member holds. However the dividend is only paid when a credit union has a sufficient surplus in a given year.⁵⁰¹

Savers also receive life insurance in proportion to their shareholding and borrower members receive the appropriate amount of loan protection insurance to their borrowing.⁵⁰² Before a loan is lent out, borrowers are scrutinised based on how much they have managed to save.⁵⁰³ Consequently, unlike on P2PL platforms, members do not sign up as either borrowers or savers, rather, once they sign up, they are entitled to also borrow.

The advantages of CUs are that loans can be made for small amounts and for a variety of period lengths which is an option not available in mainstream finance.⁵⁰⁴ Additionally, because loans are made at competitive rates, it helps people with poor credit profiles.⁵⁰⁵

3.5.3. Historical development of credit unions

The origin of CUs can be traced to the development of co-operatives in Germany in the mid-1800s, particularly the models developed by Herman Schulze and Friedrich Raiffeisen. Cooperative banking arose from underlying social economic ideals. This can be seen by its aims to promote thriftiness and self-reliance

⁵⁰⁰ Andrew Baker, 'Credit Union Regulation and the Financial Services Authority: Less Is More, but Better!' (2008) 50 *International J L and Mgmt* 301, 302.

⁵⁰¹ *ibid.*

⁵⁰² Birchall (n 502) 3.

⁵⁰³ *ibid* 4.

⁵⁰⁴ *ibid.*

⁵⁰⁵ *ibid.*

amongst low to middle-income people through savings and credit banking and through these means, develop local economies by increasing productivity.⁵⁰⁶

One of the main business models for cooperatives was set up in 1850 by Schulze in the form of a credit association. This institution consisted of a two-tier system of management and supervisory boards and the model insisted that borrowers would also become members of the institution.⁵⁰⁷ Loans were short term loans of three months, which made Schulze's system suitable for urban businesses which had no need for long-term loans, unlike farmers who required a longer period of investment.⁵⁰⁸

On the other hand, Raiffeisen's business model was more suitable for farmers because loans were more long-term and could run for up to ten years.⁵⁰⁹ He set up his first loan bank at Flammersfeld in 1849 to deal with what he saw as the problem of usury.⁵¹⁰ However, it was his third association at Anhausen, set up in 1862, where the borrowing members were also members of the association.⁵¹¹

Like Schulze's system, Raiffeisen's was a two-tier management system. However, unlike Schulze, there were no joining fees or dividends on share capital. Restricting each institution to one parish meant that growth was limited, and yet Schulze's system by comparison has been criticised for encouraging greed and risky management through high dividends, salaries and commissions which ultimately led to the decline of the system.⁵¹²

The idea of cooperative banks spread to European countries such as Austria, Switzerland and France. In Italy, Luigi Luzzatti made the societies more democratic with large supervisory boards and a specialised risks committee.⁵¹³ Catholic activists introduced a Raiffeisen-based model of cooperative banking in several Asian and African countries and in Latin America. These institutions were volunteer-led, small and based on a place of employment or a specific

⁵⁰⁶ *ibid* 135.

⁵⁰⁷ *ibid* 136.

⁵⁰⁸ *ibid* 139.

⁵⁰⁹ *ibid* 138.

⁵¹⁰ *ibid* 137.

⁵¹¹ *ibid*.

⁵¹² *ibid* 140.

⁵¹³ *ibid* 141.

community.⁵¹⁴ The idea also spread to Ireland in the twentieth century however, during the civil war all the cooperative banks failed.⁵¹⁵

It also spread to North America where in 1909 Edward Filene and Pierre Jay, achieved the Credit Union Act, with rules largely adopted from Raiffeisen's business model.⁵¹⁶ Credit unions developed in America in the early twentieth century to cater to the needs of the working class who were excluded by mainstream banks.⁵¹⁷

The credit union movement in America grew despite the Great Depression where they only lost 6.7% of their investments⁵¹⁸ because as banks continued to close and faith in the mainstream banking sector decreased, people were compelled to seek alternative forms of finance.⁵¹⁹ Its success during this period can partially be attributed to a widespread desire to move away from traditional practices and to try new forms of credit.⁵²⁰ A similar phenomenon was experienced by the P2PL industry during and after the financial crisis of 2008, where disillusionment with mainstream banking led to increased attention on the alternative finance sector, as demonstrated by a large number of news article reports portraying P2PL in a largely positive light.

By comparison, Britain had been largely unreceptive to the idea of cooperative banks at the time and there has been poor growth of CUs since then. In fact, CUs have only existed in the UK financial scene for about twenty-five years.⁵²¹ Birchall has attributed this to the industrial revolution which was more complete in Britain, meaning that most people belonged to a wage-earning class less in need of credit. In addition, the working class had a wide choice of where to deposit their money be it savings accounts, building societies or consumer cooperative share

⁵¹⁴ *ibid* 145.

⁵¹⁵ *ibid* 144.

⁵¹⁶ *ibid* 143.

⁵¹⁷ Nicholas Ryder and Clare Chambers, 'The Credit Crunch – Are Credit Unions Able to Ride out the Storm?' (2009) 11 J Banking Reg 76, 77.

⁵¹⁸ Birchall (n 502) 143.

⁵¹⁹ Ryder and Chambers (n 532) 77.

⁵²⁰ Ryder and Chambers (n 532) 77–78.

⁵²¹ Timothy Edmonds, 'Credit Unions - Commons Library Standard Note' (2014) 3 <<http://www.parliament.uk/business/publications/research/briefing-papers/SN01034/credit-unions>> accessed 30 September 2014.

accounts.⁵²² It is for similar reasons that CUs still exhibit poor growth in the UK in comparison to other jurisdictions like America, Ireland and Northern Ireland.⁵²³

CUs in the UK eventually took root as a solution to the problem of poverty in low income areas particularly in the 1980s and 1990s.⁵²⁴ This is demonstrated by the fact that by 1999, 83% of community CUs had formed as community development projects to resolve poverty and provide services for disadvantaged people.⁵²⁵

3.5.4. Consumption model of credit unions

Although the nature and principles underlying CUs hint at some traits of prosumption, overall, it can be argued that they operate under a business-to-consumer model of consumption as opposed to a prosumption model like P2PL. For example, the credit union model suggests the empowerment of individuals within the usual lending dichotomy. They are owned by the savers and borrowers that use their services through ownership of a shareholding in the credit union in proportion to how much they save in it. Additionally, the credit union industry aims to encourage independence in people and adopts a self-help philosophy by providing financial education and access to finance to enable individuals to help themselves. This self-help philosophy finds expression in the way that borrowers are only allowed to borrow from a credit union if they have also saved within it.

This differs from normal bank lending because the depositors do not have any inherent control over how the bank is run and borrowers are usually encouraged to take out more debt e.g. through the extension of credit card limits or offers of loans and overdrafts for any purpose. However, the empowerment found within CUs does not equate to the empowerment of prosumers because although they take control of the business and have voting rights, their position in the supply chain does not change. This is because, their role within the lending and borrowing aspect of the credit union does not differ from the role of ordinary consumers. Although the money lent out on CUs derives from the savings of member-savers, it is the credit union that makes and carries out the lending

⁵²² Birchall (n 502) 141.

⁵²³ Timothy Edmonds (n 537) 6.

⁵²⁴ *ibid* 3.

⁵²⁵ *ibid*.

decisions. For example, which member-borrowers can borrow, how much to lend to them and the interest rates applicable. Consequently, as with bank depositors, member-savers still play the role of the ultimate lender from whom the funds are sourced.

Following from this is the fact that the relationships between the three users of CUs remain largely the same as far as the lending aspect of the industry goes. Within the context of their role as saver or borrower, the only relationship an individual has is with the credit union because they are not directly reliant on the member-borrowers to carry out this role. On the other hand, it could be argued that the fact of the requirement of a common bond between all members indicates that they do have a relationship with the member-borrowers. In addition, it could also be argued that because the credit unions' main source of lending funds are the monies saved by the member-savers, the savers do rely on the member-borrowers because unless they repay their loans the member-savers would either lose their funds or get a poor rate of interest on their savings. However, this is no different from the relationship between bank depositors and bank borrowers. Although there is a common bond between both member-savers and member-borrowers, the relationship it is intended to create is one of a community who can trust each other to keep the credit union viable by ensuring repayment of debts. It is therefore a pre-requisite for joining the credit union and not a relationship created by their capacity as savers or borrowers respectively. In this sense, CU members also differ from P2PL users because instead of their being a tripartite relationship in each lending transaction, the saving and borrowing activities are connected by a linear relationship between the members which flows from the member-saver to the credit union intermediary and from the credit union to the member-borrower.

Another reason why CUs cannot be said to operate under a presumption model is because their users do not carry out presuming activity. That is, they do not produce what they will eventually consume. For example, apart from being the ultimate lenders, member-savers do not play an active role in the lending transaction. In fact, they do not participate in each lending transaction because it is a separate activity to the one they perform. Their role within the credit union is to save money, which they do by opening an account with a CU and depositing their funds on a regular basis. Consequently, they consume the service provided

by the credit union in relation to saving. However, before consuming this service they do not contribute to its development or creation. Their role is therefore non-participatory and passive in relation to the lending that occurs within a CU as well as the savings service they provide because the CU is in control of the major resources related to lending and borrowing. The same can be said of the member-borrowers because although their access to the borrowing facility depends on them being a member of the CU and having saved with it, this requirement is merely a prerequisite to the lending transaction at hand and does not contribute to its development or creation. As the actions of CU members do not involve any producing they cannot be said to be prosumers.

Therefore, CUs reflect a consumption model of business activity rather than a prosumption one and in this way differ substantially from online P2PL.

3.6 Payday Lending

3.6.1. Payday lending and how it works

This section compares payday lending with P2PL because both forms of lending operate in the online alternate finance sector and offer borrowers, quick, affordable credit.⁵²⁶ Consequently, there were early concerns that the P2PL industry could be as harmful to borrowers as payday lenders.⁵²⁷ Two implications follow; the comparison between P2PL and payday lending displays a lack of understanding of the way P2PL operates. Secondly, if P2PL is perceived as equally harmful, regulators may attempt to regulate it in the same way as payday lenders which might prove restrictive given recent moves to by the FCA to tighten up payday lending regulation.⁵²⁸ It is therefore necessary to demonstrate how

⁵²⁶ Although, payday loans have not always operated online and many still operate in bricks-and-mortar offices.

⁵²⁷ E.g. Emma Simon, 'Can You Trust "Peer to Peer" Lending?' *The Telegraph* (3 March 2013) <<http://www.telegraph.co.uk/finance/personalfinance/9902718/Can-you-trust-peer-to-peer-lending.html>> accessed 2 May 2017.

⁵²⁸ Financial Conduct Authority, 'FCA Confirms Price Cap Rules for Payday Lenders - Financial Conduct Authority' <<http://www.fca.org.uk/news/fca-confirms-price-cap-rules-for-payday-lenders>> accessed 9 March 2015.

fundamentally different they are and why their regulatory requirements are different.

Payday loans are small, short-term cash advances which usually last until the borrower's next pay day.⁵²⁹ They can be sold online or in the high street. When sold online, the borrower receives the money electronically into his/her bank account once the loan application has been approved and the repayments are also made electronically at the agreed date.⁵³⁰ Where the loan is sold in the high street, once the loan has been approved, the borrower receives the money physically and repayment is made using a post-dated cheque which is left at the payday lender's premises.⁵³¹ Therefore it is necessary for borrowers to have a bank account, be employed⁵³² and have regular income to receive a payday loan.

Borrowers are usually required to show proof of their identity, address, employment status, income and bank account.⁵³³ Both online and high street lenders use credit reference and fraud prevention agencies and generally limit the value of the initial loan to less than £300 so they can reduce the risk associated with new customers with an unknown repayment history.⁵³⁴ The estimated average payday loan in 2009 was £294⁵³⁵ and Collins has found that payday loans are usually between £50 and £1000.⁵³⁶

If a borrower fails to repay the payday loan by the agreed repayment date, the loan may be rolled over to the next payday or alternative extension so long as the borrower and lender are willing to agree to an extension.⁵³⁷ Approximately 10%

⁵²⁹ Damon Gibbons, Neha Malhotra and Richard Bulmore, *Payday Lending in the UK: A Review of the Debate and Policy Options* (London: Centre for Responsible Credit 2010) 7

<<http://www.responsible-credit.org.uk/uimages/File/payday%20lending%20the%20UK%20october%202010%20final.pdf>> accessed 9 March 2015; Public user, 'OFT Publishes Review of High-Cost Credit' (*The Office of Fair Trading*, 15 June 2010) Annexe E, 14 <<http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/news-and-updates/press/2010/63-10>> accessed 9 March 2015.

⁵³⁰ Gibbons, Malhotra and Bulmore (n 545) 7.

⁵³¹ *ibid* 1.

⁵³² *ibid* 3.

⁵³³ Office of Fair Trading, *Review of high-cost credit: final report* (London: Office of Fair Trading 2010) Annexe E, 16.

⁵³⁴ *ibid*.

⁵³⁵ Marie Burton, 'Keeping the Plates Spinning: Perceptions of Payday Loans in Great Britain' (Consumer Focus 2010) 12 <<http://www.consumerfutures.org.uk/wpfb-file/keeping-the-plates-spinning-pdf>> accessed 15 March 2015.

⁵³⁶ Daniel M Collins and Daniel M Collins, 'Payday Loans: Why One Shouldn't Ask for More...' [2013] JIBLR 55, 55.

⁵³⁷ Office of Fair Trading, *Review of high-cost credit: final report* (London: Office of Fair Trading 2010) Annexe C, 53.

of payday loans last longer than 90 days and more than 10% of all payday users experience payment problems.⁵³⁸

Payday lending originated in the US and is viewed as a form of sub-prime lending because its typical customers usually experience cash constraints and have few substitute borrowing options.⁵³⁹ The method of lending money against a post-dated cheque dates back to the Great Depression and possibly further, when bank credit was generally reserved for small businesses and the wealthy.⁵⁴⁰ To obtain personal finance in 1920s America, individuals had to rely on pawnbrokers, commercial small loan lenders, loan sharks or friends and family, which would have been relatively easy in the late eighteenth and early nineteenth centuries due to the localised nature of trade and exchange at the time.⁵⁴¹ In the early 1990s, many payday lenders functioned or operated out of the offices of cheque cashing shops.⁵⁴² However, there is very little firm data to document the development of payday lending in the US between 1990 and 1995.⁵⁴³

However it was brought to the UK in the 1990s largely by US based companies such as The Money Shop.⁵⁴⁴ US based companies have also established a large market presence in online payday lending within the UK. For example, Quick Quid, the second largest online lender is owned by a Delaware company called CashEuroNet UK LLC and Lending Stream Ltd is owned by Global Analytics Holdings, also a Delaware company.⁵⁴⁵ And they have targeted areas of London which have traditionally been low-paid areas.⁵⁴⁶

The short duration of payday loans means they have high annualised percentage rates (APRs).⁵⁴⁷ However in 2009, The Office of Fair Trading (OFT) found that for high street lenders, the total charge for credit in June 2009 was £12 per £100 whilst for online lenders, this was £34.14 per £100.⁵⁴⁸ This indicates that using

⁵³⁸ *ibid* 52, 53.

⁵³⁹ Gibbons, Malhotra and Bulmore (n 545) 10.

⁵⁴⁰ Carl Packman, *Payday Lending: Global Growth of the High-Cost Credit Market* (Palgrave Macmillan 2014) 5.

⁵⁴¹ *ibid*.

⁵⁴² *ibid* 30.

⁵⁴³ *ibid* 29.

⁵⁴⁴ Gibbons, Malhotra and Bulmore (n 545) 1.

⁵⁴⁵ *ibid*.

⁵⁴⁶ Packman (n 556) 37.

⁵⁴⁷ Office of Fair Trading, *Review of high-cost credit: final report* (London: Office of Fair Trading 2010) Annexe E, 14.

⁵⁴⁸ *ibid*.

APR as a measure of cost for short-term payday loans can be quite confusing⁵⁴⁹ as it can misrepresent the true cost of credit.

Payday lending is a form of credit which is used by a small proportion of the general public and a small proportion of all credit users.⁵⁵⁰ The typical payday lending borrower is an unmarried, young man with no children who lives in rented accommodation and earns over £1,000 a month.⁵⁵¹ A payday lending customer must be in paid employment at the time they take out the loan.⁵⁵² According to OFT, payday lending borrowers experience a very short period of time when their spending surpasses their income, indicating that the role of payday loans is to ease unexpected but temporary cash-flow constraints.⁵⁵³ Consequently, the borrowers tend to be people within the median income bracket of society and above the lowest income brackets.⁵⁵⁴ This is demonstrated by OFT research into the demographics of payday lending customers which shows that the majority of its users earn above £25,000 per year, whilst the typical income ranges between £11,500 and £25,000 per year.

The research of Policis and the Friends Provident Foundation displays similar results in that the majority of borrowers earn over £24,300 per year and the income of most borrowers ranges between £15,000 and £24,300 per year.⁵⁵⁵ Policis also found that for 20% of payday borrowers, payday loans were their only means of obtaining credit, whilst for 80% there were other alternatives.⁵⁵⁶ However, the debt advice charity StepChange has found that of the 36,413 people with payday loan debts it helped in 2012, whilst the average income was £1,298 per day the average payday loan debt was £1,665.⁵⁵⁷ Additionally, following the recession, there has been a rise of indebtedness along with an

⁵⁴⁹ *ibid.*

⁵⁵⁰ *ibid* 32.

⁵⁵¹ *ibid*, 15.

⁵⁵² Office of Fair Trading, *Review of high-cost credit: final report* (London: Office of Fair Trading 2010) Annexe C, 35.

⁵⁵³ Office of Fair Trading, *Review of high-cost credit: final report* (London: Office of Fair Trading 2010) Annexe E, 14.

⁵⁵⁴ Office of Fair Trading, *Review of high-cost credit: final report* (London: Office of Fair Trading 2010) Annexe C, 36

⁵⁵⁵ *ibid* 36.

⁵⁵⁶ *ibid* 41.

⁵⁵⁷ Packman (n 556) 44.

elongated period of declining incomes.⁵⁵⁸ In this vein, the Joseph Rowntree Foundation has found that in 2014, half of the people living in poverty are from working families and about two-fifths of working-age adults living in poverty are also working.⁵⁵⁹ Consequently, the fact that most payday lending borrowers are in paid employment earning a median income and that they have alternative financial suppliers does not preclude their potential to also be vulnerable consumers.

There are a variety of reasons why a borrower might choose a payday loan including certainty of the charges that will be applied to the payday loan, because their main lender will not know of the borrowing and because of the simplicity of the transaction.⁵⁶⁰ In addition to this, repeat customers are often offered more favourable borrowing terms, others may be deterred from seeking mainstream lending options because of the lengthy application process or out of a fear that their loan application will be rejected.⁵⁶¹ Other common reasons for using payday loans include cash constraints, the need to pay an urgent bill or other emergency or to keep up with rent or utility bills.⁵⁶²

3.6.2. Differences between P2P consumer lending and payday lending

One of the main ways in which payday lending differs from P2PL is in the overall structure of the mode of lending. Regardless of whether payday lenders are based on the high-street or online, payday lending uses the business-to-consumer lending model, whereas P2PL has a consumer-to-consumer structure. Therefore, unlike payday lending which depends on the establishment of a single payday lender to provide loans, the supply-side of the P2PL industry depends on the participation of multiple individual lenders.⁵⁶³

⁵⁵⁸ *ibid*; Tom MacInnes and others, 'Monitoring Poverty and Social Exclusion 2013' (Joseph Rowntree Foundation 2013) <<http://www.jrf.org.uk/publications/monitoring-poverty-and-social-exclusion-2013>> accessed 10 March 2015.

⁵⁵⁹ Tom MacInnes and others (n 574) 30.

⁵⁶⁰ Office of Fair Trading, *Review of high-cost credit: final report* (London: Office of Fair Trading 2010) Annexe E, 15.

⁵⁶¹ *ibid* 15, 16.

⁵⁶² *ibid* 16.

⁵⁶³ Lynda Livingston, 'Could Peer-to-Peer Loans Substitute for Payday Loans?' (2012) 4 *Accounting & Taxation* 77, 86.

This difference can be exemplified by the different ways the lenders in each industry screens potential borrowers. Noting that within the P2PL industry, the term ‘lender’ does not apply to the platforms’ role or actions. Within the payday lending industry lenders use a simple screening process to ensure cost-effectiveness.⁵⁶⁴ In addition to the requirements for obtaining a loan, i.e. a bank account, evidence of employment and an adequate credit history, successful borrowers are those who have a credit score above a certain threshold.⁵⁶⁵ However, the level of these checks varies between payday lenders, e.g. Burton’s interviewees reported that some lenders contacted their place of work to confirm employment but most did not.⁵⁶⁶

In contrast, P2PL involves two stages of borrower evaluation, in the first instance, the platforms screen potential loan applicants and in the second stage, the individual lenders must determine for themselves the borrowers’ riskiness using the information provided by the platforms, or on some platforms, simply the level of risk they are willing to take from a borrower. As to the first stage, the platforms generally classify borrowers according to different risk groups based on credit checks,⁵⁶⁷ and other information gathered by the borrower during the application process. They also carry out identity and fraud checks on loan applicants.

However, in relation to the second stage, the lenders are only told the borrowers’ risk assignment and they are not shown the credit score.⁵⁶⁸ On some platforms they may have access to various forms of soft information provided by borrowers like pictures, loan purpose descriptions and friend endorsements.⁵⁶⁹ From the lenders’ perspective, higher and lower quality borrowers within a risk group are presented the same way,⁵⁷⁰ creating information asymmetries and making it possible for lenders to inadvertently select a poor quality borrower. In addition, because P2PLs do not necessarily have professional or any lending experience, the lenders may not screen the loans effectively.⁵⁷¹ In fact, Loureiro and Gonzalez have found that even when P2PLs use prudent heuristics to help them make their

⁵⁶⁴ *ibid.*

⁵⁶⁵ *ibid.*

⁵⁶⁶ Marie Burton (n 551) 22.

⁵⁶⁷ Livingston (n 579) 86.

⁵⁶⁸ *ibid.*

⁵⁶⁹ Livingston (n 579) 86.

⁵⁷⁰ *ibid.*

⁵⁷¹ *ibid.*

lending decisions, information asymmetries lead to subjective decision-making behaviour, such as lenders judging potential borrowers on the basis of their age or when this is not decipherable on their attractiveness.⁵⁷²

However, within the P2PL industry, platforms attempt to mitigate these risks by applying loan caps to borrowers and providing lenders with simple and ample information.⁵⁷³ Livingston has also argued that although the provision of copious information may not necessarily lead to better borrower screening if the lender is already a poor screener, P2PLs are not poor screeners.⁵⁷⁴ This is because P2PLs make better loan selection decisions overtime, which new lenders benefit from; they have the incentive of not risking their own money; and, in the absence of collateral to rely on like traditional lenders, they are skilled at interpreting soft information provided in borrower listings.⁵⁷⁵

On the other hand, it could be argued that with a lot of P2P platforms now offering an auto-lend facility which enables automatic lending based on the lenders lending specifications, lenders can opt to rely on this and take less responsibility or action in the lending process.

Arguably, both industries have the potential to be bad screeners of potentially poor quality borrowers; the payday lenders because of their minimal credit checks and the P2PLs because of the potential for unsophisticated or ineffective methods of borrower validation. However, both inefficiencies can be improved through credit checks.

Another difference between payday lending and P2PL is in the loans that are lent. These differences are exhibited in six main ways: how the loans are lent, the size and duration of the loans, their purpose, funding speed, cost and what happens when a borrower defaults on the loan.

In the payday lending industry loans can be lent in a high-street store, online or by telephone.⁵⁷⁶ The lender either keeps a post-dated cheque signed by the

⁵⁷² Komarova Loureiro, Yuliya and Laura Gonzalez, 'Competition Against Common Sense: Insights on Peer-to-Peer Lending as a Tool to Allay Financial Exclusion' (Social Science Research Network 2014) SSRN Scholarly Paper ID 2533520 6–7 <<http://papers.ssrn.com/abstract=2533520>> accessed 12 March 2015.

⁵⁷³ Livingston (n 579) 86.

⁵⁷⁴ *ibid.*

⁵⁷⁵ *ibid.*

⁵⁷⁶ Marie Burton (n 551) 22.

borrower for a specific time before depositing it, or authorisation is granted by the borrower for the lender to debit their bank account on a future date.⁵⁷⁷ There are a various business models but the finance is mainly derived from the payday lenders' internal resources and where bank finance is used, at least 20% must come from internal resources.⁵⁷⁸

Unlike in payday lending, P2PLs sign up to a platform and decide how much they are willing to lend and for how long. Their money is transferred to a secure segregated account held in trust for the lenders and lent out by the platforms to borrowers who fit the lenders' specifications. On some auction-based platform models, the lenders can bid directly on borrower listings and a loan contract is initiated when there are enough lenders to fund a listing or when the lender's loan offer is matched with a loan request.

P2PBs also face a longer procedure than payday borrowers. On many sites, they first get a personalised loan quote and apply for a loan. The application is reviewed by the platform and if the loan request is approved by the platform following credit and other checks, the funds are transferred to the borrower. Therefore, payday lending is a faster way of obtaining finance for borrowers because whilst payday borrowers, particularly users of high-street lenders, leave the store with the money, P2P loans are not so immediately obtained.⁵⁷⁹ There is also greater uncertainty within the P2P market about whether a borrower will obtain a loan because of the greater degree of validation that they experience. In contrast, some payday borrowers believe that their lender will lend to almost anyone because of the less rigorous checks.

Unlike P2PLs, payday lenders are faced with high fixed costs because the cost of underwriting a loan is independent of the loan value and other costs are independent of the number of loans made, for example, fixed costs include rents, overheads, staffing costs and for online lenders investment in online application systems.⁵⁸⁰ Additionally, costs incurred at the application stage are made regardless of whether a loan is approved or the loan size.⁵⁸¹ As a result of these

⁵⁷⁷ Allison S Woolston, 'Neither Borrower Nor Lender Be: The Future of Payday Lending in Arizona' (2010) 52 *Arizona Law Review* 853, 859.

⁵⁷⁸ Marie Burton (n 551) 13.

⁵⁷⁹ *ibid* 22.

⁵⁸⁰ *ibid* 13.

⁵⁸¹ *ibid*.

high fixed costs, it is the number of loans granted that determines the profitability of the lender and not how many borrowers the lender services, since a lender may earn a similar amount from having one hundred loans taken out by one hundred borrowers as they would from one hundred loans taken out by ten borrowers.⁵⁸² This is no doubt due to the additional fees and charges that borrowers incur when they rollover their loan.

In contrast, the loans financed on P2P platforms are sourced from multiple lenders, for example in the UK, Zopa, Lending Works and Madiston LendLoanInvest, all direct consumer-to-consumer P2P platforms, enable lenders to contribute as little as £10 per loan contract and there is no maximum amount that they can invest. This spreads the risk and cost of providing the loan across all the P2PLs. In addition, the cost to P2PLs to provide the loans are in comparison very minimal. On some platforms lenders pay a lender fee; on Zopa this is a 1% annual fee that depends on the amount of outstanding loans where the payments are up-to-date and Lending Works does not have a lending fee. Consequently, fixed costs faced by P2PLs vary depending on the platform they use. However, overall the monetary cost of P2PL is can be quite cheap for the lenders.

The size and duration of the loans are also different. Borrowers on P2P platforms tend to borrow higher amounts for longer periods, and the loans are repaid in equal monthly instalments.⁵⁸³ Zopa, Lending Works and Madiston LendLoanInvest all enable a minimum borrowing of £1000. The maximum amount that can be borrowed on Zopa and Lending Works is £25,000 whilst on Madiston LendLoanInvest it is £7500 although the website states that this will change in the future. In addition, each of these platforms enables loan terms of between one and five years. In contrast, payday loans can be £300 or less and the agreed term is usually until the borrower's next pay date or 30 days.

The differences in size and volume also lead to differences in the uses of and reasons for using each industry's loans, which in turn leads to differences in the demographics of their users. Payday loans are small in size and short in duration because of, or leading to borrowers using them to finance short-term or

⁵⁸² *ibid.*

⁵⁸³ Livingston (n 579) 84.

unexpected financial disruptions⁵⁸⁴ and the use of the loans are determined by the unplanned event rather than by the borrower or their financial situation.⁵⁸⁵ Payday loans have been used to fund school supplies, childcare expenses and emergency travel among other things.⁵⁸⁶ And they tend to be used because of the loan application procedure's speed, simplicity and minimal scrutiny.⁵⁸⁷ Based on the borrowing options presented to P2PBs, P2P loans on the other hand could be used to for debt consolidation, vehicle purchase, home improvements, special events like weddings, and for sole traders to help business growth. In 2014, 46% of P2P consumer loans in the UK were obtained to fund a car/vehicle purchase, 26% for home improvements and 25% for debt consolidation; only 2% was borrowed for business purposes.⁵⁸⁸

Another difference between the two types of lending is what happens when a borrower defaults. In the payday lending industry, when borrowers cannot repay the loan on time, they have the option to extend or 'rollover' the loan by paying the original interest and then writing another cheque for the loan amount plus the new interest.⁵⁸⁹ Borrowers can extend their original loan numerous times which can transform a loan intended to be short-term into a significantly longer and more expensive commitment. As referred to above,

On the other hand, the default rates on P2P platforms at present are minimal. On Lending Works and Madiston LendLoanInvest default rates are currently 0% and expected default rates on both platforms are equally low being 1.54% and 1.5% respectively. However, while P2PLs are not protected by the FSCS, platforms often have their own security provisions in place which often form part of their sales pitch. For example, Lending Works markets itself as the only P2P lender with insurance against borrower default.⁵⁹⁰ Its insurance also insures against fraud, cybercrime, accident, sickness or death of the borrower and loss of

⁵⁸⁴ Woolston (n 594) 862.

⁵⁸⁵ Livingston (n 579) 82.

⁵⁸⁶ *ibid*; see also Jerry Buckland and Thibault Martin, 'Two-Tier Banking: The Rise of Fringe Banks in Winnipeg's Inner City' (2005) 14 *Canadian Journal of Urban Research* 158.

⁵⁸⁷ Marie Burton (n 551) 23.

⁵⁸⁸ Nesta, 'What Did You Raise Money through Peer-to-Peer Consumer Lending For?' (*Statista*, November 2014) <<http://0-www.statista.com.lib.exeter.ac.uk/statistics/372742/alternative-finance-p2p-consumer-lending-purpose-of-loan/>> accessed 10 March 2015.

⁵⁸⁹ Woolston (n 594) 862.

⁵⁹⁰ Lending Works, 'Lending Works - Peer to Peer Lending | Low Rate Loans' <<http://www.lendingworks.co.uk/>> accessed 26 March 2015.

employment, but it does not cover its P2PLs' rate of return. In addition to this, it has a reserve fund of £146,662 to date which is used to cover arrears.

Zopa loans have no contractual security provisions but the borrowers' are charged a fee which contributes to the platform's 'Zopa Safeguard Trust' which is held in trust for lenders by P2PS Limited. So if a borrower defaults or dies, the Zopa lender can assign their loan contract to P2PS Limited and make a claim on the Safeguard Trust for the principal loan and interest due. But if the claim is denied, then P2PS will start the debt recovery process under the relevant loan contract, deducting any enforcement costs that could not be recovered. These examples highlight that whilst the P2PLs benefit from some form of reserve fund, how these are administered and any additional provisions vary depending on the platform.

Following on from this, the demographics of the users of payday and P2PL differs. As highlighted above, payday borrowers tend to be low- and moderate-income working people with bank accounts⁵⁹¹ but little to no savings. Although payday lending borrowers tend to be middle category consumers in terms of age, income and education which by itself implies that they are not all necessarily living in poverty or financially excluded, the fact that a lot of loans are rolled over means that they are chronic borrowers – in fact, this is one of the qualities that payday lenders seek because this way they make more profit through additional interest and charges.⁵⁹² Regulation, at least in the US, has sought to limit the number of loans that borrowers can take to remedy this issue of chronic borrowing.

Finally, the relatively recent introduction of P2PL in comparison to payday lending has meant that there has been little research carried out in relation to the impact of the loans on both lenders and borrowers. As the business model is still new and developing the longer term implications are yet to be seen.⁵⁹³ Regulation has

⁵⁹¹ Woolston (n 594) 858.

⁵⁹² Livingston (n 579) 80.

⁵⁹³ It is unlikely that in the future P2PL platforms will seek to increase the interest rates that P2PBs are charged as this would reduce its general appeal. However, in terms of the general development of the industry, it is difficult to predict which direction the P2PL model will go, particularly as existing platforms try hard to differentiate themselves from their competitors. Consequently, whilst the presumption model underlying them all stays the same their actual characteristics may differ broadly. Examples of this can be seen in the Appendix, such as platforms which differentiate themselves by demanding collateral from borrowers as security for the lenders. Others may offer borrowers loans for specific purposes such as purchasing a vehicle or property. The impact on lenders and borrowers is that there may be increasing amounts of options for them to consider along with their attendant risks and benefits. Overall,

focused on not stifling the development of P2PL, and in some corners such as the industry leaders/association, this has been justified by pointing out the relatively low default rate and their thus far good practice, in addition to the fact that P2PL managed to ride the wave of the financial crisis rather than being overwhelmed by it. However, no one can predict the future and, there has been no interest rate cap on P2PL loans, so one cannot dismiss the possibility of a platform which charges borrowers extortionate rates for borrowing with them, simply because this is not currently the case. However, this does show that when discussing a new industry, it is important to consider the value and efficiency of regulating for the future.

3.6.3. Consumption model of payday lending

As with credit union lending, payday lending reflects a consumption model of lending. One reason for this is that only the payday lender controls the resources for producing the lending transaction. For example, they determine who the funds will be lent to and they hold the funds to be lent. In addition, the demographic of individuals that use payday lending often have little to no savings of their own, so they are in a position of dependency towards the payday lender. This ties them to the conception of a consumer which holds that they are the party that is in the weaker position in a given transaction. This uneven playing field is emphasized by the fact that payday lenders have often been accused of usury due to the exorbitant interest rates they charge borrowers, even though the borrowers that typically use payday loans are often already in debt or suffering from financial

the impact of the development of the industry will depend on how different P2PL becomes from mainstream lending over time. It is possible that the popularity of disintermediated finance and the sharing economy will eventually simmer down and the industry will settle into more established forms of finance, in which case the industry will have little impact on how they perceive the activities they engage in. E.g. providing lenders with traditional investment opportunities such as secondary markets and securitised loans. For the borrowers, there does not appear to be much room for development except ever faster access to finance at competitive rates. Even now, the experience of P2PBs with platform lending is little different from their experience borrowing from traditional lenders such as credit unions, banks or payday lenders. The few complaints so far raised by P2PBs at the Financial Ombudsman Service show similar concerns as borrowers of institutional lenders e.g. lack of clarity over the costs of the loan; for examples of such complaints see, Financial Ombudsman Service Limited, 'Crowdfunding and Peer-to-Peer Lending' [2016] *Ombudsman News* 1, 3-9. Therefore, it will be relatively easy to predict what types of regulatory protections are needed to protect P2PL users' interests than if there were to be more radical changes.

constraints. This is demonstrated by the wider debate surrounding payday lending which seeks to determine whether payday loans trap people in a cycle of repeated borrowing by allowing borrowers to continuously extend loans they cannot afford to repay each month⁵⁹⁴ with additional interest and charges added on top of the amount originally borrowed.

Another reason why payday lending follows the consumer model is based on the position of payday lending borrowers within the supply or production chain. The borrowers do not contribute to the development or production of the loan transaction. Rather they merely initiate the loan service by applying for a loan and then receive the loan product from the payday lender. Therefore, rather than producing to consume for their own benefit, the borrowers do not put in any work for the service they receive.

This links to the third reason why payday lenders cannot be said to operate under a presumption model, which is that within the lending transaction a borrower's role is merely to apply for and borrow money. This means that they are merely 'passive receptacles' of the lending service. Based on Bitner *et al's* framework for analysing the levels of participation of a business' customers, payday borrowers exhibit a moderate level of participation in the delivery of the service, but they only just fit within this level. This is because they cannot be said to show a low level of participation according to the framework because the payday lending service cannot go ahead regardless of whether the borrower decides to take out a loan or not; and the borrower does not simply make a payment for the service, they also have to take steps to apply for the loan. However, these roles are aimed at consumption they do not contribute to the production of the service itself. Payday borrowers operate within the moderate level of participation because their input is required for the creation of the loan service. If they do not apply for a loan, it will not be generated. However, this is as far as their participation goes.

As the underlying model of payday lending is consumptive, it fundamentally differs from the P2PL mode of financing individuals. Therefore, it cannot be treated exactly the same for the purposes of regulation.

⁵⁹⁴ Gibbons, Malhotra and Bulmore (n 545) 3; Richard M Hynes, 'Does Payday Lending Catch Vulnerable Communities in a Debt Trap?' (Social Science Research Network 2010) SSRN Scholarly Paper ID 1585805 3 <<http://papers.ssrn.com/abstract=1585805>> accessed 9 July 2016.

3.7 Crowdfunding

The basic structure of P2PL at the conceptual level is of a person-to-person transaction. To be more specific, the transactions occur lender-to-prosumer. There are many types of individuals who engage in similar activities to P2PLs and which also requires group participation for the transaction to come into effect. However, this section analyses the differences between P2PLs and these actors and shows that on a conceptual level, these models of transacting are not the same as on P2PL platforms. For example, some are truly consumer-to-consumer models, whereas others are prosumer-to-prosumer. It therefore further distinguishes the concept of 'lender' and highlights further characteristics that make up the 'lender'.

The name 'crowdfunding' is often used as an umbrella term encompassing various types of online platforms which enables people and businesses to raise money from the wider public for a specific project.⁵⁹⁵ E.g. the FCA uses it in this way to include both peer-to-peer and peer-to-business varieties. Some academics conflate the term with either variety depending on which one they are referring to at the time. For example, in their discussion of the occurrence of home bias in the crowdfunding context, i.e. the phenomenon that investors or businesses are more likely to transact with parties who are geographically closer to them, Lin and Viswanathan conflate P2PL with crowdfunding. They describe crowdfunding as:

*“where contributors or investors provide funds to an individual or business either as donations or in return for a debt repayable over time, an equity share, or a reward”*⁵⁹⁶

As with the FCA conception of the term, they use the term crowdfunding as an umbrella term to encompass a variety of different models e.g. donation-based forms of financing and debt-based models. By using the term 'contributors'

⁵⁹⁵ European Union: European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of The Books "Unleashing the Potential of Crowdfunding in the European Union"' (2014) COM(2014) 172 final 3 <http://ec.europa.eu/finance/general-policy/crowdfunding/index_en.htm> accessed 25 May 2016.

⁵⁹⁶ Mingfeng Lin and Siva Viswanathan, 'Home Bias in Online Investments: An Empirical Study of an Online Crowdfunding Market' (2014) Management Science (forthcoming) <<http://papers.ssrn.com/abstract=2219546>> accessed 10 July 2016.

alongside ‘investors’, Lin and Viswanathan allow the possibility for crowdfunding to include models in which individuals can contribute to a charitable cause through donations or where they contribute money to finance an idea which they support. By using the term ‘investors’ they also include the possibility for ‘crowdfunding’ to encompass models where individuals contribute funds with the expectation that they are going to earn something in return e.g. loan-based and equity-based forms of finance.

In contrast, Mollick defines crowdfunding as:

*“the efforts by entrepreneurial individuals and groups – cultural, social, and for-profit – to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries.”*⁵⁹⁷

Mollick’s definition is more specific because it focuses only on the type of crowdfunding that involves the financing of entrepreneurial ventures. This excludes fundraising for personal reasons such as buying a car, home improvements or a holiday, which are some of the reasons that people give for raising money on P2PL platforms. His definition also includes the essential method of crowdfunding which is that money is raised from a large crowd of individuals in small amounts. This is sufficiently broad enough to encompass all types of crowdfunding as well as P2PL because the idea behind both types of fund raising is that money is sourced from multiple people and it also shows how both tend to work. But as explained above, P2PL lending is excluded from this definition because it does not always involve raising money to fund ventures. By referring to the internet as the place which crowdfunding takes place, the definition renders itself specific to online variants of raising finance from a crowd. It therefore also excludes offline variants of crowdfunding like esusu/isusu, which is discussed later in this chapter. Finally, by excluding the use of “standard” intermediaries this definition reflects an understanding that online forms of crowdfunding are not free of intermediary involvement, rather, the ones involved are not traditional forms like banks or investment brokers. Although the definition of crowdfunding and the way it is used is still a contentious issue, in part because

⁵⁹⁷ Ethan Mollick, ‘The Dynamics of Crowdfunding: An Exploratory Study’ (2014) 29 J B Venturing 1, 1.

crowdfunding is still an emergent field of study, this definition is significant because it demonstrates that it is possible to define and conceive of crowdfunding as a separate business model from P2PL despite how similar they are.

Following on from this idea, although the umbrella usage of 'crowdfunding' encompasses different models of sourcing funding from a crowd, it does not consider the ways that the different models differ conceptually. For example, this thesis has focused on person-to-person or "peer-to-peer" lending, where individuals are on either side of the platform-intermediated lending transaction. Within these types of platforms, the participants are usually associated with consumers or prosumers. Hence, this model is also usually associated with consumer-to-consumer business models like eBay. But with equity-based crowdfunding, the participants on either side of the transaction are not always both individuals. Other forms of crowdfunding such as donation and rewards-based crowdfunding have more in relation to charitable contributions than they do with retail finance as they do not involve a financial investment return, consequently they fall outside the remit of the UK regime.⁵⁹⁸ E.g. even with rewards-based crowdfunding, the rewards may be a product or service which the lender may hope to receive if the borrower achieves the set fundraising target, e.g. tickets to a concert that the borrower was raising money to organise.⁵⁹⁹ Unlike P2PL, these types of crowdfunding can take the form of individual-to-business models, and increasingly also institution-to-business, because some crowdfunded loans are partially supplied by institutions such as hedge or pension funds.⁶⁰⁰

Therefore, on a conceptual level, these types of crowdfunding models differ from P2PL because they do not involve two consumer parties meeting over the platform and transacting, rather it is individual-to-business, whether a small business or a large one. This is because the persons raising finance are doing so in the course of their trade, or business and therefore cannot be classified as consumers, even in cases where they are raising finance in order to start a

⁵⁹⁸ Financial Conduct Authority, 'Crowdfunding' (FCA, 18 April 2016) <<https://www.fca.org.uk/consumers/crowdfunding>> accessed 25 April 2017.

⁵⁹⁹ *ibid.*

⁶⁰⁰ Amy Cortese, 'Loans That Avoid Banks? Maybe Not' *The New York Times* (3 May 2014) <<http://www.nytimes.com/2014/05/04/business/loans-that-avoid-banks-maybe-not.html>> accessed 10 July 2016.

business.⁶⁰¹ Additionally, on platforms which allow institutions to lend, the lending process may even be said to have gone full circle and returned to a business-to-consumer or business-to-business structure.

Due to the similarities with P2PL, the individuals who provide the finance on crowdfunding platforms can be conceptualised as prosumers due to them carrying out similar roles with similar levels of participation in the production side of the transaction. However, the concept of the lendsumer only applies where the lender is an individual, not a business. This is because a business cannot be said to transition between being a prosumer and a consumer at the different stages of the platform-reliant lending transaction. This is particularly the case when one considers the common EU law conception of a consumer which requires that they be natural persons. Therefore, on crowdfunding platforms where the funding crowd could be made of either/both institutions and individuals, it might be too complicated to determine who should be treated as a lendsumer and who should be treated as a business for the purposes of regulatory protection.

These are significant differences because it changes the dynamics of the relationships between the participants and may even negate in some cases the relevance of regulations such as consumer protection regulations, which will no longer be appropriate protection for the lender if it is a business such as a hedge fund. The regulations would therefore have to differ.

3.8 Esusu/Isusu

Isusu is a type of rotating credit association (RCA) formed of credit groups/clubs found in many countries around the world, particularly Africa and Asia.⁶⁰² Shirley

⁶⁰¹ For a definition of “in the course of business” see for example, Case C-269/95, *Francesco Benincasa v Dentalkit Srl* [1997] ECR I-3767; P2P business lending, equity-based lending and invoice trading are all models which involve lending to or investing in a business, sole-trader or SME. Some P2PL platforms do enable businesses to borrow on their platform, but this just means they have chosen to engage in two different business models. Should regulators recognise the underlying conceptual difference between P2PL and P2BL, and reflect this in consumer protection regulations, it would mean that platforms offering both lending and investment opportunities would have to abide by different sets of regulation. This is not unheard of as intermediaries like banks must abide by different rules or laws depending on the activities they engage in, e.g. a bank operating as a high-street bank as well as an investment bank, must abide by separate rules relating to each activity.

⁶⁰² Enoch Oluwole Adeniran, ‘Historicising African Traditional Saving System “Esusu” For Occupational Sustainability’ (2014) 2 Eur J B Mgmt 336, 336, 338; Trevor W Purcell, ‘Local

Ardener, an anthropologist defines an RCA as, “an association formed upon a core of participants who agree to make regular contributions to a fund which is given, in whole or in part, to each contributor in rotation.”⁶⁰³ This definition therefore excludes similar co-operative forms of saving and borrowing like CUs because they do not involve the key components of rotation and regularity.⁶⁰⁴

The name ‘isusu’ is what it is called amongst the Igbo of south-eastern Nigeria and means ‘a gathering’.⁶⁰⁵ In Nigeria alone it is known by many names depending on the ethnic group, e.g. ‘esusu’ amongst the Yoruba, ‘adashi’ by the Hausa and ‘oku’ by the Kalahari.⁶⁰⁶

The form varies depending on the place and culture, and ranges from the simplest form comprising regular contributions and withdrawals with no interest, reserve fund or other complications involved, to modulated cycles involving interest or a negotiated auction system for determining the distribution of the fund.⁶⁰⁷ However, it generally operates in the same way with individuals joining together and contributing money to a joint pot on a particular day of the week for a period of time.⁶⁰⁸

It played a prevalent role in most African societies of mobilising savings and allocating them for investment before the modern banking system started.⁶⁰⁹ E.g. Nwabughogu traces the origin of the institution in Ngwaland, a village in south-eastern Nigeria, to pre-colonial times when young men used it to raise money to pay the dowry for marriage. In his account, he describes how it generally worked in the past.⁶¹⁰ Any member of a village who wished to take part would meet at an elder’s house once every Igbo week of eight days and contribute a fixed amount of about four to eight manillas to the joint fund.⁶¹¹ Each member was entitled to the total amount of these contributions in turn and after receiving his share, he

Institutions in Grassroots Development: The Rotating Savings and Credit Association’ (2000) 49 Soc’l & Econ Studies 143, 146.

⁶⁰³ Shirley Ardener, ‘The Comparative Study of Rotating Credit Associations’ (1964) 94 J R A I 201, 201.

⁶⁰⁴ *ibid.*

⁶⁰⁵ Anthony I Nwabughogu, ‘The “Isusu”: An Institution for Capital Formation among the Ngwa Igbo; Its Origin and Development to 1951’ (1984) 54 Africa: J Intl African Inst 46, 56, note 2.

⁶⁰⁶ Enoch Oluwale Adeniran (n 619) 338.

⁶⁰⁷ Trevor W Purcell, ‘Local Institutions in Grassroots Development: The Rotating Savings and Credit Association’ (2000) 49 Soc’l & Econ Studies 143, 147.

⁶⁰⁸ Enoch Oluwale Adeniran (n 619) 336.

⁶⁰⁹ *ibid.*; Nwabughogu (n 622) 47.

⁶¹⁰ Nwabughogu (n 622) 47.

⁶¹¹ *ibid.*

would continue to pay his weekly contribution until he had paid the full amount received.⁶¹² The group was disbanded as soon as everyone had contributed received their share of the communal pot.⁶¹³ In pre-colonial times, membership was only open to members of the same village as this made it easier to deal with dishonesty and keep defaults to a minimum.⁶¹⁴

There are two different types of defaulters within *isusu* which impact the stability of the organisation in slightly different ways. The first category are those who default before receiving their share of the contributions.⁶¹⁵ These types were treated with more sympathy by the collective because the lack of payment could have been caused by illness or poverty. In this situation, the defaulter would be expected to find a substitute to continue their payments. If the defaulter could not find a substitute an enquiry would be instigated to find out whether this was due to negligence. If not, the members would find a substitute for him.⁶¹⁶ But if the defaulter was found not to be able to contribute because of his own negligence the members would seize one of his fowls for each week he had defaulted and order him to continue the contribution.⁶¹⁷

The second type of defaulter is one who defaults after receiving his share of the pot.⁶¹⁸ This posed a greater threat to the collective's stability because it inspired a lack of trust within the group. Consequently, this type of defaulter was treated with greater severity by being brought before the village council, ordered to pay a fine and continue his contributions.⁶¹⁹ Failure to do so would lead to his outstanding balance being treated as a debt and his property seized.⁶²⁰

In more modern times, a key characteristic of *isusu* is that a group of around twenty to thirty members must reach a solid agreement before the *isusu* starts.⁶²¹ In the past this agreement formed part of an unwritten legal code, which meant members depended on mutual trust and oaths of allegiance.⁶²² In modern times

⁶¹² *ibid.*

⁶¹³ *ibid.*

⁶¹⁴ *ibid* 47–48.

⁶¹⁵ *ibid* 48.

⁶¹⁶ *ibid.*

⁶¹⁷ *ibid.*

⁶¹⁸ *ibid.*

⁶¹⁹ *ibid.*

⁶²⁰ *ibid.*

⁶²¹ Enoch Oluwole Adeniran (n 619) 338–339.

⁶²² *ibid* 340.

some isusu groups operate with written constitutions.⁶²³ Also in modern times, the members tend to come from similar economic backgrounds, e.g. market women, members of trading guilds, artisans and childhood friends.⁶²⁴ The money is often used by individuals to start a business or expand an existing one in for example, pottery or sculpture making, soap making, farming,⁶²⁵ repayment of debt or the education of children.⁶²⁶ The aim is to create financial stability for members in times of need.⁶²⁷

Each member of the group contributes a fixed amount of money at regular periods as agreed upon by the group, which could be daily, weekly or monthly depending on what was agreed and the total amount contributed is kept by the group leader who is unanimously selected by the group and acts as a treasurer.⁶²⁸ When the time comes for sharing the savings out amongst members, non-participants are not allowed to receive any of the returns and anyone that has defaulted on an earlier round is not allowed to continue to the next.⁶²⁹ As isusu is founded on mutual trust between the members, it is typically peer pressure that causes members to make each periodic payment on time, this is accompanied by other pressures caused by social norms within the local culture.⁶³⁰

The amount each member receives when the money is shared depends on the number of people within the group,⁶³¹ and the number of shares the individual holds within the group and this in turn depends on how much they can afford to contribute on the periodic payment date.⁶³² For example, if there are nine people within an isusu collective, the first person may contribute both first and last to receive payments twice (first and last respectively). In this way, they act as both the first and tenth person within the group and hold more shares. The number of shares held also determines the person's position within the group; consequently, the shareholder with the highest number of shares is usually the president.⁶³³

⁶²³ *ibid.*

⁶²⁴ *ibid* 339.

⁶²⁵ *ibid* 337.

⁶²⁶ Nwabughuogu (n 622) 54.

⁶²⁷ Enoch Oluwole Adeniran (n 619) 339.

⁶²⁸ *ibid.*

⁶²⁹ *ibid.*

⁶³⁰ *ibid* 341.

⁶³¹ Nwabughuogu (n 622) 47.

⁶³² Enoch Oluwole Adeniran (n 619) 340.

⁶³³ *ibid* 240.

The total amount saved by all members of the group is allocated to individual members in turn by rotating the payment in a pre-defined order.⁶³⁴ However, this schedule is flexible because if a member requires emergency funds, the order can be changed to help the person in need.⁶³⁵ Once the isusu group has been formed, joining as a new member is not easy as one needs to be guaranteed by at least two existing members to be accepted.⁶³⁶

Some isusu members consider themselves to be their own bankers and prefer it to institutional forms of lending such as banks⁶³⁷ because it generally does not force them to make interest payments.⁶³⁸ Isusu provides members with easy access to loans which do not attract interest, do not incur joining or exit fees, the amount paid is dependent on what the individual can afford and default generally does not result in the appropriation of the debtor's personal belongings.⁶³⁹ Consequently, saving and borrowing money with isusu does not carry the same degree of risks that normal borrowing does.

Oluwole distinguishes between isusu/esusu and a similar type of traditional banking system amongst the Yorubas called 'Ajo'. He states that in ajo, members of a group contributed a certain amount of money periodically and all or part of the accumulated funds are given to one or more members in rotation until all members have benefited from the joint pot.⁶⁴⁰ Whereas, in isusu/esusu, members receive the accumulated funds saved by the group at the same time, rather than in turn.⁶⁴¹ However, the terms seem to be used interchangeably, particularly within the literature as some writers have described the operation of isusu/esusu as rotating in the same way that Oluwole describes ajo.⁶⁴²

Either way, there are several risks inherent in esusu and ajo alike, e.g. both systems of finance are heavily dependent on trust between members for the set up, and continuation of the group.⁶⁴³ Members of the club are typically only

⁶³⁴ *ibid* 341.

⁶³⁵ *ibid*.

⁶³⁶ *ibid*.

⁶³⁷ Nwabughuogu (n 622) 55.

⁶³⁸ Enoch Oluwole Adeniran (n 619) 342–343.

⁶³⁹ *ibid* 348.

⁶⁴⁰ *ibid* 345.

⁶⁴¹ *ibid*.

⁶⁴² Nwabughuogu (n 622); Okwara O Amogu and Okwaru O Amogu, 'Some Notes on Savings in an African Economy' (1956) 5 *Social and Economic Studies* 202.

⁶⁴³ Enoch Oluwole Adeniran (n 619) 349.

accepted on the basis of mutual trust, however loss of trust within the group could cause it to collapse, and this could be caused by such things as default or untimely contributions by some members.⁶⁴⁴

The fact that the esusu group leader also acts as the treasurer of the club creates an unhealthy dependence on them. If the group leader dies, this could create problems for the other members because the leader's family may deny knowledge of the leader's status and withhold the groups' funds.⁶⁴⁵ This is exacerbated by the lack of court mediation in these situations. This could create such a large degree of mistrust within the group that the esusu collective collapses. Similarly, a group leader's ineffectiveness at carrying out his/her role of coordinating the group might weaken the group and there is a risk that the leader-treasurer might abscond with the group's money.⁶⁴⁶

Linked to the issue of trust, an esusu group might be weakened by continual default by its members particularly as members cannot be forced to contribute if they have nothing to contribute.⁶⁴⁷

Rotating savings and credit associations (ROSCAS) like isusu split the borrowing and lending process into two separate transactions because they offer lenders a claim to the joint pot as borrowers and, separately, lending the money they have contributed to the ultimate borrowers.⁶⁴⁸

High interest rates can be attached to borrowing which is sometimes usurious, for example Jerome reported that interest rates range between zero and fifty per cent.⁶⁴⁹

Recently, Diamond Bank of Nigeria has unveiled an online version of esusu called 'eSUSU'.⁶⁵⁰ The service provided is designed to encourage Nigerians to save and has both a group and savings option. For the group lending option, Diamond bank provides a secure platform where up to twelve individuals can contribute to a

⁶⁴⁴ *ibid.*

⁶⁴⁵ *ibid* 350.

⁶⁴⁶ *ibid* 351.

⁶⁴⁷ *ibid* 350–351.

⁶⁴⁸ Theo Afeikhena Jerome, 'The Role of Rotating Savings and Credit Associations In Mobilizing Domestic Savings In Nigeria' [1991] *African Rev of Money Fin and Banking* 115, 117.

⁶⁴⁹ *ibid* 119.

⁶⁵⁰ 'Diamond Bank Introduces eSUSU Savings Scheme'

<<http://www.diamondbank.com/index.php/63-news/press-releases/690-diamond-bank-introduces-esusu-savings-scheme>> accessed 16 May 2016.

rotating savings scheme like esusu and ajo.⁶⁵¹ It gives them the ability to plan collection dates and receive bulk payment. Unlike the traditional offline version of isusu, account holders can access their contributions at any time. The digitisation of esusu not only lifts the administrative burden from the group leader-treasurer⁶⁵² but also eliminates the risk that the treasurer will abscond with the group members' money. Bringing isusu online therefore adds greater transparency to the affair in addition to greater efficiency and a reduced dependency on mutual trust to stabilise the group.

There several similarities between the isusu members and P2PLs. For example, both institutions involve a participatory community. The lending activity in an isusu is only possible because a group of people have come together to raise a fund which is then lent out. Similarly, a P2P loan is only possible because funds have been raised by a crowd. A more obvious similarity is that both institutions involve members who use their personal money to lend to others within the participatory community. They can be said to prosume at least in regards to their lending activity.

However, the digitisation of isusu highlights a major difference between P2PL and isusu. Firstly, isusu, particularly in its traditional offline versions are true forms of lending between individuals as there are no intermediaries between the members. The members come together of their own accord and require no intermediary to connect them. Even the online version seems to necessitate that a group has already formed offline before they decide to use the bank's platform to administer the isusu activities. In contrast, P2PLs and borrowers are unknown to each other and the P2PL platform is what brings them together as well as facilitates the lending and borrowing activities. Diamond Bank's platform is simply designed to make isusu easier and more efficient for the users, it does not play an intermediary role between the isusu members. Even though an isusu group relies on the president-treasurer to store and pay the collective's funds, as described by Oluwole, the president-treasurer is not only a participant in the saving/lending and borrowing activities thereby contributing to the mutual funds periodically and receiving a share, but they are generally also appointed by the

⁶⁵¹ Uzoma Dozie, 'Making Esusu Digital' <<http://www.uzomadozie.com/blog/making-esusu-digital/>> accessed 13 May 2016.

⁶⁵² *ibid.*

group themselves. This is generally the case, although there are some varieties where the group's organiser may either be required to contribute in a different form to others, e.g. in the form of feasts for some Chinese associations; or, they do not contribute at all, as with the Nupe of Nigeria.⁶⁵³ Regardless, P2PL platforms engage in intermediary activities which are more engaged, involve more control on their part and more dependency on them on the part of the P2PBs and lenders, without also participating in the lending and borrowing behaviour. Put simply, they are intermediaries. Therefore, unlike with P2PL, the participants of isusu do not experience a consumer-business relationship at any point during the collective's existence. This means that the participants are not consumers.

Linked to this, another immediate difference between isusu members and P2PLs is their capacity as borrowers and lenders. Unlike P2PLs, isusu members participate as both borrowers and lenders. In an isusu, the individual who receives an early draw is actually being advanced a credit by a saver who will later have his or her own turn to receive such an advance.⁶⁵⁴ This is because in any given isusu period, they each contribute to a pool of funds which they will receive funds or borrow from by the end of the agreement. In contrast, in each P2P transaction the lenders operate solely as lenders and do not benefit from the fund they contribute to, which is gathered from multiple other lenders to form the loan by the platform. Consequently, the capacity of the borrowers and lenders within P2PL are asynchronous.

This can be illustrated by the following scenario. Twenty people meet each month and contribute £10 each to the fund, once all the contributions have been collected that first month, £200 is handed to the first member to receive the contributions. The following month, another member receives the next batch of £200 that has been collected and so forth until all twenty members have received £200. By the end of the twentieth month, £4,000 has been raised and shared out. However, as soon as the first member of the collective receives his/her £200, he/she becomes a debtor to the rest of the members, similarly, the last member to receive the fund remains a creditor to each of the members until he/she

⁶⁵³ Ardener (n 620) 211.

⁶⁵⁴ Purcell (n 624) 147.

receives his/her share.⁶⁵⁵ This is the case with each member of the collective, each one shifting from creditor to debtor.

P2PL participants are therefore different because within their respective transaction they play only one role throughout the transaction, i.e. they are either a lender or a borrower. Although both institutions involve their members transitioning in some way, with P2PLs it is different because they remain lenders throughout the transaction but within that role, their capacity transitions from prosumer to consumer. In contrast, an isusu member remains a prosumer throughout the isusu period, so their capacity does not change, only their relationship with each other.

Isusu participants and by extension members of other types of rotary credit association can therefore be distinguished from P2PLs because although they can be classified as prosumers, they are not transitional prosumers.

By analysing the similarities and differences between esusu/isusu and P2PL, this section has demonstrated how a presumption-based form of lending works. For example, it highlights the fact that offline and online forms of esusu/isusu operate on a prosumer-to-prosumer basis. On this basis, it can be distinguished from P2PL which although it is also based on a presumption model, only one party to the P2PL transaction can be adequately described as a prosumer, i.e. the lenders. Whether the borrowers can be described as such is debatable because arguably, there is little difference between them and individuals who apply for and manage their loans online using a bank's website. In addition, P2PL differs because it is not purely prosumer-to-prosumer or prosumer-to-consumer because it operates through the platform intermediary.

The section also highlights the possibility for individuals' roles and relationships to transition during a single transaction which it shows both isusu members and P2PLs do. However, it has also demonstrated that P2PLs experience this transition in a different way to esusu/isusu members. Consequently, through the mechanism of contrast, this analysis illuminates the details underlying the concept of P2PL which need to be considered for regulation to accurately reflect the industry.

⁶⁵⁵ Ardener (n 620) 201.

3.9 Consumer-to-consumer sales: eBay

Like P2PL, eBay is another online platform which springs to mind when discussing the notion of consumer-to-consumer transactions. However, it enables both consumer-to-consumer and business-to-consumer item sales. Although the transactions on eBay involve the sale of goods rather than services, eBay and online P2PL are both online marketplaces that enable individuals to interact with others, facilitated by an independent platform. However, despite the similarity between the two business models, this section argues that they are conceptually different.

eBay is a system of electronic commerce (e-commerce) which acts as a facilitator of transactions between individuals or in some cases, small enterprises.⁶⁵⁶ eBay operates under an internet auction website business model, which empowers its users and provides a place where internet users can exchange goods and services directly with each other.⁶⁵⁷

Although, as mentioned, eBay caters to business-to-consumer sales, as this thesis focuses on peer-to-peer transactions, this section will also focus on that phenomenon within the eBay business model.

eBay functions as a virtual marketplace where its users can buy or sell items from anywhere in the world that has access to eBay. It is currently one of the largest marketplaces in the world with 162 million active buyers, access to over 200,000 small businesses in the UK alone and 800 million listings worldwide; and the mobile application allowing people to use the platform on their phones has been downloaded over 314 million times.⁶⁵⁸ The website does not take on the role of auctioneer in any of the transactions happening within its website, rather, it intermediates such transactions.⁶⁵⁹ There are two ways members can use eBay, either as a buyer or a seller.

⁶⁵⁶ Andrés Guadamuz González, 'eBay Law: The Legal Implications of the C2C Electronic Commerce Model' (2003) 19 Computer L & Secur Rev 468, 468.

⁶⁵⁷ *ibid.*

⁶⁵⁸ eBay, 'Company Profile | eBay Media Centre' <<http://www.ebay-mediacentre.co.uk/companyprofile>> accessed 21 May 2016.

⁶⁵⁹ Guadamuz González (n 673) 470.

To use eBay, buyers go to the website, search for an item or browse the product categories and view a listing. They can choose to purchase items either at a fixed price or through auction-style bidding. eBay encourages buyers to first find out more about the product by reading the description carefully and if necessary, asking the seller questions about the product using the 'Ask a question' link in the item listing webpage. Buyers can also review the reputation of the seller by looking at comments left by previous buyers and the seller's current feedback score.⁶⁶⁰ This places on buyers the responsibility of being shrewd about their purchases and the sellers they buy from. The buyer who has won at auction or bought the item immediately must send payment to the seller within three days using the payment method specified by the seller. A bid or purchase on eBay qualifies as a contract which obligates the buyer to purchase the item.

From the perspective of the seller, a seller can set up their account in advance or when they are ready to list their first item.⁶⁶¹ eBay encourages sellers to research similar products to get an idea of the starting price and listing format of other products within their category by viewing active or completed listings on eBay. They are also responsible for making themselves aware of eBay's policies on prohibited and restricted items. E.g. prohibited item listings include raffles and weapons, whereas restricted items include food and healthcare products.

To sell, a seller needs to click the 'sell' link at the top of most eBay pages and they choose whether to create an auction-style or fixed price listing. The seller manages their listing by setting up their preferences in terms of communication. They can change anything in their listing later. The seller is also responsible for ensuring that they have received payment before posting the item to the buyer. The seller can also leave feedback on the buyer.⁶⁶²

Due to the high number of transactions on eBay, both parties face difficulties using the marketplace effectively. A significant problem faced by both parties is fraudulent transactions.⁶⁶³ For example, a seller can set up multiple buyer accounts to drive up the price of an auction listing that they are holding, so that

⁶⁶⁰ eBay, 'Buying Basics' <<http://pages.ebay.co.uk/help/buy/basics.html>> accessed 21 May 2016.

⁶⁶¹ eBay, 'Sell an Item - Getting Started' <<http://pages.ebay.co.uk/help/sell/sell-getstarted.html>> accessed 21 May 2016.

⁶⁶² *ibid.*

⁶⁶³ Guadamuz González (n 673) 469.

when an authentic purchaser bids for an item, the seller can log in with his buyer accounts and bid on the item as well to drive up the price.⁶⁶⁴ On the other hand, sellers also face the risk of exposure to fraudulent buyers.⁶⁶⁵ Anecdotal evidence includes buyers purchasing a product and then claiming that it was lost in the post or damaged. In some cases, sellers have found empty return packages or products with different serial numbers returned to them.⁶⁶⁶ However, eBay has a reputation of siding with the buyers which makes this fraudulent activity easier.⁶⁶⁷ This reflects the preoccupation most organisations and institutions have with protecting the platform participant that is usually associated with the 'consumer' classification. Therefore, it is important that there is a balance of protection for both parties in P2P models.

The ability for buyers and sellers to leave feedback about other users gives eBay users the added role of monitors of the marketplace community. When things do go wrong, eBay gives its members recourse to a built-in alternative dispute resolution scheme. Neither of these community resolution tools are found on P2PL platforms, so P2PLs and borrowers rely heavily on the platform to administer the loan and resolve problems that arise between them, e.g. non-repayment of the loan.

As with P2PL, there are different participants within an online auction marketplace like eBay. Whereas on a P2PL platform, the three participants are the lender, platform and borrower, on eBay, the three entities are the buyer, the seller and eBay the platform intermediary. However, unlike on P2PL platforms, during a given transaction, the relationship between the buyers and the sellers on eBay is more direct. eBay is not involved in either the selling or buying transaction and does not form part of the contractual relationship between the buyer and the seller. eBay's role purely consists of providing a platform for buyers and sellers to meet and contract with each other. eBay does not play the role of an introducer because the buyers and sellers are capable of finding themselves within the online marketplace. For buyers, eBay provides a service which consists mainly of making information uploaded by the sellers accessible and giving them the

⁶⁶⁴ *ibid.*

⁶⁶⁵ Anna Tims, 'If eBay's Customers Are Always Right, Who'll Protect Its Sellers?' (*the Guardian*, 11 July 2014) <<http://www.theguardian.com/money/2014/jul/11/ebay-buyer-complained-decide-against-seller>> accessed 21 May 2016.

⁶⁶⁶ *ibid.*

⁶⁶⁷ *ibid.*

means to purchase items or place bids on them.⁶⁶⁸ Likewise, for sellers, eBay only provides them with the tools they need to upload a description of the item for sale, determine the sale method and the tools they need to administer the bidding process and close the auction or immediate sale.⁶⁶⁹ eBay and other online auction sites like it, therefore do not participate in the transactions that occur in their marketplaces. Most of the control lies with the buyers and sellers.

The eBay participant that is closest in comparison to the P2P lender would be the seller, in cases where the seller is an individual and not a business. However, their roles are quite different. Although the eBay seller may be an individual and may be categorised as a prosumer or just a pure producer, they cannot be categorised as a transitional prosumer, because within a given transaction, their role and capacity stays the same, i.e. they always play the role of a seller and their position or capacity within a given contract of sale never depends on eBay's intermediation. The seller on eBay is either a producer (if a business) or a prosumer (if an individual). The same goes for the buyer within the eBay marketplace because in each transaction, their role always remains that of a buyer. For both, their relationship with eBay, can be considered to be that of a consumer-to-business relationship, for example, this relationship exists when a buyer or a seller complains to eBay for help resolving a dispute using the inbuilt ADR scheme, or when they seek eBay's help or services in relation to searching for or listing a particular product for sale. However, this aspect of their membership is separate from the transaction. This is not the case with online P2PL transactions. Consequently, like the isusu/rotary club member that has a direct peer-to-peer transactional relationship, eBay members cannot be considered as transitional prosumers.

This section has provided an example of a type of electronic commerce which operates under a presumption model and compared it with P2PL which also operates under a presumption model. The comparison demonstrates that despite these similarities, there are differences which distinguish P2PL even from models that are conceptually similar. Consequently, P2PL needs to be regulated differently. Although the internet offers many different types of online

⁶⁶⁸ Christine Riefa, "To Be or Not to Be an Auctioneer?" Some Thoughts on the Legal Nature of Online "eBay" Auctions and the Protection of Consumers' (2008) 31 J Consumer Policy 167, 184.

⁶⁶⁹ *ibid.*

marketplaces whose users interact in similar ways, the nature of the P2PL model endows its users with a unique characteristic, i.e. the ability to transition from one classification to another within a single transaction.

3.10 Conclusion

The aim of this chapter has been to determine the similarities and differences between online P2PL with similar forms of financial intermediation both on- and off-line. It demonstrates that despite some prima facie similarities, the underlying model of online P2PL is fundamentally different and suggests that regulation should not simply cut and paste methods used for other forms of regulation and apply them to P2PL. Rather, careful consideration is required to ensure that regulation is suitable to the prosumer-based underlying model.

The chapter started by placing online P2PL within financial intermediation. This is important for an industry that has often painted platforms as mere facilitators of P2PL contracts between borrowers and lenders, or the industry as a new form of disintermediation. This sets the scene for regulation of platforms in the context of their intermediary capacity, such as in Chapter Five which discusses the notion of gatekeeper liability. It also enables P2PL to be properly categorised and ensure suitable comparisons with other similar methods of finance. P2PL has been compared with a range of financial intermediation models reflecting traditional and online forms of lending and commerce. These comparisons demonstrate that P2PL is fundamentally different although it fits within the categorisation of financial intermediation. For example, the comparison between traditional banking lending with P2PLs in section 3.4 highlights that although P2PLs face similar lending risks, they are ultimately different because despite the prosuming activity of the lenders, they still retain consumer features at different stages of the lending process. Significantly, the comparison highlights the transitional nature of the P2PLs' role, which is also a key difference between P2PL and the prima facie similar business model of crowdfunding it is often been conflated with. In analysing the similarities and differences between P2PL, CUs and payday lending, it has been shown that P2PL differs from pre-existing consumptive forms of financial intermediation due to its prosumption model of business activity. P2PL platforms do not provide a direct peer-to-peer experience, because the platform's intermediation is much more involved in lending transactions as Chapter Five discusses in more detail.

Overall, the chapter develops further the argument in Chapter Two that P2PL does not fit within existing conceptions of 'consumer'. In addition to not fitting

within existing definitions or notions of consumer per se, the underlying model of P2PL is not in either the consumption or prosumption model of financial interaction.

4. Regulation of P2PL in the UK

4.1 Introduction

Chapter Three shows that the P2PL model differs fundamentally from existing forms of financial intermediation. The significance is that regulation should reflect the fact that P2PL is a unique way of engaging in financial transactions and regulate in a way appropriate to its form and users' characteristics. The purpose of this chapter is to determine the assumptions of financial services regulation, particularly in relation to online P2PL, by analysing relevant UK rules and the extent they distinguish P2PL from other forms of financial intermediation.

The chapter provides an overview of the literature on P2PL regulation and the UK government's regulatory approach. Section 4.2 analyses the consumer protection measures provided by the UK P2PL regime and Government's policy, highlighting the distinction between pre- and post-contractual consumer protection measures. Sections 4.3 and 4.4 respectively explain and critically analyse P2PL applicable regulation.

Existing academic discussions of the law and regulation relating to online P2PL has largely been based on the American situation. Andrew Verstein argues that the US Securities and Exchange Commission (SEC) have mis-regulated P2PL platforms by applying securities law to P2PL.⁶⁷⁰ The application of securities law to P2PL regulation makes it less safe, costlier for borrowers and lenders and therefore threatens its existence. Verstein argues this point looking at key cases in U.S. securities case law. He accuses the SEC of suffering from agency insensitivity, which means it is likely the SEC intervened in the regulation of P2PL to prevent potential risks that P2PL might one day pose, whilst ignoring the risks of its regulation which was not required since, Verstein argues, P2P loans arguably do not constitute securities. This type of insensitivity has led to the problem of SEC regulation trying to "fit new pegs into old holes" as it misunderstands the financial innovation of P2PL to apply old regulatory frameworks. The SEC securities regime is based on formalistic disclosure rather than addressing lender needs, and it focuses on investors at the expense of

⁶⁷⁰ Verstein (n 14) 478, 517–521.

borrowers. It also creates what he terms a 'cliff effect' where some regulated P2PL platforms are treated similarly to traditional public company issuers of securities facing high compliance burdens because they are issuers, when in reality they bear different risks to traditional public companies and have different needs, whereas relatively similar P2PL platforms can avoid all SEC regulation. So Verstein points out, securities regulation treats unlike things alike, and like things differently. Rather than the SEC, Verstein argues that the new Consumer Financial Protection Bureau (CFPB) would be better suited to police the P2PL environment, whilst allowing the industry to evolve and grow. This argument reflects the need for regulation to be proportionate, appropriately designed to suit the firm or industry it intends to regulate and does not create unnecessary barriers to business operation.

Brill provides a brief overview of how modern P2PL works, summarises the regulatory and legislative issues in the United States, including an overview of the securities regulation of P2PL and the potential impact of Dodd-Frank, and discusses the relationship between regulation and innovation with regards to P2PL.⁶⁷¹ As with most other treatments on the regulation of P2PL, Brill acknowledges the need for regulation but points out that the uniqueness and mutable nature of P2PL necessitates that regulation should not create barriers too high for innovators to enter the P2PL market thus stifling its development, e.g. the withdrawal of Zopa from the American market due to concerns of over stringent regulations. This suggests that traditional command-and-control regulation would not be an effective form of regulation of P2PL due to its supposed inflexibility and bureaucracy. Brill emphasises the need for regulation to minimise barriers imposed by the current American SEC regulation and to seek more efficient ways to ensure clear and adequate disclosure and transparency for investors. This reflects the idea that regulation should place a responsibility on the consumer for the protection of their own well-being. This view of regulation does not consider the consumer or investor protection goals of regulation. It places a higher priority on economic growth.

Chaffee and Rapp analyse the regulation of online P2PL.⁶⁷² Their paper provides a comprehensive outline of the structure of two US based online P2PL platforms

⁶⁷¹ Brill (n 1) 1.

⁶⁷² Chaffee and Rapp (n 28).

and the historical and contemporary context of this new form of social lending. They state that the only thing new about P2PL is its online nature as non-institutional lending has long been a part of economic activity around the world.⁶⁷³ Like Magee and Verstein, Chaffee and Rapp analyse the regulatory regime for P2PL in the USA.⁶⁷⁴ They look at both US federal and state law and undergo a doctrinal study of case law to determine whether P2PL fits within the definition of a security as defined by the law, and should therefore be regulated as a security, an idea they agree with.

Unlike Verstein, Chaffee and Rapp argue that regulation of this emerging industry is necessary, as under-regulated financial services industries tend to grow rapidly until they suffer a dramatic crash. Ultimately Chaffee and Rapp argue that for regulation not to stifle the growth of P2PL as it continues to grow and change, regulation should be organic and it should make use of multiple regulators who will use their individual expertise from regulating traditional lending and securities investments, to regulate P2PL in a way that can evolve along with it.

Chaffee and Rapp's analysis of the regulation of P2PL is largely doctrinal in nature. It looks at what the law of securities is and tries to fit P2PL within its existing boundaries. Although they do not engage in a discussion about enforced self-regulation, their suggestion of an organic regulatory system, is akin to the one adopted by responsive regulatory theories, such as Ayres and Braithwaite's enforcement pyramids. Their analysis does not deeply engage in a comparison between P2PL and similar institutions which existed before it and how this may impact the regulation of P2PL and what form the regulation of P2PL should take. Doing so might provide insight into the most appropriate form and content of P2PL regulation, based on the type of individuals using and developing the market itself. In their analysis, they did not consider in detail the underlying person-to-person model on which P2PL is based and what effect this may have on the operation, risks or benefits of P2PL and therefore its regulation. This is important to consider so that regulation fits appropriately to online P2PL lending.

Jack Magee analyses the future of P2PL under the Dodd-Frank Wall Street Reform and Consumer Protection Act. He finds similarities between P2PL and

⁶⁷³ *ibid.*, 495.

⁶⁷⁴ *ibid.*.

microfinance.⁶⁷⁵ He states that for the new industry of P2PL lending to grow and survive in the US market, the existing regulatory scheme needs to be significantly changed, suggesting that the expensive registration requirements imposed on P2PLs should be reduced so that costs may be reduced to reasonable levels. He also argues that whilst regulation is necessary, it should be no more than is necessary to maintain consumer confidence in the P2PL industry. Magee's examination of the P2PL environment focuses wholly on the domestic regulatory situation in the US. It therefore does not consider the possibility of international regulation of P2PL

Therefore, this thesis has taken these matters into consideration to analyse whether existing regulation is adequate from the perspective of P2PL users and the online operation of P2PL models.

However, the UK government has adopted a different approach. Unlike in the United States, the UK government has treated P2P loans as a form of consumer credit. Consumer credit regulation was transferred from the Office of Fair Trading to the Financial Conduct Authority in April 2014.⁶⁷⁶ In the design of the new regulatory regime, the UK government strove to strike a balance between providing robust consumer protection and ensuring the regulations were proportionate to the types of firms regulated and the risks they posed.⁶⁷⁷ These two goals are made clear in the joint HM Treasury and Department for Business Innovation and Skills consultation paper on the future of consumer credit regulation. In the paper, the consumer protection goal is set out in terms of the Government's vision of a "well-functioning" consumer credit market which is one where firms meet the standards expected of them, lend responsibly and offer competitively designed and priced products that meet consumers' needs.⁶⁷⁸ The second goal of proportionality underlies the second part of the Government's

⁶⁷⁵ Magee(n 4) 140; see Krueger (n 4).

⁶⁷⁶ Tracey McDermott, 'Consumer Credit Regulation: The Journey so Far - Financial Conduct Authority' (8 April 2016) <<http://www.fca.org.uk/news/consumer-credit-regulation-the-journey-so-far>> accessed 10 July 2016; 'A New Approach to Financial Regulation: Transferring Consumer Credit Regulation to the Financial Conduct Authority' (HM Treasury and Department for Business Innovation & Skills 2013) <<https://www.gov.uk/government/consultations/a-new-approach-to-financial-regulation-transferring-consumer-credit-regulation-to-the-financial-conduct-authority>> accessed 7 January 2014.

⁶⁷⁷ 'A New Approach to Financial Regulation: Transferring Consumer Credit Regulation to the Financial Conduct Authority' (n 694) 3, 7.

⁶⁷⁸ *ibid* 3.

vision which is ensuring that regulation supports and does not stifle a market's ability to grow and innovate.⁶⁷⁹

The third part of the Government's vision hints at the way it aimed to balance these two goals. The consultation paper states that the Government envisions consumers being able to "*borrow sensibly, able to exercise choice and having confidence in the system...*" By referring to the idea of sensible borrowing, the Government indicates that part of its policy is to make consumers more responsible for their own affairs and actions. This is linked to their ability to exercise choice, which in consumer protection regulation tends to rely on the provision of information to the consumer, this aspect will be discussed in more detail later in this chapter. The aim of having confidence in the system reflects the Government's focus on prudential requirements to ensure the stability of the market, such as a firm's ability to meet its liabilities as they fall due, to avoid failure of the firm or industry. These three aspects suggest that the Government aims to balance the two seemingly opposed goals of consumer protection and proportionality by creating a situation where the basic standard of a regulated industry is where the status quo is an industry which is stable and well-functioning, and where the average consumer can act responsibly within that environment, therefore rendering the consumer capable of making good decisions for themselves. As shall be seen later in the chapter, these methods are seen in the P2PL regulatory environment in the Government's focus on platform stability, the absence of last-resort compensation for consumers e.g. recourse to the Financial Services Compensation Scheme (FSCS) and the emphasis on the provision of clear information for the consumer.

In a different Consultation Paper, on the future regulation of P2PL, it was confirmed that many of the current requirements under the Consumer Credit Act 1974 (CCA), do not apply to credit agreements made via P2P platforms if they are not made by the lender in the course of a business - such loans are considered 'non-commercial' for the purposes of the CCA.⁶⁸⁰ S.189 of the CCA defines a 'non-commercial agreement' as a consumer agreement which the creditor or owner does not make in the course of a business carried out by the

⁶⁷⁹ *ibid.*

⁶⁸⁰ *ibid* 34.

creditor.⁶⁸¹ This applies to P2PL agreements because the lenders are individuals who lend for personal gain rather than on behalf of a business or trade.

The meaning of 'in the course of a business' was considered in the case of *Bassano* where Popplewell J said that a transaction can be said to be carried out in the course of a business if it occurs with some degree of regularity such that it forms part of the normal practice of the business.⁶⁸² Similarly, in the case of *Davis*, Lord Keith stated that in the context of an Act that is primarily concerned with consumer protection, the expression 'in the course of a trade or business' "conveys the concept of some degree of regularity".⁶⁸³ What is meant by 'regularity' was expanded on in *Hare*, in which case the Court held that if the transaction between the parties was a "one off" or "of a type only occasionally entered into by the applicant in the course of...business" it is not a transaction made in the course of business.⁶⁸⁴ In addition, in *Tamimi* the Court of Appeal set out a list of characteristics indicative of there being a business and a list which was indicative that there was no business. For example, indications of a business are the frequency, period, size and profit involved in the loans. In most of these cases mentioned, 'frequency' was interpreted as meaning the amount of loans lent out (to the debtor). For example, in *Re Payne*, it was established that the claimant, a property developer, owed several loans to the debtors who he knew personally. On the other hand, indications that a transaction was not carried out in the course of a business included that (1) they were made to only one person, (2) they were ad hoc, (3) they were to foster goodwill, (4) they would not have been made to anybody with whom the creditor was acquainted, (5) they were not recorded in writing, (6) they had no security, and that (7) the creditor had no business premises.⁶⁸⁵

The type of agreements formed between P2PLs and borrowers fits several the indications that a transaction was not carried out in the course of a business. Namely, (1), (4), (6) and (7). Although P2PLs lend to multiple borrowers because their funds are spread across multiple borrowers in small units, they have a single credit agreement with each borrower that their unit of funds was lent to. In relation

⁶⁸¹ The Consumer Credit Act 1974 c. 39, s 189.

⁶⁸² *Bassano v Toft* [2014] EWHC 377 (QB) [32].

⁶⁸³ *Davies v Sumner* [1984] 1 WLR 1301 (HL) 1375.

⁶⁸⁴ *Hare v Shurek* [1993] CCLR.

⁶⁸⁵ *Tamimi v Khodari* [2009] EWCA Civ [36]-[37].

to (4) this indication is met by the fact that in online P2PL, loan agreements are made between strangers rather than friends or family. (6) and (7) are also indications met by P2PLs because they loans are unsecured and the fact that P2PL is conducted purely online, means that the lenders do not operate the lending transactions from a physical building used for business premises. Therefore, prior to the introduction of regulation specific to P2PL, the lending transactions would have been non-commercial loans.

The overall effect of this is that the borrowers would not be afforded certain protections under the CCA when they borrow through P2PL platforms.⁶⁸⁶ E.g. part five of the CCA provides rights to the borrower such as the right to withdraw from the agreement without giving any reason and without incurring additional charges or being held liable to compensate the lender for the withdrawal;⁶⁸⁷ the right implied under s.77 which imposes a duty on the creditor to give information to the debtor under a fixed-sum agreement, i.e. a copy of the executed agreement and a statement showing how much has been paid and how much remains to be paid;⁶⁸⁸ and, the requirement of the creditor to give notice to the debtor before varying the terms of the agreement.⁶⁸⁹ However under s.74(1)(a), the provisions in Part Five do not apply to non-commercial agreements, and under s.82(7) the provisions in s.82 which include the requirement for notice before varying the terms is also excluded for non-commercial agreements. This means that prior to the introduction of the new regulation of P2PL in April 2014, P2PBs did not benefit from these rights.

Additionally, if the credit is provided to a business borrower which is a company, it also falls outside the scope of the CCA.⁶⁹⁰ The Consultation Paper stated that a new regulated activity would be created which covers what P2PL platforms do when they arrange credit agreements between borrowers and lenders and which aims to provide protection for both lenders and borrowers taking into consideration the actual benefit to consumers of such protections.⁶⁹¹

⁶⁸⁶ 'A New Approach to Financial Regulation: Transferring Consumer Credit Regulation to the Financial Conduct Authority' (n 694) 34.

⁶⁸⁷ The Consumer Credit Act 1974 c. 39, s 66A(1).

⁶⁸⁸ The Consumer Credit Act 1974 c. 39, s 77(1).

⁶⁸⁹ The Consumer Credit Act 1974 c. 39, s 82.

⁶⁹⁰ 'A New Approach to Financial Regulation: Transferring Consumer Credit Regulation to the Financial Conduct Authority' (n 694) 34.

⁶⁹¹ *ibid* 13, 34.

Benston reviews regulations imposed to protect consumers of banking, securities and insurance considering the UK Financial Services Authority regulatory goals. He identifies six regulatory goals within these markets: the maintenance of consumer confidence in the financial system; to ensure that a supplier that consumers rely on does not fail; to assure consumers receive sufficient information to make good decisions and are dealt with fairly; to assure fair pricing; protect consumers from fraud and misrepresentation and to prevent undesirable discrimination against individuals.⁶⁹²

He finds that capital regulation is a useful regulatory technique to achieve the second goal of preventing the failure of a supplier, but with regards to the other goals, regulations specific to financial services are not necessary or desirable.⁶⁹³ For example, he argues that financial services providers have strong incentives to provide their customers with useful information, and there is no reason to think that government agencies can provide better information than they can.⁶⁹⁴ Similarly, he argues that protecting consumers from fraud and misrepresentation is a valid regulatory goal, but because financial institutions and instruments are less subject to these concerns than other types of firms and products, there is no justification for specifically regulating financial services providers.⁶⁹⁵

Micklitz documents the change caused by EU law in Germany, from the consumer protection law paradigm to the consumer law paradigm. He argues that when the European Union took over consumer legislation it gradually changed the approach from consumer protection law to consumer law. So the emphasis is no longer on protection of the weakest consumer, but the average consumer, which increasingly resembles a private small business rather than “the small man” on the street’.⁶⁹⁶ However, he points out that the shift in paradigm does not negate the need for legal rules which protect the weakest in society.⁶⁹⁷

⁶⁹² George J Benston, ‘Consumer Protection as Justification for Regulating Financial-Services Firms and Products’ (2000) 17 *Journal of Financial Services Research* 277, 279.

⁶⁹³ George J Benston, ‘Consumer Protection as Justification for Regulating Financial-Services Firms and Products’ (2000) 17 *J Financ Serv Res* 277, 277

⁶⁹⁴ Benston (n 710) 297.

⁶⁹⁵ *ibid.*

⁶⁹⁶ Micklitz, ‘The Expulsion of the Concept of Protection from the Consumer Law and the Return of Social Elements in the Civil Law’ (n 317) 285.

⁶⁹⁷ *ibid* 283; see section 2.6 for a more detailed discussion of Micklitz argument.

Enchelmaier considers consumer protection from the perspective of article 59 of the EC Treaty, freedom to provide services.⁶⁹⁸ Article 59 precludes the application of any national legislation which without objective justification impedes a provider of services from exercising that freedom. Enchelmaier notes that this broad meaning does not affect the question of the relationship between freedom to provide services and restrictions imposed on this freedom in the name of consumer protection.⁶⁹⁹

Roman Inderst focuses on the disclosure of conflicts of interest, particularly of commissions and ‘kickbacks’ that financial intermediaries or advisers receive which is a requirement of MiFID.⁷⁰⁰ MiFID is The Markets in Financial Instruments Directive 2004 which provides harmonised regulation for investment services amongst EU member states and provided various investor protection measures.⁷⁰¹ Inderst argues that competition is the best way to protect consumers, calling it an “ally” of consumers.⁷⁰² In answer to the theory of banking which argues that more competition leads to increased risk-taking and higher default risk ultimately leading to situations like the 2008 financial crisis, Inderst argues that recent research demonstrates that this is not always the case either theoretically or empirically.⁷⁰³ Inderst also lays the blame on policy and supervision stating that regulation and government intervention either created situations which could be exploited or supervision did not react flexibly.⁷⁰⁴ Inderst also argues that competition is a key to generating innovations and financial innovation will arguably address agency concerns, information asymmetries,

⁶⁹⁸ Stefan Enchelmaier, ‘Freedom to Provide Services and Consumer Protection’ (2002) 3 ERA Forum 164, 164.

⁶⁹⁹ *ibid.*

⁷⁰⁰ Inderst (n 333) 455, 456.

⁷⁰¹ Council Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (The Markets in Financial Instruments Directive) [2004] OJ L145/1.

⁷⁰² Inderst (n 333) 461.

⁷⁰³ *ibid* 462; see also Hasan Doluca, Roman Inderst and Ufuk Otag, ‘Bank Competition and Risk-Taking When Borrowers Care about Financial Prudence’ <http://mail.wiwi.uni-frankfurt.de/Professoren/inderst/Finance/banking_competition_mai09.pdf> accessed 10 December 2013; Gianni De Nicoló and Abu M Jalal, *Bank Risk-Taking and Competition Revisited: New Theory and New Evidence* (International Monetary Fund 2006) <[http://books.google.co.uk/books?hl=en&lr=&id=MTrVWwTSMloC&oi=fnd&pg=PA3&dq=J.+H.+Boyd,+G.+De+Nicolo+and+A.M.+Jalal,+Bank+Risk-Taking+and+Competition+Revisited:+New+Theory+and+New+Evidence,+IMF+Working+Paper+06/297+\(2006\)&ots=6oiFOhuNqo&sig=NBZxvmidwiHQZqdPU86GBqNvYY0](http://books.google.co.uk/books?hl=en&lr=&id=MTrVWwTSMloC&oi=fnd&pg=PA3&dq=J.+H.+Boyd,+G.+De+Nicolo+and+A.M.+Jalal,+Bank+Risk-Taking+and+Competition+Revisited:+New+Theory+and+New+Evidence,+IMF+Working+Paper+06/297+(2006)&ots=6oiFOhuNqo&sig=NBZxvmidwiHQZqdPU86GBqNvYY0)> accessed 10 December 2013.

⁷⁰⁴ Inderst (n 333) 462.

reduce transaction costs, respond to new risk factors or technological developments and complete the market.⁷⁰⁵ Inderst concludes that consumer protection policy must be based on sound economic policy with competition seen as a key feature of consumer protection and this would entail rules limiting the opportunistic behaviour of firms whether through policy intervention or industry self-regulation.⁷⁰⁶

4.2 Consumer Protection Regulation

Quite commendably the FCA's regulatory approach to the regulation of P2PL does incorporate a number of consumer protections. This demonstrates the FCA's recognition of the fact that P2PL users are individuals transacting outside the course of business and who are in need of protection. On the pre-contractual side of the transactions, the protections are largely disclosure-based, whilst post-contractual protections include prudential requirements, client money rules and recourse to the Financial Ombudsman Service. Respectively, these protections involve provisions that are designed to ensure the stability of the P2PL platform e.g. by ensuring that the platform sets aside sufficient funds to run efficiently; to protect the lenders' money in cases of platform failure and prevent fraudulent activity by ensuring that the platform keeps its own funds separate from the funds provided by the lenders. In addition, recourse to the Financial Ombudsman Service reflects the desire to hold give the borrowers and lenders the ability to hold platforms accountable for their actions towards them.

The consumer protection elements of the regulatory regime adopted by the FCA is chiefly based on disclosure as a means of ensuring that the lenders have the information they need to make informed investment decisions and that this information is fair, clear and not misleading.⁷⁰⁷ However, the use of disclosure as a regulatory tool has been the subject of much debate. On one hand, if lenders cannot be sure that the information regarding their investments are true, they will

⁷⁰⁵ *ibid.*

⁷⁰⁶ *ibid* 463–264.

⁷⁰⁷ Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (Policy Statement, PS14/4) 30.

not have faith in the market, and if that is the case, they may decide that lending on P2PL platforms is not worth the risk. This may be bad for the economy because the P2PL industry contributes to its growth and efficiency since it enables the transfer of resources from those with excess resources, the lenders-savers, to those who have less resources yet are better able to put those resources to good use. The underlying rationale of disclosure-based rules is that investors can be considered to be fully protected so long as all the relevant aspects of the market they operate in are fully and fairly disclosed to them.⁷⁰⁸ This is because they would then be able to evaluate the merits of the investment and protect themselves against poor ones.⁷⁰⁹

Proponents of mandatory disclosure point to its many benefits. A few examples consist of the ability of disclosure to prevent information underproduction by the market which would exacerbate information asymmetries because information would not be optimally verified and not enough effort would be made to search for material information by the investor.⁷¹⁰ In addition, wide availability of information is thought to result in more efficient pricing of investments because with information, investors can judge the value of the investment more accurately. As such, the underproduction of information leads to a less efficient market and mispricing of financial assets, and a corresponding misallocation of resources. Thirdly, mandatory disclosure will standardise the information disclosed in the financial market, which would aid comparability of the information that investors need to read to make their investment decisions. This relates to its function as a method of balancing information asymmetries between the borrower/platform and the lender. However, although these arguments point to the worth of information disclosure, they do not necessarily lead to the conclusion that information disclosure is sufficient regulation by itself. This point has been supported academics like Schwarcz who has argued that in a world of complexity, disclosure alone is insufficient to tackle the information asymmetries that they are designed to mitigate.⁷¹¹

⁷⁰⁸ Steven L Schwarcz, 'Rethinking the Disclosure Paradigm in a World of Complexity' (2004) 2004 University of Illinois L Rev 1, 11.

⁷⁰⁹ *ibid* 12.

⁷¹⁰ John C Coffee, 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 Virginia Law Review 717, 722.

⁷¹¹ Schwarcz (n 726) 11–17.

In addition to the regulatory regime being largely based on disclosure, the FCA adopts a principles-based approach to regulation which has meant that it does not prescribe specific disclosures nor their form and content. Rather it is left to the platforms themselves to identify any investment risks which arise as a result of their own business models.⁷¹² For example, the credit risks faced by lenders using Zopa and Bondora by iseParkur, P2PL platforms which offer lenders the opportunity to fund borrowers on an unsecured basis, are slightly different from the risks faced by lenders who use the P2PL platform Unbolted where the borrowers borrow against collateral because collateral provides the latter with extra security and protection against loss.

The regulation also leaves it to the platforms to figure out what information is needed by their customers to make informed decisions⁷¹³ about their lending or borrowing choices, for example which lending or borrowing options they are going to choose, how much to lend and borrow based on the information provided and from the perspective of the lenders what class of borrower to lend to, based on the credit valuation provided by the platform. This approach is self-regulatory because it allows the platforms to determine what amounts to a risk and to take steps to mitigate the risk through their own efforts. It is indicative of the idea that the regulated party is better aware or has more knowledge about its business operations than a regulator does.

On one hand, it is good that platforms are made responsible for identifying the risks inherent in their business model as it reduces regulatory costs, ensures that the platforms are engaged in the regulatory process and if done correctly, may ensure that protections are tailored to the operations of a particular platform. However, there is a risk that this method of enforced self-regulation, i.e. regulation which gives corporate officials partial responsibility for setting their own standards and establishing internal units to monitor compliance with those standards and

⁷¹² Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (Policy Statement, PS14/4) 31.

⁷¹³ *ibid* 31.

holding the monitors of these standards liable for their failure,⁷¹⁴ can lead to a lack of uniform information amongst platforms, which can affect lenders' ability to compare the risks of various platforms when choosing which platform to invest on. This in turn would compound the problems faced by lenders in terms of information asymmetries and may lead to confusion. In addition, although it is a flexible approach that takes into consideration the fact that different platforms might vary in the risks that they pose to lenders and borrowers, it leaves open the possibility that a platform might not take into account all the risks faced by the lenders and borrowers either intentionally or not.

The FCA stated that this approach is meant to reflect the fact that mandatory specific disclosures are not appropriate in situations where business models within an industry vary.⁷¹⁵ This approach is logical because it reflects the need for regulation to suit the firm or industry it intends to regulate. Where firms within an industry vary, a one-size-fits-all approach may cause firms confusion about how they should do it. It might also raise unnecessary barriers to business operations for some firms within an industry because the regulatory requirements might be too restrictive or unsuited to how their business works, whilst at the same time it might be suitable for other firms within the same industry, therefore creating an unfair business advantage. Verstein made a similar point in his argument that the US Securities and Exchange Commission (SEC) had mis-regulated P2PL platforms by applying securities law to P2PL. He argued that P2P loans could not be classified as securities, so by regulating them as such, the SEC was trying to "fit new pegs into old holes" as it misunderstood the financial innovation of P2PL in order to apply old regulatory frameworks to new phenomenon. The effect of which is to make P2PL costlier for borrowers and lenders and threaten the viability of the industry because of the unnecessary barriers to operation created.⁷¹⁶ The same can be said in terms of regulation which suits some firms within an industry but not others because it forces the unsuited firms into a wrongly shaped box.

⁷¹⁴ John Mendeloff, 'Overcoming Barriers to Better Regulation' (1993) 18 L & Soc'l Inquiry 711, 712.

⁷¹⁵ Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (n 612) 31.

⁷¹⁶ Verstein (n 14).

Having identified the risks found within their platform and the information the platform organisers consider to be relevant to their users, the platforms must then disclose appropriate and accurate information to them.⁷¹⁷ The rationale behind this is that in the P2PL industry business models vary⁷¹⁸ and the underlying assumption is that each platform will be in a better position than the regulator to know the risks involved in their operations and the needs of their customers. So in the interest of balancing regulatory costs and benefits the FCA has essentially left the platforms to self-regulate their disclosures.⁷¹⁹

The approach exhibited here and in the P2PL regulatory regime in general is based on the 'Better Regulation' policy of the UK government. This is an initiative of the government to ensure the improvement of regulation through the reduction of the regulatory burden on businesses. The way this is being done is by ensuring that regulation is simplified, effective, and absolutely necessary through a number of principles which aim to guide regulators in the design of law and regulation by telling them 'how' the regulation should regulate.⁷²⁰ The five principles of good regulation are 'proportionality', which is the idea that regulators should only intervene when necessary and remedies should be appropriate to the risk posed; 'accountability', which is that regulators should be able to justify their decisions and be made subject to public inquiry; 'consistency' which is the idea that rules and standards must be connected, taking into account existing or proposed regulation and also be implemented fairly. The fourth principle is 'transparency' which requires regulators to be open and simply regulations for ease of use. The final principle is 'targeting' which is that regulation should be focused on the problem and minimise side effects through the adoption of a goals-based approach where possible.⁷²¹

The overall aim of the policy approach is to ensure the existence of a regulatory framework that is conducive to the success of businesses. The better regulation agenda concerns balancing the need to regulate businesses with the need to

⁷¹⁷ Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (n 612) 31.

⁷¹⁸ *ibid* 31.

⁷¹⁹ *ibid* 15.

⁷²⁰ Anne Meuwese and Patricia Popelier, 'Legal Implications of Better Regulation: A Special Issue' (2011) 17 *Eur Public L* 455, 455.

⁷²¹ 'Principles of Good Regulation' (Better Regulation Task Force 2003) 4–6.

reduce the costs of legislation. Underscoring the policy is the idea that it is essential that there is regulation which protects consumers, but it needs to be balanced with the desire or need to avoid hindering business growth or economic prosperity. This is because regulation creates costs for businesses, particularly small businesses. One implication of this policy is the need for regulation to strike a balance between the right conditions for businesses to start up, invest and grow and the rights of consumers. A second implication is that the better regulation agenda attempts to understand and take account of the impact of businesses in order to create an improved business environment. However, this might mean that a greater focus is placed in favour of businesses. A lot of consideration is placed on the opinions of businesses e.g. what they feel would improve regulation. This might dampen the effect of regulation if it is intended to protect consumers. An example of this is the already mentioned FCA's self-regulatory approach to allowing P2PL platforms to determine what counts as a risk for the individuals using their platforms and choosing what information is required to counteract any negative effects of the risk.

It is possible that the reason why the FCA considers the variations between firms to be significant enough to justify excluding the possibility of specific disclosure rules, is because it has conflated P2PL with crowdfunding. Therefore, creating the perception that P2PL firms are more varied than they really are. As the earlier case studies on P2PL firms in the UK demonstrates, most platforms work in the same way with a few different qualities designed to increase their competitiveness. To take from the earlier example, lenders and borrowers on Zopa, Bondora by iseParkur and Unbolted, carry out the same functions, behaviours and exhibit similar levels of reliance on the platforms for the administration of their loans. However, Unbolted has provided the added advantage of collateral-backed loans. This advantage is provided to distinguish itself from other platforms and attract lenders to its services. Although it provides its lenders with increased protection in the case of borrower default, the lenders still face the risk that the platform has control over the valuation of the collateral and may either not value the collateral correctly or may not select an appropriate valuation agency.

However, the competitive differences promoted by different platforms do not change the fact that P2PL platforms are conceptually the same, i.e. they operate on a presumption model of lender-to-consumer transactions. Therefore, focusing on face-value differences results in an inaccurate conceptualisation of P2PL which is broader than necessary due to its inclusion of crowdfunding platforms. This in turn leads to regulatory choices which might not benefit P2P users in the long-run such as the FCA's decision to let platform's self-regulate their information disclosure. In doing so, the FCA has affected little change from the pre-regulation period of P2PL where platforms already provided their users with information.

Regulators in general seem to select disclosure as their default method for tackling consumer protection concerns.⁷²² The basis for this centres on the idea that one of the main causes of market failure is when significant differences in information endowments exist between market participants and accurate disclosures can resolve this market inefficiency by restoring the information balance, thus enabling consumers make better informed choices.⁷²³ However, in practice disclosure alone cannot provide adequate consumer protections because whilst it might lead to an improvement in the quality and extent of information consumers can rely on, it has little bearing on the ability of consumers to comprehend the information provided.⁷²⁴ It would not be fair to consumers to impose the responsibility of making sound choices based on the information provided without incorporating an element of financial education to improve their comprehension of the information provided. To do otherwise might limit access to the P2PL market to members who already have a high degree of financial acumen as is currently the case in the peer-to-business (P2B) lending market in Funding Circle. Therefore, disclosure regulation may need to be coupled with financial education by ensuring that platforms play a part in the education of their customers about financial risks and what this means for them and their investments and not just disclosing information to them.

⁷²² Stephen Lumpkin, 'Consumer Protection and Financial Innovation' (2010) 2010 OECD Journal: Financial Market Trends 117, 122.

⁷²³ *ibid.*

⁷²⁴ *ibid* 134.

However, disclosure and financial education alone is not sufficient to protect the P2P lender from the potential problems that can occur during the lifespan of a P2P loan. No matter how much information is provided to a lender there will always be elements that cannot be foretold at the time the loan contract is entered into, such as the risk of a borrower's default, inflation risk and the possibility of the platform itself failing.⁷²⁵ One could argue that as the amounts lent by one P2P lender to one P2P borrower only constitutes a small fraction of the principal loan borrowed as it is made up of funds sourced from numerous lenders, the risk and loss borne by that lender in the event that the borrower defaults or fails to pay is not significant enough to warrant more interventionist post-contractual protections.

However, this does not preclude the fact that P2PLs and borrowers are part of a wider society and can be affected by what happens in the external financial economy. For example, the subprime mortgage crisis of 2007-10 was caused by the expansion of mortgage credit to include borrowers with average credit histories who would normally have found it difficult to obtain a mortgage. However, in the mid-2000s mortgage lenders started to make such high-risk mortgages available by repackaging high-risk mortgages into pools which were sold to investors to fund the mortgages. This led to an increase in demand for housing and an increase in property prices. For a while, these increases were sufficient buffer to cover the costs of loan defaults by the high-risk borrowers, because if a borrower was not able to make their loan repayments, they were able to either refinance the mortgage or sell the property at a gain and use the proceeds to repay their mortgages. However, when house prices peaked and started to fall, these options were no longer available to them and it led to rising mortgage loss rates for the mortgage lenders and the investors who bought their risky, repackaged mortgage loans (private label mortgage-backed securities (PMBS). Several PMBS were downgraded to low credit ratings and many mortgage lenders closed leading to the collapse of the sub-prime mortgage market.⁷²⁶ This in turn led to loss of investor confidence in the subprime mortgage

⁷²⁵ *ibid* 124.

⁷²⁶ John V Duca, 'Subprime Mortgage Crisis - A Detailed Essay on an Important Event in the History of the Federal Reserve.' (*Federal Reserve History*, 22 November 2013) <<http://www.federalreservehistory.org/Events/DetailView/55>> accessed 11 July 2016.

sector and caused a liquidity crisis. By September 2008, the crisis had impacted stock markets around the world which crashed.

The financial crisis of 2007/8 demonstrates that the financial problems of individuals are interlinked with crisis in the entire financial sector and financial stability. The crisis impacted ordinary people which permeated their lives; some people lost their jobs, businesses and homes and found it difficult to pay household bills and existing debts. It is therefore not hard to conclude that should the P2PL market continue to grow into a major source of finance for individuals and businesses, it too can become exposed to such crises through its connection with individuals living and experiencing real world issues within the wider financial sector and which can affect the ability of large amounts of borrowers to be able to repay their P2P loans.

The FCA regulations do go some way to protecting lenders from adverse situations following the formation of the P2P loan contract. For example, loan-based P2PL platforms will be expected to take reasonable steps to have arrangements in place to ensure the continued management and administration of P2P loan agreements in the event that the platform fails or ceases to carry on the regulated activity.⁷²⁷ This rule removes uncertainty on the part of lenders and removes the cost burden on them of having to recuperate loan payments from unidentifiable borrowers. However, the FCA will not prescribe what form of arrangements platforms must introduce, instead it is left up to the different platforms to design processes which are suitable to their business model.⁷²⁸ The lack of uniform standards is done in the interests of balancing regulatory costs and benefits.⁷²⁹ However, it leaves it open to debate what is meant by an appropriate arrangement and gives rise to questions concerning how regulators will decide whether an arrangement was appropriate. Whilst it does allow for a more tailored procedure by leaving it to the subjective decisions of each platform according to their business models, it could lead to more work for regulators in the long term, because should the third party loan administrator also fail the issue

⁷²⁷ Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (n 612) 28.

⁷²⁸ *ibid* 28.

⁷²⁹ *ibid*.

of whether the procedure was appropriate would arise and it would have to be dealt with by regulators on a firm-by-firm basis. However, by this time, it might be too late for the P2PLs because they would have already lost their capital, unless platform is bailed out to prevent its failure. This happened to Funding Knight who went into administration amidst fears that about 900 lenders using its platform would not be able to get back their invested funds. But the platform was rescued by an investment firm called GLI Finance.⁷³⁰

Additionally, the FCA has not specified what should happen if the arrangements fail to work, culpability for the failure of the arrangements and more importantly what recourse lenders can rely on if it does not. Rather, platforms are to rely on disclosure methods to clearly warn lenders of the risks involved and that even these safeguarding measures may not work as expected,⁷³¹ because P2PL increasingly attracts more retail investors who are less knowledgeable and less experienced than sophisticated investors⁷³² and therefore may not be able to use the information effectively. So potential lenders are expected to take these factors into consideration or at least be aware of them when deciding to lend on a particular platform. The implication is that the lenders themselves will bear the ultimate risk of failure.

This situation is compounded by the fact that under the new rules, lenders in loan-based P2PL will still have no recourse to the FSCS for the monies already lent to borrowers should the platform fail⁷³³ or borrowers default on their payments. This will not include un-lent funds which the platforms hold in a bank account as these would be within the remit of the FSCS due to the use of a bank account. As of 1 January 2016, the FSCS guarantees savings of up to a total of £75,000 and consumers who deposit their savings with a bank would usually qualify for FSCS

⁷³⁰ Tara Evans, 'If Funding Knight went bust how safe is peer-to-peer lending?' *The Telegraph* (London, 7 July 2016) < <https://uk.finance.yahoo.com/news/funding-knight-went-bust-safe-093918887.html> > accessed 9 July 2016.

⁷³¹ Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (n 612) 28.

⁷³² Naomi Rovnik, 'FCA to probe peer-to-peer lending sector' *Financial Times* (London, 9 July 2016) 17.

⁷³³ Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (n 612) 17.

protection against default⁷³⁴. In coming to this decision, the FCA has stated that it took into account the amount of loss lenders might suffer if a platform fails and the amount that would be covered by the FSCS should they be brought into FSCS remit.⁷³⁵ In doing so, the FCA has applied the principle of proportionality by weighing up the benefits of cover against the regulatory costs that would be imposed on platforms should they be brought within the FSCS' remit. However, this again reflects the FCA's preference of focusing on encouraging the growth and innovation of an industry above interventionist approaches to consumer protection such as regulation that foresees potential problems rather than just on the basis of current risks levels.

Some platforms may choose to provide a similar safety net. For example, Zopa introduced a 'safeguard fund' in April 2013 which is held in trust by P2PS Limited and would intervene to repay a loan plus interest in the event that a borrower misses four loan payments and defaults. However, not all platforms have this type of fund and even if they did, there is no guarantee that such funds would not run out. Therefore, to ensure a consistent approach and to encourage lender investment within the market, the FSCS may need to be applied to P2PL.

4.2.1 Government policy

Government policy towards both the earlier discussed CUs and P2PL has focused on the benefits or contributions each industry may make to the reduction of social and financial exclusion. However, the extent of this focus is not as strong with regards to P2PL in light of the fact that it is a fledgling industry.

A review of government reports relating to CUs over the last twenty years shows that successive governments have focused on the social potential of CUs. Government policy thus far has been to view CUs as the answer to financial and

⁷³⁴ FSCS, 'New Deposit Protection Limit Coming on 1 January' (3 July 2015) <<http://www.fscs.org.uk/news/2015/july/new-deposit-protection-limit-coming-on-1-january/>> accessed 12 July 2016.

⁷³⁵ Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (n 612) 17.

social exclusion on a local level,⁷³⁶ community regeneration, small firm and self-employment support and as a way to undo the high cost of the credit sector.⁷³⁷ This can be seen from reports by the HM Treasury Credit Union Task Force in 1999 and coalition government initiatives such as the credit union expansion project.

HM Treasury Credit Union Taskforce

Although the Credit Union Taskforce was set up to look at ways of developing the credit union movement, the report explicitly tied the development of CUs with its potential use to reduce or eliminate financial exclusion. The aims laid out in the report were “*to explore ways in which banks and building societies can work more closely with credit unions (CUs) to increase their effectiveness; look at ways to widen the range of services that are provided to CU customers; and encourage the continued expansion of the movement.*”⁷³⁸

On the face of it, these aims were not overtly connected with the theme of financial exclusion and by themselves could engender the government’s desire to simply support the growth of a financial industry. However, the first aim begs the question: effectiveness in or doing what? Whereas the latter two aims beg the question of why? Why should the range of services provided to credit union customers be increased and why should the government take a positive interest in developing the industry? Highlighting these underlying questions result in little surprise that the report ties these aims with the end of reducing financial exclusion, a key concern for the government even now. For example, after considering the development of CUs in the UK and the objects of these institutions as set out in the Credit Union Act 1979, the report goes on to highlight three reasons why CUs help fight financial exclusion:

- They are open to people who fall into low income brackets;
- They encourage their members to be self-reliant and inculcate an understanding of the virtues of thrift;

⁷³⁶ Nicholas Ryder, ‘Banking on Credit Unions in the New Millennium?’ [2001] *Insolvency Lawyer* 164, 164.

⁷³⁷ Timothy Edmonds (n 537) 4.

⁷³⁸ HM Treasury Taskforce, ‘Credit Unions of the Future’ (HM Treasury) <<http://collections.europarchive.org/tna/20090518140838/http://archive.treasury.gov.uk/docs/1999/creditunion.html>> accessed 20 December 2014.

- They provide low cost credit.⁷³⁹

At the time the report was published in November 1999, about 2.5 to 3.5 million adults, or 10 percent of households, did not have a bank account.⁷⁴⁰ These included young people yet to obtain a job, adult unemployment, the elderly, sick and disabled and unemployed or part-time working single parent women, whose reasons for not having a bank account varied from preferring to use cash to not applying for an account for fear of being turned down.⁷⁴¹ The report also identified that two key aspects of financial exclusion were access to a bank account and access to credit. It recognised that banks could help alleviate the problem of access to bank accounts by providing basic accounts. However, they would not be able to resolve the issue of access to credit because they would not be able to help those who would not be deemed credit-worthy by any financial institution or those who were able to repay loans but for whom banks would find it difficult to confirm their credit-worthiness.⁷⁴²

The report suggested that CUs could help the latter group because since the individuals are members of a common bond, a credit union would be able to lend to them with greater confidence – CUs would therefore be able to make a difference because they could give access to affordable credit to people who did not want bank accounts and those who could not access credit from mainstream financial institutions because of their low income or poor credit history.⁷⁴³

Consequently, the suggested improvements to CUs and credit union regulation made throughout the report all align with the policy of reducing financial exclusion. The overarching suggested improvement was to ensure a significant growth of membership⁷⁴⁴ so that CUs could reach a larger proportion of the people within its common bond and thus the target group, i.e. those who could not access credit from mainstream financial institutions. The underlying reasoning behind the focus of credit union expansion was to ensure a greater balance between people who

⁷³⁹ *ibid* para 7.

⁷⁴⁰ *ibid* para 8.

⁷⁴¹ *ibid* para 8.

⁷⁴² *ibid* para 10.

⁷⁴³ *ibid* para 10.

⁷⁴⁴ *ibid* para 11.

work and who can therefore contribute to the pool of funding used by CUs to provide affordable loans, and the less well-off who find it hard to access finance.⁷⁴⁵

The other suggestions made in the report support this overall goal of enabling the growth of CUs. E.g. the purpose of the credit union movement taking a new direction according to the report was to make a significant impact in the provision of affordable services for those who lack access to them, as opposed to the public at large.

Similarly, the key elements in the report's growth strategy were to encourage larger individual CU; professional management; the capacity to offer a wider range of services; enhanced regulation; a viable share protection scheme; customer/member care and a better matching of CUs to areas of need.⁷⁴⁶ The rationale of the first strategy was that being too small affects credit unions' ability to grow and their ability to afford paid staff which leaves them dependent on volunteers, which in turn limits growth. In addition, if these small CUs have a large common bond, their existence restricts other CUs operating within that common bond and prevents otherwise eligible people from access to a credit union.⁷⁴⁷

The report also highlighted that a larger sized credit union would have a more attractive and professional appearance because of its ability to afford better office facilities and paid staff⁷⁴⁸ and the provision of a wider range of services through partnerships with other financial service providers like banks and insurance companies.⁷⁴⁹ The key concern with these strategies was therefore providing CUs with a broader reach to members of society – the reasoning being that if CUs were larger and more professionally managed would attract the better off who would deposit their savings with CUs, which would be less likely if CUs remained small and therefore continued to be perceived as the poor man's bank.

Another similar example of the close links between the report's suggestions and the policy of the reduction of financial exclusion is its suggestion that there should be greater regulation so as to provide a formally constituted share protection scheme because depositor confidence in CUs is necessary to the success of the

⁷⁴⁵ *ibid* para 12, 15.

⁷⁴⁶ *ibid* para 31.

⁷⁴⁷ *ibid* para 33.

⁷⁴⁸ *ibid* para 34.

⁷⁴⁹ *ibid* para 36.

movement.⁷⁵⁰ This again recognises that without a sufficient base of depositors, CUs will not have sufficient funds to recycle into the loans and other services used to lend to less well-off member-borrowers.

To counteract any negative effects of greater regulation on smaller CUs, the report emphasises the need to abide by the principle of proportionality. This is so that regulation accommodates weaker CUs and gives them space to grow rather than regulating them out of existence.⁷⁵¹ To this end, the report also suggests a two-tier system based on s.11C of the Credit Unions Act 1979 which stipulates that CUs that the Registrar considers to be adequately managed can lend greater amounts for longer periods. So, those CUs which are unable to achieve the higher standards of regulation may be able to continue as a form of local savings club, with possible migratory provisions which enable them to become CUs once they meet the standard requirements.⁷⁵²

However, it is clear from the suggestions made in the report that the aim of the government policy and suggested changes was the reduction of financial exclusion.⁷⁵³

Labour and Coalition Government initiatives

The initiatives of successive governments have also sought to use CUs as a vehicle for combatting financial exclusion. Labour Government initiatives included the Financial Inclusion Fund, which was administered by the Department of Work and Pensions. Under the umbrella of this fund, grants were made to third sector lenders such as CUs so that they could lend to people who were financially excluded.⁷⁵⁴ Mitton explains that the main concern of policy was to improve access to not-for-profit or third sector lenders like CUs and to improve responsible lending by mainstream services by meeting the needs of people on low

⁷⁵⁰ *ibid* para 39.

⁷⁵¹ *ibid* para 45.

⁷⁵² *ibid* para 41.

⁷⁵³ *ibid* para 29.

⁷⁵⁴ Timothy Edmonds (n 537) 22.

incomes.⁷⁵⁵ These needs included access to small loans for short periods; swift access to credit without long or intrusive application procedures; affordable weekly payments; access to mainstream credit despite past poor credit history and denial of credit due to age.⁷⁵⁶

In the report, Mitton identified that the advantage of expanding third sector lenders was that they could lend at lower interest rates than other non-mainstream lenders and in light of the needs of those on lower incomes, affordable credit could be provided by expanding not-for-profit CUs.⁷⁵⁷ However, the report does express an understanding that CUs are not a cure-all solution because they require members to save with them before taking out loans, thus inhibiting their ability to provide widespread access to credit and they are also not available or accessible everywhere.⁷⁵⁸ Consequently, rather than being the resolution to the problem of financial exclusion, CUs are simply a part of it.

The coalition's Credit Union Expansion Project (CUEP) was based on similar goals. This is demonstrated in the Department of Work and Pensions (DWP) Credit Union Expansion Project Feasibility Report, which identifies that the problem they were responding to, is the "poverty premium."⁷⁵⁹ This problem is created because lending to consumers on lower incomes is expensive and risky due to the higher rate of default and debt write-off within this social grouping.⁷⁶⁰ To serve them would require high interest rates to ensure adequate returns on capital, but this could risk the lending institutions' reputation.⁷⁶¹ Consequently banks tend not to serve this sector, leaving a gap in the credit market for people with low incomes, which had previously been filled by organisations which would charge these people high interest rates or premium prices such as mail order catalogues and rent to buy companies.⁷⁶² The report stated that CUs already played a part in dealing with the main gap in the credit market – lack of access to affordable credit; however, because of their high operating costs and dependency

⁷⁵⁵ Lavinia Mitton, 'Financial Inclusion in the UK: Review of Policy and Practice' (Joseph Rowntree Foundation 2008) 30 <<http://www.jrf.org.uk/publications/financial-inclusion-uk-review-policy-and-practice>> accessed 13 January 2015.

⁷⁵⁶ *ibid.*

⁷⁵⁷ *ibid.*

⁷⁵⁸ *ibid.* 31.

⁷⁵⁹ Colin Purtill, John Cray and Cath Mitchell, *DWP Credit Union Expansion Project: Feasibility Study Report*, Department for Work and Pensions at para 3.1.

⁷⁶⁰ *ibid.* para 3.2.

⁷⁶¹ *ibid.*

⁷⁶² *ibid.* para 3.2, 4.1.

on grant income from the DWP, they were not financially stable enough to serve more lower-income consumers.⁷⁶³

The CUEP was rolled out over a period of three years by the Department of Work and Pensions to enable CUs to expand and modernise through £38 million of funding over a period of three years.⁷⁶⁴

4.2.2. Government policy towards P2PL

Similar to the credit union experience, P2PL forms part of the government's policy of increasing access to finance. For example, in October 2014, the Chancellor announced plans to allow P2P loans to be eligible to be held in investment ISAs. This was to further the government's aim to "diversify the different sources of finance that are available to borrowers by encouraging the growth of the P2PL sector."⁷⁶⁵ This is seen as necessary due to the loss of consumers' trust and confidence in the financial services in recent years because of the banking sector, causing the government to see it as necessary to create a financial system which enables people to "access and manage" their finances confidently and easily.⁷⁶⁶

This indicates that as with the credit union industry, the government's method of using P2PL as a means to reduce financial exclusion is to encourage the expansion and growth of the industry. However, the difference is that whereas CUs are viewed as a viable method because of their nature and the ideology behind them, the P2PL industry is seen as such because they are an alternative finance option for borrowers and savers/investors. This idea is supported the government's wider goal of creating a competitive market which enables people to take responsibility for their own finances.⁷⁶⁷ For example, in the Public Accounts Committee thirty-eight report, "Improving access to finance for small and medium-

⁷⁶³ *ibid* para 4.2, 4.4.

⁷⁶⁴ Timothy Edmonds (n 537) 25.

⁷⁶⁵ HM Treasury and David Gauke MP, 'Government Sets out Options to Include Peer-to-Peer (P2P) Loans in ISAs' <<https://www.gov.uk/government/news/government-sets-out-options-to-include-peer-to-peer-p2p-loans-in-isas>> accessed 27 January 2015.

⁷⁶⁶ HM Treasury, The Rt Hon George Osborne MP and Andrea Leadsom MP, 'Making It Easier for People to Access and Use Financial Services - Policy - GOV.UK' <<https://www.gov.uk/government/policies/making-it-easier-for-people-to-access-and-use-financial-services>> accessed 9 February 2015.

⁷⁶⁷ *ibid*.

sized enterprises,” P2PL and crowdfunding are referred to as “challenger forms of finance” and John Kingman makes it clear that the interest of the government in this sector is quite simply the need for more competition in the financial sector, rather than because of any altruistic motives.⁷⁶⁸

As highlighted above, the government’s policy objective towards P2PL is seen clearly in its move to include P2PL within the eligibility criteria of ISA investments. An ISA is a tax-advantaged savings account where any interest, dividends or capital gains that arise in it are tax-free.⁷⁶⁹ There are two policies behind this move. Firstly, the government’s aim is to improve competition within the banking sector by increasing the available sources of finance and secondly, to increase the choice of investments available to ISA investors.⁷⁷⁰ By making P2P loans ISA qualifying investments, P2P loans can be made by investors using ISA subscriptions and the interest payable on the loans to the investor will be free of income tax.⁷⁷¹

By enabling P2PL loans to qualify as ISA investments, the government will be creating greater incentives for consumers to invest their savings on P2PL platforms because it will be cheaper and easier to do so. In so doing, the P2PL sector, and to some extent the financial sector in general, will be easier to access from the investors’ perspective making it more likely for the industry to continue to grow. Not only will this increase the choices available to consumers of financial products, but it will further create a more substantial competitor for the banking industry and therefore a more competitive financial market. Consequently, P2PL enables the government to achieve its policy on both angles.

Another difference between the policy focus on CUs and P2PL are the subjects which are considered ‘financially excluded’. Whereas, with CUs these were people on the lower income bracket, with P2PL the financially excluded which the industry is seen to potentially help are small and medium-sized enterprises (SMEs). For example, on 18 July 2012, when debating whether the P2PL industry should be regulated, Lord Sharkey highlighted that the reason it would be

⁷⁶⁸ Public Accounts Committee, ‘Improving Access to Finance for Small and Medium-Sized Enterprises’ (House of Commons 2013) 38.

⁷⁶⁹ HM Treasury, ‘ISA Qualifying Investments: Consultation on Including Peer-to-Peer Loans’ para 1.1 <<https://www.gov.uk/government/consultations/isa-qualifying-investments-consultation-on-including-peer-to-peer-loans>> accessed 9 February 2015.

⁷⁷⁰ *ibid* 1.2.

⁷⁷¹ *ibid*.

undesirable for the industry to fail due to rogue players entering the, at the time unregulated market, was because there was a “desperate need for new and innovative financial services to provide real competition for existing banks and to fund those areas of commercial life, particularly SMEs and start-ups, that the banks are so obviously failing to fund”.⁷⁷² Again this is tied to the ability of P2PL to provide competition to the banking sector.

⁷⁷² HL Deb 18 Jul 2012 col 325 available
<<http://www.publications.parliament.uk/pa/ld201213/ldhansrd/text/120718-0003.htm>> accessed 9 February 2015.

4.3 FCA Crowdfunding Regulation

4.3.1. The Crowdfunding and Promotion of Non-readily Realisable Securities Instrument 2014 regime

The Crowdfunding and Promotion of Non-readily Realisable Securities Instrument 2014 (CPNRS 2014) introduced regulation for crowdfunding in the UK by amending existing financial regulations within the FCA's Handbook of rules and guidance (the Handbook). It regulates P2P platforms which facilitate lending to consumers, sole traders, and small partnerships in relation to capital requirements, safeguarding client money, disclosure and promotions and the loan administration in the event of a platform's failure.

4.3.2. Annexe A: amendment to the Glossary of definitions

A key aspect of the regulation is the amendment of the glossary module of the Handbook so that it accommodates the P2PL industry. It does this by introducing three new terms, 'loaned funds', 'operating an electronic system in relation to lending' and 'P2P agreement'. It defines a P2P agreement in accordance with article 36H of the *Regulated Activities Order* as:

“an agreement between one person (‘the lender’) by which the lender provides the borrower with credit...and in relation to which either the lender is an individual, or if the lender is not an individual, the borrower is an individual and either:

- *The lender provides credit...of less than or equal to £25,000; or*
- *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.”*

The effect of this definition is that for an agreement to be classified as a P2P agreement, it does not need to be undertaken by two individuals. Rather, so long as one of the parties to the agreement is an individual, the agreement can still be treated as P2P. This is emphasised by the use of the word 'person' rather than 'individual' because 'person' is legally usually interpreted as including

corporations as well as individuals. This route is also taken within this regulation because within the Handbook, a person includes a body of persons corporate or incorporate, so that it does not have to be a natural person.

As a result of this definition, the potential participants of P2PL is broad and it is possible for a traditional business-to-consumer lending agreement to occur under the guise of P2PL. Where the lender is not an individual but the borrower is, the lender is required to provide credit of no more than £25,000. It is possible that this restriction is designed to ensure that if a business does lend within a P2P platform, it does not disadvantage the individual lenders using the platform because of its large financial resources.

However, it could be argued that the definition is an attempt to both accommodate a broad variety of crowdfunding activity and the potential for change within the industry and how it works, and the desire to reflect the fact that P2PL in its traditional sense at least, should involve an agreement between two peers. Consequently, this definition attempts to retain the air of P2P activity by levelling the playing field between a business lender and an individual lender through restrictions that try to ensure that whatever the case may be, the participants are acting like consumers. For example, the restriction on the amount lent by a corporate lender seems to aim to make the business lender as similar to an ordinary consumer as possible through the assumption that an ordinary consumer will not have the resources to lend more than £25,000 on a platform.

However, where the institutional lender does lend more than £25,000, the definition ensures that at least one party remains a consumer, by requiring that the borrower's purpose is not wholly or largely for business purposes. Because if the latter were the case, the lending agreement would be a business-to-business transaction and it would be difficult to classify the agreement as P2P.

On the one hand, the FCA can be commended for trying to ensure that by using a broad definition of P2P agreement they do not restrain the growth or development of the P2PL industry in the UK. After all, the US industry has developed differently from the UK such that the vast majority of platform lending involves institutional lenders and some P2B platforms already allow for institutional lenders. It is therefore possible to envision this type of lending becoming more commonplace in the future of the UK industry as well.

Consequently, by providing for this phenomenon now, the regulators would not need to keep reviewing the regulation each time the industry's user base evolves.

On the other hand, it is much more likely that the broad definition is designed to accommodate two different types of lending. By including the possibility of institutional lenders within the definition of P2P agreement, the FCA conflates pure person-to-person lending agreements with other forms of crowdfunding. This is potentially limiting because it means that not only does the regulation treat both P2P and P2B lending as exactly the same, it also means that it does not focus specifically on the nature and requirements of each type, thereby reducing its ability to create certainty.

Another key aspect of the amended glossary is the addition of the regulatory activity of 'operating an electronic system in relation to lending' in accordance with art. 36(H) of the *Regulated Activities Order (Specified Activities)*. Including this as a regulated activity provides recognition of the P2PL industry in a way that was not, prior to the introduction of the regulation. By creating a new regulated activity tailored towards P2PL the regime avoids trying to fit P2PL within existing regulation designed for different forms of financial activities such as existing banking regulation which is suited to institutional lenders.

According to art 36(H), operating an electronic system in relation to lending consists of enabling two separate persons in becoming the lender and borrower under an article 36H agreement. This is based on the condition in subsection two that the operator's system is capable of determining which agreements should be made available to the lender and borrower, whether or not this is in accordance with general instructions given to the operator by the lender or borrower. For example, this could refer to the role performed by platforms in connecting lenders and borrowers based on their chosen lending requirements.

The purpose of article 36(H) is to specify the particular activities which are regulated and therefore would bring a platform under the remit of the FCA. It specifies these activities in subsection three, which includes such activities as, presenting/offering P2P agreements to persons with a view to them becoming either a borrower or lender under a P2P agreement;⁷⁷³ providing lenders with

⁷⁷³ Article 36(H)(3)(a).

financial information about the borrowers' creditworthiness;⁷⁷⁴ pursuing debt owed to the lenders⁷⁷⁵ and enforcing the rights of a lender in performance of the operator's duties etc.⁷⁷⁶ The specified activities listed in subsection three reflects the specific roles carried out by a platform at all stages of a P2PL cycle. This highlights the earlier point made that the new regime is tailored specifically to P2PL. In addition the definition shows that the FCA's focus is on regulating the platform intermediaries. To an extent this is a good thing because it hints at a recognition that regulating the platform is a way of protecting the platform's users which hints at support for the concept of gatekeeper liability.

4.3.3. Annexe B: amendment to the Senior Management Arrangements, Systems and Controls

Annex B amends the Senior Management Arrangements, Systems and Controls Sourcebook (the SYSC). The SYSC focuses on ensuring that authorised firms have appropriate systems of control, supervision and accountability in place,⁷⁷⁷ thus providing for operational risk.

It requires that an operator of electronic systems relating to lending must take reasonable steps to ensure that there are arrangements in place ensuring that P2P agreements facilitated by it continue to be managed and administered according to the terms of the contract, in cases where the operator ceases to carry out the regulated activity.⁷⁷⁸ The aim of this amendment is to provide better protection for the P2P lender by preventing P2P loan agreements from failing simply because a platform has ceased to exist. Although prior to the April 2014 regulations some P2PL platforms already had such arrangements in place, the fact that it was not required in order for them to run a platform meant that not all platforms needed to have one. This in turn meant that lenders faced varying levels of risk depending on the platform they used, e.g. the risk of lending was

⁷⁷⁴ Article 36(H)(3)(b).

⁷⁷⁵ Article 36(H)(3)(c).

⁷⁷⁶ Article 36(H)(3)(d).

⁷⁷⁷ David Ridley, 'Will New Regulation on Crowdfunding in the United Kingdom and United States Have a Positive Impact and Lead to Crowdfunding Becoming an Established Financing Technique?' (2016) 37 Statute L Rev 57, 67.

⁷⁷⁸ Senior Management Arrangements, Systems and Controls Sourcebook. s 4.1.8A.

reduced if the platform they chose had an insolvency arrangement in place, but if it did not their lending risk was increased.

However, this higher level of risk may not have been reflected in the pricing structure of the platform with no insolvency arrangements, because the only risk taken into account on most platforms are the risks associated with the borrowers' creditworthiness. Consequently, the lending process would incur additional costs for the lender, both in the form of information asymmetries as well as in terms of the time, resources and skills required of a lender to determine the true benefits of lending on one platform over another. This of course assumes that a lender prior to the April 2014 regulation would undertake such a rational approach to every decision in the lending decision and would not be motivated to lend on a particular platform based on emotional or circumstantial reasons.

The problem with this regulatory measure is two-fold. In an attempt to remain flexible and proportionate, the FCA does not require a particular type of insolvency arrangement. Secondly, the measure is not accompanied by a set of standard which the platform must adhere to. This leaves it open for platforms to decide what level of protection they provide to their users in the case of their insolvency. Whilst this gives platforms an opportunity to compete for customers on the basis of their arrangements, the change it creates from the pre-regulatory situation is just slight. This is because it does little to prevent unscrupulous platforms from providing a poor standard of arrangements on behalf of their lenders, merely paying lip service to the regulation. As a result of the lack of standards, and the self-regulatory nature of this provision, it is also difficult to envision how the FCA will be able to ensure that the platform has adequate measures in place. As a result of the nature of the very circumstance that this provision is designed to protect against, i.e. the potential failure of a platform which is a future event which cannot be foreseen when a platform first applies to be licensed, it could be argued that by the time the FCA is notified of the poor standard of arrangements it will be too little too late because the platform would already be in the process of winding up.

4.3.4. Annexe C: amendment to the Interim Prudential Sourcebook for Investment Businesses

As with the Annexe B's requirement of appropriate insolvency arrangements, the prudential requirements provided by Annexe C are also focused on the protection of the P2P users in the event of platform failure.

This amendment introduces chapter twelve to the Interim Prudential Sourcebook for Investment Businesses (IPRU). It is a new chapter called "Financial resources requirements for operators of electronic systems in relation to lending". It requires platforms to follow strict accounting procedures in the measurement of their assets and liabilities when preparing their annual financial statements and according to s.12.2 a platform is required to at all times be able to meet its liabilities as they fall due, ensuring that its financial resources are never less than its financial resources requirement. The chapter is very detailed and thorough in the way it demonstrates how to calculate total value of loaned funds, financial resources and subordinate debt in order to do this. It also takes into consideration the possibility that a platform might carry out more than one regulated activity.

The effect of this amendment is to ensure that a platform acts prudently and continuously monitors its financial resources. The intended aim is that by having adequate financial resources the firm will be resilient to financial crises and go some way to preventing instances of the platform's failure. Unlike the insolvency arrangements provided by Annexe B, this provision provides greater certainty to the platforms because it sets out how they should work out their capital requirements rather than leaving it to the platforms to create an arrangement based on their perceptions of what is appropriate. The provision therefore tries to ensure that there is cover for operational and compliance failures, redress payments and reduces the possibility of a shortfall in the platforms funds.⁷⁷⁹

In general, the aim of the FCA P2P regulator regime is to protect consumers through the creation of a stable platform and industry, rather than giving them any particular rights of action against the platform or other users. This is nowhere more clear than in s.12.1.6.R of the IPRU specifically states that the fact of a platform contravening chapter twelve, does not give rise to right of action by a

⁷⁷⁹ Interim Prudential Source for Investment Business s 12.1.4 G.

private person under section 138D of the Act. Consequently, although the purpose of such prudential provisions is to inspire greater confidence amongst potential and existing P2P users, by giving them an indication of the platform's creditworthiness and level of commitment to its owners,⁷⁸⁰ it does not provide P2P users with an enforceable right against the platform. This limits level of accountability a platform has towards its users.

4.3.5. Annexe D: amendments to the Conduct of Business sourcebook (COBS)

Annexe D brings the activity of operating an electronic system in relation to lending under the conduct of business rules. However, the remit of this provision is restricted to the platform's role in helping a person become a lender under a P2P agreement. It gives platforms examples of the type of information they should provide to lenders to explain the specific nature and risks of P2P agreements. For example, the expected and actual default rates in line with the requirements of COBS 4.6 on past and future performances;⁷⁸¹ a description of how loan risk is assessed, including a description of the criteria that must be met by the borrower before the firm considers the borrower to be eligible for a P2P agreement;⁷⁸² a description of a lender's likely actual return, taking into account fees, default rates and taxation⁷⁸³ and an explanation of what would happen if the platform fails.⁷⁸⁴ This emphasises the regime's pre-occupation with protecting lenders through the provision of better information.

4.3.6. Other aspects of the P2PL regulation regime

The regulatory regime also provides for other ways of regulating P2PL. As with the various provisions set out in the CPNRS 2014 annexes, these regulatory

⁷⁸⁰ *ibid.*

⁷⁸¹ Conduct of Business sourcebook (COBS) s 13.3.7A(1).

⁷⁸² COBS s 3.3.7A(3).

⁷⁸³ COBS s 13.3.7A(6).

⁷⁸⁴ COBS s 13.3.7A(10).

requirements focus regulation on the platforms without recognising the specific roles played by P2PLs and borrowers.

For example, the lenders' cancellation rights is derived from the Distance Marketing Directive (DMD), which requires financial services contracts made without the simultaneous physical presence of the supplier, intermediary or customer, to give the customers the right to cancellation within a certain period without penalty. As pointed out by some respondents to the regulatory consultation process, it is not clear which type of contract within P2PL will qualify as a distance contract because the DMD provides that the right of cancellation is lost where the performance of the contract has begun with the consumer's agreement. This would seemingly not apply to both the service contract between the lenders and the platform, as well as the P2P agreement between the borrowers and lenders because in both cases the agreements begin with the lenders' agreement. The FCA's response to this dilemma has been to suggest that the right of cancellation should apply to the initial agreement between the platform and its users and not to each loan contract. Ultimately, it leaves this decision at the discretion of the platforms, however this stance reflects the FCA's general regulatory approach which is based on regulation solely of the platform without regard to the C2C nature of the transactions. It is assumed that this rationale is based on the FCA's pragmatic approach to achieving a simple and easy to understand regime.

Another example of this is in the dispute resolution provisions and the access given to lenders to recourse to the Financial Ombudsman Service should they have a complaint about the service they have received from the platform. The FCA proposed that lenders who are unhappy with the service they have received from a platform should have the right to complain. They must first take their complaint up with the firm directly and failing a resolution between themselves, they can refer their complaint to the Financial Ombudsman Service. The dispute resolution rules do not require platforms to follow a specific complaints procedure, it leaves it for them to develop suitable processes for their business model.

According to the Handbook, "complaint" is defined broadly as:

"any oral or written expression of dissatisfaction, whether justified or not, from, or on behalf of, a person about the provision of, or failure to provide, a financial

service or a redress determination, which alleges that the complainant has suffered (or may suffer) financial loss, material distress or material inconvenience”.

This gives lenders and borrowers a broad remit to complain to the platform for the way it carries out its role and services in regards to them. Although the regulation in general does not give them any actionable rights in court, recourse to the Financial Ombudsman Service means that platforms can be held accountable for any reasonable complaint that a lender or borrower may bring against it. It is also a more flexible approach than the court system, because the Financial Ombudsman Service determines an outcome based on the concept of fairness, rather than a right or duty.

However, although the dispute resolution rules give lenders and borrowers the right to complain about a platform’s services it does not give them the right to complain about each other, such as the dispute resolution offered on eBay. This is discussed in more detail in chapter six. This hints at the fact that the regulatory regime does not treat P2PL as a consumer-to-consumer market where individuals contract with each other through the mediation of the platform. Rather it bypasses this notion by regulating the platforms only. It is possible to argue, that to recognise the essential C2C model of P2PL, regulation should also create a remit for alternative dispute resolution between consumers such as eBay has on its website between buyers and sellers, with eBay as the mediator. This approach would reduce expensive court costs which might not be worth it for the relatively small amounts that are lent on each loan agreement. This possibility is not prevented by the anonymity of P2PL users, because again, as on eBay, the dispute resolution could be started against an anonymous person with a username and the platform knows the identity of both the lender and the borrower putting it in the best position to mediate between the two.

4.4. Critique of the FCA regulatory regime

4.4.1. The pre-contractual nature of the FCA regime

Consumer protection regulation is traditionally regarded as a body of laws designed to prevent individuals from taking on excessive risks⁷⁸⁵ and to protect consumers' interests at the individual transaction levels.⁷⁸⁶ Relevant "harm" is considered a failure in individual transactions and usually occurs at the origination stage or in the substance of a transaction.⁷⁸⁷ This explains why most consumer protection measures such as information disclosure focus on the pre-contractual stage of transactions and aim to prevent failures that inhibit consumers' ability to enhance their welfare.⁷⁸⁸ For example, bargaining power and knowledge is often highlighted in the EU consumer policy and suggests an approach that leans heavily towards the pre-contractual stage of transactions. Although EU consumer law has introduced post-contractual withdrawal and cancellation rights in favour of consumers, it is only applicable in limited cases such as distance and doorstep selling to enable consumers to reverse irrational decisions.⁷⁸⁹ As confirmed in the new Consumer Rights Directive,⁷⁹⁰ withdrawal/cancellation rights in such contracts protect consumers who are vulnerable because of the lack of opportunity to inspect goods and to meet, discuss and agree on contractual terms.⁷⁹¹

Limiting consumer protection to pre-contractual scenarios only seems too restrictive and inadequate for P2PLs because of its peculiar nature. Although P2PLs, for example, face information asymmetries before agreeing to lend, the

⁷⁸⁵ Erik F Gerding, 'The Subprime Crisis and the Link between Consumer Financial Protection and Systemic Risk' (2009) 5 Florida Inter Florida Intl U L Rev 93, 94; Oren Bar-Gill and Elizabeth Warren, 'Making Credit Safer' (2008) 157 U Pa L Rev 1.

⁷⁸⁶ Huffman (n 90).

⁷⁸⁷ *ibid* 9.

⁷⁸⁸ *ibid*.

⁷⁸⁹ Christian Twigg-Flesner and Reiner Schulze, 'Protecting Rational Choice: Information and the Right of Withdrawal' in Geraint Howells and others (eds), *Handbook of Research on International Consumer Law* (Edward Elgar Publishing Inc 2010) 130.

⁷⁹⁰ Council Directive 2011/82/EU of the European Parliament and of the Council of 25 October 2011 on consumer rights, amending Council Directive 93/13/EEC and Directive 1999/44/EC of the European Parliament and of the Council and repealing Council Directive 85/577/EEC and Directive 97/7/EC of the European Parliament and of the Council Text with EEA relevance [2011] OJ L304/64-88 implemented in the UK by the Consumer Rights Act.

⁷⁹¹ Joasia A Luzak, 'To Withdraw Or Not To Withdraw? Evaluation of the Mandatory Right of Withdrawal in Consumer Distance Selling Contracts Taking Into Account Its Behavioural Effects on Consumers' (2013) 37 Journal of Consumer Policy 91, 94.

main concern is the execution and performance of loan contracts, including prompt loan repayments and debt collection. Unlike banks, P2PLs are largely incapable of establishing and operating their own debt recovery arrangements. The provision of appropriate amount of pre-contractual information may be necessary but it is an insufficient protection for such lenders. This suggests the need for a more interventionist approach to the post-contractual side of P2PL transactions rather than the traditional focus on pre-contract protection.

The new FCA regulations therefore seem right in attempting to protect lenders from adverse situations following the formation of P2P loan contracts. For example, a loan-based P2PL platform is required to take reasonable steps to have arrangements in place to ensure the continued management and administration of P2P loan agreements if it fails or ceases to carry on the business.⁷⁹² This provision protects lenders from the uncertainty and costs of recuperating loan payments from unidentifiable and anonymous borrowers, but it has a limited scope. There is no prescribed form of arrangements and platforms are free to design and introduce processes that suit their business model.⁷⁹³ Although this lack of uniform standards is understandably in the interests of balancing regulatory costs and benefits,⁷⁹⁴ it still leaves the meaning of an appropriate arrangement open to debate between platforms and regulators. Whilst this allows a more tailored procedure, it could lead to more work for regulators in the long term. Should an arranged third party loan administrator fail, the appropriateness of the procedure would arise and be dealt with by regulators on a firm-by-firm basis. The FCA has not specified the consequences of the failure of arrangements, culpability for failures and, most importantly, lenders' alternative recourse. Platforms are only required to warn lenders of the risks involved and that safeguarding measures may not work as expected.⁷⁹⁵ Potential lenders are expected to take these factors into consideration or at least be aware of them when deciding to lend on particular platforms and will ultimately bear the risk of failure. This approach therefore follows the rational choice model of consumer protection that emphasises limited pre-contractual disclosure and

⁷⁹² Crowdfunding and the Promotion of Non-Readily Realisable Securities Instrument 2014, Annex B, 4.1.8A; Financial Conduct Authority, (Policy Statement, PS14/4), 28.

⁷⁹³ *ibid* Annex B, 4.1.8; Financial Conduct Authority, (Policy Statement, PS14/4) 28.

⁷⁹⁴ Financial Conduct Authority, (Policy Statement, PS14/4) at 28.

⁷⁹⁵ *ibid*.

leaves little room for the outcomes of consumer decisions such as repayment default and inability to recuperate debt as well as post-contractual remedies such as reimbursement of money paid and provision of new services.

4.4.2. Conflated Concept of Consumer

The Financial Services Bill defines consumers broadly enough to include a range that covers retail customers and wholesale and professional investors.⁷⁹⁶ It adopts a differential approach to defining consumers which means that the Financial Conduct Authority, in treating participants as consumers would need to take into consideration the varying degrees of risk involved in different investment or transactions they are involved in; and the differing degrees of experience and expertise that different consumers might have.⁷⁹⁷ The effect of this is that different types of consumer will be provided with different levels of consumer protection and different regulated activities will be subject to varying degrees of intervention, depending on what category the consumer of that service falls into. This might create problems for P2PL regulation as although there are two types of consumers involved with similar levels of experience, because they are participating in different ways (one as lender, one as borrower), they may find themselves subject to different levels of protection.

Under the FCA regime, P2PLs fall into the 'retail investor' category rather than the 'retail' consumer category. 'Retail consumers' are defined as buying financial products or services for their own use or benefit either directly or through a regulated firm e.g. travel insurance. Meanwhile, 'retail investors' are persons that purchase financial instruments such as shares, bonds and exchange traded funds.⁷⁹⁸ The consumer protection measures that they receive are largely informational, e.g. firms providing appropriate information to consumers, at the right time.

The problem with this is that the regulation of the 'retail investor' tends to imbibe the characteristics of neo-classical philosophy and aims to 'responsibilise' the

⁷⁹⁶ Joint Committee on the draft Financial Services Bill, Session 2010-12 Para 105

⁷⁹⁷ *ibid* Para 108

⁷⁹⁸ FSA, 'The Financial Conduct Authority; Approach to Regulation' (June 2011) at 16

consumer through information disclosure and consumer education. Although there are increasingly signs in the EU consumerisation of retail investors, as discussed in Chapter Two the ‘consumerised’ regulatory measures do not apply to P2PL because they largely concern the distribution of retail services and information or advice provided for them. Therefore, neither the responsabilisation approach adopted by P2PL regulation nor the consumerisation approach adopted in the general regulation of retail financial services outside of P2PL, are suitable for lenders of P2P loans. This is because as explained above, these lenders are individuals who would normally just deposit their money in a bank, and thus may not have high levels of investment know-how. Additionally, the increase of information does not solve all the problems they face during the lifecycle of a P2PL transaction. Behavioural theory shows that for such people, too much information may not be a good thing. Information as a regulatory tool essentially offers P2P users only two main courses of action: because of the information, the P2P user may decide that they do not want to risk their funds and not to use the P2PL mode of saving/investing or borrowing; or they may decide that they are prepared to risk their money and lend or borrow on the chosen platform despite the risks. This would be the case regardless of the type and amount of information given to them or how clear it is. It does not help resolve other conflicts the users may face using the platform post-contract. Therefore, information-based regulation alone is insufficient.

The only effect of this provision is that by broadening the definition of consumers, P2PLs will be covered by some sort of protection. However, P2PL platforms already provide similar protections as those suggested by the draft bill for retail investors. So, the provisions, if applied to P2PL, would not change the situation of P2PLs as retail investors are usually provided with less protection than borrowers, yet face a greater risk, i.e. loss of money through default and inability to reclaim this money.

One of the operational objectives of the FCA is to strike a balance between the principles of consumer protection and consumer responsibility by adopting a differentiated approach to regulating consumer protection, which considers what is ‘appropriate’ consumer protection in each situation.⁷⁹⁹ The aim of this approach

⁷⁹⁹ Joint Committee on the draft Financial Services Bill, Session 2010-12 Paras 124 and 125; FSA, ‘The Financial Conduct Authority; Approach to Regulation’ (June 2011) 17.

is to ensure that different consumers are dealt with in different ways, for example, it recognises that the needs of a consumer purchasing a pension policy are different from the consumer buying a car insurance policy.⁸⁰⁰ Consequently, the regulator is expected to consider in each scenario, what level of consumer knowledge it is reasonable to expect from a consumer, how complex a product is, the differing degrees of risk involved in different types of investment and transactions and the varying degrees of experience and expertise that different consumers have.⁸⁰¹ However, the Joint Commission highlighted that taking these factors into consideration is not sufficient if it is not complemented by a corresponding responsibility on firms to act honestly, fairly and professionally in the best interests of their customers, e.g. by providing addressing the needs of consumers for advice and information that is timely, accurate, intelligible and appropriately presented.⁸⁰² The rationale behind this addition was that information alone will not be enough to improve consumers' ability to make well-informed decisions; rather information needs to be easily understandable and accessible.⁸⁰³

These approaches do not suit P2PL where the risk to the lender – loss of money through default – cannot be solved through more and more information, or more appropriately presented information. It also does not suit the structure of P2PL because the risk is not one between the firm and the consumer, but between two different consumers who under some models may not know each other. The platforms cannot provide further information to the lenders about each transaction because they are not party to individual transactions. The platforms can and often do provide general information about how to lend, and advice about how to choose which borrowers to lend to. However, with regards to individual transactions, essentially all they do is present information to the lenders which the borrowers have provided. In this case the approach may be relevant to the platforms' duty to ensure their credit ratings are accurate and presented to lenders in a way that they can understand and use in their transactions. But this does little to balance the risk to the lenders.

⁸⁰⁰ Joint Committee on the draft Financial Services Bill, Session 2010-12 Para 124.

⁸⁰¹ *ibid* Para 124.

⁸⁰² *ibid* Para 126.

⁸⁰³ *ibid* para 127.

Consumer protection as the provision of information is limited to pre-contractual scenarios. This is insufficient for P2PL because although the participants face information asymmetries before agreeing to lend, the large part of their problems are faced in the execution of the loan contract. For example, ensuring loan repayments are made by the borrower and debt collection and recovery. One might say that because lenders hold the capital, they are in a better bargaining position than the borrowers so do not need the same level of protection. However, unlike traditional lending institutions such as banks, they are not capable or in a position to carry out their own debt recovery arrangements, for this they depend on the lending platforms. For lenders therefore, discussing the appropriate amounts of pre-contractual information needed is inappropriate. Consumer protection regulations for lenders should be largely interventionist and focus on the post-contractual side of the transaction.

Lenders on P2PL platforms are often described as investors rather than consumers because they lend money directly to borrowers. This is exemplified by the FCA which appears to recognise P2PLs as consumers following the amended provisions of the Financial Services Act 2012 which define consumers broadly enough to include a range of retail customers and wholesale and professional investors.⁸⁰⁴ Under the Act, consumers are, “persons who use, have used or may use regulated financial services...have relevant rights or interests in relation to any of those services, have invested, or may invest, in financial instruments, or have relevant rights or interests in relation to financial instruments.”⁸⁰⁵ The FCA, however, essentially treats P2PLs as “retail investors” rather than “retail consumers”. Retail consumers are defined as buyers of financial products or services for their own use or benefit either directly or through regulated firms, while retail investors are persons that purchase financial instruments such as shares, bonds and exchange-traded funds.⁸⁰⁶

Classification as investor rather than consumer is significant because investor protection is completely different from consumer protection. Investor protection rules often assume a degree of expertise and are therefore less likely to be

⁸⁰⁴ *ibid* para 105.

⁸⁰⁵ Financial Services Act 2012.

⁸⁰⁶ Financial Services Authority, “The Financial Conduct Authority: approach to regulation” (June 2011) 16.

interventionist than ordinary consumer protection regulations. This type of regulation has been adopted by the FCA P2PL regulatory regime which despite at times calling P2PLs consumers, still only provides them with the usual investor protection measures. Typical investor protection rules including the segregation of client and financial intermediary's accounts⁸⁰⁷ may be irrelevant in consumer protection. A non-interventionist approach may seem appropriate and proportionate to the circumstances of the traditional lending and investment framework where the investors are investing in the true sense of the expression. Peer-to-business lenders may even be so regarded as investors going by the available research evidence⁸⁰⁸ suggesting a degree of financial awareness among such lenders. P2PL is, however, different because its lenders may well be ordinary people like its borrowers and share similar levels of investment/lending experience and knowledge, and, in fact, may face a greater risk of loss of money through borrowers' default. P2PLs and borrowers are unlikely to be significantly different in demonstrating "lack of experience, unfamiliarity with the subject matter of the contract, [and] weak bargaining position"⁸⁰⁹ in their relationship and dealings with platforms.

Nonetheless, the consumer protection measures of the recent FCA regime for retail investors are largely informational and restricted to appropriate information.⁸¹⁰ This may seem right since the Financial Services Act 2012 adopts a differential approach to defining consumers and requires the FCA to take into consideration the varying degrees of risk involved in different investments or transactions consumers are involved in and their differing degrees of experience and expertise.⁸¹¹ Different types of consumer are provided with different levels of consumer protection and different regulated activities are subject to varying levels of intervention depending on what category a consumer of that service falls into.

⁸⁰⁷ Panagiotis Staikouras, 'A Novel Reasoning of the UK Supreme Court Decision in Lehman Brothers: The MIFID Segregation Rule from the Angle of Financial Intermediation and Regulation Theory' (2014) 2 *Journal of business law* 97.

⁸⁰⁸ Yannis Plerrakis and Liam Collins, 'Banking on Each Other: The Rise of Peer-to-Peer Lending to Businesses' (April 2013) <<http://www.nesta.org.uk/publications/banking-each-other-rise-peer-peer-lending-businesses>> accessed 20 April 2014.

⁸⁰⁹ *Director-General of Fair Trading v First National Bank plc* [2001] UKHL 52, [2002] 1 AC 481 [17], per Lord Bingham.

⁸¹⁰ That the consumer simply needs to have sufficient information to give informed consent is certainly the basis for the most important EU consumer protection measure including Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts OJ L095/29-34.

⁸¹¹ Financial Services Act 2012 ss 1C(2)(a) and (b); Joint Committee on the draft Financial Services Bill, Session 2010-12 para 108.

This differential approach is, however, problematic for P2PL which involves two consumers with similar levels of knowledge and experience who may find themselves subject to different levels of protection simply because of their participation as lender and borrower. It is noteworthy that experience is a critical factor in whether consumer protection measures apply to particular individuals.⁸¹²

The designation of P2PLs merely as retail investors tends to imbibe the neo-classical/rational choice philosophy that aims to “responsibilise”⁸¹³ and empower⁸¹⁴ consumers through information disclosure and education. This may not be suitable for P2PLs who lack sufficient high levels of investment know-how and are not very different from individual customers/depositors in traditional banking, particularly in pure, person-to-person P2PL models. Such lenders are unlikely to have independent access to information about borrowers, including potential use of multiple platforms, and are faced with the problems of information asymmetry and behavioural bias in addition to directly bearing the risk of borrowers’ default. Compared to platforms, which may have independent verification and monitoring mechanisms, an individual P2P lender who has lent a fraction of a loan may not know the real financial situation of a borrower. The lender depends solely on what the borrower discloses and may not know whether the borrower has mounting financial difficulties from several sources.⁸¹⁵

It is instructive that similar issues of information asymmetry and behavioural bias trigger regulation in traditional bank lending. Banks are subject to regulation on deposit handling and how payments are made because they handle customers’ deposits, which are repayable on demand, and primarily bear the risk of borrowers’ default. Technically, banks simultaneously act as intermediaries between their customers and borrowers since loans are derived from customers’ deposits and borrowers are unknown to the customers. Borrowers do not know which proportion of borrowings comes from any particular customer and customers likewise are unaware of the destination of their money as loans. P2PL

⁸¹² *Maple Leaf v Rouvroy* [2009] EWHC 257, [2009] 2 All ER (Comm) 287; *Patel v Patel* [2009] 3264 (QB), [2010] 1 All ER (Comm) 864; *Rahman v HSBC Bank plc* [2012] EWHC 11 (Ch).

⁸¹³ Iain Ramsay, ‘Consumer Law, Regulatory Capitalism and the “New Learning” in Regulation’ (2006) 28 Sydney L Rev 9.

⁸¹⁴ Anu Arora, ‘Unfair Contract Terms and Unauthorised Bank Charges: A Banking Lawyer’s Perspective’ 1 Journal of Business Law 44, 50.

⁸¹⁵ Contrast the facts of the non-P2P social lending case of *Patel v Patel* [2009] EWHC 3264 (QB), [2010] 1 All ER (Comm) 864.

platforms similarly act as intermediaries between lenders and borrowers, although the degree of their involvement in the lending processes appears to be played down.

The second difficulty is that the philosophy of responsabilisation and empowerment is not well suited to P2PL lenders. Indeed, such a philosophy assumes the ability to exercise power. P2PL lenders are however in fact powerless. This is in the sense of behavioural research which regards powerlessness as the inability to achieve desired outcomes.⁸¹⁶ For instance, transactional parties respond to stressful situations in different ways and can cope by applying primary and secondary controls. Primary control uses active behaviours to change a situation to a preferred one while secondary control involves active and passive behaviours designed to alter oneself rather than a stressful situation.⁸¹⁷ Powerlessness, which occurs when a party is unable to exercise primary control, is more likely to be case with online P2PL participants, particularly the lenders. Lenders rely on the platforms to deliver key aspects of the P2PL transaction, e.g. loan repayments, credit risk assessments and pursuit of defaulting borrowers; and can at best apply secondary control and may not be able to exercise primary control at all.

Rather than control, trust seems a key factor for lenders' participation in P2PL.⁸¹⁸ Trust makes a person vulnerable to another party even when that person is unable to monitor or control the other party.⁸¹⁹ Trustworthiness can arise out of the personality of the one who trusts, the competence and reputation of the one who inspires trust, or governance provided by a third party that enforces trust.⁸²⁰⁸²¹ Legal and economic theories emphasise the third party element of this tripartite typology which builds trust through the regulation of participants' exchange and

⁸¹⁶ Matthew Bunker and A Dwayne Ball, 'Consequences of Customer Powerlessness: Secondary Control' (2009) 8 J Consum Behav 268, 269.

⁸¹⁷ *ibid* 270.

⁸¹⁸ Iyer and others (n 66); Mingfeng Lin, Nagpurnanand R Prabhala and Siva Viswanathan, 'Judging Borrowers by the Company They Keep: Friendship Networks and Information Asymmetry in Online Peer-to-Peer Lending' (2013) 59 Management Science 17; Duarte, Siegel and Young (n 69).

⁸¹⁹ Roger C Mayer, James H Davis and F David Schoorman, 'An Integrative Model of Organizational Trust' (1995) 20 The Academy of Mgmt Rev 709.

⁸²⁰ Ashta and Assadi (n 38) 10–11.

⁸²¹ Arvind Ashta and Djamchid Assadi, 'An Analysis of European Online micro-lending Websites' (2010) 6(2) Innovative Marketing 7, 10-11.

ensuring that participants keep their promises.⁸²² Research demonstrates that individuals' reluctance to engage in internet-based transactions is overcome if they trust business counterparties in terms of security, privacy and reliability. Similarly, online P2PL transactions require strangers to trust and cooperate with each other via platforms that have an exclusive access to participants' personal recognisability factors. By analogy to a physical shop, a platform is arguably part of a consumer's transactional decision. The concept of transactional decision includes the decision to enter a shop and any other decision related to "any decision taken by a consumer concerning whether, how and on what terms to purchase."⁸²³ One can argue, for example, that P2PL platforms are the online equivalents of prominent shopping brands/shop owners that allow multiple retailers and service providers to use their shop spaces, subject to a certain level of control from the owners.

The fact that the regulatory regime has largely focused on the conduct of the business, follows a general trend in UK financial regulation following the financial crisis. Following the crisis, the priority of regulators was in the stabilisation of financial systems, which has led to a regulatory approach focused on the conduct of business.⁸²⁴ This results in looking at the way businesses operate and how the way they do so affects consumers.⁸²⁵ This approach is evident in the P2P regulatory regime as explained above. It is also made clear by the government's policy towards the P2PL industry, a thread which runs through all aspects of the regulation. For example, this approach was highlighted by Christopher Woollard, the FCA Director of Strategy and Competition during a speech given at the FCA's event on UK FinTech. He stated that the concern about fostering innovation is linked to the FCA's duty to promote competition in the interests of consumers and a good way of doing this was to facilitate disruptive innovation.⁸²⁶

⁸²² *ibid* 10.

⁸²³ *Trento Sviluppo srl and another v Autorità Garante della Concorrenza e del Mercato* (Case C-281/12) [2013] WLR (D) 507.

⁸²⁴ Sue Lewis and Dominic Lindley, 'Financial Inclusion, Financial Education, and Financial Regulation in the United Kingdom' 9

<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2672777> accessed 28 May 2016; see also, Olha O Cherednychenko, 'The Regulation of Retail Investment Services in the EU: Towards the Improvement of Investor Rights?' (2010) 33 *Journal of Consumer Policy* 403..

⁸²⁵ Lewis and Lindley (n 843) 9.

⁸²⁶ Christopher Woolard, 'UK FinTech: Regulating for Innovation - Financial Conduct Authority' <<https://www.fca.org.uk/news/uk-fintech-regulating-for-innovation>> accessed 29 May 2016.

4.4.3. P2P Borrower-specific Protections

The thesis has so far focused on P2PLs who, as demonstrated in Chapter 2, are a unique type of participant in the financial market, and thus elucidates on their classification and implications for regulation. The discussions in Chapter 2 about consumers and prosumers, however, show clear that P2PBs are no different in their nature, role and level of participation in P2PL transactions from ordinary consumers in traditional consumer credit markets who borrow money from institutions like banks.

The analysis of the P2PL regulatory regime above reveals some borrower protections. For example, all users of P2PL have recourse to the Financial Ombudsman Service should they have any complaints about the platform⁸²⁷ perhaps because the FCA perceives both lenders and borrowers as consumers. The prudential requirements which ensure the stability of the platform can also be viewed as a method of protecting borrowers in the long run for the same reason that it can be seen to protect lenders – a stable platform ensures consumer confidence in the market and thus a safe and viable environment to transact. The client money rules also protect borrowers by ensuring that lenders receive the borrowers' repayments. A more specific protection is the fact that the pursuit of debt owed to lenders and the enforcement of the lenders' rights under the obligations of the platforms are classified as regulated activities in the *Regulate Activities Order (Specified Activities)*.⁸²⁸ This means that there is an expectation that the pursuit of funds on behalf of lenders will be carried out ethically. The regulation of P2PL debt recovery is dealt with in the Consumer Credit Sourcebook in the FCA Handbook CONC 7 which relates to situations where borrowers are in arrears or default and the firm must recover repayments. CONC 7.17 – 18 deal specifically with the P2PL industry. CONC 7.17 provides that where the P2P agreement is a fixed-sum credit, platforms are expected to give borrowers fourteen days' notice of arrears and provide borrowers with further notices at intervals not exceeding six months. It also provides details of how platforms should go about providing arrears notices and the information

⁸²⁷ Financial Ombudsman Service Limited (n 610) 3.

⁸²⁸ Article 26(H)(3)(c) and (d).

contained in them. CONC 7.18 has similar provisions in relation to P2P agreements for running account credit and 7.19 deals with notices of default sums under P2P agreements. The provisions indicate that P2PL firms are subject to the same rules that conventional lenders are in situations of debt recovery. For example, CONC 7.3 makes it clear that lenders are expected to treat borrowers with forbearance and due consideration and where appropriate to inform them that free and impartial advice is available from not-for-profit advice bodies. S.7.3.14 also requires that no disproportionate action is taken against borrowers in arrears or default, e.g. before court action is taken, all other proportionate measures should be fully explored. These regulations ensure that like their counterparts in traditional forms of lending, P2PBs are protected from the risk of illegal payment collection methods and abusive behaviour in the collection process.

As highlighted in Chapter Two, responsible lending requirements were first introduced in the UK to implement the Consumer Credit Directive and are part of the FCA legal regime.⁸²⁹ For example, the rules in the Consumer Credit Source in the FCA Handbook, CONC 5.2.1 R s.1 sets out the requirement for firms to carry out creditworthiness assessments of customers prior to agreement, which must be based on information obtained from customers and, where necessary, credit reference agencies. In 5.2.1 R s.2 a firm is expected to consider the potential for the commitments under the credit agreement to adversely impact the borrower's financial situation and the ability of the borrower to make repayments as they fall due. Although the provision does not apply to non-commercial loans, CONC 5.5.2 G s.2 states that P2P agreements may also be considered a credit agreement or regulated credit agreement, which would make the provisions of the CCA or CONC applicable. CONC 5.5 deals specifically with creditworthiness assessments in P2P agreements bringing the industry in line with the rules in CONC 5.2.3 (which set out the creditworthiness assessment requirements of lenders generally), as they would otherwise not apply to non-commercial agreements such as P2P loans.

⁸²⁹ Andrea Fejős, 'Achieving Safety and Affordability in the UK Payday Loans Market' (2015) 38 *Journal of Consumer Policy* 181, 188; Iain Ramsay, *Consumer Law and Policy: Text and Materials on Regulating Consumer Markets* (3 edition, Hart Publishing 2012) 382.

The responsible lending provisions contained in the Consumer Credit Sourcebook therefore protect P2PBs from lending practices that pay little or no regard to the borrower's ability to meet repayment obligations. With regards to where the burden of the responsibilities falls, i.e. the actual lenders or the platforms, the provisions demonstrate that the FCA regulatory regime has chosen the platforms even though they are not party to the P2P loan contract.⁸³⁰ This indicates that the regulators are willing to accept platforms, in their role as facilitators, are the best possible means of ensuring safe and ethical lending practices in the P2PL industry.

4.5 Conclusion

From the start, the FCA's aim has been to balance the aim of securing an appropriate degree of protection for consumers and promoting effective competition in the interests of consumers. This is a difficult feat to achieve. The regime largely amalgamates regulation for crowdfunding investment under a single regulator thereby going some way towards eliminating confusion for customers, which in turn gives the P2PL concept greater credibility and reduces regulatory costs for them and the platforms. However, in doing so, the FCA has adopted a largely information and disclosure-based regime with regards to the P2P participants. The regulation provides a basic level of consumer protection, but it still imbues a largely caveat emptor approach to P2PL, which means that once a lender or borrower has been given clear, fair and not misleading information, it is up to them to decide whether and how they invest and the consequences are left to them to bear. This is emphasised by the fact that aside from the alternative dispute resolution provisions provided to lenders and potentially the borrowers also, the regulation does not assign any rights of action against the platform, or against other users. In this way, it limits the users' ability to enforce any of the regulation designed to protect them. This means that changes to the regime or the practices of a firm can only be triggered by relatively

⁸³⁰ This problem was discussed in chapter two, when the topic of responsible lending was initially introduced.

largescale issues that may arise, e.g. platform-wide or industry-wide malpractice, as opposed to malpractice faced by a lender or borrower.

By focusing its attentions on the regulation of the P2P platform, the regulatory regime accounts for the role played by P2PL platforms during both the lending and management stages of the loan cycle. As seen above, it caters to the role of the platforms in ensuring the creditworthiness of borrowers, the pursuit of unpaid debts to the lenders, and deals with the risks faced by lenders of platform abuse of their funds. In so doing the regulation does not imbibe the idea that platforms are mere conduits just because they are not party to the lending agreement, but recognises their true role as an active intermediary. However, because the regime aims to also encourage the growth of the P2PL industry, it does not go far enough in its use of the platform to regulate P2PL transactions. Consequently, the platforms are not regulated as gatekeepers.

A key part of this thesis has focused on the conceptualisation of P2P users, viewing lenders as transitional prosumers, i.e. 'lendsumers' and borrowers as consumers. However, the UK P2PL regime maintains a conceptualisation of both parties as consumers. In itself, this is a positive step towards recognising the basic conceptual framework of P2PL as consumer-to-consumer, particularly because it ensures that the P2PLs are treated with the same level of protection that the borrowers, who are traditionally associated with the consumer role, are. However, because the regime treats them as consumers, the protection it affords them is limited to their relationship with the platform. Consequently, the consumer protection measures provided by the FCA regime are effectively based on the business-to-consumer paradigm of levelling the playing field between a business which has the upper hand and an individual that does not. This is why it focuses so much on information disclosure and other pre-contractual remedies designed for situations where there is an uneven playing field between the business and consumer.

While such an approach is useful for protecting a lendsumer during the stage of the lending process when they behave like consumers, i.e. when they are reliant on the platforms for the administration and enforcement of the loan, it does not fully provide for the roles and characteristics at the stage of the loan where they behave like prosumers. It also does not consider the relationship between the lendsumer and the borrower. As they are already on a similar level playing field,

the usual consumer protection rules that are meant to even a playing field, do not have much relevance in monitoring their relationship. However, just because a consumer protection regime does not fit the relationship between a P2P lender and borrower, does not mean that the rights and responsibilities towards each should be ignored. Assumedly, the FCA regime tries to replace the need to focus on the lenders and borrowers' relationship between each other, by placing all regulatory focus on the platforms. However, because the regulation does not treat all aspects and phases of the P2PL transaction, nor adopt a gatekeeper liability approach which holds the platforms responsible for the actions of its users, it fails to consider the need for some form of regulation of the actions between the lenders and the borrowers.

5. Towards Clarity and a Regulatory Paradigm for P2PL

5.1 Introduction

Chapter Four critically analysed the UK regulatory regime for P2PL and concluded that because it does not adequately conceptualise P2PL, its regulations are largely focused on the pre-contractual side of P2PL transactions and the platform alone. Rather than recognising the underlying presumption model of P2PL, the FCA regime treats P2PL as another form of business-to-consumer financial business. The purpose of this chapter is to suggest a P2PL regulation model. Section 5.2 sets the scene by analysing the meaning, goals and typical forms of regulation. Section 5.3 confirms the central arguments that P2PL is a new and different way of doing business by placing it in the wider financial regulation framework. A key point in section 5.4 is that clarity in law and regulation requires regulatory measures to adapt to new concepts and new ways of doing business. Sections 5.5 to 5.7, set out the use of gatekeeper liability to regulate platforms in such a way that considers P2P structure and the concept of “lendsumer” as an analytical tool to help regulators better understand the roles and characteristics of individuals that are protected.

Before the advent of P2PL platforms, two main financial institutions have acted with a comparable intermediary capacity. These are banks and investment companies. These operate in the mainstream financial sector and demonstrate the reasons why it is important to regulate intermediaries.

Having already mentioned the way that banks act as intermediaries between their depositors and borrowers in an earlier section, it serves only to summarise at this point that they act as intermediaries by pooling and transforming depositors' money into long-term loans and by taking on the credit risk involved in lending.⁸³¹ This means that regardless of whether the borrower repays the full amount of the loan or defaults and never repays, the depositor can obtain the full amount that they deposited on demand and do not have to bear the loss of the default or late payment.

⁸³¹ Davis and Gelper (n 62) 1220.

This is not the same with investments made through an investment company. An investment company issues stocks or other securities to investors and use the proceeds to buy diversified portfolios of securities which they contract out to investment advisors to manage in line with shareholder approved investment goals.⁸³² Investors may or may not be able to redeem their shares on demand depending on the type of fund.⁸³³ They are also not provided with any guarantee that the value of their shares will remain the same.⁸³⁴ Consequently, the risk that the share value may decrease during the term of investment lies with the investor and not with the institution.

Another type of financial institution that has an intermediary role are brokers. These are agents who negotiate trade agreements or bargains and buy and sell shares on behalf of an investor for a fee. For an additional fee, they can offer other services such as financial advice. However, they do not own the title to the property being traded. In their analysis of not-for-profit P2P organisations, Davis and Gelpert argued that brokers cannot be compared to P2P organisations because they do not pool customer funds, rather they simply facilitate direct investment.⁸³⁵ The basis of their distinction was that unlike brokers, P2P intermediaries do not help individual investors to lend directly to the ultimate recipient of his/her funds, so they do not have direct claims⁸³⁶ against an individual borrower who benefits from their investment.

On the one hand, it is understandable why Davis and Gelpert have made this distinction. Their research is in the context of charitable P2P intermediaries, and their comparison between P2P intermediaries and mainstream financial institutions focuses on the similar benefits they provide to the investors. Namely, the pooling of funds from many investors which enables the diversification of investments; and, providing an information service which reduces the transactional transparency barriers that individual investors may normally face without an intermediary e.g. the skills necessary to evaluate the risks associated with lending to particular borrowers.⁸³⁷

⁸³² *ibid.*

⁸³³ *ibid.*

⁸³⁴ *ibid* 1221.

⁸³⁵ *ibid.*

⁸³⁶ *ibid.*

⁸³⁷ *ibid.*

On the other hand, by focusing on the comparable benefits, this analysis does not consider the similar characteristics that brokers have with P2P intermediaries. For example, P2PL websites are for-profit organisations which earn a fee for their intermediation services. As with brokers they are not party to the actual transaction they facilitate; whereas for brokers this is the purchase or sale of shares or insurance products, for P2P platforms this is the lending contract between a borrower and lender and the subsequent repayment of the debt and the associated interest payments. The fact that despite brokers not being party to a contract does not stop them from being held liable when things go wrong in certain circumstances, implies that the same thing can be done for P2P platforms.

On the other hand, whereas with brokers it is clear they are the agent of the investor, it is not clear who the P2PL platforms are agents of, if any. In this sense one can say that they are truly impartial intermediaries who facilitate a transaction. This will need to be considered when investigating their liabilities to both parties to the transaction they facilitate.

Regulating P2P platforms involves the same regulatory concerns that surrounds the regulation of other financial forms and institutions, i.e. the promotion of innovation whilst still ensuring the safety and soundness of the platform, consumer protection goals, the promotion of financial inclusion and the prevention of systemic risk.⁸³⁸ These concerns are further complicated by the fact that regulators need to take into account the fact that whilst the P2PL market is currently relatively small, it is a growing and changing method of finance which at some point in the future, may render any early imposed regulations obsolete or ineffective.⁸³⁹

P2P platform intermediation is a socially valuable activity because it can contribute to more efficient reallocation of resources within and between the savings and lending markets. However, it does also bear hidden risks. For example, from the lenders perspective, there may be concerns that the platform may misuse the lent funds or fail in the performance of its duties. Meanwhile, from the borrower's perspective there's a possibility that the intermediary might make off with the money leaving them with the repayment obligation.⁸⁴⁰ An example of

⁸³⁸ *ibid* 1216.

⁸³⁹ *ibid*.

⁸⁴⁰ *ibid* 1224–1225.

this can be seen in the recent suspension of the Swedish platform TrustBuddy by the Swedish FSA, following alleged misconduct within the company's management. In this case, the breaches identified included the company using lender's capital in violation with their instructions or without their permission, resulting in a discrepancy between the amount owed to the lenders and the available balance of the client bank accounts. There are some indications that these practices have occurred since the TrustBuddy platform began.

From the lenders' perspective, one regulatory issue is to ensure that they understand the risks and terms of the financial transaction to protect their varying expectations of the transaction. Key questions include which party the lender has a direct claim against, the borrower or the platform; and what the legal and financial relationships between the parties are, particularly where the creditworthiness of either the platform or the borrower is called into question⁸⁴¹ As argued by David and Gelpert, because not all lenders are sophisticated investors, regulators should not assume that they will all be efficient at managing the risk of the transactions by themselves or that the platforms will necessarily volunteer substantial, correct, accurate and understandable information on which they can rely in the absence of regulation.⁸⁴²

David and Gelpert have argued that the risks associated with financial intermediaries are affected by the degree of discretion they have over the lenders' funds. So the more discretion the intermediary has concerning how the funds are used, the more justified it is to have intrusive regulation to ensure that the management of the intermediary is sound.⁸⁴³ They have given the example that for 'true' intermediaries like deposit-taking banks, intrusive regulation is justified because they have a greater degree of control over the use of funds as opposed to mere 'middlemen' such as wire transfer services which have little to no authority over their clients funds.⁸⁴⁴ They've stated that the risks associated with broad discretion can be found in principal-agent relationships where there's a risk that the intermediary, employees or key agents may be incompetent, have conflicting interests with the lenders, and mis-use funds etc.⁸⁴⁵

⁸⁴¹ *ibid* 1226.

⁸⁴² *ibid*.

⁸⁴³ *ibid* 1227.

⁸⁴⁴ *ibid*.

⁸⁴⁵ *ibid*.

Arguably, no principal-agent relationship exists within the P2PL structure since the platforms are not party to the lending contract and contracted to act on behalf of either the lenders or borrowers and have no actual or apparent authority to do so. Even if such a relationship exists, the structure of P2PL is unclear whether the principal-agent relationship would be between either the lender and the platform or the borrower and the platform; or if these two principal-agent relationships exist simultaneously. However, as highlighted above, P2P platforms can have characteristics similar to both traditional deposit-taking intermediaries and brokers alike. Consequently, whilst David and Gelpern's regulatory rule of thumb also applies to P2PL platforms, it is not just in relation to the degree of discretion platforms have over the monies lent. Rather, this rule of thumb of how much risk the lenders are exposed to by the platforms, should be extended to include the degree of *control* a platform has not just over the funds, but also the formation of the transaction, its implementation and management and up to the point that the monies are repaid. As this more accurately reflects the life-cycle of a P2PL transaction and the fact that the platform's role and influence does not just end once the introductions have been made and the contractual arrangements concluded.

Another regulatory challenge posed by P2P platform operations is caused by the fragmented way that finance is raised for borrowers. This is a beneficial method of capital raising, as one borrower's funds may be raised from a large number and variety of lenders from different areas of the country, thereby speeding up and spreading the risk involved in financial lending. However, this method creates problems of collective action for the lenders because it would be difficult to jointly monitor the platforms or to make joint-decisions when the necessity arises.⁸⁴⁶

From the borrowers' perspective, platforms should also be regulated to minimise the risks that they face. As with lenders, they also experience agency and asymmetric information problems, among other things, because until they receive the funds, they have to depend on the platforms carrying out their functions and duties towards them.⁸⁴⁷ Similarly, questions are raised when considering the conditions and obligations that the borrowers owe the platform and the lenders

⁸⁴⁶ *ibid* 1228.

⁸⁴⁷ *ibid* 1231.

e.g. whether these obligations are fair and whether they are enforced in a fair and reasonable manner.⁸⁴⁸

It is also necessary to regulate P2P platforms from a public policy perspective. Although the money that is being lent and borrowed on the P2P platform consists of private money belonging to individuals, arguably wider society has an interest in how this money is spent and to whom it is going. For example, the interest lies in preventing money laundering, or the funding of shield activities, i.e. activities named on the application form as the purpose for the loan when the loan is really to fund illegal activities. Society also has an interest in ensuring that the money lent will be used in ways which promotes its values and aids its interests.⁸⁴⁹ It may be impractical or insufficient to regulate every single lender or borrower using a platform, so it would be better to hold the platform intermediary accountable for the type of lenders, borrowers and activities they allow to operate on their platforms.

⁸⁴⁸ *ibid* 1232.

⁸⁴⁹ *ibid* 1230.

5.2 Regulation and Financial Regulation

5.2.1. Defining regulation

‘Regulation’ as a concept or activity is not so easily defined. This is particularly the case because it comes in a multiplicity of formations, e.g. command-and-control regulation, responsive regulation, reflexive law etc. Given the wide variety of regulatory types, it is almost inevitable that it will be just as easy to point out the many differences between them as it is to point out their similarities – and as such, very difficult to define regulation.

Jordana and Levi-Faur state that there are multiple and often confusing meanings of regulation and the different definitions reflect the particular disciplinary concerns advanced at a particular time.⁸⁵⁰ They chart the application of three definitions of regulation identified by Baldwin, Scott and Hood⁸⁵¹ over time, and conclude that it is not important to agree on a conclusive definition of what regulation is, rather it is better to look for a specific context and goal that shapes the particular meaning of the idea of regulation.⁸⁵² This perspective is adopted in this thesis as the key concern is to promote regulation which enforces and protects the interests of all three participants of P2PL.

The three main meanings of regulation identified by Baldwin Scott and Hood are:

1. Targeted rules
2. All forms of state intervention in the economy
3. All mechanisms of social control.

These definitions increase in broadness of scope; definition one being the narrowest because it applies only to a specific type of rule and definition three being the broadest because it includes all forms of social control which might include regulation by bodies which are not necessarily the state.

⁸⁵⁰ Jacint Jordana and David Levi-Faur, ‘The Politics of Regulation in the Age of Governance’ in Jacint Jordana and David Levi-Faur (eds), *The Politics of Regulation* (Elgar and the Centre on Regulation and Competition, University of Manchester Forthcoming) 3, 4.

⁸⁵¹ Robert Baldwin, Colin Scott and Christopher Hood, ‘Introduction’ in Robert Baldwin, Colin Scott and Christopher Hood (eds), *A Reader on Regulation* (Oxford University Press 1998).

⁸⁵² Jacint Jordana and David Levi-Faur, (n 869) 7.

The first definition is regulation in its narrowest form.⁸⁵³ Under this notion, it is the creation of an authoritative set of rules accompanied by a mechanism of monitoring or securing their compliance; the latter mechanism is usually a public agency.⁸⁵⁴ An example might include the creation by law of an institutional agency designed to regulate or ‘target’ a particular sector of the economy or a particular problem. One might include in this definition an example of targeted rules, the creation of the Financial Conduct Authority (FCA) in the United Kingdom. The second definition includes all state efforts to direct the economy.⁸⁵⁵ In addition to rule-making, this definition includes measures such as redistribution and taxation.

Lastly, the third definition of regulation stretches to include all methods of social control. It is broader than the first two definitions because it is not limited to state action and legal norms, but can also include non-institutional arrangements and non-state mechanisms.⁸⁵⁶ Consequently, anything that influences behaviour can be considered to be regulation.⁸⁵⁷ It is particularly apt to describe the growth of ‘semi-consensual’ international regimes for the control of global problems like climate change. Such regulatory regimes can be established through voluntary agreements and may lack strong monitoring and enforcement mechanisms.⁸⁵⁸ This meaning is increasingly becoming popular within the socio-legal and constructivist literature in light of the interests in international regulatory regimes and the problems of enforcement that this definition entails.

Jordana and Levi-Faur argue that to an extent, these three definitions reflect changes in the economic and social context of regulation and they also reflect different research and disciplinary interests.⁸⁵⁹ For example, up to the end of the 1980s, scholars outside of the U.S. used the word ‘regulation’ to refer to the general instruments of government used to control the economy and society. In line with the second definition, the word ‘regulation’ was used interchangeably with ‘intervention.’⁸⁶⁰ Economists used to refer to ‘regulation’ in the broader sense of the word possibly because it was useful for conveying a widespread aversion

⁸⁵³ Jacint Jordana and David Levi-Faur (n 869) 5.

⁸⁵⁴ Baldwin, Scott and Hood (n 870) 3.

⁸⁵⁵ *ibid.*

⁸⁵⁶ *ibid* 4; Jacint Jordana and David Levi-Faur (n 869) 5.

⁸⁵⁷ Jacint Jordana and David Levi-Faur (n 869) 5.

⁸⁵⁸ *ibid* 6.

⁸⁵⁹ *ibid* 5.

⁸⁶⁰ *ibid* 6.

to over-regulation,⁸⁶¹ however, given the establishment of independent regulatory institutions in various sectors of the economy, e.g. the FCA and the Prudential Regulatory Authority (PRA) which were established by the Financial Services Act 2012; the rise of institutional economics; and law and economics scholarship, the conception of regulation as ‘targeted rules’ is growing popular.⁸⁶²

In line with the first definition of regulation posited by Baldwin *et al*, Adler considers regulation as, “nontax, noncriminal, public law” i.e. legal directives or utterances such as licences:

1. That are issued and enforced by governmental bodies, rather than by private litigants.
2. That are principally enforced through sanctions or incentives other than criminal litigants
3. That are not taxes (more specifically, not taxes principally designed to raise revenue, such as the income tax).⁸⁶³

This conception of regulation therefore excludes court action where private parties seek relief from the courts, which is the case with tort or property law.⁸⁶⁴ It also excludes self-regulation because of the necessity of a governmental body to implement and enforce regulation. By implication this means that activities which are self-regulated are not actually regulated despite the name and even though industries may have appointed bodies to implement and enforce good behaviour within their markets. So, although some P2PL platforms were part of the P2P Association which regulated its members through a code of conduct, prior to the April 2014 P2PL was an unregulated activity by this definition.

Adler notes that regulation does not only amount to duty-imposing norms, but can also include liberties and powers. As such regulation can also take the shape of pre-event controls of behaviour as well as *ex post* compensation or damages for bad behaviours.⁸⁶⁵

⁸⁶¹ *ibid.*

⁸⁶² *ibid.*

⁸⁶³ Matthew D Adler, ‘Regulatory Theory’ (2009) 592

<<http://papers.ssrn.com/abstract=1553781>> accessed 10 December 2013.

⁸⁶⁴ *ibid* 591.

⁸⁶⁵ *ibid.*

Considering these definitions, prior to the introduction of the April 2014 regulatory regime, the form of P2PL regulation fell under the third, broad definition of social control. This type of regulation affects the behaviour of those P2PL platforms, but its breadth of control is limited only to those who have voluntarily consented to be regulated by these codes. Take for example the case of Quakle, explained earlier in the thesis. Before the failure of that platform, Quakle was not part of the P2P Association as it had not volunteered, consequently, it was not governed by the rules they had instituted relating to capital requirements. Whereas Quakle has failed due to poor financial management, the other platforms members like Zopa have continued to grow. This shows that the voluntary nature of self-regulation means that by itself, it will not always achieve the aim of regulating an industry as there are some firms that may decide not to adhere to the non-binding rules.

However, the current regulation of P2PL in the UK now falls within the first definition of regulation, targeted rules because it is monitored and enforced through a public agency and is governed by a set of authoritative rules. The creation of regulation designed to regulate online P2PL can be considered an example of targeted rules since in the United Kingdom, the government has decided to regulate it through a public agency – the FCA. On the other hand, this might be a stretch since the FCA was not designed specifically for the regulation of P2PL, rather its regulation is being fitted within the remit of a new but existing regulatory agency. Consequently, the second meaning might also be apt to describe the regulation of P2PL since, at least in the UK its regulation will be a form of state intervention. For the sake of analysis, this paper adopts the first definition of Baldwin *et al*, i.e. targeted rules

5.2.2. Goals of regulation

To create particular goals for regulation or to question what the aim of a particular piece of regulation is implies that regulations must be held accountable to their effects or consequences. This suggests that their moral value is consequentialist in nature and the best method of evaluating regulation is to weigh up their outcomes. In other words, regulation must serve a particular purpose and produce a desired end result to be considered effective.

This is the perspective adopted by most normative scholarship, which has been consequentialist in nature.⁸⁶⁶ Consequentialism is a theory of morality that evaluates an action or rule etc., through the comparison of alternative outcomes in terms of their consequences and stipulates that the best action or rule is the one that yields the maximum amount of some good.⁸⁶⁷ Welfarism is a form of consequentialism that views well-being as the only morally relevant characteristic of an outcome.⁸⁶⁸ From the perspective of P2PL regulation, this implies that the best regulation to adopt would be one that produces some sort of social welfare.

There are three main positions on the nature of well-being: the preference-satisfaction view, mental-state view and objective-good view.⁸⁶⁹ The preference-satisfaction view suggests that outcome *a* is better for an individual only if the individual has the right sort of preference for *a* over *b*.⁸⁷⁰ The mental-state view follows the same logic but posits that *a* is only ever better than *b* if the individual's mental state is better in *a* than it is in *b*. Lastly, the objective-goods approach states that *a* is better than *b* if the individual can obtain a better bundle of objective goods in *a*.⁸⁷¹⁸⁷²

According to economists' 'Pareto indifference' principle, if the well-being produced by outcome *a*, is the same as the well-being produced by outcome *b*,

⁸⁶⁶ *ibid* 592.

⁸⁶⁷ Dudley Knowles, *Political Philosophy* (Routledge 2001) 25.

⁸⁶⁸ Adler (n 882) 592.

⁸⁶⁹ *ibid* 594; Matthew D Adler and Eric A Posner, *New Foundations of Cost-Benefit Analysis* (Harvard University Press 2006) 28–39.

⁸⁷⁰ Adler (n 882) 594.

⁸⁷¹ *ibid*.

⁸⁷² *ibid*.

both outcomes would be considered to be morally good.⁸⁷³ Economists also argue in favour of the 'Pareto-superiority' principle which stipulates that if each individual is at least as well off in outcome *a* as they are in outcome *b*, and at least one individual is better off in outcome *a*, then *a* is the better outcome than *b*.⁸⁷⁴ Therefore, unless there is a difference between the well-being produced by different regulations, this view supposes that there is no difference in their value.⁸⁷⁵ However, contrary to this view, welfare production is not the only aim of regulation. It might be asked what the role of regulation is, e.g. whether it is to put people in a better place than they would normally be in or whether regulation exists simply to ensure people follow the same rules, have an equal footing in the market and can conduct their affairs with peace of mind etc.

Based on this welfarist approach, most normative scholarship on regulation argues that regulation is only justified in certain cases of failure of the free market.⁸⁷⁶ Market failures that financial regulation aims to correct include imperfect information which can lead to the inaccurate or incorrect pricing of financial products. For example, inaccurate information about P2PBs could lead to the prices of the loans not reflecting the full risk involved in the transaction, consequently, the lender could be underestimating the risk involved in the lending. Regulation can try to protect this by controlling the type and quality of information that is made available to the market.⁸⁷⁷ Other examples of market failures include natural monopolies which regulators could resolve by subsidising new entrants in the market.⁸⁷⁸

However, within the sphere of financial regulation, the goal of correcting market failures is not the only goal. For example, the goal of prudential regulation can be said to be to manage and minimise the risk of failure by institutions that are seen to be critical to maintaining stability within the financial market.⁸⁷⁹ The goal of

⁸⁷³ *ibid* 592.

⁸⁷⁴ *ibid* 593.

⁸⁷⁵ *ibid* 592.

⁸⁷⁶ *ibid* 595.

⁸⁷⁷ Eric J Pan, 'Understanding Financial Regulation' (2012) 2012 Utah Law Review 1897, 1903.

⁸⁷⁸ Stephen G Breyer, *Regulation and Its Reform* (Harvard University Press 1982) 15.

⁸⁷⁹ Ana Carvajal and others, *The Perimeter of Financial Regulation* (International Monetary Fund Washington, DC 2009) 3

<<http://econ.tu.ac.th/archan/rangsun/ec%20460/ec%20460%20readings/global%20issues/Global%20Financial%20Crisis%202007->

[2009/Academic%20Works%20By%20Instituion/IMF/IMF%20Staff%20Position%20Notes/2009/The%20Perimeters%20of%20Financial%20Regulation.pdf](http://econ.tu.ac.th/archan/rangsun/ec%20460/ec%20460%20readings/global%20issues/Global%20Financial%20Crisis%202007-2009/Academic%20Works%20By%20Instituion/IMF/IMF%20Staff%20Position%20Notes/2009/The%20Perimeters%20of%20Financial%20Regulation.pdf)> accessed 24 June 2016.

managing and minimising risk is often coupled with the management of market failures. This can be seen with the current UK financial regulatory system in which the FCA deals with market failure and the PRA deals with the management of risk through prudential requirements. On a micro-level, prudential regulation supervises individual financial institutions. This is usually achieved with mechanisms such as minimum capital requirements and liquidity requirements, mechanisms to require early intervention by regulators, safety nets like deposit insurance and insolvency and resolution mechanisms.⁸⁸⁰

Prior to the financial crisis of 2008, various arguments were raised to argue for the limitation of prudential regulation, these seem to have been linked to the general movement towards a more decentralised form of regulation, a concept which views regulation as not necessarily tied to or predominated by the state for example, self-regulation.⁸⁸¹ One such argument was that only certain types of institutions posed a systemic risk to the wider financial market.⁸⁸² Although P2PL platforms do not take deposits, they do involve the circulation and reallocation of money. This is because they take money from lenders – money that could be derived from individuals' savings – and lend it to borrowers. According to a Nesta survey conducted between March and September 2014, 25% of borrowers raised finance on P2PL platforms for debt consolidation and 2% to raise money for their own business.⁸⁸³ Research commissioned by the insurance group RSA showed that over half of new small businesses in the UK fail to survive longer than five years.⁸⁸⁴ If the economy struggles and the individuals or sole traders start to be affected by it, there could be a rise of bad debts and the loss of the lenders' money due to failure to repay. Considering this, the public policy argument does not take into account the wide variety of interrelating factors that affect the users of P2PL platforms, and their finances. For example, borrowers, being ordinary people are vulnerable to external factors like rent or mortgage payments, sudden financial shocks which might reduce or eliminate their cash flow to the extent of

⁸⁸⁰ *ibid.*

⁸⁸¹ Julia Black, 'Critical Reflections on Regulation' (2002) 27 *Australian Journal of Legal Philosophy* 1, 2.

⁸⁸² Carvajal and others (n 898) 3.

⁸⁸³ Nesta (n 605).

⁸⁸⁴ Daniel Edward and Amy Andrew, 'Small Businesses Close despite Improving Economy' *This is Money* (15 November 2014) <<http://www.thisismoney.co.uk/money/smallbusiness/article-2801698/Small-businesses-close-despite-improving-economy-HALF-fail-survive-five-years.html>> accessed 17 July 2016.

being unable to meet debts or other obligations, e.g. accidents and job losses; likewise, there are many number of reasons a business might fail including too much competition, business rates and the cost of running a business. Additionally, they are both vulnerable to the wider state of the economy so if there is a financial crisis the borrowers could be impacted. Consequently, although the P2PL itself might not be very risky, the fact that it involves individuals and sole traders/small businesses subject to such risks externally, it cannot claim not to be subject to systemic risks in the wider financial market. Through its participants, it is also vulnerable to systemic risk.

Another argument that had been made in favour of limiting prudential regulations was that applying regulation to a wider range of nonbanks and financial instruments was too costly and would reduce innovation.⁸⁸⁵ Whilst this is a pertinent argument, it is based on a very narrow conception of what regulation is and what it is meant to achieve. The underlying assumption of this argument is that the market operates efficiently for all the industry participants, so that it does not cause harm to society. This in turn assumes that regulation should adopt a neutral and non-judgemental approach to the regulated subject, that is, whether the direction or subject being regulated is a good or bad one or could be operated better to the advantage of the society at large. Therefore, it does not allow for the notion that regulation might play a role in expressing or putting into place new values that might be beneficial for society, so the basis of this argument is also that regulators have no role in steering an industry in a particular direction. Rather, so long as the industry poses no harm to society it should be left to the industry to decide what direction it takes.

However, this is not adopted in practice as demonstrated by the existence of social regulation which tries to achieve goals that private persons on their own will may not pursue, e.g. distributional justice and access to judicial remedies.⁸⁸⁶ An example is the policy adopted by the government in relation to access to finance, as has been seen in the discussion of the policy behind the regulation of CUs in the UK, the underpinnings of said regulation has been to steer the credit union industry through the pursuit of making it a way to access finance for people

⁸⁸⁵ Carvajal and others (n 898) 3.

⁸⁸⁶ Pan (n 896) 1903; Julia Black (n 900) 10.

who do not typically have access to it. This in itself is a value-based goal imposed on the industry by the external regulators. The fact this happens suggests that it is possible for other goals or uses to be imposed on an industry.

In contrast to these pre-financial crisis arguments against stringent prudential regulations, the crisis showed that the failure of some non-bank entities had systemic repercussions by disrupting the financial markets and contributing to a widespread loss of confidence, e.g. the failure of the Lehman Brothers early in the crisis.⁸⁸⁷ The largely light-touch regulation adopted by the UK financial regulator pre-crisis failed to take into account the systemic risks that can arise from the interaction between regulated and unregulated institutions because bank regulation did not reflect the risks of loan originators which had poor underwriting standards.⁸⁸⁸ This example demonstrates that financial markets are not mutually exclusive, if they are exposed to each other in one way or the other, they might be rendered vulnerable in an indirect way to the risk posed by the other market. e.g. a borrower who uses a P2PL platform is not necessarily precluded from other forms of borrowing – in fact many platforms themselves have used the fact that the borrowers they authorise can obtain loans from other sources like banks as an advertising tool. It is not uncommon for individuals or businesses to have multiple co-existing debts e.g. credit cards, multiple loans etc. Failure to pay multiple of these debts might lead to the borrower's financial ruin and this could impact their ability to repay a loan. Such personal financial crises are exacerbated during societal financial crises which impact most members of society. Consequently, through their users, P2PL platforms are exposed to such systemic crises as well.

A final goal of financial regulation is consumer protection. This can be both a type of financial law as well as a goal in the broader sense. Consumer protection aims to protect the weaker or more vulnerable party to financial transactions and prevent them from being victim to unscrupulous practices such as mis-selling of unsuitable products like payment protection insurance and packaged bank accounts; or services like irresponsible lending. There are a wide variety of mechanisms through which consumer protection regulation achieves these goals, including redress to put consumers in the position they would have been

⁸⁸⁷ Carvajal and others (n 898) 4.

⁸⁸⁸ *ibid.*

in if the wrong had not been done to them; consumer protection intervention tends to be implemented through access to accurate information, as demonstrated by the FCA's recent intervention in the P2PL markets in February 2016 because of misleading information having been to users about. Enforcement mechanisms are also used, such as the requirement that all financial firms notify their customers that they have access to the complaints resolution service provided by the Financial Ombudsman Service. However, the focus of consumer protection and the mechanisms provided to achieve its goals focus on the weak party in a B2C model of business. Consequently, the current framework of consumer protection does not fit all the situations that are faced by P2PLs it only provides for the B2C relationships between the lenders and platform and borrowers and the platform respectively.

In addition to the regulatory mechanisms already mentioned, these regulatory goals can be achieved through several mechanisms which include rulemaking, supervision and certification or licensing.⁸⁸⁹ The rulemaking mechanism is the ability to set rules or standards to govern the acts of private persons. The rules act as the norm which mandates or guides conduct in each situation, and for this reason they need to be articulated precisely to adequately define the conduct which the regulator wants the target to achieve.⁸⁹⁰ The importance of this is to ensure that there is no regulatory confusion brought about by imprecise wording or lack of clarity about what is expected of the regulation's target. The P2PL regulatory regime uses the rulemaking mechanism in relation to its prudential aims, for example, the minimum capital requirements are specific in their mandate for how much the platforms need to set aside in proportion to their loan books and the rule dictating that platforms must have a plan in place to ensure continued administration of loans in case of failure. The latter rule is intended to mandate a platform's action but it does not provide guidance of what type of action should be taken which is left to the platform to decide for the sake of flexibility.

The supervisory mechanism is carried out by the regulators monitoring, assessment and guidance of an entity's efforts to meet the obligations set out by

⁸⁸⁹ Pan (n 896) 1909.

⁸⁹⁰ *ibid.*

the rules or principles established by the regulatory regime. Under their supervisory powers the regulator focuses on how to apply the rules.

In addition, regulators also use certification or licensing as a mechanism to prevent the spread of poor quality or undesirable products and services. It has uses for both prudential and consumer protection purposes. From the prudential perspective, it can be used to minimise risks to the financial system posed by substandard products or firms. Indeed, many financial institutions need to be licensed, for example banks and now also P2PL platforms need to be licenced to carry out an electronic business in relation to lending, i.e. to operating a P2PL platform. From a consumer protection perspective, this mechanism can be used to ensure that only sound products and services which are beneficial to consumers and society members are allowed into the market.

5.2.3. Types of regulation

Command and Control

Systems of regulatory control generally adopt the following steps: firstly, the regulation lays down a broad set of desirable outcomes or policy goals, e.g. consumer protection or responsabilisation of the consumer. Secondly, it sets suitable targets for achieving those goals. Lastly, it takes specific actions which will achieve the targets.⁸⁹¹ Consequently, within a regulatory system, the following functions are required: rulemaking, communication of the rules to the regulatees, monitoring, enforcement, adjudication, sanctions and evaluation of the regulatory system.⁸⁹² Command-and-control regulation typically refers to the third stage i.e. measures which directly affect the firm or regulated entity, and in classic command-and-control systems, government has a high degree of involvement in all of the functions of the regulatory system.

Traditional regulation is often termed 'command-and-control' because it consists of legal standards (commands) which are reinforced by legal sanctions (controls)

⁸⁹¹ Chris Hilson, *Regulating Pollution: A UK and EC Perspective* (Hart Publishing 2000).

⁸⁹² Margot Priest, 'The Privatization of Regulation: Five Models of Self-Regulation' (1997) 29 *Ottawa L Rev* 223, 223, 228.

and it is therefore a prescriptive form of regulation.⁸⁹³ Steele and Jewell have defined command-and-control regulation as the prohibition of defined behaviour and the enforcement of said prohibition through criminal law.⁸⁹⁴ Meanwhile Hutter has defined it as the command of law supported by the state's authority.⁸⁹⁵ It features measures such as standard setting followed by permitting or licensing, monitoring and inspecting and if necessary enforcing and sanctioning. These definitions indicate that command-and-control regulation is centralised requiring state intervention to enact laws and enforce them.

Command and control regulation has been criticised as too restricted because it suggests that regulatory rules are only meant to constrain, rather than aid or encourage activities or changes of behaviour by the regulated firm or individual. It has also been criticised as being costly and inefficient, causing enforcement difficulties and stifling innovation,⁸⁹⁶ in comparison with self-regulation.

However, Sinclair notes that when one examines the proliferation of different forms of regulation which are apparently described as either command-and-control or self-regulation, it is not easy to compartmentalise them in such a rigid manner, rather the range of policies fall between the two theoretically polar opposite forms of regulation.⁸⁹⁷ For example, enforced self-regulation/responsive regulation, cooperative agreements, negotiated compliance and corporate reporting etc.⁸⁹⁸ These policies tend to incorporate elements of both. Similarly, although the FCA generally adopts a principles-based approach to regulation as exemplified by the Better Regulation principles and its Principles of good regulation,⁸⁹⁹ the mechanisms used by the FCA to regulate P2PL are known to command-and-control regulation such as rules which are backed by sanctions

⁸⁹³ Neil Gunningham and Peter Grabosky, *Smart Regulation: Designing Environmental Policy* (Oxford University Press 1998).

⁸⁹⁴ Jenny Steele and Tim Jewell, 'Law in environmental decision-making' in Tim Jewell and Jenny Steele, *Law in Environmental Decision-Making: National, European, and International Perspectives* (Oxford University Press 1998)

⁸⁹⁵ Bridget Hutter, *A Reader in Environmental Law* (Oxford University Press 1999).

⁸⁹⁶ Alan Moran, 'Tools of Environmental Policy: Market Instruments Versus Command-and-Control' in Robyn Eckersley, *Markets, the State, and the Environment: Towards Integration* (Macmillan Education AU 1995); Janis D Bernstein, 'Alternative Approaches to Pollution Control and Waste Management: Regulatory and Economic Instruments' (The World Bank 1993) Discussion Paper 11711.

⁸⁹⁷ Darren Sinclair, 'Self-Regulation Versus Command and Control? Beyond False Dichotomies' (1997) 19 L & Pol'y 529, 531–532.

⁸⁹⁸ *ibid* 532.

⁸⁹⁹ Financial Conduct Authority, 'Principles of Good Regulation' (FCA, 30 March 2016) <<https://www.the-fca.org.uk/about/principles-good-regulation>> accessed 17 July 2016.

enforced by the regulator. Additionally, Cole and Grossman have argued that at least within the environmental regulation discourse, command-and-control regulations can and have produced social benefits which exceed their costs and can be more efficient than alternative economic regulatory measures.⁹⁰⁰

Since, at least in the UK, the P2PL industry have actively sought government regulation, this suggests that there are benefits to command-and-control regulation, for example, the enforcement aspect of this regulatory form or at the very least, the show of doing something to regulate the industry.

Self-regulation

Self-regulation refers to the delegation of regulatory responsibility from the government to an industry or group over its own activities or behaviour.⁹⁰¹ This includes voluntary codes of conduct which are voluntarily established by contract and usually involve very little public input in the formation.⁹⁰² For example, the pre-April 2014 UK P2PL industry was one that had developed voluntary codes of conduct⁹⁰³ without any direct government supervision or consumer input. It was used to ensure certain standards within the industry were maintained. Another example of self-regulation is statutory self-regulation where the government legislates a self-regulatory structure and power is delegated to the industry or firm to implement it.⁹⁰⁴

Self-regulation is a form of regulation that has a lot of potential to ensure the compliance of the regulated firm, industry or person, however as stated by Priest, it is more likely to work under certain conditions. For example, the existence of relatively few industry players; high exit costs; a history of cooperation by the regulatee; expertise and resources for regulation are available in the industry; noncompliant behaviour can be punished; consumers value compliance; fair

⁹⁰⁰ Daniel H Cole and Peter Z Grossman, 'When Is Command-and-Control Efficient-Institutions, Technology, and the Comparative Efficiency of Alternative Regulatory Regimes for Environmental Protection' [1999] Wis. L. Rev. 887, 888.

⁹⁰¹ Margot Priest (n 911) 237.

⁹⁰² *ibid* 242.

⁹⁰³ See for example, Peer2Peer Finance Association, 'Rules & Operating Principles' available <<http://www.p2pfinanceassociation.org.uk/rules-and-operating-principles>> accessed 24 March 2013.

⁹⁰⁴ Margot Priest (n 911) 242.

dispute settlement mechanisms exist and public participation and oversight has a part to play in the industry.⁹⁰⁵ This makes sense as these are factors which make securing compliance either easier or more efficient. For example, where there are fewer industry players, it would be easier for compromises to be made, agreements reached and to monitor each participant for compliance to the rules. In addition, unless the industry has the ability or authority to exercise punishment for non-compliance amongst each other, then the self-regulatory rules are likely to be toothless. So, in the absence of these factors, self-regulatory systems are likely to be less effective at securing compliance. Self-regulation may therefore require at least minimal government action to encourage the regulatory structure,⁹⁰⁶ for example to give it a semblance of legitimacy or the support of accountability.

Self-regulation has many advantages over traditional forms of regulation. A practical advantage is that it can allow regulation that would not be feasible due to cost restraints, lack of skill or expertise and/or personnel, if implemented by the government.⁹⁰⁷ It enables the government to ensure critics that an industry is being regulated and the public is being protected, without having to take direct responsibility for implementing or enforcing the regime.⁹⁰⁸ It is also said to be a very flexible regime with rules that can quickly adjust to changes within the industry as compared to the much slower command-and-control route,⁹⁰⁹ enabling firms within the industry to remain competitive.

However, there are several disadvantages of self-regulation. Where regulation is meant to protect the public interest for example, through consumer/investor protection or limiting irresponsible lending practices, there is a concern that self-regulation may be used as a façade to hide the pursuit of the industry/firm's own interests.⁹¹⁰ Or they may seek self-regulation to prevent stricter and more direct forms of regulation.⁹¹¹

⁹⁰⁵ Margot Priest (n 788) 233.

⁹⁰⁶ Margot Priest (n 788) 239; Christodoulos Stefanadis, 'Self-Regulation, Innovation, and the Financial Industry' (2003) 23 J Reg Econ 5, 224.

⁹⁰⁷ Margot Priest (n 788) 268.

⁹⁰⁸ *ibid* 269.

⁹⁰⁹ *ibid*.

⁹¹⁰ *ibid*, 271-272.

⁹¹¹ *ibid* 271.

In addition, the advantage of flexibility may be limited by the possibility of favouritism within self-regulatory structures.⁹¹² The self-regulatory body is likely to be dominated by the bigger or longer established firms and may be designed to pursue their interests through maintenance of the status quo, at the expense of smaller firms and the public interest.⁹¹³ This indicates a potential conflict of interests inherent in the self-regulatory structure which is whether the industry should regulate for the public interest or the industry interest. For the P2PL model, there might need to be a combination of both since self-regulation is often more effective when it works in the 'shadow' of government regulation.⁹¹⁴ Regulation would need to be loyal to the public interest because unless its consumers, both lenders and borrowers, have confidence in the P2PL market, very few would use the service thus rendering the market irrelevant. On the other hand, in light of relatively recent introduction of the P2PL market, regulation would also need to pursue the market's interests in flexibility, innovation and competitiveness. However, the issue of how regulation should balance the interests within the P2PL market is one that the literature does not consider.

⁹¹² *ibid* 272.

⁹¹³ Margot Priest (n 788) 272; Robert N Katz, 'Industry Self-Regulation: A Viable Alternative to Government Regulation' in Robert N Katz and National Affiliation of Concerned Business Students (eds), *Protecting the Consumer Interest: Private Initiative and Public Response* (Ballinger Pub Co 1976) 165.

⁹¹⁴ Margot Priest (n 788) 302; see also, Christodoulos Stefanadis (n 802) 224.

Responsive regulation

Securing compliance is a critical theme of regulatory enforcement which gave rise to the 'deterrence vs. compliance' debate. Supporters of deterrence strategies argued that only punitive sanctions would compel corporate compliance with the law, whilst supporters of compliance argued that this could only be achieved through persuasive methods.⁹¹⁵ The debate was one-dimensional as it focused on which regimes compelled corporate compliance. Ayres and Braithwaite's two regulatory enforcement pyramids arose from the need to transcend this debate.⁹¹⁶ Through the framework of these pyramids, they argued that regulatory agencies act more efficiently when deterrent strategies are balanced by persuasive tactics,⁹¹⁷ that is, when regulation is more responsive.

Responsive regulation is the idea that regulatory processes and decisions should take into account industry structures, since different structures will be amenable to different degrees and tools of regulation.⁹¹⁸ In this way, the firm or industry's behaviour should direct the severity of regulatory sanctions or extent of intervention.⁹¹⁹ Deterrence by itself, i.e. command-and-control regulation, often fails to secure compliance commitment because it does not take into account businesses' perceptions of the morality of the regulated activity, rather it puts a price on noncompliance and depends on the operation of the imposed sanctions, or 'deterrence trap', to secure compliance.⁹²⁰ In contrast, responsive regulation seeks to build moral commitment to compliance with the law.⁹²¹ This idea is enacted by escalation and de-escalation along the pyramids' hierarchy of levels, and is instigated by non-cooperation by firms/industries.⁹²²

⁹¹⁵ Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press 1995) 20; e.g. compliance see Keith Hawkins, 'Compliance Strategy, Prosecution Policy, and Aunt Sally-A Comment on Pearce and Tombs' (1990) 30 *Brit J Criminology* 444; Keith Hawkins, 'Enforcing Regulation-More of the Same from Pearce and Tombs' (1991) 31 *Brit J Criminology* 427; e.g. deterrence see Frank Pearce and Steve Tombs, 'Ideology, Hegemony, and Empiricism Compliance Theories of Regulation' (1990) 30 *Brit J Crim* 423; Frank Pearce and Steve Tombs, 'Policing Corporate Skid Rows-A Reply to Keith Hawkins' (1991) 31 *Brit J Criminology* 415.

⁹¹⁶ Ayres and Braithwaite (n 934) 3, 5, 20.

⁹¹⁷ *ibid* 21.

⁹¹⁸ *ibid* 4.

⁹¹⁹ *ibid* 4.

⁹²⁰ Christine Parker, 'The "compliance" Trap: The Moral Message in Responsive Regulatory Enforcement' (2006) 40 *L & Soc Rev* 591, 592.

⁹²¹ *ibid*.

⁹²² Ayres and Braithwaite (n 934) 6.

By combining the two strategies, Ayres and Braithwaite highlighted that using one particular method is problematic because a regime that is purely punitive or persuasive fails to account for the varying values of corporate actors,⁹²³ leading to regulatory responses which lack understanding of the causes of a particular case of non-compliance and missing their targets by using inappropriate regulatory tools.⁹²⁴ Therefore, Ayres and Braithwaite argued that regulators need to be responsive to different corporate conduct and based on this, decide when to punish or persuade to effectively secure compliance.⁹²⁵ The regulatory pyramids seek to provide the framework for this and their ultimate aim is to change the behaviour/attitude of firms so they become more compliant with regulation and embrace socially responsible motivations as better than purely economic values in the long run.⁹²⁶

The pyramid of regulatory enforcement (PRE) is designed to regulate individual firms and escalates with severity of sanction.⁹²⁷ Regulatory action begins at the base of the pyramid, where regulators push for compliance through persuasion. Escalation occurs upon failure of the regulated firm to cooperate with regulators, moving up from warning letter, to civil penalties, criminal penalty, licence suspension and finally licence revocation.⁹²⁸ However, it is not the content of the PRE that counts but the logic of its structure, i.e. the pyramidal shape and the use of escalating TFT responses.⁹²⁹ So, different regulators can choose which type of sanctions to place at each level of the pyramid depending on what is appropriate in their regulatory arena.

The pyramid of regulatory strategies (PRS) works with the same logic as the PRE, the difference is the PRS targets industries not individual firms and increases state intervention.⁹³⁰ If regulators can convince industry associations that compliance with a particular law or regulation is beneficial to them, then the association can persuade individual firms to comply.⁹³¹ At the base of the PRS lies self-regulation, because when it works it is cheaper for society and the

⁹²³ *ibid* 19.

⁹²⁴ *ibid* 20.

⁹²⁵ *ibid* 19.

⁹²⁶ *ibid* 26.

⁹²⁷ *ibid* 35.

⁹²⁸ *ibid* 35-36.

⁹²⁹ *ibid* 36.

⁹³⁰ *ibid* 38.

⁹³¹ *ibid* 39.

regulated industry. This is followed by enforced self-regulation, command regulation with discretionary punishment and finally command regulation with non-discretionary punishment.⁹³² As with the PRE, the content of the PRS depends on what suits the enforcing state. One benefit of the PRS is it appears to treat self-regulation of companies as a privilege which can be removed or impinged whenever firms/industries misbehave. This slightly mitigates the dangers of permanent self-regulation e.g. exploitation of the privilege, and the performance of environmental or social responsibilities reduced to the bare minimum of standards.

The hierarchy of sanctions/interventions reflect Ayres and Braithwaite's argument that punishment as a first response is counterproductive.⁹³³ From the point of view of the state, the pyramidal strategy is economically advantageous, because it gives the cheaper options of persuasion and self-regulation the opportunity to work first and only when they fail does it utilise more expensive punitive strategies.⁹³⁴ This implies that whenever persuasion proves successful, the state saves resources which would have been wasted had they immediately used penal sanctions e.g. court proceedings.⁹³⁵ The EPs therefore make regulation cheaper, because by starting with persuasion or intervention, they inform companies that unless they effectively self-regulate, e.g. punish themselves according to agreed company policies, the regulators will punish them instead and they are prepared to go as far as required to do so.⁹³⁶

The strategy of their enforcement pyramids has a convincing theoretical basis which has influenced policy documents and regulatory strategies worldwide.⁹³⁷ For example, it was applied by the Australian Tax Office's (ATO) Compliance Model, helping it to manage firms' perceptions of the morality of their conduct by not focusing solely on deterrent strategies.⁹³⁸ This enabled the ATO to settle the

⁹³² *ibid* 38.

⁹³³ *ibid* 26.

⁹³⁴ John Braithwaite, 'Responsive Regulation and Developing Economies' (2006) 34 *World Development* 884, 887.

⁹³⁵ Ayres and Braithwaite (n 934) 884, 888.

⁹³⁶ John Braithwaite (n 954) 888.

⁹³⁷ Robert Baldwin and Julia Black, 'Really Responsive Regulation' (2008) 71 *The Modern Law Review* 59, 62; Yeung (n 103).

⁹³⁸ Parker (n 940) 592, 592, 599.

TNT freight case using reputation and publicity as an incentive for the firm to settle.⁹³⁹

However, the logic of the enforcement pyramids, based on responsiveness and tit-for-tat strategy, is too focused on transcending the deterrence/compliance debate and thus fails to overcome weaknesses and ethical and practical problems inherent in the strategy. For example, whether a company cooperates with the regulator is the main factor for responsiveness, hence escalation occurs upon non-cooperation. This two-dimensional portrayal of corporate decisions and conduct affects the ability of regulators to take truly responsive actions and judgements, and potentially leads to inappropriate enforcement action.

Additionally, the enforcement pyramids' validity is undermined by weaknesses inherent in the TFT strategy such as the assumption that in every regulatory encounter, actors will be able to reach each other's conduct, when in reality, regulators are not always certain about the details of firms' conduct, on which their response depends.⁹⁴⁰ They are also undermined by the responsive method of regulation on which they are based, such as the conceptual problem of how to 'start' using the pyramids.

Responsive regulation is a method of regulation that may be applicable in a wide variety of contexts. The literature has applied it to the food industry,⁹⁴¹ the environment,⁹⁴² fisheries controls,⁹⁴³ and tax enforcement regulation⁹⁴⁴ etc. Given the relatively recent origin of P2PL, the literature does not consider the application of responsive regulation to this industry.

Responsive regulation is not a form of regulation, but a method of implementing existing regulation, as such it provides a useful framework, at least in theory, for analysing the potential practical implications or usefulness of P2PL regulation.

⁹³⁹ *ibid* 599–601.

⁹⁴⁰ Roderick M Kramer, Jane Wei and Jonathan Bendor, 'Golden Rules and Leaden Worlds: Exploring the Limitations of Tit-for-Tat as a Social Decision Rule' in John M Darley, David M Messick and Tom R Tyler, *Social Influences on Ethical Behavior in Organizations* (Psychology Press 2001) 183–184.

⁹⁴¹ Peter Mascini and Eelco Van Wijk, 'Responsive Regulation at the Dutch Food and Consumer Product Safety Authority: An Empirical Assessment of Assumptions Underlying the Theory' (2009) 3 Reg & Gov 27.

⁹⁴² Baldwin and Black (n 957) 59.

⁹⁴³ *ibid*.

⁹⁴⁴ Sagit Leviner, 'An Overview: A New Era of Tax Enforcement—from "big Stick" to Responsive Regulation' (2008) 2 Reg & Gov 360.

One concern however, is that the literature focuses on the regulation of firms and industries, for example, the enforcement pyramids are applied to firms. However, it is not clear how this can be easily translated to P2PL which necessitates the regulation not just of the platforms which act as intermediaries, but also of the borrowing and lending consumers that use the service. Responsive regulation, which involves the initial use of self-regulation may only be applicable to the regulation of the platforms as it is difficult to envision the self-regulation of individuals within the industry, short of stating that there is to be no regulation of them at all. Consequently, like the current P2PL regulatory regime, it also does not consider the regulation necessitated by a P2P business model.

Responsibilisation

However, this is something that in part seems to be encouraged by policies such as the responsabilisation of consumers of financial services and products. The responsabilisation of these individuals might be considered self-regulation at the individual level. To responsabilise an individual is to enhance his awareness of his own responsibility for the decisions he makes and for finding solutions to his investment or financial problems.⁹⁴⁵

The responsabilisation of consumers is often thought to be achieved through financial literacy and education.⁹⁴⁶ Williams notes that the economic model of financial education often couches it in terms of the 'empowerment' of financial consumers because it is supposed that education reduces barriers to participation in markets and improves the accessibility of key information.⁹⁴⁷ This is because the confusion caused by the increasing supply and variety of financial products, coupled with information asymmetries, i.e. the risk of the market circulating poor-quality or unusable information and the complexity of the available information, means that consumers' interests are threatened,

⁹⁴⁵ Ronen Shamir, 'The Age of Responsibilization: On Market-Embedded Morality' (2008) 37 *Economy and society* 1, 1.

⁹⁴⁶ Williams (n 400) 227.

⁹⁴⁷ Williams (n 318) 227; For example, see Peter Cartwright, (2004) *Banks, Consumers and Regulation*. Oxford: Hart Publishing.; Jonathan Fox, Suzanne Bartholomae and Jinkook Lee (2005) "Building the Case for Financial Education," *The Journal of Consumer Affairs* 39: 195-214.; Geraint Howells, (2005) "The Potential and Limits of Consumer Empowerment by Information," *Journal of Law and Society* 32, 349-70.

particularly their interests in financial products supplied under long-term contracts.⁹⁴⁸

In this way, education acts together with consumer protection regulation to improve decision-making skills and help individuals to benefit from remedies such as disclosure.⁹⁴⁹ However, others view financial education as a shift of responsibility for personal economic security from the state to the individual and as an expression of the interests of states and firms in expanding consumer financial markets.⁹⁵⁰ Policy discourse often conceives of financial illiteracy as a problem of national interest, linking it to the performance of domestic financial markets and the overall health of national economies.⁹⁵¹ For example, an OECD report asserted that higher levels of financial literacy would help all economies and potentially moderate the volatility of financial markets in 'emerging economies'.⁹⁵²

However, whilst responsabilising the consumer might be empowering them to seek private means of protecting their interests, it also encourages individualistic tendencies and contributes to the erosion of solidarity as the key principle of social policy.⁹⁵³ It fails to address issues of public and collective goods for example, collective information and action.⁹⁵⁴ Additionally, the limits of the effectiveness of information provision have already been discussed in the review of the literature on paternalism above. The weaknesses inherent in the provision of information necessitate that any regulation with the goal of responsabilising the consumer, should be accompanied by other regulations to ensure that the market runs efficiently from the perspective of both the recipients and the industry.

⁹⁴⁸ Williams (n 400) 232.

⁹⁴⁹ *ibid* 227.

⁹⁵⁰ *ibid* 227; For example, Julie Froud and others, 'The Quiet Panic about Financial Literacy' in Assassi L and others (eds), *Global Finance in the New Century: Beyond Deregulation* (Palgrave Macmillan 2006); Pamela Odih and David Knights Odih P and Knights D, "'Discipline needs time": Education for Citizenship and the Financially Self Disciplined Subject' (1999) 10 *The School Field* 127.

⁹⁵¹ Williams (n 318) 229.

⁹⁵² OECD, 'Improving Financial Literacy: Analysis of Issues and Policies' (OECD 2005) 35 <<http://www.oecd.org/finance/financial-education/improvingfinancialliteracyanalysisofissuesandpolicies.htm>> accessed 5 August 2016.

⁹⁵³ Williams (n 318) 243.

⁹⁵⁴ Donnie L. Kidd Jr and William H. Daughtrey Jr, 'Adapting Contract Law to Accomodate Electronic Contracts: Overview and Suggestions' (2000) 26 *Rutgers Computer and Technology Law Journal* 215, 224.

Within the context of P2PL, responsabilising regulations, may take the form of ensuring the “lendsumers”⁹⁵⁵ access accurate information about current market prices i.e. loan prices, or from the borrowers’ perspective, educating them about the risks of taking on new borrowing. This could help ensure the efficient running of the market by preventing market failures caused by mis-pricing of or overestimation of how much an investment might be worth and by contributing to the reduction of borrowers who borrow more than they know they can repay. Educating the consumer does not need to be reserved to preventing potential problems, but could also consist of directing consumer lenders or borrowers to various solutions to their problems – however, this would mean that the consumer would have to take personal steps to resolve their own problems. However, within P2PL they might not be able to do so, for example, privately recuperating unpaid debts from a borrower, might be impossible because lenders may not have access to this information for data protection purposes.

5.2.4. Dual Regulation and Civil Liability Approach

Regulation and civil liability relationship

As discussed in Chapter Four, P2PLs are provided with some protections within the UK regulation. However, whilst they can seek ordinary contract and tort laws’ remedies for certain wrongdoings, lenders cannot privately enforce the protections enacted for their benefit in the regulatory instruments. This relates to the principles surrounding statutory liability. The basic rule is that a breach of statutory duty is not a private law cause of action for damages. The presumption, as originally stated by Lord Tenterden CJ *Doe d. Murray* is that “where an Act creates an obligation, and enforces the performance in a specified manner...that performance cannot be enforced in any other manner”.⁹⁵⁶ In *Lonrho Ltd v Shell Petroleum Co Ltd (No)*,⁹⁵⁷ Lord Diplock confirmed that a statutory duty can only be enforced in the manner prescribed by statute.⁹⁵⁸ He, however, identified two exceptions to this presumption: firstly, on a true construction of the relevant

⁹⁵⁵ See section 5.7. of the thesis for a detailed discussion of the concept of “lendsumer”.

⁹⁵⁶ *Doe d. Murray v Bridges (1831) 1 B & Ad 847, 859.*

⁹⁵⁷ *Lonrho Ltd v Shell Petroleum Co Ltd (No 2)*, 68 [1982] AC 173.

⁹⁵⁸ *Lonrho Ltd v Shell Petroleum Co Ltd (No 2)*, 68 [1982] AC 173, 185.

statute, it is clear that the obligation or prohibition was imposed for the benefit or protection of a particular class of individuals; and secondly, the statute creates a public right and a member of the public suffers what Brett J in *Benjamin v Storr* described as “particular, direct and substantial” damage “other and different from that which was common to the rest of the public.”⁹⁵⁹ Consequently, one of the main factors which determines whether there is a statutory right of action is whether the scope and wording of a statute demonstrates that Parliament intended to make the prescribed duty one owed to private members of the public or a public duty only.

The English courts have found no relevant intention of Parliament in some cases. For example, in *Harris v Evans*⁹⁶⁰ it was held that taking into account the intention of the Health and Safety at Work Act 1974, to protect the public, the Health and Safety Executive did not owe a duty of care to a business owner regarding information provided by one of its inspectors about the safety requirements for that business. The reasoning that a duty of care would likely cause untoward cautiousness that would be detrimental to the proper discharge of the Executive’s enforcement responsibilities. Likewise, in *Badham v Lambs Ltd*,⁹⁶¹ the court had to consider whether s.1 of the Road Traffic Act 1934 which deemed it unlawful to sell a motor vehicle in a condition that would render its use on a road illegal, gave the purchaser a right of action against the seller. The defendant in the case had sold the claimant a second-hand car that was unlawful to drive because it had defective brakes. Consequently, the claimant brought an action for damages for breach of statutory duty. It was held that the main objective of the legislation was to punish offenders and not to protect purchasers of motor vehicles or provide a right of action and nothing in it showed relevant parliamentary intention. Duparc LJ insisted that the legislation “does not say so”, apart from providing financial penalties for guilty sellers.

The second exception is that if on construction of the statute, it appears it was passed for the benefit of a particular section of the community, and the claimant belongs to this community, there is a strong ground for concluding that an action

⁹⁵⁹ *Benjamin v Storr* (1874) LR 9 CP 400, 407.

⁹⁶⁰ *Harris v Evans* [1998] 1 WLR 1285 CA.

⁹⁶¹ *Badham v Lambs Ltd* [1946] KB 45.

will arise.⁹⁶² However, if the statutory duty appears to be for the protection of society as a whole, rather than a limited class, there is no private right of action as decided in *DC Accountancy Services Ltd v Education Development International Plc*.⁹⁶³ A quasi-regulator imposed a sanction on the provider of education services for alleged poor service. The provider's claim in tort for negligent assessment failed because the regulator owed a duty of care to the general public and not to the provider specifically.

The general rule also applies even in cases where Parliament had the intention to protect, but does not provide a remedy for breach of the regulatory measure imposed. In *R v Deputy Governor of Parkhurst Prison Ex p. Hague* the House of Lords held that because the fact that a particular regulatory provision was intended to protect certain individuals is insufficient to confer private law rights of action.⁹⁶⁴ The case concerned prisoner segregation in good faith in breach of procedures prescribed by the Prison Rules 1964 under the Prison Act 1952. The prisoner's claim for damages for false imprisonment failed.

Although there is no rule against recovering economic loss in an action for breach of statutory duty if the claimant can prove that the purpose of the statute was to protect his/her financial interests, the courts may be slow to infer such an intention. Stuart Smith LJ in *Richardson v Pitt-Stanley* opined that the court would be less likely to construe a civil cause of action arising out of statute for mere economic loss, than in cases relating to the safety and health of a particular class of persons.⁹⁶⁵ For P2P users then, it is necessary for the statute or regulation to specifically provide for a right of action since they are more likely to claim for economic loss rather than physical injury.

P2PL regulation and civil liability relationship

As mentioned in the previous section, it is generally the case that a statutory duty does not automatically provide individuals with a private right of action against offending parties, which in the context of P2PL regulation, would be the platforms.

⁹⁶² Per Lord Brown-Wilkinson in *X (Mminors) v Bedfordshire CC* [1995] 2 AC 633, 731.

⁹⁶³ *DC Accountancy Services Ltd v Education Development International Plc* [2013] EWHC 3378 QB.

⁹⁶⁴ *R v Deputy Governor of Parkhurst Prison Ex p. Hague* [1992] 1 AC 58, 170.

⁹⁶⁵ *Richardson v Pitt-Stanley* [1995] QB 123, [132].

The regulatory instruments made under the FSMA 2012 in relation to P2PL specifically state that they do not give rise to any rights of action for P2PLs and borrowers. Consequently, P2PL users only have the usual private actions provided by ordinary rules of contract. Since P2PL platforms are not party to the lending transaction, users do not have direct means of pursuing justice or enforcement of rights against the platforms or at the very least a causal link would be difficult to prove. Therefore, in the UK P2PL regulatory system, the relationship between civil liability and regulatory liability is tenuous at best and non-existent at worst.

Regulation and civil liability in P2PL regulatory regime

Civil liability is an older form of regulation and enforcement than administrative regulation.⁹⁶⁶ Whereas regulation is an *ex ante* approach to providing victims with a remedy, civil liability consists of an *ex post* approach.⁹⁶⁷ Typically, regulation requires that the regulated party should pay a fine if there has been a violation of regulatory standards, the criteria of which the concerned parties are already aware of.⁹⁶⁸ This is the case even where no harm has occurred from violations of regulations.⁹⁶⁹ However, one problem with regulatory measures is that an offender will only pay the fine if the regulatory authorities are aware of the wrongdoing.⁹⁷⁰ The effect is that the protections provided by public regulatory measures are effective only in so much as the regulatory agencies enforcing them are. Nonetheless, this can equally apply to private regulation which depends on the will of private actors to pursue rights of action in court. Other remedies of administrative regulation include disqualification, revocation of a licence and in some cases imprisonment.⁹⁷¹ Overall, regulation provides potential offenders with the incentive not to engage in misconduct. Regulatory authorities also have

⁹⁶⁶ Fabrizio Cafaggi, 'A Coordinated Approach to Regulation and Civil Liability in European Law: Rethinking Institutional Complementarities' (European University Institute 2005) Working Paper 3 <<http://cadmus.eui.eu/handle/1814/3333>> accessed 8 February 2017.

⁹⁶⁷ PM Prasad, 'The Relative Efficiency of Liability Versus Regulation In Providing Incentives To Tortfeasor' (1999) 41 *Journal of the Indian Law Institute* 405, 405.

⁹⁶⁸ *ibid.*

⁹⁶⁹ *ibid.*

⁹⁷⁰ *ibid.* 406.

⁹⁷¹ Laurynas Didziulis, 'Private Enforcement of European Financial Markets Regulation and Lithuanian Experience' (2016) 2016/1 *International Journal for Financial Services* 1 <<https://papers.ssrn.com/abstract=2843526>> accessed 5 February 2017.

access to public funds to assist in enforcement of regulation, the authority to collect fines and when formulating regulatory standards, they can do so following thorough information gathering about the regulated industry and users.⁹⁷²

In contrast to regulation, civil liability is a court-based form of regulation in which courts set the due level of care based on the nature and facts of particular cases.⁹⁷³ This means that standards are not completely clear to parties before cases arrive in court.⁹⁷⁴ As mentioned above, this system of regulation only provides protection through payment of damages if victims exercise their right of action in court. Used alone, this form of regulatory protection is vulnerable to the apathy of potential claimants. For example, even if the total damage caused by perpetrators is very high, the individual damage might not be. Consequently, rational self-interested victims might not wish to expend the time, effort and legal expenses associated with the court system of redress.⁹⁷⁵ This is known as rational apathy.⁹⁷⁶ Additionally, the burden of proof lies on claimants to prove that the perpetrator has acted negligently or that they have suffered loss or harm because of the perpetrator's misconduct.⁹⁷⁷ It is therefore substantially linked to the idea of blame and the need for a causal link between the misconduct and the harm experienced by the victim.⁹⁷⁸ Furthermore, private remedies are also usually only effective as long as the wrongdoer is solvent because the typical civil remedies are damages award, although avoidance of financial transactions is also possible.⁹⁷⁹ These factors mean that private enforcement often leads to less enforcement than administrative regulation.⁹⁸⁰

However, these weaknesses do not necessarily mean that one form of regulation is better than the other and that administrative regulation should be chosen over and above civil regulation. Historically, the relationship between civil liability and administrative regulation has been one of "relative functional complementarity".⁹⁸¹ This is where one form of regulation compensates for the weaknesses of the

⁹⁷² Prasad (n 987) 406.

⁹⁷³ *ibid.*

⁹⁷⁴ *ibid.*

⁹⁷⁵ *ibid* 415.

⁹⁷⁶ *ibid.*

⁹⁷⁷ *ibid* 406.

⁹⁷⁸ An exception to this general rule is of course the doctrine of vicarious liability through which companies and employers can be found liable for harm caused to victims.

⁹⁷⁹ Didziulis (n 991) 1.

⁹⁸⁰ Prasad (n 987) 415.

⁹⁸¹ Cafaggi (n 986) 6.

other.⁹⁸² For example, Cafaggi gives the example of how as civil liability did not ensure sufficient protection to workers and victims of road traffic accidents, regulators intervened to provide regulatory schemes primarily aimed at compensation.⁹⁸³ Similarly, as de-regulation decreased the level of protection, this forced civil liability to expand its remit to protect old and new victims.⁹⁸⁴

Regulation often intervenes when civil liability is unable to provide victims with adequate compensation due to difficulty of proving a causal link or limited range of remedies.⁹⁸⁵ Likewise, public regulatory agencies act under an administrative framework and therefore take only expressly prescribed actions into consideration.⁹⁸⁶ This often makes them to respond only to intentional wrongs and leave aside negligent breaches, making public regulation to be less flexible than private enforcement.⁹⁸⁷ As regulators are subject to budgetary constraints, the range of supervisory actions available to them is limited which results in an inability to police every aspect of the financial market.⁹⁸⁸ In contrast, because private parties usually the first person to become aware of the perpetrator's breach of duty, they may be the first person to respond against it.⁹⁸⁹ Therefore, the roles performed by civil liability and administrative regulation complement each other, but they do not do the exact same thing. Their respective strengths and abilities should be better harnessed in P2PL regulation by combining them for a more effective protective regulatory regime. Sections 5.5 and 5.6 demonstrate that gatekeeper liability is a step in this direction. The doctrine not only considers the high degree of control exercised by platforms in P2PL transactions and thus reflects the need for corresponding responsibility, but it also helps to reduce the difficulties associated with seeking justice through civil rights of action such as proving a causal link to the financial intermediary.

⁹⁸² *ibid.*

⁹⁸³ *ibid.*

⁹⁸⁴ *ibid.*

⁹⁸⁵ *ibid* 4–5.

⁹⁸⁶ Didziulis (n 991) 2.

⁹⁸⁷ *ibid.*

⁹⁸⁸ *ibid.*

⁹⁸⁹ *ibid.*

5.3 P2PL in the Wider Financial Regulation Framework

As highlighted in chapter four, one problem with the P2PL regulatory regime is that although it calls lenders consumers, the regulatory approach that the FCA has adopted is still based on the business-to-consumer paradigm of regulation, rendering its treatment of P2PL as P2P nominal only. Consequently, it does not reflect the new concept underlying the P2PL business model, i.e. one of intermediated consumer-to-consumer or prosumer-to-consumer structure. Arguably, old concepts should give way to new concepts and regulators should not, as the FCA has done, try to adapt old concepts to new ones because they cannot fit. The P2PL industry has demonstrated that a new method of doing business has emerged and is still evolving, so law and regulation should also adapt to the new concepts and regulate on its basis. This is essential to produce clarity in the law.

Despite the widespread knowledge, use and popularity of businesses like eBay, Uber, micro-lending and more directly relevant to this thesis, P2PL, which are based on the underlying concept of a C2C business model, the C2C concept is still largely unseen in law and regulation of financial services. This is particularly the case because regulatory measures tend to only understand the business-to-consumer relationship, which is why regulation adopts and reflects this approach. The fact that the P2P regulatory regime is limited to the regulation of the P2P platforms only, demonstrates the importance of clarity of language and an understanding of the theoretical concepts underpinning the practical side of business operation. Although insight of the practicalities is important, this should not be at the expense of theory.

Although the P2PL regulatory regime has been lauded by the P2PL and crowdfunding industries as flexible and proportionate, this is not unexpected, because the main concern of the industry practitioners, i.e. the platform operators, is the growth and development of their business. For example, the FCA recently warned P2P platforms about their promotions because it had found that some services had been comparing loans to savings accounts without explaining how the returns would be taxed or showing the APRs clearly. In response Christine Farnish, the chair of the Peer-to-Peer Finance Association, stated that “*The report is correct to highlight incidences of where companies have*

*misled customers and the FCA is right to take a tough line as this could bring the whole sector into disrepute.*⁹⁹⁰ This demonstrates that their concern for consumer safety and the need for regulation is tied to this because from their perspective, regulation and consumer protective measures are good for business, i.e. they inspire confidence in and encourage use of their platforms by potential lenders and borrowers.

Consequently, whilst approval of current regulation by industry practitioners is a good sign that a regulatory regime may work, it should not wholly be relied on as it risks regulatory capture and the potential to overlook the perspectives of all the relevant parties within the transaction. Secondly, approval of the current regulation is not a sign that it will be approved of in the future, as no one can predict future events which may render the regulation ineffective. Rather, a better sign that regulation of the P2PL business model will be effective is that it first recognises the concept of the P2P within its framework because in doing so, it will not overlook and/or compromise the very structure of the P2PL market, i.e. its ability to operate on a P2P level.

5.4 Importance of Clarity in Regulation

Following on from this, the importance of the clarity of language for regulation cannot be understated. One reason for this can be expressed in the words of John L Austin who said that, “to say something is to *do* something; or in which *by* saying something we are doing something.”⁹⁹¹ This questions the assumption that to say or write an idea merely states the case or describes it.⁹⁹² This is not the case, because how an idea is conceived can influence how it is put into effect. This is demonstrated in the theory of grammar by the concept of a ‘performative statement’. For example, whilst on the face of it, such statements appear to be merely statements, in fact, by saying them a person is *doing* something, i.e. they cause something to happen. Austin gives the example of the statement given

⁹⁹⁰ Chris Torney, ‘FCA Warns over P2P and Crowdfunding Promotions’ <<http://blog.zopa.com/2015/02/06/fca-warns-over-p2p-and-crowdfunding-promotions/>> accessed 12 July 2016.

⁹⁹¹ John Langshaw Austin, *How to Do Things with Words* (Clarendon Press 1975).

⁹⁹² *ibid* 12.

when a person makes their marriage vows, “I do” (take this woman/man to be my lawful wedded wife/husband).⁹⁹³ Under the right circumstances, by stating these words the person is actually doing them, i.e. marrying the person, not just describing or reporting that they are doing or going to do so.⁹⁹⁴

Linked to this, another reason why it is important to express a concept correctly is because of the productive power of language. This idea that language has the power to influence and create is not new and can be found in the linguistics literature and age-old religions. For example, within the Judeo-Christian tradition, the world began through the divine, creative power imbibed in a phrase, “‘let there be light’, and there was light.” In a similar vein, Sutton argues that language is not just a medium for communicating stereotypes and prejudices, rather, it is a causal force in its own right because it also has the power to create, augment and transform them.⁹⁹⁵ This means language can affect as well as reflect how people think and react to certain concepts. An example is the metaphor of language as a lens which focuses and directs cognition, i.e. has power over it. Like a lens, language has the power to direct the focus of the sender’s and recipients’ attention, thought and memory. Consequently, Ng found that the use in English language of the masculine terms like ‘man’ and ‘his’ to express genderless concepts like ‘humanity’, ‘mankind’ and ‘people’, is not perceived by some people as referring to both men and women. Rather it influences their thoughts to such an extent that in a memory test it was found that they had encoded the masculine generic to refer to men only.⁹⁹⁶ The implication of this is that male individuals will be viewed as the ones who are responsible for the feats of ‘mankind’, not women.⁹⁹⁷ Consequently, language or concepts expressed incorrectly can intentionally or otherwise focus attention and understanding in the wrong direction. As stated by Phillips and Hardy, “social reality is produced and made real through discourses, and social interactions cannot be fully understood

⁹⁹³ *ibid.*

⁹⁹⁴ *ibid* 13.

⁹⁹⁵ Robbie M Sutton, ‘The Creative Power of Language in Social Cognition and Intergroup Relations.’ in Howard Giles, Scott Reid and Jake Harwood (eds), *Dynamics of intergroup communication*, vol 8 (Peter Lang 2010) <<https://kar.kent.ac.uk/26135/>> accessed 13 June 2016.

⁹⁹⁶ Sik Hung Ng, ‘Androcentric Coding of Man and His in Memory by Language Users’ (1990) 26 *Journal of Experimental Social Psychology* 455; Sutton (n 1015) 7.

⁹⁹⁷ Sutton (n 1015) 7.

without reference to the discourses that give them meaning.”⁹⁹⁸ Similarly, Watson argues that language is not separate from action and reality and that “language...is itself action, and plays a part in the construction of realities.”⁹⁹⁹

Similar arguments have been made within the context of regulation. For example, Osuji argues that language effects how regulators, stakeholders and businesses respond to particular issues.¹⁰⁰⁰ And that a regulatory strategy that amalgamates different concepts together can have significant consequences.¹⁰⁰¹ For example, a particular regulatory issue may derive from an ethical basis and not from one based on the economic benefits for the business, as a result, the business or industry at large may view it as non-essential for regulatory purposes despite its relevance to society.¹⁰⁰² This is particularly so in regulatory environments like the FCA regime where government policy leans towards encouraging growth of the sector that is being regulated.

On this basis, the idea also extends to regulation because how a concept is conceived influences how law or regulation relating to it is written, which in turn influences how it is first interpreted and then how it is applied. If the regulation misunderstands or uses a limited conception of the subject it is regulating, this effects the conduct of those who are going to comply with it and this may shape business proceedings or consumer rights either negatively or positively depending on the concept adopted. Therefore, it is important for there to be clarity of language within regulation.

A legal example of this problem is demonstrated by the way the SGA 1979 defines the concept of ‘goods’, how this relates to digital content and the effect it has on the consumers. In recent times, the internet has changed the way commerce works and how people transact with one another. Items that were once sold in physical formats such as books, music and computer software can now

⁹⁹⁸ Nelson Phillips and Cynthia Hardy, *Discourse Analysis: Investigating Processes of Social Construction*, vol 50 (Sage Publications 2002) 3
<https://books.google.co.uk/books?hl=en&lr=&id=-cOiCgAAQBAJ&oi=fnd&pg=PR4&dq=discourse+analysis+investigating+processes+of+social+construction+pdf&ots=RK0fPwKqVW&sig=9gUOqueFHrcdo5x4CAS_VQ6ewwE> accessed 13 June 2016.

⁹⁹⁹ Tony J Watson, ‘HRM and Critical Social Science Analysis’ (2004) 41 *Journal of Management Studies* 447, 451.

¹⁰⁰⁰ Onyeka Osuji, ‘Fluidity of Regulation-CSR Nexus: The Multinational Corporate Corruption Example’ (2011) 103 *Journal of Business Ethics* 31, 35.

¹⁰⁰¹ *ibid.*

¹⁰⁰² *ibid.*

be sold as downloadable digital content like eBooks, mp3 music and computer programs. One would think that so long as the item is the same, the purchaser will be provided with the same legal protections regardless of whether they purchased it on the internet or physically. However, this depends on whether the item qualifies as a good under the SGA 1979.

Whether computer software can be classified as a good has been the subject of much debate. The SGA 1979 defines the term in s. 61(1) as including “*all personal chattels other than things in action and money.*” This definition was created by the original SGA 1893 in s.62(1) when there was no such thing as the internet or digital technology. Even when the 1979 Act was enacted, the internet and digital technology were in their nascent phase. However, since the establishment of the SGA, the commercial world, has developed at a fast pace producing new ways of carrying out sales of goods transactions.¹⁰⁰³ Yet, the definition of goods was based on a conceptualisation of the word that is tied to the traditional idea of physical, store-bought goods, e.g. software bought in the form of a CD. The lawmakers did not envision the possibility of sale of goods transactions occurring on the internet, where a software could be downloaded directly to the buyer’s computer.

Central to the problem is the fact that the concept of goods is tied to the issue of tangibility, such that intangible things cannot be classified as goods. From a legal perspective, the classification of digital content is ambiguous because there is no consistency in how it is classified at common law. The legal consequence of the SGA 1979 is that digital content such as eBooks and computer software that is downloaded directly from the internet to the buyer’s computer would not be classified as a good because they are intangible, e.g. computer software comprises of a set of computer instructions like a manual, which is strictly intangible. However, if the exact same eBook or software was supplied on a CD they would fall within the definition of goods under the SGA 1979.¹⁰⁰⁴ Consequently, how an item is classified depends on how it is purchased and the relevant law applicable to a transaction will depend on whether the digital content

¹⁰⁰³ Althaf Marsoof, ‘Digital Content and the Definition Dilemma under the Sale of Goods Act 1979: Will the Consumer Rights Bill 2013 Remedy the Malady’ (2014) 9 J. Int’t Com. L. & Tech. 285, 285.

¹⁰⁰⁴ See, *St Albans City and DC International Computers Ltd* [1996] 4 All ER 481 and *London Borough of Southward v IBM UK Limited* [2011] EWHC 549, [13].

has been delivered through a physical medium or downloaded from the internet, regardless of whether the purpose of such transactions might be the same in the mind of the consumer.

Whether digital content should be treated as “goods” in the ordinary sense as defined by the SGA 1979 is a much-debated issue, as is whether they are “services” under the Supply of Goods and Services Act 1982. Indeed, Bray and Kerry argue that digital content cannot be treated as goods because the SGA does not cover intangible items and ownership in goods tends to be transferred to the buyer whereas digital content is simply licensed and so cannot technically be considered a sale.¹⁰⁰⁵

As a result of the digital and therefore, intangible nature of computer software, their sale over the internet has been classified as a sale of services rather than as a sale of goods. Therefore, it has been regulated under the Supply of Goods and Services Act 1982. Bradgate discusses these differences in considerable detail in his influential report, for example, he states that only contracts for sale of “goods” benefit from the protections afforded by the implied terms in sections 12-15 of the SGA 1979.¹⁰⁰⁶ The 1982 Act provides consumers with a lower level of protection for the product transferred during the sale than is provided by the SGA 1979.¹⁰⁰⁷ For example, in the Supply of Goods Act the supplier must ensure that they provide a service with reasonable skill and care whereas under the SGA 1979, the seller must ensure that the good is of satisfactory quality and s.13 stipulates that if the sale of goods takes place by description, as often happens online, there is an implied term that the goods should correspond with the description by which they were sold. This produces an unfair situation for consumers who purchase the digital content not suspecting that their chosen medium of purchase, whether they purchase the content in CD format online or instore, or whether they purchase a digital version of the same product online, can produce significant differences in the legal protection they are afforded under the two separate acts. The lack of clarity in the law in this area has been caused

¹⁰⁰⁵ Oliver Bray and Ben Kerry, ‘Digital Content under the Consumer Rights Act 2015’ (2015) 26 *Entertainment Law Review* 271, 271.

¹⁰⁰⁶ Robert Bradgate and Department for Business, Innovation and Skills, ‘Consumer Rights in Digital Products’ (Institute for Commercial Law Studies, University of Sheffield 2010) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31837/10-1125-consumer-rights-in-digital-products.pdf> accessed 3 January 2017.

¹⁰⁰⁷ *ibid.*

by an arbitrary conceptualisation of the term ‘goods’ in relation to software, largely because of the courts and lawmakers reluctance to soften or completely remove the concept’s ties with the notion of tangibility, at least so far as the internet is concerned. However, under the Consumer Rights Act 2015, consumer contracts for the provision of digital content, defined as “data which are produced and supplied in digital form,”¹⁰⁰⁸ are required to be of satisfactory quality,¹⁰⁰⁹ fit for purpose¹⁰¹⁰ and as described.¹⁰¹¹ This provides consumers of digital content with similar protections as consumers of traditional “goods” under the SGA. Thus the Act brings the law closer to the digital and internet age.

The digital content example demonstrates how a concept is initially conceived can have considerable consequences for its practical application. This issue is exacerbated in cases involving rapidly developing areas or industries such as e-commerce and the internet. Whereas in the defining of the concept of ‘goods’ for the SGA, the internet was so embryonic that it is possible to suggest that lawmakers did not conceive the role it would later play in commercial transactions, the same cannot be said for the regulation of P2PL. In this context, regulators already have an idea of not just the fact that the industry evolves rapidly and so may play a much greater role in online financial transactions in the future – something they are hoping for and aim to facilitate through their regulation – but they also already have examples of the basic concept underlying the P2PL industry. For example, the online C2C model has been operating online and successfully for years in the form of online marketplaces like eBay and Alibaba. So, failing to take this concept into account in the first P2PL regulation was a missed opportunity and one which could also affect the rights and responsibilities of individuals using the P2P platforms.

However, there are examples of the law adapting to changing concepts to make the regulated industry or subject area workable, e.g. the adaptation of the law to include digital goods and emails. The implication is that the same can be done for the regulation of lenders specifically and the C2C financial model of

¹⁰⁰⁸ The Consumer Rights Act 2015 s 2(9).

¹⁰⁰⁹ The Consumer Rights Act 2015 s 34.

¹⁰¹⁰ The Consumer Rights Act 2015 s 34(3)(a), 35.

¹⁰¹¹ The Consumer Rights Act 2015 s 36.

transactions in general. An example of this is how contract law has adapted the need for writing to accommodate electronic contracts in e-commerce.

The different form of transaction online meant that the requirements of writing were no longer always suitable as few businesses are likely to retain old ways of doing business.¹⁰¹² As a result of the internet businesses can create and perform contracts using electronic mediums without the need to meet either face-to-face by using websites, emails and chat services.¹⁰¹³ Emails are comparable with letters sent through the postal system because they are typically written and distributed by a person for another person or group; the contents of the mail are personal and includes only the sender and recipient and emails can be digitally signed.¹⁰¹⁴ It can be used in commerce to communicate information pertaining to the contract negotiations, offer and acceptance or a draft copy of the contract.¹⁰¹⁵ And if the contract relates to electronic goods, the email can itself be the object of the transaction¹⁰¹⁶ or used as a method of delivery of the items, in this way applying it to performance of the contract.

In contract law, some types of agreement are subject to formalities requiring them to be made or evidenced in writing, failing which, the contract would not be enforced. Reasons behind this include the need for evidence of the agreement, to put the parties on notice, or to mark the transition between the stages of negotiation and contract.¹⁰¹⁷ In addition, the aim of using signatures in commerce is to provide the parties to a contract with certainty about the identity of the signatory and his or her personal involvement in the act of signing and the authenticity of the transaction documents.¹⁰¹⁸ The vast amount of online

¹⁰¹² Donnie L. Kidd Jr and William H. Daughtrey Jr (n 974) 218.

¹⁰¹³ *ibid* 220 and 223.

¹⁰¹⁴ *ibid* 224.

¹⁰¹⁵ *ibid*; for example, in *Thomas v BPE Solicitors (a firm)* [2010] EWHC 306 (CH), [90] the presiding judge considered the issue of acceptance by email and at what point in time it occurred. He stated that the question of whether an email acceptance of contract is effective when it arrives, or when the offerer could reasonably be expected to have read it is a complex issue that must be resolved by considering the intention of the parties, sound business practice and by a judgement of where the risks should lie. However, in the facts of *Thomas v BPE*, an email that was sent at 18:00 was considered to have been available to be read within working hours, so acceptance would have been effective upon receipt of the email at or about 18:00. See also, *Bernuth Lines Limited v High Seas Shipping Ltd* [2006] 1 Lloyd's Rep 537, 541-542, in which it was held that notice of arbitration was validly served by email even though it may not have reached the relevant staff in the recipient company.

¹⁰¹⁶ *ibid*.

¹⁰¹⁷ *ibid*.

¹⁰¹⁸ Rob Sumroy and Brett Sherrard, 'Electronic Signatures: Are We Getting There?' [2012] *PLC Magazine* <<https://slaughterandmay.com/what-we-do/publications-and->

transactions is ever increasing and the same need for certainty is needed online as much as it was offline.

Whilst the concepts of a contract in writing and a signature make sense in a physical world where contracts are made of paper and signatures are signed manually, this is not so much the case in the paperless online environment. However, the case of *J Pereira*¹⁰¹⁹ demonstrates the court's willingness and ability to adapt the concept of writing to suit an electronic means of communication, i.e. email.

In that case, the defendant was a director of a company which failed to pay for goods supplied to it by the claimant so the claimant petitioned for the company to be wound up. The defendant asked one of his staff members to send an email to the claimant's solicitors requesting that the hearing of the winding up petition be adjourned subject to him giving a personal guarantee for the amount owed by the company. His name did not appear in the body of the email but this was automatically supplied by the ISP. The claimant's solicitors orally accepted the proposal and agreements were sent to the defendant. However, the defendant did not return them, neither did he pay the amounts owed. The District Judge held that for the purposes of section four of the Statute of Frauds 1677 – which, before it was repealed, required written evidence and a signature for an agreement to be enforceable – the email constituted a guarantee and the presence of his email address was constituted a signature.

On appeal, Judge Pelling held that the email could be deemed to be sufficient writing for the purposes of the 1677 Act. Although, he held that the automatic inclusion of the defendant's email address was not sufficient to constitute a signature and on this basis, the guarantee was not enforceable. In this case the judge treated an email in a similar way one would treat a physical document as the focus in his consideration was on its contents rather than the medium itself.¹⁰²⁰

Similarly, the concept of signatures has been adapted to e-commerce through the article 9(1) of the EC Directive on Electronic Commerce (2000/31 OJ L178/1), which requires EU member states to ensure that their respective legal systems

seminars/publications/client-publications-and-articles/e/electronic-signatures-are-we-getting-there.aspx> accessed 14 June 2016.

¹⁰¹⁹ *J Pereira Fernandes SA v Mehta* [2006] 1 WLR.

¹⁰²⁰ *J Pereira Fernandes SA v Mehta* [2006] 1 WLR [16], [30].

enables the possibility for contracts to be concluded by electronic means without the creation of obstacles which could divest them of their legal effectiveness.

So far it has been demonstrated that there is a need for law and regulation to properly conceive of new concepts and demonstrate an understanding of the concept in regulation designed for it. It has also been shown that failure to do so can have adverse effects on those subject to the regulation. By analogy the same issue applies to P2PL regulation and the need to understand the underlying concept of a peer-to-peer operational framework.

P2PL is a new type of financial intermediation and it is not just a conceptual issue as it has financial consequences for the economy if it continues to grow. Current projections are that the industry will continue to do so. The implication is that it needs regulation which sees and treats it for what it is conceptually.

In an interview with the BBC on 10th February 2016, Lord Adair Turner, the former chair of the defunct Financial Services Authority (FSA) issued a grave warning about the potential for the P2PL industry to be the cause of losses that would, “make the worst bankers look like absolute lending geniuses”. This statement of course refers to the bankers’ now infamous role in the financial crisis of 2008. The relevance of this statement is clear against the backdrop of some industry practitioners like Funding Circle which launched its investment trust in November 2015 raising £150 million; as P2P loans have started to be securitised in the US; and as more platforms are beginning to work with institutional partners.¹⁰²¹ The industry has largely reacted with harsh disagreement with the Lord Turner’s warning, resorting at times to personal references to his own handling of the former FSA. However, what must be emphasised is the inability to predict the future and the possibility that something that appears to be safe and useful in now may in the future prove otherwise should the economic environment change. So, it is necessary to maintain a neutral stance to an industry if it is the subject of regulation and not allow oneself to be blinded by the desire for and potential of an innovative, ‘upstart’ industry to produce positive societal goals.

¹⁰²¹ ‘City Grandee Lord Turner Warns on Peer-to-Peer Lending Risks - FT.com’ <<http://www.ft.com/cms/s/0/e123234c-cfd4-11e5-92a1-c5e23ef99c77.html#axzz4BWaYyWdM>> accessed 14 June 2016.

Lord Turner was concerned about the simple and light way that the platforms themselves perform credit checks.¹⁰²² However, it is also in reality indicative of the great potential of the industry to become increasingly mainstream as is desired by the government and regulators for the benefit of the economy and by industry practitioners for the benefit of their business. If it does, then it could affect the rest of the economy and financial services eventually reaching ordinary members of society who would not normally invest in the stock markets or in property etc. Such individuals may start borrowing money to lend on P2P platforms – something that already occurs in other forms of investment like property investment. There, it is not unheard of for investors to take out credit cards, bridging loans etc., to leverage their spending power within the investment. This illustrates how if the enthusiasm for the P2PL industry follows suit, the potential for the industry to affect the wider financial economy through the interconnectedness of the consumers' investments with external sources of borrowing.

For this reason, it is a mistake for regulation to conflate the two different business models of 'crowdfunding' and 'peer-to-peer lending'. The FCA regulation uses the term 'crowdfunding' as an umbrella term to denote multiple different forms of marketplace lending because it is convenient to do so. The FCA regulation is capable of distinguishing between the different types of P2PL operation, e.g. it distinguishes between loan-based lending, investment-based lending, donation and rewards-based lending. However, the use of the term crowdfunding, has influenced the regulation in such a way that it no longer conceives of P2PL as peer-to-peer. This is reflected in how the regulation includes P2B and even B2B scenarios (since small businesses can be seen as consumers) as well under the regulation. The result of which is a regulation that should be regulating a person-to-person industry, but instead regulates it in the same way that it would normally regulate a business-to-consumer industry – by focusing only on the business participant in the tripartite participant relationship. As a consequence, it misses the opportunity to see the P2PLs for what they are, instead treating them in the same way as consumers who operate in a business-to-consumer environment, rather than as prosumers who are vulnerable to business' practices and state of health, as well as the borrower's actions, but are arguably even more vulnerable

¹⁰²² *ibid.*

than an ordinary consumer because of the additional risks and responsibilities they take on in combination with their dependency on the platform once the contract is underway. These roles and characteristics do not benefit from a corresponding control or power to prevent those risks from materialising or an ability to enforce their interests in the way institutional characters like banks can in a comparable position. Additionally, the P2PL industry does not provide the lenders with any rights against them or a malfeasant borrower should things go awry as part of their business structure – which can be contrasted to eBay which as part of its business structure provides its customers with an internal alternative dispute resolution mechanism to hold each other accountable. It could be argued that the regulation is merely reflecting the current state of the industry. However, regulation that intends to protect the lender/investor/consumer as the FCA regime states it intends to, does also have a role to play in directing its attentions at the subjects and beneficiaries that matter. In a purely P2PL context, this should include a focus on the needs and responsibilities of lenders and borrowers and creating a level field on which they can operate in respect of all three P2PL participants, and not just the respective two-way relationship between the borrower and the platform or the lender and the platform. It is also not unfeasible for regulation to step in to create rights within an industry where none exist – after all, this is the basis of consumer protection law in the first place, i.e. the law intervening to create rights where none previously existed.

Additionally, the P2PL regulatory regime does not consider the ways that different forms of crowdfunding differ conceptually. For example, this thesis has focused on person-to-person (P2PL) in its purest form, where individuals are on either side of the transaction. However, with other forms of crowdfunding, it may not be individuals on either side, it could be consumer-to-business and on in some cases institution-to-consumer. So, on a conceptual level, they differ because rather than two consumers meeting and transacting, you have a business and consumer intermediated by the platform and sometimes a mixture because of the nature of crowdfunding. This is significant because it changes the dynamics of the relationships between the participants and may even negate in some cases the relevance of consumer protection law – which will not be appropriate for a business, hedge fund or pension fund for example. Consequently, the regulation needs to be separate to not only provide separate rights and protections for

lendsumers and borrowers in the context of pure P2PL compared with the participants of other forms of marketplace lending.

5.5 Inapplicability of Doctrine of Passivity to P2PL

There is a classical division between passive and active intermediaries. When an intermediary actively participates in actions or conduct of the primary actor, the doctrine of passivity applies. Examples of passive intermediaries can include, search engines, social networks and online marketplaces. These types of intermediaries do not create content or involve themselves with the online activities of their users.¹⁰²³ Whereas examples of active intermediaries can include banks, CUs and brokers.

It might be argued that because P2P platforms are not party to the lending contract, they should not be held liable if the contract fails or if the participants engage in illegal or socially harmful activities whilst using its platform services. The doctrine of passivity is a potential justification for limiting the liability of P2P platforms for actions carried out by a borrower or lender when a lending agreement goes awry. However, it is argued that P2P platforms are not at all passive and so should not benefit from the protection of the doctrine of passivity. Consequently, in this context, the doctrine of passivity demonstrates why and how P2PL platforms can be held liable for their participants' behaviour. It is not possible for P2PL platforms to argue non-liability based on non-involvement because even at the most basic P2PL model, the platforms are involved at every stage of the transaction: formation, management and enforcement.

There is a need for a functional approach to the regulation of P2PL platforms which takes into consideration the active role that platforms play in the P2PL lending transaction. The fundamental idea behind this is that P2PL platforms are not merely inactive conduits through which P2PL transactions come to exist. The fact that they are actively involved in the transaction justifies holding them responsible when things go wrong. As P2PL platforms have a lot of involvement

¹⁰²³ Wei Gao and Yao Yang, 'Chaining Cyber-Titans to Neutrality: An Updated Common Carrier Approach to Regulate Platform Service Providers' (2015) 31 *Computer Law & Security Review* 412, 413.

in the P2PL transaction lifecycle, it is not unreasonable to expect them to bear a proportionate amount of responsibility and to be held accountable for the P2PL participants' actions.

The underlying premise behind this is that if an online intermediary is passive and has very little involvement in the activity complained of, they should not be held accountable when things go wrong.

To understand why a non-passive intermediary like P2P platforms should be held liable for third party actions, it is first necessary to understand the concept of a passive intermediary. A similar concept to this is considered in regulation 17(1) of The Electronic Commerce (EC Directive) Regulation 2002 which contains what has been called the 'mere conduit' defence.¹⁰²⁴ It states:

“Where an information society service is provided which consists of the transmission in a communication network of information provided by a recipient of the service or the provision of access to a communication network, the service provider (if he otherwise would) shall not be liable for damages or for any other pecuniary remedy or for any criminal sanction as a result of that transmission where the service provider – a) did not initiate the transmission; b) did not select the receiver of the transmission; and c) did not select or modify the information contained in the transmission.”

The subject matter of subsection a) pertains to causation, and to a positive act. It indicates that a service provider that did not start a transmission or cause one to come into being cannot be held responsible for that transmission. The wording of the clause also precludes any form of negligent or vicarious responsibility because it requires the accused service provider to have caused the transmission. Consequently, if a third party who the service provider supplies or is responsible for creates a wrongful transmission, liability for the transmission would remain solely with the third party and not vest in the service provider. The subsection also appears to require the service provider to have done more than just allow something to have been started. For one to 'initiate', one must do something, or take an action. Therefore, the wording of the regulation also requires the active participation of the service provider in whatever qualifies as

¹⁰²⁴ Ian Lloyd, *Information Technology Law* (Oxford University Press 2014) 433.

the 'initiation' of the transmission, be it the creation, sending or dissemination of the transmission.

However, the defence against liability provided by regulation 17(1) is a narrow one. Although, causation is only part of a multi-stage test for liability under this provision. Based on the wording, the provision requires that all three factors be present for a service provider to be found not liable for a transmission. Consequently, it is not enough that a service provider did not cause the transmission; it also must not have played a part in selecting the receiver of the transmission or have any control over the information within the transmission either. It therefore follows that if a service provider played no part in the initiation of the transmission, but exercised control over the transmission by modifying it in some way and/or played a role in choosing who received the transmission, the service provider in question could still be found liable for the wrongful transmission.

Subsections b) and c) relate to the provision of access to the transmission.¹⁰²⁵ They both hint at the underlying concept of control. In subsection a) the control lies in the service provider's ability or action in determining who receives or accesses the transmission. Whereas subsection c) relates to whether the service provider had any role in determining the information transmitted. The implication on the defence of 'mere conduit' is that it is based on the idea that the lack of control over the transmission demonstrates a lack of responsibility or blame for its consequences which justifies precluding or limiting the service provider's liability.

The concept was discussed briefly in the case of *Bunt v Tilly* which was brought in the context of defamation law. In *Bunt v Tilley*¹⁰²⁶ the common law issue before the Court of Appeal, was on what basis an internet service provider (ISP) could be held liable for material which was merely communicated using the services it provided. In other words, when an ISP could be found liable in circumstances where it did not actively participate in the wrongful conduct.

In that case, the claimant sought remedies in libel against six defendants. The first three were individuals who the claimant alleged were responsible for posting

¹⁰²⁵ Mr Andrew Sparrow, *The Law of Virtual Worlds and Internet Social Networks* (Gower Publishing, Ltd 2012) 50.

¹⁰²⁶ *Bunt v Tilley and others* [2007] 1 WLR.

defamatory messages on websites hosted by third party websites. The remaining three defendants were the ISPs, AOL, Tiscali and BT. The claimant also sought remedies against them because the defamatory messages were communicated “via the services provided” by them. The key point is that the claimant had not accused the ISPs of either authorising, publishing or being vicariously responsible for the defamatory messages. The only role the claimant could attribute to the ISPs was that they provided the first three individual defendants, with internet connection, which ultimately enabled them to post the comments online. The claimant’s argument was that the ISPs acted as intermediaries by providing the third parties with access to the internet which enabled them to pass an electronic communication from one computer to another, resulting in a posting on a message board about the claimant’s business.

Eady J held that to be liable for the defamatory publication, it was not enough that the defendant had merely played a passive instrumental role in the process. As a matter of law, an ISP which performed no more than a passive role in facilitating postings on the internet could not be deemed to be a publisher at common law.¹⁰²⁷ Consequently, the claims against the ISPs were struck out. Put another way, if the ISPs had played more than just a passive role in the third party message postings, they could have been held liable for the third parties’ actions.

In the case, Eady J seemed to accept the analogy between ISPs and postal services and telephone carriers.¹⁰²⁸ In that their role of carrying internet communications from one computer to another is like the mere conduit roles of postal and telephone service providers because they enable communications to occur without playing a part in their creation or the accrual of their content; and whilst having no actual knowledge of the content carried by their service.

The concept of ‘knowledge’ and ‘awareness’ is a key factor in the doctrine of passivity theory of liability because without it, it would be difficult to justify imposing liability on a third party intermediary. As stated by Eady J in *Bunt v Tilley*, “*there must be knowing involvement in the process of publication of the relevant words. It is not enough that the person plays a passive instrumental role in the process.*”¹⁰²⁹ This means that in a broader context, if the intermediary knew

¹⁰²⁷ *Bunt v Tilley and others* [2007] 1 WLR, [36].

¹⁰²⁸ *Bunt v Tilley and others* [2007] 1 WLR, [9], [15].

¹⁰²⁹ *Bunt v Tilley and others* [2007] 1 WLR, [23].

of the wrongful action and failed to prevent it, given the opportunity and if it had the ability to do so, then there can be no reason why liability should not be imposed.¹⁰³⁰

This leads back to the idea of control. If an intermediary has no knowledge or awareness of the wrongful behaviour, it cannot exercise any control over its creation or continuation and it can therefore be said to be blameless. Consequently, for an intermediary to demonstrate that it was truly passive, it must demonstrate that it exercised no control over the bringing about of the wrongful conduct, i.e. it had no knowledge of it.

Similarly, the case of *Metropolitan International Schools Ltd* demonstrates what counts as passive conduct. Again, in this case, defamatory comments were posted on a website. When an internet search was conducted under the claimant's name, the comments appeared as an extract of information in the google search engine. It was held that the search was completed without Google Inc's involvement, rather it was an automatic one and because Google Inc. had not authorised or caused the extract to appear on the searcher's screen, it's role was merely that of a facilitator which provided a search engine service.

The connection between knowledge, control and passivity is highlighted in the more recent case of *Tamiz v Google Inc.* [2013].¹⁰³¹ In this case, the claimant brought a claim against Google Inc. about eight comments which he thought were defamatory against him. The comments had been posted anonymously on a blog hosted on Blogger.com which was run by Google. Blogger.com is a platform which allows users to create an independent blog and provides them with the design tools to do so. The claimant claimed that eight comments posted on a blog called, 'The London Muslim' were defamatory against him. Google Inc. received the claimant's letter of claim and forwarded it to the blogger who some days later removed all the comments complained about. The case was brought in relation to the publication of the comments before they were removed from the blog.

In this case the court discussed the question of whether Google Inc. could be found to be a publisher under the common law of defamation. The court discussed two possible levels of liability – whether Google Inc. was a primary

¹⁰³⁰ *Bunt v Tilley and others* [2007] 1 WLR [21].

¹⁰³¹ *Tamiz v Google Inc* [2013] 1 WLR 2151.

publisher or whether it could be found to be a secondary publisher. Both liabilities were based on the how much Google Inc. knew and the point at which Google Inc. came into knowledge of the disputed conduct.

In the case, Google was held not to be a primary publisher of the alleged defamatory material because even though part of its role included helping third parties to publish blogs and comments, it did not have prior knowledge or control over the blog's contents or have an agency or employment relationship with the blogger. Also, for the period before Google was notified of the material, it could not be held to be a secondary publisher either because it did not know or ought to have known through reasonable care that the comments posted on the blog were likely to be defamatory. This particular part is relevant to P2P platforms because, for example, it could be argued that due to the vast number of lenders and borrowers using their facility and the lack of an employment or agency relationship between them and the platform, the platform would not have any control or prior knowledge of its users' conduct or actions whilst using the platform.

In fact, this issue was raised by the trial judge, Eady J in *Tamiz v Google*. He pointed out that it was impossible for Google Inc. to exercise editorial control over the content of the blogs it hosts because the vast number of blogs and words written per minute made assigning responsibility to Google Inc. unrealistic.¹⁰³² The key concern here is the practicalities of imposing liability.

But the appeal case does point to the fact it is possible to assume the role of a secondary publisher at common law – and in so doing, assume responsibility for the wrongful conduct. Richards LJ held that even if Google Inc. had no prior knowledge of the alleged defamatory material, if after notification and a reasonable time had been given to remove the material, Google had not done so; it could be assumed that Google Inc. had associated itself with or made itself responsible for the continuation of the wrongful material/conduct. In this way, it could assume the role of a secondary publisher.¹⁰³³

This highlights two points. Firstly, once knowledge or control comes into the picture, it might be possible for an intermediary to be found liable for wrongful

¹⁰³² *Tamiz v Google Inc* [2012] EWHC 449 (QB) [35].

¹⁰³³ *Tamiz v Google Inc* [2013] 1 WLR 2151 [34].

conduct. Therefore, once a platform has knowledge or control over wrongful conduct, it is no longer a merely passive intermediary. Secondly, it indicates the extent to which an intermediary such as a platform, can be described as passive. That is, so long as the platform has no knowledge or control over the conduct and there are no reasonable grounds for expecting it to, and if it does not later assume responsibility for the conduct in question, it cannot be described as passive.

In all the cases mentioned, the ISPs and Google provided a service which involved providing access to various tools, be it the internet or a service. They facilitated actions, but their facilitation did not require direct involvement, knowledge or control of the subsequent actions which their service facilitated. For example, although the ISPs provided access to the internet, they were not found responsible for wrongful conduct carried out using the internet, using the internet service they provided. Similarly, Google provided tools for individuals to create independent online blogs, but this did not make them liable for the content of those blogs. All intermediaries facilitate something, but these cases show that to be classified as a passive intermediary, the level of involvement needs to be very minimal.

This idea finds support in recital 42 of the E-Commerce Directive which states that the exemptions from liability imposed by the Directive only relate to cases where the role of the information society service provider is of a “mere technical, automatic and passive nature”. This is because technical and automatic roles imply a lack of knowledge and control. The example it gives of such a role is when an information society operates and gives access to a communication network, such as a message board, it transmits or stores the information posted by third parties temporarily for the sole purpose of making the transmission more efficient.

In the trial case of *Tamiz v Google*, Eady J provided an analogy of “a purely passive” platform provider. He compared Google Inc’s ownership of Blogging.com to the ownership of a wall, which overnight is covered with defamatory graffiti. The owner can clean the graffiti, but this does not mean that they are the publisher of the graffiti.¹⁰³⁴ This analogy again indicates the requirement of knowledge of and control over the specific wrongful act.

¹⁰³⁴ *Tamiz v Google Inc* [2012] EWHC 449 (QB) [38].

However, the way the analogy conceptualises the degree of knowledge and control necessary to impute blame is limited and incomplete. Firstly, the analogy only assigns blame if there was prior knowledge of the wrongful act. Its concept of control is limited to whether the owner had any direct involvement in creating the defamatory graffiti. But it does not cover aspects of control such as due diligence and prevention. To take the analogy further, this could include applying anti-graffiti paint on the wall to prevent all forms of graffiti, or other preventative measures. Of course, this analogy was designed with defamation law in mind, so it does not adequately cover other areas of law where due diligence might be required. Secondly, the analogy suggests that an intermediary can only be classed as purely passive if it did not take any positive steps towards producing the defamatory material. It implies that because there was no intention on the part of the owner of the wall to allow the graffiti to be drawn and because the owner did not draw the graffiti himself, the owner can never be responsible for the graffiti on its wall. However, this is not the case, as the lack of positive action by the owner does not mean that he cannot later assume responsibility, as was discussed in the appeal court in the same case of *Tamiz v Google*. Richards LJ said as much in the case, when he stated that it was wrong of Eady J in the trial to attach significance to the absence of any positive steps by Google Inc. concerning the continued publication of the comments.¹⁰³⁵

In a similar way, there is some indication that the courts are less willing to classify intermediaries as passive. In *Davison v Habeeb* [2012], Judge Parkes QC stated that as Google Inc's role within its blogging service was not merely facilitative, it was arguable that Google Inc. could be a publisher at common law of the defamatory material in question. He distinguished Google Inc's role from the service provided by the ISPs in *Bunt v Tilley*. He argued that the ISPs in *Bunt v Tilley* were comparable to the postal service because they were conduits facilitating the passage of messages from one person/computer to another. However, Blogger.com was more like a "gigantic noticeboard" which is under Google Inc's control in the sense that it provides the noticeboard for use and can take down notices. Judge Parkes QC said that Google Inc. should be seen as a publisher responding to requests, rather than as a mere facilitator playing a

¹⁰³⁵ *Tamiz v Google Inc* [2013] 1 WLR 2151 [23].

passive instrumental role.¹⁰³⁶ This suggests a narrow definition of the concept of a mere facilitator or passive intermediary and that an intermediary cannot rely on the defence of the doctrine of passivity just because it has no direct involvement or knowledge of the wrongful conduct.

Similarly, in *Tamiz v Google*, Richards LJ distinguished it from *Bunt v Tilley* by saying that unlike the ISP's in the latter case, Google Inc's role in relation to the blogs on Blogger.com was not purely passive. It provided a platform for bloggers with design tools and unlike the search engine in *Metropolitan International Schools Ltd* [2011],¹⁰³⁷ it made the blogger service available on its own terms and it could easily remove or block access to any blog which did not comply. Additionally, although it does not exercise prior control over the blogs' contents, Google Inc. defined the limits of permitted content and had the authority to remove or block access to offending material drawn to its attention.¹⁰³⁸ This marks a shift in the concept of passivity from the earlier case of *Bunt v Tilley* to a narrower conceptualisation of the classification.

Therefore, P2P platforms which do not merely provide a bulletin-board style platform service where lenders and borrowers communicate and organise their own lending relationships directly with each other, cannot benefit from the liability limitation provided by the doctrine of passivity.

5.6 Gatekeeper Liability Basis for P2PL Platforms

One possible way of ensuring the efficiency of P2PL platforms, and therefore inspiring confidence in the online -P2PL market is through entry authorisation. A system of licensing of platforms could help prevent future problems in the market, ensure that all platforms are subject to the same conduct of business rules and to financial supervision.¹⁰³⁹ This could potentially help prevent situations like Quakle's collapse risking confidence in the market, due to poor business operations and inefficiencies. The cause of Quakle's failure in 2011 was said to

¹⁰³⁶ *Davison v Habeeb and others* [2012] 3 C.M.L.R. 6 [38], [39].

¹⁰³⁷ *Metropolitan International Schools Ltd (trading as Skillstrain and/or Train2Game) v Designtecnica Corpn (trading as Digital Trends) and others* [2011] 1 W.L.R. 1743.

¹⁰³⁸ *Tamiz v Google Inc.* [2013], per Richards LJ [24].

¹⁰³⁹ Wood (n 481) 328.

be the fact that rather than using the personal and business credit information available for borrowers, it instead used their social media profile and ranking to ascertain the level of risk they posed.¹⁰⁴⁰ Inevitably, many of the borrowers defaulted because they were not creditworthy and using social media-based information to determine such risks proved to be unreliable. The amount lent on Quakle was small in comparison to other platforms at the time, e.g. when it was trading the amount of loans issued on its platform amounted to 0.1% of loans in the P2PL market, in comparison to Zopa's contemporary amount of 2%.¹⁰⁴¹ However, the small amount of loans lent on the platform, did not change the fact that the platform's users experienced substantial losses. For example, one customer reported that he stood to lose 70% of his initial £1,120 investment because they were yet to be repaid and Quackle had failed to recuperate these repayments from the borrowers before its collapse.¹⁰⁴²

Before the onset of the FCA regulatory regime, the Operating Principles of the P2P Association required each member to maintain their own funds calculated in accordance with Method A of the Payment Services Regulations 2009.¹⁰⁴³ This was good, but the benefit of these capital requirements in ensuring the liquidity of the platform was limited because the P2P Association is voluntary and at the time, only three P2PL platforms were members who were required to obey those capital requirements.

One thing that was absent in the voluntary, pre-FCA regime regulation of P2PL and still is absent under the FCA regime, is membership of a compensation scheme. The insolvency of individual borrowers and the potential insolvency of a platform, causes losses to P2PLs which in large amounts can cause a loss of confidence in the P2PL market. On the one hand, regulation could step in to provide these lenders with the assurance that if all were to go wrong, at least some of their money would be recoverable. Such regulation is pertinent for unsophisticated lenders who do not have the time, skills, information or tools to

¹⁰⁴⁰ Simon Ward, 'Social Lender Quakle Goes Bust' *Love Money* (8 December 2011) <<https://www.lovemoney.com/news/13740/social-lender-quakle-goes-bust>> accessed 12 July 2016.

¹⁰⁴¹ Robert Powell (n 32).

¹⁰⁴² *ibid.*

¹⁰⁴³ Peer2Peer Finance Association, 'Rules & Operating Principles' available <<http://www.p2pfinanceassociation.org.uk/rules-and-operating-principles>> accessed 24 March 2013.

monitor the financial health of the borrowers or the platform ahead of default or platform insolvency; or are financially illiterate. It would go some way to inspiring greater confidence in the P2PL market place because it acts as a safety net which users can rely on as a last resort. The existence of a mechanism which ensures at least some of their money is safeguarded even during times of financial instability, reduces the amount of risks that lenders would normally have to consider when deciding whether to use P2PL as a form of investment. If a platform were to fail but the lenders were to experience no losses despite the failure, it will give them the impression that the market is a stable one. This in turn may encourage more consumers to invest their savings through P2PL activities because of the confidence stability inspires, and ultimately lead to growth in the industry.

On the other hand, it could be argued that those participating as lenders on P2PL platforms would typically have some degree of financial literacy and self-reliance, because studies of the P2PL and crowdfunding markets show that most individuals using them had pre-existing investment experience before they started using P2PL platforms and are the type of people that like to try new things. Secondly, if they did not have some form of self-reliance they would not risk their savings by lending to strangers. In support of this view are studies which indicate that most P2PL lenders are experienced investors. Additionally, it could be argued that over-reliance on such a regulated compensation scheme could lead to P2PLs heavily relying on regulators to prevent insolvency or bail them out if it were to happen. Although this might not be an issue where defaults are few and far between, where incidences of defaults are high and/or are coupled with either the platforms general lack of ability or competence in collecting debt; or with the insolvency of the P2PL platform, then the costs on the regulator or taxpayer to bail out the lenders will increase.

Consequently, over-reliance on the regulator may lead to a situation where lenders become more careless, less prudent and become free-riders of the state by passing the risk to the regulators and tax-payers. Therefore, although a financial compensation scheme should be applied in the case of online P2PL to encourage consumer confidence in the market, this shows that regulation should also limit its use, to avoid abuse of the compensatory system and the attendant costs to the taxpayer. Such limits could be imposed in several ways, e.g. limiting

the circumstances in which the compensation scheme applies to P2PL users or restricting the criteria by which a lender could qualify for the compensation scheme. It also demonstrates that there needs to be an element of consumer responsibility in the form of a duty to be prudent when choosing borrowers to lend to. This might mean providing assurance that they have considered all the information that has been provided by the platform at the time of lending, that they have taken into consideration other factors that might affect their investment such as their own ability to invest and its impact on their financial circumstances, their current financial situation and that there is an expectation that the lender has considered the risks associated with their choice of borrower. As another example, the compensation scheme could be limited to those lenders who chose to lend to grades A-B rated borrowers, borrowers who were previously held to have a highly unlikely chance of default, so that the lender cannot be faulted for choosing quasi-riskless borrowers to lend to. Whereas a lender that chose to lend to a grade C-D borrower, would have to accept responsibility for choosing such a risky investment in return for high profits. In so doing, the regulator can combine protection of the P2PLs whilst also assuring that this does not lead to abuse of the system. The implication is that a compensation scheme can be adapted to suit the context of P2PL, rather than being dismissed as disproportionate because in its current form it is too costly for the platforms when weighted against its benefits.

The effective operation of online P2PL transactions requires trust between the participants. For cooperation to exist, strangers need to be assured of each other's trustworthiness.¹⁰⁴⁴ Sources of trust include: the personality of the one who trusts, the competence and reputation of the one who inspires trust and governance provided by a third party that enforces trust.¹⁰⁴⁵ In situations where the contracting parties do not know each other, they cannot rely on the first two factors, e.g. they cannot depend on the skills, capabilities, history of honesty or other characteristics that might usually inspire their trust in a friend or person they have met, because they simply do not know them. Legal and economic theories tend to emphasise the last element of this tripartite typology, in that trust can be built through regulation of the participants of exchange by a third party, which

¹⁰⁴⁴ Ashta and Assadi, (n 38) 11.

¹⁰⁴⁵ *ibid* 10.

ensures that the participants keep their promises.¹⁰⁴⁶ The fact that an external source of trust such as a court or regulator can hold the parties to their promises gives them faith that the transaction will be honoured.

The doctrine of passivity is a basic exemption method of imposing liability, but it is not complex enough to deal with the P2P platform. The unique nature of P2P platforms as an online intermediary requires a more carefully fitted development of rules which help determine when it is appropriate to impose liability on the platforms even though they are third parties to the transactions. As has been shown above, the doctrine of passivity provides no justification for limiting the liability of P2PL platforms, consequently the question at hand turns to how they should be regulated.

However, the dilemma for regulators lies in striking a balance between the need for P2P platforms to be regulated and allowing the freedom of private parties to act in a way they see fit and for the industry to grow.¹⁰⁴⁷ A further dilemma for regulators is striking a balance between the need to protect the lenders and the need for regulation to be helpful to economic activity by keeping the costs of business low.¹⁰⁴⁸ Regulation which compromises the ability of the P2PL market to operate on a P2P level – the very structure of the business model, should be recognised as imposing a severe cost on them. However, arguing that imposing liability on the platform in some situations would do this, would be an exaggeration.

This means that to provide effective lender protection, regulation would need to ensure that investors have appropriate remedies against market participants who harm their interests.¹⁰⁴⁹ These remedies should be achievable, i.e. it does not impose hurdles too high for the lenders to jump over to get recompense. For example, by making them bear the burden of proof for factors that the lender would find very hard to verify due to informational asymmetries found within the industry. Similarly, regulation should not lead to situations where lenders find

¹⁰⁴⁶ *ibid.*

¹⁰⁴⁷ Ronald J Mann and Seth R Belzley, 'Promise of Internet Intermediary Liability, The' (2005) 47 *Wm. & Mary L. Rev.* 239, 243.

¹⁰⁴⁸ Carston Gerner-Beuerle, 'The Market for Securities and Its Regulation Through Gatekeepers' (2009) 23 *Temple International & Comparative Law Journal* 1, 57 <<http://papers.ssrn.com/abstract=1330190>> accessed 17 October 2015.

¹⁰⁴⁹ Carston Gerner-Beuerle, 'The Market for Securities and Its Regulation Through Gatekeepers' (Social Science Research Network 2009) SSRN Scholarly Paper ID 1330190 57 <<http://papers.ssrn.com/abstract=1330190>> accessed 17 October 2015.

themselves with no defendant to seek action against. For example, P2PLs may not have recourse against the individual borrowers they lent to because said borrower is likely to be bankrupt. This is the current state of affairs within the UK P2PL market, it is also the effect of a regulatory regime of intermediaries which relies on passivity to limit intermediary, and by extension, platform liability.

On the other hand, the same regulation must also avoid creating an environment which is unsuitable for the industry as this could stagnate the industry's growth and inhibit the overall will of the market participants. Consequently, to reduce the cost of capital, regulation should be clear about when an intermediary is at risk of liability so that it can calculate or control this, rather than incurring high costs for legal advice or defence to avoid liability. Regulation should also ensure that the intermediary is the appropriate body to impose the law on. For example, if an intermediary was unable to control the wrongful conduct of its participants, and yet was faced with strict liability for not doing so, it would incur high costs to mitigate these liabilities through out-of-court settlements or the purchase of insurance to cover the potential liability.

This means that regulators should only impose liability on internet intermediaries if they are in the position to monitor and control the actions of their participants.

5.6.1. Gatekeeper liability theory

Gatekeeper liability is a supplementary form of liability which can be placed on P2P platforms to help regulate the conduct within its platform service and which courts can turn to as a second stage test once no liability can be found in the usual normative fashion. It recognises that the platforms are in a better position than P2PLs and borrowers to control what goes on there. Consequently, the rationale behind gatekeeper liability does not depend on a normative assessment of the degree of responsibility, participation or support a platform had in relation to the wrongdoing. Rather, it turns on the balance between the social costs of the wrongdoing and how well a platform can be relied on to stop or prevent it.¹⁰⁵⁰

¹⁰⁵⁰ Mann and Belzley (n 1068) 265–266.

Academics have offered numerous definitions of the term ‘gatekeeper’ and there is little agreement about what form gatekeeper liability should take. For example, Kraakman, who developed the concept in the 1980s, defined gatekeepers as “*private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers.*”¹⁰⁵¹ He states that the key idea behind gatekeeper liability is the duty it imposes on intermediaries to prevent misconduct by withholding support, which could be a good, service or form of certification that is essential for the wrongdoing to succeed. It is the withholding of support that he believes acts as the ‘gate’ of gatekeeper liability.¹⁰⁵²

On the other hand, Coffee defines gatekeepers as “*reputational intermediaries who provide verification and certification services to investors*”.¹⁰⁵³ The services he describes include verifying a company’s financial statements, evaluating its creditworthiness, appraising the fairness of a transaction and in general, assessing or vouching for a corporate client’s statements about itself or a specific transaction.¹⁰⁵⁴ It is clear from this that Coffee’s gatekeeper plays a largely reputational role, and this might be caused by the fact that his perspective comes from the capital market context. His definition is also narrowly construed as it only applies to reputational intermediaries, not allowing room for other types of intermediaries to be considered.

Meanwhile, Gerner-Buerle defines gatekeepers as, “*agents that ensure compliance of the primary market actor with the applicable rules by reviewing its disclosures and withholding their participation in transactions if violations occur.*” This definition comes from the perspective of securities law as demonstrated by the reference to the disclosure requirements faced by issuers.

However, Hamdani refers to gatekeepers as, “*parties who sell a product or provide a service that is necessary for clients wishing to enter a particular market or engage in certain activities*”. He considers gatekeepers to be third parties like auditors, lawyers and underwriters.¹⁰⁵⁵ His definition is broader than Coffee’s and is closer to Kraakman’s because it reflects the fact that not all parties subject to

¹⁰⁵¹ Reinier H Kraakman, ‘Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy’ (1986) 2 *Journal of Law, Economics, & Organization* 53, 53.

¹⁰⁵² *ibid* 54.

¹⁰⁵³ John C Coffee, ‘Understanding Enron: “It’s About the Gatekeepers, Stupid”’ (2002) 57 *The Business Lawyer* 1403, 1405.

¹⁰⁵⁴ *ibid*.

¹⁰⁵⁵ Assaf Hamdani, ‘Gatekeeper Liability’ (2003) 77 *Southern California L Rev* 53, 55.

third-party liability are intermediaries involved with reputation management. So, whilst true of liability for securities fraud, it might not be true of all other contexts.¹⁰⁵⁶

Embedded within Kraakman's definition of a gatekeeper is the issue of ability to disrupt misconduct. It implies that if a private party is not "able" to exhibit this type of control over the primary actor's conduct, it cannot be classified as a gatekeeper. This idea is also reflected in Hamdani's conception of gatekeeper. Hamdani has stated that a third-party can only be a gatekeeper and thus face gatekeeper liability if it can detect the wrongdoing at a reasonable cost and prevent its clients they know to be wrongdoers from committing misconduct.¹⁰⁵⁷ Without these two elements, it would be unjust and impractical to impose liability on the gatekeeper.

These definitions have a different conception of what the "gate" is, i.e. the element of control the gatekeeper is capable of exhibiting over the primary actors, but they all contain an element of withholding a service. As mentioned above, Kraakman's is the withholding of support from the primary actors. Coffee's is not clearly stated but seems to be the provision of verification and certification services, which it is assumed he intends for the intermediary to withhold when wrongdoing occurs. Gerner-Buerle's is the withholding of a primary actor's participation and Hamdani's also has an element of withholding because although not clearly stated like Coffee's, it involves withholding services which are necessary for the primary actor to even enter the market. Therefore, the key feature of a gatekeeper's role is the ability to control the primary actor's actions, through withholding a key element of their service. In addition, the 'ability to control' involves being able to detect and prevent the action in question.

P2P platforms are capable of being gatekeepers because they contain these main elements of gatekeeper liability. They have a "gate" to control because without the service they provide, a lender or borrower would not be able to enter the P2P market or lend or borrow in that way. They also exhibit control over that gate through the verification processes they carry out to determine whether a borrower is creditworthy enough to borrow over the platform. At present, they do

¹⁰⁵⁶ *ibid* 58.

¹⁰⁵⁷ *ibid* 98.

not carry out checks on the lenders or the monies provided by lenders e.g. whether they are legitimate funds and not the source of criminal activity. However, this is probably due to the desire to encourage individuals to lend on the platform by making it straightforward; and therefore, lender checks are something that could be carried out by the platform. P2P platforms are also in the best position to detect wrongdoing on the platform in comparison to lenders and borrowers, not least because due to their role facilitating transactions, they have access to all the borrowers and lenders that use their platform and access to information about all the transactions on their platform.

However, it is worth pointing out that the above quoted conceptions of a gatekeeper focus on the intermediary as something that enables access to a service or the provision of goods. So, if they detect wrongdoing they can withhold the service or the goods. This may limit their role to after-the-fact wrongdoing so that the intermediary only steps in once the crime or contravention of a private law right has already occurred. This is demonstrated by the outcome of Mann and Belzley's analysis of internet intermediary liability which was to suggest three schemes of intermediary liability: traditional liability for damages, takedown schemes where the intermediary removes offensive content upon notice and 'hot list' schemes in which the intermediary avoids facilitation of transactions with certain parties known to be malfeasors.¹⁰⁵⁸ All of which require the intermediary to act after the wrongdoing has occurred.

However, it is more useful to include within the conception of a gatekeeper an intermediary that can also act as a gatekeeper to wrongdoing, therefore incorporating preventative action. This means that any intermediary with the ability to control an action or wrongdoing, can act as a gatekeeper for the purposes of regulation.

Traditionally, the law has pursued a direct approach to liability where the primary malfeasant is the actor who can most efficiently prevent the internet-related misconduct. E.g. internet gambling would not occur if both a gambler and a gambling website did not exist. So, if either of these actors can be controlled directly, the social harm caused by internet gambling can be prevented.¹⁰⁵⁹

¹⁰⁵⁸ Mann and Belzley (n 1068) 240.

¹⁰⁵⁹ *ibid* 259.

Existing schemes of liability have largely resulted in broad freedom from liability for intermediaries because they have relied on the traditional fault-based tort principles to determine intermediary liability. In addition, as these principles are underlain by the doctrine of passivity, they have for some time absolved intermediaries from responsibility.¹⁰⁶⁰ Even when courts have suggested the possibility of intermediary liability on a common law basis, they can fall back on exemptions provided by European legislation such as article 12 of Council Directive 2000/31/EC, 2000 OJ (L178) 1 which provides immunity to ISPs when they are acting as mere conduits for the transfer of copyrighted materials and article 15 of the Directive bans member states from imposing a general duty on ISPs to monitor.

However, the usual normative, fault-based liability schemes are not adequate in an online environment. One problem is that traditional liability schemes tend to assume that intermediaries are inherently passive, which would make it unfair to impose responsibility on them for the actions of the primary actors.¹⁰⁶¹ However, this perspective is flawed because it paints all intermediaries the same colour and fails to consider other reasons for imposing liability on an intermediary, e.g. that it is a cost effective method of online regulation.¹⁰⁶² They also reflect an irrational fear that imposing liability on intermediaries would automatically harm the electronic industries they belong to. Consequently, traditional schemes of liability focus on targeting the primary wrongdoer who committed the actual malfeasance.

This leads to the problem of identifying and locating the primary malfeasor to hold them accountable. If a lender wishes to identify a borrower to pursue a private law right, they are reliant on the platform to provide the necessary identification details. However, the platform has a duty of care over the borrower to protect his or her identity and provide adequate confidentiality and data protection. This can prevent the platform from providing useful information about the borrower's identity to the lender when needed, such as their real name and contact details.

This is compounded by the anonymity of platform users and that the information provided to lenders by borrowers on the platform is largely self-provided and therefore unverified. As stated by Lessig, “[b]oth data and people are unidentified

¹⁰⁶⁰ *ibid* 260.

¹⁰⁶¹ *ibid* 261–262.

¹⁰⁶² *ibid* 262.

in this world, and while it is often possible to make good guesses, it is also easy to make good guesses impossible.”¹⁰⁶³ In addition, so long as the wrongful action is not a criminal activity and remains a civil matter, the platform is unlikely to disclose this information to a lender without being ordered to do so by a court. Unless there is legislation which requires the platform to do so on receipt of notice from the injured party.¹⁰⁶⁴ All this imposes the burden of high costs on the lender seeking to pursue the primary malfeasor.

However, because of the high volume of transactions and low value of each transaction on a P2P platform, pursuing the primary malfeasor might create a situation where the costs of the pursuit of justice and recompense is disproportionate to its actual benefits. This in turn might force the injured party/lender to accept the loss and forego his private law right because of his incapability of enforcing it. These scenarios also create a situation where the wrongdoer is effectively “judgement proof”¹⁰⁶⁵ because of their anonymity and ability to escape liability on the grounds of a purely economic cost/benefit analysis.

Arguably, accepting that one party must always forego their rights because it is difficult to enforce law and regulation against the primary malfeasor is unacceptable in a society which desires to respect the rule of law. Therefore, regulators that wish to continue pursuing the primary malfeasor as a strategy, must choose between allowing certain harms to continue unimpeded due to impracticality or finding an alternative regulatory strategy¹⁰⁶⁶ to pursue a more just outcome.

Rather than focusing liability on the question of who is at fault for a specific offence, the most appropriate regulatory question to ask is whether the P2P platform is the party in the best position to stop the bad practices at issue. This would reflect one of the many aims of regulation and law which is the prevention of wrongful conduct. Making an intermediary liable for a primary actor’s wrongful conduct does not necessarily mean that the primary actor will escape liability. Rather, it means that a separate form of liability could be created to reflect the

¹⁰⁶³ Lawrence Lessig, *Code and Other Laws of Cyberspace* (Basic Books 1999) 33.

¹⁰⁶⁴ Reed (n 30) 52.

¹⁰⁶⁵ Mann and Belzley (n 1068) 259.

¹⁰⁶⁶ *ibid.*

role of the intermediary in allowing, enabling or failing to prevent or act against the wrongful conduct, which does not rely on the restrictive doctrine of passivity to determine the intermediary's level of blameworthiness.

Because of the nature of the relationships on P2PL platforms, this form of structural liability might be a more pragmatic and better form of finding liability rather than focusing on fault-based liability. In situations like fraud or where problems have arisen because incorrect information was supplied by the borrowers, it would be more practical to pursue the platform rather than the borrowers themselves.

Mann and Belzley identified three changes caused by the internet which mean that intermediaries are more likely to be the least cost avoiders, i.e. the body who would spend the least on preventing the losses caused by misconduct,¹⁰⁶⁷ and therefore the bodies which should be held liable for misconduct. These are that the internet brought:

- an increase in the chance that it would be easy to identify specific intermediaries for large classes of transactions
- a reduction in the information costs which make it easier for intermediaries to monitor the conduct of its end users; and
- increased anonymity across the internet makes seeking remedies against individual users generally less effective.¹⁰⁶⁸

All three factors are relevant to the P2P industry. Out of all three P2P participants, the platform is the only entity associated with all the transactions which carry on within its service. Compared to the platform participants, the platform is the most readily identifiable party within a transaction. From the lenders' and borrowers' perspectives, the platform is also the most likely to be associated with a transaction because a single loan transaction can be funded by multiple lenders whilst the individual borrower might be anonymous to the lenders; and a single investment by the lender might be shared by numerous borrowers across the platform. Yet despite these numerous transactions, the platform is at the centre of them all and is what connects the borrowers with the lenders.

¹⁰⁶⁷ Reed (n 30) 65.

¹⁰⁶⁸ Mann and Belzley (n 1068) 240.

Additionally, the platform is the party most likely to hold most of the information about either party, which they may not have on each other. When a borrower defaults, it is very difficult for a P2P lender to pursue them directly, either because of the contractual terms or because of data protection reasons they do not have all the necessary details about the borrower. This also means that the platform would be the one that could most effectively prevent and control misconduct within its network, thus saving litigation costs.¹⁰⁶⁹

However, imposing gatekeeper liability poses the risk of increasing costs to platform users because a platform might decide to pass on the costs of exercising its controls on to its users. Gao and Yang have also suggested that liability might lead to a censoring of services provided by sites by giving them the power to decide what can and cannot be done on the internet. Censoring on a P2P platform could take the form of more stringent checks. In turn this might serve to limit entry into the market by some sectors of society, e.g. borrowers from poorer sectors of society who have poor credit rating. But this may already happen anyway through platforms' existing credit checks for borrowers.

In addition, MacCarthy has challenged the argument that intermediaries should be held liable because they are the least cost avoider. Based on his analysis of the enforcement of US anti-gambling laws through payment intermediaries, he points out that there are numerous costs which supporters of the least cost avoider rationale do not consider. For example, the cost of maintaining and enforcing an internet gambling coding and blocking scheme that is completely manual and cannot be automated; the cost of over-blocking legal transactions; the cost to screen and check the business activity of merchants participating in the payment systems; the cost to monitor the use of payment systems for specific illegal activity, here the payment systems are in no better position than anyone else to conduct this monitoring activity; the cost to defend against legal challenges; etc.

Arguably, this argument only relates to payment intermediaries and other intermediaries which are external to the actual transaction or industry in question. Although they are third parties, unlike P2PL platforms their relationship to the market activity is not as close or linked. While their role within the online gambling

¹⁰⁶⁹ Gao and Yang (n 1044) 420.

market is necessary because without it money would not be exchanged, their level of control and power over gambling participants is not as high as that exhibited by platforms within their own service. In essence, their degree of separation from the misconduct is further away than a P2PL platform's, so their level of control and involvement is not as extensive as a P2PL platform's would be. The unacknowledged costs raised by MacCarthy may cause concern in relation to payment intermediary liability, but the examples provided are things that platforms already or should already be doing to provide a quality and safe borrowing and lending experience.

MacCarthy also presents the US litigation between Tiffany and eBay as an example of why intermediaries are not always the least cost avoider. He states that the fact that Tiffany and eBay were unable to agree on compensation for the infringement of Tiffany's trademarks despite years of negotiations and discussions, suggests that the full costs of the enforcement efforts exceeded what Tiffany was willing to pay. Moreover, if Tiffany was a rational actor that was willing to pay up to the amount that it would cost to take its own enforcement actions, the failure to reach an agreement suggests that eBay was not the least cost enforcer in that case.¹⁰⁷⁰

However, whilst this argument applies within a business-to-business context where the businesses are expected to be on a similar level playing field, within a P2P platform service, the platform will always be the least cost avoider because the participants involved are not other businesses, but individuals, and not all of them, if many, will be high net worth individuals capable of funding enforcement. Neither would they have the ability to enforce it themselves.

But gatekeeper liability ultimately provides more benefits than it does risks. It provides P2PLs with an additional defendant who will, in most cases, be more solvent than the borrower; it will enable the injured party and, if a matter arises in court, the court to discuss not just the issue of causality, but also a more accurate allocation of responsibility which takes into account all the parties involved and the quality of the platform's services and its standard of care in providing them. Consequently, it will prevent platforms from shifting liability away from

¹⁰⁷⁰ Mark MacCarthy, 'What Payment Internet Intermediaries Are Doing About Online Liability and Why It Matters' (2010) 25 Berkeley Tech LJ 1037, 1049.

themselves, creating a vacuum of justice and judgement-proofing unidentifiable primary actors. It will also enable them to adopt a more reflexive approach to regulating conduct on their platforms by encouraging them to consider the correlation between their own actions or standard of care and the existence or likelihood of misconduct by their users.

Consequently, gatekeeper liability through regulation of the platform intermediary offers regulators an easy way to provide a more suitable scheme of liability adapted to the structure of P2PL activity. Unfortunately, the legal community in the UK and large parts of Europe typically ignore the insights of gatekeeper liability theory when drafting and interpreting financial market regulation.¹⁰⁷¹

5.7 Concept of Lendsumer

The emergence of online P2PL necessitates a reconsideration of what it means to be a consumer of financial services. This is because P2PL alters the characteristics of the key participants of lending. This creates the regulatory problem of what is the appropriate degree of protection that should be afforded to the P2PLs.

The concept of the lendsumer identifies the fact that P2PLs are more than just consumers. They have an increased role and responsibility because of their increased participation. Arguably, this is a good thing because customer involvement leads to greater customer empowerment. Although one might argue that greater customer involvement should go hand in hand with greater responsibility being placed on the customer for their actions, this is not the logical next step. Customer empowerment is not completed by simply enabling the customer to make bigger decisions and take part in the production of their goods or services, rather, it must also be accompanied with the means to support and enforce this added participation and the responsibility that follows from it. If not, it leaves the lendsumer in a similar position as the ordinary consumer – dependent on the producer and facing information asymmetries etc. – whilst also

¹⁰⁷¹ Gerner-Beuerle (n 1070) 4.

engaging in more risky activities and taking on the role and position of traditional lending institutions.

The implication for regulation, is it needs to suit the role and position of the lender, a concept which by considering the status of the P2P lender throughout the lifetime of the P2PL cycle, requires regulation to also provide for the full lifetime of the loan. Simply providing for the lender's informational needs only supports them in the pre-contractual stage to make better decisions. It does not consider their roles, activities and general dependency on the platforms following this.

Therefore, well-rounded P2PL regulation should also provide for the full experience of the P2P lender. This includes effectiveness in enforcing their rights against platforms and borrowers as well as the stability of the platform and the legitimacy and transparency of the platform.

The analysis within the chapters on the roles and characteristics of P2PL platforms and lenders give rise to numerous questions which can be directed at P2PL regulation. Particularly in regards to the extent to which the regulation deals with the specific roles of the participants. In respect of the platforms, one question that is asked is whether the regulation deals with all the roles that the platform undertakes. For example, ensuring the creditworthiness of the borrowers; the facilitation of the transfer of funds from the lenders to the borrowers and vice versa; and the pursuit of unpaid loans for the lenders. Another question that could be asked is the extent to which the regulation reflects the fact that the platforms' roles extend through both the pre-contractual and administrative stages of the lending agreement in a substantial way. Does the regulation therefore cover both the pre-contractual and management stage of the lending cycle also?

Secondly, does the regulation clearly identify or consider the relationships within the transactions? For example, which party the lender has a direct claim against, be it the borrower or the platform and what the legal and financial relationships between the parties are, e.g. where the creditworthiness of either the platform or the borrower is called into question. Such regulatory considerations would go some way to providing certainty for the lenders.

Thirdly, does the regulation imbibe the idea that platforms are mere conduits simply because they are not party to the lending agreement, or does it recognise

that they are active intermediaries because they have much more involvement in each transaction and should be regulated as such? The regulatory regime should not treat P2PL platforms as passive intermediaries, because whereas the latter do not create content or involve themselves with the online activities of their users, P2PL platforms should be liable for their participants' behaviour when things go wrong because even at the most basic level P2PL model, platforms are involved at every stage of the transaction: formation, management and enforcement. The examination of the doctrine of liability showed that P2P platforms which do not merely provide a bulletin-board style of platform service where lenders and borrowers communicate and organise their own lending relationships directly with each other, cannot benefit from the liability limitation provided by the doctrine. In contrast, the unique nature of P2P platforms as online intermediaries requires a more carefully fitted development of rules which help determine when it is appropriate to impose liability on the platforms even though they are third parties to the transactions.

Finally, there is the issue of whether the regulation provides appropriate redress for the platforms participants. To ensure effective lender protection, regulation would need to ensure that investors have appropriate redress against market participants who harm their interests. These remedies should be achievable, e.g. by not creating a situation where the lender/borrower does not have any defendant to seek action against.

The section on the P2P participants focused on the P2PLs. It highlighted that their roles and behaviour is like consumers' in terms of their relationship of dependency on the platform and to an extent they can be described as prosumers in terms of their lending activity to the borrowers. This was conceptualised by the classification, 'lendsumer'. Consequently, a key question for existing regulation from the perspective of the P2PLs is whether it recognises the fact that in each lending transaction and its administration, from the start to completion, the lenders' capacity transitions from prosumer to consumer.

Prior to April 2014, the regulatory landscape of P2PL was not completely bare, however it was quite problematic for platforms to operate in because of the uncertainty created by the need to consult a broad spectrum of statutes and regulation to determine their liabilities or whether they are in breach of them. The former Office of Fair Trading regulated consumer credit arranged through P2PL

platforms that adopted the loan-based model.¹⁰⁷² Additionally, crowdfunding, in the general sense, fell within the scope of FCA regulation if it involved a person carrying on a regulated activity in the UK, for example, the communication of a financial promotion.¹⁰⁷³

In addition, prior to April 2014, it was possible that some forms of marketplace lending could be regulated as a collective investment scheme (CIS) because the definition of a CIS was very wide. The fact that “any arrangements with respect to property of any description” could be classified as a CIS meant that it covered all types of investment funds. Similarly, some forms of investment-based platforms could fall within this definition because funds are pooled by a platform and distributed to investors. However, this classification may not have included all forms of loan-based P2PL. Where a platform’s operations did fall within the definition of a CIS, it needed to be approved by the FCA. However, this was done on a case-by-case basis. The case-by-case nature of FCA approval prior to the April 2014 regulation created an environment of regulatory uncertainty, because start-up platforms could not be sure how their business model would be regulated without having to consult multitudes of different regulations. The case-by-case nature of authorisation also added to their overhead costs which in turn means that P2PL could only be limited to high net worth investors.¹⁰⁷⁴ Consequently, although P2PL was not completely devoid of any regulation, prior to the April 2014, there was no regulation tailored specifically to suit P2PL creating regulatory confusion. The FCA’s answer to this situation was to create an umbrella regulation designed to cover what it calls ‘crowdfunding’, an umbrella term for both loan-based and investment-based P2PL.

The UK regulation of P2PL came into force on 1 April 2014. Most platforms are still going through the transition period and at the time of writing, none has yet been fully licensed by the FCA. Despite the establishment of a body of regulation that is specific to P2PL, the regulation of this market is still a debatable issue, particularly because of increasing regularity in which new risks and issues either arise within the market or are pointed out by senior regulators. For example,

¹⁰⁷² Ridley (n 796) 62.

¹⁰⁷³ The Financial Conduct Authority, ‘CP13/13: The FCA’s Regulatory Approach to Crowdfunding (and Similar Activities) - Financial Conduct Authority’ para 1.3 <<http://www.fca.org.uk/news/cp13-13-regulatory-approach-to-crowdfunding>> accessed 27 May 2016.

¹⁰⁷⁴ Ridley (n 796) 63.

Andrew Tyrie, the current Treasury committee chairman has recently written to the FCA and PRA with warnings about the risks of P2PL and questioning whether current regulation of the market is apt.¹⁰⁷⁵ Key to the points he made were the questions he asked about how the platforms judged creditworthiness, how the P2P users could be certain that they were getting accurate information and how they could assess the risks of lending; and the fact that the wider prudential risk of unsecured lending on the rest of the financial sector is unclear.¹⁰⁷⁶ This emphasises the limits on a purely disclosure-based regulatory regime. This follows on from the statement made by the former head of the FSA, Adair Turner, who in February 2016 warned that the P2P sector could cause bigger losses than the bankers did during the financial crisis.

This shows that far from settling the matter of how P2PL should be regulated, the UK regulation has provided a temporary solution to the question of how the industry should be regulated. This has been implied by the FCA itself which in their Policy statement PS14/14, repeatedly states that many aspects of the regulation will be reviewed, and the FCA's assurance that in the policy statement that they will review the situation in 2016. This makes the subject of its regulation a pertinent issue.

5.8. Regulatory Implications of 'Lendsumer'

This thesis proposes an original concept of a "transitional consumer" or "lendsumer" and adaptation of the existing concept of gatekeeper liability to online P2PL. Both concepts have different but related implications for P2PL regulation. Whilst "lendsumer" has implications for regulatory perception and protection of P2P lenders under the UK P2PL regulatory regime, gatekeeper liability details how to go about it using a form of civil liability. "Lendsumer" is a new paradigm of consumer which has implications for protection of certain consumers of financial services. Although new, lendsumer is built on existing concepts previously

¹⁰⁷⁵ Sam Barker, 'Tyrie Warns FCA on Regulation of Peer-to-Peer Lending' <<http://www.moneymarketing.co.uk/tyrie-warns-fca-on-regulation-of-peer-to-peer-lending/>> accessed 4 June 2016.

¹⁰⁷⁶ *ibid.*

discussed in Chapters Two and Three. The effect is not to create a new method of regulation but to add more precision to the way regulators perceive and carry out the protection of lenders or similar transitional consumers.

Paternalism can be a responsive action to a recognised need (Chapter 2 above). One of the implications of behavioural research is the role of third parties in assisting people to deal with cognitive and emotional biases, prejudices and faults. Although individuals have an interest in exercising their freedom of choice and liberty, they also have an interest in avoiding bad situations and consequences, even the results of their freely chosen actions. This requires that the action taken is appropriate and the need is properly identified. As explained in Chapter Two, 'soft' paternalism involves policies that are limited to targeting agents who do not act knowledgeably. It is different from 'hard' paternalism because the latter involves policies and regulations which target knowledgeable and competent agents. Even this definition implies the use or need for information to improve knowledge.

The concept of lender reflects 'soft' paternalism by targeting agents who may be vulnerable due to their lack of knowledge, information asymmetries during lending transactions and the intermediation of platforms, whilst ultimately respecting their decision to engage in P2PL. Furthermore, it acknowledges that P2PLs and transitional consumers operating in similar environments can be vulnerable due to their inability to exert control over their affairs and reliance on a third party for the execution and management of transactions. For P2PLs, this lack of control occurs post-transaction as discussed earlier in this chapter. Therefore, the lender concept demonstrates that lenders behave and act very much like the classical consumer paradigm at the post-transaction stage, hence the '-sumer' aspect of the moniker.

The implication for regulators is that once the P2P lender has transformed from a prosumer back to an ordinary consumer, the type of protections necessary for their protection and facilitation need to be highly interventionist and information provision will be inadequate. The EU retail credit regulation has shown an increasing interventionist pattern of protection for retail investors, e.g. product prohibition and regulation of independent financial advisors and product/service sale. Such protections have limited effect on P2PL transactions post-contract due to their conception of the retail investor as a consumer and being designed with

a different type of financial model that is largely B2C and where retail investors or borrowers purchase a service or borrow money. In contrast, P2PL is an intermediated C2C transaction and where one of the consumers involved acts both prosumptively and consumptively in any given transaction. Therefore, retail credit regulations are not broad enough to deal with both consumer risks and lending risks faced by P2PLs. Instead, regulation should focus on holding the party with the most control, i.e. the platforms, more accountable for aspects of the transaction which they have knowledge and control over.

This can be achieved through a policy designed around user accountability and greater communication in addition to the competition and industry stability policies demonstrated by existing regulations. In essence, “lendsumer” requires that P2PL is not treated like an ordinary investment where, for example, the value of stocks is expected to fluctuate due to uncontrollable market forces, rather than what it is: enforceable lending rights. One would not tell banks or CUs that if a borrower does not repay lent funds, they must accept this fate as a learning point. This is what P2PLs are being told by treating lending transactions as a pure investment with all the attendant warnings that their capital is at risk.

Suggestions in this thesis from a communications perspective include a database shared by P2P platforms to enable them to determine how many P2P loans borrower have taken and the way they have managed their repayments across platforms to provide a more accurate picture of borrowers’ borrowing and financial habits. A dispute resolution body for complaints by individuals using C2C platforms can be set up. This could be run similarly to the Financial Ombudsman Service but for individuals rather than disputes between businesses and consumers. The problematic issues of authority and redress which are, firstly, a body may have little enforcement power over individuals unless it is government authorised and, secondly, individuals might not have sufficient resources to compensate others adequately. This suggests the need for some form of FSCS backing for lenders’ deposits.

Such a bold intervention is not impossible for P2PL. For example, a UK tribunal ‘reached behind the veil’ of the C2C disintermediated business model by ruling that Uber drivers should not be treated as self-employed and deserve employee

rights such as minimum wage.¹⁰⁷⁷ This is on the basis that Uber exercises a greater degree of control over the driver's role than would normally be expected where someone is operating on a self-employed basis. Furthermore, the FCA recently announced proposals for new rules for credit card companies designed to help customers get out of persistent debt. The rules will require firms to take steps to help customers in persistent debt, e.g. prompting e faster repayments if a customer has been in persistent debt for eighteen months.¹⁰⁷⁸ This is an interventionist form of consumer protection which, like the Uber tribunal ruling, prioritises individuals in need of protection rather than the continuation or stability of the intermediating platform. Similarly, regulators can adopt the same level of protection for P2PLs and a more interventionist policy towards the platforms.

Lendsumer also draws on the theoretical conceptualisations of the classical consumer and prosumer. As discussed in Chapter Two, the classical definition of consumer is a natural person acting outside of his/her trade, business or profession with certain exceptions. Such legal definitions are based on the idea that the consumers are the weaker party as natural persons rather than on the fact of how they act and behave in certain circumstances. Consequently, Schüller argued that it is the act of buying consumer goods that should define the consumer and not their nature.¹⁰⁷⁹

The consumer aspect of 'lendsumer' is not based on the economic construction in the EU and similar definitions of consumer based on the nature of the individual, nor those which assume contracts of sale of goods. Rather, it focuses on the acts and behaviours of individuals during the transaction at hand, i.e. a situational conception of consumers that recognises that an important factor of consumer behaviour is the situation e.g. type of goods, environment and experience.

¹⁰⁷⁷ Costas Pitas, 'UK Tribunal Rules Uber Drivers Deserve Workers' Rights' (*Reuters*, 28 October 2016) <<https://uk.news.yahoo.com/uk-tribunal-rules-uber-drivers-deserve-workers-rights-132223513--sector.html>> accessed 17 April 2017; Hilary Osborne, 'Uber Faces Court Battle with Drivers over Employment Status' *The Guardian* (19 July 2016) <<https://www.theguardian.com/technology/2016/jul/19/uber-drivers-court-tribunal-self-employed-uk-employment-law>> accessed 17 April 2017.

¹⁰⁷⁸ 'FCA Proposes New Rules for Credit Card Firms to Help Millions of Customers Get out of Persistent Debt' (*FCA*, 31 March 2017) <<https://www.fca.org.uk/news/press-releases/fca-proposes-new-rules-help-customers-persistent-debt-credit-cards>> accessed 17 April 2017.

¹⁰⁷⁹ Schuller (n 279) 123.

Similarly, lendsumer is based on the theoretical concept of 'prosumer'. 'Prosumer' is an amalgamation of the concepts of producer and consumer. and defines an individual who is involved in the design or production process of goods which the individual will eventually or potentially purchase. The prosumer engages in activities which are traditionally considered separate – production and consumption. Unlike consumers, prosumers work for the things they consume – they are active participants. A prosuming transaction is one which requires or encourages the actor to produce or consume. However, although prosumer blurs the lines between producer and consumer, firms, which do most of the work, still control the major resources required to fully carry out transactions.

Lendsumer draws on the concept of prosumer by describing an individual who during a given transaction transitions from a prosumer (lending activity) to a consumer (reflecting passivity and dependence on P2P platforms). Lendsumers are, however, different from prosumers for not consuming the product they produce. Unlike prosumers, lendsumers are not simultaneously producers and consumers of a single product or service, rather they produce a loan that another individual will eventually consume while they consume the ultimate benefit of this which is the interest payments made in addition to repayments of loan premiums. P2PLs therefore combine the producer and consumer capacities differently from prosumers. 'Lendsumer' reflects the fact that P2PLs that take over the production role of traditional lenders are also consumers during the second stage of transactions.

The concept shows that P2PL is a long-term activity involving different stages, during which the users' roles and capacities experience changes. The implication for regulators is the need to design protections appropriate for each stage of the P2PLs' activities – protections suitable for them in their capacity as lenders, and protections suitable for them in their capacity as consumers of the platform's services. Regulation therefore needs to govern both relationships occurring in the tripartite activity that is P2PL, the relationship between lenders and borrowers, lenders and the platform and borrowers and the platform and not just the lenders/borrowers and platform relationship.

One consequence of the conceptualisation of P2P lenders as lendsumers and P2P borrowers as consumers in the classical sense, is the fact that current consumer protections do not currently regulate the relationship between them

directly. The UK P2PL regulatory regime focuses attention on the platforms. To an extent, the encouragement of responsible borrowing for borrowers, and responsible lending for lenders, is arguably as far as the current regime is willing to go in regulation of these two individuals' relationship. Regulators need to determine the efficacy of further and more direct regulation, however, proportionality and pragmatism suggest a continuation of the focus on platforms with greater intervention via gatekeeper liability to give platforms more responsibility for the actions and behaviours of the intermediated parties towards each other, in correlation with the degree of control and knowledge that the platforms have over transactions. Gatekeeper responsibility recognises the underlying model of online P2PL as one of intermediated C2C transactions requiring regulation of the behaviours of individuals towards others to avoid moral hazard by targeting the participant with the most authority and control.

The third component of the 'lendsumer' paradigm is the notion of intermediated finance. In pure C2C transactions, individuals that provide products and services to recipients cannot be transitional consumers/prosumers because, firstly, they maintain the same role/capacity throughout single transactions and, secondly, there are either no intermediaries involved such as in esusu or the intermediary is purely a facilitator of the transaction as in eBay. The completion or success of sales does not require or involve eBay's direct involvement i.e. sales can be executed without eBay ever needing to get involved. P2PL transactions are different because for loan transactions to be executed and managed, the platform's involvement is required throughout the loan's lifecycle. In particular,, loans have a longer life-cycle than simple sale of goods transactions which end as soon as the buyer receives the goods. Consequently, lendsumers prosume through lending activities in which their active participation in the bringing about the transaction is heightened in comparison to the classical consumer, and are, however, consumers in their relationship with the platforms during the execution and management of loan transactions. The implication is that P2PL platforms should be regulated as financial intermediaries and the degree of paternalistic intervention for the protection of the lendsumers should reflect the degree of control platforms exercise over transactions and parties in their system. P2PL cannot be treated as purely C2C due to an involved intermediary that has control

over what goes on within its platform and should therefore be held accountable where necessary to protect lenders and consumers.

Following Chapter Four's analysis of existing regulations of online P2PL, the lender theoretical paradigm highlights the need for a more bespoke regulation, particularly in consumer protection. Protections to be needed to reflect the underlying intermediated person-to-person aspect of P2PL. Regulations need to reflect an understanding that P2PL transactions have a longer life-cycle than sale of goods and services transactions that are of the classical consumer and prosumer. P2PLs should be treated as lenders and not consumers and retail investors, thereby taking into account the roles, responsibilities and risks in the lending activity, which are different from those experienced by retail investors and consumers.

Furthermore, lender entails the need for designing regulations capable of protecting individuals at both the prosumer and consumer stages of transaction. This requires regulation that reflects the overlapping or simultaneous relationships occurring in P2PL transactions. f Example are: the prosuming relationship between lenders and borrowers; the prosuming relationship between lenders and platforms where lenders rely on platforms to execute loans as designed by lenders; the consumer relationship between lenders and platforms for post-contractual services platforms provide once loan contracts are underway e.g. when platforms assume the traditional lender role by paying the loan to the borrowers and the responsibilities of managing loan repayments on behalf of lenders by ensuring timely collection and pursuit of debtors; the pre-contract consumer relationship between lenders and platforms e.g. ensuring that prospective borrowers are credible and providing well-run and stable platforms to lend on; and the corresponding relationships between consumers, platforms and lenders.

Rather than viewing the prosuming action of P2PLs as an indication of heightened self-reliance, individualism, responsibility and capability, regulators should realise that the additional 'work' by individuals who prosume exposes them to risks either greater in degree or extent than what ordinary, passive consumers would face. Indeed, Comor argues that in the absence of a radically changed political, cultural and economic structure, the prosumer's engagement mostly serves status quo interests and the prosumer is likely to become, at the

very least, the subject of ongoing exploitation.¹⁰⁸⁰ Regulators should therefore not perceive these broad prosumer characteristics as a reason to minimise the need for greater consumer protections for lendsumers.

Further to the theoretical analysis, the implications of the proposed model for the UK regulatory system are as follows. Firstly, as online P2PL is a form of financial intermediation and involves an underlying C2C business model, regulation by the FCA is appropriate. The discussions on intermediated finance in Chapter Three, along with comparisons of online P2PL with other forms of intermediated finance such as traditional lending, esusu and eBay demonstrate that P2PL is not disintermediated finance, but a new form of intermediated finance that uses consumers to carry out lending activities. Furthermore, the inapplicability of the doctrine of passivity to P2PL demonstrates that platforms exercise more control over the affairs and management of lending transactions than the individual participants. Whilst online P2PL is based on a C2C model it is not a pure form of it.

A more accurate description is consumer-platform-consumer (CPC) transactions. Therefore, because the FCA is the most appropriate body to regulate platform services since online P2PL concerns the interaction of consumers through a business. The current UK FCA-based regulatory approach already does this. The FCA was created to regulate the conduct of financial services firms and markets whilst the other financial regulatory body, the PRA,¹⁰⁸¹ was created as part of the Bank of England for prudential regulation and supervision of banks, building societies, CU, insurers and investment firms. Having shown that online P2PL is fundamentally different from traditional lending provided by banks and CUs and that exclusive focus on the stability of the industry and platforms will not provide sufficient protections for P2PLs and borrowers, the industry is rightly regulated by the FCA that is more consumer focused than the PRA.

However, as demonstrated in Chapter Four, the way the FCA currently regulates online P2PL falls short of what is needed. Although the FCA correctly separated P2PL regulation from bank lending and provided specific rules for the

¹⁰⁸⁰ Edward Comor, 'Contextualizing and Critiquing the Fantastic Prosumer: Power, Alienation and Hegemony' (2011) 37 *Critical Sociology* 309, 322.

¹⁰⁸¹ 'Prudential Regulation Authority'

<<http://www.bankofengland.co.uk/pru/Pages/default.aspx#>> accessed 26 April 2017.

crowdfunding industry in general, the amalgamation of all forms of crowdfunding under one body of regulation distinguishable only as 'investment-based crowdfunding' or 'loan-based crowdfunding' is unhelpful.¹⁰⁸² Existing regulation has focused on the protection of consumers in the classical sense. This has resulted in largely pre-contractual, information-based consumer protections which are designed to protect consumers who are vulnerable for being unable to inspect goods and services or properly assess the claims or advice of businesses, as opposed to consumers who lack the post-contract power to protect their interests once the lending cycle is underway.¹⁰⁸³ Consequently, whilst P2PBs can be appropriately protected under the current regime, the protection of P2PLs has shortcomings. Therefore, P2PL-specific regulation is necessary to ensure adequate protection for lenders.

Suggestions about the proposed regulatory approach include, firstly, the empowerment of P2PLs through the ability to hold third party platforms accountable rather than empowerment through information provision and delivery. This would recognise that P2PLs, despite their prosumption activities are powerless for being unable to exercise primary post-contract control.¹⁰⁸⁴ Indeed, prosumption without the control of the post-contract stage of lending activity, or direct enforcement of lending rights, partly accounts for P2PLs' vulnerability in the first place. It is therefore suggested that interventionist protection applies gatekeeper liability as shown in Chapter Five. Regulation cannot responsabilise and empower participants lacking sufficient degree of primary control over their affairs.

Regulation should be more specific about what it requires of P2P platforms for lender protections and provide lenders with enforceable rights against the platforms for not carrying out their regulatory responsibilities in a satisfactory manner.¹⁰⁸⁵ At present, some key protections for lenders such as the requirement for platforms to have measures in case of the platform's liquidation or cessation of business lack a minimum standard or set of criteria. This results in a largely self-regulatory environment which is unenforceable by lenders should things go

¹⁰⁸² Financial Conduct Authority, (Policy Statement, PS14/4), 6-7.

¹⁰⁸³ See section 4.4.1 of this thesis.

¹⁰⁸⁴ See section 4.4.2.

¹⁰⁸⁵ See section 5.2.4 on the need for both regulation and civil liability in the regulation of P2PL where this is discussed.

wrong. Specific criteria would protect P2PLs by enabling them to judge the efficacy and reliability of prospective platforms.

Regulatory standards are arguably inflexible and inefficient forms of regulation. However, this applies only regulatory standards are imposed on activities that are constantly changing and not in P2PL because even if the P2PL industry changes, so long as it is based on the current lender-sumner-platform-consumer model, the need for measures to assure the continuance of lending activities will not change. Consequently, specific measures will protect lenders and even provide regulatory certainty for platforms.

Additionally, rights of action would greatly encourage P2PL activities by letting lenders know that if things go wrong they have recourse to justice. Rights of action should also exist against platforms for the actions or conduct of its users through gatekeeper liability where appropriate. For example, widespread misconduct exemplified by P2PLs on the Chinese platform Jiedaibao (section.2.3.1 above), could be regulated by holding platforms as opposed to individual lenders responsible. Platforms are in a better position than P2PLs and borrowers to control what goes on and exercise preventative action to wrongdoing or risky conduct on the platform.

Finally, access to FSCS protection of lenders' money should be provided. P2PL is not a pure investment. Although it is not traditional bank lending form due to its individual lenders, P2PL is a form of financial intermediation different from investment of stocks and bonds. Once P2PLs decide to lend money, how and to whom, the platform carries this activity out. Bank lending consumers have access to FSCS protection for not being party to banks' lending decisions, i.e. banks decide without consumers' express permission to use their money to make money for itself. Consequently, consumers who do not directly lend need access to FSCS protection in case the banks lose the money and are unable to repay on demand. However, the lack of explicit permission to lend using the deposits cannot be the sole justification for the provision of FSCS protections to bank customers, because credit union members also have access to FSCS protection even though they are already aware that the loans from their credit union are largely derived from the deposits of members. This suggests at least implicit consent to using their savings to fund the credit union's lending. Similarly, institutional lending does not confer peculiar benefits to bank customers, because

P2PLs equally receive returns on their investment in the form of interest repayments on loans, whilst bank customers receive interest on their savings and deposits. The fact that these amounts can be minimal is irrelevant as they depend on the bank and the state of the market.

The fact that P2PLs expressly decide to lend funds to borrowers through platforms does not necessary lead to the conclusion that their funds do not merit regulatory protection. Firstly, P2PLs are not only using their savings just like indirect lenders of banks and CU, they are also contributing to the health of the economy by widening access to finance to individuals. Arguably, this should be encouraged and confidence in the market can be boosted by knowledge of the relative safety of the lenders' money. This does not need to be a guarantee of all the money initially lent, but could be about 25% of the loan principal. Alternatively, the proportion of lending funds guaranteed by the compensation scheme could be determined by a scale of risk lenders voluntarily took, e.g. as discussed in Section 3.5.6 lenders who chose to lend to highest risk borrowers can receive the least amount from the compensation scheme.

Ultimately, regulators need to determine appropriate amounts to encourage confidence in the market. Overall, this should reflect the transitional nature of P2PLs as both prosumers who take on lending responsibility upon themselves and therefore rightly held responsible for this decision, and consumers of the platform's services, depending on its ability to manage loans, honesty, and ability to handle the lenders' money until loan are repaid in full, and also dependent on borrowers who may or may not be sufficiently responsible throughout the loan cycle to manage their finances well enough to afford repayments.

This thesis has therefore proposed a dual regulatory framework comprised of regulation and civil liability. It is the concept of "lendsumer" which enables civil liability to be used as a regulatory tool of the P2PL industry. It also facilitates an understanding of the need for this dual regulatory approach. The concept was introduced to show firstly, that based on the role and nature of lendsumers, there is a need for regulation to protect the lendsumer and secondly, for lendsumers to have the right to take action against P2PL platforms – a right that is extendable to P2PBs. Civil liability, based on gatekeeper liability, concerns the issues of who has a right of action, against whom and for what reason. It therefore provides platforms with a level of accountability through rights of action that lendsumers

can enforce, thus protecting them at the post-contractual stage of their transaction – something that regulation alone has insufficiently provided them with. Meanwhile, the regulation aspect of the dual regulatory framework is meant to adequately protect lendsumers at all stages of the P2PL transaction cycle.

These suggestions will strengthen the current P2PL regulatory regime and provide adequate protection to P2PL participants in recognition of its underlying lendsumer-platform-consumer model, and vulnerabilities of lenders who are not mere consumers or prosumers, but an amalgamation of both in the form of a transitional consumer.

5.9. Conclusion

This chapter has argued that the FCA regulatory regime of P2PL assumes that either the P2PL business model is based on a B2C structure or that the only important aspect of the industry's operations necessitating regulation is its B2C aspect. This assumption occurs even though the language used by the regulators to refer to the industry refers to the person-to-person form, i.e. they regulate P2PL on a B2C level, but refer to it as P2PL. The effect of this assumption is a lack of clarity of language which reflects on the practical aspect of the regulation by the fact that it does not consider the risks, needs or conduct of P2PLs and borrowers in relation to each other. This is a cause for concern because P2PL does not exist in a vacuum, but within the wider context of other C2C, disintermediated services such as Uber, eBay, and micro-lending, for which the regulation is also largely business-to-consumer based because it focuses on the regulation of the intermediaries' conduct.

The chapter also argues that clarity of regulatory language is important because how an idea is conceived impacts how it is put into effect. Consequently, because of a lack of understanding of the underlying conceptual framework of P2PL, i.e. its C2C nature, the UK regulatory regime has focussed its regulation on the traditional B2C aspects of the industry's practice. Yet, P2PL is part of the wider movement towards disintermediation which involves a change in concepts, from consumer to prosumer and from B2C to C2C, or to take it further 'prosumer-to-prosumer'. However, the chapter demonstrates that it is not impossible for the

law to adapt to changing concepts, rather it is important it does so to remain appropriate and relevant. This is particularly the case considering how new technologies often change the way businesses operate, just as the internet did to the way businesses communicate and the contracts are signed due to the onset of electronic means of carrying out such actions.

In light of the UK regulatory regime's focus on the B2C relationship between the users and the platforms, Chapter Five analyses the role of P2P platforms in their capacity as intermediaries between the lenders and borrowers. This is a focus that the regulatory regime does not thoroughly engage with. The chapter argues that P2PL platforms are not passive intermediaries, therefore they should not benefit from the limited liability provided by the doctrine of passivity. As they are not merely passive, it is possible to hold them to account for the malfeasant or detrimental actions of the borrowers and lenders towards each other.

Chapter Five suggests gatekeeper liability as a way of doing this, but to maintain an appropriate balance between the business interests of the platforms and the interests of the P2P users, liability should only be imposed in situations where the platforms are in a position of control over the P2PL users' actions. This also reflects the need for regulation to be proportionate to the actions and conduct of the participants whilst also providing user protection and the means to enforce their rights. Although, P2PL platforms are typically in a position of control as argued in this chapter, this requirement adds a degree of flexibility to consider the possibility of P2PL business models where platforms are genuinely passive entities.

Finally, to aid the conceptual understanding of P2PL, Chapter five argues in favour of the need for a reconsideration of the concept of 'consumer' in relation to P2PL. Linking back to the analysis of the notions of 'consumer' and 'prosumption' in chapter three, and the fact that P2PLs are more than just 'consumers', it puts forward the concept of 'lendsumer' as a more accurate reflection of the roles, conduct and nature of P2PLs and as an analytical tool by which the suitability of regulation can be questioned from the perspective of the users of P2PL.

6. Conclusion

6.1. Introduction

This thesis has discussed the regulation of P2PL in the United Kingdom as it pertains to the consumer-to-consumer basis of P2PL operations and from the perspective of its participants. P2PL is a relatively new tool which enables individuals to save or invest money (the lenders) or raise funds (borrowers) through the assistance of other individuals. As P2PL platforms connect individuals with each other, it forms part of the wider 'sharing economy' which itself is part of the continual quest of innovators to simplify processes and goods through disintermediation.

This thesis has argued that because of the tripartite relationship between the individuals and the P2PL platforms, P2PL represents a new form of intermediation which does not fit within the current conceptions of consumer law and protection. The implication is that if the law wishes to provide adequate protection for the P2PL users, it needs to reflect a better understanding of them conceptually, which will lead to regulation which is more tailored to the industry and which takes into consideration the risks, actions and characteristics of P2PL users.

The general literature on the P2PL tends to focus on the more practical issues of credit risk and trust and the implications these factors have for the way platforms are run, or how to improve the lending and borrowing experience for the users. Analysis of the legal and regulatory rules surrounding P2PL has concentrated on the north American experience, particularly in relation to the way the SEC had classified P2PL as a form of securities investment. The difficulties that such legislation in America had on the P2PL industry there, led some academics like Verstein to argue in favour of no regulation or laws at all for P2PL because of the restrictive impact it had on the development of P2PL there. This highlighted the need to explore the theoretical justifications of P2PL regulation and to justify the interventionist stance that most regulation adopts in relation to private agreements between individuals as a starting point when analysing the legal rules. In contrast with the US situation, the literature focusing on the legal

regulation of P2PL in the UK was sparse and where it does exist, generally consists of a review or analysis of the existing P2PL regulatory regime. By not exploring the theoretical justifications of regulation first, the underlying assumption of such work is that existing conceptions of regulation and its purpose fit the P2PL model of finance. This thesis argues that it does not and highlights that the current crop of rules and regulations e.g. consumer protection law, were developed in light of B2C business structures and therefore are more suited to regulating scenarios within that framework of interaction. However, the thesis has argued that such concepts are not easily translated to the C2C context in which P2PL largely exists and this is an important consideration because of the necessity of rules/regulations to have clarity of language, and for regulation to fully take into consideration all risks and experiences faced by P2PLs and borrowers.

This thesis sought to answer two questions arising from this gap in the literature:

- a. What are the theoretical and practical justifications for P2PL regulation?
- b. Are current regulatory instruments fit to resolve the regulatory difficulties posed by P2PL?

6.2. Summary of Findings

6.2.1. The theoretical and practical justifications for P2PL regulation

To answer the first research question, the thesis analysed three theoretical justifications for more or less interventionist regulation, which are RCT, behavioural economics theory and paternalism. The aim was to show that paternalism and by extension, consumer protection law which is a type of paternal regulation, provided a basic justification for P2PL regulation which is protection of the weaker party in a contractual relationship.

The analysis highlighted that the basic assumption of the RCT perspective of regulation which is that people are rational beings who will always choose the outcome that will best maximise their welfare, is unrealistic because it is based

on what might happen in a perfect market. However, perfect markets do not exist because there are market failures which in reality make transacting in a rational way very difficult. For example, information asymmetries are a form of market failure caused by the fact that one party may have more information than another and not have any incentive to share this information with other market participants if left to their own devices. Consequently, the party in the weaker or more vulnerable position, i.e. the one lacking the information may be susceptible to actions by the stronger party to mislead them and to the fact that the market might not truly reflect the risks involved. The discussion of paternalism in chapter two sought to answer the problems raised by liberalists who, although they may consider regulation necessary object to regulation which comprises of (too much) state intervention. This problem is also expressed by the regulatory aim to balance proportional regulation with the need to encourage growth and innovation within a given industry.

The thesis used the findings of behavioural economics theory to demonstrate that state intervention through regulation was justified. The behavioural economics theory paradigm argues that people are subject to emotional and psychological biases which can impede their ability to act and think rationally when making private transactions. For these reasons, the thesis considers P2PL interventionist regulation justified because of the failure of the markets to adequately resolve the problems that arise from the individuals' inherent biases without the assistance of regulation.

P2PL and existing conceptions of consumer and consumer protection

The consideration then turned to the problem of whether this justification was appropriate in relation to P2PL since the two transacting parties could both be viewed as 'consumers', and therefore one may not necessarily be weaker than the other in terms of their level of experience or expertise in using P2PL as a form of finance. To answer this research question, the thesis critically examined the meaning and conceptualisation of the term 'consumer'. The analysis was based on the EU definition of consumer because of its widespread influence in European countries, of which the UK is one.

The analysis of the EU definition of consumer demonstrates that P2PL does not fit within the existing conceptions of consumer and consumer protection, because existing conceptions are based on an economic construction of the consumer which views them as rational beings. It posits that to truly understand what a consumer is, one must understand that they are not always predictable and do not always act rationally. Therefore, to understand what a consumer is, one must examine what they do and how they behave rather than impose a one-size-fits-all approach to defining them. The concept of 'prosumer' is used as an analytical tool to compare P2PL users with consumers to highlight the ways in which they differ, because rather than focusing on the nature of consumers, it takes into consideration what they do. Using the 'prosumer' concept the thesis highlights the limited nature of the 'consumer' concept in describing the P2PL participants' activities and the reasons why P2PL users cannot accurately be described as consumers.

Through an analysis of the different conceptualisations of 'consumers', i.e. the 'average' and 'vulnerable' consumers, the chapter argues that previous conceptions of the consumer did not fit all the circumstances experienced by P2PLs and borrowers because they were narrowly based on the idea that firstly the transactional relationships governed by consumer protection law is automatically going to be the one based on the B2C model of business and that the role of consumers is to consume or receive the services or products from a more sophisticated business. However, the discussion of the idea of the prosumer in combination with a review of the actions that P2PLs and borrowers must take to engage in P2PL demonstrated that this is not the case.

However, the thesis also argues that P2PLs do not fit accurately within the prosumer concept either because they display a combination of consumer and prosumer traits depending on the situation they find themselves in within a single P2PL transaction. It is argued that in relation to the P2PLs' actions and level of participation during the formation of the loan service provided to the borrowers, they behave like prosumers because of their high level of participation in the production side of the transaction. However, once the agreement has been made, their level of participation drops and their dependency on the platforms to administer the loan agreement replaces their prosumer-like tendencies such that they behave more like consumers. This analysis is important because it reveals

the different types and levels of risks faced by P2P users depending on which point in the transaction, or which relationship one is considering at any one time.

A further significance that this analysis reveals, and which contributes to the answering of the second research question, is that the consumer protection regulatory regime focuses only on a limited section of the P2PL process/transaction. For example, the focus on information disclosure as a means of consumer empowerment and the focus on regulating the platform's activities and conduct without the provision of rights of action to the borrowers or lenders, only focuses on the market failures that present itself in a typical B2C transaction. This neglects the risks or problems faced by P2PLs and borrowers in relation to each other's actions or lack thereof. It also demonstrates that the regulation of P2PL is still based on an understanding of business operations as being B2C and the idea that consumer protection is only justified in relation to market failures caused by the existence of a weaker party and stronger party, as opposed to market failures that exist when two individuals within the same category interact with each other. The focus also does not reflect the wider disintermediated changes taking place within the sharing economy in which P2PL exists. These considerations therefore answer the research sub-question in the negative, i.e. P2PL does not fit within existing conceptions of the consumer and consumer protection. Consequently, it acts as the foundational argument to the second research question answered in chapter four because it suggests that because P2PL does not fit within the consumer paradigm, the regulation is not suitably adapted to it.

It also points out that consumer behaviour can vary depending on the situation they find themselves in, for example, it might depend on the type of service they are contracting into or the goods they are buying. This chapter therefore creates awareness of the importance of considering the transitional nature of consumers depending on which point of the transaction process they have found themselves in, to provide them with adequate regulation.

P2PL and other existing kinds of financial intermediation

To answer this research sub-question, the thesis compared the similarities and differences between P2PL and other forms of intermediation both on and offline.

It compared P2PL with traditional bank lending, esusu/isusu which is a form of rotary savings, the C2C transactions that occur on the eBay marketplace, payday lending and CU. This research question was answered in chapter four. The aim was to further demonstrate the uniqueness of P2PL by distinguishing it from existing forms of lending and direct consumer-to-consumer transactions. Through the comparisons between P2PL and other forms of lending and C2C transactions, the chapter contributed to the overarching research question by showing that P2PL does not fit within existing forms of intermediation because it reflects a prosumption rather than consumption-based model. The key factor behind this difference is the transitional nature of P2PLs and the way they are no longer just merely consumers. This finding emphasises the need for regulation of P2PL to be more tailored to the way it works, rather than simply trying to apply existing forms of regulation catering to B2C-type intermediaries to it.

6.2.2. Current regulatory instruments and the regulatory difficulties posed by P2PL

This question was treated in chapters four and five. Chapter four critically analysed the current P2PL regulatory regime and policy in the UK. It argues that although the current regulatory regime provides consumer protections for the lenders and borrowers, from the perspective of the lenders, these protections are limited to the potential market failures that can be faced between a business and a consumer, in this context, the P2PL platform and the lenders. This is demonstrated by the fact that the protections afforded by the regime are largely information-based protections designed to responsabilise the consumer. However, apart from a right to complain about the platform's services to the Financial Ombudsman Service, the regulation does not provide the lenders or borrowers with any enforceable rights against each other in relation to their lending or against the platform itself. This leaves the lenders dependent on the platforms for the administration and execution of the loan. It demonstrates that the success of the regulatory regime's consumer protection successes, is hindered due the underlying assumption of the current regime, that consumer protection consists of protecting the weaker party which leads the regime to

provide a substantial amount of pre-contractual, information-based protections but very few post-contractual ones that deal with the key concerns of P2PLs which is the continued repayment of their loans. Consequently, it demonstrates that the current regulatory regime is only partially fit to resolve the regulatory difficulties posed by P2PL because it only largely focuses on the pre-contractual market failures and the risk posed by the platform itself.

Within the traditional bank lending framework, the participants are banks, customers and borrowers. The bank operates as the lender; however, the money lent to borrowers is derived from their customers' deposits, so technically they simultaneously act as intermediaries between their customers and borrowers. In this scenario, the borrowers are unknown to the customers. The borrowers do not know which proportion of their borrowing comes from any particular customer and the customer likewise does not know exactly where his or her money is going. Because the bank handles the customers' deposits, which they have a duty to repay on demand, they are subject to regulation on deposit handling and how payments are made. They also bear the risk of default.

Within the P2PL framework, the traditional customers of the bank now operate as lenders on the platforms, particularly in its pure, person-to-person business model. This means that they are faced with similar problems of information asymmetries and behavioural biases as borrowers, with the addition that they now bear the risk of the borrowers' default by themselves. Therefore, as individuals, they cannot be subject to similar regulation and liabilities as bank lenders. Rather, they will need the benefit of consumer protection regulation.

However, because the lenders on P2PL platforms lend their money directly, they are often called investors rather than consumers. For regulatory purposes this classification as an investor rather than consumer is significant because the protections available to investors often assumes a degree of expertise and are therefore more non-interventionist than the protections available to ordinary consumers. In the traditional lending and investment framework this approach makes sense as it means that regulation is proportionate to the circumstances. However, in the P2PL framework, where lenders/investors may hold the same level of investment/lending experience or knowledge as the borrowers, this classification and the different protections which come with them, are not proportionate.

This chapter reviews the regulation of P2PL in the United Kingdom from a lender's perspective. It analyses the extent to which the regulation creates a suitable environment for lenders to use P2PL and the extent to which it reflects the degree of involvement of the P2P platforms. It demonstrates that although the regulation recognises that the term 'crowdfunding' is an umbrella term under which there exists many business models, it does not reflect the underlying concept of consumer-to-consumer transactions that underlies P2PL in particular, the prosumers that use it nor the transitional nature of P2PLs.

Having demonstrated the limits of the current UK regulatory regime, chapter six makes a theoretical argument in favour of the importance of the clarity of language. This supports the discussion about the concept of the lender made earlier because it emphasises the theoretical need to first understand a concept thoroughly before regulating it.

6.3. Theoretical implications: the consequences of adopting a lendsumer conceptualisation of P2PL

The main contribution of this thesis is the concept of the 'lendsumer'. It contributes to the academic debates and discussions about the prosumer by expanding the meaning and application of the terms 'consumer' and 'prosumer'. It does this by demonstrating that the concept of 'consumer' is not just a fluid one in the sense that it is changing into or being replaced by the concept of 'prosumer', rather, it demonstrates that a single individual can embody both concepts during a single transaction.

One implication of this is that this idea of a capacity that transforms is not limited to just the P2PL context. P2PL just provides an interesting and unique way of exemplifying it and has been used to show that consumer interaction has changed. However, the concept of 'lendsumer' can also be applied to other forms of consumer-to-consumer or prosumer-to-prosumer interactions such as on eBay's buyers and sellers and Uber's passengers and drivers. Of course, the name can be changed but the underlying idea of an individual's transitional capacity remains the same.

The concept can be used as an analytical tool. In the context of P2PL the concept has been used to demonstrate a more detailed, full and insightful understanding of the P2P users. Insightful because of its emphasis on looking at the actions and roles of the customer and what they do, not just the nature of the person and the purpose of the transaction, as the concept of the consumer demands due to its definition. Whereas the concept of consumer comes with the underlying assumption that the consumer is automatically going to be the weaker party, the lendsumer encourages a look at everything the individual does, their capacity within the industry they are operating in and the issues or problems they face during the transaction from the beginning to the end. This is done without any automatic assumptions of weakness. The implication for consumer protection law and regulation is that they have a positive or active role and not just a negative one, i.e. they need not only look for market failures caused by consumers' inherent weakness in relation to the business party to a transaction, but can also help resolve or protect consumers from problems faced in a transaction e.g. the inability to hold another party to account for misconduct.

A related implication of the use of the concept of lendsumer is that by not focusing on relationships of weak party versus strong party, it goes some way towards moving away from the idea that consumer protection rules should only apply to relationships between individuals and businesses, but also encompasses the transactional relationships between individuals who interact more directly. For example, the lend in lendsumer draws attention to the productive actions that the individual undertakes in the transaction, thereby focusing on the relationship with the P2PBs, whereas the '-sumer' draws attention to the consumption activity of the lendsumers in their relationship with the platforms. These ideas can be substituted for other types of interactions within the disintermediated sharing economy.

Appendix: The role and conduct of P2P lenders and borrowers on P2PL platforms

The following section provides a case study of what P2P lenders and borrowers do on the platforms they have chosen to use and explains their main characteristics. The information is gathered from the platforms respective websites and a table summarising the main characteristics of the platforms features on the p2pmoney website.¹⁰⁸⁶ The case studies look at various factors that make up the P2P users' overall conduct on the platforms, e.g. their roles, capacities, and responsibilities etc. The aim is to provide a general insight into the behaviours and activities of P2PL users which in turn will highlight whether they fall into the category of consumer or prosumer.

Zopa

P2P lenders' role

P2P lenders on Zopa make fixed rate loans of between one to five years to multiple people under individual loan contracts. The money is lent in small amounts to different borrowers. If the lender wishes to retrieve his funds, he or she has the ability to transfer the loan to another lender using the 'Rapid Return Facility' on the website. In order to use the platform's services, the lender has to set up a lending account, transfer money to the Zopa account from his/her personal bank account and select a lending option. This also involves choosing how much to lend and when and how to access their money. The money is lent automatically by Zopa once the lender's conditions for lending have been met. Once the loan is formed, the lender must monitor the loans to keep updated about what is going on.

Capacity of P2P lender

In Zopa the lenders are individuals who lend on a personal basis. Although it is possible for institutions to lend on the platform, but only in a professional capacity.

¹⁰⁸⁶ 'Peer-to-Peer Companies' (*p2p Money*) <<http://www.p2pmoney.co.uk/companies.htm>> accessed 16 April 2016.

This means that a proportion of any one loan could be partly funded by a business and therefore partly business-to-consumer (B2C) funding. However, because loans are created from multiple lenders' investments, the B2C contribution to the loan might be relatively small.

P2P lenders using Zopa tend to be a mixture of retail, high net worth and sophisticated lenders. Businesses lending on the platform need to have a consumer credit license.

Dependency on the platform

P2P lenders rely on Zopa to carry out a number of pre-contractual activities vital to the formation of the loan. For example, the platform carries out the necessary identity, fraud and credit checks prior to the formation of the contract. It also assesses the affordability of the loan to the borrower.

They also rely on Zopa to administer the loan according to Zopa's principles once the loan has been formed. If a borrower misses a repayment, this is chased by collections agency appointed by the platform unless or until a default occurs. Zopa maintains the 'Zopa Safeguard Trust' which is held by P2PS Limited in trust for lenders and covers the risk of a borrower not repaying the loan. However the trust is not guaranteed and whether it pays out depends on how much money is held in the fund. If a borrower has defaulted after four months in arrears, the loan contract is assigned to P2PS Limited and the platform makes a claim on the lender's behalf to the Safeguard Trust to reimburse the loan principal and interest that is due.

In situations where the lender wishes to pull out of a loan agreement and retrieve his/her money, there is no guarantee that they'll be able to access the money they have already lent using the Rapid Return facility if there are no other lenders to assign the loan contract to.

Another way in which they rely on the platform is to diversify their investment. The money transferred to the platform is automatically split into numerous microloans that are lent to multiple borrowers at a fixed rate. Therefore, they rely on the platform to do the actual lending by transferring the funds to the ultimate borrower.

P2P lender's self-reliance/liabilities

The P2P lender places his/her capital at risk with no compensation scheme to act as a financial safety net in case things go wrong.

P2P borrower's role

To use the platform's facilities, the P2P borrower must sign up to Zopa as a borrower. In order to borrow, they check Zopa's loan rates using the Zopa loan calculator. Following this, they choose the amount they want to borrow and for how long. Zopa provides them with a quote, which if they are happy with it, they accept and apply for a loan.

Their role during the loan agreement is to repay the loan and interest on a monthly basis.

Capacity of P2P borrowers

On Zopa, borrowers act, i.e. borrow money, in a personal capacity.

P2P borrowers' reliance on the platform

The borrowers rely on Zopa to authorise the loan and transfer the money to them upon approval.

P2P borrowers' responsibilities

In addition to paying the monthly loan repayment, Zopa expects its borrowers to pay a loan servicing fee when they join which includes an amount to cover the risk of non-repayment. They are also expected to have an income, to ensure that they are able to afford the repayments.

Bondora

P2P lenders' role

On Bondora lenders fill in an identification form and transfer their funds to Bondora's account.

There are two types of lenders that use Bondora, passive and active. Passive lenders with little time on their hands can automate their investments with Bondora's Portfolio Manager. Lenders who chose to lend this way select the portfolio manager settings and add the necessary funds to the account.

Active lenders use an interface called API, to access the Bondora system programmatically. They have to take steps to learn more about API and contact Bondora to do so. They are advised to gain more experience using Bondora and only become an active lender if they are lending larger sums of money.

Both types of lenders must set up a Portfolio Manager by selecting their desired target risk-return and agreeing to the terms and conditions. Lenders can choose to spread their investment between several borrowers or set a limit on investments to a single borrower.

Lending takes place by the lender transferring their funds to the platform. Once this has happened, the money is lent to numerous borrowers. The initial capital and interest is also automatically lent out.

Capacity of P2P lender

On Bondora, individuals lend on a personal basis. Businesses and charities can also open lending accounts but for a business related purpose.

Lenders using the platform can be retail, high net worth and sophisticated investors.

Dependency on the platform

Bondora lenders rely on the platform to risk-assess the borrowers using sophisticated underwriting models. The platform assigns borrowers into credit groups with an interest rate that reflects the relevant risks.

Bondora is responsible for payment collection and for chasing payment where there has been non-payment or default. In addition, lenders are reliant on Bondora to safeguard the money lent by keeping it in a separate client account.

As passive investors use an automated lending system, the platform does the lending once the settings have been chosen, including reinvesting the repayments from the lenders' investments. The Portfolio Manager continues to invest according to the lender's chosen risk-return setting, monitors it and continuously corrects future investments to match the level selected. For example, by targeting lower risk loans when the portfolio risk level is higher than the selected risk-return setting. Lenders are also dependent on the platform's automatic diversification.

P2P lender's self-reliance/liabilities

The P2P lender places his/her capital at risk with no compensation scheme to act as a financial safety net in case things go wrong. The burden of operational risk is also borne by the lender, for example, the risk of the lender going bankrupt.

The lender also bears the burden of currency risk as all loans are denominated in euro. The lender must take currency risk into account if they have converted their local currency to euro and back when investing on Bondora, as currency fluctuations can have a strong impact on net returns.

P2P borrower's role

P2P borrowers on Bondora must provide the platform with information requested by the platform which it needs to perform the necessary identity, fraud and affordability checks. The borrowers then receive several credit offers based on their rating and must choose one. Once the offer has been chosen it enters the marketplace and triggers all portfolio managers matching the criteria of the loan.

The borrower must determine the purpose of the loan, the maximum loan and interest amounts and the loan duration. They also have to select their preferred currency of the loan.

Capacity of P2P borrowers

On Bondora, borrowers act, i.e. borrow money, in a personal capacity.

P2P borrowers' reliance on the platform

The borrowers rely on Bondora to authorise the loan and transfer the money to them upon approval.

P2P borrowers' responsibilities

In addition to paying the monthly loan repayment, Bondora expects the borrowers to provide information which is true and accurate.

Unbolted

P2P lenders' role

P2P lenders must register on the platform as an investor. Once they are registered they transfer their funds to the platform. Their role involves selecting their lending criteria e.g. how the funds are deployed and the maximum amount per loan. Lenders also decide whether to use AutoLend, which enables automatic bidding on all loans that suit the lender's pre-defined lending criteria.

During or following the lending process, lenders decide whether to change or cancel AutoLend instructions. They can also decide whether to actively manage their investments, rather than using AutoLend. In such cases, the lenders bid on specific loan offerings by themselves and choose a particular loan they want to invest in. Such active lenders diversify their loan portfolio by choosing particular asset classes. The platform does also enable AutoLend lenders to self-select individual loans.

Capacity of P2P lender

On Unbolted, lenders invest in personal capacity.

Dependency on the platform

Unbolted, is a P2PL platform in which borrowers borrow against collateral of value. The platform, rather than the lenders, determine the value of the asset lent against by partnering with selected firms who are internationally recognised for creating or managing auctions for a particular category of assets. The platform uses their mid-range estimate to determine the value of the asset. So lenders are dependent on the platform and its associates to accurately value the asset which borrowers lend against.

The asset is under the control of Unbolted during the term of the loan and lenders do not have private access to it.

If the borrower defaults, the platform puts the asset up for auction. The funds received, less the charges for selling it through a third party auctioneer, are used

to pay off the outstanding loan principal and interest. The lender is therefore dependent on the platform's ability to sell the asset at the best value for money on their behalf.

The platform has a 'Provision Trust' which protects the principal of the loan. It is funded by 1% of the principal of every loan made out of the platform's own fees. If there is a shortfall in the recovery of the loan principal, the platform puts in a claim against the Provision Trust on behalf of the lenders to cover the shortfall. Lenders of Gold Loans, i.e. loans backed by gold assets, are protected by the Gold Trust for their entire dues, including interest.

P2P lender's self-reliance/liabilities

The P2P lender places his/her capital at risk with no compensation scheme to act as a financial safety net in case things go wrong.

Borrowers are not credit checked because the lending system on Unbolted is based on one that is backed by assets with a resale value.

P2P borrower's role

To engage in the borrowing process, borrowers upload photographs of their asset, describe it and apply for a loan. They send the asset(s) to the platform by next day courier which is free and fully insured. They must then accept the loan and receive the funds.

Once the loan has been made they must make the loan repayments monthly.

Capacity of P2P borrowers

Individuals borrow in a personal capacity. However, small businesses can also borrow on the platform.

P2P borrowers' reliance on the platform

The borrowers' assets are held by the platform during the loan term, so they are dependent on the platform to keep it safe until it is returned to them.

The asset is valued by the platform, so they are also dependent on the platform to obtain an accurate valuation of their asset, which will impact the extent of their borrowing, e.g. amount.

P2P borrowers' responsibilities

This is not mentioned on the platform's website.

eMoney Union

P2P lenders' role

On eMoney, P2P lenders must first register on the platform and then deposit money into the eMoneyUnion account, so that it can be lent out by the platform. Following this, they decide and choose their personal appetite for risk. They select the amount they wish to lend, the amount per borrower and over what term.

Lenders must also decide whether to lend automatically using eBidPal, to borrowers suiting the risk rating the lender chooses. They can also decide to purchase pieces of loans in the platform's secondary market which are called eMicroLoans. Lenders can also decide to bid on loans which were not fully funded at the loan approval stage in the eMarketPlace.

They must monitor the loans to keep updated on the loans they have and the repayments using the lender dashboard.

Capacity of P2P lender

P2P lenders lend in a personal capacity and can be retail, high net worth or sophisticated investors.

Dependency on the platform

Lenders are dependent on the platform in a number of ways. The borrower's repayments are secured on property or by the eProvision fund. The platform automatically matches lenders with borrowers who have been approved and received a risk grade from the platform's underwriters.

They are reliant on the platform to chase late payments and in cases of non-payment, the platform puts in a claim to the eProvisionFund on their behalf to ensure they do not suffer a loan repayment default. However, there is no guarantee that the claim will succeed as it is subject to their being sufficient funds available within the fund.

As with all platforms, the lenders are dependent on the platform to keep their money safe in the case that it ceases to trade.

Their lending decisions are based on the platform's credit and borrower checks and they are dependent on the platform to for the administration of the loan.

Lastly, the borrowers' details are anonymous as they use a membership number to identify them on the platform.

P2P lender's self-reliance/liabilities

The lender places their capital at risk when lending on the platform.

P2P borrower's role

The borrower's role consists of providing the information necessary for the platform to carry out credit checks and to pay a set-up fee of between £40 and £325, a proportion of which goes to the provision fund. They must also make their monthly loan repayments.

Capacity of P2P borrowers

The platform does not state this.

P2P borrowers' reliance on the platform

The platform determines the borrower's risk rating on which basis their borrowing depends.

P2P borrowers' responsibilities

The platform does not state this.

Folk 2 Folk

P2P lenders' role

P2P lenders on Folk 2 Folk must apply to lend. They can choose 'Greenlight Lending' which leaves the platform to automatically commit their funds to the first available lending, or choose from a list of available lending opportunities on the platform website.

The lenders choose to lend to one borrower or to a number of different borrowers. So they bear some active responsibility for the diversification of their investment, unlike on other platforms where this is embedded within the model by automatically dividing the lenders' money between multiple loans.

The P2P lenders also have to monitor the loans to know what is going on with the loans and repayments using the lender dashboard.

Capacity of P2P lender

Folk 2 Folk targets both individual and business lenders. Individuals lend on a personal basis and can be retail, high net worth or sophisticated investors. They can also be a self-invested personal pension (SIPP).

The platform describes lenders as essentially high net worth individuals with liquidity but wanting to earn income from it.

Dependency on the platform

P2P lenders rely on the platform to secure the funds with a mortgage over the property. They also rely on the platform to perform credit and security checks.

P2P lender's self-reliance/liabilities

The P2P lender places his/her capital at risk with no compensation scheme to act as a financial safety net in case things go wrong.

****P2P borrower's role***

To use the platform, borrowers must complete an application form. They secure the loan on property and must make their monthly repayments.

Capacity of P2P borrowers

Borrowers tend to borrow in a personal capacity e.g. to purchase a second property, refurbish a house or purchase an investment property.

The platform describes borrowers as essentially high net worth individuals in need of liquidity.

P2P borrowers' reliance on the platform

Although lenders are discouraged from serving notice on a loan, they have the right to give three months' notice. During which time the platform will try to find a replacement lender. Borrowers are reliant on the platform's ability to do this.

P2P borrowers' self-reliance/liabilities

The loan is secured on a mortgage over a property. If the lender withdraws from the loan agreement and the platform cannot find a replacement, the borrower is responsible for repaying the loan/lender.

The platforms do not provide a brokerage service where they introduce the lenders and borrowers to each other, helps them negotiate terms and then step out of the picture altogether. Rather, they maintain a vital role and presence after the loan has been agreed and started.

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