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The Future of Fintech in the U.K. – The Kalifa Review

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The U.K. has been a successful incubator of innovation in the banking and financial services sector. The Brexit process has questioned whether the centre of gravity of the FinTech industry will shift to continental Europe. Whilst it is still early days, the end of the Transition Period has not witnessed an exodus from the U.K. and HM Treasury's Report on a Strategic Review of U.K. Financial Technology, headed by Ron Kalifa (the "Report"), lays out important initiatives to foster financial technology in the U.K. and ensure that the U.K. maintains its pre-eminent position in the field.

The review sets out five overarching recommendations. In this note we focus on the recommendations made in connection with Policy and Regulation and Investment. The three other recommendations cover Skills, International Initiatives and National Connectivity. The full review can be accessed from this link: Kalifa Review of U.K. Fintech (publishing.service.gov.uk).

Investment

The Report sets out a detailed analysis of the investment environment for financial technology businesses in the U.K. In summary, it concludes that the U.K. lacks sufficient domestically available capital to fund Fintechs. This both acts as a constraint on the development of the sector and also results in investment opportunities in U.K. businesses being taken up by foreign investors.

In this connection, the Report also considers the relative position of the London Stock Exchange and U.S. exchanges (the NYSE and NASDAQ), noting that there has been a fall in listings on the LSE and that U.S. exchanges have also been much more successful in attracting listings of technology businesses.

A number of recommendations are made to address these issues.

A Fintech Growth Fund

The Report proposes the establishment of a U.K. Fintech Growth Fund of £1 billion to fill the current funding gap for U.K. Fintechs. This would comprise a dedicated pool of institutional capital expected to be backed by large institutions contributing £500m and smaller institutions the balance.

The Report acknowledges that the U.K. Government will need to liberalise certain existing rules to facilitate the development of a Fintech Growth Fund. This includes changes to the rules on Defined Contribution pension schemes' ability to make such investments and Solvency II requirements that would permit longer-term strategic investment by insurers. The fact that the U.K. market is no longer connected to the EU is not seen a particular disadvantage. The Report notes that the EU market continues to be fragmented with competition taking place at the national level within the EU.

Fintech Listings

The last five years have seen a large fall in the total values of IPOs on the LSE (from £14.5bn in 2015 to £5.5bn in 2020), while IPO values on the NYSE and NASDAQ have increased in the same period. The Report suggests that the U.K. can plug some of this gap by providing maturing Fintechs with public market capital and improving their access to longer-term and more cost-effective funding. A review of the U.K.'s listing framework is already being carried out by Lord Hill but the Report highlights a few key areas for reform that will be of particular assistance to Fintechs.

Dual Share Class Listings

The Report notes that due to requirements for a Premium Listing, dual share class structures which incorporate different voting rights are not permitted under the LSE's rules. As such, founders floating a company will have to reconcile with ceding control, given that they will not be able to list with a separate share class giving founders weighted or entrenched voting rights. Other markets permit dual listings providing greater flexibility. The Report proposes an easing of listing rules in the U.K. to allow golden shares and dual share class listings.

Level of the free float

Secondly, the Report also refers to requirements for companies with a Premium Listing to maintain at least 25% of their shares as a free float. The NYSE and NASDAQ impose value thresholds rather than a percentage so that the free float percentage can be lower than 25%. Again, the flexibility available in the U.S. is considered to provide U.S. markets with an advantage, as demonstrated by the fact that the NASDAQ and NYSE together made up 53% of total Fintech IPO listings between January 2015 and December 2020 (compared to 6.7% on the LSE).

The Report proposes a reduction in free float requirements from 25% to 10% or the putting in place of a minimum threshold.

Pre-emption rights

The Report advocates the maintenance of the current relaxation of pre-emption rights.

Under current U.K. rules a company can rise capital up to 5% of its issued capital over a 12-month period for general corporate purposes and an additional 5% for specified acquisitions or investments. These levels were relaxed to 20% last year based on guidelines from the Pre-Emption Group, to facilitate the raising of capital in the context of the COVID crisis.

The Report recommends the continuance of this relaxation, which it believes will support Fintechs in raising capital.

Tax Credits & Reliefs

The Report recognises that tax incentive schemes can accelerate growth by providing entrepreneurs with more assurance that they can obtain funding. In this connection it proposes the liberalisation of rules on tax credits. Specifically, that Research and Development tax credits can be claimed for costs relating to the collation and maintenance of financial data sets. The Report notes that financial data sets are particularly important to Fintech businesses and the costs of establishing such data sets can be significant. A tax credit in this respect would provide a source of capital to fund growth.

The Report also considers the position in relation to tax reliefs for EIS, SEIS, and VCT. Such reliefs are not always available in the case of Fintechs. This is due to the fact that Fintechs can carry on excluded activities which mean that they are not eligible for such reliefs to be available. This may be particularly relevant where Fintechs cross from carrying on unregulated activities into regulated banking or financial services activities.

A new regulatory framework

Certain key regulatory initiatives directed at the financial technology space are already underway. These include new rules on marketing or promoting cryptocurrencies, the prohibition on sales of crypto derivatives, and the recent HM Treasury consultation on a new regulatory framework for crypto assets (*U.K. regulatory approach to cryptoassets and stablecoins*), which will impose new regulations on stablecoins and their supporting ecosystem and infrastructure.

Similar developments are taking place in the European Union with proposals for a Markets in Crypto Assets Regulation ("MiCA") under consultation at the moment.

The Report recommends that the U.K. develop a comprehensive digital finance package to create a new regulatory framework for emerging technology. This approach recognises that the development of digital finance will need to be supported by reform of regulations over a broad area and not just financial and banking regulations. For example, the Report emphasises the importance of updating data privacy laws and creating a new framework for digital identities. It also suggests that the regulatory position in relation to the use of Artificial Intelligence should be clarified by the PRA and FCA.

New Crypto Regulations

As part of the comprehensive digital finance framework, the Report supports the introduction of a new U.K. regime for the regulation of crypto assets. While noting that the U.K. already has a strong position that it should capitalise on, the Report also recognises the existence of competing propositions (such as the EU's MiCA) and advocates that the U.K. act quickly to preserve its position. The U.K.'s exit from the EU allows it to depart from EU legislation and standards. Interestingly the Report states that while the U.K. proposition should be "*at least as broad in ambition as MiCA*", the Government should also consider whether it can develop a bespoke regime that is more innovation-driven and will accommodate growing trends such as Decentralised Finance.

Sandbox to Scalebox

One clear success for the U.K. has been the FCA's regulatory sandbox which offers innovators a more benign regulatory environment in which to develop and test their business models. The Report notes that the U.K. sandbox is the busiest in the world!

The Report supports the development of this initiative into a "*scalebox*" that supports firms focussing on innovative technology to grow by offering additional regulatory support. At the same time, the Review advocates the enhancement of the sandbox so that it is available to a broader category of firms through the loosening of eligibility criteria.

Markets and Exchanges

Various initiatives are underway to digitise securities markets and their supporting infrastructure. The Six Swiss Exchange has announced plans to launch a new trading platform using blockchain technology. Similar proposals are also under consideration in Australia. Markets and infrastructure are an area where the application of technology can reduce costs, increase access and expedite processes. However, the transition to trading in digital assets will require changes to the law to ensure legal certainty around trading.

The Report supports the digitisation of investment exchanges and Financial Markets Infrastructure ("FMI"). It notes that the modernisation of U.K. law to allow U.K. FMIs to process digital instruments is "*essential*". To this end, it proposes that the U.K. should pursue plans to fully dematerialise securities and consider how the trading of tokenised securities can be facilitated on investment exchanges (including how blockchain-based ledgers can be used to record transactions in securities). The introduction of new digital technology does give rise to uncertainties as to the transfer of ownership rights, the settlement of transactions and the impact of insolvency events on exchanges and market participants. These potentially thorny legal issues will need to be clarified.

Digital identities and data privacy

The Report recognises the importance of the role of data in the Fintech sector. Attempts have already been made under PSD2 open architecture requirements and the U.K.'s Open Banking initiative to improve access by service providers to customer data. The Report notes that this needs further development through facilitating the use of Smart Data and the development of digital identities for corporates and individuals which will facilitate access to services and provide additional security for transactions.

Concluding

The Kalifa Review is impressive in the range of issues that it has covered. It must be correct that the development of the Fintech sector requires a cross-sectoral and holistic approach. While many aspects of the matters considered in the Kalifa Review are already under development, for example, through the Hill Review of the U.K.'s Listing Regime and HM Treasury's work on crypto assets, it is important that these matters are considered together rather than independently and that there is consideration of the organisational structures around it. Delivery is also key and the proposal to establish a Centre for Finance, Innovation and Technology to ensure delivery of the Review's Recommendations is an important step in ensuring that the U.K.'s Fintech crown does not slip.

The Brexit process, whilst undoubtedly complicating matters, does provide the U.K. with an opportunity to depart from EU regulations. The U.K. will clearly maintain high regulatory standards, but it is encouraging to see the report focus on ensuring that the U.K. remains a competitive global market.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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