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Vulnerability in Financial Regulation: The Case of SMEs

Anat Keller *

Small and medium-sized enterprises (SMEs) are the driving engine of the world economies making up 70 to 95 per cent of all companies and accounting for 60 per cent of total employment in OECD countries.[1] In the UK, 5.9 million SMEs employ 60% of the private sector workforce and contribute 50% of GDP.[2] Nonetheless, despite this collective power and being "the backbone of our economy",[3] the intertwined nature of the personal and business aspects of SMEs makes them fragile.[4] As such, the consequences of mistreatment can spread beyond the business itself, potentially leading to devastating lost livelihoods, lost homes and bankruptcies.[5] Much like the consumer sphere, SMEs may lack resources, expertise or bargaining power to ensure their fair treatment or to engage in a long-lasting court battle.

This article suggests that there is a clear regulatory gap in the conduct of business with SMEs and in particular, in lending to SMEs. This lacuna may expose SMEs to poor conduct and unfair treatment and in certain circumstances, could deprive SMEs of regulatory protections and effective dispute resolution. To fill in the regulatory void in this sphere, financial supervisors have resorted to indirect, ad-hoc and complementary legal mechanisms. This allows regulators to adjust supervision and regulation incrementally in the face of new

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[1] OECD, *Small, Medium, Strong Trends in SME Performance and Business Conditions* (2017) https://read.oecd-ilibrary.org/industry-and-services/small-medium-strong-trends-in-sme-performance-and-business-conditions_9789264275683-en#page4 (accessed 26 October 2021), 15; OECD, *Enhancing the Contributions of SMEs in a Global and Digitised World* (Paris, 7-8 June 2017), 9.
SMEs in the EU "… account for a striking 99.8 percent of all employer firms, 65 percent of private sector employment and 54 percent of private sector gross output." Sebnem Kalemli-Ozcan and others, *Covid-19 and SME Failure*s IMF Working Paper 207 (2020). As will be discussed in 2.1, the definition of an SME is variable. For statistics purposes, SME is any business with fewer than 250 employees (Department for Business https://www.gov.uk/government/collections/business-population-estimates).

[2] Bank of England, *Open Data for SME Finance: What We Proposed and What We Have Learnt* (March 2020) https://www.bankofengland.co.uk/-/media/boe/files/fintech/open-data-for-sme-finance.pdf (accessed 26 October 2021).

[3] Cabinet Office, *Small Businesses Are the Backbone of Our Economy*, *GOV.UK* (9 April, 2018) https://www.gov.uk/government/news/small-businesses-are-the-backbone-of-our-economy (accessed 26 October 2021).

[4] Promontory Financial Group (UK), *S.166 FSMA 2000 Skilled Person Report - RBS Group's Treatment of SME Customers Referred to the Global Restructuring Group - Report prepared for the FC*A (September 2016) (Hereinafter: 'the Promontory Report') highlights in para 2.2.67 that this can be partly attributed to the corporate structure of many small businesses that lacks independent shareholders and the prevalence of owner managers.

[5] Treasury Committee, *Misconduct and Regulation in SME Banking, Past Misconduct in SME Banking* (HC 2017-19, 805-24), para 76.

challenges[6] by utilising a mix of regulatory mechanisms such as self-regulation[7] and draw on banks and other independent industry bodies as important actors in the regulatory sphere.[8] The plethora of solutions and actors fit well within pluralist, multi-sourced and incremental theories of regulation. Yet, it is rather patchy and lacks an underlying rationale for the fair treatment of SMEs that is threaded along its many parts and could potentially yield unintended results. This article, therefore, contends that there is an urgent need to assess how the various regulatory interventions fit together and to establish close coordination across financial supervisors[9] and the industry. In particular, it proposes to broaden the application of vulnerability, which was initially designed with natural persons in mind, to guide the fair treatment of SMEs. Expanding the application of vulnerability to SMEs would reflect the hybrid nature of this business model which is often akin to that of individual consumers. It is suggested that the Financial Conduct Authority (FCA) may be more open for such a shift in light of the inclusion of SMEs in the definition of 'retail clients' in the recent FCA Proposal for a Consumer Duty.[10]

This article focuses on conduct of business with SMEs in the UK for two key reasons. The first is that the regulation of SMEs provides an interesting case study of how the law gradually overcomes historical misconceptions and evolves to become more nuanced and moulded to fit the hybrid nature of this business form. Second, the pandemic exposed the importance of SMEs to the economy but also their very fragile position. SMEs faced a rapid loss of revenues and disruption of cash flow and banks were under immense pressure to provide loans to SMEs to prevent "scarring to the economy that could leave a lasting

[6] On incremental regulation see Sidney A Shapiro and Robert L Glicksman, *Risk Regulation at Risk: Restoring a Pragmatic Approach* 148 (Stanford University Press, 2002).
[7] Neil Gunningham and Darren Sinclair, *Regulatory Pluralism: Designing Policy Mixes for Environmental Protection* 21(1) Law and Policy 49 (1999).
See also Darren Sinclair, *Self-Regulation Versus Command and Control? Beyond False Dichotomies* 19(4) Law and Policy 529 (1997) who suggests leaving the dichotomy between pure self-regulation and command and control regulation and adopt a more nuanced approach which combines the two approaches to provide an optimal regulatory solution. Where there is a realistic threat of irreversibility, however, regulation should be located closer to the strict command and control end of the continuum (p 538).
[8] Peter Grabosky, *Meta Regulation* in *Regulatory Theory: Foundations and Applications,* 149-150 (Australian National University Press, P Drahos, 2017).
[9] Point made, albeit in a different context, in NAO, *Financial Services Mis-selling: Regulation and Redress* (HC 2015-16, 851-24), 6-7. This ensure that an integrated approach is taken that considers policies, institutions and tools as a whole, at all levels of government and across sectors in line with the OECD, Recommendation of the Council on Regulatory Policy and Governance (2012), para 1.2.
[10] FCA, *A New Consumer Duty*, Consultation Paper CP21/13 (May 2021) https://www.fca.org.uk/publication/consultation/cp21-13.pdf (accessed 26 October 2021).

damage".[11] The resulting high level of borrowing among SMEs could lead to risks to the stability of the financial system.[12] Most importantly, however, the pandemic acted as a magnifying glass for the lacunas in the regulation of SME lending and the corresponding exposure of SMEs to unfair treatment when borrowing from authorised financial firms.

The article is structured as follows. After this introduction, Part II begins with analysing the variable definition of SMEs. It then outlines the restricted and incoherent perimeter of the FCA and the regulatory void and inconsistency in conduct-of-business with SMEs. Part III considers the ad-hoc legal mechanisms and frameworks that emerged to fill in this regulatory void and mitigate the risk of poor treatment of SMEs, including (1) clarifying the boundaries of the FCA regulatory and supervisory reach on the edges of its perimeter; (2) broadening the accessibility of SMEs to dispute resolution and redress, including, expanding the role of the Financial Ombudsman Services (FOS); introducing voluntary complaints and compensation schemes such as ad-hoc redress schemes, the establishment of the Business Banking Resolution Service and the use of a new innovative test case tool; (3) the emergence of new industry codes and the introduction of the recognition process of certain industry codes by the FCA and finally, (4) reinforcing individual accountability via the Senior Managers and Certification Regime. Part IV critically analyses the desirability of a pluralist, multi-sourced and incremental regulation, in general, and in the context of SME regulation, in particular. Part V puts forward vulnerability as an umbrella term that can be used to apply an adaptable and targeted supervisory approach to conduct of business with SMEs. It also considers the potential perils and challenges in transposing the construct of vulnerability that was designed with individual consumers in mind and utilising it in a different business sphere. Part VI concludes.

Part II – The regulatory gap of conduct of business with SMEs

[11] OECD, *Coronavirus (Covid-19): SME Policy Response*s (Updated 15 July 2020) http://www.oecd.org/coronavirus/policy-responses/coronavirus-covid-19-sme-policy-responses-04440101/ (accessed 26 October 2021).
For statistics on the number of applications and approved cases in the UK see https://www.gov.uk/government/collections/hm-treasury-coronavirus-covid-19-business-loan-scheme-statistics (accessed 26 October 2021).
[12] Bank of England, *Financial Stability in Focus: The Corporate Sector and UK Financial Stability* (October 2021) https://www.bankofengland.co.uk/financial-policy-summary-and-record/2021/october-2021/financial-stability-in-focus (accessed 26 October 2021).

2.1 Defining SMEs and their misguided perception

According to the Federation of Small Businesses, SMEs account for 99.9% of the business population (6.0 million businesses).[13] The UK government's definition of SMEs encompasses a micro-enterprise (less than 10 employees and an annual turnover under €2 million), a small enterprise (less than 50 employees and an annual turnover under €10 million) and a medium-sized enterprise (less than 250 employees and an annual turnover under €50 million).[14]
For regulatory purposes, however, there is no unified definition of SMEs or a single set of enterprise size thresholds applying to the rules throughout the FCA Handbook.[15] The definition of an SME varies according to the purpose of regulation[16] and while some rules in the FCA Handbook refer to micro-enterprise,[17] other rules refer to the definition of a Small Company under section 382 of the Companies Act 2006.[18]

The absence of a single SME definition and lack of consistency is also apparent, at the global level. There is significant heterogeneity across jurisdictions in terms of SME definitions. The number of employees is a widely used criterion, but jurisdictions also apply (separately or concurrently) other criteria such as annual sales, size of assets or amount of loans.[19]

As we shall see in section 2.3, SMEs are offered restricted regulatory protection in the UK. It is not difficult to trace back the origins of this approach that was largely driven by the conception that SMEs are more sophisticated and have stronger bargaining power than individual consumers.[20] It was also motivated by the concern that a heavy regulation could potentially inhibit the much-needed supply of credit to SMEs.[21] These assumptions, however,

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[13] https://www.fsb.org.uk/uk-small-business-statistics.html (accessed 26 October 2021).
[14] Small and Medium-Sized Enterprises Action Plan 2020 to 2022 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/961722/SME-Action-Plan.pdf (accessed 26 October 2021)
[15] On the thresholds in the FCA Handbook see FCA, *Our Approach to SMEs* (2015), para 34 and Table 1.
[16] In the FCA Glossary, there is a definition of SME for the purposes of MAR5 and IFPRU and a definition of a small business for the purposes of COMP and DISP.
[17] A Micro-enterprise is defined in the FCA Handbook Glossary as a business that employs fewer than 10 persons and has a turnover or annual balance sheet that does not exceed €2 million.
[18] Which defines SMEs for accounting purposes.
[19] FSB, *Evaluation of the Effects of Financial Regulatory Reforms on Small and Medium-sized Enterprise (SME) Financing* (November 2019), 6. Across the EU, however, SME is defined in European Commission Recommendation 2003/361/EC of 20 May 2003 OJ L 124, p. 36 as – "any entity of any legal form engaged in an economic activity that employs fewer than 250 persons, has an annual turnover not exceeding €50m and/or a balance-sheet total not exceeding €43m". European Commission, *User Guide to the SME Definition* (2020).
[20] FCA, *Our Approach to SMEs*, para 2.5.
[21] Treasury Committee, *Oral Evidence: RBS' Global Restructuring Group and its Treatment of SMEs* (HC 2017-2019, 475) on 7 February 2018, Q196; Treasury Committee, *Oral Evidence RBS' Global Restructuring Group and its Treatment of SME* (HC 2017-19, 737) on 30 January 2018, Q207; Treasury Committee, *SME Finance* (HC 2017-19, 805-24), para 71 point out that HM Treasury, *Financial Services and Markets Bill, Regulated Activities - A Consultation Document* (February 1999) did not seek public view on SME lending.

were not without contention. It has long been recognised that, in reality, many SMEs are often simply individual consumers wearing a business hat, are no more financially sophisticated than everyday consumers[22] and therefore, may require the same level of protection as other consumers.[23] Moreover, evidence suggests that SMEs, in particular at the smaller end of the spectrum, face an information asymmetry when dealing with banks and other finance providers, leaving them vulnerable to investing in unsuitable products and lacking the ability to assess risks appropriately.[24]

2.2 The 'Dash for Cash' project – Exposing the weakness of SMEs

The Covid-19 crisis was not the first shock to expose the vulnerability of SMEs and the regulatory gap in addressing their vulnerability. In 2013, the Tomlinson Report laid out serious allegations of unfair treatment of SMEs by RBS, widely known as the 'Dash for Cash' project.[25] The allegations suggested that RBS artificially distressed otherwise viable businesses, transferred them into its business support division (the Global Restructuring Group (GRG)) and thus put them on an expedited journey towards administration, receivership and liquidation.[26] It was alleged that the GRG existed to "make a profit for RBS through the destruction of viable businesses" and utilising "fees, increased margins and devalued assets".[27] The damning Tomlinson Report concluded that RBS's actions went beyond mistreatment of customers by harming those customers and "causing their financial downfall."[28]

In response to these allegations, the FCA commissioned an independent Skilled Person Review under section 166 of FSMA conducted by Promontory.[29] The Promontory Report, which was published in a full unredacted form in February 2018, was much more forgiving than the Tomlinson Report. It found no evidence that RBS artificially distressed

[22] FCA, *Our Approach to SMEs* , 9–10.
[23] For instance, Financial Services Consumer Panel, *Response to the Treasury Committee SME Finance Inquiry (29 March* 2017).
[24] J Lean and J Tucker, *Information Asymmetry, Small Firm Finance and the Role of Governmen*t 1(1) Journal of Finance and Management in Public Services 43 (2001).
[25] L Tomlinson*, Banks' Lending Practices: Treatment of Businesses in Distress* (25 November 2013) (Hereinafter: the Tomlinson Report).
[26] Ibid, 5.
[27] Ibid, 2
[28] Ibid, 19.
[29] Hereinafter: The Promontory Report. Letter from the Chief Executive of the FCA to the Treasury Committee Relating to the Powers and Perimeter of the FCA (30 January 2018). Although the conduct in issue was unregulated, the test for the appointment of a Skilled Person under s 166 FSMA was met. Skilled Persons' reports are not normally published but in recognising the public interest in the RBS case, the FCA published an interim summary of the findings and conclusions (FCA, *Update on the FCA's Review of RBS's Treatment of SME Customers referred to its GRG*, 23 October 2017).

and transferred otherwise viable SME businesses to GRG to profit from their restructuring or insolvency. Yet, the Promontory Report identified systematic "widespread inappropriate treatment of SME customers by GRG".[30]

The final nail in the coffin was the 2019 FCA's report.[31] The FCA emphasised that GRG lending to SMEs for business purposes was mostly outside its regulatory perimeter[32] and that the FCA's powers to take actions for GRG's alleged mistreatment of SME customers were limited.[33] But even, as we shall see below, where the FCA did have the relevant powers to take actions against individuals for lack of fitness and propriety, it chose not to do so as "it would not have reasonable prospects of success."[34]

The 'Dash for Cash' saga exposed two regulatory gaps. The first was that there were no conduct of business rules against which to assess the treatment of SME customers in business lending, largely falling outside the FCA's perimeter. The second was that, at the time, many SME customers were not eligible to use the FOS dispute resolution service as an alternative to bringing disputes to courts.[35]

2.3 Regulatory gaps and incoherence in conduct of business with SMEs

Regulatory gaps and incoherence in conduct of business with SMEs are evident at multiple levels: first, with regard to what is within or outside the FCA perimeter; second, within the FCA perimeter, which protections in the FCA Handbook are afforded to different types of SMEs and third, the extent of the FCA regulatory reach that goes beyond its perimeter.[36]

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[30] The Promontory Report, 11. The Promontory Report reiterated that most of the GRG customer-facing activities were not regulated by the FSA and therefore, it was primarily based on standards that RBS set for itself, Forward, para XIII. The inappropriate treatment was largely attributed to RBS failings "to fully recognise and manage the conflicts of interest inherent in GRG's twin objectives (turnaround of businesses in distress and financial contribution to RBS)" and "to put in place the appropriate governance and oversight procedures to ensure that a reasonable balance was struck between the interests of RBS and SME customers (para 1.62).

[31] FCA, *Report on the FCA's Further Investigative Steps in Relation to RBS's GRG* (June 2019). The report was described in the press as "a complete whitewash" Caroline Binham and Nicholas Megaw, *FCA Report into Disgraced RBS Unit Branded a 'Whitewash,* Financial Times (13 June 2019).
The FCA has a single strategic objective (to ensure that relevant markets function well) which is underpinned by three operational objectives: to secure an appropriate degree of protection for consumers; to protect and enhance the integrity of the UK's financial system, and to promote effective competition in the interest of consumers (s. 1B of FSMA 2000, as amended).

[32] Ibid, 4.
See also FCA *Our Approach to SMEs as Users of Financial Services* (November 2015) DP15/7, 12.

[33] Ibid, 7.

[34] Ibid, 11.

[35] FCA, *Final Summary – A Report on an Independent Review of RBS Group's Treatment of Small and Medium-sized Enterprise Customers Referred to the Global Restructuring Group* 3 (November 2017).

[36] It is to be noted that while the proposed Consumer Duty (n 10) casts the net wide and includes SMEs in the definition of 'retail client' – it only applies to financial services that the FCA *regulates* and therefore, will not affect directly those three aspects.

2.3.1 The FCA's restricted and incoherent perimeter and its blurred regulatory reach

The financial services activities that the FCA regulates are primarily set out in the Financial Services and Markets Act 2000 (FSMA 2000) (Regulated Activities) Order (hereinafter: RAO).[37] The boundary set by the RAO and other relevant legislation, which provide the FCA with additional regulatory powers, is referred to as the 'FCA perimeter'.[38] What is within the FCA perimeter and what is outside the perimeter requires some investigation. For instance, while mortgage lending and consumer credit activity,[39] business lending activity is largely outside the FCA perimeter. It is generally only a regulated activity where both the loan is up to £25,000, and the borrower is either a sole trader or a 'relevant recipient of credit'.[40]

In practical terms, this means that when lending in a commercial setting, there are no FCA rules that govern how that activity should be carried out. It also means that the majority (8 out of 11) of the FCA's Principles for Businesses as set out in PRIN 2.1 of the FCA Handbook do not apply.[41] To give an example, the Consumer Credit Sourcebook (CONC) sets out the FCA rules for creditworthiness and affordability checks[42] and the treatment of customers who are in default or arrears, ensuring they are treated with forbearance and due consideration.[43] However, CONC applies to 'credit-related regulated activities'[44] and given that most lending

[37] SI 2001 No 544. For an activity to be a regulated activity it must be carried on 'by way of business' (FSMA, s 22). The Treasury has the power to change the meaning of business elements (FSMA 2000 (Regulated Activities by Way of Business) Order 2001 (SI 2001/1177). Before they can be carried out, these regulated activities require FCA/PRA permission (FSMA 2000 s. 55A). FCA powers are also based on an amalgamation of UK and EU legislation such as the Money Laundering Regulations 2019. FCA, *Perimeter Report 2018/19*, paras 1.5-1.6.
[38] FCA Perimeter Report 2019/20, para 1.10.
[39] RAO, ss 60B, 61.
[40] RAO, s 60C and PERG 2.7.19C on "exempt credit agreement". Not much has changed since the *Wheatley Review of Libor: Initial Discussion Paper* (2012) that observed that the regulatory framework of LIBOR-related activities was "complex and somewhat piecemeal" thus impeding on the FSA's ability to supervise and take enforcement action (para B.2). Historically, consumer credit regulation covered some non-corporate business lending. *The Report of the Committee on Consumer Credit* (the Crowther Report) (Cmnd 4596, 1971) recognised that 'the position of the small unincorporated business buying on credit…is often not much different from that of an individual buying or borrowing for personal or family use' (para 1.1.3). But CCA 2006, s.16B introduced a new exemption category where £25,000 made "wholly or predominantly" for the debtor's business purposes are rendered 'exempt agreements'.
[41] The Principles for Businesses which apply to unregulated activities are Principles 3 (Management and Control), 4 (Financial Prudence) and 11(Relations with Regulators) since complying with these rules could have a direct bearing on the proper running of the firm in relation to its regulated activities. See Treasury Committee, *Misconduct and Regulation in SME Banking, Past Misconduct in SME Banking* (HC 2017-19, 805-24), Table 2. SME lending could fall under Principle 3 if it relates to the prudential context of unregulated activity, such as if the activity has, or might be reasonably viewed as likely to have a negative effect on the confidence in the financial system. This may be the case in relation to lending to SMEs that could have system-wide implications.
[42] CONC 5.2A
[43] CONC 7.3.4R. Conduct related to mortgages is set out in the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB).
[44] CONC 1.1.1.

activity to SMEs is an "exempt agreement", it will not be governed by the FCA rules and benefit from their protection.

The focus of the FCA regulatory framework on 'regulated activities', which set the limits on its perimeter, often resulted in confusion and somewhat arbitrary consequences in areas of activities of authorised firms with SMEs. This was the case with regard to the sale of interest rate hedging products (IRHPs). While IRHPs were within the FCA perimeter, commercial loans with 'embedded' interest rate hedging products, such as Tailored Business Loans, remained outside the FCA perimeter.[45] This created "...a logically inconsistent result…" where "…products whose effects may be identical fall on both sides of the perimeter."[46] There is also a concern that the lack of understanding resulted in firms deliberately gaming the perimeter to undertake regulatory arbitrage.[47]

Alternatively, when regulated firms engage with SMEs in a regulated activity that is within the FCA perimeter, there are inconsistencies in the application of the regulatory protections. The level of protection available to SMEs tend to decrease with business size and incorporation[48] and can differ across the various parts of the FCA Handbook. For instance, the BCOBS, which sets the high-level rules and guidance of retail banking conduct of business, apply to a firm when it accepts deposits from a "banking customer".[49] The term "banking customer" in BCOBS refers to consumers as well as "micro-enterprises" and charities with an annual income of less than £1 million. In contrast, the ICOBS, which sets the standards for general insurance firms on how to deal with their customers, states that 'Different provisions in this sourcebook may apply depending on the type of person with whom a firm is dealing".[50] Customers in the ICOBS can be either "a consumer" defined as "any natural person who is acting for purposes which are outside his trade or profession" or "a commercial customer" defined as "a customer who is not a consumer."[51]

Moreover, even in those cases where protection is afforded to SMEs under the FCA Handbook, SMEs still face a hurdle in bringing a case to Court. Section 138D of FSMA reserves the right of action for damages for contravention of a rule made by the FCA by an

[45] Treasury Committee, *Conduct and Competition in SME Lending* (HC 2013-14, 204) paras 138-139.
[46] Ibid, para 149.
[47] Treasury Committee, *The Work of the FCA: The Perimeter of Regulation* (HC 2017-2019, 2594), para 17.
[48] FCA *Our Approach to SMEs*, para 6.1.
[49] BCOBS 1.1.1.
[50] ICOBS 2.1.1
[51] ICOBS 2.1.1 subsections 3 and 4.

authorised firm to a 'private person' who suffered loss as a result of the contravention.[52] A 'Private person' is "(a) any individual, unless he suffers the loss in question in the course of carrying on— (i) any regulated activity; or (ii) … (b) any person who is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind".[53] The courts held that this definition should be given a broad effect so as to exclude corporate entities carrying on business of any kind, leaving SMEs, once again, largely out in the cold.[54]

Finally, the FCA has some powers over authorised firms when they conduct unregulated activities. However, these powers are generally more limited than the FCA's powers over regulated activities.[55] For instance, under certain circumstances, Principles for Businesses 3, 4 and 11 can be applied to "unregulated activities".[56] Similarly, as we shall see in section 3.4, the FCA can also take action against individuals under the Senior Managers and Certification Regime for unregulated activities, going beyond its narrow RAO perimeter.[57] Therefore, determining the boundaries of the FCA regulatory and supervisory reach and its power to act is not always a straightforward exercise.[58] The fact that the FCA regulatory reach spreads, to a certain extent, beyond its strict perimeter makes it difficult for both regulated firms and SMEs to decipher what is regulated and what is not. In addition, where a supervisory action is taken beyond the perimeter, it is often coupled with concerns

[52] FSMA 2000, s. 138D(2). But according to s 138D(3) the FCA has the discretion to disapply that right with regard to a contravention of a specified provision of its rules, subject to the exceptions in 138D(5) FSMA 2000. See, for instance, PRIN Schedule 5.
[53] FSMA (Rights of Action) Regulations 2001 (SI 2001 No. 2256), Reg 3(1).
[54] *Titan Steel Wheels Limited* v *The Royal Bank of Scotland Plc* [2010] EWHC 211 (Comm). The decision was followed in *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd* [2012] EWHC 7, [2012] PNLR 15 In a recent case, *Target Rich International* v *FXCM Ltd* [2020] EWHC 1544 (Comm), para 90 the court rejected the claimant's argument that *Titan Steel* was wrongly decided. There are limited circumstances where it would be possible for companies to bring action under s 168D FSMA 2000. See FSMA 2000 (Rights of Action) Regulations 2001 (SI 2001/2256), Reg 6.
See also Diane Bugeja, '*Reforming Corporate Retail Investor Protection Regulating to Avert Mis-Selling*' (Hart, 2019), 55; Keith Stanton, *Investment Advice: The Statutory Remedy* 33(2) Tottel's Journal of Professional Negligence 153-174 (2017).
[55] FCA, Perimeter Report 2018/19, June 2019, para 2.4. See discussion in s 3.1 below on when the FCA is more likely to act with regard to unregulated activities outside its perimeter.
[56] FCA, Principles for Businesses, 3.2.3. The FCA focuses primarily on regulated activities but where it is relevant to its operational objectives it may take action or refer to other bodies. FCA, *Mission Approach to Consumers* (2019), 12. For instance, the FCA acted in the unregulated spot FX market: 'FCA fines five banks £1.1 billion for FX failings and announces industry-wide remediation programme', 12 November 2014 https://www.fca.org.uk/news/press-releases/fca-fines-five-banks-£11-billion-fx-failings-and-announces-industry-wide-remediation-programme (accessed 26 October 2021).
[57] COCON 1.1.6 and 1.1.7.
[58] It is important to distinguish between the narrow sense of the FCA's strict perimeter (i.e. RAO regulated activities and activities that the FCA regulates set out in standalone legislation) and a broader meaning of 'perimeter, i.e. regulatory and supervisory reach which will allow the FCA to regulate incidentally even though it is not a 'regulated activity' within the RAO. This article uses the term 'perimeter' in the former narrow sense.

that, by intervening, the FCA may breach its remit.[59] These concerns and ambiguity may lead to regulatory forbearance and risk the FCA supervisory approach being reactive to emerging risks, potentially failing to take prompt and incisive action as soon as harm is identified.[60] Any supervisory action may be based on partial information thus inhibiting the effectiveness of the FCA response and its targeted nature.

2.3.2 The previous narrow remit of the Financial Ombudsmen Services

The second gap in regulating SMEs was related to the remit of the Financial Ombudsman Service (FOS). The FOS was set up under Part XVI of the FSMA to resolve certain disputes quickly and with minimum formality.[61] Previously, eligible complainants to the FOS included individual consumers and 'micro-enterprises'. To qualify as a micro-enterprise, a business was required to employ fewer than 10 employees and have an annual turnover or balance sheet total of less than €2 million.[62] Many SMEs, therefore, were outside the FOS's threshold.[63] The narrow scope of the FOS was of particular concern given that the alternative route of bringing a case to court, by and large, was reserved to "the richest businesses" without the advantage of s. 138D.[64] Furthermore, banks may seek to limit their potential liabilities to SMEs through contractual terms[65] and in the absence of real bargaining power or expertise, SMEs often do not negotiate these terms.[66] This means that even where SMEs do take disputes to court, their causes of action are rather narrow compared to those available to individual consumers.[67] Overall, many SMEs remained without an effective forum to pursue redress for unfair treatment or resolve disputes with their banks.[68]

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[59] This was the case when the FCA issued warnings on Initial Coin Offering products beyond its perimeter. FCA, *Consumer Warning about the Risks of Initial Coin Offerings* (February 2019) voicing such concerns; Treasury Committee, *Oral Evidence: Digital Currencies* (HC 2018, 910), Q 199.
[60] FCA Perimeter Report 2018/19, June 2019, para 2.6
[61] FSMA 2000, s 225. On the effectiveness of the FOS see Treasury Committee, *SME Finance, The Financial Ombudsman Service: The Ability of SMEs to Access the Ombudsman* (HC 2017-19, 805-24), paras 92-97.
[62] FCA Handbook DISP 2.7.3 (prior to its amendment).
[63] Simon Walker, Christopher Hodges and Robert Blackburn, *Review into the Complaints and Alternative Dispute Resolution Landscape for the UK's SME Market* (23 October 2018) (hereinafter: the Walker Review). See also Bugeja, *Reforming Corporate Retail Investor Protection*, 53.
[64] The Walker Review, 2.
[65] To the extent that it is permissible under the FCA rules. FCA, *Our Approach to SMEs*, para 1.13. In the context of IRHP-related mis-selling claims see Bugeja, *Reforming Corporate Retail Investor Protection*, 112.
[66] FCA, *Our Approach to SMEs*, para 1.13.
[67] Treasury Committee, *SME Finance*, para 118.
[68] FCA, *SME Access to the Financial Ombudsman Service – Near-final Rules* (Policy Statement PS18/21 October 2018), para 1.14.

Part III – ad-hoc mechanisms developed to fill in the regulatory gaps and prevent SME consumers' harm

The numerous attempts to promote legislative changes that would have enhanced SMEs' protection have, unfortunately, failed. For instance, the Treasury Committee urged the Government and Parliament to bring commercial lending into the FSMA regulatory perimeter,[69] acknowledging that many SMEs "are no more financially sophisticated than everyday consumers".[70] The FCA also sought to extend the application of its Principle for Businesses 5 (A firm must observe proper standards of market conduct) to unregulated activities of authorised firms.[71] However, after seeking the views of the industry, the FCA decided against pursuing the proposal further, *inter alia*, based on observations made by respondents that applying principle 5 to unregulated activities would increase costs for firms.[72] This is regrettable since this change would have enabled the FCA to take action against authorised firms for serious firm-level misconduct when lending to SMEs, without creating a significant new compliance burden.[73]

Instead, the evident lacuna in regulating the relationship between SMEs and authorised firms resulted in an ad-hoc expansion of the regulatory domain and the use of a myriad of legal mechanisms, some without needing the legislator's intervention. These included (1) establishing mechanisms to clarify the boundaries of the FCA regulatory and supervisory reach beyond its perimeter line. (2) widening accessibility to dispute resolution and redress via expanding the remit of the FOS; the emergence of other voluntary complaints and compensation schemes including ad-hoc voluntary redress schemes set up by the FCA with the banks; establishing the Business Banking Resolution Service and introducing a new innovative Test Case tool (4) an industry initiative to devise conduct codes to ensure fair and equal treatment of SMEs and recognising certain industry tools under the FCA Handbook. (5)

[69] Treasury Committee, *SME Finance*, para 85 suggests that "…the justification for leaving commercial lending outside the regulatory perimeter is feeble, and it is unclear whether this issue was subject to sufficient public debate when the regulatory perimeter was first established." The Government rejected the recommendation based on increased compliance and monitoring costs and potential stifled product innovation, narrower product choice for SMEs, and higher barriers to entry: Treasury Committee, *Government and Financial Conduct Authority Responses to the Committee's Twenty-Fourth Report: SME Finance* (HC 2017-19, 1873) 9–10. See also the Treasury Committee, *The Work of the FCA*, paras 23-31.

[70] And thus, cannot be left to fend for themselves. Treasury Committee, *SME Finance*, paras 70-77; FCA, 'Handling of Insurance Claims for SMEs' (May 2015) https://www.fca.org.uk/publication/thematic-reviews/tr15-06.pdf (accessed 26 October 2021), para 1.3.

[71] This would have enabled the FCA to take enforcement action against firms for breaches of Principle 5 to be differentiated from its ability to take action against *individuals* for failing to observe proper standards of market conduct under the SMCR. FCA, *Consultation Paper on Industry Codes of Conduct and Discussion Paper on FCA Principle 5* (CP17/37, November 2017), para 6.10.

[72] FCA, *Industry Codes of Conduct and Feedback on FCA Principle 5* (PS18/18 July 2018), para 4.6.

[73] Ibid.

reinforcing individual accountability via the Senior Managers and Certification Regime. These legal mechanisms and the level of protection they offer to SMEs will be examined in turn.

3.1 Clarifying the FCA regulatory and supervisory reach – responding to activities at the edge of its perimeter

As we have seen in section 2.3.1, the FCA powers extend beyond the "regulated activities" narrow perimeter line, but the boundaries of its regulatory and supervisory reach are imprecise. The FCA acknowledged that "*Financial services markets are dynamic, so defining where and how we might act outside the perimeter is not simple*."[74] In an attempt to provide a clearer picture of its regulatory and supervisory reach over unregulated activities, the FCA set out a broad-brush guideline - "*we are more likely to act where the unregulated activity: is illegal or fraudulent, has the potential to undermine confidence in the UK financial system, is closely linked to, or may affect, a regulated activity*."[75] Since 2019, the FCA has been publishing an annual Perimeter Report which provides an overview of the perimeter and explains how the FCA manages issues and responds to activities at the edge of the perimeter.[76] Setting pre-ante clear guidelines assists the FCA in monitoring unregulated activities and taking a more proactive approach whilst not overstepping its statutory remit. It also enables the FCA to keep its regulatory reach under constant review and ensure that new product offerings and services or deliberate attempts to avoid the perimeter are met with an appropriate supervisory response.[77] More recently, the UK government has committed to holding an annual perimeter review meeting and publishing a record of these meetings to ensure a more prominent engagement between HM Treasury and the FCA/PRA.[78] These initiatives, however, may not go far enough to alleviate market uncertainty as to the areas in which the FCA may use its powers. There is still a substantial risk of arbitrage between regulated and unregulated activities by authorised firms, for instance by structuring products

[74] FCA, *Our Mission 2017 How We Regulate Financial Services*, https://www.fca.org.uk/publication/corporate/our-mission-2017.pdf (accessed 26 October 2021), 20; 'FCA Powers and Perimeter', Letter from Andrew Bailey to the Treasury Committee (30 January 2018).
[75] FCA, *Our Mission*, 20.
[76] FCA Perimeter Report 2018/2019, para 2.2. The Perimeter Report deals with issues that go beyond the narrow understanding of the FCA perimeter (i.e. regulated activities set out in the RAO and powers in other standalone legislations) (see section 2.2.2 and in particular, n 44).
[77] Ibid. Either via an enforcement action (where the FCA has the power) or by making recommendations to Government and Parliament.
[78] HM Treasury, Financial Services Future Regulatory Framework Review Phase II Consultation Paper 305 (October 2020) para 3.33.

with similar characteristics but which fall outside the FCA perimeter.[79] The government previously rejected the Treasury Committee's recommendation to give the FCA a supervisory power to make recommendations to the Treasury as to changes to the FCA perimeter.[80] Such power would have replaced the current informal system of the FCA requesting those changes from the Treasury and would have enhanced the FCA's ability to meet its objectives, in particular, to prevent systematic and prevalent practices that could lead to SME consumers' harm.

3.2 Widening accessibility to dispute resolution and redress

(a) The expanded remit of the Financial Ombudsman Services

In April 2019, based on the recommendations of independent review into the complaints and alternative resolution landscape for SMEs (known as the Walker Review)[81] and following a public consultation, the FOS's remit was extended. The remit now includes complaints made by larger SMEs, i.e. a small business that is an enterprise which is not a micro-enterprise; has an annual turnover of less than £6.5 million, and has a balance sheet total of less than £5 million, or employs fewer than 50 employees.[82] In addition, the FOS's monetary award limit increased from its current level of £150,000 to £350,000.[83]

The expanded remit of the FOS will undoubtedly assist SMEs in resolving disputes with authorised firms, regardless of whether the activity is within or outside the FCA perimeter. In particular, it could assist SMEs in resolving disputes around unregulated commercial borrowing under the Covid-19 government schemes, including the Coronavirus Business Interruption Loan Scheme (CBILS) and a Bounce Back Loan Scheme (BBLS).[84]

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[79] As was the case with the sale of Tailored Business Loans (see section 2.2.1 above). Customers' confusion from these grey areas is of concern as indicted in a recent FCA Dear CEO letter :"We have recently become aware of firms issuing financial promotions which suggest or imply that all of the activities which they undertake are regulated by us and/or the PRA when, in fact, they are not… could leave consumers unable to understand whether the products or services which are promoted are regulated by us and/or the PRA."

[80] Treasury Committee, *The Work of the FCA*; FCA, *Response to the Treasury Report* (14 October 2019) https://publications.parliament.uk/pa/cm201919/cmselect/cmtreasy/132/13202.htm (accessed 26 October 2021). This will prevent a situation that arose with Tailored Business Loans, where the FCA was unable to address the problem under its perimeter and the Treasury failed to have responded formally to the FCA on the matter. Treasury Committee, *Conduct and Compensation in SME Lending* (HC 2014-15, 204-11) para 146.

[81] Simon Walker CBE, Professor Christopher Hodges, Professor Robert Blackburn, *Review into the complaints and Alternative Dispute Resolution L?andscape for the UK's SME market* (October 2018).

[82] Small Business (Eligible Complainant) Instrument 2018 (FCA 2018/61) FOS 2018/7. For Eligible Complainants see FCA Handbook, DISP 2.7.3.

[83] FSMA 2000 s. 229(5) the FOS can recommend payments above this level. The FOS's compulsory jurisdiction generally covers complaints against respondents (including firms) about regulated activities, and also other activities which are listed at DISP 2.3.1R.

[84] hereinafter together: "The Covid-19 government schemes". FCA, Business Plan 2020/21 https://www.fca.org.uk/publication/business-plans/business-plan-2020-21.pdf (accessed 26 October 2021).

Still, the exceptional circumstances under which commercial lending took place during the Covid-19 crisis could put the FOS's "fuzzy" regulatory sphere under strain. The FOS is required to decide complaints based on what, in his opinion, is fair and reasonable in all the circumstances of the case.[85] In considering this, the FOS takes into account relevant law and regulations; regulators' rules, guidance and standards and codes of practice; and where appropriate, what he considers to have been good industry practice at the relevant time.[86] The courts, however, voiced dissatisfaction from the FOS's jurisdiction that 'occupies an uncertain space outside the common law and statute' leaving the relationship between what is 'fair and reasonable and what the law lays down unclear',[87] reflecting long-standing concerns and criticisms of ombudsman schemes.[88]

The potential tension between the law and what is "fair and reasonable" could become particularly apparent during stress times. However, the manner in which the FCA and the FOS coordinated to pre-empt any potential discrepancies in their approaches is an epitome of good regulation. Recently, the RAO was amended to include lending under the BBLS as an exempt agreement to mitigate any delays in lending.[89] This meant *inter alia* that BBLS lenders were not required to conduct creditworthiness assessments when considering an application.[90] In addition, the FCA clarified that where a customer is temporarily experiencing exceptional financial pressures at the time of applying to the CBILS, it "does not mean that the firm is prevented by CONC 5.2A.5R (creditworthiness assessment – my addition) from making the loan".[91] The FCA reiterated that "banks may now be making

[85] DISP 3.6.1; FSMA 2000 s. 228 sets the fair and reasonable test for compulsory jurisdiction and DISP 3.6.2 extends it to voluntary jurisdiction.
[86] DISP 3.6.4 R. FOS's discretion to depart from relevant law and regulation is subject to an obligation to explain the reasons behind its decision. *R (Heather Moor & Edgecomb) v FOS* [2008] EWCA Civ 642, para 49; *R (Aviva Life and Pensions) v FOS and others* [2017] EWHC 352 (Admin), para 55.
[87] *Aviva Life and Pensions) v FOS and others*, para 73.
[88] Naomi Creutzfeldt and Chris Gill, *Critics of the Ombudsman System: Understanding and Engaging Online Citizen Activists* (December 2015) Centre for Socio-Legal Studies, University of Oxford Consumer Insight Centre Queen Margaret University https://www.law.ox.ac.uk/sites/files/oxlaw/critics-of-the-ombudsmen-system-understanding-and-engaging-online-citizen-activists-dec15.pdf (accessed 26 October 2021).
[89]Art 60C(4B) of RAO inserted by FSMA 2000 (Regulated Activities) (Coronavirus) (Amendment) Order 2020 SI 2020/480. Otherwise, lending £25,000 or under the BBLS to sole traders, certain small partnerships and other relevant small businesses would have been a regulated credit agreement. 'Debt-collection' in relation to such loans is regulated (RAO s. 39H(1A)).
[90] FCA Handbook CONC 5.2A. Also, onerous formality requirements are inapplicable.
[91] and that 'The terms of the loan, including any default charges or right to enforce security, also affect the application of the rules in CONC 5.2A." FCA, *Business Loans to which the Coronavirus Business Interruption Loan Scheme applies* (20 March 2020) https://www.fca.org.uk/firms/business-loans-which-coronavirus-business-interruption-loan-scheme-applies (accessed 26 October 2021).

different judgments and adopting a different risk tolerance than they would prior to the Covid-19 pandemic."[92]

Following these statements, the FCA sought clarification from the FOS as to its own approach in judging lending practices under the Covid-19 government schemes. The FOS confirmed that "taking individual circumstances into account, goes to the heart of what it means to act fairly and reasonably" and acknowledged that the covid-19 government schemes require lenders to take a different approach to lending dictated by their particular requirements and the new regulatory arrangements.[93]

On this occasion, the FCA and FOS worked collaboratively[94] to align their approaches where there was a need to adapt to urgent developments. Yet, as will be discussed in the following sections, it may become more difficult, if not impossible, to ensure that such collaboration is achieved given that the number of moving parts and layers in this regulatory sphere is growing rapidly.

(b) Ad-hoc voluntary redress schemes

The FSMA empowers the FCA to require regulated firms to establish and operate an industry-wide redress scheme where the failure by firms would otherwise have given the consumer a right of action in court.[95] As discussed in section 2.3.1, a right of action which relates to a breach of an FCA rule is largely limited to "private persons"[96]thus excluding SMEs from seeking redress under these schemes. The FCA (and its predecessor, the FSA) have, therefore, exercised their discretion and set up voluntary redress mechanisms.[97] For instance, the FSA (and subsequently, the FCA) set up voluntary redress schemes to review alleged mis-selling of IRHPs.[98] The scope of the IRHPs voluntary schemes went beyond "private persons" and provided redress to "unsophisticated customers" as defined in the

[92] FCA, *Dear CEO Letter on Lending to Small Businesses* (15 April 2020) https://www.fca.org.uk/publication/correspondence/dear-ceo-lending-small-businesses-coronavirus.pdf (accessed 26 October 2021). Though, taking a loan under the Covid-19 government schemes is, in itself, considered by lenders as a factor in assessing creditworthiness of their customers. Katherine Denham, *Landlords Who Took Bounce Back Loans Facing Rejection,* The Times (26 July 2020).
[93] FOS's response about CBILS and BBL to the FCA (4 May 2020) https://www.financial-ombudsman.org.uk/files/273434/FCA-letter-to-Financial-Ombudsman-Service-about-CBILS-and-BBL-04052020.pdf (accessed 26 October 2021).
[94] The FCA and the FOS have a longstanding Memorandum of Understanding: https://www.fca.org.uk/publication/mou/mou-fos.pdf (accessed 26 October 2021).
[95] FSMA 2000 s. 404.
[96] FSMA 2000 s. 138D.
[97] Treasury Committee, *The Ability of SMEs to Access the Ombudsman*, paras 98-112. Using their 'powers of persuasion' (i.e. status as regulator) and firm's incentive to 'please' regulator.
[98] IRHPs are derivatives which are separate to a lending arrangement and are for the purpose of managing interest rate fluctuations.

agreement reached between the banks and the FCA.[99] The FCA hoped that the voluntary schemes will provide redress to these customers "more quickly, and with greater certainty, than if (the FCA's – my addition) formal powers had been used".[100]

The outcome in that case was indeed impressive with nine banks paying out a total of £2.2 billion to customers.[101] Nonetheless, being based on a voluntary agreement, the scope of the IRHPs redress schemes was seen as arbitrary, partly guided by the interests of the participating banks and effectively excluding some non-sophisticated customers from the reviews.[102] The reviews were guided by the "fair and reasonable" principle,[103] relied primarily on the judgement of the respective bank, on a case-by-case basis and were subject to approval from an independent reviewer.[104] It comes as no surprise that the Treasury Committee identified flaws in the review process, voicing concerns of lack of independence[105] as well as inconsistencies in the decisions of banks and across different independent reviewers.[106]

In response to these concerns, the FCA commissioned, in June 2019, an independent review conducted by John Swift QC. The Swift Review's Terms of Reference included questions as to whether the FSA's intervention via the voluntary agreements was a reasonable response to its concern about the mis-selling of IRHPs; whether the definitions of SMEs who might benefit from the scheme was appropriate and whether overall, the scheme delivered

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[99] For that purpose, 'non-sophisticated' customers are generally "small businesses that are unlikely to have possessed the specific expertise to understand the risks associated with these products." As this is not a readily identifiable group, the FSA created a test that would enable the banks to differentiate between the 'sophisticated' and 'non-sophisticated' businesses. The original sophistication test, which was taken from the Companies Act 2006, did not always achieve the warranted outcome and was amended (FSA, *IRHPs Pilot Findings* (March 2013). The criteria were re-drafted to address these concerns and is available in the Supplemental Agreement, January 2013 (FCA, '*IRHP: Agreements with the Banks and Instructions to the Independent Reviewers* (April 2016) https://www.fca.org.uk/consumers/interest-rate-hedging-products/agreements-banks-instructions-independent-reviewers (accessed 26 October 2021)).

[100] Letter from the Complaints Commissioner to Complainant (19 September 2017) FCA00374 https://frccommissioner.org.uk/wp-content/uploads/FCA00374-FD-19-09-17.pdf (accessed 26 October 2021) quoting the FCA's reasoning for choosing to design the redress scheme as it did.

[101] FCA, *Interest Rate Hedging Products* (April 2016) https://www.fca.org.uk/consumers/interest-rate-hedging-products#footnote-2 (accessed 26 October 2021).

[102] Treasury Committee, *Conduct and Compensation in SME Lending*, (HC 2014-15, 204-11) para 91.

[103] putting customers back in the position they would have been had the breach of regulatory requirements not occurred. FCA, *IRHP: Background to the Review* (May 2016) https://www.fca.org.uk/consumers/interest-rate-hedging-products/background-review (accessed 26 October 2021).

[104] appointed under s 166 FSMA. Treasury Committee, *Conduct and Compensation in SME Lending*, para 92.

[105] Ibid, para 91.
See also Kevin Hollinrake, *Fair Business Banking For All, How to Improve Access to Justice for Businesses in Financial Services Disputes*, Centre for Policy Studies (2018) https://www.cps.org.uk/files/reports/original/180710122917-FairBusinessBankingforAll.pdf (accessed 26 October 2021).

[106] Ibid, para 91. For a critical view of the voluntary redress schemes see Richard Samuel, *Tools for Changing Banking Culture: FCA are you Listening? Why the FCA's IRHP Mass Dispute Resolution System Has Failed and What the FCA Can Do About It* 11(2) Capital Markets Law Journal 129 (2016)

fair and consistent outcomes for SMEs.[107] Due to the Covid-19 crisis, the deadline for submission of the report was extended.[108] However, the National Audit Office (NAO)'s observation that the FCA failed to evaluate formally its chosen redress schemes in order to assess whether they achieve their intended outcome[109] raises a red flag. An assessment of supervisory actions should be an integral part of the FCA's approach particularly since the failings in voluntary schemes appear to be systematic. In the redress scheme that was set up to address disputes with RBS in the GRG case, the Treasury Committee had to intervene and introduce several improvements to its operation and transparency including publication of regular updates on complaint outcomes and clarification of published information about the scheme.[110]

The FCA's decisions regarding the route of intervention (instigating formal supervisory powers or engaging in voluntary agreements with banks) are currently done on a case-by-case basis. In the absence of a coherent supervisory approach, the FCA may not be able to visualise how the different supervisory tools fit together and may fail to assess their relative effectiveness.[111] Where the law develops in such a sporadic manner, it is vital for the FCA to develop pre-defined guiding principles on the chosen route of intervention and the tools utilised to achieve its supervisory objectives. In addition, the FCA and the FOS must coordinate to ensure that the approaches in redress processes, channelled through different bodies, are coherent and consistent.[112]

The proposal, which was advocated in the "Fair Business Banking for All' Report, to extend the right of action for breaches of the FCA rules in section 138D FSMA to SMEs[113] could substantially minimise the need to resort to these ad-hoc voluntary redress schemes. The launch of the Business Banking Resolution Services can also formalise an additional alternative dispute resolution scheme, but, as we shall see in sub-section 3.2(c) below, it presents its own challenges.

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[107] FCA, *Terms of Reference, Lessons Learned Review commissioned by the FCA Non-Executive Directors into the Supervisory Intervention on IRHPs* (20 June 2019) https://www.fca.org.uk/publication/corporate/terms-of-reference-interest-rate-hedging-products.pdf (accessed 26 October 2021).
[108] FCA, *FSA/FCA Interest Rate Hedging Products Lessons Learned Review deadline extended until early 2021*' (20 March 2020) https://www.fca.org.uk/news/news-stories/fca-interest-rate-hedging-products-lessons-learned-review-deadline-extended-early-2021 (accessed 26 October 2021).
[109] NAO, *Financial Services Miss-selling: Regulation and Redress* (HC 2015-16, 851).
[110] Treasury Committee, *SME Finance*, para 107.
[111] NAO Report, 22.
[112] NAO Report, 24.
[113] Hollinrake, 10, by amending the 'private person' definition contained in the FSMA's Rights of Action Regulations 2001 (FSMA (RAR)) 2001.

(c) The Business Banking Resolution Service

In addition to expanding the FOS's jurisdiction, the Walker Review also recommended that banks establish and fund a voluntary ombudsman scheme to support larger SMEs that were not "eligible complainants" to the FOS. In November 2018, shortly after the Walker Review publication, seven participating banks have agreed to establish an interim voluntary dispute resolution process for SMEs with a turnover between £6.5 million and £10 million and a balance sheet of £7.5 million.[114] The initial commitment of the participating banks was for this scheme to be delivered via the FOS, acknowledging that it "…would help deliver wider industry participation than a standalone voluntary scheme".[115] The Business Banking Resolution Service (BBRS) was established in 2019 but as an interim standalone voluntary scheme pending further consideration of the FOS's role[116] and its capability to cope with an even broader remit.[117] Currently, eligible complainants to the BBRS are those that are not eligible for the FOS; have a turnover up to £10m per annum; and total assets up to £7.5m.[118] In line with the recommendation of the Walker Review, under the BBRS's remit, there is an award limit of £600,000 to disputes.

Whilst the BBRS is still in its pilot mode, a few observations are warranted. First, to enhance the effectiveness of the BBRS it is vital that non-bank lenders, which serve eligible SMEs, will also take part in the scheme.[119] Second, the independence of the BBRS and its insulation from the industry should not only be established but also be seen. Indeed, concerns that the BBRS "has been set up by the banks and it will be paid by the banks. So how can it be a truly independent organisation? " have already been raised.[120] This is particularly the case given that the BBRS is a separate entity to the FOS (which, though operationally

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[114] UK Finance, *Response to the Walker Review*, 4.
[115] Ibid, 8. This was in line with the Walker Review' recommendation, 53.
See also UK Finance, *Response to the Walker Review* https://www.ukfinance.org.uk/system/files/Industry-Response-to-Walker-Review.pdf (accessed 26 October 2021), 4.
[116] Ibid, 4.
[117] Treasury Committee, *SME Finance*, para 27. UK Finance emphasised that it is an interim solution since "the natural home for the ADR mechanism for this cohort of businesses is within the framework of the FOS" (UK Finance's website https://www.ukfinance.org.uk/banking-industry-fund-new-alternative-dispute-resolution-adr-scheme-larger-smes (accessed 26 October 2021).
[118] From 1 April 2019 onwards. See https://thebbrs.org/eligibility/
[119] UK Finance estimates that about 30% of SME finance comes from non-banks. UK Finance, The Crucial Role of the Non-bank Specialist Lender Sector and the Impact of Covid-19 https://www.ukfinance.org.uk/news-and-insight/blogs/crucial-role-non-bank-specialist-lender-sector-and-impact-covid-19 (accessed 26 October 2021).
[120] Jon Mcleod's comments during a BBRS Seminar on 4 June 2020 https://thebbrs.org/webinars/webinar-transcript-4th-june-2020 (accessed 26 October 2021).

independent) is within the FCA's field of authority and its operation is guided by the rules that the FCA sets.[121]

These concerns can be addressed by a more inclusive governance structure. To maintain impartiality, the BBRS board includes five non-executive members, a chair, a CEO and a chief adjudicator. In the initial industry response to the Walker Review, the plan was for the scheme to operate under an independent board of directors with representation from the mainstream business community, e.g., the Federation of Small Businesses and the British Chambers of Commerce.[122] Additionally, the Walker Review envisioned the Small Business Commissioner to be an ex-officio member of the advisory board. These recommendations were not adopted and instead, the BBRS committed to setting up an SME liaison panel to continuously feed-in an independent voice of SMEs.[123] The governance of the BBRS's board can be starkly contrasted with the governance of the FOS board that exhibits a stronger legitimacy basis. In the FOS board, all directors are non-executive and appointed by the FCA under FSMA and the chairman is appointed by the FCA with the approval of HM Treasury.[124] To ensure coherence across redress frameworks and until the BBRS can be brought under the wings of the FOS, the BBRS's board would benefit from a more inclusive membership with visible consumers' representation.

(d) The Financial Markets Test Case Scheme

Another mechanism, which was not designed with SMEs in mind but could nevertheless broaden their access to redress, is the Financial Markets Test Case Scheme. In October 2015, the High Court introduced a specialist Financial List for the determination of claims by judges with expertise in the financial markets. The criteria for inclusion in the Financial List was that a claim must either relate to banking and financial transactions where over £50 million is in issue; or require particular judicial expertise in the financial markets; or raise issues of general importance to the financial markets.[125] The Financial List introduced a pilot of the Financial Markets Test Case Scheme (Test Case Scheme) designed to facilitate the

[121] FCA Handbook, Dispute Resolution: Complaints (DISP). Under FSMA 2000, the FCA must take 'such steps as are necessary' to ensure that the FOS can carry out its role. For that purpose, the FCA signed a MoU with the scheme operator, the FOS Limited, 18 December 2015. In addition, the FCA Oversight Committee provides support and advice to the FCA Board to satisfy the FCA's legal obligations in relation to the FOS.
[122] Details of the BBRS' board https://thebbrs.org/about-us/our-board/ (accessed 26 October 2021).
[123] BBRS Webinar, 20 May 2020 https://thebbrs.org/webinars/webinar-transcript/ (accessed 26 October 2021).
[124] FSMA 2000 Sch.17 s. 3(2). But according to s. 3(3) the terms of their appointment (and in particular those governing removal from office) must be such as to secure their independence from the FCA in the operation of the scheme.
[125] CPR Part 63A, PD 51M para 2.1.

resolution of issues of general importance to the financial markets which require "immediately relevant authoritative English law guidance" (qualifying claim) to be heard in the Financial List, without the need to present cause of action between the parties.[126]
On 5 June 2020, despite no cases going to the Test Case Scheme, the Civil Procedure Rule Committee agreed that it should be incorporated as a permanent Practice Direction under CPR Part 63A.[127] This is, undoubtedly, a welcomed decision. The Test Case Scheme is an innovative tool that will allow the FCA to be more proactive in its intervention in consumer issues, particularly in areas that suffer from a regulatory lacuna.

More recently, the FCA brought, for the first time, a claim under the Test Case Scheme in relation to key contractual uncertainties surrounding disputed insurance claims under policies covering business interruption.[128] The case of the FCA was built on the premise that "SMEs are less likely to be sophisticated customers and many exhibit similar knowledge and experience to that of retail consumers when buying general insurance products."[129] The FCA contended that the policies should be construed consistently with the regulatory responsibilities of insurers to treat their customers fairly, emphasising that the policies concerned did not involve any form of bespoke negotiations of the relevant insuring provisions and policy terms.[130]

The Test Case Scheme provides yet another example of a legal mechanism that can promote the achievement of the FCA's operational objectives to ensure appropriate protection for consumers. Through bringing the business interruption case under the Test Case Scheme the FCA was seeking expedited clarity for the benefit of stakeholders, in particular SMEs, acknowledging their hybrid and unique character and circumstances. The transparency of the proceedings and the engagement with the relevant stakeholders

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[126] Guide to the Financial List, Practice Direction 51M, para 2.2. In addition, it must be brought by a person who is or was actively in business in the relevant market against another person who is or was actively in business in the relevant market, the parties must have opposing interests as to how the legal issue raised should be resolved and agree as to the proceedings being issued (PD 51M para 2.3). This followed a previous decision to extend the application of the Test Case Scheme for three years considering its availability to be "important and useful". CPR Committee Minutes, May 2017. The requirement for claims to raise issues of general importance to the financial markets specifically was omitted.
[127] The change is to be affected by the 122nd CPR Practice Direction update, with effect from 1 October 2020.
[128] Directions in the High Court Financial List, *Financial Markets Test Case Scheme between FCA and Arch (Insurance) and others* (June 2020) FL 2020- 000018 https://www.fca.org.uk/publication/corporate/bi-insurance-test-case-court-order.pdf (accessed 26 October 2021). The FOS paused consideration of individual cases that are affected by the test case <https://www.financial-ombudsman.org.uk/businesses/complaints-deal/complaints/coronavirus-covid-19-information-businesses>.
[129] Claimant's Trial Skeleton in the High Court Financial List, Financial Markets Test Case Scheme between FCA and Arch (Insurance) and others (June 2020) FL 2020- 000018 https://www.fca.org.uk/publication/corporate/bi-insurance-test-case-fca-skeleton-argument.pdf (accessed 26 October 2021), para 9.
[130] Ibid, para 8.

positioned the FCA as a 'defender' of SMEs.[131] Even prior to the Supreme Court judgment,[132] the FCA was making use of various supervisory tools under its armour. Within days of the High Court decision, it had issued a Dear CEO letter emphasising the need for insurers to conclude claims speedily, where possible and communicate clearly with customers[133] and published draft guidance for policyholders on how to prove the presence of coronavirus.[134] The FCA's conviction in promoting its "consumer objective" will, however, eventually be tested according to how it will decide to use, as appropriate and necessary, its enforcement powers.[135]

3.3 Industry codes of conduct and the FCA recognition process

Industry codes of conduct are voluntary, not legally binding and can improve the standards of conduct.[136] Most importantly, the scope of industry codes can expand beyond the regulatory perimeter. They can, therefore, address the lacuna of unregulated activities beyond the FCA perimeter. For instance, the Standards of Lending Practice for Business Customers (Business Lending Standards) set standards for firms in offering suitable products and providing effective explanations to their customers.[137]

The key benefits of industry codes of being flexible and easy to adapt are particularly apparent in times of crisis. Accordingly, the Business Lending Standards were updated to reflect the special lending circumstances under the Covid-19 government schemes.[138] The update recognises that by participating in those schemes "firms may not be able to apply in full effect all provisions within the Standards as certain aspects of the products have been determined by Government."[139]

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[131] 'Small Firms Are Thrown a Lifeline in Insurance Case Ruling', BBC News (15 September 2020).
[132] *FCA* v *Arch Insurance (UK) Ltd and others* [2021] UKSC 1 (15 January 2021) on appeal from: [2020] EWHC 2448 (Comm).
[133] FCA, *Dear CEO Letter on Business Interruption Insurance* (18 September 2020).
[134] FCA, *Draft Guidance on Business Interruption Insurance Test Case - Proving the Presence of Coronavirus*, December 2020. Prior to the appeal, the FCA continued discussions with insurers and action groups to enable speedy pay-outs on eligible claims.
[135] Ben Martin, *Force Insurers to Pay Firms Hit by Covid, Watchdog is Urged,* The Times (24 September 2020).
[136] FCA, *Consultation Paper on Industry Codes of Conduct*, paras 2.9-2.11.
[137] The Business Lending Standards were launched in March 2017 by the Lending Standards Board (LSB), a not-for-profit limited company and apply to loans, overdrafts and credit cards, commercial mortgages and asset finance. There is a MoU between the FCA and the LSB https://www.lendingstandardsboard.org.uk/resources/mou-between-the-lsb-and-financial-conduct-authority.
[138] LSB, *Response to the Launch of the Bounce Back Loan Scheme* (*LSB,* 4 May 2020).
[139] LSB, *Update to the Standards of Lending Practice for Business Customers - Coronavirus Business Interruption Loans Scheme and Bounce Back Loan Scheme* (*LSB,* 5 August 2020).

Industry codes, however, often lack effective 'teeth' and present "little incentive for firms to comply".[140] To encourage firms to conform to proper standards of market conduct, voluntary codes are often supported by internal and external compliance tools.[141] The recognition process, introduced by the FCA to certain codes for unregulated markets and activities,[142] is an example of such a supporting mechanism. The recognition criteria require the code to advance the FCA strategic objective of ensuring that the relevant markets function well and one or more of the FCA three operational objectives alongside other criteria such as wide participation and being subject to scrutiny that allows for alternative views to be voiced.[143] This process could enhance compliance, encourage the industry to keep codes under review[144] and act as a catalyst for the development of new industry codes of conduct.[145]

The compliance challenge of voluntary industry codes is also mitigated by the intertwined nature of the relationship between the FCA recognition process and the Senior Managers and Certification Regime (SMCR). Certified individuals and other individuals of authorised firms subject to the SMCR are required to comply with the individual conduct rules set out in COCON 2.1, including Rule 5: "You must observe proper standards of market conduct." The FCA Handbook provides that behaviour that is in line with an FCA-recognised industry code will tend to indicate compliance, in carrying out unregulated activities, with applicable FCA rules that reference "proper standards of market conduct".[146]

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[140] Letter from the FCA to the Treasury Committee, *FCA Powers and Perimeter* (30 January 2018); HM Treasury, Bank of England and FCA, *Fair and Effective Markets Review Final Report* (2015), para 32. See also Andrew Bailey, *Oral Evidence taken on 31 October 2017* (HC, 2017–19, 475), Q90.

[141] This is the case, for instance, with the Prompt Payment Code (PPC), a voluntary code administered by the Chartered Institute of Credit Management which is supported by the Reporting on Payment Practices and Performance Regulations 2017 Instrument No 395 and by a compliance board that has the authority to suspend signatories that failed to meet the PPC's standard http://www.promptpaymentcode.org.uk/ (accessed 26 October 2021). Recent evidence suggests that there is a low level of participation and compliance with the PPC. Lloyds Bank in association with Small Business Commissioner, *Reporting on Payment Practices* <https://www.smallbusinesscommissioner.gov.uk/wp-content/uploads/2019/04/Payments-Practices.pdf> 20. With regard to the Business Lending Standards, while the LSB can bring a disciplinary action it is only used as a last resort <https://www.lendingstandardsboard.org.uk/the-slp/#breaches>.

[142] FCA, *Industry Codes of Conduct* (2018), para 3.2. The Business Lending Standards were recognised in April 2020 https://www.lendingstandardsboard.org.uk/resources/fca-recognition-of-the-business-standards/ (accessed 26 October 2021).

[143] See https://www.fca.org.uk/about/recognised-industry-codes-criteria-process

[144] A code can only be recognised for a period of three years.

[145] Recently, several UK banks have been working on a new industry-wide code of conduct that will set tailored debt collection standards to loan defaults under the Schemes. Kalyeena Makortoff, *UK Banks Prepare Code of Conduct on Defaulting of Covid-19 Business Loans*, Guardian (6 July 2020). But several respondents to the FCA consultation raised concerns that the recognition process may disincentivise the industry to submit codes for recognition or draft defensive codes.

[146] FCA Handbook, EG 2.10A; FCA, *Industry Codes of Conduct and Feedback on FCA Principle 5*, para 1.12. However, adherence to the recognised codes is not the only means of complying with FCA rules.

Furthermore, the courts also play a role in strengthening the effect of industry codes. Under certain circumstances, the courts may infer from the commitment of subscribers to an industry code their commitment to follow the best practice set out in that code. This was the case in *Philip Thomas and others* v *Triodos Bank NV.*[147] Triodos Bank had subscribed and advertised its subscription to the industry code at the time, the Business Banking Code (BBC). The BBC included a fairness commitment to customers and in particular a promise to give the customer a balanced view of the product, in response to the customer's enquiry, in plain English, with an explanation of its financial implications.[148] Based on the commitment and in the absence of any exclusions or basis clauses, the Court held Triodos Bank to a higher standard of duty of care going beyond the duty not to mislead or misstate.[149]

Finally, regulatory theorists often raise concerns about diminished accountability and fairness of procedures in voluntary codes.[150] Therefore, it may be the case that the key to enhancing the effectiveness of voluntary codes does not necessarily lie with establishing stronger compliance mechanisms but rather with designing a drafting an open and inclusive drafting process that ensures that diversity of opinions is being considered. This is indeed what the FCA aimed to achieve with the recognition criteria, which focuses on processes and governance rather than compliance.

Overall, linking self-regulation with a regulatory regime could mitigate the risk of arbitrage between regulated and unregulated activities, provide articulation of expectations of good conduct in unregulated markets and encourage adherence to the codes.[151] It may come, however, with the risk of introducing further ambiguity to the FCA regulatory reach and its role in unregulated markets.[152]

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[147] *Philip Thomas & Others v Triodos Bank NV* [2017] EWHC 314 (QB), para 81.
[148] Ibid, para 61.
[149] Ibid, para 78 but that "The existence of a duty of care, and the level of that duty, will depend on the particular facts and whether, as a matter of policy, it is thought appropriate to impose such a duty in the circumstances."
[150] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation Theory, Strategy and Practice in Self-Regulation, Meta-regulation, and Regulatory Networks*, 142-144 (OUP, 2012).
[151] FCA, *Industry Codes of Conduct Consultation*, paras 4.2-4.7.
[152] For instance, The Association for Financial Markets in Europe and UK Finance, *Response to the FCA Consultation on Industry Codes* (5 February 2018) raised questions with regard to codes with broader application across regulated and unregulated business and requested clarification on how 'unregulated activities' are defined.

3.4 Senior Management and Certification Regime and good lending practice

(a) The Scope of the SMCR

The Senior Managers and Certification Regime (SMCR) applies to UK banks, building societies, credit unions, branches of foreign banks operating in the UK and the largest investment firms regulated by the PRA and the FCA. It also applies to dual-regulated insurers and to FCA solo-regulated firms. The SMCR covers both regulated and unregulated financial services activities and enables the FCA to take enforcement action beyond its perimeter.[153] Thus, a GRG-type scenario will now fall within the SMCR and will be met with clear standards for holding individuals accountable.[154] Yet, the SMCR also brings to the fore an anomaly between authorised firms and individuals in those firms.[155] Under the SMCR, individuals performing financial services activities in firms are required to observe proper standards of market conduct in unregulated activities, including lending to SMEs. In contrast, the firm itself may not be held accountable where the activity is not regulated and falls outside the FCA's perimeter. In this multi-layered regulatory sphere, there is merit in aligning the firm-level obligations and individuals' market conduct obligations and bringing both within the FCA perimeter.

(b) How should firms and individuals apply the SMCR when lending to SMEs?

In April 2020, the FCA sent a Dear CEO letter emphasising the importance of avoiding the mistakes of the past when lending to SMEs and ensuring that SMEs are treated fairly.[156] The FCA reiterated that financial services firms are required to appoint a senior manager/s with clear responsibility for lending to SMEs[157]and ensure that when lending to SMEs, individuals comply with the FCA rules and other obligations under the SMCR.[158] The Dear CEO letter also reminded CEOs and other Board members of their obligation to take reasonable steps to ensure that the senior manager(s) with responsibility for lending to SMEs is discharging his/her responsibility suitably.[159] This responsibility includes collecting

[153] FCA Handbook, COCON, 1.1.6 and 1.1.7.
See also FCA, *Letter to the Treasury Committee* (2018).
[154] Ibid.
[155] FCA, Industry Codes of Conduct and Feedback on FCA Principle 5, PS18/18 (July 2018), para 4.2.
[156] This is at the top of the FCA agenda and the FCA established a new small business unit to gather intelligence on treatment of SMEs by firms and where appropriate promote adequate supervisory action.
[157] FCA, *Dear CEO Letter on Lending to Small Businesses*.
[158] Ibid. These include the individuals conduct rules (CONCON 2.1) including Rule 4: You must pay due regard to the interests of customers and treat them fairly and the Senior Manager Conduct rules (CONCON 2.2).
In discharging their duties, individuals should also consider the recently recognised industry code, the Standards of Lending Practice for Business Customers.
[159] FCA Handbook CONCON 2.2.3

information on the bank's treatment of SMEs and where appropriate, challenging senior manager(s).[160]

These requirements go to the heart of the FCA regulatory agenda of instilling a culture that supports the fair treatment of customers, including SMEs.[161] Nevertheless, the effectiveness of the SMCR also depends on the ability and willingness of the FCA to bring enforcement actions. This is more so given that the effectiveness of Dear CEO letters as a supervisory tool has yet to be assessed.[162] Publishing any emerging concerns or themes from firms' responses to those letters will ensure that they do not become a box-ticking exercise and that they can be used as a source of market intelligence to the FCA and bring a cultural change within authorised firms.

Part IV: Multi-sourced and incremental regulation; Is this type of regulation smart?

So far, we have seen that the regulatory lacuna in protections available to SMEs, particularly in unregulated lending activity, spurred the FCA, the industry and the legislator to resort to indirect and ad-hoc legal mechanisms. The legal framework in this sphere developed incrementally, at times sporadically, to promote fair treatment of SMEs and respond to new challenges. The emerging solutions outlined in Part III fit within a pluralist, multi-sourced and incremental theories of regulation and more specifically, under the auspice of smart regulation. At the heart of smart regulation is the implementation of complementary combinations of instruments and participants.[163] It is a form of regulatory pluralism that embraces a broader range of regulatory actors to include businesses and third parties and encompasses multiple policy instruments such as, self-regulation by the private sector and industry bodies.[164] While this plethora of instruments and actors may be necessary to fill in the regulatory void, it is rather patchy and lacks an underlying rationale that is threaded along its many parts. The tools are not always complementary, at least to begin with, and may yield unintended results. This reflects a somewhat distorted implementation of smart regulation

[160] FCA, *Senior Managers and Certification Regime Banking Stocktake Report* (5 August 2019) https://www.fca.org.uk/publications/multi-firm-reviews/senior-managers-and-certification-regime-banking-stocktake-report (accessed 26 October 2021). Keeping records of that challenge and the reasonable steps taken is also paramount.
[161] FCA, *Business Plan 2019/20* (17 April 2020) <https://www.fca.org.uk/publication/business-plans/business-plan-2019-20.pdf>, 38; FSA, *Treating Customers Fairly – Culture* (July 2007) https://www.fca.org.uk/publication/archive/fsa-tcf-culture.pdf (accessed 26 October 2021).
[162] On the expanding use of Dear CEO letters as a supervisory tool *Number of 'Dear CEO' Letters Hits Record High*, Financial Times (18 May 2020).
[163] Neil Gunningham and Darren Sinclair, *Smart Regulation'* in *Regulatory Theory: Foundations and Application* 133 (Australian National University, P Drahos, 2017).
[164] Ibid.

that uses "a 'grab bag' of tools" rather than "a judicious combination of complementary ones".[165] Moreover, smart regulation should be used cautiously in a sphere where the risks of catastrophic consequences to livelihoods and the potential destabilising effect on the economy are real. While this article focused on conduct of business regulation, the potential systemic implications of the discussion should not be overlooked. Prevailing practices with consumer protection concerns can lead to suboptimal allocation of investments and risks and can weaken markets' confidence and impair their functioning. Accordingly, a regulatory gap in the fair treatment and effective dispute resolution of SMEs may produce negative externalities to the system as a whole, contributing to a large scale of defaults and a surge in insolvencies which could potentially 'bounce-back' into the financial system.[166]

Smart regulation can function effectively and support the fair treatment of SMEs only where there is close coordination across all its actors, including financial supervisors, industry bodies and the private sector. There are signs that such coordination takes place, at least partly, between the FCA and the FOS.[167] Nonetheless, in the absence of guiding principles and a systematic assessment of costs and benefits of the various tools, incoherence remains a risk. This is, of course, not a novel idea. The Walker Review had already acknowledged the importance of coordination in regulating SMEs and recommended establishing a monitoring council that will bring together all involved parties including SMEs, the FOS, lenders, the LSB and others to act as an early warning mechanism.[168] Unfortunately, the proposal was not carried forward, leaving this regulatory sphere weak. To address the identified shortcomings, part V advocates utilising vulnerability as an umbrella term that can promote a targeted and adaptive regulatory regime[169] that safeguards against unfair treatment of SME customers.

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[165] Ibid, 144.
[166] Sebnem Kalemli-Ozcan and others, *Covid 19 and SMEs Failures* (September 2020) IMF Working Paper No 207. Though the paper identifies significant heterogeneity of SME failures based on factors such as country and sector. The lack of granularity in reporting requirements for smaller companies makes the estimation of the impact of Covid-19 shock on small companies (and in turn, the system-wide risk) very challenging. See Bank of England, Financial Stability Report, August 2020, 33-36.
[167] As already noted, the FCA and the FOS have a (longstanding) MOU: https://www.fca.org.uk/publication/mou/mou-fos.pdf (accessed 26 October 2021).
[168] The Walker Review, 34.
[169] Smart regulation did not address the adaptability of regulatory regime. Van Gossum and others, *From Smart Regulation to Regulatory Arrangements* 43(3) Policy Sciences 245 (2010) therefore emphasise the importance of adding a dynamic dimension of policy learning and adaptability.

Part V Vulnerability – an umbrella term that can promote a tiered, targeted, and adaptable regulatory regime

The FCA's definition of vulnerability refers to natural persons who are or may be in vulnerable circumstances.[170] In light of the hybrid nature of SMEs and given the wide spectrum of their needs, resources and capabilities[171] it should be considered whether the regulatory treatment of defined SMEs, including the application of the vulnerability principle, should be akin to that of individual consumers.[172]

The idea of expanding vulnerability to SMEs has recently floated amongst industry bodies suggesting that "People who run small businesses are no less likely to be in a vulnerable situation than personal customers, yet there is a noticeable lack of research in this area."[173] Banks, however, are lagging behind in devising and implementing policies to identify and treat vulnerability in SMEs partly due to the limited regulatory attention given to it and partly due to the limited understanding of how vulnerability might impact a business customer.[174]

This section addresses, accordingly, the following questions: What is the FCA's approach with regard to vulnerability? Should vulnerability refer to the individual/s running the business, rather than to the SME itself given that the two aspects are often intertwined?

5.1 The FCA's approach to vulnerability

One of the FCA's operational objective is protecting consumers.[175] The FCA acknowledges that the type of consumer is of importance and can dictate the nature of supervision and the level of protection needed.[176] Indeed, the FSMA 2000 specifically requires the FCA to have

[170] FCA, *Consumer Vulnerability* (February 2015) Occasional Paper No.8 https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-8-consumer-vulnerability (accessed 26 October 2021).
See also Bugeja, *Reforming Corporate Retail Investor Protection*, 13.
[171] FCA, *Our Approach to SMEs* (2015), para 1.15.
[172] Ibid, Annex 4, para 41.
[173] LSB and Money Advice Trust, *Supporting Business Customers in Vulnerable Cir*cumstance (July 2018), Foreword.
[174] Ibid, s 7.2.
[175] FSMA 2000 ss 1B(3), 1C and the wide definition of 'consumer' in s 1G that refers, inter alia, to persons who "use, have used or may use (i) regulated financial services, or (ii) services that are provided by persons other than authorised persons but are provided in carrying on regulated activities".
[176] The FCA takes a risk-based and proportionate approach to ensure that consumers are appropriately protected and when it considers "what is an appropriate degree of protection, there has to be a balance struck. An important part of our approach is establishing, through our policy-making processes, where that balance might lie in relation to different consumers…" FCA, *The FCA's Approach to Advancing its Objective*s (July 2013) 11.

regard to "the differing degrees of experience and expertise that consumers may have".[177] The supervisory focus of the FCA on customers' vulnerability as a manifestation of this flexible approach, is evident. Vulnerability takes a prominent role in the FCA Business Plans,[178] its mission and other policy documents such as its Guidance Consultations on the Fair Treatment of Vulnerable Customers.[179]

The FCA defines a vulnerable customer as "someone who, due to their personal circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care."[180] The FCA then set out a non-exhaustive list of risk factors for vulnerability including low literacy, numeracy and financial capability skills; physical disability or severe or long-term illness, mental health problems; low income and/or debt; being 'older old' for example over 80 or being young (associated with less experience); change in circumstances (e.g. job loss, bereavement, divorce); lack of English language skills and non-standard requirements or credit history.[181]

The term vulnerability, however, is far from being static.[182] Recently, the FCA directed financial services firms to be aware that the Covid-19 crisis and the associated measures are likely to exacerbate or trigger personal circumstances that can cause vulnerability.[183] For the first time, the FCA also acknowledged that whilst its definition of vulnerability was developed with individuals in mind, "micro-enterprises and small businesses can also face circumstances that can make them especially susceptible to harm if a firm's failure to act with appropriate levels of care means their complaint is not resolved promptly and fairly."[184] This may be the first sign of a future change in the FCA supervisory approach. Identifying the drivers of vulnerability and developing clear criteria for its

[177] FSMA 2000 s 1C(2)(b).
[178] For instance, FCA 2017/18 Business Plan, 34; FCA Business Plan 2018/19, 51; FCA 2019/20 Business Plan, 5; FCA Business Plan 2020/21, 4.
[179] In July 2019, the FCA published an initial consultation (*Guidance for Firms on the Fair Treatment of Vulnerable Customers The FCA's Future Approach to Regulating Consumers* GC 19/3 (hereinafter: First Consultation on Fair Treatment of Vulnerable Customers) setting out its view of what the Principles for Businesses require of firms to treat vulnerable consumers fairly; In July 2020, the FCA published *Guidance Consultation and Feedback Statement Guidance for Firms on the Fair Treatment of Vulnerable Customers* GC20/3 (hereinafter: Second Consultation on Fair Treatment of Vulnerable Customers).
See also FCA, *FCA Mission: Approach to Consumers* (2018) https://www.fca.org.uk/publication/corporate/approach-to-consumers.pdf (accessed 26 October 2021).
[180] FCA, *Consumer Vulnerability* (February 2015) Occasional Paper No 8, 7.
[181] Ibid, 23.
[182] Iris Kapelouzou, *Implementing the Vulnerability Taskforce Principles and Recommendations'* (UK Finance blog, 10 October 2018).
[183] FCA, *Firms Handling Complaints During Coronavirus* (1 May 2020) https://www.fca.org.uk/firms/firm-handling-complaints-during-coronavirus (accessed 26 October 2021) (the statement is no longer in force).
[184] Ibid. See section 2.1 above for the definitions of a Micro-enterprise and a Small Business in the FCA Handbook.

identification will promote fair treatment of SMEs bringing them, justifiably, closer to the treatment of individual consumers. This new approach will also ensure that the heterogeneous nature of SMEs is acknowledged and that SME regulation does not take an aggregated form.[185]

5.2 Is there a vulnerable SME?

The FCA acknowledges that "micro-enterprises and small businesses can also face circumstances that can make them especially susceptible to harm".[186] But is there a vulnerable SME? In its 2019 draft '*Guidance for Firms on the Fair Treatment of Vulnerable Customers*' (hereinafter: 'The proposed Guidance') the FCA clarified that the guidance applies to the supply of products or services to retail customers who are natural persons.[187] During the consultation that followed, several respondents sought clarity on whether the scope of the proposed Guidance also includes business customers that could potentially interact with the firm as a 'retail customer'.[188] In the second consultation on the Guidance and Feedback Statement, opened in July 2020, the FCA responded to these comments and clarified that – "The proposed Guidance does not apply where businesses are incorporated…" but that "firms must still meet the standards set by the Principles, including the obligation to treat customers (in this case incorporated businesses) fairly…incorporated businesses may employ individuals with characteristics of vulnerability. Firms may therefore find aspects of the Guidance helpful when considering how to comply with the Principles (i.e. High-level principles in the FCA Handbook – my addition) in relation to incorporated businesses."[189] Thus, vulnerability is seen as a concept that applies to individuals but can provide guidance and used as a benchmark for the fair treatment of SMEs.

Expanding the application of vulnerability to particular SMEs will be in line with the Business Lending Standards. The standards provide enhanced protections for customers in

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[185] Treasury Committee, *Conduct and Competition in SME Lending* (HC 2014-14, 204-11), paras 2 and 28. See also BankingFutures, *Banking Small Businesses: Forging Closer Ties between Bank and the Real Economy* (July 2017) https://www.investorforum.org.uk/wp-content/uploads/2018/08/BankingFutures-%E2%80%93-Banking-Small-Businesses.pdf (accessed 26 October 2021), 7 advocating "…a more disaggregated definition of SMEs to better understand the varied policy, advice and protection needs of the sector.".
[186] FCA, *Firms Handling Complaints During Coronavirus* (2020).
[187] The same meaning as 'retail client' as defined in the FCA Handbook Glossary., i.e., individuals and also business customers, where businesses are not incorporated (This includes sole traders and some partnerships).
[188] For instance, UK Finance queried whether the Guidance would apply to the business where the customer has both a personal banking and business account with the same firm and is identified through the personal relationship as vulnerable. See UK Finance, *Response to the Consultation GC19/3: Guidance on Fair Treatment of Vulnerable Customers* (3 October 2019) https://www.ukfinance.org.uk/system/files/20191003-GC193-UK-Finance-Response-FINAL.pdf (accessed 26 October 2021).
[189] FCA, *Second Consultation on Fair Treatment of Vulnerable Customers* (2020), para 3.32.

vulnerable circumstances, requiring firms to establish 'systems and controls that are capable of assisting with the identification of customers who either are, or may be, in a vulnerable situation.'[190] Vulnerability of businesses in the Business Lending Standards is based on the vulnerability of the individual behind the business (rather than the business itself), i.e. "a person who, when taking into account information available to the firm about how the business is structured and operates, is able to exert significant control over the way in which it is run."[191] The LSB explains how 'personal vulnerability' relates to 'business vulnerability' suggesting that "the impact of the individual's vulnerability on the business customer's relationship with their registered firm will depend on a number of non-exhaustive factors such as: the legal structure of the business, its sophistication, the role and level of responsibility of the individual within it and the extent of the individual's vulnerability."[192] SME's vulnerability, therefore, should be determined on a case-by-case basis and derive from the vulnerability of an individual who exerts significant control over the way the SME is run (rather than from the vulnerability of the business itself). The Business Lending Standards, accordingly clarify that – "a business in financial difficulty would not necessarily be considered to be vulnerable for the purposes of these Standards."[193] In addition, while vulnerability is in itself a construct, according to the Business Lending Standards it requires the interpretation of another construct, i.e. sophistication. As we have seen in Part III, sophistication was used by the FCA and the industry to define eligibility criteria in voluntary reviews of financial products but was subject to much controversy and claims of arbitrariness. Therefore, where the definition of vulnerability relies on sophistication, it calls for an evidence-based regulatory design with data collection that goes beyond mere turnover and size.

In light of the substantive heterogeneity of SMEs, the FCA should provide more clarity on the criteria for identifying vulnerability. The benchmark should not rely solely on the SME size but rather on the rationale behind the need for protection, i.e. asymmetries of information and weak bargaining power. The abovementioned guidance for drivers in the Business Lending Standards is a good starting point but at this stage, it would be the

[190] The Business Lending Standards, 19.
[191] Ibid.
[192] LSB, *Information for Practitioners The Standards of Lending Practice for Business Customers Treatment of Customers in Financial Difficulty* (August 2020) https://www.lendingstandardsboard.org.uk/wp-content/uploads/2020/08/6.-Financial-difficulty-Information-for-Pracititoners-Business-%C2%A325m-August-2020.pdf (accessed 26 October 2021), 4. In addition to personal and business drivers, there may be external economic conditions outside the SME's control that could have a devastating impact on its viability. The unprecedented market conditions during the Covid-19 crisis are a stark example of such a vulnerability driver.
[193] Ibid, 13.

responsibility of lenders to establish criteria and processes to identify vulnerability to meet the requirement of appropriate fair treatment of their SME customers.

6. Conclusion

SMEs are the driving force of economies. For many years, this supported, somewhat ironically, the neglect in designing a coherent regulatory framework to ensure their fair treatment. But the reality is that many SMEs face information asymmetries, lack resources and negotiation power and in the absence of regulatory protection are exposed to harm. In recent years, mounting ad-hoc, eclectic responses have mushroomed to address various aspects of appropriate conducts standards, dispute resolution and accountability. While these mechanisms allow for adaptability and dynamism, they may prove to be inadequate to achieve the FCA's consumer protection objectives. Institutional coordination via a coordinating council; a systematic supervisory assessment of the relative effectiveness of the various regulatory and supervisory tools and utilisation of vulnerability as a guiding principle may generate more consistent and effective regulation that can weather the challenges that this form of business activity presents. The Covid-19 crisis will expose the fragility of SMEs on the one hand and their vitality to the economy on the other. This should, in turn, drive a reform that adopts a more nuanced approach to SME regulation and takes into account their unique features and their inherent vulnerability.