

# Our approach to SMEs as users of financial services

November 2015





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**NOTE: This paper includes a high-level summary discussion of how the provision of financial services to SME clients is regulated under the Financial Services and Markets Act 2000 and treated under the rules in the FCA Handbook. It is provided to assist readers of this Discussion Paper only and is not a comprehensive statement of relevant laws or of our rules, nor is it intended to be guidance on our rules.**

We are asking for comments on this Discussion Paper by 18 March 2016.

You can send them to us using the form on our website at:  
[www.fca.org.uk/your-fca/documents/discussion-papers/dp15-07-response-form](http://www.fca.org.uk/your-fca/documents/discussion-papers/dp15-07-response-form).

**Or in writing to:**

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We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

You can download this Discussion Paper from our website: [www.fca.org.uk](http://www.fca.org.uk). Or contact our order line for paper copies: 0845 608 2372.

## Abbreviations used in this paper

<b>ABI</b>	Association of British Insurers
<b>ADR</b>	Alternative dispute resolution
<b>AEC</b>	Adverse effect on competition
<b>BCOBS</b>	Banking Conduct of Business Sourcebook
<b>BIBA</b>	British Insurance Brokers' Association
<b>BSB</b>	Banking Standards Board
<b>CCA</b>	Consumer Credit Act 1974
<b>CCD</b>	Consumer Credit Directive 2008/48/EC
<b>CIDRA</b>	Consumer Insurance (Disclosure and Representations) Act 2012
<b>CMA</b>	Competition and Markets Authority
<b>COBS</b>	Conduct of Business Sourcebook
<b>COMP</b>	Compensation Sourcebook
<b>CONC</b>	Consumer Credit Sourcebook
<b>CRDIV</b>	Capital Requirements Regulation (EU) No 575/2013 and Directive 2013/36/EU
<b>DGSD</b>	Deposit Guarantee Scheme Directive
<b>DMD</b>	Direct Marketing Directive
<b>DISP</b>	Dispute Resolution: Complaints Sourcebook
<b>EEA</b>	European Economic Area
<b>EFG</b>	Enterprise Finance Guarantee
<b>FSB</b>	Federation of Small Businesses
<b>FSMA</b>	Financial Services and Markets Act 2000

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<b>FSCS</b>	Financial Services Compensation Scheme
<b>FPO</b>	Financial Services and Markets Act 2000 (Financial Promotions Order) 2005
<b>IDD</b>	Insurance Distribution Directive (previously the Recast Insurance Mediation Directive, or IMD2)
<b>IFA</b>	Independent financial adviser
<b>IMD</b>	Insurance Mediation Directive
<b>GRG</b>	RBS Global Restructuring Group
<b>ICOBS</b>	Insurance: Conduct of Business Sourcebook
<b>IRHP</b>	Interest rate hedging product
<b>ICSD</b>	Investor Compensation Schemes Directive
<b>MCOB</b>	Mortgages and Home Finance: Conduct of Business Sourcebook
<b>MCD</b>	Mortgage Credit Directive
<b>ODR</b>	Online dispute resolution
<b>PCBS</b>	Parliamentary Commission on Banking Standards
<b>PRA</b>	Prudential Regulation Authority
<b>PSD</b>	Payment Services Directive
<b>RAO</b>	Financial Services and Markets Act 2000 (Regulated Activities Order) 2001
<b>RPPD</b>	Responsibilities of providers and distributors for the fair treatment of customers
<b>SME</b>	Small or medium sized enterprise
<b>TSC</b>	Treasury Select Committee

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# 1. Introduction

**1.1** This discussion paper reviews the way in which small and medium sized enterprises (SMEs) that use financial services are treated in our rules, as well as some of the recent evidence of poor outcomes experienced by such businesses. We are asking for your thoughts on whether the level of protection provided to SMEs in our Handbook is broadly right; whether our rules should treat more SMEs like individual consumers<sup>1</sup> and extend provisions reserved only for the smallest SMEs to larger ones; how good practices could best be promoted among firms; and whether more ambitious voluntary standards could provide an alternative to, or complement, changes to our rules.

**1.2** In the remaining chapters of this discussion paper we:

**Chapter 2:** explain the strategic context in which our discussion of SMEs as users of financial services takes place.

**Chapter 3:** define SMEs and describe in broad terms how the framework of financial regulation applies to firms' dealings with them, contrasting their treatment in our rules, where appropriate, with that of individual consumers.

**Chapter 4:** consider the recent evidence of poor outcomes and detriment experienced by SMEs, and the first-principles case for and against greater intervention by the FCA or more ambitious self-regulation.

**Chapter 5:** outline our options for changing the jurisdiction of the Financial Ombudsman Service.

**Chapter 6:** outline our options for harmonising the application of our rules to firms' dealings with SMEs and encouraging self-regulatory initiatives, so that firms' business clients are covered by a more consistent framework of conduct rules for firms.

**1.3** The **annexes** to this paper provide:

- A list of the questions to help you respond to the Discussion Paper.
- An overview of the structure, diversity, and financial capability of firms' SME clients, as well as the sector's use of financial services.

<sup>1</sup> In this paper we use the term 'individual consumers' to mean individuals who are acting wholly or mainly for purposes outside their business, in contrast to business clients who are acting wholly or mainly/predominantly for the purposes of their business. This is because the word 'consumer' has different meanings in different pieces of legislation. Under the Consumer Rights Act 2015 and EU law, for example, it is generally used to mean individuals who act for purposes wholly or mainly outside their business, trade, craft or profession. Under the consumer credit provisions of the RAO (Financial Services and Markets Act 2000 (Regulated Activities Order) 2001), only a credit agreement between a lender and an individual, a partnership of two or three persons (not all of whom are bodies corporate), or an unincorporated association which does not consist entirely of bodies corporate could be regulated. However, agreements involving the provision of more than £25,000 of credit wholly or predominantly for business purposes are specifically exempted.

- A list of primary and secondary research sources on the experiences of SMEs as users of financial services.
- A high-level sourcebook-by-sourcebook summary of the rules applicable to firms' dealings with SME clients, with an emphasis on cases where these might differ between individual and business clients or between SMEs and larger businesses.

### **Who should read this document?**

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- 1.4** This paper is focused on SMEs as users of financial services. In particular, we want to hear from businesses and self-employed individuals, the firms that provide them with financial services, and their advisers and representatives. The paper should also be of interest to consumer organisations.

### **Is this of interest to consumers?**

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- 1.5** This paper is focused on SMEs as users of financial services and is therefore of direct interest to consumers who are self employed, own or manage SMEs, or contribute to a family business.

### **What do you need to do next?**

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- 1.6** Throughout this Discussion Paper we ask questions, inviting you to participate in the discussion. We have compiled a list of these in Annex 1. Please send us your comments and any accompanying evidence by 18 March 2016. To submit your evidence, please use the online response form on our website or write to us at the address on page 2.

### **What will we do?**

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- 1.7** We will use responses to this paper, alongside evidence from discussions and roundtables with stakeholders, to consider whether to consult on changing our rules or take other action. We will consider all views and comments and publish our feedback. We will also use our findings and all public responses to this paper in order to inform our ongoing interaction with firms, stakeholders, legislators, policymakers and regulators in the UK and abroad.

### **Equality and diversity**

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- 1.8** In compliance with the Public Sector Equality Duty of the Equality Act 2010, the FCA has due regard to the need to eliminate discrimination, advance equality of opportunity and foster good relations in the exercise of our functions. As such, we consider the equality and diversity implications of our proposals throughout our policy-making process.
- 1.9** The Equality Act 2010 sets out nine protected characteristics: age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex, sexual orientation, and marriage or civil

partnership status. We believe that improving outcomes for SMEs, especially through greater certainty regarding available protections, may particularly benefit enterprises owned by women or members of ethnic minorities. There is evidence that female-owned enterprises tend to be smaller, and that ethnic minority-owned SMEs are more likely to be put off applying for finance that they need and could obtain due to fear of rejection.<sup>2</sup> We welcome any other examples of, as well as your views on, the equality and diversity implications of the ideas set out in this Discussion Paper.

### Summary of this document

- 1.10** In recent years, our work has revealed that some firms' SME clients may experience poor outcomes across a wide range of scenarios, including some high-impact cases of detriment such as the mis-selling of interest-rate hedging products (IRHPs). In this document we seek evidence and views on whether our rules should provide SMEs with greater protections, including access to the ombudsman service, thus treating them more like individual consumers.
- 1.11** When providing SMEs with financial services that are regulated activities<sup>3</sup> under the Financial Services and Markets Act 2000 (FSMA) (and certain ancillary activities), firms must comply with our principles for businesses<sup>4</sup> and, where applicable, relevant conduct of business rules. However, not all dealings of authorised firms with SMEs are regulated – credit agreements over £25,000 wholly or predominantly for business purposes, for instance, are not; nor is lending to companies (see Annex 4).
- 1.12** This means that the regulatory protections afforded to SMEs by our principles and rules vary depending on, among other things, the financial services that SMEs use; in particular, some protections are only available to individual consumers. The regulatory protections available to SMEs under our rules tend to decrease as businesses get larger, and in some cases a change of legal form or increase in size may result in an abrupt relative loss of protections across multiple activities. For example, a company with 12 employees, turnover of £5m and net assets of £3m will not have access to the same protections that would be available to an unincorporated business with eight employees, turnover of £0.9m, £1.2m in assets and no debt (see Table 1).
- 1.13** Individuals have a general statutory right of action against firms that have broken our rules under section 138D of FSMA, but this right is not normally available to companies.<sup>5</sup> This means that SME companies must normally rely on the general law to obtain redress through the courts when things go wrong. However, the courts may expect businesses to be more financially and commercially sophisticated than individual consumers, and firms may seek to limit their potential general law liabilities to SME customers through contractual terms.<sup>6</sup> Most SMEs do not have the bargaining power, knowledge or expertise to negotiate such terms in contracts for financial services.

2 Carter, S., Ram, M., Trehan, K., and Jones, T. (2013), *Diversity and SMEs' Enterprise Research Centre White Paper (2013)*: [http://www.enterpriseresearch.ac.uk/wp-content/uploads/2013/12/ERC-White-Paper-No\\_3-Diversity-final.pdf](http://www.enterpriseresearch.ac.uk/wp-content/uploads/2013/12/ERC-White-Paper-No_3-Diversity-final.pdf)

3 In general terms, a 'regulated activity' is an activity, specified in the Regulated Activities Order 2001 (RAO), which is carried on by way of business in relation to one or more of the investments also specified in the RAO.

4 There are detailed provisions setting out how the principles apply in the PRIN sourcebook.

5 In certain limited cases, companies may be able to bring an action for damages. We note that the Court of Appeal is due to consider in July 2016 the restriction on companies generally bringing actions for damages under section 138D in the case of *MTR Bailey Trading Limited v. Barclays Bank PLC* (case reference: A3/2014/3286). See the judgment of Lord Justice Kitchen of 10 June 2015 [2015] EWCA Civ 667.

6 To the extent that this is permissible under our rules. For example, under the client's best interests rule and accompanying guidance – see COBS 2.1.1R and COBS 2.1.3G. This says that firms must not seek to limit any duty or liability to clients under FSMA or under our rules. Where they do so, even companies may be able to bring an action for damages under s. 138D of FSMA (see regulation 6 of the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (SI 2001/2256)).

- 1.14** Nevertheless, only micro enterprises (i.e. businesses with fewer than 10 employees and either turnover or assets no greater than €2m) are currently eligible to refer complaints to the ombudsman service, which provides a cheaper, less formal alternative to the courts. Ineligible businesses may be a small share of the SME population, but they account for a large share of the SME sector's demand for financial services.
- 1.15** Not all SMEs have the same needs, resources and capabilities; we want to know where you think our rules should draw the line, in principle, between those that generally require greater safeguards and those that do not.
- 1.16** We would also like you to consider some more specific options available to us. We want to know whether more SMEs should be eligible to complain to the ombudsman service and be covered by our complaints handling rules, and whether some rules applying to firms' dealings with individual consumers should also cover SME clients, or cover a greater share of SMEs than they currently do. We are also exploring options to further harmonise the application of our rules to firms' dealings with SMEs, or clarify it by issuing guidance. Finally, we want to know how proportionate such changes would be and whether they would risk reducing SMEs' access to financial services, or the level of choice and service they could expect.
- 1.17** Such changes cannot address all differences in the treatment of businesses and individual consumers, or businesses of different size and legal form, under the current system of financial regulation. This is particularly true where different treatments (as in the case of consumer credit) result from the regulatory perimeter or from other legislation. We therefore also want to consider how we might encourage the industry to promote good practices by developing or strengthening voluntary standards.

## 2. The strategic context

- 2.1** SMEs are important contributors to economic growth in the UK and valuable clients for financial services firms; between them, 5.4 million SMEs account for 47% of private sector turnover, 60% of employment and 70% of net job creation (see Annex 2). Promoting investment by SMEs and ensuring a greater range of financing options were confirmed as Government priorities in the 2015 Budget. Additionally, the recently enacted Small Business, Enterprise and Employment Act aims to ‘reduce the barriers that can hamper the ability of small businesses to innovate, grow and compete’ and ‘ensure that the UK continues to be recognised globally as a trusted and fair place to do business’.
- 2.2** The FCA has a strategic objective of ensuring relevant markets work well. This is supported by three operational objectives, which are relevant when we discharge our functions and exercise our powers. Our operational objectives are to secure an appropriate degree of protection for consumers<sup>7</sup>, protect and enhance the integrity of the UK financial system and promote effective competition in the interest of consumers. In pursuing our consumer protection and competition objectives, however, we must have regard to how consumers, which in this context includes SMEs that use regulated financial services,<sup>8</sup> differ from each other, e.g. in their experience and expertise, their capabilities, their information needs, their expectations, the products they use and the risks involved, and their ability to access financial services in the first place.
- 2.3** Our competition objective is premised on the fact that competition can improve outcomes for SMEs, both independently and by complementing regulation. We have therefore closely followed the Competition and Markets Authority’s (CMA) investigation into the retail banking market. The summarised provisional findings of this investigation were published in October 2015. We are keen to understand, among other things, how SME outcomes are linked to the high levels of concentration and customer inertia the CMA has identified in the market, or to the difficulty SMEs experience in comparing current accounts (see Annex 2.9).
- 2.4** This Discussion Paper follows the emergence of a number of issues with the way in which some financial services firms have treated their SME clients. These have prompted questions from various sources, including the Treasury Select Committee (TSC) and the Parliamentary Commission on Banking Standards (PCBS), about whether more small business customers should be able to refer complaints to the ombudsman service. In this paper we acknowledge the high-impact cases the TSC and PCBS focused on but also consider provisions for SMEs throughout our Handbook, not just their access to redress.
- 2.5** Across regulated industries, SMEs have traditionally been treated as having greater self-sufficiency and bargaining power than individual consumers. So they have often been seen by regulators as requiring less assistance than these, even though their needs, behaviour and

<sup>7</sup> Note that the definition of a ‘consumer’ for the purposes of our operational objectives is not the same as that of the term ‘individual consumer’ as used throughout this paper. Also see Footnote 1.

<sup>8</sup> The specific definition of ‘consumer’ for the purposes of our operational objectives is set out in section 1G of FSMA. An SME would be included in this definition if, for example, it uses, has used or may use regulated financial services, or it has relevant rights or interests in relation to any of those services.

expertise are often similar. Our own work has shown that SMEs can experience poor outcomes in a wider range of situations. They can be exposed to risk at the point of purchase due to product complexity, limited choice or poorly managed expectations. When things go wrong, some struggle to navigate the complaints and claims processes or to obtain redress.

- 2.6** Both additional provisions in our rules and more ambitious voluntary standards can improve outcomes for SMEs and encourage them to engage with the industry. However, by increasing the minimum cost to firms of serving SME customers that individually generate relatively little revenue, interventions might reduce SMEs' access to services, such as lending, or the level and quality of service available to them,<sup>9</sup> or even incentivise firms to provide SMEs with unsuitable products. Regulatory uncertainty can also dampen innovation and discourage entry into the market, limiting the level of competition and choice for SMEs. This is particularly likely if the new provisions interact with initiatives in the regulatory and policy pipelines.

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<sup>9</sup> See e.g. Oliver Wyman and Intrum Justitia, *European Retail and SME Credit (2015)*: [http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/feb/2015\\_European\\_Retail\\_and\\_SME\\_Credit\\_report.pdf](http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/feb/2015_European_Retail_and_SME_Credit_report.pdf)

## 3. SMEs as users of financial services

### Defining SMEs

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- 3.1** In broad terms, an SME is defined in European Commission Recommendation 2003/361/EC 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.
- 3.2** The SME definition includes two sub-categories:
- micro enterprises (employing less than 10 persons, annual turnover and/or annual balance sheet total not exceeding €2m)
  - small enterprises (employing fewer than 50 persons, annual turnover and/or annual balance sheet total not exceeding €10m).
- 3.3** The Small Business, Enterprise and Employment Act 2015 will allow the Secretary of State to specify UK definitions for small and micro businesses in secondary legislation.
- 3.4** However, the term 'SME' does not occur in the FCA Glossary and there is no single set of enterprise size thresholds applying to the rules throughout our Handbook. Some rules use the Commission's micro-enterprise definition or cross-refer to the definition of a small company in section 382 of the Companies Act 2006, which currently requires that a company meet two out of three criteria: no more than 50 employees, turnover of no more than £6.5m and a balance-sheet total of no more than £3.26m.<sup>10</sup> Finally, for the purposes of our Compensation Sourcebook we define a small business as any partnership, body corporate, unincorporated association or mutual association with turnover below £1m, a large partnership as a partnership (or unincorporated association) with net assets above £1.4m, and a large mutual association as a mutual association (or unincorporated association) with net assets above £1.4m. The £1m turnover threshold is also relevant to our Mortgage Conduct of Business Sourcebook (MCOB).
- 3.5** Annex 2 provides details of the structure of the SME population, and its use of financial services.

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<sup>10</sup> For financial years from 1 January 2016, the turnover and balance sheet criteria are being increased to £10.2m and £5.1 million respectively. Transitional provisions are currently in force.

## How does the current regulatory framework apply to firms' dealings with SME clients?

### The regulatory perimeter

- 3.6** This chapter summarises at a high level the analysis of our Handbook's treatment of firms' dealings with SMEs. See also Annex 4.
- 3.7** Whether or not the provision of financial services to an SME client is regulated under FSMA (and thus whether the provider of the service needs to be authorised) depends on whether the financial services firm is carrying on a regulated activity by way of business in the UK, as set out in the RAO.<sup>11</sup> Whether this is the case depends in part on the services provided: for example, whether the SME client is seeking to operate a current account, borrow, insure or invest.
- 3.8** Although many financial services provided to SMEs are within this regulatory perimeter, lending to SMEs for business purposes is mostly outside the regulatory perimeter. For example, unsecured lending to an SME borrower for the purposes of their business will only be regulated if the SME is unincorporated and the amount being borrowed is £25,000 or less<sup>12</sup>; mortgage lending for the purposes of a business will only be regulated if (among other things) the borrower is an individual or a trustee.
- 3.9** In general, the boundaries of the regulatory perimeter are determined by FSMA and various pieces of secondary legislation, primarily the RAO, and also EU law. They can therefore be changed by HM Treasury and Parliament and, where applicable, by EU legislation, but we cannot alter the regulatory perimeter by changing our rules.
- 3.10** In addition to our regulatory functions, since 1 April 2015 we have had powers<sup>13</sup> to enforce against breaches of competition law under the Competition Act 1998 and conduct market studies under the Enterprise Act 2002. Our concurrent competition powers are not limited by reference to the regulatory perimeter and instead can be applied in relation to the provision of 'financial services'. This term is not defined in legislation, but in our view this includes any service of a financial nature such as banking, credit, insurance or investments.

### Our principles and conduct rules

- 3.11** When carrying on regulated activities firms must comply with our principles for businesses.<sup>14</sup> However, some of the principles will not apply where the firm is providing services that are not regulated activities (or certain other specific activities), and in some cases activities will not be regulated where the service is provided to particular types of SME.<sup>15</sup> Although it is not possible to take a financial services firm to court directly as a result of breaches of our principles<sup>16</sup>, we are able to take enforcement action against firms that breach them. Firms should also take into account the principles when handling complaints under our rules.

<sup>11</sup> Some activities may also be regulated under other legislation such as the Payment Services Regulations 2009.

<sup>12</sup> See also footnote 1. Under the consumer credit provisions of the RAO, only a credit agreement between a lender and an individual, a partnership of two or three persons (not all of whom are bodies corporate), or an unincorporated association which does not consist entirely of bodies corporate could be regulated. However, agreements involving the provision of more than £25,000 of credit wholly or predominantly for business purposes are specifically exempted.

<sup>13</sup> These are known as concurrent powers because the Competition and Markets Authority (CMA) has the same powers in relation to financial services and all other sectors of the economy. More information on our concurrent powers can be found on our website: <https://www.fca.org.uk/about/what/promoting-competition>

<sup>14</sup> See footnote 4.

<sup>15</sup> For example, in relation to a regulated mortgage contract, the borrower must be an individual or trustee.

<sup>16</sup> FSMA gives the FCA the ability to 'switch off' the right to bring an action for damages for specified rules. We have done so in relation to, for example, the principles for businesses.

**3.12** We also have detailed conduct of business rules. How these rules apply to firms' dealings with SMEs acting in their business capacity depends on the products and services offered (see Annex 4, as well as Table 1 for an illustration):

- As depositors and account holders, SMEs are covered by our conduct rules similarly to individual consumers (i.e. with limited exceptions) if they are micro enterprises.
- As investors, the vast majority of SMEs are categorised as retail clients and the relevant rules do not distinguish between businesses and individual consumers. Clients that are authorised firms, or categorised as per se professional clients under the 'large undertaking test,' or opted up into professional client status, are not covered by certain rules that apply to firms' business with retail clients. In practice, however, only a small share of the SME population, including the largest or most sophisticated SMEs, are categorised in these ways.
- As customers of insurance products the position of SMEs under our conduct rules may depend on the type of insurance involved. In relation to non-investment insurance, SMEs (acting in their trade or profession) will be categorised as commercial customers (and not consumers) affecting how some Insurance Conduct of Business (ICOBS) conduct rules apply. ICOBS has very limited application to firms mediating contracts of large risks for commercial customers. For life policies, SMEs will often be categorised in the same way as set out above in relation to investors, with the same results.
- Where their borrowing is regulated, SME borrowers do not benefit from our rules on consumer credit promotions and communications, and firms are permitted to provide them with mortgages on an execution-only basis. Firms may also tailor the information they provide to and require from them. Individuals or trustees who want a regulated mortgage for business purposes may only be covered by our conduct rules if the business in question is not a large business customer.<sup>17</sup>
- Regardless of the products or services used, distance marketing disclosures and cancellation rights are generally only available to individual consumers. Exceptionally, micro enterprises have the right to cancel retail banking contracts (including current accounts).
- Finally, SMEs that are not micro enterprises are not covered by our complaints-handling rules for many types of financial services, and firms do not have to report high-level information to us on complaints they receive from them.

#### **Redress and compensation**

**3.13** Individuals who have suffered loss as a result of firms not complying with our rules have a general statutory right of action for damages under section 138D of FSMA. This right, however, is generally only available to private persons – a concept defined in secondary legislation made by the Treasury. The effect of the definition is, for example, that sole traders may be able to bring an action for damages but SME companies that suffer loss while carrying on business of any kind may not.<sup>18</sup>

<sup>17</sup> A large business customer is a client who borrows credit for the purposes of a business which has a group annual turnover of £1m or more. If the customer is not a large business customer, the lender can choose to apply tailored versions of some of the rules.

<sup>18</sup> See footnote 5.

- 3.14** As a result, many business clients can only rely on claims under the general law (e.g. for misrepresentation, negligence, or breach of contract) in order to seek redress through the courts. The courts may expect businesses to be more financially and commercially sophisticated than individual consumers, and firms may seek to limit their potential general law liability to SME customers through contractual terms.<sup>19</sup>
- 3.15** Businesses that lack the resources, knowledge and bargaining power to negotiate contract terms may therefore be less likely to obtain redress through the courts. We have powers under the Unfair Terms in Consumer Contracts Regulations 1999 and the Consumer Rights Act 2015 to challenge unfair terms in standard-form consumer contracts. However we cannot do so for firms' contracts with business clients.<sup>20</sup>
- 3.16** The ombudsman service provides a quick and less formal alternative to the courts, which is free for the complainant. It is able to make decisions based on what is fair and reasonable in all the circumstances of each case, taking into account not only relevant law but also our rules, guidance and standards, codes of practice and, where appropriate, what it considers to have been good industry practice at the relevant time. Its jurisdiction, set out in rules, does not strictly mirror the regulatory perimeter and it can, for example, consider some complaints about business lending.
- 3.17** However, only SMEs that are micro enterprises have access to the ombudsman service in the same way as individual consumers. Ineligible SMEs may make up a small minority of the SME population, but they account for a substantial share of the sector's demand for financial services (see Annex 2 for detailed estimates).
- 3.18** SMEs' access to compensation from the Financial Services Compensation Scheme (FSCS) varies according to the nature of the claim (see Annex 4). As with individual consumers, an SME that is eligible can only claim compensation if it has a valid civil claim against the relevant person in default.
- 3.19** As to eligibility, SMEs that are depositors generally have the same access to compensation as individuals (with exceptions discussed in Annex 4, including authorised firms). SMEs can claim compensation in respect of long-term insurance or a liability subject to compulsory insurance. In general, only small businesses have the same access to compensation as individuals for claims in respect of non-compulsory general insurance and mediation of non-compulsory general insurance, and this only applies if they are not large partnerships, large mutual associations or large companies. SMEs that are users of home finance mediation can claim through the FSCS if they are not a large partnership, large mutual association or large company. Small businesses and unincorporated associations that are investors also have access to compensation in the same way as individuals.
- 3.20** The maximum amount of redress that the ombudsman service can require firms to pay to a complainant is £150,000 excluding interest and costs, but the ombudsman service can recommend that the firm pay more where it considers this fair. There is also a limit to compensation from the FSCS for depositors, and another for investors and users of home finance mediation. These limits may affect outcomes for businesses that are successful in complaining to the ombudsman service or claiming compensation from the FSCS, if their claims are generally larger than those of individuals.

<sup>19</sup> See footnote 6.

<sup>20</sup> A client acting wholly or mainly for purposes connected with the client's business, trade, craft or profession.

### Complementing financial regulation

- 3.21** The system of financial regulation is complemented by a network of voluntary commitments. These include initiatives that make provision for smaller SMEs, as the Lending Code does for micro enterprises. While we cannot take action in respect of breaches of voluntary codes or compel firms to adopt them, the ombudsman service can take them into account in decisions.
- 3.22** When our rules and industry codes of practice do not apply to firms undertaking particular activities, SME clients may have access to redress under the common law or other legislation. However, as discussed earlier, this may be more limited in practice.

### Our ability to intervene

- 3.23** Under section 404 of FSMA we have powers to set up an industry-wide consumer redress scheme where it appears to us that there may have been a widespread or regular failure to comply with requirements, such as FCA rules. The section 404 power can only be used to require redress where a remedy or relief would be available in legal proceedings so there are limits on what it can be used for in relation to business customers (e.g. for rule breaches, given the restrictions on companies bringing actions for damages under section 138D). In very broad terms, the ombudsman service is bound to apply the terms of such schemes to any complaints received about the subject matter of such a scheme or a failure by a firm to make a determination under the scheme, unless a firm and a consumer agree that the scheme should not apply in relation to the complaint.
- 3.24** We also have the power to require a firm to establish a redress scheme which corresponds to, or is similar to, an industry-wide scheme established under section 404 by using our powers to impose or vary an individual firm's requirements or permissions under sections 55J and 55L of FSMA. In addition, we could establish other forms of voluntary redress schemes, or we may rely on firms' obligations under the rules in the 'Dispute resolution: complaints' part of the FCA Handbook (DISP – see Annex 4).
- 3.25** Under section 166 of FSMA, we have the power to require a firm and certain other persons to provide a report by a skilled person, or we can appoint a skilled person to produce such a report. We can use this power to support redress schemes, for example to assist in their design. We also have powers to require information from regulated firms and appoint investigators. Further information on these powers, our powers to impose or vary a firm's requirements, and our powers of restitution and redress can be found in our Supervision sourcebook and our Enforcement Guide.
- 3.26** As noted in 3.9, we also have the power to enforce against breaches of competition law in relation to financial services. This means that we can take action where we think that firms may have been breaching competition law, such as abusing a dominant position, in relation to the provision of financial services. Such anti-competitive behavior can harm the users of financial services, including SMEs.
- 3.27** While this Discussion Paper considers the potential benefits to SMEs of additional intervention, we also know that regulation can inhibit competition in markets. When we write new rules, in addition to considering our other objectives, we will need to consider if and how we can promote competition to achieve the good outcomes we want for consumers. Independently

of our review of the treatment of SMEs, we have also been reviewing the Handbook more generally in order to understand where our rules may have had unintended consequences and adverse effects on competition. Wherever it is possible for us to change rules to make competition work better alongside our standards of consumer protection and market integrity, we will make those changes.

## 4.

# Evaluating our approach to SMEs

### What are the risks to SMEs?

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- 4.1** Over the past three years, several cases have highlighted circumstances in which the SME clients of authorised firms have experienced poor outcomes.
- In 2012 we found serious failings in the sale by four firms of certain interest rate hedging products (IRHPs) to SMEs, with many small business clients obtaining complex derivatives alongside loans without fully understanding the nature and risks of the products. Nine firms are reviewing their sales of IRHPs as part of a voluntary redress scheme, supported by independent reviewers appointed under section 166 of FSMA. As of June 2015, the firms had paid just under £2bn in redress to the clients affected.
  - In November 2013, reports by Lawrence Tomlinson and Sir Andrew Large raised concerns over RBS's treatment of SME clients in financial difficulty who were referred to RBS's Global Restructuring Group (GRG). We have commissioned a section 166 report to examine RBS's treatment of such customers and consider allegations of poor practice. We also wrote to the CEOs of 13 other banks seeking confirmation that they did not engage in any of the poor practices alleged in the Tomlinson and Large reports.
  - In January 2015, RBS announced that an examination of a sample of Enterprise Finance Guarantee (EFG)-backed loans offered to SME clients revealed instances in which loans were offered without an appropriate explanation of the borrowers' and guarantors' respective liabilities in case of default. The firm committed to contacting around 1,800 customers potentially affected by such practices and promised to restore these to 'the position they believed they would have been in' had the terms of this product been correctly communicated to them.
- 4.2** Additionally, over the last two years research and market studies have raised concerns for firms' SME customers:
- With the CMA we undertook a market study into SME banking between 2013 and 2014. The final joint report was published in July 2014, alongside the CMA's market investigation into personal current accounts. As a result of its findings, the CMA launched an investigation into retail banking in November 2014.
  - The CMA published its provisional findings in October 2015. With regards to business current accounts, it has provisionally found that the combination of low customer engagement, barriers to searching and switching, product linkages and incumbency advantages is giving rise to adverse effects on competition (AECs). With regards to lending to SMEs, it has provisionally found that the combination of barriers to searching, product linkages, the nature of demand for SME lending, information asymmetries and incumbency advantages is giving rise to AECs. A provisional decision on remedies is due in February 2016, and a final report by 5 May 2016.

- Our thematic review into conflicts of interest among general insurance intermediaries working with SME customers (TR14/9) found that not all intermediaries understand or take steps to mitigate the conflicts of interest arising from their business models. It also found an expectation gap between SMEs, which often expect to receive advice from intermediaries, and the services the firms themselves are prepared to offer.
- Our thematic review into general insurance claims made by SMEs (TR15/6) found there is a gap between SMEs' expectations and the claims service they received. Claims were not always managed effectively in the interests of SME customers – issues included a lack of ownership and poor communication throughout the claim.
- Our research into SME complaints (see Annex 3) demonstrates that cognitive and behavioural biases, product complexity, limited choice and poorly managed expectations may expose SMEs to risk at the point of purchase. When things go wrong, SMEs may experience complex and escalating problems, and then struggle to navigate and afford the complaints and claims processes. Firms and their staff may also lack adequate incentives to take ownership of and improve outcomes.

**4.3** In their inquiries focusing on the banking sector, the Treasury Select Committee (TSC) and the Parliamentary Commission on Banking Standards (PCBS) have each raised concerns that some SMEs may not have appropriate redress options given their limited resources and their inability to obtain redress through the courts. Both have recommended that we examine whether the jurisdiction of the ombudsman service needs to expand to include a greater share of the SME population. More recently, the Government has also asked for stakeholders' views on whether the current legislative framework regarding the sale and supply of goods and services to micro enterprises and small enterprises is sufficient, or whether there are gaps to be addressed.<sup>21</sup> Although financial services were outside the core scope of the call for evidence, the Government has welcomed views on small enterprises' experiences in dealing with firms in the sector.

**Q1: Are there specific products, services or distribution channels that are particularly associated with poor outcomes for SMEs?**

### When should our rules treat businesses like individuals?

- 4.4** As discussed in Chapter 3, many aspects of the broader regulatory framework for SMEs cannot be altered by changing our rules. These include the regulatory perimeter, which can only be changed by HM Treasury and Parliament and, where applicable, by EU legislation. It may, however, be possible for more SMEs to be treated like individual consumers under some of our rules, for instance by being able to access the ombudsman service. More ambitious voluntary standards or guidance could provide an alternative to such rule changes, or complement them.
- 4.5** The case for treating some SMEs in this way is based on four traits common to many businesses:
- For most SMEs, purchasing financial services and pursuing claims or complaints are not core business operations. They are reliant on advice when they can afford to pay for it; when they cannot, they rely on non-expert, time-poor individuals without relevant industry or product expertise.

<sup>21</sup> BIS (2015) 'Protection of small businesses when purchasing goods and services: Call for Evidence' [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/433139/bis-15-209-protection-of-small-businesses-when-purchasing-goods-and-services-call-for-evidence.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/433139/bis-15-209-protection-of-small-businesses-when-purchasing-goods-and-services-call-for-evidence.pdf)

- Like individual consumers, many SMEs have limited access to finance, financial reserves and ability to diversify investments, which means they cannot absorb cashflow interruptions or major investment losses.
- For incorporated businesses, access to redress is limited by the fact that businesses do not have a general right of action against firms that cause them loss as a result of a breach of our rules. They must instead rely on the common law.<sup>22</sup> Most SMEs do not have enough market power, product knowledge or legal expertise to negotiate contract terms or the features of products available to them, and firms may seek to contract out of obligations that normally benefit individual consumers.<sup>23</sup>
- SMEs always have the option of pursuing a case against a firm through the courts. However, recourse to the courts is likely to be costly, and incorporated SMEs may also have fewer options than individual consumers with regards to the grounds on which they can pursue redress in this way; they may therefore be less successful in securing redress.

**4.6** On the other hand, where individual consumers benefit from additional provisions in our rules compared to business clients, extending these to SMEs may not be appropriate if the circumstances of the two groups differ. A number of arguments can be made against such an approach:

- Generally speaking, businesses undertaking risks that they understand in the pursuit of profit should not expect to be insulated in all cases from any possibility of losses – that is, they should take an appropriate degree of responsibility for their activities. This may be particularly true of companies, whose owners benefit from limited liability.
- Many SMEs purchase financial products, e.g. insurance or mortgages, as part of their core business. In the case of larger SMEs, these may include complex products e.g. derivatives linked to commodities used in their core operations.
- Firms' business clients may be more experienced than individuals in assessing the implications of contract terms, determining their product needs and negotiating on price.
- Many SMEs have access to professionals who can provide information and generic advice over the course of their business activities, such as accountants.
- Some SMEs are themselves authorised firms and may have substantial relevant knowledge, experience and expertise with regards to particular products.

### **Balancing the costs and benefits of rule changes for a diverse sector**

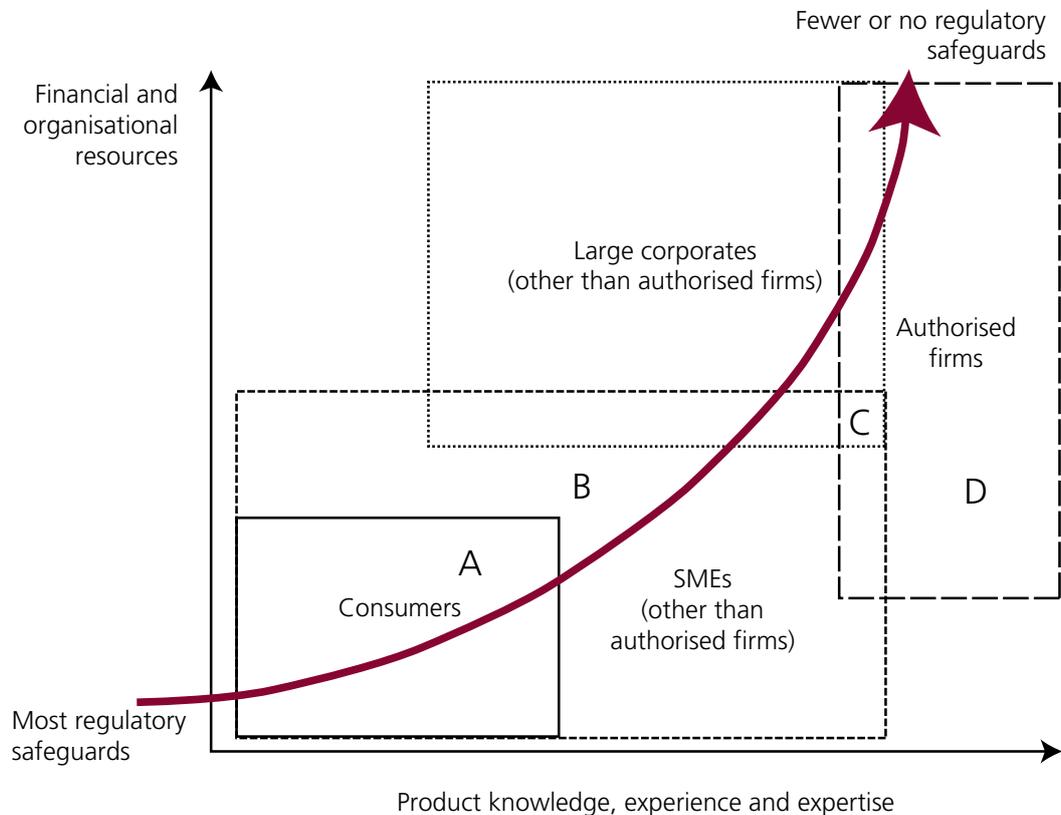
**4.7** In addition to providing potentially valuable safeguards to clients, higher standards of conduct might increase the SME sector's engagement with the industry by reducing uncertainty and supporting user confidence. However, regulation or voluntary codes of practice setting minimum standards can increase the minimum cost of serving SMEs. Given the limited revenue generated by individual SMEs, this may reduce the level of service firms are able to offer them, reduce access to important services such as credit, or incentivise firms to provide SMEs with unsuitable but unregulated products.

<sup>22</sup> See footnote 5.

<sup>23</sup> See footnote 6.

- 4.8** Higher standards of conduct can also have a dampening effect on competition by limiting the range of product features or terms that firms can offer to SMEs. In its work on the retail banking sector the CMA has also received feedback from firms suggesting that a changing regulatory environment might increase the cost of developing new products and the time it takes to bring them to market.<sup>24</sup>
- 4.9** In our ongoing internal review of rules inherited from the FSA, we are considering where pro-competitive changes could be made to our rules in the interests of consumers. As an example, we are reviewing the competition implications of the numerous disclosure rules throughout our Handbook. This exercise has found no fundamental concerns with our rules from a competition perspective, but has identified areas meriting further thought. For example, our review of disclosures and our broader Smarter Consumer Communications work have identified a number of areas where we might encourage the industry to consider improvements. We have invited firms with innovative ideas to work with us to test these ideas and, if appropriate, we will consider waiving our rules to enable such testing.
- 4.10** For optimal outcomes, our interventions in markets need to be necessary, proportionate and free from unintended consequences. They also need to be pitched at the right level to ensure that, while poor practices become less prevalent, there is sufficient 'headroom' above the minimum standards in which firms can still innovate and compete.
- 4.11** In line with our operational objectives, we need to allow for the diversity of firms' business clients, as illustrated in Figure 1, so that any additional provisions in our Handbook are applied to the segments of the SME population that need them:
- Small and simple businesses buying products and services in which they do not have significant expertise should generally have the greatest access to consumer provisions (point A in Fig. 1).
  - SMEs that are also authorised firms, purchasing products they have experience of and expertise in (point D in Fig. 1), should not generally benefit from provisions intended for individual consumers.
  - Larger SMEs with sophisticated operations have less need for consumer provisions (point C in Fig. 1), except when making purchases unrelated to their core business, without relevant expertise (point B in Fig. 1).

<sup>24</sup> This section summarises 2.15 – 2.17 of Annex 2.

**Figure 1: Regulatory safeguards and the diversity of the SME population**

**Q2: How and where should we draw the line between SMEs that should benefit from the consumer safeguards in our Handbook and those that should not? Should we aim to treat all SMEs in the same way where possible?**

### Assessing our approach

- 4.12** Broadly speaking, the treatment of SMEs as users of financial services in our Handbook is proportionate in that the smallest businesses, particularly micro enterprises, are more likely to have access to regulatory safeguards across products than larger SMEs or large corporates. It is also proportionate in that high-level conduct of business rules treat almost all SMEs in the same way as individuals when they buy or use more complex products (e.g. investments) but detailed rules allow a more tailored treatment of SMEs when it comes to products that are typically less complex (e.g. credit or insurance).
- 4.13** In most cases, our rules adhere to the long-standing principle of freedom of contract between businesses. A further safeguard is provided to micro enterprises, as they are eligible to refer complaints to the ombudsman service, which is able to consider what is fair and reasonable in the circumstances of each case.
- 4.14** However, the application of our rules to firms' dealings with SMEs is very complicated, and the safeguards available to SMEs under our rules vary depending on the products and services used. It may therefore be difficult in some cases to assess their combined effect on user confidence,

or on competition and innovation in the SME market. This is particularly true when SMEs use multiple products, or services incorporating multiple regulated activities (e.g. current accounts with an overdraft facility, which may be subject to our own conduct of business rules for banking and credit as well as the Consumer Credit Act and the Payment Services Regulations).

- 4.15** The criteria that determine how an SME client is categorised in our rules may become less appropriate with time or changes in policy. For example, the European Commission has not reviewed its micro enterprise size thresholds, which also determine SMEs' eligibility to refer complaints to the ombudsman service, since they were introduced in 2003.
- 4.16** Incorporated SMEs that are not micro enterprises have more limited access to redress even when firms have not complied with our rules. These make up an economically important but small and diverse population of clients. As a result, avoiding poor outcomes for larger SMEs requires substantial supervisory effort, much of it reactive. This is particularly true when the incentives for non-compliance are high or when SMEs face limited choice.

**Q3: Is the current treatment of SMEs in our rules broadly correct? What do you see as the most important benefits and shortcomings of our current approach?**

## 5. Expanding the remit of the Financial Ombudsman Service

- 5.1** In 2013, the PCBS recommended that we consider changing the eligibility criteria of the ombudsman service so a wider range of businesses can refer complaints to it. The PCBS' concern was that many businesses were mis-sold IRHPs or loans with similar features, but were simultaneously too large to refer their complaints to the ombudsman service and lacking the resources to pursue redress effectively through the courts.
- 5.2** As mentioned in Chapter 1, a small percentage of SMEs lack access to the ombudsman service but these businesses account for a disproportionately large share of the SME sector's use of financial services. Like some micro enterprises, they may be unable to take firms to court for breaches of our rules, limiting their access to redress. Many of these may also lack the knowledge, expertise and bargaining power to understand and negotiate contract terms with firms; obtaining redress through the courts may not be a realistic option for them. As with other regulatory provisions (see Chapter 3), the question of whether SMEs should have access to the ombudsman service is complicated by the diversity of the sector:
- At one extreme, small and unsophisticated businesses should be able to refer complaints to the ombudsman service (see point A in Fig. 1).
  - At the other, SMEs that are also authorised firms should not generally be able to refer to the ombudsman service complaints about regulated activities they are authorised to provide (point D in Fig. 1). The same principle may apply to large SMEs buying financial products they understand well, as part of their core business (point C in Fig. 1).
  - In most other circumstances (e.g. Point B in Fig. 1), there is no obvious threshold beyond which larger or more sophisticated SMEs can be assumed to have reasonable access to redress through the courts, and therefore not require access to the ombudsman service.
- 5.3** Complaints referred to the ombudsman service as business disputes currently account for about 1% of all complaints<sup>25</sup> and the impact on its operations is limited. However, complaints referred by SMEs that are not currently eligible complainants may, on average, be more complex, involve larger sums, and take longer to resolve.
- 5.4** Changing the definition of an eligible complainant to include more SMEs would give more SMEs access to the ombudsman service, but also expand the applicability of our complaints handling rules – including the range of clients whose complaints must be reported to us in aggregate by firms, or whose complaints firms must subject to root-cause analysis. Our research (see Annex 2) suggests that large firms also align their internal customer segmentations with the ombudsman service's jurisdiction; wider eligibility might therefore mean that more SMEs are

<sup>25</sup> Financial Ombudsman Service, *Annual Review Financial Year 2014/15 (2015)*: <http://www.financial-ombudsman.org.uk/publications/ar15/ar15.pdf>. The ombudsman service notes this may slightly underestimate the true extent of complaints from firms' business clients.

classified internally by firms as retail or personal clients (rather than, for example, business or corporate clients).

**Q4: Should we expand the eligibility criteria of the ombudsman service? How and where should the line be drawn?**

- 5.5** If larger business clients were to be given access to the ombudsman service, the current binding award limit of £150,000 might also need to be reconsidered in light of the larger sums that newly eligible businesses might borrow, deposit, insure and invest. It might in fact need to be increased regardless of changes to the eligibility criteria. As the TSC found in the case of IRHP mis-selling, the financial losses sustained by SMEs may exceed it substantially.

**Q5: Should the ombudsman service's award limit be increased from its current value of £150,000 for some or all SME complainants? Would it be fair for different award limits to apply to eligible complainants depending on whether the complainant is a business or an individual consumer?**

## 6. Harmonising the treatment of SMEs and promoting good practice

- 6.1** The boundaries of the regulatory perimeter mean that products and services provided to some SMEs may be regulated while similar ones provided to other SMEs are not. But even within the perimeter our rules do not apply uniformly to firms' dealings with all SMEs across products and services. The consistency of application tends to decrease with business size and incorporation in a way that might be disproportionate to the risks to our objectives (see Table 1).
- 6.2** We could extend the application of some parts of our Handbook to SMEs that are not currently covered by including a wider range of firms' business clients in our customer definition, where this is unconstrained by the regulatory perimeter, or by making specific provision for these clients in our rules. Alternatively, we could realign the application of our complaint handling rules with, for example, that of our Mortgage Conduct of Business Rules (to the extent this is possible under EU law). However, there may still be inconsistencies between the treatment of businesses using different services because, for example, expanding the application of Banking Conduct of Business (BCOBS) rules so that small enterprises (or other SMEs) are also banking customers, would make the application of BCOBS less aligned with that of the Payment Services Regulations 2009.

**Q6: Should we make our rules more consistent, to the extent possible, across the products and services used by SMEs?**

- 6.3** None of the options discussed above would address the differences in treatment of SMEs and individual consumers that arise from the scope of the regulatory perimeter, as this would require legislative change. These changes would also not affect the extent to which SMEs can go to court to bring an action for damages for breaches of our rules under section 138D of FSMA, unless the relevant secondary legislation was also amended. In some cases, further changes to the scope of our rules would also go beyond what is required under EU legislation.<sup>26</sup>
- 6.4** To address these limitations in a proportionate way, we could encourage the industry to promote best practice through voluntary standards, including in areas that are not covered by our rules. Such codes might provide at least the smallest or least sophisticated SMEs with greater certainty, while allowing the ombudsman to take into account good practice as identified by the industry when determining complaints.
- 6.5** More specifically, voluntary codes could:
- Identify sub-segments of the SME population that signatories will treat in the same way as they do individual consumers, even when such treatment is not required by our rules.

<sup>26</sup> This may result in 'gold plating' of EU law e.g. in extending the scope of EU law, not taking full advantage of derogations, or retaining pre-existing higher UK standards.

- Identify products and services that are currently unregulated when provided to some types of SMEs (e.g. business lending to SME companies).
  - Specify sub-segments of the SME population that signatories would afford a higher level of care to when using such products and services, and set out what the relevant provisions would be.
  - Set out expectations regarding the conduct of staff involved in selling products and services to SME clients, including those likely to deal with multiple products (e.g. a current account, loan and insurance contract) at once.
  - Demonstrate how signatories might implement these high-level commitments, using examples of good practice in the industry and individual case studies, as well as how the industry might monitor signatories' performance and share their findings with us.
- 6.6** We would seek to engage with industry associations and bodies, as well as with the Banking Standards Board (BSB) and its member firms, and encourage them to develop and take ownership of such voluntary codes.
- 6.7** As with other forms of intervention encouraging minimum standards, voluntary agreements among existing firms can have a dampening effect on competition by limiting the range of product features or terms on offer; they could even reduce the supply of services, e.g. credit to SMEs. It is important that any intervention is proportionate, and that it is pitched at the right level to ensure that, while poor practices become less prevalent, there is sufficient 'headroom' above the minimum standards in which firms can still innovate and compete.
- 6.8** There is also a risk that voluntary agreements could raise barriers to entry in that market, depending on the cost of adhering to any minimum standards and on whether involvement in the voluntary agreements is imperative to the success of a new entrant (e.g. if it is the only way to access key industry infrastructure or the services of membership bodies, or commercial advantages of any kind). It is therefore also important to ensure that entry barriers are not raised unduly.
- 6.9** We see an ongoing role for self-regulatory initiatives in amplifying good and bad practice and helping firms monitor crystallised and emerging risks to SME clients. Our recent review of the handling of general insurance claims for SMEs, for example, welcomed the British Insurance Brokers' Association's (BIBA) plans to issue technical guidance on ensuring customers do not have inadequate sums insured. We also note that a review of the Lending Code, which was led by Professor Russel Griggs, recently sought evidence on, among other things, 'areas of potential detriment impacting personal and small business customers, not presently addressed adequately by the Code or statutory rules'. Professor Griggs' report is now being considered by the Lending Standards Board and the Lending Code sponsors, and a new code is expected to be published in spring 2016.

**Q7: Should we encourage the development of voluntary codes of practice in the manner discussed above?**

- 6.10** Alternatively, we could issue guidance to further clarify how our rules apply to firms' business with SME clients and, in particular, what good practice looks like. In addition to improving understanding, guidance could encourage timely behaviour change by signalling our interest in specific aspects of firms' conduct. Many of the high-profile cases of detriment to SMEs uncovered in recent years involved non-compliance with our rules and might not have been prevented by changes to ensure more SMEs are covered.

**6.11** Guidance might, for example, be focused on:

- what is expected of firms providing services or products to SMEs under our principles for businesses
- how our thinking on individual vulnerability may apply to individuals who are self-employed or business owner/managers –e.g. those in financial difficulty
- how firms might best use their judgement in assessing the needs and information requirements of business clients.

**Q8: Should we issue guidance to firms on particular aspects of their dealings with SME clients, and, if so, which aspects?**

Table 1: Do SMEs consistently have access to the same provisions as individual consumers? Some illustrative cases.

Case	Deposits (BCOBS)	Insurance (ICOBS)	Credit (CONC)	Mortgages (MCOB)	Investment (COBS)	Dispute resolution (DISP)	Compensation	Cancellation & distance marketing (all)
Unincorporated partnership of two, £0.9m turnover, net assets of £1m, eight employees	Yes, except right of set-off disclosure	May differ – firms must consider outcomes, focusing on their customer's / needs/experience / knowledge/ability	Yes, for facilities below £25,000	Yes, tailored	Yes, unless opted up as professional client or eligible counterparty	Yes	Yes	Only for banking, payments and credit (CCA)
Unincorporated partnership of two, £0.9m turnover, net assets of £3m, eight employees	Yes, except right of set-off disclosure	As above	Yes, for facilities below £25,000	Yes, tailored	Yes, unless opted up as professional client or eligible counterparty	Yes	Protected investment business, compulsory insurance and long-term insurance only	Only for banking, payments and credit (CCA)
Unincorporated partnership of two, £1.2m turnover, net assets of £3m, eight employees	Yes, except right of set-off disclosure	As above	Yes, for facilities below £25,000	No	Yes, unless opted up as professional client or eligible counterparty	Yes	Protected investment business, compulsory insurance and long-term insurance only	Only for banking, payments and credit (CCA)
Company, £1.2m turnover, net assets of £3m, eight employees	Yes, except right of set-off disclosure	As above	No	No	Yes, unless opted up as professional client or eligible counterparty	Yes	Yes, except non-compulsory general insurance and mediation for non-compulsory general insurance	Only for banking, payments and credit (CCA)
Company, £5m turnover, net assets of £3m, 12 employees	No	As above	No	No	Yes, unless opted up as professional client or eligible counterparty	No	Yes, except non-compulsory general insurance, mediation for non-compulsory general insurance	No
Company, £15m turnover, net assets of £10m, 60 employees	No	As above	No	No	Yes, unless opted up as professional client or eligible counterparty	No	Deposits, long-term insurance and compulsory insurance only	No

All of the above businesses are assumed to have debt of less than £50,000, including any new facilities sought.

Protection is identical or near identical to what is available to individuals

Same high-level protections apply, but firms may be subject to different detailed rules than when dealing with individuals

Protections apply but are likely to differ substantially from what is available to individuals. Note that the distance marketing rules in BCOBS only apply to individual consumers.

No protections apply

# Annex 1

## Questions for discussion

1. To help guide our thinking on how to improve outcomes for SME clients, we are inviting stakeholders to provide evidence and feedback around eight themes. We recognise that there are substantial gaps in the publicly available evidence on this subject and we have allowed additional time for responses so that stakeholders can provide as much input as possible.

- Q1:** Are there specific products, services or distribution channels that are particularly associated with poor outcomes for SMEs?
- Q2:** How and where should we draw the line between SMEs that should benefit from the consumer safeguards in our Handbook and those that should not? Should we aim to treat all SMEs in the same way where possible?
- Q3:** Is the current treatment of SMEs in our rules broadly correct? What do you see as the most important benefits and shortcomings of our current approach?
- Q4:** Should we expand the eligibility criteria of the ombudsman service? How and where should the line be drawn?
- Q5:** Should the ombudsman service's award limit be increased from its current value of £150,000 for some or all SME complainants? Would it be fair for different award limits to apply to eligible complainants depending on whether the complainant is a business or an individual consumer?
- Q6:** Should we make our rules more consistent, to the extent possible, across the products and services used by SMEs?
- Q7:** Should we encourage the development of voluntary codes of practice in the manner discussed in Chapter 6 of this Discussion Paper?
- Q8:** Should we issue guidance to firms on particular aspects of their dealings with SME clients, and, if so, which aspects?

## Annex 2

# SMEs as users of financial services

### Size and structure of the SME sector

1. As of early 2015, there were 5.4m SMEs in the UK, which accounted for around 60% of the total employment in the UK private sector, more than 51% of its value added and around 47% of its turnover. The SME sector consistently creates the majority of new jobs in the UK, boasting 70% of net job creation between 2014 and 2015,<sup>1</sup> yet larger SMEs have also lagged the rest of the UK private sector in terms of productivity growth in the recovery,<sup>2</sup> partly as a result of subdued investment.<sup>3</sup>
2. The SME sector is very diverse and includes many established businesses with significant resources; however, as Table 1 shows, the majority are very small and many are informal. More than three quarters (76%) have no employees and another 20% have fewer than 10 employees. Much of the SME sector's workforce (28%) is made up of working proprietors, and 56% of all SMEs are both unincorporated and not registered for either PAYE or VAT.<sup>4</sup> Rates of business incorporation have, however, been rising for years in the UK, driven by the benefits of limited liability as well as tax and National Insurance savings.<sup>5</sup>

**Table 1 Breakdown of UK businesses in 2015**

Employee size band	Companies			Partnerships			Sole proprietorships		
	Businesses	Employment 000s	Turnover £m	Businesses	Employment 000s	Turnover £m	Businesses	Employment 000s	Turnover £m
0	722,625	722	104,678	304,030	678	26,729	3,050,930	3,051	105,784
1 to 9	695,460	2,567	340,305	111,050	557	40,425	262,305	885	54,894
10 to 49	171,980	3,348	*	19,830	425	24,883	11,715	193	*
50 to 249	31,285	3,073	1,040,111	1,030	*	*	245	*	*
0 to 249	1,621,350	9,710	1,485,094	435,940	*	*	3,325,195	*	*
250+	6,900	10,216	1,952,477	55	*	*	10	*	*
Total	1,628,250	19,928	3,437,571	435,995	1,789	101,627	3,325,205	4,154	171,080

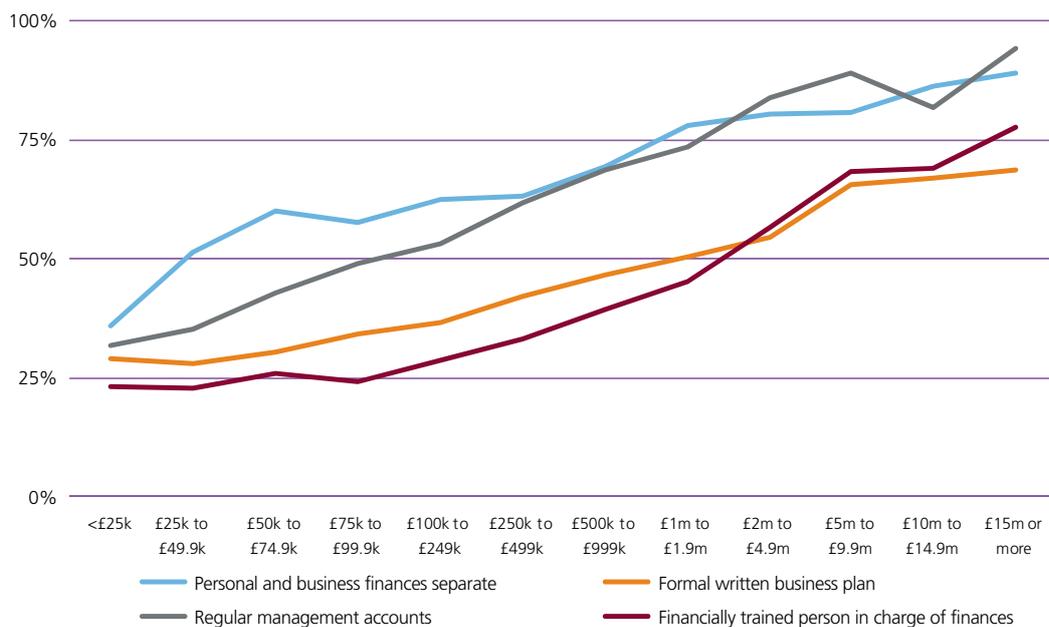
Source: BIS Business Population Estimates 2015. \*Potentially disclosive data not provided by BIS

- 1 All estimates from BIS (2015) 'Business Population Estimates for the UK and Regions 2015' [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/467445/bpe\\_2015\\_detailed\\_tables.xls](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/467445/bpe_2015_detailed_tables.xls) except the Value Added estimate, which is derived from DIW Econ (2014) *SME Performance Review 2013/2014*. [http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2014/annual\\_report\\_database.zip](http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2014/annual_report_database.zip) This is an under-estimate as it excludes unregistered businesses.
- 2 DIW Econ op cit.
- 3 British Business Bank (2014) *Small Business Finance Markets 2014* [http://british-business-bank.co.uk/wp-content/uploads/2014/12/BBB\\_Small-Business-Finance-Markets-2014\\_Online\\_Interactive.pdf](http://british-business-bank.co.uk/wp-content/uploads/2014/12/BBB_Small-Business-Finance-Markets-2014_Online_Interactive.pdf)
- 4 BIS (2015) op cit.
- 5 Ipsos MORI Social Research Institute (2014) *Reasons Behind Incorporation* HMRC Research Report 317 [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/342335/HMRC\\_Research\\_Report\\_317\\_-\\_Reasons\\_behind\\_incorporation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/342335/HMRC_Research_Report_317_-_Reasons_behind_incorporation.pdf)

**The management and financial capabilities of SMEs**

- 3. The smallest businesses generally have limited access to financial expertise, but this grows with rising business turnover or headcount as well as incorporation (see Figures 1 and 2).<sup>6</sup> A substantial share of SMEs seek generic advice in order to complement their capabilities.<sup>7</sup>

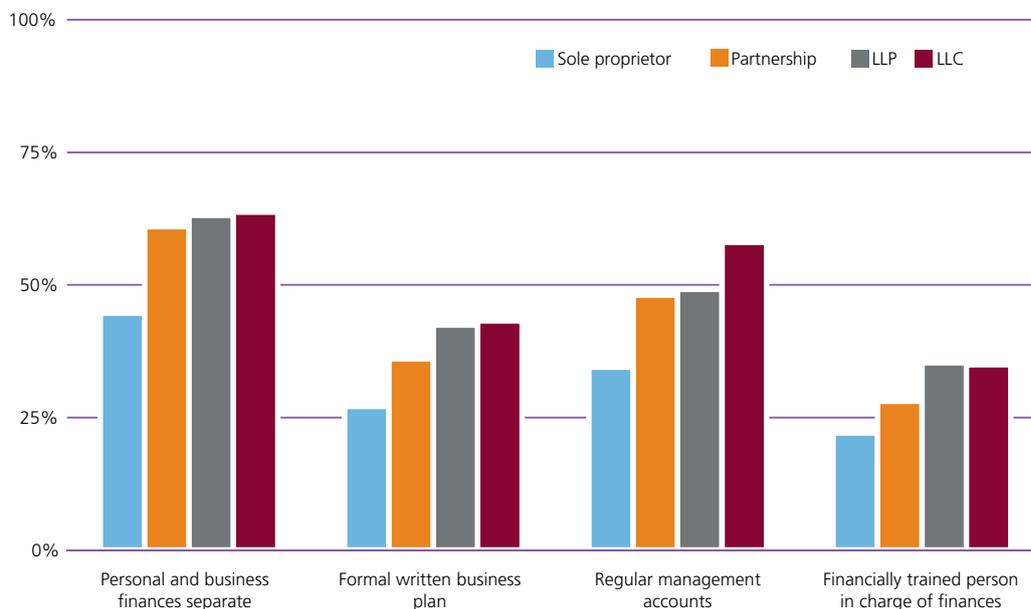
**Fig. 1 Financial capability proxies by turnover**



Source: BDRC SME Finance Monitor, data from Q1-2 2011 to Q3 2014

6 See Annex 2. BDRC (2014) SME Finance Monitor 2014 Annual Report [http://bdrc-continental.com/?pdf\\_file\\_url=aHR0cDovL2JkcmMtY29udGluZW50YWwuy29tL3dwLWNvbnRlbnQvdXBsb2Fkcy8yMDE1LzAyl0JEUKNDb250aW5lbnRhbF9TTUVfRmluYW5jZV9Nb25pdG9yX1E0XzlwMTQucGRm](http://bdrc-continental.com/?pdf_file_url=aHR0cDovL2JkcmMtY29udGluZW50YWwuy29tL3dwLWNvbnRlbnQvdXBsb2Fkcy8yMDE1LzAyl0JEUKNDb250aW5lbnRhbF9TTUVfRmluYW5jZV9Nb25pdG9yX1E0XzlwMTQucGRm)

7 BMG Research (2013) *Small Businesses Survey 2012: Businesses with no Employees* [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/193548/bis-13-p180-small-business-survey-2012-businesses-with-no-employees.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193548/bis-13-p180-small-business-survey-2012-businesses-with-no-employees.pdf)

**Fig. 2 Financial capability proxies by legal form**

Source: BDRC SME Finance Monitor, data from Q1-2 2011 to Q3 2014

4. SMEs are generally less able to withstand economic shocks and financial disruption than larger businesses. Micro enterprises in particular are much more likely than medium-sized ones to report cashflow issues and to have an above-average risk rating, and the typical micro enterprise has access to about £5,000 in cash on average over the year.<sup>8</sup> The typical lifespan for a UK business is just under four years.<sup>9</sup>

### SMEs' use of financial services

5. There were approximately 3.7m SME current accounts and 1.6m savings accounts in 2014<sup>10</sup> with balances of £87.2bn and £64.8bn respectively.<sup>11</sup> A gross £22.4bn worth of new bank loan and overdraft facilities were extended to SMEs in 2014 and £98.9bn of SME bank loans and overdrafts were outstanding at the end of the year, 34% and 39% respectively to businesses with turnover up to £2m.<sup>12</sup> The same period saw firms provide an additional £24.6bn of asset-based finance to businesses with turnover of less than £10m, 19% of which was to businesses with turnover of less than £1m,<sup>13</sup> while alternative finance providers such as peer-to-peer lenders and equity crowdfunding platforms raised another £1bn for SMEs.<sup>14</sup> SME insurance

<sup>8</sup> BDRC op cit

<sup>9</sup> ONS (2014) 'Business Demography, 2013' [http://www.ons.gov.uk/ons/dcp171778\\_387261.pdf](http://www.ons.gov.uk/ons/dcp171778_387261.pdf)

<sup>10</sup> Mintel (2013) *Small Business Banking Report*. Note that this estimate is a forecast.

<sup>11</sup> British Bankers Association [BBA] (2015) 'Bank Support for SMEs – 4th Quarter 2014' <https://www.bba.org.uk/news/statistics/sme-statistics/bank-support-for-smes-4th-quarter-2014/>

<sup>12</sup> Ibid. Some of the reporting banks provide data for businesses with turnover of £1m or less instead of £2m or less. The BBA does not distinguish between regulated and unregulated credit to SMEs, although Annex 3 provides estimates of the number of facilities that are regulated.

<sup>13</sup> Asset Based Finance Association [ABFA] (2015) 'ABFA Association History Q4 2014' <https://www.abfa.org.uk/statistics/2014/Q4%202014/ABFA%20Association%20History%20Q4%202014.xls>

<sup>14</sup> Beck, P., Collins, L and Zhang, B (2014) *Understanding Alternative Finance: the UK Alternative Finance Industry Report 2014* <https://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf>

premiums were expected to reach £6.2bn per year by 2014<sup>15</sup> – with micro enterprises in particular accounting for 63% of the total. The most common types of insurance among SMEs are public liability, employer’s liability and property insurance.

6. The SME sector has traditionally been less engaged with pensions provision than with the rest of the financial services industry. As of 2014, fewer than 10% of all people working for businesses with fewer than 13 employees had occupational pensions; roughly one in five employees of businesses with 13 to 99 employees did.<sup>16</sup> Moreover, the share of self-employed people benefiting from occupational pensions fell over the last two decades to around one in five in 2012/13.<sup>17</sup> Auto-enrolment into workplace pension schemes, launched in 2012 and expected to be fully rolled out by 2018,<sup>18</sup> has marked a significant departure from past practice among SMEs.
7. Little information is publicly available on the financial investments made and products held by SMEs. As of June 2015, our review into sales of interest rate hedging products (IRHPs) had identified 4,974 businesses that purchased IRHPs but exceeded the size threshold for small companies and groups.<sup>19</sup> This suggests that a substantial share of medium-sized businesses may have bought such products.

### Market function and dynamics

8. The markets for business banking and general-purpose business lending are highly and persistently concentrated – the four largest providers of business current accounts serve 83% of business account holders in England and Wales, and a greater share in Scotland and Northern Ireland. The market for general-purpose loans to micro enterprises is even more concentrated, and there are strong links between the provision of business current accounts and other products, especially business loans.<sup>20</sup> With more than a fifth of all SMEs switching insurance providers at renewal, loyalty to providers in the SME insurance market is much lower than in SME banking, but still higher than in the consumer insurance market.<sup>21</sup>
9. In its provisional findings report of October 2015,<sup>22</sup> the Competition and Markets Authority (CMA) suggested that SME banking is characterised by a high degree of customer inertia and low levels of switching; it also noted signs of latent dissatisfaction, or reluctance to switch even when dissatisfied. Opening a business account with a new bank is sometimes seen as a lengthy, risky process with the potential to disrupt the business’ access to finance, while the business accounts and lending products on offer are often difficult to compare in advance

15 Datamonitor (2014) *UK SME Insurance: Market Dynamics and Opportunities*.

16 Office for National Statistics [ONS] (2015) ‘2014 Annual Survey of Hours and Earnings: Summary of Pensions Results’ <http://www.ons.gov.uk/ons/rel/ashes/annual-survey-of-hours-and-earnings-pension-tables/2014-provisional-results/art--2014-annual-survey-of-hours-and-earnings--summary-of-pension-results.html#tab-Membership-by-occupation--size-of-employer-and-region>

17 ONS (2014) ‘Private Pension Scheme Membership: 2014 Edition’ in *Pension Trends* <http://www.ons.gov.uk/ons/rel/pensions/pension-trends/chapter-7--pension-scheme-membership--2014-edition/art-chapter-7--private-pension-scheme-membership--2014.html#tab-Self-employed-pension-membership>

18 To qualify, schemes will eventually have to make minimum contributions of 8% of an employee’s qualifying earnings, of which at least 3% must come from the employer. However, during the phasing period from October 2012 to September 2017 the minimum contribution will be 2% of an employee’s qualifying earnings of which at least 1% must come from the employer. Employers with between 50 and 249 employees were expected to enrol their eligible employees from 1 April 2014, so a limited number were included in the ONS’ 2014 data.

19 FCA, (2015) ‘Progress of Sales through stages of the review as at 30 June 2015’ <http://www.fca.org.uk/static/documents/aggregate-progress.pdf>

20 CMA (2015) ‘Retail banking market investigation – Provisional findings report’ [https://assets.digital.cabinet-office.gov.uk/media/5630c3da40f0b674d3000008/Retail\\_banking\\_market\\_investigation\\_-\\_provisional\\_findings\\_report.pdf](https://assets.digital.cabinet-office.gov.uk/media/5630c3da40f0b674d3000008/Retail_banking_market_investigation_-_provisional_findings_report.pdf)

21 Datamonitor (2014), *UK SME Insurance: Marketing and Distribution*

22 CMA (2015) op cit

for cost or quality. The CMA has noted that, so far, new entrants and innovations in the retail current accounts market have been more likely to target individual consumers as opposed to SMEs. It is considering the possibility that, at least in the short-term, incumbent banks' large branch networks may continue to contribute to the advantage that larger established banks have over in acquiring customers, and that prospective lenders to SMEs may be held back by limited access to transactional data useful for assessing and pricing risk.

10. A substantial share of SMEs purchase financial products and services through intermediaries. Almost half (45%) of all SMEs purchase insurance through a broker, although micro enterprises are significantly more likely to purchase insurance directly or through online comparison sites. Banks are also involved in the distribution of insurance to SMEs, especially large ones.<sup>23</sup> A lot of bank and non-bank lending to SMEs is facilitated by intermediaries; members of the National Association of Commercial Finance Brokers (NACFB) facilitate about £9.7bn of lending to SMEs per year.<sup>24</sup>
11. The smaller end of the SME market is characterised by a widespread use of personal and informal finance. The finances of 41% of SMEs overlap with those of their owners,<sup>25</sup> and this has been known to threaten the finances of self-employed persons.<sup>26</sup> Trade creditors have additionally become an increasingly important source of finance for SME companies over the last decade.<sup>27</sup> Additionally, many of the smallest businesses do not use finance of any kind: 36% of UK SMEs were using no finance whatsoever in 2014<sup>28</sup> and 15% had no commercial insurance. This may even include some employers, for whom it is a legal obligation to have employer's liability insurance.<sup>29</sup>

### Commercial segmentations of SMEs by financial services firms

12. In late 2014 we carried out a preliminary analysis on how C1 banks segment their business clients. At the time, the C1 banks generally distinguished 'personal' or 'retail'<sup>30</sup> clients from commercial clients. Services likely to be offered only to commercial clients included trade finance, risk management services (including foreign exchange), cash pooling, growth finance, structured finance and European Investment Bank (EIB) guarantees, as well as commercial mortgages.
13. The thresholds for personal or retail banking varied, but were often harmonised either with the micro enterprise definition (which defines eligibility for the ombudsman service and the application of our BCOBS rules) or with the past limits of the ombudsman service's jurisdiction (£1m turnover, corresponding to our small business definition). Business customer segmentations are more diverse in the insurance sector, where commercial customers are kept distinct from individual customers (reflecting their treatment in our Insurance Conduct of Business Sourcebook), and segmentations are more likely to reflect the value of the cover and the distribution channel. In the retail banking sector, the CMA has provisionally found that

<sup>23</sup> Datamonitor (2014) op cit

<sup>24</sup> Alois, J.D. (2014) 'NAFB: UK SME Lending Jumps 20%' *Crowdfund Insider* <http://www.crowdfundinsider.com/2014/09/48409-nacfb-uk-sme-lending-jumps-20/> The amount of buy-to-let lending facilitated over the same period was £3bn

<sup>25</sup> BDRC op cit

<sup>26</sup> <https://www.fca.org.uk/static/documents/consultation-papers/fsa-mm-datapack2012.pdf>

<sup>27</sup> Wilson, N. (2014) *Trade Credit in the UK Economy (1998-2012): An Exploratory Analysis of Company Accounts* [http://www.cips.org/Documents/Knowledge/Procurement-Topics-and-Skills/10-Developing-and-Managing-Contracts/Contract-Management/Trade\\_Credit\\_in\\_the\\_UK\\_Economy\\_Report.pdf](http://www.cips.org/Documents/Knowledge/Procurement-Topics-and-Skills/10-Developing-and-Managing-Contracts/Contract-Management/Trade_Credit_in_the_UK_Economy_Report.pdf)

<sup>28</sup> BDRC op cit

<sup>29</sup> Datamonitor op cit

<sup>30</sup> In this section, 'retail' is in quotes in order to distinguish this use of the term from the retail client categorisation under COBS.

banks' acquisition and retention strategies, including incentives for relationship managers and the firms' willingness to negotiate, are focused on larger SMEs, which are, on average, more profitable clients for banks than micro enterprises.<sup>31</sup>

### Access to credit and its implications

14. Although credit conditions for SMEs have improved as the recovery progresses, structural obstacles to access to finance remain and demand for credit among SMEs remains relatively subdued. More than 60% of first-time credit applications and about 30% of all other applications for new credit facilities by SMEs are turned down. Business size is known to be an important determinant of application outcomes, but is far from the only one.<sup>32</sup> The TSC has noted, for instance, that young businesses or high-growth businesses relying on intangible assets are more likely to face financing constraints regardless of size.<sup>33</sup> The fact that SMEs do not have uninterrupted access to finance and many rely on suppliers for credit means that they cannot easily absorb cashflow interruptions, which tend to escalate and propagate along the supply chain.

### The impact of (self)regulation on competition, innovation and access

15. Most lending to SMEs is unregulated. As a result, a network of voluntary commitments have been developed around business lending to help improve outcomes for SME borrowers. These include initiatives such as the BBA's Lending Code, the Finance and Leasing Association's (FLA) Business Finance Code and the independent loan appeals process, the Asset Based Finance Association's (ABFA) code and independent complaints process, and the Institute for Turnaround's statement of principles for the business support units of banks.
16. In addition to providing potentially valuable safeguards to clients, higher standards of conduct might increase the SME sector's engagement with the industry. For example, awareness of lenders' commitments under the Lending Code or the loan appeals process makes it less likely that SMEs with financing needs will be put off applying to a bank by the fear of rejection.<sup>34</sup> Knowing that crowdfunding platforms are regulated by the FCA may make SMEs more willing to raise funds there,<sup>35</sup> and a lack of regulatory oversight of some innovative services, e.g. account aggregators, may have held back their adoption rate in the UK by undermining consumer confidence.<sup>36</sup>
17. However the cost and uncertainty associated with some types of regulation may dampen innovation and competition in the SME market. In some cases, banks have told the CMA that a changing regulatory environment tended to increase the cost of developing new products and

<sup>31</sup> CMA (2015) op cit

<sup>32</sup> BDRC (2014) op cit

<sup>33</sup> Treasury Select Committee [TSC] (2015) *Conduct and Competition in SME Lending* [http://www.parliament.uk/documents/commons-committees/treasury/Conduct\\_and\\_Competition\\_in\\_SME\\_lending.pdf](http://www.parliament.uk/documents/commons-committees/treasury/Conduct_and_Competition_in_SME_lending.pdf)

<sup>34</sup> Fraser, S. (2014) 'Back to Borrowing? Perspectives on the Arc of Discouragement' Enterprise Research Centre White Paper no 8. <http://www.enterpriseresearch.ac.uk/wp-content/uploads/2014/03/ERC-White-Paper-8-Discouragement-Stuart-Fraser-Full-March-2014.pdf>

<sup>35</sup> Baeck, P., Collins, L. and Zhang, B. (2014) *Understanding Alternative Finance London*: Nesta. <https://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf>

<sup>36</sup> Deloitte (2015) *The Impact of Innovation in the UK Retail Banking Market* London: CMA [https://assets.digital.cabinet-office.gov.uk/media/55ba0461ed915d155c000013/The\\_impact\\_of\\_innovation\\_in\\_the\\_UK\\_retail\\_banking\\_market\\_\\_2\\_.pdf](https://assets.digital.cabinet-office.gov.uk/media/55ba0461ed915d155c000013/The_impact_of_innovation_in_the_UK_retail_banking_market__2_.pdf)

the time it took to bring them to market or to enter a new market.<sup>37</sup> Deloitte's research for the CMA likewise gives an example of how uncertainty around future regulatory developments may have reduced incentives to adopt new account aggregation services. Firms considering entering the retail banking market, on the other hand, have not generally mentioned conduct rules as a barrier – though some did suggest that the current framework for capital requirements gives large incumbents an advantage.<sup>38</sup> Finally, the CMA has provisionally found that the way in which some banks choose to implement anti-money-laundering (AML) requirements and Know Your Customer (KYC) checks could slow down, complicate and ultimately discourage switching by some SMEs.<sup>39</sup>

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37 See eg. Virgin Money and Tesco case studies in CMA (2015) op cit

38 CMA (2015) op cit

39 CMA (2015) op cit

## Annex 3

# Evidence of consumer outcomes for SMEs

1. In addition to the reviews and reports cited in this Discussion Paper, our analysis of outcomes for SMEs drew on three sources of primary research:
  - a. our SME complaints survey, disseminated among 378 SMEs by three participating firms between February and March 2015
  - b. a set of 25 case studies prepared for us by GfK, based on interviews carried out in late 2014 with SMEs that reported<sup>40</sup> that they had experienced some type of problem, or had had cause to complain or seek redress
  - c. the ombudsman service's review of 238 complaints referred to them in 2014 by micro enterprises<sup>41</sup>
2. Our findings were complemented by insights from reviews of the SME experience across industries, carried out by the Federation of Small Business (FSB)<sup>42</sup>, Citizens Advice<sup>43</sup> and the Money Advice Trust.<sup>44</sup>
3. Our review of SMEs' experiences has so far aimed to provide an overview of what we have known to go wrong, and provide the basis for further research, rather than be representative of the experience of all or most SMEs.

40 The recruitment of interviewees relied on self-reporting, and the incidence of problems or detriment was not verified by GfK or the FCA; interviewers prompted respondents with an indicative list of problems that they might have encountered.

41 Financial Ombudsman Service (2015) *Micro-enterprises and financial services. A review of complaints*. Ombudsman Service Insight Briefing. <http://www.financial-ombudsman.org.uk/publications/pdf/Micro-enterprise-complaints-Aug-2015.pdf>

42 Fletcher, A., Karatzas, A., & Kreutzmann-Galasch, A. (2014) *Small Business as Consumers: Are They Sufficiently Well Protected? A Report for the Federation of Small Businesses* [http://www.fsb.org.uk/policy/assets/fsb%20project\\_small\\_businesses\\_as-consumers.pdf](http://www.fsb.org.uk/policy/assets/fsb%20project_small_businesses_as-consumers.pdf)

43 Citizens' Advice Bureau (2014) *The concerns of Small Business as Consumers in Regulated Markets* [http://www.citizensadvice.org.uk/the\\_concerns\\_of\\_small\\_businesses\\_as\\_consumers\\_in\\_regulated\\_markets\\_final.pdf](http://www.citizensadvice.org.uk/the_concerns_of_small_businesses_as_consumers_in_regulated_markets_final.pdf)

44 Money Advice Trust (2015) *The Cost of Doing Business: Supporting the self-employed and small businesses* [http://www.moneyadvicetrust.org/SiteCollectionDocuments/Research%20and%20reports/MAT\\_BDL\\_COST\\_OF\\_BUS.pdf](http://www.moneyadvicetrust.org/SiteCollectionDocuments/Research%20and%20reports/MAT_BDL_COST_OF_BUS.pdf)

## Annex 4

# FCA Handbook approach to SMEs

1. This annex contains a high-level overview of how firms' business with SME clients is treated in the main parts of our Handbook and in our principles for business. It is provided to assist readers of the Discussion Paper only and is not a statement of the law under which we operate or of our rules, nor guidance on our rules. The FCA Handbook sets out in detail what our rules require and the circumstances in which they apply.
2. The focus of this annex is on differences in treatment between business clients and individual consumers, and between larger and smaller businesses. This analysis is summarised in Chapter 2 of the Discussion Paper.

### Conduct of Business Sourcebook (COBS)

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3. The obligations of firms towards SMEs that are investors are in our Conduct of Business Sourcebook (COBS).

#### How SMEs fit into the COBS client categorisation

4. The application of COBS does not distinguish between individual and business clients. In practice, the vast majority of clients are likely to be categorised as retail clients and only authorised firms or large undertakings (both of which include a small share of the SME population) may be categorised as per se professional clients or per se eligible counterparties.<sup>45</sup>
5. Authorised firms that are per se professional clients by default include any firms carrying out the characteristic activities of the entities mentioned below, whether authorised by a European Economic Area (EEA) state or a third country and whether or not authorised by reference to a directive:
  - a. a credit institution (b) an investment firm (c) any other authorised or regulated financial institution (d) an insurance company (e) a collective investment scheme or the management company of such a scheme (f) a pension fund or the management company of a pension fund (g) a commodity or commodity derivatives dealer (h) a local (i) any other institutional investor.
6. The criteria of the large undertakings test depend on whether or not a firm is carrying on MiFID or equivalent third-country business. For MiFID or equivalent third-country business, an entity must meet two of the following size requirements in order to be a large undertaking:
  - a. balance sheet total of €20,000,000

<sup>45</sup> Only certain limited services constitute eligible counterparty business: (a) *dealing on own account, execution of orders on behalf of clients* or reception and transmission of orders; or (b) any ancillary service directly related to a service or activity referred to in (a); or (c) *arranging* in relation to business which is not MiFID or equivalent third country firm business.

- b.** net turnover of €40,000,000
  - c.** own funds of €2,000,000.
- 7.** Under the regime for non-MiFID or equivalent third-country business, the requirements of the large undertakings test are different. A client must be one of the following:
- a.** A body corporate (including a limited liability partnership) which has (or any of whose holding companies or subsidiaries has) (or has had at any time during the previous two years) called up share capital or net assets of at least £5m (or its equivalent in any other currency at the relevant time).
  - b.** An undertaking that meets (or any of whose holding companies or subsidiaries meets) two of the following tests:
    - i.** a balance sheet total of EUR 12,500,000
    - ii.** a net turnover of EUR 25,000,000
    - iii.** an average number of 250 employees during the year.
  - c.** A partnership or unincorporated association which has (or has had at any time during the previous two years) net assets of at least £5m (or its equivalent in any other currency at the relevant time) and calculated in the case of a limited partnership without deducting loans owing to any of the partners.
  - d.** A trustee of a trust (other than an occupational pension scheme, small self-administered scheme (SSAS), personal pension scheme or stakeholder pension scheme) which has (or has had at any time during the previous two years) assets of at least £10m (or its equivalent in any other currency at the relevant time) calculated by aggregating the value of the cash and designated investments forming part of the trust's assets, but before deducting its liabilities;
  - e.** A trustee of an occupational pension scheme or SSAS, or a trustee or operator of a personal pension scheme or stakeholder pension scheme where the scheme has (or has had at any time during the previous two years):
    - i.** at least 50 members
    - ii.** assets of at least £10m (or its equivalent in any other currency at the relevant time) under management
  - f.** A local authority or public authority.
- 8.** Almost all (99.9%) SMEs would not meet the criteria for large undertakings with regard to firms' MiFID or third-country equivalent business. This includes 94% of medium-sized businesses (50 to 249 employees) and 99% of all small enterprises (10 to 49 employees).<sup>46</sup> Additionally, 99.9% of non-financial SMEs would not meet the quantitative criteria for large undertakings

<sup>46</sup> This approximation is based on SME Finance Monitor data from Q2 and Q3 2014 and includes all SMEs with either a balance sheet of less than £15m or average credit and deposit balances of less than £1m. It is therefore a slight underestimate. It was impossible to apply the turnover criterion as it was above the threshold for eligibility for the SME Finance Monitor sample – effectively all businesses on the sample met this criterion. SMEs that could not provide estimates of either their total assets or total credit balances and deposits were excluded from the calculation altogether.

with regards to firms' non-MiFID business. This would also include some 87% of medium-sized businesses.<sup>47</sup>

9. The following entities are categorised as *per se* eligible counterparties for the purposes of eligible counterparty business only:

(1) an investment firm (2) a credit institution (3) an insurance company (4) a collective investment scheme authorised under the UCITS Directive or its management company (5) a pension fund or its management company (6) another financial institution authorised or regulated under EU legislation or the national law of an EEA State (7) an undertaking exempted from the application of MiFID under either Article 2(1)(k) (certain own account dealers in commodities or commodity derivatives) or Article 2(1)(l) (locals) of that directive (8) a national government or its corresponding office, including a public body that deals with the public debt (9) a central bank (10) a supranational organisation.

### Opting up

10. Retail clients can ask to be 'opted up' by firms from retail client status into the elective professional client classification. In so doing, they forfeit some of the protections available to retail clients (see below). The criteria for opting-up to elective professional client and elective eligible counterparty status are set out in COBS 3.5.3 R and COBS 3.6.4 R respectively.
11. To opt a client up to elective professional client status, firms have to undertake an assessment of the expertise, experience and knowledge of the client in light of the services and transactions envisaged. This assessment needs to provide reasonable assurance that the client is capable of making their own investment decisions and understand the risks involved (the 'qualitative test').
12. If activities in question are MiFID or equivalent third-party business, the assessment must also include a quantitative assessment of two of the following three (the quantitative test):
- (a) The client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters (b) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds €500,000 (c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.
13. Clients must state in writing that they wish to be 'opted up' into professional client status, then be notified by firms of the protections that they are forfeiting, and then confirm, in writing, that they understand these. The onus is on the firm to check that a client who has opted up meets the qualitative and, where applicable, the quantitative criteria for such categorisation, and must take appropriate action if they become aware that the client no longer fulfills those criteria.
14. Clients may request that firms reverse categorisation as a professional client at any time, and firms have an obligation to take appropriate action if information emerges that would suggest they are no longer appropriate.
15. For the purposes of eligible counterparty business only (see above), a firm may treat a client as an elective eligible counterparty if:
1. the client is an undertaking and:

<sup>47</sup> This approximation is based on SME Finance Monitor data from Q2 and Q3 2014 and includes all SMEs with either a balance sheet of less than £10m or turnover of less than £10m. It was impossible to apply the headcount criterion, as no businesses in the sample had more than 250 employees. SMEs that could not provide estimates of either their total assets or total credit balances and deposits were excluded from the calculation altogether.

- a. is a *per se* professional client (unless only because it is an institutional investor) and, in relation to business other than MiFID or equivalent third country business
    - i. is a body corporate (including a limited liability partnership) which has (or any of whose holding companies or subsidiaries has) called up share capital of at least £10m (or its equivalent in any other currency at the relevant time) or
    - ii. meets two out of three condition in the quantitative test for elective professional clients (see above) or
  - b. requests such categorisation and is an *elective professional client*, but only in respect of the services or transactions for which it could be treated as a *professional client* and
2. the firm has, in relation to MiFID or equivalent third-country business, obtained express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty.

#### **Protections not available to professional clients and eligible counterparties**

16. Under current rules (see 'Ongoing Changes to our Rules') professional clients are not afforded some of the protections available to retail clients – including the following:

- Firms' obligation to act honestly, fairly and professionally in accordance with the best interests of their clients with regards to their non-MiFID business (COBS 2.1).
- Firms' obligation to communicate information in a manner tailored to the target audience, without giving benefits undue prominence or diminishing risks, including making fair and balanced comparisons (COBS 4.5).
- Detailed rules on describing the past or future performance of investments (COBS 4.6).
- Rules relating to the restrictions on and the required contents of direct offer financial promotions (COBS 4.7)
- The obligation on firms to provide client agreements (COBS 8.1) with regard to their non-MiFID business.
- Requirements on firms making personal recommendations or managing investments with regard to non-MiFID business, to carry out suitability analysis (COBS 9.2).
- Special rules for giving advice on a stakeholder product (COBS 9.6)
- When assessing the suitability of a personal recommendation in relation to MiFID or third-party equivalent business, firms may assume that a professional client has the necessary experience and knowledge to understand the risks involved, and that the client is able financially to bear any investment risks consistent with their investment objectives (COBS 9.2.8).
- When carrying out appropriateness tests related to their MiFID business, firms may assume that a professional client has the necessary experience and knowledge in order to understand the risks involved in relation to those particular investment services or transactions, or types of transaction or product, for which it has been classified a professional client (COBS 10.2).

- Requirements that firms providing a client with best execution prioritise the overall costs of the transaction as being the most important factor in achieving best execution for the client, and consider their own commissions and costs relating to each of the eligible execution venues available when assessing which to use in order to provide best execution (COBS 11.2). Also the requirements that firms notify clients of any material difficulty to the proper carrying out of orders (COBS 11.3).
  - The obligation to provide sufficient information in a key features document for a retail client to make an informed decision, including additional requirements for packaged products (COBS 13.3.1) and the obligation not to provide a generic key features illustration (COBS 13.4).
  - Firms' obligations relating to the confirmation of transactions (COBS 16.2) apply in a modified form to firms' dealings with professional clients. Provisions regarding extra reporting requirements for dealings with retail clients and provision of hard copies of confirmations not accessed electronically will not apply.
  - Professional clients may not have access to the ombudsman service in relation to some complaints about investments (see DISP chapter of this annex).
- 17.** Finally, the conduct of business rules in relation to best execution (COBS 11.2), client order handling (COBS 11.3) and certain conduct of business obligations (e.g. COBS 8.1 on client agreements in the case of firms' MiFID business) do not apply to eligible counterparty business. Firms' obligation to disclose limit orders (COBS 11.4) should only apply where the counterparty is explicitly sending a limit order to the firm for its execution.

#### **Sophisticated investors and high net worth individuals**

- 18.** For the purposes of COBS 4.12 rules, clients may be certified by firms or self-certify as 'sophisticated investors' or certified as 'high net worth investors', provided certain criteria have been satisfied. Table 2 sets these criteria out.
- 19.** Firms are allowed to promote non-mainstream pooled investments to sophisticated and high net worth investors that they are not allowed to promote to other retail investors. These include any of the following:
- (a) a unit in an unregulated collective investment scheme; (b) a unit in a qualified investor scheme; (c) a security issued by a special purpose vehicle, other than an excluded security; (d) a traded life policy investment; (e) rights to or interests in investments that are any of (a) to (d).

**Table 2: Sophisticated investors and high net worth investors**

<b>Category</b>	<b>Criteria</b>
High net worth investors (COBS 4.12.6)	Signed within the last 12 months a declaration accepting promotional communications which are exempt from the restriction on promotion of non-mainstream pooled investments, acknowledging the risk of losses and opportunity to seek advice from an authorised person, and confirming that at least one of the following applies to them: a) an annual income to the value of £100,000 or more b) net assets of £250,000 or more, net of: primary residence and any funds secured against this, rights under a qualifying contract of insurance, or benefits payable on termination of service, death or retirement.
Certified sophisticated investors (COBS 4.12.7)	1) Assessed within the last 36 months by a firm as sufficiently knowledgeable to understand the risks associated with engaging in investment activity in non-mainstream pooled investments and 2) having signed within the last 12 months a statement accepting a significant risk of losing all of the money or other property invested, and stating awareness of the option to seek advice from an authorised person.
Self-certified sophisticated investors (COBS 4.12.8)	Signed within the last 12 months a declaration accepting promotional communications by authorised persons which relate to investment activity in non-mainstream pooled investments, and acknowledging a significant risk of losing all of the property invested. One of the following must apply to them: (a) member of a network or syndicate of business angels for at least six months (b) more than one investment in an unlisted company in the last two years (c) working in private equity or in the provision of finance for SMEs (d) director of a company with an annual turnover of at least £1m.

20. In addition some of the protections implementing the Distance Marketing Directive (distance marketing disclosures in COBS 5 and cancellations in COBS 15,) are unavailable to businesses (irrespective of whether they are retail or professional clients), because they are available only to consumers who are individuals acting outside their business, trade or profession.

#### **Ongoing changes to our rules**

21. Following the implementation of MiFID II from January 2017, many of the protections currently reserved for retail clients will be extended to professional clients and, in some cases, to eligible counterparties as well. MiFID II's implementing measures are likely to set specific criteria for firms to identify target markets and consumer needs, and to set out clear management oversight of this process. Product distributors will also be required to understand products and assess their compatibility with specific client needs. We issued DP15/3 on MiFID II implementation in March 2015 and will consult on final rules starting December 2015. These changes are likely to increase the protection available to clients categorised as professional clients (including some of the largest and most sophisticated SMEs) and may lead to firms better defining SMEs as a target market.

### Insurance: Conduct of Business Sourcebook (ICOBS)

- 22.** Provisions in ICOBS apply to firms depending on the type of person with whom the firm is dealing.<sup>48</sup> ICOBS rules can apply to the following categories of persons:
- Policyholders, which includes anyone who, upon the occurrence of the contingency insured against, is entitled to make a claim directly to the insurance undertaking.
  - Customers, which includes the separate categories of:
    - consumer – a natural person acting outside their trade, profession or business
    - commercial customer – all other customers not falling in the definition of ‘consumer’.
- 23.** This means that SMEs acting in their business capacity will be categorised as commercial customers, and thus firms’ dealings with them will not always be subject to the same detailed requirements as in their dealings with individuals. ICOBS rules have limited application to firms mediating contracts of large risks for commercial customers.<sup>49</sup> However, ICOBS will apply to the vast majority of situations involving SMEs. The turnover, balance sheet and sector criteria for these are not met by at least 93% of non-financial SMEs (including 95% of those with 10 to 49 employees and 77% of those with 50 or more employees).<sup>50</sup>
- 24.** The applicability of different ICOBS rules is driven to some extent by EU Directives such as:
- Distance Marketing Directive (DMD) requirements relate to firms’ business with consumers. Therefore distance marketing disclosures and cancellation rights are only extended to consumers and not to commercial customers.
  - Insurance Mediation Directive (IMD) requirements relate to firms’ dealings with all customers (including commercial customers). Requirements in relation to status disclosure and scope of service for instance apply to commercial customers and non-business consumers who are individuals.
- 25.** High-level claims handling rules in ICOBS apply equally to insurers’ dealings with commercial customers and consumers. However, detailed rules that prohibit insurers from rejecting claims unreasonably (e.g. due to non-fraudulent non-disclosure) apply to firms’ dealings with consumer policyholders’ claims only.

<sup>48</sup> ICOBS 2.1.

<sup>49</sup> contracts of insurance cover risks within the following categories, in accordance with article 5(d) of the First Non-Life Directive:

- (a) railway rolling stock, aircraft, ships (sea, lake, river and canal vessels), goods in transit, aircraft liability and liability of ships (sea, lake, river and canal vessels);
- (b) credit and suretyship, where the policyholder is engaged professionally in an industrial or commercial activity or in one of the liberal professions, and the risks relate to such activity;<sup>10</sup>
- (c) land vehicles (other than railway rolling stock), fire and natural forces, other damage to property, motor vehicle liability, general liability, and miscellaneous financial loss, in so far as the policyholder exceeds the limits of at least two of the following three criteria:<sup>10</sup>
  - (i) balance sheet total: €6.2 million;
  - (ii) net turnover: €12.8 million;
  - (iii) average number of employees during the financial year: 250.

<sup>50</sup> This approximation uses SME Finance Monitor data from Q2 2014 to Q3 2014 and is based on businesses with fewer than 250 employees and either turnover of less than £10m or a balance sheet total of less than £5m that are not in the transport, storage and communications sector. All businesses that could not provide a turnover estimate were excluded from the calculation. It is not possible to account in this way for credit and suretyship. The SME Finance Monitor does not include data from business in the financial services sector.

26. Firms have to bear in mind the restrictions on unreasonably rejecting claims and guidance is provided on ways of ensuring customers know what must be disclosed when taking out the policy.<sup>51</sup> This includes, for example, explaining to commercial customers the duty to disclose all circumstances material to a policy, what needs to be disclosed and the consequences of any failure to make such a disclosure.

#### Ongoing changes to our rules

27. The Insurance Act 2015 ('the Act') will introduce a new duty of 'fair presentation' on insured parties, which will apply to non-consumer insurance contracts. New, more flexible, remedies will apply where the insured has breached the duty of fair presentation, which will enable the insurer to avoid the insurance contract only where the breach was deliberate or reckless or where the insurer would not have entered into the contract on any terms had the breach not occurred. The Act will also abolish the law that breach of a warranty in a contract of insurance results in the discharge of the insurer's liability under the contract. Instead, the insurer's liability will be suspended in such circumstances until the breach is remedied. Consideration is currently being given to what changes, if any, are needed to the FCA Rules as a result of the Act. Further regulatory change may result from the implementation of the Insurance Distribution Directive (IDD), which is currently anticipated to be in place by the end of 2017.

#### Banking Conduct of Business Sourcebook (BCOBS)

28. The obligations of firms towards SMEs that are depositors (including current account holders) are set out in BCOBS. In the case of payments services, BCOBS 4 (rules on customer communications) does not apply, and the remaining provisions of the Sourcebook apply only to the extent that they deal with matters not covered by the Payment Services Regulations 2009 (PSRs).
29. BCOBS applies to firms' dealings with any banking customer, defined as
- a. a consumer
  - b. a micro enterprise (a business with a turnover or balance sheet total of less than €2m and fewer than 10 employees, irrespective of legal form) or
  - c. a charity which has an annual income of less than £1m.
30. The application of BCOBS to firms' dealings with business customers is broadly aligned with the application of the PSRs. The conduct provisions of the PSRs generally apply to firms' dealings with all business customers even if they are not micro enterprises, but many of their provisions can be contracted out of if the client is not a micro enterprise.
31. About 97% of all autonomous SMEs (including 98% of all businesses with fewer than 10 employees) would be classified as banking customers under BCOBS.<sup>52</sup>
32. BCOBS does not specify any services that must be advised but lays out rules on the information that must be provided to customers, and which is similar regardless of whether the customer is a business or consumer.

<sup>51</sup> ICOBS 5.1.4G.

<sup>52</sup> This is the average of two sets of estimates: one assumes turnover or assets less than £2m and fewer than 10 employees, the other assumes turnover or assets less than £1m and fewer than 10 employees. Both sets of estimates are based on SME Finance Monitor data from Q2 and Q3 2014.

- 33.** Per BCOBS 4, a firm must provide or make available to a banking customer appropriate information about their services (1) in good time (2) in an appropriate medium and (3) in easily understandable language and in a clear and comprehensible form, so that the banking customer can make decisions on an informed basis. In determining what these terms mean, a firm should consider the importance of the information to the decision-making process of the banking customer and the time at which the information may be most useful. Both of these elements can be different when the customer is a business compared to when the customer is an individual.
- 34.** Similarly, the 'fair, clear and not misleading' rule applies regardless of the nature of the banking customer, but in a way that is appropriate and proportionate, taking into account the means of communication and the information that it is intended to convey. A communication addressed to a banking customer who is not a consumer may not need to include the same information, or be presented in the same way, as a communication addressed to a consumer.
- 35.** Some protections are only available to consumers – particularly with regard to the firms' right of set-off, which must be explained in detail to consumers at the point of sale and also at least two weeks before the right is exercised; notification must also be provided once this right has been exercised. A business customer will not have access to this protection. Additionally, consumer protections related to distance marketing (as derived from the Distance Marketing Directive) apply only to firms' dealings with individual consumers, and not businesses. Exceptionally, businesses still have the same cancellation rights as consumers under BCOBS as long as they are banking customers.

#### **Ongoing changes to our rules**

- 36.** Implementation of the second Payment Services Directive, which should take place by 2017, may lead to changes to BCOBS rules that may be relevant to SME depositors. Additionally, the findings of the CMA's retail banking market investigation could lead to changes to the competitive and regulatory landscape in banking for SME clients. The CMA's investigation is focused on: (i) impediments to customers' ability to effectively shop around and switch (ii) market concentration giving rise to market power for some banks, which results in worse outcomes for consumers, and (iii) barriers to entry and expansion. The CMA published its provisional findings and a remedies notice in October 2015. A provisional decision on remedies is due in February 2016, and a final report by 5 May 2016.

#### **Consumer Credit Sourcebook (CONC)**

- 37.** Consumer credit regulation under the Consumer Credit Act (CCA) and CONC applies to agreements under which credit is provided to individuals. The Handbook definition of an 'individual' combines two separate categories in the Regulated Activities Order (RAO) – 'individual' (including natural persons and sole traders) and 'relevant recipient of credit' (partnerships of two to three persons not all of whom are bodies corporate, and unincorporated bodies of persons that are not a partnership and do not consist wholly of bodies corporate).
- 38.** The regime also covers consumer hire (where goods are hired to an individual or relevant recipient of credit and the hire period is capable of exceeding three months), credit broking, and debt-related activities such as debt collecting, debt counselling and debt adjusting. Credit broking and debt-related activities may be regulated even if the underlying credit or hire agreement that created the debt was unregulated.

39. There are various exemptions from the scope of regulated credit agreements. These include where credit is provided wholly or predominantly for business purposes and the amount of credit exceeds £25,000 (there is a parallel exemption for consumer hire). In such cases, the CCA/CONC rules do not apply, although the borrower has the right to apply to a court under the unfair relationships provisions in section 140A CCA.
40. We estimate that fewer than half of all loans and overdrafts applied for by SMEs or reviewed between 2010 and 2014 (41% and 45% respectively) could potentially fall within the regulatory perimeter.<sup>53</sup> Zero-employee businesses would account for about three quarters or more of all the regulated facilities applied for or reviewed, but even among this group some 40% of facilities would be unregulated.
41. Successive governments have taken the view that ‘small business borrowers are often akin to ordinary consumers and require similar protections’.<sup>54</sup> Nevertheless, the CCA/CONC rules distinguish between borrowing for personal and business purposes in some limited cases. In particular, the CONC 3 rules on financial promotions and communications do not apply to financial promotions and communications which indicate clearly that they are solely promoting credit/hire for the purposes of a customer’s business. In addition, with regards to business lending the CCA requirements on pre-contract information and agreements allow lenders to comply with the 2004 consumer credit regulations as opposed to the regulations implementing the CCD.
42. We emphasise in PS14/3<sup>55</sup> that issues of proportionality are embedded in our rules (as they were in Office of Fair Trading (OFT) guidance) in key areas such as creditworthiness and explanations. For example, we expect firms to make a reasonable assessment of creditworthiness (including affordability), having regard to the nature and amount of the credit and the risks to the individual borrower, but we do not prescribe the checks that should be made or the evidence that should be sought. Firms should act reasonably and in line with the principles and guidance in CONC. This therefore enables firms to take into account the situation of the individual borrower, including whether they are a business or consumer.
43. Some CONC rules apply to firms’ dealings with consumers only. These include rules related to distance marketing disclosures and cancellation rights flowing from EU Directives. Business borrowers have cancellation rights pursuant to the CCA in the same way as individuals, and a right to withdraw from peer to peer (p2p) lending agreements in the same way as individuals, but only when the sum applied for does not exceed £60,260.
- Ongoing changes to our rules**
44. Between February and May 2015 we consulted on changes to CONC rules (CP15/06), including guidance that specifies that it may be reasonable for lenders to have regard to a borrower’s business plan – though the assessment must not be based on this alone. We published the final rules and guidance in September 2015 (PS 15/23).

53 These estimates are based on SME Finance Monitor data and refer to the number, not the value of facilities. They were based on the share of all SME applications, reviews and auto-reviews that involved facilities of less than £25,000 and businesses that were not companies or LLPs. Responses relate to facilities applied for between Q1 2010 and Q3 2014 and the final facilities may have been larger or smaller than the ones originally applied for. Due to data limitations, it was not possible to model precisely the share of loan facilities reviewed by firms that would fall within the perimeter. It has been possible to estimate the share of such facilities that were applied for to unincorporated businesses, but this is almost certainly an over-estimate.

54 [http://www.legislation.gov.uk/uksi/2010/1014/pdfs/uksem\\_20101014\\_en.pdf](http://www.legislation.gov.uk/uksi/2010/1014/pdfs/uksem_20101014_en.pdf)

55 FCA (2014) *Detailed Rules for the FCA Regime for Consumer Credit – Including Feedback on FCA QCP 13/18 and ‘made rules’*. <http://www.fca.org.uk/static/documents/policy-statements/ps14-03.pdf>

45. The Small Business, Enterprise and Employment Act 2015 contains measures aimed at improving access to SME credit information and helping to match SMEs rejected for finance with alternative lenders. The relevant regulations will require banks to a) share SME credit information with designated credit reference agencies (CRAs), which must then provide such information to finance providers on request, and b) provide information about rejected SME loan applicants to designated finance platforms, which must then provide such information to finance providers on request. This exchange of information will be subject to the SME's permission. We have consulted (CP 15/19) on Handbook changes to ensure we have arrangements in place that are consistent with the government's legislation, and will be publishing details of feedback received later this year.

### **Mortgages and home finance: Conduct of Business Sourcebook (MCOB)**

46. Like CONC, the Mortgage Conduct of Business (MCOB) Sourcebook has a restricted applicability to firms' dealings with businesses. Mortgages are regulated only if the borrower is an individual, a trustee, or an unincorporated partnership. Furthermore, at least 40% of the total of the land to be given as security must be used as or in connection with a dwelling by the borrower, a beneficiary of the trust, or a related person (RAO article 61). Our rules also do not apply to firms' dealings with individuals, unincorporated partnerships or trustees borrowing for the purposes of a large business (group annual turnover of £1m or more).
47. The rationale for this treatment, discussed in FSA CP 146, was to achieve alignment with our complaint rules at the time – under which businesses were eligible complainants only if they were small businesses, i.e. had turnover below £1m. CP 146 stated that these businesses are unlikely to be better informed or more able to protect their interests than ordinary consumers.<sup>56</sup>
48. We estimate that at most only 10% of all property-secured loans and 20% of all property-secured overdrafts granted to SMEs between 2010 and 2014 could be both regulated and subject to MCOB rules. Around 61% of all such facilities would have been granted to businesses without employees.<sup>57</sup>
49. Under MCOB, it is for firms themselves to determine whether mortgages are being sought for a business purpose. In such cases, tailored rules can be applied which reflect how these loans differ (either in design or the sales process) from usual consumer mortgage borrowing – although firms have the option to comply with the generally applicable provisions of MCOB instead. A table of the tailored provisions applicable to business loans and high net worth mortgage customers appears in MCOB 1.2.4B, and is reproduced below as Table 3.
50. Under MCOB, the sale of a regulated mortgage that is solely for a business purpose does not have to be advised and can proceed on an execution-only basis even if verbal or other interactive dialogue has taken place.

<sup>56</sup> FSA (2012) CP146 *The FSA's Approach to Regulating Mortgage Sales* <http://www.fsa.gov.uk/pubs/cp/cp146.pdf>

<sup>57</sup> These estimates are based on SME Finance Monitor data from Q1 2011 to Q3 2014 and refer to the number, not the value of facilities. Due to data limitations, they were based on the share of all facilities granted to SMEs, not facilities applied for. 'Property secured' facilities include commercial mortgages, as well as all loans and overdrafts secured against other commercial, personal or mixed property. Only facilities offered to unincorporated businesses with less than £1m turnover were counted as subject to MCOB rules, and those only if they were secured against personal or mixed property. Due to data limitations, it was impossible to filter for the precise percentage of mixed properties used for personal purposes. All SMEs that could not provide a turnover estimate were excluded from this analysis.

**Table 3: MCOB provisions for lending for business purposes**

<b>Provisions</b>	<b>Tailored provisions or applicable in all cases?</b>	<b>For business loans only, are the provisions applicable to all business loans, or only where the loan is solely for a business purpose?</b>
Various of the provisions in MCOB 4.7A (rules on providing advice to customers) and MCOB 4.8A (rules for dealing with unadvised customers)	Applicable in all cases	Applicable only where loan is solely for a business purpose
MCOB 4.9	Tailored (requires firms to call the facility provided something other than mortgage, e.g. secured overdraft or secured business credit)	Applicable to all business loans
MCOB 5.7	Tailored (affects the content of illustration documents that firms must draw up for borrowers)	Applicable to all business loans
MCOB 6.7	Tailored (affects the content of mortgage offer documents that firms must provide to borrowers)	Applicable to all business loans
MCOB 7.7	Tailored (affects the information that must be provided to borrowers when they request an increase in their mortgage or overdraw on their mortgage)	Applicable to all business loans
Various provisions in MCOB 11.6 (rules on affordability assessments)	Applicable in all cases	Applicable only where loan is solely for a business purpose
MCOB 12.6	Tailored (affects firms' obligation to notify borrowers of changes to early repayment charges)	Applicable to all business loans
MCOB 13.7	Tailored (affects the way in which information about mortgage arrears must be provided to the borrower)	Applicable to all business loans

### Ongoing changes to our rules

51. The Mortgage Credit Directive (MCD) must be implemented by 21 March 2016. As the MCD applies equally to first, second and subsequent charge mortgages, the Government has decided to extend the definition of a regulated mortgage contract, meaning that second-charge lending to SMEs that is currently subject to CONC is likely to be captured by MCOB from the date of implementation onwards. We published PS15/9 in March 2015 and PS15/20 in July 2015 setting out the final changes to our rules ahead of implementation.

### Dispute resolution: complaints (DISP)

- 52.** The Dispute Resolution Sourcebook covers firm complaint-handling procedures (DISP 1), sets out the jurisdiction of the ombudsman service (DISP 2) and also sets out the procedures of the ombudsman service when it considers complaints referred to it (DISP 3).
- 53.** DISP 1 outlines firms' obligations with regards to consumer awareness and complaints handling, resolution, recording, reporting and complaints data publication. Although any client can of course complain to a firm, firms' obligations under DISP 1 generally only apply to complaints from eligible complainants (although for some activities, certain rules apply even if the complainant is not an eligible complainant).
- 54.** Very broadly, eligible complainants include non-business consumers who are individuals, micro enterprises (enterprises with fewer than 10 employees and turnover or balance sheet no greater than €2m<sup>58</sup>), charities with an annual income of less than £1m, or trustees of trusts with a net asset value of less than £1m. Access to the ombudsman service was aligned to the EU micro enterprise definition in 2009 when the UK was implementing the Payment Services Directive (PSD). This contained specific provisions on out-of-court redress procedures for micro enterprises.
- 55.** For a complainant to be eligible in relation to most financial services, the respective size thresholds must not have been exceeded at the time when the complaint was made to the financial services provider. However, in the case of complaints that relate in whole or in part to payments services, a business will be an eligible complainant if it falls within the relevant thresholds either at the time of contract or at the time the complaint is made. Our guidance to firms is that, if in doubt about whether a complainant is eligible, they should treat them as eligible.
- 56.** For firms' non-MiFID business, DISP 1 applies only to complaints from eligible complainants that are also retail clients. For firms' MiFID business, it applies to eligible complainants that are retail clients, but in addition, the complaints handling and recording rules in DISP 1 also apply to clients categorised as retail clients even if they are not eligible complainants. For both MiFID and non-MiFID business, only eligible complainants who are also retail clients can refer their complaints to the ombudsman service unless they are consumers who are individuals acting outside their trade, business, craft or profession.
- 57.** Before 2009, a business had to have a turnover of less than £1m (i.e. be a small business) in order to be an eligible complainant. The 'small business' concept was established through consultation (FSA CP4 and CP33) between 1997 and 2000, and the applicability of our Mortgage and Home Finance Sourcebook as well as eligibility for compensation in our Compensation Sourcebook are still aligned to it.
- 58.** DISP 1.10 specifies that firms have an obligation to report on the number of complaints made to them by eligible complainants, regardless of whether these are referred to the ombudsman service or not.<sup>59</sup> Most firms are likely to have to do so twice a year or otherwise annually.
- 59.** The scope of the ombudsman service's compulsory jurisdiction is set by the FCA and set out in DISP 2.

<sup>58</sup> An enterprise that exceeds the headcount or financial ceilings of the micro-enterprise definition at the date of closure of its accounts does not lose the status of a micro-enterprise unless it has done so over two consecutive accounting periods.

<sup>59</sup> Different reporting requirements apply to firms with permission to carry on only credit-related regulated activities or operating an electronic system in relation to lending and whose annual revenue from those activities is less than or equal to £5m.

60. The ombudsman service cannot generally consider a complaint if six months have elapsed since the firm sent its final response or redress determination, or if more than six years have elapsed since the events the complaint relates to or (if later) more than three years have elapsed since the customer realised (or ought to have realised) they had cause to complain. There are certain exceptions to these time limits, including where the firm consents to the ombudsman service considering the complaint and where the ombudsman services considers the failure to comply with a time limit resulted from exceptional circumstances.
61. Where a complaint is determined in favour of the complainant, the ombudsman service can require firms to provide redress of up to £150,000 excluding any interest on the amount payable under a money award, costs, and interest awarded on costs. However, the ombudsman service can recommend to a firm that it pay more than this where they consider it fair.
62. Under current criteria, we estimate that about 97.3% of all SMEs that are autonomous businesses (including virtually all zero-employee businesses, 98.5% of all businesses with fewer than 10 employees and 97% of all businesses that are companies or LLPs) would be classified as eligible complainants under DISP.<sup>60</sup> However, due to the complexity of the SME definition, this is likely to be an overestimate of the share of all SMEs that are eligible. In particular, it has not been possible to model in the same way the populations of businesses that are linked to or partners of other enterprises, and therefore the share of enterprises that might not be eligible due to links or partnerships with businesses that do not meet the quantitative criteria of the micro enterprise definition. It has also not been possible to model the share of businesses that have exceeded the size thresholds of the micro enterprise definition only recently or temporarily, and are therefore still micro enterprises.
- Ongoing changes to our rules**
63. The Alternative Dispute Resolution (ADR) Directive has been implemented recently and the Online Dispute Resolution (ODR) Regulation must be implemented by January 2016, with implications for the powers, obligations and operations of the ombudsman service. In December 2014 we launched a consultation (CP14/30) on complaints handling and implementation of the ADR Directive, which also discussed the possibility of extending firms' options for informal resolution of complaints, allowing eligible claimants to refer complaints to the ombudsman service earlier, and requiring that firms inform eligible complainants of their right to refer complaints to the ombudsman service. In July 2015, we published our feedback and final rules in PS15/19. Taken together, these changes are likely to lead to greater awareness of the ombudsman service among SMEs and faster resolution of some SME complaints.

### Compensation

64. Under the Financial Services and Markets Act (FSMA), the FCA and the Prudential Regulation Authority (PRA) make the rules for the Financial Services Compensation Scheme (FSCS) (available in our Compensation Sourcebook and Depositor Protection and Policyholder Protection parts of the PRA's rule book respectively). These include the rules on what businesses are eligible for compensation and on the amount of compensation that the FSCS can pay. The following paragraphs consider the eligibility rules in relation to the sizes of businesses, but it should be noted that a business which meets the requirements described below may nonetheless be unable to claim through the FSCS because it is ineligible for other reasons described in the rules or because the remaining conditions for payment have not been met.

<sup>60</sup> This is the average of two sets of estimates: one assumes turnover/assets less than £2m, the other assumes turnover/assets less than £1m. Both sets of estimates are based on SME Finance Monitor data from Q2 and Q3 2014. All businesses that did not provide a turnover/balance sheet estimate were excluded from the calculation.

- 65.** PRA rules cover the position in relation to deposits, dormant accounts and long-term and general insurance contracts. On 1 April 2015, the PRA published Policy Statements 5/15 and 6/15, setting out changes to the PRA compensation rules including those relevant to FSCS eligibility for policyholders and depositors respectively. On 3 July the PRA also published PS14/15 which set out changes to the depositor protection rules and changes to the current limits for depositor compensation.
- 66.** PS 6/15 sets out a range of claims on firms that are not eligible deposits, including among others deposits by financial institutions, insurance undertakings and investment firms, or deposits made by credit institutions on their own behalf or for their own account.
- 67.** Eligible business claimants are eligible to claim: (a) in relation to long-term insurance contracts and compulsory insurance contracts, regardless of size, and (b) generally, in relation to general insurance contracts as long as they are a small business (annual turnover of less than £1m) or were a small business when the contract was entered into.
- 68.** The FCA rules cover FSCS cover in respect of investments, home finance mediation, and non-investment insurance mediation claims for compulsory, non-compulsory general and pure protection insurance.
- 69.** The FCA's rules on eligibility for investment claims implement the Investor Compensation Scheme Directive (ICSD). Companies and partnerships are eligible if they do not exceed the size test for small companies set out in the Companies Act 2006, i.e. if they meet two or more of the following criteria:
- turnover of no more than £6.5m
  - balance sheet total of no more than £3.26m
  - no more than 50 employees.<sup>61</sup>
- 70.** 99% of SMEs will not be prevented from claiming through the FSCS on the basis of size alone, including 99% of all businesses with 1 to 9 employees and 92% of all businesses with 10 to 49 employees – but only 1.5% of businesses with more than 50 employees. About 98% of companies and limited liability partnerships (LLPs) would not be prevented from claiming on the basis of size, and 29% of all businesses small enough to not be prevented from claiming would be incorporated.<sup>62</sup> All unincorporated associations irrespective of size are able to claim through the FSCS in respect of protected investment business.
- 71.** Under FCA rules, a claimant is eligible to claim through the FSCS in relation to home finance mediation if it is not a large partnership, large mutual association (net assets of more than £1.4m) or large company.
- 72.** Finally, all claimants are eligible to claim on the FSCS in relation to non-investment insurance mediation for compulsory insurance or pure protection. A business claimant will be eligible to claim in relation to mediation for non-compulsory general insurance if it was a small business

<sup>61</sup> For financial years from 1 January 2016, the turnover and balance sheet criteria are being increased to £10.2 million and £5.1 million respectively. Transitional provisions are currently in force.

<sup>62</sup> This estimate is based on SME finance monitor data from Q2-Q3 2014. Due to data limitations, the percentages are averages of two scenarios – one with a £2m balance sheet threshold and a £5m turnover threshold, and one with a 5m balance sheet threshold and a 10m turnover threshold. In both scenarios, a 50-employee threshold applies. Businesses are considered eligible if they are sole proprietorships or otherwise if they meet two out of three quantitative criteria. Any businesses that could not provide estimates for turnover and assets have been omitted from this analysis.

(annual turnover of less than £1m) when the contract commenced, and provided not a large partnership, large mutual association or large company.

- 73.** For the FSCS rules made by the FCA, COMP 10.2 specifies the maximum amount of compensation available to claimants (see Table 4 below). Compensation limits are the same whether the claimant is a business or not. However if claims by SME clients are consistently larger than those of individuals, the compensation limits might be more relevant to them.

**Table 4: Claim limits under COMP (FCA)**

Type of claim	Level of cover	Compensation limit
Protected investment business	100% of claim	£50,000
Protected home finance mediation	100% of claim	£50,000
Protected non-investment insurance mediation	(1) where the claim is in respect of a liability subject to compulsory insurance: 100% of claim	Unlimited
	(2) In all other cases: 90% of claim	Unlimited

### Principles for businesses (PRIN)

- 74.** Our principles for businesses, described in Table 5, provide a general statement of the fundamental obligations of firms under the regulatory system.

**Table 5: principles for business**

<b>1</b> Integrity	A firm must conduct its business with integrity
<b>2</b> Skill, care and diligence	A firm must conduct its business with due skill, care and diligence
<b>3</b> Management and control	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems
<b>4</b> Financial prudence	A firm must maintain adequate financial resources
<b>5</b> Market conduct	A firm must observe proper standards of market conduct
<b>6</b> Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly
<b>7</b> Communications with clients	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading
<b>8</b> Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client
<b>9</b> Customers: relationships of trust	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment
<b>10</b> Clients' assets	A firm must arrange adequate protection for clients' assets when it is responsible for them
<b>11</b> Relations with regulators	A firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.

- 75.** Principles 6, 7, 8, 9 and 10 impose requirements on firms expressly in relation to their clients or customers. Where they apply, what they may require depends, in part, on the characteristics of the client or customer concerned. This is because what is 'due regard' (in principles 6 and 7), 'fairly' (in principles 6 and 8), 'clear, fair and not misleading' (in principle 7), 'reasonable care' (in principle 9) or 'adequate' (in principle 10) will depend in part on those characteristics.
- 76.** Some of the principles will not apply where the firm is providing services that are not regulated activities, and in some cases activities will not be regulated where the service is provided to particular types of SME. For example, in relation to a regulated mortgage contract, the borrower must be an individual or a trustee.
- 77.** The principles also apply differently to services provided to 'eligible counterparties'.
- 78.** Our principles provide a framework for the conduct of firms even when specific rules do not apply. In specific, appropriate cases, we may take enforcement action on the basis of a breach of our principles and firms should take the principles into account when handling complaints under our DISP rules. However, consumers and business clients alike cannot take firms to court on the basis of a breach of the principles alone.

Financial Conduct Authority



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