A critique of the territoriality rules applying to UK insurance regulation: Part I

Jonathan Goodliffe*[1]

1 Introduction

This article analyses some of the territorial limits of insurance regulation in the United Kingdom. It discusses how it may overlap or "underlap" with regulation in other countries.

Insurance is often an international business. So problems may arise when insurance supervisors[2] in different countries try to supervise the same services. Similar issues arise when legislation or rules in different countries apply to the same insurance contracts. The opposite problem can also arise. Insurance may not be regulated at all or it may be inadequately regulated, typically because each of the countries concerned assumes that an other is taking responsibility. Sometimes the basis on which a country or a supervisor exercises jurisdiction may give rise to problems or appear to be illogical.

I have illustrated some of the problems with the FCA rules by reference to equivalent rules in France[3]. Other legal jurisdictions based on the Civil Code may apply similar rules to the French ones.

There are multiple aspects to the territoriality of UK insurance regulation. I shall be considering some of them in outline in this article. In particular I consider the territoriality of:

- the regulated activity of effecting and carrying out contracts of insurance,
- the financial promotion restriction in its application to insurance,
- the FCA's conduct of business rules,
- the rules on determining jurisdiction in insurance disputes.

A follow up to this article (Part II) will consider some of the remaining issues[4].

Territoriality issues often turn around the different business models which are used for carrying on business overseas. So, for example, a foreign insurer may:

* solicitor and former editor of the BILA journal.

[1] I am grateful to Dr Caroline Bell, the honorary editor of the BILA Journal, for her comments on an earlier version of this article.

[2] In this article the word "supervisor" refers to the public body that exercises supervisory jurisdiction over insurance and/or financial services. A "regulator" is a supervisor which also has the power to make legally binding rules. So there are two insurance regulators in the UK, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). In relation to insurance companies the FCA is the conduct regulator and the PRA is the prudential regulator. By contrast in France the Autorité de contrôle prudentiel et de résolution (ACPR) acts as prudential and conduct supervisor.

[3] Comparisons with the rules in France are made in sections 6.1, 6.2, 6.6 and 6.7.2.

[4] See section 8 below.

- insure UK risks without a presence in the UK, or with a presence in the UK falling short of a branch or establishment – this is sometimes referred to as “unadmitted (re)insurance”,
- set up a branch or establishment in the UK,
- set up an insurance subsidiary in the UK, or take over ownership of an existing insurance company in the UK, or
- move the headquarters of its group into the UK.

Each of these business models is subject to distinct territoriality rules.

Another key distinction is between wholesale and retail insurance business. Retail insurance business is more stringently regulated than wholesale insurance business. Territoriality rules applicable to retail business are more assertive. Within the retail market insurance with an investment element[5] tends to be more stringently regulated than pure protection business[6], which in turn may be more stringently regulated than general insurance business[7]. This relative stringency may also be reflected in the territorial application of relevant UK rules.

Another important point of distinction between retail and wholesale business is that the retail European insurance market is ill developed. Consumers mostly still buy insurance from firms based in the country where they live, so some territoriality issues may arise in theory within the retail market but not yet in practice. The wholesale European market, on the other hand, is much better developed.

2 Regulated activities and the general prohibition

A good starting point to insurance territoriality is s. 19 of the Financial Services and Markets Act 2000 (“FSMA”). It states that:

> “no person may:
>
> - carry on a regulated activity
> - in the United Kingdom, or
> - purport to do so, unless
> - he is
>   a) an authorised person; or
>   b) an exempt person.”

This is the “general prohibition”. A breach of the general prohibition is subject to criminal penalties under s. 23 FSMA. It may also lead to winding up proceedings against the firm concerned.

[5] Such as an insurance bond or a mortgage endowment policy, each of which carries a surrender value.

[6] Such as a mortgage protection policy which may repay the balance of the mortgage on the death of the mortgagor but has no surrender value.

[7] Such as a household insurance policy.

On the other hand where a UK authorised person (such as a bank) carries on insurance business without a specific permission to that effect within its overall FSMA authorisation, it is treated under s. 20 FSMA as having contravened a requirement imposed by the FCA[8]. It may therefore face enforcement action short of criminal proceedings.

An activity is a regulated activity for the purposes of FSMA if

- it is an activity of a specified kind
- which is carried on by way of business and
- relates to an investment of a specified kind[9].

The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("the RAO") specifies the activities and the investments for the purpose of the general prohibition. Article 10 of the RAO specifies:

- effecting contracts of insurance as principal, and
- carrying out contracts of insurance as principal,

as regulated activities.

Article 75 identifies contracts of insurance as "specified investments".

The various classes of general and long term insurance are listed in Schedule 1 to the RAO. The list is derived, with some changes, from Annex II to the Solvency II Directive[10]. That directive is now the main piece of primary[11] European legislation applying to the prudential regulation of insurance.

Where a person is authorised under FSMA, that triggers the application of numerous provisions. These include the application to the person of many rules adopted by the regulators, their power to impose requirements on firms and their enforcement powers. These include the power to vary or terminate the permissions of any firms. The regulators also have power to make rules applying to personnel within regulated firms and to take enforcement action against them.

When insurers and reinsurers are authorised in the UK they receive permissions to effect and carry out contracts of insurance. Reinsurance is included as a subset of insurance. If the firms are in run off they may only have permission to carry out and not to effect.

Insurers will get other permissions as well, particularly if they are selling their own products, rather than just operating through intermediaries. When insurers sell their own products they will be carrying out

[8] In fact banks will not receive permission to carry out insurance business because of the requirement that insurance business should be carried out only by insurers. See PRA rule "Conditions Governing Business" 9.1.

[9] Or in the case of an activity of a kind which is also specified for the purposes of section 22(1)(b), is carried on in relation to property of any kind. This is not an issue for insurance.

[10] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance.

[11] i.e. "level 1" legislation adopted through the ordinary legislative procedure involving the Council and the European Parliament, as opposed to level 2 legislation adopted by the European Commission under delegated powers conferred in the level 1 legislation.

insurance mediation activities[12] as well as effecting and carrying out insurance contracts. Distinct permissions for insurance mediation activities are then required.

3 Effecting and carrying out contracts of insurance in the UK

In simplified terms "effecting" a contract of insurance refers to the process of creating the contract. "Carrying out" refers to what happens afterwards, including in particular the claims process[13]. "As principal" keeps the focus on who is carrying the risk.

So what is significant is where the decision to provide cover is taken (e.g. in Bermuda) rather than where, for instance, the documentation is issued. So it is possible for an insurer authorised outside the European Economic Area to insure UK risks while keeping its activities offshore. It may thus avoid a breach of the general prohibition. This, indeed, explains the success of the Bermuda insurance market and of other offshore insurance markets[14]. They mainly or exclusively provide cover for foreign rather than local business.

The overseas insurer may, however, delegate the decision making process to, for instance, a UK broker or coverholder, in which case the "effecting" will have taken place in the UK. This will be in breach of the general prohibition, unless the overseas, non EEA, insurer has a UK authorisation.

Care is needed, however, in organising activities between the offshore country and the UK. In *Re Great Western Assurance Co SA and others*[15] the Court of Appeal held that business activities commonly undertaken by an insurance broker which were outside the scope of acting as a broker, such as:

- deciding what risks to refer to the insurers according to guidelines agreed with the insurer,
- using their own knowledge and experience in advising of likely premium rates and in making recommendations to the insurer as to the acceptance of a particular risk,
- receiving notification of claims within guidelines agreed with the insurers,
- instructing loss adjusters and settling claims below a specified amount,

could not be excluded from consideration of whether the off-shore companies had carried on insurance business within the United Kingdom. It was not enough that those activities were performed by the United Kingdom companies as brokers.

A typical situation is where an overseas, non EEA, insurer, X, has a subsidiary, Y, in the UK. Suppose the PRA has imposed a premium income limit[16] on Y and Y has exhausted that limit. In that event further cover in the UK can only be provided by X. X and Y would then need to establish appropriate

[12] To be renamed "insurance distribution activities" when the Insurance Distribution Directive (EU) 2016/97 takes effect in 2018 (see below).

[13] See *Re Whiteley Insurance Consultants (a firm)* [2008] All ER (D) 332.

[14] Such as Mauritius and the Seychelles.

[15] [1999] Lloyd's Rep IR 377.

[16] i.e. a requirement imposed under FSMA that the insurer limits the amount of premium which it earns to a specified amount, so that the firm should not "overstretch itself".

systems to ensure that the decision making took place in the overseas jurisdiction and that Y was doing no more than providing information to X. Otherwise Y might be treated as doing the effecting and carrying out itself and be in breach of the premium income limit.

Another situation in which UK regulation is arbitraged concerns pools of general insurers operating on the London Market. The leading insurer must have a UK authorisation but the following market may not require it. The arrangements within the pool must, however, take due account of the territoriality of UK regulation. In particular the lead must not have any authority to bind the following market, whose underwriting decisions, including the decision to follow, should be taken offshore[17]. Arrangements of this kind are often referred to as "non-admitted (re)insurance". Non admitted insurance tends to be allowed in sophisticated markets, such as the UK, but not in developing markets such as China and Brazil.

Section 418(5) FSMA identifies a case where a person is to be treated as carrying on a regulated activity in the UK even where he would not otherwise be so treated. This is where he has his head office outside the UK but carries on a regulated activity from an establishment maintained by him in the UK. The definition of establishment in article 145 (1) of the Solvency II Directive makes clear that the key element is that there should be staff who have "permanent authority to act for the undertaking as an agency would". An interpretative communication by the European Commission expresses similar views[18]. So it seems unlikely that section 418(5) would apply in a case where the overseas insurer was not otherwise to be treated as effecting or carrying out contracts of insurance in the UK.

4 A flaw in the above analysis?

There is, however, a potential flaw in the above analysis. Within the EEA, where insurers authorised in one member state (their "home state") insure risks located in another member state (the "host state") they are required to serve formal notification to that effect to the host state supervisor. This is done through the home state supervisor[19].

Where the host state is the UK the "passporting" insurer consequently qualifies for a UK authorisation under Part II of Schedule 3 of FSMA. The insurer may passport on an "establishment basis" when it is to establish itself permanently in the UK, or on a mere "services" basis when it is only covering UK risks. It may therefore acquire a UK authorisation, even if it does not effect or carry out contracts of insurance in the UK. By contrast a non EEA insurer can, as described above, cover UK risks without any UK authorisation at all.

[17] This example is provided in Linklaters "Insurance Update" for August 2006. See also *DR Insurance Co. v Seguros America Banamex* [1993] 1 Lloyd's Rep 120.

[18] Commission interpretative communication on "Freedom to provide services and the general good in the insurance sector" OJ C 43, 16.2.2000.

[19] The home state supervisor may refuse to do this if, for example, it considers that the insurer concerned does not have adequate systems for conducting cross-border business.

This is a paradox, since authorisation carries significant burdens. Thus the non EEA insurer is treated more favourably than the EEA insurer, which is not supposed to happen. The principle is articulated, in relation to reinsurers, in article 174 of the Solvency II Directive:

> "A Member State shall not apply to third-country reinsurance undertakings … provisions which result in a more favourable treatment than that granted to reinsurance undertakings which have their head office in that Member State."

In fact it is arguable that the UK treatment of non EEA insurers is inconsistent with article 162 of the Solvency II Directive. This states:

> "(1) Member States shall make access to the business referred to in the first subparagraph of Article 2(1) [i.e. direct insurance] by any undertaking with a head office outside the Community subject to an authorisation."
>
> (2) A Member State may grant an authorisation where the undertaking fulfils at least the following conditions:
>
> (a) it is entitled to pursue insurance business under its national law;
>
> (b) it establishes a branch in the territory of the Member State in which authorisation is sought;
>
> …"

The Commission has expressed the view[20] that article 162 provides that a third-country insurance undertaking may only insure risks located in a Member State through a branch authorised by the competent supervisory authority of that Member State. That view is supported by a literal reading of the article.

An alternative interpretation, consistent with practice in the UK[21], would treat article 162 as only applicable when third country insurers seek to establish themselves in the EEA. This interpretation has been applied in the UK ever since the predecessors to article 162 were incorporated in the first generation of insurance directives in the 1970s[22]. Geoffrey Maddock of Herbert Smith Freehills LLP has commented[23]:

> "If third country firms were suddenly to be required to seek an authorisation in order to operate remotely it would significantly reduce the amount of cover available in the market."

[20] Quoted in the Minutes of the Meeting of the Expert Group on Banking, Payments and Insurance, 14 July 2015 http://ec.europa.eu/finance/general-policy/docs/expert-group/150714-minutes_en.pdf accessed 25 January 2017.

[21] See PRA supervisory statement 27.11.15 SS44/15 Solvency II: third-country insurance and pure reinsurance branches.

[22] Article 27 of the First Life Directive 79/267/EEC and 23 of the First Non Life Directive 73/239/EEC.

[23] See publication at http://hsfnotes.com/fsrandcorpcrime/2015/08/25/authorising-third-country-insurance-firms-has-the-commission-got-it-wrong/ accessed 25 January 2017.

It is possible that the European Commission might take the opportunity of the UK's proposed withdrawal from the European Union to apply its interpretation of article 162 more assertively across the European Union.

5 Financial promotion restriction and rules

Most of the FSMA regime only applies to firms which are authorised. This is not the case, however, in relation to financial promotion (i.e. advertising). So the UK financial promotion regime can, but does not always, apply extra-territorially. Its application, however, to insurers operating offshore seems to some extent illogical, as I will proceed to explain. Here the rules are exceptionally complex and convoluted. The effect of the regime, which may or may not be intended, is to disapply the restrictions on financial promotion to most non EEA insurers carrying on general insurance business. I describe how this arises below.

5.1 The restriction

The starting point is s. 21 FSMA which provides:

> "(1) A person ("A") must not, in the course of business, communicate an invitation or inducement to engage in investment activity [which includes insurance].
>
> (2) But subsection (1) does not apply if–
>
> > (a) A is an authorised person; or
> >
> > (b) the content of the communication is approved for the purposes of this section by an authorised person.
>
> (3) In the case of a communication originating outside the United Kingdom, subsection (1) applies only if the communication is capable of having an effect in the United Kingdom."

This is referred to as "the financial promotion restriction".

Under subsection 5 of s.21 HM Treasury ("HMT") may by order specify circumstances in which subsection (1) does not apply. These circumstances may include compliance with financial promotion rules. The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 ("Finprom") specifies those circumstances.

5.2 Insurance

In relation to insurance, Finprom uses a number of key expressions which include:

- "real time communications", which are any communication made in the course of a personal visit, telephone conversation or other interactive dialogue. "Non real time communications" are any communication other than a real time communication,
- "qualifying contract of insurance" ("QCI") which in simplified terms means a contract of long term insurance (not reinsurance) which generates a surrender value. This is broadly equivalent to:
  - an "insurance based investment product" (IBIP) under the EU Regulation[24] on key information documents for packaged retail and insurance-based investment products (PRIIPs) and to
  - the investment based insurance products regulated under the FCA's Conduct of Business sourcebook (COBS)[25].
- a "relevant insurance activity" ("RIA") which is any insurance activity not involving QCIs.
- "large risks" which are certain business related risks as defined in detail in article 25(2) of Finprom[26]. They do not, however, include most risks insured by small and medium sized enterprises. As large risks are a key concept I have explained them in more detail in an appendix to this article.

The following provisions of Finprom are relevant:

- article 25, which dis-applies the financial promotion restriction in relation to non real time communications involving only reinsurance and large risks,
- article 26 which dis-applies the financial promotion restriction in relation to any real time communication (whether solicited or unsolicited) which relates to a RIA,
- article 24 which dis-applies the financial promotion restriction in relation to any non-real time communication which relates to an RIA. This operates subject to the communication providing certain basic information, set out in paragraph (2), about the relevant insurer and the existence of dispute resolution schemes,
- Article 10 which provides that nothing in Finprom exempts from the application of the financial promotion restriction a communication which invites or induces a person to enter into

[24] (EU) No 1286/2014. QCI, however, is a somewhat wider classification than IBIP. An IBIP must be directly or indirectly exposed to market fluctuations. The surrender value under a QCI may, by contrast arise because the policyholder's life expectancy has diminished and he has paid the premiums on his policy.

[25] "Non investment insurance", broadly equivalent to RIA, being regulated under the FCA's "Insurance Conduct of Business Sourcebook" (ICOBS).

[26] The definition derives from article 13(27) of the Solvency II Directive.

a QCI with a person who is not exempt, authorised in the UK or the EEA or in Jersey, Guernsey, the Isle of Man, Pennsylvania or Iowa[27].

In summary, the effect of these provisions is as follows:

- The financial promotion restriction does not apply in relation to real time or non real time communications involving reinsurance or large risks.
- The financial promotion restriction does not apply to real time or non real time (subject to minimal compliance requirements) communications involving RIA.
- The Financial promotion restriction ***does*** apply to real time and non real time communications involving QCIs where the insurer is outside the EEA or the territories listed in article 10.

Apart from the financial promotion restriction, the FCA has the power to make financial promotion rules under section 137D FSMA. These rules may specify the form and content of promotions or how authorised firms should approve promotions by others. The key requirement is that promotions should be "fair clear and not misleading[28]."

These rules, however, only apply to authorised persons, i.e. UK authorised persons or firms passporting into a UK authorisation. They do not apply to firms operating outside the UK that do not need a UK authorisation and are exempted from the financial promotion restriction[29]. So promotions from outside the EEA relating to RIAs (whether real time or non real time) are outside the scope of the financial promotion rules in ICOBS. The requirement that promotions should be fair clear and not misleading does not, therefore, apply to such firms. Yet the intention in s. 21 FSMA clearly was that such rules should apply to a promotion capable of having an effect in the United Kingdom.

By contrast equivalent promotions (whether real time or non real time) relating to QCIs where the insurer is outside the territories mentioned in article 10 Finprom are indirectly within the scope of COBS. This is because to make the promotion lawfully the communicator will need to get the approval of an authorised firm, which in giving that approval will need to comply with COBS 4.

5.3 Comment

It is possible that this anomaly arose because when the original version of Finprom was adopted in 2001, the then regulator, the Financial Services Authority ("FSA"), only regulated conduct of business relating to QCIs and not RIAs. That changed in 2005 with the transposition of the Insurance Mediation Directive and the creation of ICOBS. Yet the appropriate amendment to Finprom was not made. The effect of the anomaly, in any event, is to apply a more favourable treatment to some persons outside the EEA than applies to persons within the EEA.

[27] Why Pennsylvania and Iowa and not any other US states, one wonders?

[28] COBS 4.2.1R and ICOBS 2.2.2R.

[29] Except where the financial promotion restriction is dis-applied conditionally on compliance with financial promotion rules s. 21(5) FSMA.

If this has not yet created problems it may be because market forces prevent non EEA insurers from making unfair promotions to UK retail customers. That could change, however.

6 Conduct of business rules

In this section I consider the extra territorial application of the FCA's insurance conduct of business rules.

6.1 What are conduct of business rules?

In relation to insurance, The FCA conduct of business sourcebooks apply rules and guidance to firms, which may be insurers or intermediaries. The rules cover how they should deal with customers, what notifications should be made, what products are suitable for what customers, standards to be applied when giving advice or making recommendations, what terms should be included in the contract, what services are provided after the sale, and how claims should be dealt with.

The FCA has two sourcebooks applying conduct of business rules and guidance to insurance business. These are:

- the Insurance Conduct of Business Sourcebook (ICOBS) which applies to non-investment insurance products[30] and
- the Conduct of Business Sourcebook (COBS) which in general applies to investment products, including non insurance investment products and insurance products with an investment value. It also applies to long term care insurance[31].

The FCA may enforce conduct of business rules using its usual disciplinary powers. Apart from this, private persons[32] who are affected by a breach of the rules (not the guidance) may usually sue for damages under s. 138D FSMA. Most conduct of business rules apply in relation to retail customers, although some rules are also aimed at the wholesale market.

In many ways ICOBS remedies the inadequacy of the underlying insurance law[33]. COBS and ICOBS also transpose the requirements of EU Directives, such as the Insurance Mediation Directive[34] and the Distance Marketing Directive[35] as well as containing rules unrelated to EU legislation.

In other European jurisdictions, however, the distinction between insurance conduct of business rules and insurance law is less clearly drawn. So a rule contained in ICOBS, for instance, may be matched by

[30] Broadly equivalent to the insurance involved in "relevant insurance activity" (see above).

[31] Long term care insurance is insurance to cover the cost of care for those who are unable to care for themselves.

[32] As defined in The Financial Services and Markets Act 2000 (Right of Action) Regulations 2001.

[33] See Smethurst, J, Heukamp, W Goodliffe, J and Miller, R "Conduct of business regulation: a survey of the UK regime and a comparison with the US, German and Hong Kong approach" in Burling J and Lazarus, K "Research Handbook on International Insurance Law and Regulation", 2012.

[34] 2002/92/EC. To be replaced by the Insurance Distribution Directive 2016/97/EU in 2018.

[35] 2002/65/EC.

a provision in the French Code des Assurances, which contains insurance law rules as well as rules of insurance regulation covering conduct and prudential standards[36].

6.2 The conflict of law background

To help understand how the territoriality of the conduct of business rules works, the conflict of law background should be borne in mind. This section can be skipped by people familiar with conflict of law issues.

First under chapter II section 3 of the Brussels Regulation[37] a policyholder, insured or beneficiary can sue an insurer in the member state of the former's domicile and the insurer must sue them in the same state. This right can in general only be excluded in relation to defined risks which are broadly equivalent to large risks[38]. So claims management is a host state, rather than a home state responsibility.

A similar rule applies to consumers (as opposed to policyholders) more generally under section 4 of the Regulation. It would in particular apply in the context of a dispute between an insurance intermediary and a retail customer.

Apart from this, most member states apply an informal dispute resolution mechanism to disputes between regulated firms and their retail customers. The UK scheme is operated by the Financial Ombudsman Service (FOS). FOS applies what it considers to be "fair and reasonable" outcomes to such disputes[39]. It may decide not to follow the law. Under its compulsory jurisdiction FOS only determines claims against UK firms or EEA firms who have passported into the UK on an establishment basis or non EEA firms with a UK authorisation. However, EEA firms with a mere services authorisation may opt into FOS's "voluntary jurisdiction".

Secondly article 7 of the Rome I Regulation sets out the rules for determining the law applicable to an insurance contract. The default rule for insurance contracts[40] is that the governing law is the law of the member state where the risk[41] is situated. In the UK the default rule may be changed without restriction. Other states, including France[42], may apply less flexible rules.

Under article 13(13) and (14) of the Solvency II Directive the member state of the risk is usually the state of the habitual residence of the policyholder. The risk within long term insurance contracts is referred to as "the commitment". So most member states can be expected to apply their insurance law to insurance contracts where they are the state of the risk. This is, for instance, explicitly the position in

[36] So, for instance, the UK rules on linked long term products are set out in COBS 21 (see section 6.8.3 below). The equivalent French rules are in article L131 of the French code. Other provisions in the code match rules in English common law or statutes, such as article L121 which provides for under-insurance.

[37] (EU) No 1215/2012.

[38] See appendix at the end of this article.

[39] In accordance with s. 228(2) of FSMA.

[40] other than those covering large risks.

[41] In contrast to Solvency II the Rome I Regulation uses the word risk to include non life as well as life insurance. Solvency II refers to the latter as "commitments".

[42] See footnote 43 below.

France. Under French law when the state of the risk is other than France, the parties can choose between French law and the law of the state of the risk[43]. Similarly in the UK, the law of the relevant part of the UK will doubtless be applied under the Insurance Act 2015[44] when the UK is the state of the risk, in compliance with the Rome I Regulation.

The operation of article 7 of the Rome I Regulation is subject to article 9(2). This provides that "Nothing in this Regulation shall restrict the application of the overriding mandatory provisions of the law of the forum[45]." Article 9(1) explains that "overriding mandatory provisions are provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract under this Regulation."

Many FCA rules in COBS and ICOBS will qualify as "mandatory rules".

6.3 The default territoriality rules in COBS and ICOBS

The "default" territoriality rule under COBS is Rule 1.1.1R. It applies except in cases where COBS provides for a different basis of territoriality. It provides:

> "This sourcebook applies to a firm with respect to the following activities carried on from an establishment maintained by it, or its appointed representative, in the United Kingdom:
>
> (2) designated investment business;
>
> (3) long-term insurance business in relation to life policies;
>
> and activities connected with them."

The equivalent rule in ICOBS 1.1.1R is to similar effect:

> "This sourcebook applies to a firm with respect to the following activities carried on in relation to a non-investment insurance contract from an establishment maintained by it, or its appointed representative, in the United Kingdom:

[43] Article L181.1 and 2 of the French Code des Assurances which read (translated into English):
1° When the risk is located on the territory of the French Republic (within the meaning of article L. 310-4) and the policyholder has his principal residence or head office there, the applicable law is French law, to the exclusion of any other.

2° When the risk is located on the territory of the French Republic (within the meaning of article L. 310-4) and the policyholder does not have his principal residence or head office there, the parties to the insurance contract can choose to apply either French law or the law of the country where the policyholder has his principal residence or his head office.

[44] The Insurance Act 2015 has, among other things, changed the UK rules on how information should be presented to insurers on the risk to be covered in business insurance.

[45] i.e. the court hearing the case.

> > (1) an insurance mediation activity;
> >
> > (2) effecting and carrying out contracts of insurance;
> >
> > (3) managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's;
> >
> > (4) communicating or approving a financial promotion;
>
> and activities connected with them."

There is a rider to the ICOBS territoriality rule in COBS 1 Annex 1 :

> (1) This sourcebook applies to a firm which carries on business with a client in the United Kingdom from an establishment overseas.
>
> (2) But the sourcebook does not apply to those activities if the office from which the activity is carried on were a separate person and the activity:
>
> > (a) would fall within the overseas persons exclusions in article 72 of the Regulated Activities Order; or
> >
> > (b) would not be regarded as carried on in the United Kingdom.

This rider, however, is less significant in the insurance context than in, for instance, the context of the Markets in Financial Instruments Directive, since as explained above it is possible to carry on an insurance business from abroad with a client based in the UK.

6.4 Implications of the default territoriality rules

So an insurance company authorised in another EEA jurisdiction selling its products through a UK appointed representative will be required to comply with those provisions of ICOBS which apply to insurance companies. An appointed representative acts under the instructions of an authorised person (who, in the insurance context, may be an insurer or an authorised intermediary). An appointed representative is exempt from authorisation. Where its principal is a non UK insurer it may be effecting and carrying out contracts of insurance in the UK on behalf of its principal or it and the insurer may organise their activities so as to avoid that outcome.

There may be cases in which the insurance company sells in the UK through an intermediary such as a UK broker, or a UK financial adviser, which has its own authorisation. In that event ICOBS will apply to the intermediary but not to the insurance company, unless the intermediary is effecting and/or carrying out contracts of insurance on behalf of the insurance company, which may well be the case.

It would seem that if a non UK insurer is, for instance, effecting contracts of insurance through a UK appointed representative but doing its own carrying out then any ICOBS provisions applicable to carrying out would not apply to the insurance company.

The default territoriality rule does not invariably apply. It is sometimes changed. I shall be considering examples of this below.

On the face of it it seems surprising that so much of the FCA's regulatory regime does not apply to services passporters. The FCA does not, with a few exceptions, use the concept of the state of the risk to trigger the application of its rules. That is what the Rome I Regulation seems to envisage and that is the approach in France. So whereas the FCA default territoriality rule would apply for the benefit of French customers of a UK firm operating from a UK establishment, it is far from clear that that would operate in reverse. Why should it, if member state supervisors concentrate on protecting their own policyholders? In the context of the proposed regulation of ancillary insurance intermediaries under the Insurance Distribution Directive, the FCA has remarked[46]:

> "It is unlikely that the firm's category will be a major factor in influencing 'customers' decisions about where to buy their insurance. Having two different standards of conduct would have the effect of lessening customer protections based on a distinction that customers are unlikely to be understand, or see as relevant."

Most customers would surely not see the difference between services and establishment passporters as having any relevance to them.

These issues currently create fewer problems, however, than might be expected, first because, as noted above, the European retail insurance market has yet to establish itself. Secondly it may be difficult for non UK firms to penetrate the market without a UK establishment. Thirdly, if they do they may need to comply voluntarily with the FCA regime and submit to the voluntary jurisdiction of FOS in order to work effectively with UK intermediaries, online supermarkets etc.

6.5 The Distance Marketing Directive

The Directive on Distance Marketing of Consumer Financial Services[47] ("DMD") imposes requirements on EEA firms when conducting an activity relating to a distance contract with a consumer. The requirements cover the provision of pre-contract information[48], information about the firm, its services and remuneration[49], product information[50], ensuring the customer can make an informed decision[51], cancellation rules[52] and other specific rules implementing the DMD[53].

The DMD places responsibility for requirements within its scope on the Home State of the firm concerned, except in relation to business conducted through a branch. In that case the responsibility rests with the EEA State in which the branch is located (this is sometimes referred to as a 'country of origin'

[46] FCA CP 17/7 page 31 para 6.10.
[47] 2002/65/EC.
[48] ICOBS 2.2.
[49] ICOBS 4.
[50] ICOBS 6.
[51] ICOBS 6A.1.4R.
[52] ICOBS 7.
[53] ICOBS 3.1.

or ‘country of establishment’ basis of supervision). So there will be many cases where ICOBS requirements do not apply to firms passporting on a services basis, but they do not need to apply because the requirements of the DMD are applied to the firm in its country of origin.

6.6 The E Commerce Directive

The country of origin rule also applies under the Directive on Electronic Commerce[54]. The e commerce Directive, unlike the DMD, applies to wholesale as well as consumer business.

A key element of the e commerce Directive is that a person from one EEA State may carry on an electronic commerce activity freely into another EEA State. The territorial application of the rules in ICOBS and COBS is modified. The modification ensures that they apply to a firm carrying on an electronic commerce activity from an establishment in the United Kingdom with or for a person in the United Kingdom or another EEA State.

Conversely, a firm that is a national of the United Kingdom or another EEA State, carrying on an electronic commerce activity from an establishment in another EEA State with or for a person in the United Kingdom, need not comply with the relevant rules in COBS and ICOBS. This is because the country of origin should in principle apply its own rules to the transaction[55]. Rules in other directives are subordinated to the e commerce Directive to that extent.

The FCA glossary definition of e commerce activity is based on the obscure expression “information society service” (“ISS”)[56]. This is derived from article 1(2) of the Technical Standards and Regulations Directive[57]. An ISS is in summary any service normally provided for remuneration, at a distance, by means of electronic equipment for the processing (including digital compression) and storage of data at the individual request of a service recipient. It applies to services provided entirely on line. So if, for instance, a person purchases an insurance policy over the internet from an insurance intermediary, but at the end of the process the policy is sent to him by post, the intermediary would not, it seems, be providing an ISS.

The e commerce Directive is subject to a number of derogations. These include provisions now contained in the Solvency II Directive and the Rome I Regulation. The FCA considers that this allows it to continue to apply its financial promotion rules to insurers authorised in the EEA who are promoting their products to UK residents. This “insurance derogation” does not apply to insurance intermediaries, who are therefore subject to the country of origin rule in relation to e commerce. In other member states where the application of rules equivalent to COBS and ICOBS is dependent on the applicable law of the contract, the insurance derogation may be applied more aggressively.

There is also a derogation in the e commerce directive for “contractual obligations concerning consumer contacts”. This has considerable potential for undermining the country of origin principle. This

[54] 2000/31/EC.

[55] See ICOBS 3.2.

[56] Probably derived from the German "Dienste der Informationsgesellschaft".

[57] 98/34/EC.

derogation is not applied at all by the FCA[58], but is applied in, for instance, the French transposition of the Directive[59]. There is thus potential for the selling rules of two distinct member states to apply to the same transaction or, less frequently, for the transaction to escape the application of any system of rules.

6.7 How the territoriality rule applies: ICOBS

Here are a few examples of how the territoriality rule applies. I start with non-investment examples from ICOBS.

6.7.1 Handling claims promptly and fairly

ICOBS 8.1 applies certain regulatory duties to insurers when they deal with claims, including the duty to handle claims promptly and fairly. If, say, a French insurer is insuring UK risks on a services basis but is not carrying out contracts of insurance in the UK through an appointed representative or otherwise, this rule will not apply to it. Nor will French law with its own protections apply[60] unless it has been validly chosen in the contract.

So policyholders may lose the protection of both UK regulation and French law. Contracts entered into after 4 May 2017, however. will have an implied term under section 13A of the Insurance Act 2015 that if the insured makes a claim under the contract, the insurer must pay any sums due in respect of the claim within a reasonable time. This provision will be subject to the conflicts rules in the Rome I Regulation.

The FCA might, perhaps, consider extending the territoriality of ICOBS 8.1, so that it applies when the member state of the risk is the UK and the law of another EEA member state has not been chosen. Since a UK policyholder has the option to sue in the state of his domicile and the policy will normally be governed by English law it seems appropriate that UK regulatory duties should also apply.

It may be noted here that the FCA’s “Treating customers fairly” principle does not apply in this context either. I shall be discussing that principle in more detail in the second part of this article[61].

[58] ICOBS 1 Annex 1 para 8.4G.

[59] Loi n° 2004-575 du 21 juin 2004 pour la confiance dans l'économie numérique, article 17.

[60] See footnote 43 above.

[61] PRIN 3.1.1(3)R.

6.7.2 Commission disclosure

ICOBS 4.4.1R and 4.4.2R provide

> "An insurance intermediary must, on a commercial customer's request, promptly disclose the commission that it and any associate receives in connection with a policy.
>
> Disclosure must be in cash terms (estimated, if necessary) and in writing or another durable medium. To the extent this is not possible, the firm must give the basis for calculation.
>
> An insurance intermediary should include all forms of remuneration from any arrangements it may have. This includes arrangements for sharing profits, for payments relating to the volume of sales, and for payments from premium finance companies in connection with arranging finance."

These provisions have very reduced application, as they do not apply to large risks[62]. The definition of large risks does not extend to most SME risks, but SMEs are defined by reference to a formula which has not changed since the early 1990s[63]. So many firms which would qualify as SMEs for other purposes would not qualify for the protection of ICOBS 4.4.

ICOBS 4.4. is subject to the usual territoriality rule, so whether it applies to EEA intermediaries passporting into the UK on a services basis depends on whether they are carrying out an insurance mediation activity in the UK. The insurance mediation activity is likely to be arranging contracts of insurance. Rule 5.12.8G of the FCA's Perimeter Guidance Manual (PERG) states: "Persons that arrange contracts of insurance will usually be considered as carrying on the activity of arranging in the location where these activities take place". This suggests that EEA intermediaries who deal remotely with UK clients may be able to avoid the application of ICOBS, but only where they do not give advice. This is because PERG 5.12.8G concludes: "In the case of advising, this is generally considered to take place where the advice is received".

The equivalent French rule to ICOBS 4.4 is in R 511-3 of the Code des Assurances. It too does not apply to large risks and only applies when the annual premium is or is expected to be over €20,000[64]. It would not normally apply to a transaction between a French firm passported into the UK on a services basis and a UK customer, except perhaps where the e commerce Directive applies[65].

So there is a small but not insignificant risk of transactions falling between both systems of rules. Whether any intermediary is likely to be devious enough to take advantage of this may be

[62] ICOBS 1 Annex 1, part 2, para 2.1.

[63] See appendix.

[64] Surely a very high "de minimis" limitation for a rule primarily benefiting SMEs.

[65] See footnote 43 above.

doubtful. This issue is expected to be addressed, in any event, by harmonising rules under the Insurance Distribution Directive[66], shortly before the UK exits the European Union.

Apart from the regulatory position in the UK, common law duties may in any require the disclosure of commission. Two Court of Appeal cases[67] make any undisclosed commission taken by an intermediary acting as the customer's agent the property of the client. Leading compliance consultant Adam Samuel[68] has commented "Failure to disclose commission in this area is madness, regardless of what the regulator says".

6.8 How the territoriality rule applies: COBS

I now turn to some examples from COBS of the territorial application of rules concerning insurance with an investment value.

6.8.1 Rules on cancellation and provision of pre-contract information

The Solvency II Directive is mostly about prudential regulation. It does, however, in article 185, inherited from Solvency I, lay down minimum requirements as to cancellation rules and provision of pre-contract and post contract information in long term insurance. The latter rules have been heavily "gold-plated"[69] within COBS.

Article 185(8) states that:

> "the detailed rules for implementing paragraphs 1 to 7 shall be laid down by
> the Member State of the commitment[70]"

The FCA discussion of this provision at COBS 1 Annex 1 paragraphs 5.1G and 5.2G takes the view that this means that the rules of the member state of the commitment ***must*** apply. But to require that the rules should be laid down does not mean they must apply in every case. This creates an inflexibility not contemplated in the directive.

So suppose a bank were to decide that it wanted to sell insurance based investment products to the ex-patriate community in an international centre such as London or Paris. Each sale would, if the FCA is right, have to comply with the rules of the state of the habitual residence of each such ex-pat, thus creating a disproportionate compliance burden.

However, this reading ignores the fact that article 7 of the Rome Regulation allows the parties to a contract to choose the applicable law[71] when the relevant state has granted them that

[66] Directive (EU) 2016/97.

[67] *Wilson & Another v Hurstanger Ltd* [2007] EWCA Civ 299 and *McWilliam v Norton Finance (UK) Ltd (in liquidation)* [2015] EWCA Civ 186.

[68] See http://www.adamsamuel.com/

[69] i.e. they have been applied more stringently than the directive requires.

[70] As explained in section 6.2 above, the risk within a long term insurance contract is referred to as "the commitment".

[71] See footnote 43 above.

freedom, which the UK has. So the relevant COBS rules could be dis-applied where the parties had chosen another system of laws because, for instance, that was the system of the state where the transaction was actually carried out.

A weakness in this argument is that although the UK allows the parties to an insurance contract to choose any applicable law they wish, this is not necessarily the case in other member states, particularly not in France[72]. So a sale to a French ex-pat in London would have to comply with French rules even if a sale to a British ex-pat in Paris did not have to comply with FCA rules.

It may be, in any event, that this will become less of an issue when the EU regulation on Packaged Retail and Insurance-based Investment Products (PRIIPs) comes into force. This will standardise documentation relating to among other things, insurance based investment products. The UK will probably have to comply with it despite BREXIT, if it wants to penetrate the European market.

6.8.2 The open market option

The open market option is a key element in the FCA's policy relating to retirement products. The underlying principle is simple. A person may have provided for his or her retirement by taking out, for instance, a private pension plan. When they reach retirement age they can convert the proceeds of the plan into an annuity by buying the annuity from the firm which supplied the pension plan. They are often likely to get a better deal, however, by shopping around with other annuity providers. The open market option in COBS 19.4 allows them to do so. It requires firms to provide customers with full information to enable them to make a choice. So customers have the right to use the proceeds from their pension policy to buy an annuity with any provider.

Firms do not, however, always comply with the requirements of COBS 19.4, as the FCA's 2016 thematic review of annuity sales practices reports[73]. In particular firms may make it difficult for people to exercise the option.

The open market option is subject to the general application rule in COBS 1.1.1R. So it applies to a firm with respect to designated investment business and long-term insurance business in relation to life policies and activities connected with them carried on from an establishment maintained by it, or its appointed representative, in the United Kingdom.

There is no reason in principle why an EEA firm operating outside the COBS 1.1.1R application statement should not offer retirement products to a UK customer, although there may be practical reasons why it would be difficult for it to do so. The open market option does not derive from an EEA directive, so foreign firms dealing with UK customers would be unlikely to comply unless compelled to do so.

[72] See footnote 43 above.

[73] Thematic Review TR16/7 of annuity sales practices October 2016.

It may therefore be appropriate to argue that if firms outside COBS 1.1.1R are operating in the UK in this market the application of the rule should be extended to apply to them. If there are no such firms operating in the UK then extending the rule will cause no problems in any event.

6.8.3 Permitted links

Some long term insurance products provide for benefits which are linked to the value of property, such as an investment fund or land. Or they may be linked to an index such as the Financial Times Stock Exchange 100 index. Examples include pensions, annuities, mortgage endowment policies and insurance bonds[74].

Before Solvency II came into force on 1 January 2016, insurers in most, if not all, EEA states could only link benefits within long term contracts to a limited number of assets types. This was the same list of assets, “admissible assets”, in which they were permitted under the insurance directives to invest their technical provisions[75].

In 2016 this rule was abolished along with the rules on admissible assets. Member states are now free to apply their own permitted link rules to products where the policyholder is a natural person. This is subject to such rules being no more restrictive than those applying to undertakings for the collective investment of transferable securities (UCITS).

Where the policyholder is not a natural person, but a legal person, such as a pension scheme, the member state cannot restrict the assets to which benefits may be linked[76]. This is all subject to the “prudent person principle” under which insurers are to take full responsibility for prudent investment of assets[77].

The outcome of this change was that the European permitted link rules were entirely “de-harmonised”. So some member states, such as the UK, applied a protective regime[78] and others, such as the Republic of Ireland, a more liberal one. The Irish motivation is at least partly, no doubt, to attract business from people interested in exotic insurance products.

The FCA has maintained since 2016 the same rules as to territoriality in relation to permitted links as applied before Solvency II. So COBS 21.1.1R states:

[74] An insurance bond usually provides for benefits by reference to the performance of a pool of assets. The benefits are usually paid out of income or on surrender or part surrender of the policy. An element of life cover is also provided to ensure that the arrangement qualifies as an insurance policy. Insurance bonds are thus only insurance by an artificial contrivance, but they were held to be so by the Court of Appeal in *Fuji Finance Inc. v. Aetna Life Insurance co. Ltd. and another* [1997] Ch. 173.

[75] Article 24 of the Life Directive 2002/83/EC.

[76] Article 133(3) of the Solvency II Directive.

[77] Article 132.

[78] Set out in COBS 21.

> "The rules in this section apply on an ongoing basis to linked long-term contracts that are effected by:
>
> (1) insurers other than EEA insurers; and
>
> (2) EEA insurers in the United Kingdom."

It is not a difficult matter, however, for an insurer to effect linked long term contracts, particularly insurance bonds, in one EEA state and arrange for them to be sold in another. The value of these products is usually determined by the value of the investments or property to which they are linked, rather than by the health of the policyholder, as in the case of more conventional life insurance. This is because the amount payable on death will usually be the same as or very close to the amount payable on surrender.

So, for instance, an Irish insurer could arrange for its linked products to be sold in the UK even if they do not comply with the UK permitted link rules, although UK intermediaries might be reluctant to recommend them to clients.

By contrast, on a literal reading of COBS 21.1.1R, a UK insurer would be required to comply with the permitted link rules. This would apply not only within the UK, but also wherever else within the EEA it might effect these products, even in countries with more liberal permitted link rules. This is because s. 418(2) FSMA treats the carrying on of a regulated activity by a UK firm in another EEA state as if it were carried out in the UK. The UK firm could only arbitrage the UK rules by doing its effecting entirely outside the EEA.

A possible solution to this problem might be to apply COBS 21 in all cases where the policyholder is habitually resident in the UK and to remove the illogical link between the application of the rules and the location where the products were underwritten. It could be argued, however, that this runs counter to the spirit of Solvency II, which is to create a free market across Europe and to the freedom to provide services under article 56 of the Treaty on the Functioning of the European Union.

7 Territoriality in dispute resolution

As noted above EEA firms passporting into the UK on a services basis are not subject to the jurisdiction of the Financial Ombudsman, unless they opt into the "voluntary jurisdiction". So retail customers have to sue these firms in the courts. This may be a disadvantage from the claimant's perspective, since the courts do not have the Ombudsman's extended powers to, for instance, disapply legal rules in determining what is "fair and reasonable". The alternative is for the complainant to invoke the out of court redress mechanism in the home state of the firm concerned, assuming that that mechanism has jurisdiction over the complaint. The UK Ombudsman has that jurisdiction. It can deal with complaints wherever the complainant is based[79].

[79] DISP 2.6.5G.

Article 15(1) of the Insurance Distribution Directive, due to come into effect in 2018, provides:

> “Member States shall ensure that adequate and effective, impartial and independent out-of-court complaint and redress procedures for the settlement of disputes between customers and insurance distributors concerning the rights and obligations arising under this Directive are established in accordance with the relevant Union legislative acts and national law, using existing bodies where appropriate. Member States shall ensure that such procedures are applicable, and the relevant body’s competence effectively extends, to insurance distributors against whom the procedures are initiated.”

The FCA considers this to be a home state responsibility. So it proposes to introduce a requirement for insurance distribution business conducted by EEA branches of UK (re)insurers and intermediaries to adhere to an alternative dispute resolution (ADR) entity in the EEA state in which they are established to resolve consumer disputes. The FCA does not propose that this should extend to firms operating in other EEA states on a services basis.

Article 15, however, does not support this distinction. Nor does the French out of court redress scheme appear to have the same limitation[80]. So a UK firm passporting into France on a services basis may think, based on the UK rules, that it is not subject to the French scheme but will be required to adhere to it nonetheless.

If insurance claims are subject to the jurisdiction of the courts of the policyholder’s domicile and if they are usually governed by the law of the policyholder’s residence it makes more sense for out of court redress to be treated as a host state competence and for it to apply .regardless of whether firms passport on a services or an establishment basis.

8 What is to be covered in Part II

Part II of this article will be published later in the BILA journal. It will discuss the territoriality of some remaining PRA/FCA rules. These will include:

- the FCA’s Principles for Businesses and the PRA Fundamental Rules,
- how the regulators’ jurisdiction to exercise:
    - prudential supervision and
    - supervision over insurance groups

  is determined, and
- the distinction between prudential and conduct supervision.

[80] See http://www.mediation-assurance.org/Litiges+transfrontieres

APPENDIX

FCA Glossary definition of "contract of large risks"

The definition is as follows:

> (in ICOBS) contracts of insurance covering risks within the following categories, in accordance with article 13(27) of the Solvency II 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;
>
> (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:
>
> > (i) balance sheet total: €6.2 million; [until 1993 €12.4]
> >
> > (ii) net turnover: €12.8 million; [until 1993 €12.4]
> >
> > (iii) average number of employees during the financial year: 250. [until 1993 500][81]

Notes:

The definition ultimately derives from the Second Non-Life Directive 88/357/EEC. That directive provided for the current figures for balance sheet total, net turnover and number of employees to be the figures above in square brackets until the end of 1992. The 1993 figures have not been updated since that directive.

The Solvency II Directive (which repealed and re-enacted the second directive) gives member states the option of adding to (c) the risks insured by professional associations, joint ventures or temporary groupings. This does not seem to have been done in the case of the UK.

The Solvency II Directive also provides that "if the policyholder belongs to a group of undertakings for which consolidated accounts within the meaning of Directive 83/349/EEC are drawn up, the criteria set out in point (c) of the first subparagraph shall be applied on the basis of the consolidated accounts". This provision has not found its way into the FCA glossary definition.

This definition is aimed partly protecting small or small and medium sized enterprises. They are defined in the EU recommendation 2003/361. The factors determining whether an enterprise is an SME are: staff headcount and either turnover or balance sheet total**.** The following figures apply.

[81] The figures currently being used to identify SMEs under the Modern Slavery Act 2015 are £36 million annual turnover and £18 million balance sheet total.

Company category	**Staff headcount**	**Turnover**	Or	**Balance sheet total**
Medium-sized	< 250	≤ € 50 m		≤ € 43 m
Small	< 50	≤ € 10 m		≤ € 10 m
Micro	< 10	≤ € 2 m		≤ € 2 m

Risks which are not large risks for any purpose consist of accident, sickness, legal expenses and assistance (for people who get into difficulty while travelling etc).

In the 2016 study for the FCA of “Commercial Insurance Claims by SMEs: Report of Findings from File Reviews” the following statement was made “The Department for Business Innovation and Skills describes businesses with 0-49 employees as small businesses and businesses with 50-249 employees as medium businesses. The Federation of Small Businesses further segregates the small category into micro (0-9 employees) and small (10-49 employees) categories. We have used these definitions in this work”.

See also criticisms of the definition of “large risks” by Marcel Fontaine in “Principles of European Insurance Contract Law: A Model Optional Instrument” edited by Project Group Restatement of European Insurance Contract Law, Helmut Heiss, Mandeep Lakhan. He points out that the definition does not adequately protect SMEs.